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Special Timing Rule

Are You Withholding Too Much on Nonqualified Deferred Compensation?

If you have a nonqualified deferred compensation plan for select employees, you are probably aware that benefit payments under a properly structured plan are generally not taxable for income tax purposes until the payments are received by the employee.

However, unless you are aware of the “special timing rule,” you may have been withholding Social Security and Medicare taxes (collectively referred to here as “FICA”) on the total benefit amounts when paid. Under the special timing rule outlined in Treas. Reg. § 31.3121(v)(2)-1, FICA tax may be due earlier than payment of the deferred compensation, depending on how the nonqualified deferred compensation plan and payments are structured. While this earlier FICA withholding may initially seem like a burden, in most cases withholding FICA earlier under the special timing rule will result in less FICA being paid overall, as explained in more detail below.

FICA Timing

The timing of when FICA must be withheld under the special timing rule depends on whether the nonqualified deferred compensation plan is an “account balance plan” or a “nonaccount balance plan.” Account balance plans are arrangements that pay benefits solely based on a principal amount and income/loss on that amount. All other types of nonqualified deferred compensation plans are nonaccount balance plans (e.g., a defined benefit-style SERP). For account balance plans, benefits are wages for FICA purposes when they are no longer subject to a substantial risk of forfeiture (i.e., when they become vested). For example, if an employer contributes to a nonqualified deferred compensation plan account for an employee with contributions vesting after five years but payable upon retirement, once that five-year mark is reached, the benefits are vested and are includable in wages for FICA purposes (but not included in income for federal or state income tax purposes until

paid upon retirement). If the plan allowed participants to make elective deferrals (which are never subject to vesting), FICA would be due immediately on those amounts. For nonaccount balance plans, FICA is not due until the present value of the benefits are reasonably ascertainable (generally, upon termination of employment or once payments begin) (the “resolution date”).

The exact timing of when FICA is due to be paid is the date of vesting for account balance plans or the resolution date for nonaccount balance plans. FICA taxes may also be paid later in that year under the “rule of administrative convenience,” which allows the tax to be withheld and remitted as late as December 31 of the same tax year, with the amount of FICA wages 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.

Another FICA payment alternative to ease the administrative burden, especially for plans that make benefit credits late in a year, is to use the “lag method” of withholding and reporting. The lag method allows an additional three months beyond the latest date to include the benefits in FICA wages (i.e., up to three months after December 31, or March 31). The amount included as FICA wages under the lag method must be adjusted from the December 31 benefit amount to reflect interest at the January mid-term “applicable federal rate.” But note that combining the rule of administrative convenience and the lag method generally changes the tax year in which FICA taxes are paid, possibly exposing the benefit to additional FICA taxes since the second year’s Social security wage base may be higher, and the employee may have already been paid wages of more than that wage base, and therefore have owed no additional social security taxes if the amount had been included in wages late in the prior year.

Advantages to Special Timing Rule

There are two main advantages to the special timing rule. First, once FICA tax is paid on the benefit at vesting, no additional FICA is due in the future on any growth in the value of the benefit when paid.

Second, due to the way the FICA tax is structured, in most cases the amount of nonqualified deferred compensation will not be subject to the full FICA rate of 7.65% due to the Social Security Wage Base limit (\$132,900 for 2019) on that portion of the tax (the Medicare tax has no cap on the amount of wages to which it applies). So, for example, an employee has a salary of \$125,000 in 2019 with \$500,000 of deferred compensation that vested in 2019 but which is not payable until retirement, in annual installments of \$100,000 plus earnings over five years. In this case, only \$7,900 of the \$500,000 deferred compensation benefit is subject to the 6.2% Social Security tax portion of the FICA due to the employee reaching the Social Security Wage Base with combined salary and vesting of deferred compensation. The entire amount is subject to both the employee and employer paying an additional 1.45% Medicare tax, and amounts over \$200,000 (for single tax filers) are subject to the Additional Medicare tax withholding of 0.9% (employee only).

If FICA was not withheld on the benefit until payments were made, most of the amount would be subject to the full FICA tax since the \$100,000 annual payments after the year of retirement when no salary is earned would not hit the Social Security Wage Base (assuming the employee had no other compensation in the years payments are received).

Funding FICA Tax and Correcting Errors

The employee's share of FICA can result in a financial burden to the employee since the FICA tax is due but none of the deferred compensation is being paid to the employee to cover the expense. Most commonly, FICA is withheld from the employee's other W-2 wages (salary or bonuses). When there are not enough wages to withhold from or the employee prefers no withholding, the employee may write a check to cover the FICA owed. A more popular alternative is accelerating a portion of the nonqualified deferred compensation payments due in the future to cover the FICA expense (plus the income taxes due on the amount advanced to pay the employee's share of FICA). This is a permissible acceleration under Internal Revenue Code Section 409A, as long as

the nonqualified deferred compensation plan allows it, and the employee does not have discretion as to whether and when this feature is used.

If FICA is not paid in accordance with the special timing rule, the issue may be corrected if caught in time to amend withholding returns; otherwise, FICA is due when payments are actually (or constructively) received and become taxable for income tax purposes (likely resulting in more FICA due overall). According to the IRS, only the prior three years are open for correction, and earlier tax years cannot be opened to apply the special timing rule. So, for example, FICA corrections for 2019 must be made by April 15, 2023. In order to correct for a prior quarter, a Form 941-X for the specific quarter must be used to report the corrected FICA taxes and, for prior years, a Form W-2c must also be completed to correct the employee's previously filed W-2. The IRS does not charge penalties or interest for timely corrections of inadvertent FICA errors; however, any additional Medicare tax (the 0.9% on amounts in excess of \$200,000) for a prior year must be corrected by the employee.

As you can see, the special timing rule offers a number of advantages to employers and employees with little downside, other than having to handle the cash flow for payment at a time when benefits are not being paid. Employers should be careful to understand their nonqualified deferred compensation plans, and how tax withholding works under those plans, otherwise an employee may have a claim against the employer if unnecessary FICA has been paid (see *Davidson v. Henkel Corp.*, 2015 WL 74257 (E.D. Mich. Jan. 6, 2015)). If an employer has not withheld under the special timing rule, an employer should consider correcting open years.

In the meantime, if you have questions about any of the issues raised above, you can contact me (Carl Lammers; clammers@fbtlaw.com) or any member of [Frost Brown Todd's Tax Group](#) – providing [Tax Law Defined™](#).

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