FICA Tax: Navigating the Nonqualified Deferred Compensation Special Timing Rule

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Compensation is generally subject to federal income tax and FICA tax when compensation is actually paid to an employee. However, nonqualified deferred compensation (NQDC) may be subject to FICA taxation before federal income taxation under a FICA tax special timing rule. The scope of NQDC subject to FICA taxation is broad, including voluntary deferrals of salary, restricted stock units and performance stock units with deferral features, SERPs, and certain deferred bonuses. Understanding when FICA tax applies to NQDC, and how to take advantage of FICA tax timing rules, can help employers avoid errors when administering their NQDC arrangements. Below is a summary of the FICA tax special timing rule and our insights.

FICA Tax

The Internal Revenue Code imposes FICA tax on compensation employers pay to employees for services. FICA is comprised of two separate taxes: old-age, survivor, and disability insurance tax (OASDI) (commonly called the Social Security tax) and hospital insurance tax (HI) (commonly called the Medicare tax), which are imposed on both employees and employers.

The Social Security tax rate for both employees and employers is equal to 6.2% of compensation up to an annual wage base (currently $176,100 for 2025), which may be adjusted annually to reflect changes in the national average wage index. The Medicare tax rate for both employees and employers is equal to 1.45% of compensation (there is no annual wage base). There is also an Additional Medicare tax imposed on only employees at a rate equal to 0.9% of compensation over $250,000 for married taxpayers ($125,000 if filing separate returns) and $200,000 for all other taxpayers.

Employers must withhold the employee portion of FICA taxes from employees' compensation (the Additional Medicare tax must be withheld on compensation over $200,000) and must remit the employee (and employer) portion of FICA taxes to the Internal Revenue Service.

FICA Tax NQDC Special Timing Rule

Generally, under a special timing rule that applies to deferred compensation, an employer must withhold the employee's share of FICA tax and pay the employer's share of FICA tax on amounts deferred under a NQDC plan as of the later of (1) the date on which the employee performs the services that creates the right to a deferral, or (2) the date on which the amount deferred is no longer subject to a substantial risk of forfeiture.

This special timing rule generally accelerates the timing of FICA taxation to the time of deferral for fully vested compensation or to the time of vesting (that is, no longer subject to a substantial risk of forfeiture) for compensation subject to vesting conditions. Because of this, FICA taxation may occur before NQDC is actually paid to the employee, creating a mismatch between the timing of federal income taxation and FICA taxation.

NQDC plans are either account balance plans or nonaccount balance plans for FICA tax purposes. An account balance plan is a plan under which the employee's benefit consists solely of a principal amount credited to an employee plus income credited to the principal. If a plan is not an account balance plan, it is a nonaccount balance plan.

Once NQDC is taken into account under the special timing rule, neither the amount taken into account nor the income attributable to the amount taken into account is treated as compensation for FICA tax purposes (that is, when actually paid). This is known as the "nonduplication rule." However, if an amount is not taken into account for FICA tax purposes and FICA tax was not paid under the special timing rule, then the nonduplication rule does not apply and the NQDC is subject to FICA tax when actually paid.

Less FICA tax could actually be paid under the special timing rule. The Social Security tax portion is only imposed up to the annual wage base. Employees receiving NQDC oftentimes earn more than the Social Security tax annual wage base. If an employee already has earned compensation over the annual wage base, the 6.2% Social Security portion of FICA tax does not apply to the NQDC. Only the 1.45% Medicare tax and the 0.9% Additional Medicare tax apply when the annual wage base is exceeded. If FICA taxation occurred when payment was actually paid, payments could be made in a year where an employee has not exceeded their annual wage base. In that case, both the Social Security tax and Medicare tax portions would apply.

Rules to Ease Employer Administrative Burdens

There are a number of rules in the FICA tax regulations that give employers flexibility to administer the timing and calculation of FICA taxation, including the following:

- **Rule of Administrative Convenience:** Under this rule, if NQDC is subject to the special timing rule, an employer may treat the NQDC as being taken into account for FICA tax purposes on either (i) the date the NQDC is no longer subject to a substantial risk of forfeiture or (ii) any date after such date through December 31st of the same calendar year. However, if NQDC is treated as being taken into account for FICA tax purposes after the deferral date, any earnings on the NQDC through the date chosen are also subject to FICA tax.

- **Estimated Method:** This method permits an employer to make a reasonable estimate of the NQDC on the date on which the amount is required to be taken into account for FICA tax purposes and take that estimated amount into account as compensation paid by the employer and received by the employee on that date for withholding and depositing purposes. There are technical rules for making subsequent adjustments if the estimated amount is an overestimate or an underestimate.

- **Lag Method:** This method permits employers to withhold FICA tax up to three months after the date on which NQDC was required to be taken into account for FICA tax purposes. If an employer uses the lag method, FICA tax is based on the value of the NQDC at the time of withholding, including any income that may have accrued on the NQDC since the date on which the NQDC was required to be taken into account.

- **Reasonably Ascertainable Method:** This is a special rule for nonaccount balance plans. This rule permits an employer to delay subjecting NQDC to FICA tax until the amount deferred is considered “reasonably ascertainable,” which is defined as the first date (the resolution date) on which the amount, form, and beginning date of the NQDC are known, so that its present value can be computed. When the present value of NQDC becomes reasonably ascertainable, the present value amount is subject to FICA tax. Even before the resolution date, an employer may instead choose to subject the NQDC to FICA tax under the special timing rule.

For example, assume an employee earns a bonus in 2025 equal to 1% of the employer's profits for 2024. The bonus will be paid in a lump sum in 2027. The amount of the profits (and therefore the bonus) depends on the results of a company audit that will not be completed until 2026. Because the NQDC arrangement is a nonaccount balance plan, the employer is not required to take the bonus into account for FICA tax purposes until the results of the audit are completed in 2026 when they are reasonably ascertainable, even though payment would not be made until 2027. However, the employer could choose to take the bonus into account for FICA tax purposes in 2025 using the estimated method.

Proskauer Perspective

The administration of calculating and withholding FICA taxes with respect to NQDC is often more complex than employers may realize. It is critical for employers to understand how their NQDC programs operate and when the special timing rule applies and how its nuances can be used to their advantage. Given the complexities, however, errors may occur. Errors could result in IRS penalties, employees having to pay more FICA tax, and employees potentially having a private right of action against the employer (for example, see *Davidson v. Henkel*).

Proskauer's Compensation & Benefits team advises companies on resolving FICA tax issues. Please contact a member of our team with questions.

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