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The Honorable Gary Condit
Member, U.S. House of Representatives
920 16th Street, Suite C
Modesto, CA 95354

Attention: Ms. Pat Austin

Dear Congressman Condit:

This letter is in reply to your inquiry, dated April 14, 2000, on behalf of your constituent, Mr. [REDACTED], President of [REDACTED]. Mr. [REDACTED] asks about the special timing rule governing Federal Insurance Contributions Act (FICA) taxes on nonqualified deferred compensation. I hope the following information is helpful to you in addressing your constituent's concerns.

An Explanation of FICA

Both the employee and the employer pay FICA taxes on wages. Internal Revenue Code (Code) sections 3101 and 3111. FICA tax has two components: old-age, survivors and disability insurance (OASDI) tax, and hospital insurance (HI) tax. The employer and the employee each pay OASDI tax of 6.2 percent and HI tax of 1.45 percent. Wages are generally subject to FICA tax when actually or constructively paid. A special rule applies for wages deferred under a nonqualified deferred compensation plan,¹ the rule your constituent asks about.

¹ A "nonqualified deferred compensation plan" is any plan or other arrangement for deferral of compensation other than a qualified retirement plan, a tax-favored annuity, or other plan described in section 3121(a)(5).

The Congress enacted a special timing rule [section 3121(v)(2)] in 1983, at the same time it repealed the general retirement FICA tax exclusions [section 3121(a)(2)(A), (a)(3), and (a)(13)(A)(iii)]. The law now says that amounts deferred under a nonqualified deferred compensation plan are subject to FICA tax when those amounts are earned and vested:

- Any amount deferred under a nonqualified deferred compensation plan shall be treated as wages for purposes of the FICA tax as of the later of:
 - (i) when the services are performed, or
 - (ii) when there is no substantial risk of forfeiture of the rights to such amount. [Code section 3121(v)(2)(A)].
- A nonduplication rule says once FICA taxes are paid on deferred wages, those deferred wages and the income attributable to them are not again treated as wages for FICA tax purposes. [Code section 3121(v)(2)(B)].

Consequently, section 3121(v)(2) generally accelerates the FICA tax timing of deferred compensation to the time of deferral so no FICA tax is due on principal or income when it is paid to the employee. The special timing rule generally does subject the employer and the employee to additional FICA taxes at a time when no additional wages are paid from which to withhold those FICA taxes. But usually much less total FICA tax is paid than if the taxes were paid at the time the benefits were paid.

Benefits of Paying FICA Tax On Deferral:

Less overall FICA tax generally is paid when the taxes are paid on deferral for two reasons. First, when the FICA taxes are paid at the time of deferral, the deferred wages earn interest that is not subject to FICA tax. Second, the OASDI portion of FICA tax is only imposed on a certain amount of wages each year. For the year 2000, the wage base amount is \$76,200. Participants in nonqualified deferred compensation plans usually earn more than that OASDI wage base. If an employee already has earned FICA wages over that wage base, the 6.2 percent OASDI portion of FICA tax does not apply to the deferred compensation. Only the 1.45 percent HI tax applies once the OASDI wage base is exceeded. If FICA taxation occurred at the time of retirement, when benefit payments begin, the recipient might not have exceeded the wage base. Then, both the OASDI and HI portions of FICA tax would apply, presumably at a time when the recipient has less income with which to pay the taxes.

Final Regulations under section 3121(v)(2), which apply on or after January 1, 2000, were published January 29, 1999. The regulations help employers comply with the special timing rule by helping them determine the amount subject to FICA tax and when that amount is subject to FICA tax. Under these final regulations, employers with account balance plans and nonaccount balance plans that provide a benefit that is “reasonably ascertainable” (as defined in Employment Tax Regulation § 31.3121(v)(2)-1(e)(4)(B)) must pay FICA taxes on the amount deferred at the time of the deferral.

An employer with a nonaccount balance plan that provides a benefit that is not reasonably ascertainable has more flexibility. If a nonaccount balance plan provides a benefit that is not reasonably ascertainable, the employer may:

- Estimate the tax and pay upon deferral (the “early inclusion” rule); or
- Wait to pay the tax until the amount deferred becomes reasonably ascertainable (the “resolution date”). See Empl. Tax Reg. § 31.3121(v)(2)-1(e)(4).

Thus, an employer that finds payment of tax upon deferral burdensome may choose to provide employees with a nonaccount balance plan that does not have a resolution date until benefits begin. If the benefits are not reasonably ascertainable until the benefits begin, then no tax must be paid until that time. Thus, the interpretation of the law provided by the IRS regulations actually provides employers with greater flexibility in applying the special timing law for FICA taxation of nonqualified deferred compensation.

I hope this information is helpful to you in responding to your constituent. This letter will be made available for public inspection after names, addresses, and other identifying information have been deleted, as appropriate, under the Freedom of Information Act. If you have questions regarding this letter, or if I can be of further assistance, please contact me or Dan Boeskin (ID No. 50-16785) of my staff at (202) 622-6040.

Sincerely,

MARY OPPENHEIMER
Assistant Chief Counsel
Office of Division Counsel/
Associate Chief Counsel
(Tax Exempt and Government Entities)