EMPLOYEE TAX REPORTING (FORM W-2)

Amounts deferred by employees, or amounts contributed by employers, to nonqualified deferred compensation plans are not subject to income taxes until benefit payments are considered received. Employee deferrals are subject to FICA taxes (Social Security and Medicare) and FUTA (Federal Unemployment) taxes when the deferral occurs. Employer contributions are subject to FICA and FUTA taxes when the contributions are no longer subject to a substantial risk of forfeiture, normally when vesting in the account occurs.

WAGE REPORTING

Since nonqualified employee deferrals and employer contributions are not subject to income taxes, these amounts should not be included in amounts reported in W-2, Box 1, Wages, Tips, and Other Compensation. Most states follow the federal rules for income tax withholding. Check with your state for any differences from federal rules.

FICA, FUTA, AND STATE UNEMPLOYMENT TAX REPORTING

Employee deferrals into nonqualified deferred compensation plans are subject to FICA and FUTA taxes currently, as if the employee had received the compensation. The employer must withhold these taxes and pay any employer taxes at the later of:

- When the services are performed.
- When the employee no longer has a substantial risk of forfeiting the deferred compensation. This usually occurs when the employer contributions become vested.

The calculation of these taxes on employer contributions depends on the vesting schedules used:

- If the employee is immediately 100-percent vested, FICA and FUTA taxes are due when employer contributions are made to the participant's account.
PAYROLL TAX REPORTING FOR CONTRIBUTIONS TO NQDC DEFERRED COMPENSATION PLANS

- For accounts that are not 100-percent vested, at the end of each year, the employer must calculate the change in the employee's vested portion from the prior year. FICA and FUTA taxes are due at that time on the increase in the vested amount. If, due to investment losses in the participant's account, the vested account balance is lower than the prior year's vested balance, the participant should not be refunded FICA taxes already paid. In this circumstance, however, FICA and FUTA taxes will not become due in the future until the new vested balance exceeds the original amount on which tax had already been paid. Once the employee becomes 100-percent vested in their employer contribution account, FICA and FUTA taxes are due only on additional vested employer contributions to the account, not on any earnings in the account.

Social Security wages should be reported in Box 3 (up to the wage base minimum), and Social Security taxes withheld should be reported in Box 4. Medicare wages should be reported in Box 5, with Medicare taxes withheld reported in Box 6.

Any Social Security or Medicare wages reported in Box 3 or Box 5 related to services performed in prior years should be reported in Box 11, Nonqualified Plans. This would include changes in vested amounts in the employer contribution account that are related to prior year's contributions. Amounts in Box 3 or Box 5 that are related to current year services, either employee deferrals or employer contributions, should not be reported in Box 11.

Most states follow federal rules for unemployment taxes. Check with your state for any differences.

INDEPENDENT CONTRACTOR TAX REPORTING (FORM 1099)
No income tax or self-employment (SECA) taxes are due on deferrals or employer contributions into the plan at the time of deferral. Any distributions from the plan to the participant are reported on Form 1099 in the tax year of distribution, and all taxes are paid at that time.

CODE SECTION 409A REPORTING (W-2 AND 1099 MISC) AND NOTICE 2008-115
Section 409A of the Internal Revenue Code mandates employer reporting of certain information related to deferred compensation plans. Under Section 409A, employers are required to report the amount of compensation deferred for each plan participant and also report any amounts deferred that are in violation Section 409A. For employee participants, on Form W-2, the IRS has specified Code Y for reporting deferral amounts and Code Z for reporting amounts taxable due to plan violations. For nonemployee participants, on Form 1099 MISC, the IRS has specified Box 15a to report deferred amounts and Box 15b to report amounts taxable due to plan violations.

The Internal Revenue Service issued Notice 2008-115 detailing W-2 reporting and 1099 MISC reporting requirements for employers with nonqualified deferred compensation arrangements.

- The IRS has suspended the reporting requirements for W-2 Code Y and 1099 MISC Box 15a (deferral) reporting for the 2008 and 2009 tax years.
- For any amounts subject to taxation due to a violation of Section 409A, the IRS is mandating W-2, Box 12 Code Z and 1099 MISC Box 15b reporting. The notice specifies the mechanics of reporting these amounts.

In order to avoid Code Z reporting and participant tax penalties, employers should carefully scrutinize all deferred compensation arrangements to ensure they are in compliance with Section 409A.