General FICA Guidance for Defined Benefit Plans

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Section 3121(v) of the Internal Revenue Code created the Special Timing Rule, which governs FICA taxation for all nonqualified deferred compensation plans. For defined benefit plans, the Special Timing Rule requires that a benefit amount that is earned (accrued) be recognized for FICA purposes at the time of vesting, as long as (1) the amount, (2) the commencement date, and (3) the form of payment is known. (When all three components are known, the benefit is considered “reasonably ascertainable” in accordance with the regulations.) The includible amount for FICA is the present value of the expected future payments of this earned amount to be paid.

For example, assume a plan provides a benefit of $100,000 per year for 10 years commencing at age 65 to a participant who is age 45. The benefit is vested 5% each year (or $5,000 based on 5% or 1/20th of $100,000). The amount of the vested payment is currently known ($5,000), the commencement date of payment is known (age 65), and the form of payment if known (10 installments). Consequently, the benefit is “reasonably ascertainable,” and each year the employer (i.e., plan sponsor) will include for FICA purposes the current present value of $5,000 per year payable at age 65 for 10 years. The discount rate used for present value calculations must be based upon “reasonable assumptions” at the time of inclusion.

The regulations state the Special Timing Rule is not elective, and if an employer does not take into account the appropriate amount (including payment of any resulting FICA tax) when required, interest and penalties may be imposed, and FICA tax will be imposed instead when the benefit is actually paid (FICA taxation at the time the benefit is actually paid is known as the “General Timing Rule”).

Consider the example above, but instead of benefits commencing at age 65, the benefit is to be paid upon a separation from service. In this case, it is not necessary for the employer to report FICA tax under the Special Timing Rule until it is reasonably ascertainable, since the commencement date is not known until separation from service actually occurs.

However, the regulations also allow for an earlier inclusion of FICA tax for amounts deemed not reasonably ascertainable as long as there is a true-up (i.e., what was paid and what should be paid) at the time all components are known. The regulations refer to this time as the “resolution date” (or the date the benefit becomes reasonably ascertainable).

Generally, utilizing the Special Timing Rule for a non-account balance plan (i.e., a defined benefit plan) provides two potential financial advantages to both plan participants and plan sponsors:

1. Under the Special Timing Rule, as stated above, FICA tax is paid on the present value of the increase in the vested accrued benefit for the year. If the Special Timing Rule is not applied at the appropriate time, FICA tax will be paid on the full dollar value of this benefit at the time of payment rather than the present value of this benefit.

2. Applying the Special Timing Rule may result in a lower tax rate for FICA tax purposes. The Social Security tax component of FICA (i.e., 6.2% due from both the employee and the employer, totaling 12.4%) only applies to the first $118,500 of wages paid in 2016 (i.e., the Social Security wage base which may increase in future years). Consequently, if the Social Security wage base is reached at the time of applying the Special Timing Rule, the combined 12.4% FICA tax will be avoided. However, there is no cap on the Medicare tax component of FICA (i.e., 1.45% due from both the employee and the employer, totaling 2.9%), so it applies on the entire amount subject to FICA taxation. Furthermore, the employee may be subject to an additional 0.9% Medicare surtax, bringing his or her share of Medicare tax to 2.35% (1.45% plus 0.9%) if Adjusted Gross Income (AGI) is $200,000 or more for single individuals ($250,000 for married individuals).

FICA taxes must be withheld through payroll and reported in Boxes 3, 5, & 11 of Form W-2. Assuming FICA taxes are paid in accordance with the Special Timing Rule, only income taxes will need to be withheld at the time of benefit distribution.

The FICA rules require special handling by a plan sponsor's payroll department or payroll firm (if payroll is outsourced). If, for whatever reason, a plan sponsor did not pay FICA tax in the year of vesting when it was deemed reasonably ascertainable, the regulations state that the plan sponsor must follow the General Timing Rule (i.e., withhold the full FICA tax from each distribution at the time of payment). As stated above, this may result in higher FICA tax being paid than what would have been paid if the Special Timing Rule was applied earlier as well as the possibility of interest and penalties.

What are the alternatives?

The Pangburn Group (Pangburn) will provide to the plan sponsor the amount subject to FICA tax in a given year for a non-account balance plan (i.e., a defined benefit plan) based upon the present value of the increase in the vested accrued benefit for each year. If the amount is "reasonably ascertainable" (e.g., if the benefit is based upon payment at a specified age or date and not the occurrence of an event such as separation from service or change in control), Pangburn recommends including and paying the amount reported for current FICA tax purposes.

If the amount is not "reasonably ascertainable" (i.e., the benefit payment is triggered by the occurrence of an event), then:

A. The amount subject to FICA may be currently included and withheld as increases in vesting occur with a true-up when the benefit is reasonably ascertainable (i.e., upon the occurrence of the event triggering the payment). Pangburn will provide the true-up amount;

B. The amount subject to FICA may be included and withheld only at the date in which it is reasonably ascertainable (i.e., upon the occurrence of the event triggering the payment); or

C. Do not include the amount subject to FICA currently (as increases in vesting occurs), and instead withhold FICA tax on the dollar value of the benefit when it is actually paid. Note: This approach follows the General Timing Rule and may be subject to interest and penalties. Pangburn does not generally recommend this approach.

References:
Treas. Reg. § 31.3121(v)(2)

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