Managing Nonqualified Deferred Compensation Distributions: What Employers Need to Know

Nonqualified deferred compensation (NQDC) plans often are an important part of a company’s retirement benefits package for top executives. Not only can the plans be a powerful tool for generating additional retirement savings, they also can help highly compensated executives manage their tax liabilities throughout their careers. But while NQDC plans frequently are offered alongside qualified retirement plans, such as 401(k)s, they are subject to very different regulations than those qualified plans.

One of the biggest differences between NQDC plans and qualified plans comes when it’s time to distribute deferred compensation to participants. Even if the money is distributed after the participant’s retirement, the payments are not considered retirement income like a distribution from a 401(k) or a defined benefit plan. Instead, the distribution is considered supplemental wages, which must be reported on a Form W-2 Wage and Tax Statement rather than on the Form 1099-R used for retirement income.

As a result, NQDC distributions carry different tax requirements than retirement income. And recent changes in IRS regulations — such as the Medicare surtax on income above $200,000 and the mandatory maximum federal flat rate withholding on supplemental income over $1 million — have made those tax calculations more complex. Now, the timing of an NQDC deferral or distribution may affect tax calculations, based on whether a participant has reached the income thresholds for those tax rate changes in a given year.

To ensure the accuracy of those tax calculations and the proper timing of tax payments, employers must actively oversee the payout of NQDC distributions. After all, employers are the ones with access to all the information needed to perform the calculations, including details on the multiple sources of supplemental income — such as noncash fringe benefits — that an individual may be receiving. Fortunately, this process is similar to tasks that employers regularly perform — such as managing payroll, bonus payments or other supplemental income for their employees. There are just a handful of important considerations when calculating taxes on NQDC distributions and reporting those payments to the IRS.

This paper explains the key items to remember to manage your NQDC distributions properly. By following these guidelines, you can help ensure the plan retains the unique tax management and retirement savings advantages that make it such a valuable benefit for your participants and your company.
Understanding your responsibilities

For participants, one of the most appealing features of NQDC plans is the ability to defer compensation to manage their tax liability. But the payment of income taxes is simply delayed, not eliminated. It’s the employer’s responsibility to ensure that taxes are taken out at the right time and calculated properly for each participant to ensure the right amount is paid.

Here are five recommendations that can help employers manage that task:

1. **Know when to take out Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA) taxes**

   Within these plans, compensation is only considered deferred for income tax purposes. That means employers must ensure that Medicare and Social Security taxes are withheld from deferred compensation at the time the employee performs the services or when there is no longer substantial risk of forfeiture of the deferred amount (for example, when the money vests), whichever comes first.

   To calculate those taxes, think of it just like payroll. For a participant’s NQDC plan contribution:
   - Social Security is due only on the first $118,500 in earnings (in 2015).
   - Medicare tax is owed on a two-tiered rate: 1.45% of income up to $200,000 and .09% on all income above that level.
   - If the employer contribution vests upon distribution, then the employer and the participant may owe some FICA taxes at that time.
   - If there is no vesting schedule for employer contributions (i.e., employer contributions are credited to the participant’s NQDC account immediately), then those FICA taxes must be paid at the time of contribution.

   In all cases, it’s essential to keep track of vesting schedules (or lack thereof) to ensure the company pays those taxes at the right time.

   Failure to follow the rules for FICA withholding on deferred compensation can undermine the primary advantage of NQDC plans. For example, if FICA taxes are not paid up front or upon vesting, the IRS will seek to collect those taxes upon distribution of the money. At that point, FICA taxes will apply to both the original deferred amount and any subsequent earnings — resulting in a significantly higher tax burden for the participant and the company.

   Companies should work with their tax counsel and payroll provider to manage NQDC plans in compliance with FICA tax rules.

2. **Keep NQDC participants in your payroll system even after they’ve left the company**

   In some cases, plan rules allow participants to delay the start of distributions or receive money in installments that could extend 10 or 15 years beyond retirement. Because NQDC distributions are paid to participants as supplemental wages, it is easy to process those payments through the company’s payroll. Employers should keep NQDC participants in the payroll system for as long as they have elected to receive distributions.

   It’s also critical to maintain participants’ payroll information, such as payment records and participants’ addresses, in order to make state income tax decisions and deliver the correct tax forms to participants at the time of distribution. That information is also required for employers to claim their tax deductions for NQDC payments. NQDC deductions are taken when the money is distributed, not when it is deferred. This is unlike tax deductions for 401(k) contributions, which are taken at the time the employer contributes the money.
Employers should work with their payroll processor to ensure that participants who have left the company receive their distributions and that the company reports them to the IRS properly.

3. **Remember other sources of income when calculating taxes on distributions**

Federal income tax on deferred compensation is due when employers distribute money from an NQDC plan. However, supplemental wages of less than $1 million are taxed at a different rate than supplemental wages of more than $1 million.

Therefore, to properly calculate taxes on an NQDC distribution, employers must take into account the total amount of all supplemental income that a participant received during the calendar year. That income could include bonuses, commissions and other forms of supplemental wages like retroactive wage increases, noncash fringe benefits or income from exercising stock options.

Given that employers have a more complete picture of a participant’s total supplemental income, they are in the best position to report that amount to their payroll provider for proper tax withholding.

4. **Be aware of differences in state income tax requirements**

If NQDC participants receive a distribution while living in the same state they worked when deferrals were made, and that state collects income tax, those taxes are due on deferred compensation at the time of distribution. However, calculating state taxes can be more complicated if a participant has moved to another state after retirement and has chosen to receive either a lump-sum payment or distributions lasting less than 10 years.

In those cases, participants may still owe income tax to the state in which they originally earned the compensation, according to Title 4 U.S. Code § 114 – Limitation on State Income Taxation of Certain Pension Income. By contrast, participants that elect to receive distributions in installments lasting at least 10 years may owe state income tax in their state of residence.

Because of these variables, employers should work with their tax counsel and payroll provider to determine each participant’s state income tax obligations.

5. **Report distributions on the proper tax documents**

NQDC distributions to retired and other former employees are still considered wages from a tax standpoint, even when they are paid to participants who have left the company. That means companies must report federal income tax for those distributions on the W-2 form.

Some NQDC plans allow for nonemployee participants, such as members of the company’s board of directors, independent contractors or a participant’s beneficiary. NQDC distributions for these participants are reported on Form 1099-MISC. Employers are not required to withhold income taxes of nonemployees.
Getting support from your team

Employers are in the best position to oversee the timing, amount and tax calculations for NQDC distributions. However, they don’t have to manage the complexity of the process on their own.

In fact, there are two key team members who can help. First, and most important, is the company’s payroll provider. The second is the company’s NQDC plan recordkeeper.

The payroll provider — with input from the employer about a participant’s complete supplemental income picture — can handle the majority of the tax payment and reporting process, such as:

- Calculating FICA taxes with an eye on the different thresholds for Social Security and Medicare rates
- Tracking all supplemental wages and determining amounts in excess of $1 million
- Maintaining records in the payroll system for participants who have left the company through retirement or otherwise
- Paying taxes on distributions according to the participant’s W-4 elections
- Reporting those tax payments properly

The NQDC recordkeeper is responsible for providing the information about deferred compensation that the employer and the payroll provider need to do their jobs correctly. The recordkeeper maintains data on each participant’s deferrals and distribution elections, as well as vesting schedules for employer contributions, which means the recordkeeper can:

- Provide reporting of vested employer contributions to ensure the company has the data needed for FICA withholding
- Provide employers with correct gross distribution amounts when it’s time for participants to receive their distributions

By working closely with this team — and understanding each member’s role — employers will be in a stronger position to ensure their NQDC distributions are paid on time, in the right amount and with accurate calculations for tax liabilities. Should questions arise during any part of the process, they will know where to turn for an answer.

Remember that participants are relying on their NQDC plans to help them achieve important financial planning goals, such as providing additional retirement income and managing their taxes. Taking a careful approach to distributions will help employers deliver those advantages to their most valuable top executives.
Working together with your team

**Employer’s responsibilities:**
- Providing payroll provider and NQDC recordkeeper names of all participants
- Providing NQDC recordkeeper with vesting schedule for company contributions
- Providing payroll provider with participants’ total supplemental income information for proper tax calculation on distributions

**Payroll provider’s responsibilities:**
- Calculating and withholding FICA taxes on participant and employer contributions
- Calculating and withholding state and federal taxes from distributions
- Maintaining records in the payroll system for participants even after they’ve left the company
- Reporting tax payments on the proper forms

**NQDC recordkeeper’s responsibilities:**
- Recording participants’ deferral and distribution elections
- Monitoring vesting schedules for employer contributions (if applicable)
- Reporting gross distribution amounts to employer when it’s time for participants to receive distributions
Robust recordkeeping

Employers must be confident that their NQDC plan provider offers the highest level of recordkeeping and reporting capabilities to help them manage their plans effectively. These capabilities include careful tracking of participants’ deferral and distribution selections and monitoring of company contribution vesting schedules, as well as flexible reporting capabilities to help employers plan for and fulfill distribution responsibilities.

Bank of America Merrill Lynch offers one of the industry’s most robust recordkeeping and reporting systems, along with representatives who understand the important role that NQDC plans can play in a company’s overall benefits strategy. For more information about NQDC plans, contact your Bank of America Merrill Lynch representative. You also can call us at 877.902.8730, visit us online at benefitplans.baml.com or email us at benefitplans@baml.com.