PRESENT LAW AND ISSUES
RELATING TO
SOCIAL SECURITY TAX TREATMENT
OF NONQUALIFIED DEFERRED COMPENSATION

Scheduled for a Hearing

Before the

SUBCOMMITTEE ON SOCIAL SECURITY

of the

HOUSE COMMITTEE ON WAYS AND MEANS

on April 5, 1990

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

April 2, 1990

JCX-8-90

CONTENTS

INTRODUCTION

The Subcommittee on Social Security of the House Committee on Ways and Means has scheduled a public hearing on April 5, 1990, on the social security tax treatment of nonqualified deferred compensation.

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a brief description of present-law tax rules (Part I), legislative background (Part II), and a discussion of issues regarding the treatment of deferred compensation for social security tax purposes (Part III).

In announcing the hearing, the Subcommittee on Social Security indicated that the scope of the Subcommittee hearing would include the following issues:

- The absence of IRS regulations and near absence of reporting requirements for nonqualified deferred compensation plans means that there is little existing information about the nature of payments covered by the present-law social security tax rules regarding nonqualified deferred compensation. What general types of nonqualified deferred co pensation plans currently exist? To what extent are these plans structured to provide retirement benefits? To what extent do they provide benefits for rank-and-file employees?

- Should present law be revised to address the problems identified by the IRS in attempting to draft regulations? Specifically, should nonqualified deferred compensation be defined? What additional changes, if any, are needed?

- What categories of self-employed individuals defer compensation from customers through contractual arrangements? How widespread are the plans? To what extent are they available to self-employed individuals with low or moderate earnings? Should these arrangements be treated the same as nonqualified deferred compensation of employees? If so, how would this change affect the social security trust funds and the tax liability of self-employed individuals? What effect, if any, would the change have on the growth of nonqualified plans among self-employed individuals?

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[1] This document may be cited as follows: Joint Committee on Taxation, Present Law and Issues Relating to Social Security Tax Treatment of Nonqualified Deferred Compensation (JCX-8-90), April 2, 1990.

I. PRESENT LAW

A. Overview of Deferred Compensation Arrangements

In general

In general terms, deferred compensation or deferred income is compensation or income that is earned currently, the payment of which is made sometime in the future. Under the Internal Revenue Code, the taxation of deferred compensation (for both income and social security tax purposes) depends in part on whether the compensation is provided under a nonqualified or qualified program.

Qualified plans

A plan of deferred compensation that meets the qualification standards of the Code (sec. 401(a) and secs. referred to therein) is referred to as a qualified plan. The qualification standards and related rules governing qualified plans are designed to ensure that qualified plans benefit an employer's rank-and-file employees as well as the employer's highly compensated employees. They also define the rights of plan participants and beneficiaries and provide limits on the amounts that can be accumulated under a qualified plan. As described below, qualified plans are provided favorable tax treatment in recognition of the special standards that apply to such plans.

Nonqualified plans

A plan of deferred compensation that does not meet the qualification standards of the Code is referred to as a nonqualified plan. The Code generally does not prescribe standards for such plans or limit the benefits that can be provided under such plans.[2] For example, nonqualified deferred compensation plans can be discriminatory in that they can benefit only highly compensated employees. Similarly, the Code does not limit the amount of benefits that can be provided under a nonqualified plan.

Although the Code does not impose standards on nonqualified plans, such plans are subject to the requirements of the Employee Retirement Income Security Act (ERISA) unless they are limited in scope. ERISA imposes minimum participation, funding, and vesting requirements on all deferred compensation plans established by an employer

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[2] Certain limitations apply to unfunded deferred compensation plans maintained by State and local governments and nongovernmental tax-exempt organizations (sec. 457).

for its employees that can apply regardless of whether the plan is qualified under the Code. If a plan is subject to ERISA, but is not qualified, the plan may not have the desired effect of deferring the inclusion of the compensation in gross income.

In order to be exempt form ERISA's requirements, a nonqualified plan is generally required to be either (1) a plan established solely to provide benefits in excess of those that may be provided under a qualified plan of the employer due to the Code limitations on benefits under a qualified plan (an "excess benefit" plan), or (2) a plan that is unfunded and maintained by an employer primarily to provide deferred compensation for a select group of management employees (a so-called "top-hat" plan).

Deferred compensation of self-employed individuals

A self-employed individual (e.g., a sole proprietor or a partner in a partnership) may establish and participate in a qualified plan. In addition, a self-employed individual may have deferred income by arranging for payments for services provided by the individual to be deferred. For example, insurance companies often compensate agents for a period of years after the agent has stopped selling insurance based on the value of the policies sold by the agent.

B. Income Taxation of Deferred Compensation

In general

The income tax treatment of deferred compensation generally does not depend on whether the deferred compensation is provided to an employee or a self-employed individual. Such treatment does depend, however, on whether the compensation is provided under a qualified plan or a nonqualified deferred compensation plan.

Qualified plans

Contributions to and benefits provided under a qualified plan are not includible in the gross income of plan participants until the benefits are paid (secs. 402 and 72).[3]

Nonqualified plans

The taxation of benefits under a nonqualified deferred

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[3] Even though inclusion of qualified plan benefits in employees' gross incomes is deferred, employers are allowed a current tax deduction (within limits) for contributions to a qualified plan (sec. 404).

compensation plan depends on whether the plan is funded or unfunded.[4] In general, unfunded deferred compensation is includible in gross income when it is actually or constructively received by the recipient. If the deferred compensation is funded, then it is generally includible in income at the later of when the services relating to the compensation are performed or when the compensation is not subject to a substantial risk of forfeiture (secs. 451 and 83).[5]

C. Taxation of Deferred Compensation for Social Security Purposes

In general

Under the Federal Insurance Contributions Act (FICA), social security taxes are imposed on the wages of employees to the extent the wages do not exceed the social security taxable wage base ($51,300 for 1990). Similarly, under the Self-Employment Contributions Act (SECA), social security taxes are imposed on the net earnings from self-employment of self-employed individuals to the extent such income does not exceed the social security taxable wage base.[6] The rules that apply to social security taxes also generally apply for purposes of calculating social security benefits.

In general, whether an individual is an employee (and therefore subject to FICA taxes rather than SECA taxes) is determined under common-law rules. However, the following persons are treated as employees for FICA tax purposes regardless of whether they would be employees under the common law test (1) certain drivers engaged in distributing meat, vegetables, and certain other products; (2) a home worker performing work according to specifications furnished by the person for whom the services are performed; (3) a

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4 An employer is generally not entitled to a deduction for nonqualified deferred compensation until it is includible in the gross income of the recipient.

5 Under certain circumstances, an individual may elect to have deferred compensation includible in income when it is transferred (i.e., funded), even though there is still a substantial risk of forfeiture (sec. 83(b)).

6 FICA taxes are paid both by the employer and the employee. The combined FICA tax rate, consisting of both the employer and employee portion for old age, survivors, and disability insurance (OASDI) and hospital insurance (HI or Medicare) is 15.3 percent for 1990 (7.65 percent on the employer and 7.65 percent on the employee). Similarly, the SECA tax rate is 15.3 percent.

traveling or city salesman, or (4) a full-time life insurance salesman.

Wages are generally taken into account for FICA tax purposes when actually or constructively paid by the employer. Self-employment income is generally taken into account for SECA purposes when it is includible in gross income for income tax purposes. Certain exceptions apply to these general rules of inclusion. In particular, certain exceptions to the normal inclusion rules are provided in the case of deferred compensation.

<u>Nonqualified deferred compensation payable to employees</u>

Contributions to or benefits payable from a qualified plan (other than contributions made at the election of the employee) are not subject to FICA taxes. In addition, contributions (other than contributions made at the election of the employee) to or benefits payable from a qualified annuity (sec. 403(a)), a simplified employee pension (SEP) (sec. 408(k)), certain governmental plans, and tax-sheltered annuities (sec. 403(b)) are not subject to FICA taxes (sec. 3121(a)(5)). These types of plans are subject to restrictions similar to those applicable to qualified plans, and are also treated favorably for income tax purposes.

Contributions made to a qualified plan, SEP, or tax-sheltered annuity at the election of the employee are generally taken into account for FICA tax purposes when they would have been paid to the employee but for the election to defer (sec. 3121(v)(1)).

Nonqualified deferred compensation is taken into account for FICA purposes as of the later of (1) when the services relating to such compensation are performed, or (2) when there is no substantial risk of forfeiture of the right to such deferred compensation (sec. 3121(v)(2)). For this purpose, nonqualified deferred compensation is defined as compensation payable under a plan other than a qualified plan, a qualified annuity, a tax-sheltered annuity, SEP, or certain governmental plans.

<u>Deferred compensation of self-employed individuals</u>

Deferred compensation of self-employed individuals is generally subject to the general rule of inclusion. Thus, it is taken into account for SECA tax purposes at the time it is includible in gross income for income tax purposes (sec. 1402).

Under a special rule, certain retirement benefits payable by a partnership to a partner are not subject to SECA taxes. To qualify for this exception, the amounts must be received by a partner pursuant to a written plan of the partnership, the plan must provide for payments on account of retirement on a periodic basis to partners generally or to a class of partners, and the payments must continue at least until the partner's death. In addition, the exception applies only if the partner did not provide services to the partnership during the year the amounts were received, the partnership has no other obligation to the partner (other than to make the retirement payments), and the partner's share of the capital of the partnership has been paid to him or her in full.

This exception does not apply, for example, to situations in which a self-employed individual has arranged by contract for deferred payment for services. In such a case, the normal income tax rules would apply. Thus, the income would be subject to SECA taxes when actually or constructively received (if the amount is unfunded) or when no longer subject to a substantial risk of forfeiture (if funded).

II. LEGISLATIVE BACKGROUND

The Social Security Amendments of 1983 (the 1983 Amendments) substantially revised the rules relating to the inclusion of deferred compensation in wages for social security tax purposes. Prior to the 1983 Amendments, benefits paid under qualified plans were not included in wages. In addition, payments made on account of retirement, either on an individual basis or under a plan or system of the employer providing for employees generally (or for a class or classes of employees) were excluded from the wage base. For nonqualified deferred compensation, this treatment applied to the extent that payments pursuant to a deferred compensation agreement constituted payments on account of retirement, which were excluded from the wage base.

Under the rules in effect before the 1983 Amendments, amounts that were voluntarily contributed by an employee to a qualified plan were not included in wages for employment tax purposes when contributed to the qualified plan or when distributed or made available from such plan. This treatment conformed to the general treatment of benefits under qualified plans. However, the Internal Revenue Service (IRS) had taken the position with respect to tax-sheltered annuities (sec. 403(b)) that amounts paid pursuant to a salary reduction agreement were includible in the employee's social security wages. Amounts distributed from a tax-sheltered annuity were not includible in wages for employment tax purposes.

The 1983 Amendments provided that amounts that an employee electively contributes to a qualified plan (i.e., through a qualified cash or deferred arrangement), tax-sheltered annuity, eligible State deferred compensation plan, etc., are includible in wages when deferred. This change conformed the FICA tax treatment of such elective contributions to the treatment of contributions to an individual retirement arrangement (IRA). The 1983 Amendments did not otherwise change the exclusion of amounts contributed to, or distributed from, qualified plans from the definition of wages. However, the 1983 Amendments provided that amounts deferred under a nonqualified deferred compensation plan are included in the wage base as of the later of (1) when the services are performed or (2) when there is no substantial risk of forfeiture of the right to such amount. This rule was added because the Congress concluded that the favorable treatment accorded to qualified plans was not appropriate in the case of nonqualified deferred compensation.

The 1983 Amendments did not alter the FICA tax treatment of deferred compensation of self-employed individuals.

III. ISSUES REGARDING THE SOCIAL SECURITY TAX TREATMENT OF DEFERRED COMPENSATION

The appropriateness of a rule regarding the social security tax treatment of nonqualified deferred compensation of self-employed individuals depends on (1) the effect of the rule on social security revenues, (2) the effect of the rule on the establishment of nonqualified deferred compensation plans, (3) the parity of treatment of employees and self-employed individuals, and (4) the administrability of the rule.

Effects on social security revenues and establishment of nonqualified deferred compensation arrangements

The application of the present-law FICA tax rules to nonqualified deferred compensation of self-employed individuals would generally accelerate the time at which such compensation is taken into account for SECA purposes. The effect such acceleration has on the collection of SECA taxes and the establishment of deferred compensation arrangements depends on individual circumstances and the desire to minimize taxes.

In general, employers and individuals (including employees and self-employed individuals) want to maximize their after-tax cash flows.[7] In determining the sizes of these cash flows, both income tax and social security tax treatment are important. That is, employers are concerned about the timing of the deduction of an additional dollar of payment to an employee (either in the current year or when the deferred compensation payment is actually made to the employee). In addition, the individual is concerned about the time the payment is included in taxable income (either the current year or when the deferred payment is actually received), about when the payment is taken into account for social security tax purposes, and about whether the payment would affect the amount of social security benefits ultimately received.

If a self-employed individual's compensation for the current year is at the social security taxable wage base (without taking into account nonqualified deferred compensation), then extending the present-law FICA rule to self-employed individuals would mean that the deferred

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[7] For further discussion of the economics of compensation systems, see Myron Scholes and Mark Wolfson, "Employee Compensation and Taxes: Links with Incentives, Investment, and Financing," Stanford Graduate School of Business Working Paper, October 1984.

compensation is at no time subject to social security taxes. This occurs because the change would generally have the effect of accelerating the time of inclusion for SECA purposes to the time the services are performed or the time rights to the payment are fixed.

The ability to avoid social security taxes makes deferred compensation more attractive, and could accelerate the growth of deferred compensation arrangements. Most nonqualified deferred compensation arrangements (of employees as well as self-employed individuals) are unfunded, as that approach generally provides the maximum income tax deferral. The FICA tax rule for nonqualified deferred compensation is generally the rule for funded nonqualified deferred compensation. This rule provides for earlier inclusion than the rule for unfunded deferred compensation. The combination of these rules as applied to nonqualified deferred compensation enables a taxpayer with income at or above the taxable wage base to minimize both income and social security taxes.

In the case of FICA taxes, present law can also encourage employers to favor deferred compensation over current compensation. Present law permits employers to avoid paying the employer share of FICA taxes on deferred compensation of employees with wages (excluding the deferred compensation) in excess of the taxable wage base.

Some argue that the present-law rule itself, or extending the present-law rule, inappropriately encourages the growth of deferred compensation arrangements and permits taxpayers to manipulate the tax system. They argue that such adverse effects could be avoided by having the same rule apply for income and social security tax purposes.

Proponents of the present-law rule argue that, if nonqualified deferred compensation is taken into account in the future, an individual may have to pay social security taxes on such amounts even though such amounts will not increase benefits, because the individual is already at the maximum benefit level. However, this situation is not unique to those receiving deferred compensation but could occur in a variety of situations. Thus, some argue that this possibility should not form the basis for a special rule for nonqualified deferred compensation.

Proponents of extending the present-law rule to self-employed individuals also argue that the rule would not lead to the growth of deferred compensation arrangements. They argue that such arrangements are generally unfunded, meaning that the arrangement is an unsecured promise to pay. If a self-employed individual contracts with a customer to defer payments, the individual must rely on the customer's future willingness and ability to pay. This uncertainty makes such arrangements less attractive.

On the other hand, there is evidence that these arrangements are not uncommon, at least in certain business fields. Thus, for example, there is evidence that insurance agents, doctors, corporate directors, and ministers utilize nonqualified deferred compensation arrangements.[8]

Accelerating the inclusion of nonqualified deferred compensation for SECA tax purposes could be unattractive to a self-employed individual with income above the taxable wage base if deferring the inclusion could result in increased social security benefits.

Acceleration could also adversely affect individuals with current income below the taxable wage base. In such a case, although the individual will generally earn credit toward benefits, the individual will also be required to pay taxes on amounts that have not yet been received. Thus, the increase in tax liability will not be accompanied by the receipt of additional funds with which to pay the tax.

Parity of treatment of self-employed individuals and employees

Proponents of applying the present-law FICA tax rule to self-employed individuals argue that there is no reason to treat self-employed individuals different than employees. Opponents argue, as discussed above, that the better rule would be to conform social security treatment to income tax treatment and that equality should be achieved by modifying the FICA tax rule.

Some also argue that the present-law FICA rule was not the favored rule, but was a compromise made as part of the 1983 Amendments, and should not be further extended.

Administrability

The effectiveness of any tax rule depends on the extent to which it can be applied and enforced by taxpayers and the IRS. To date, no regulations have been issued under the FICA tax rule for nonqualified deferred compensation.[9] In the

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8 See, U.S. General Accounting Office, Social Security: Taxing Nonqualified Deferred Compensation, (GAO/HRD-90-82).

9 Implementation problems arising from present law and reasons for IRS failure to issue regulations is discussed further in U.S. General Accounting Office, Social Security: Taxing Nonqualified Deferred Compensation (GAO/HRD-90-82), March 1990.

absence of such guidance, taxpayers must make their own determinations as to whether a particular payment arrangement constitutes nonqualified deferred compensation and, if so, the amount that is subject to FICA tax. These determinations can be difficult and can also lead to disputes with the IRS.

For example, although the statute distinguishes between qualified and nonqualified deferred compensation, there is no definition of deferred compensation itself. Depending on the circumstances, a particular payment stream, for example, a compensation package that makes payments to an individual over a period of years if the individual retires early, could be either compensation for prior years of service (i.e., deferred compensation) or compensation for early termination of employment (i.e., current compensation). If an individual's income already exceeds the taxable wage base for FICA tax purposes, he or she will have an incentive to characterize the payments as deferred compensation in order to avoid payment of FICA taxes. The issue is likely to arise when the amounts are paid, and the IRS claims they should be subject to FICA taxes and the individual claims they were includible in a prior year.

Another problem under present law is the difficulty in determining the amount of the deferred payment. In many cases, the actual payment to be made in the future is dependent on future events, such as final salary or performance of the company, so that an accurate measurement of the amount of deferral cannot be made at the time the income is earned. Complex present value computations may also be necessary to determine accurately the amount of income deferred.

Some argue that it would be preferable to try to resolve the problems of present law rather than exacerbating enforcement problems by extending the rule to self-employed individuals.

Some would also argue that a more administrable rule would be appropriate. For example, a rule requiring inclusion when amounts are received would address the problems of present law discussed above.