

The Special Timing Rule for Taxation of Nonqualified Deferred Compensation

February 13, 2024 – Cross-Border Counselor
by Jenna Steiner

For an employee who is a U.S. taxpayer, both the employer and the employee are liable for a portion of Social Security taxes and Medicare taxes (collectively referred to as “FICA” taxes) on the employee’s compensation. Employers are liable for withholding and remitting both the employer and the employee portions of FICA taxes, which typically occurs at the time the compensation is received by the employee, which is known as the “General Timing Rule.” However, when dealing with awards of nonqualified deferred compensation (“NQDC”) to U.S. taxpayers, a Special Timing Rule (outlined in Treas. Reg. §31.3121(v)(2)-1) may apply. Under the Special Timing Rule, FICA taxes are owed when the employee becomes *vested* in the NQDC, whether or not the NQDC is actually paid at that time. If a Canadian company is unaware of this Special Timing Rule, it could result in the employer withholding and reporting incorrect FICA amounts as well as the employee overpaying FICA taxes.

What is Nonqualified Deferred Compensation?

A NQDC arrangement is really any kind of compensation that has been earned by an employee in one tax year, but that the employee will not receive until a later tax year. This could be as simple as a bonus earned in one year and payable in a later year, or as complex as equity-based awards, such as Restricted Stock Units, phantom stock, or a supplemental executive retirement plan (to name a few). However, this Special Timing Rule generally does not apply to stock options.

What is the Special Timing Rule for FICA?

As mentioned above, under the Special Timing Rule, FICA taxes are due on NQDC on the later of: (1) when the employee provides the related services, or (2) when the compensation is no longer subject to a substantial risk of forfeiture (i.e., when the amounts vest). In other words, FICA taxes could be due before the NQDC is actually paid to the employee. For a typical employer contribution-based cash plan or phantom stock plan, this rule means that FICA taxes will be due in the year when any deferred

Related People

- Jenna Steiner

Related Capabilities

- Canada Cross-Border Transactions

compensation (and any earnings) vest. This can become complex to track when there is an extended vesting schedule to ensure that the appropriate amount of FICA taxes are paid by the employer and employee when each tranche of the compensation (and earnings) vest. For a plan where employees are deferring salary or bonus, FICA taxes will be due in the year when the employee makes the deferral.

To help ease some of the administrative complexity, there is a “rule of administrative convenience.” The rule allows FICA taxes to be withheld and remitted as late as December 31 of the same tax year, with the amount of wages subject to FICA adjusted to reflect the value on December 31 (or an earlier date if payment is made earlier) after interest or earnings on the benefit are applied. This rule can be helpful if amounts under a plan vest at numerous times during a year. There are additional rules that can be utilized to help manage this complex issue.

What are the Consequences of not Complying with the Special Timing Rule?

The Special Timing Rule, although a bit administratively complex, is typically advantageous to the recipient of the NQDC. If FICA taxes are paid when the NQDC vests (but is not paid out), then FICA taxes will not be owed when the NQDC is paid (to avoid double taxation). This generally means that any interest or accruals on the amounts that have already been subject to FICA taxes, will not be subject to FICA taxes at all. On the flip side, the Special Timing Rule can occasionally be disadvantageous if NQDC is never paid, as regulations do not allow employees to recover FICA taxes paid on NQDC amounts that are never received.

Unfortunately, many employers forget, or are not aware of the requirement, to include NQDC in income for FICA tax purposes at the time of contribution or vesting. If FICA taxes are not paid in accordance with the Special Timing Rule, the issue may be corrected if caught in time to amend withholding returns; otherwise, FICA taxes are due when payments are actually (or constructively) received and become taxable for income tax purposes (likely resulting in more FICA taxes due overall). The correction process is complex, as it involves determining open tax years for which correction is available, amending prior returns and issuing corrected W-2s. Therefore, employers should be careful to understand their nonqualified deferred compensation plans, and how tax withholding works under those plans.