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INTERNAL REVENUE SERVICE
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OFFICE OF THE CHIEF COUNSEL

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The Honorable Patty Murray
United States Senator
2988 Jackson Federal Building
915 Second Avenue
Seattle, WA 98714

Attention:

Dear Senator Murray:

I apologize for the delay in responding to your inquiry dated May 24, 2016, on behalf of your constituent, . wrote that her former employer previously reported her retirement payments on a Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., but recently began reporting them on a Form W-2, Wage and Tax Statement, and withholding income and Federal Insurance Contributions Act (FICA) taxes. questioned whether the reporting on Form W-2 and the withholding of income tax and FICA tax are correct and whether the amounts are properly characterized as deferred compensation.

As a member of my staff and you discussed on August 2, 2016, this area of the law is complex, and we believe a phone call with would be the best way to address her concerns. In the meantime, I am providing the following general information on the federal income and employment tax provisions that apply to the type of retirement payments is receiving. I hope the information is helpful.

In general, pensions and retirement payments, including payments from a nonqualified, ineligible plan, are wages subject to income tax withholding (Internal Revenue Code (Code) section 3401) and reported on a Form W-2.

For federal tax purposes, deferred compensation is compensation that an individual earns (or has a legally binding right to) in one year and is paid in a later year. A payment of deferred compensation is not limited to a payment under a written plan that states that its objective is to defer compensation for retirement. Instead, a payment of

deferred compensation may be made under any program, method, employment agreement or other arrangement that results in a deferral of compensation. An election to defer compensation is not a prerequisite for an amount to be considered deferred compensation. Thus, if as part of her or his employment, a taxpayer received a legally binding right to monthly retirement payments in future years from a former employer, these payments are deferred compensation for federal tax purposes.

In general, there are two types of deferred compensation: qualified and nonqualified (NQDC) plans. A plan administrator, trustee, or custodian, instead of the employer, generally makes payments under qualified plans. In broad terms, qualified plans must comply with vesting, contributions, trustee, minimum coverage, and employee participation requirements. These requirements do not apply to NQDC plans.

Section 457 of the Code sets forth the tax rules for NQDC plans sponsored by eligible employers. (The constituent identified the former employer as an entity that would be an eligible employer under section 457(e)(1)). Eligible employers may maintain two types of NQDC: eligible plans under section 457(b) (eligible plans) and ineligible plans under section 457(f) (ineligible plans). Section 457 of the Code provides different tax rules for eligible and ineligible plans. Participants in eligible plans may defer a limited amount of compensation on an annual basis (\$18,000 for 2016), without having to include the amounts in gross income until the amounts are paid or made available to them (section 457(a)(1)). Furthermore, eligible plans must be in writing and contain certain mandatory provisions for plan qualification.

In contrast, no limits apply to the amount of compensation participants in ineligible plans may defer. However, participants in ineligible plans must include the value of the deferred compensation benefit in gross income for the first taxable year in which the compensation is no longer subject to a substantial risk of forfeiture, regardless of when the benefit is paid (section 457(f)(1)(A)). A benefit is subject to a substantial risk of forfeiture if substantial future services must be performed to receive the benefit (section 457(f)(3)(B)). The value of the benefits not subject to a substantial risk of forfeiture is includible in gross income as wages and reported on a Form W-2.

Payments made from an ineligible plan are included in income as determined under section 72 of the Code and unpaid amounts taxed in one year are not again taxed when paid in a later year. Furthermore, if for any reason benefits are not included in income when they are no longer subject to a substantial risk of forfeiture, the benefits must be included in income when they are paid. (See Treasury Regulation section 1.457-11(c).)

FICA taxes are imposed on wages as defined in section 3121(a) of the Code. The term "wages" is defined in section 3121(a) as all remuneration for employment, including remuneration for employment paid on account of or upon retirement (Social Security

Amendments of 1983 (Public Law 98-21)). Pursuant to the Social Security Amendments of 1983, retirement pay under eligible and ineligible plans is subject to FICA taxation.¹

The Social Security Amendments of 1983 added section 3121(v)(2) of the Code which provides for special FICA taxation rules for amounts deferred under NQDC plans. These rules are somewhat complex, and an explanation may be helpful.

For FICA tax purposes, the law defines a NQDC plan in general as any plan or other arrangement--established by an employer for one or more employees that provides for the deferral of compensation--that is not a qualified plan. Thus, if, outside of the qualified plan context, a promise to make retirement payments is legally binding, the payments would be part of NQDC subject to FICA. For FICA purposes, ineligible plans are generally included in the definition of NQDC plan, regardless of whether benefits are paid pursuant to a participant's election. See Treasury Regulation section 31.3121(v)(2)-1 for further information on the FICA tax treatment of NQDC.

For purposes of the FICA, NQDC plans are "account balance plans" or "nonaccount balance plans." An arrangement not based on a balance in an individual account, but that is, for example, based on a formula or a specified amount, is a nonaccount balance plan.

Generally, "amounts deferred" under a NQDC plan are "taken into account" and subject to FICA taxes as of the later of when the services are performed or when no substantial risk of forfeiture of the rights to such amounts exists. This is referred to in the FICA regulations as the "special timing rule" under which FICA is generally imposed on amounts deferred before those amounts are distributed. For a nonaccount balance plan, the amount deferred for a period equals the present value of the additional future payment or payments to which the employee has obtained a legally binding right under the plan during that period.

An amount deferred under a nonaccount balance plan is not required to be taken into account as wages for FICA tax purposes under the special timing rule until the first date on which all of the amount deferred is reasonably ascertainable ("resolution date"). An amount deferred is considered to be "reasonably ascertainable" on the first date on which the amount, form, and commencement date of the benefit payments attributable to the amount deferred are known, and the only actuarial or other assumptions regarding future events or circumstances needed to determine the amount deferred are interest and mortality.

¹ FICA taxes include the Old-Age, Survivors, and Disability Insurance Tax (social security taxes) and hospital insurance taxes (Medicare taxes). Social security taxes are imposed by sections 3101(a) (employee's portion) and 3111(a) (employer's portion) of the Code. Medicare taxes are imposed by sections 3101(b) (employee's portion) and 3111(b) (employer's portion) of the Code.

Once an amount deferred is taken into account under the special timing rule for FICA tax purposes, then neither the amount taken into account nor the income attributable to the amount taken into account is treated as wages for FICA tax purposes thereafter. This is referred to as the “nonduplication rule.” However, if an amount is not taken into account for FICA tax purposes and appropriate FICA tax was not paid under the special timing rule for the period when the amount was deferred, then the nonduplication rule does not apply and the “general timing rule” applies, and the NQDC is subject to FICA tax when actually or constructively paid.

For example, if an amount must be taken into account in a particular year and the employer fails to withhold and pay the resulting additional FICA tax, then the amount deferred and the income attributable to the amount is included as wages when the benefits are paid. Thus, if a legally binding promise to make retirement payments is not subject to a substantial risk of forfeiture and the value of the payments is not taken into account for FICA tax purposes upon retirement, then the payments are wages subject to FICA when they are actually paid and reportable on a Form W-2.

If, however, rights to benefits are not legally binding, then retirement payments would not be part of a NQDC. Nevertheless, the payments would still be subject to FICA taxes, income tax withholding, and reporting on Form W-2 because they are payments for employment (that is, retirement payments).

I have enclosed additional information that discusses the taxation and reporting of retirement payments: Publication 575, *Pension and Annuity Income (2015)*, and Publication 525, *Taxable and Nontaxable Income (2015)*.

Again, we would be happy to have _____ contact us so that we can explain how the tax laws apply to her situation. If you have questions, please call me at _____, or _____ or _____ at _____.

Sincerely,

Victoria A. Judson
Associate Chief Counsel
(TEGE Associate Chief Counsel)

Enclosures (2)