Sponsoring a Non-Qualified Deferred Compensation Plan? Don't Forget the FICA Tax!

Evan Giller

The Federal Insurance Contributions Act, better known as FICA, is the statute that imposes a tax on compensation to fund Social Security (under the Old Age, Survivors and Disability Program or “OASDI”) and Medicare’s Hospital Insurance (“HI”) Program. Under the OASDI component, employers and employees each pay the current tax rate of 6.2% of wages on a maximum of $128,400 of compensation (the “social security wage base” in 2018). The Medicare program’s tax rate is 1.45% paid by employers and employees, but with no maximum wage limit. In addition, employees who earn more than $200,000 (for taxpayers filing as single; $250,000 for joint filers) must pay an additional 0.9% Medicare tax. The employer does not pay this additional tax.

When an employer pays wages to its employees, the employee portion of the FICA tax is subject to withholding at the time the compensation is paid. An employer’s contributions to a non-qualified deferred compensation (“NQDC”) plan are also subject to FICA withholding, but they are covered under some special rules. NQDC plans include any plans that provide for the deferral of compensation unless specifically excluded under the Internal Revenue Code (the “Code”). Examples of plans under which employer contributions are not subject to FICA tax include plans that are under Code sections 401(a), 403(b), or 457(b) (for governmental, but not tax-exempt employers).

The Code provides a special timing rule for FICA tax on contributions to an NQDC: such contributions are subject to FICA tax at the time that the services to which the deferrals relate are performed, or, if later, when the deferrals are no longer subject to a substantial risk of forfeiture (that is, when they are fully vested). That means that if the contribution is vested when it is made to the plan, FICA tax should be withheld at that time. If FICA tax is timely withheld, then no FICA tax is due when the employee takes a distribution from that plan. This can result in a significant benefit for the employee, because it means that none of the earnings on the account will be subject to FICA tax.
On the other hand, if FICA tax is not withheld at the time the contribution vests, it must be withheld at the
time that the employee takes a distribution from the plan. If that is the case, the FICA tax will be calculated
on the earnings in addition to the contributions. This will likely cause both the employee and the employer to
pay additional FICA taxes. While no additional OASDI tax will be due if the employee’s income in the year
of the distribution is in excess of the social security wage base, additional Medicare tax would still be due
because there is no cap on the amount of compensation for the Medicare component of FICA tax. And if the
employee’s wages are over the threshold for the additional Medicare tax, the employee will owe even more
FICA tax. We are aware of at least one lawsuit brought by an employee against an employer for failing to
withhold FICA tax when contributions were made to an NQDC plan, which resulted in higher taxes for the
employee at the time the distribution was taken from the plan.

Best Practices for Employers Sponsoring NQDC Plans

• Review your payroll practices to determine whether FICA tax is being withheld at the time that
  contributions to the plan vest. In our experience, it is not unusual to find FICA tax properly withheld on
  employee elective deferrals to the NQDC plan, but that the FICA withholding is overlooked when the
  contributions are from the employer. This is because employer contributions often do not go through
  payroll and are outside of the normal withholding process.

• Review your plan document to determine if there is any specific language governing the payment of
  FICA tax. It is better to have language in the plan that does not require you to pay the FICA taxes when
  the contributions vest, so that if you inadvertently fail to do so you are not in violation of the plan and
  potentially liable to participants for any increase in their FICA tax at distribution.

• If you determine that FICA tax has not been withheld properly for previous periods, you will likely want
  to correct the error so that FICA will not be due on distribution. The IRS allows you to correct the failure
  to file the correct amount of FICA on an interest free basis for any tax year that is still open (generally,
  three years from the date that the original returns were due). You will need to file a corrected FICA tax
  return, and issue a corrected W-2 to affected employees. A more limited correction period applies to the
  additional Medicare tax: it can be corrected on an interest free basis only until the end of the calendar
  year of the failure. If the employee had earned wages in excess of the social security wage base in the
  year being corrected, there will not be any additional FICA tax due for the OASDI component. However,
  there will be tax due under FICA’s Medicare component.

• For tax years that cannot be corrected because they are closed, you will want to determine what portion
  of the account under the NQDC plan will be subject to FICA tax upon distribution from the plan, and
  make certain to have controls in place to withhold properly when the participants take withdrawals from
  their accounts.
New Contraceptive Regulations Part 2 – Interaction with California Law and Recent Challenges

Katrina Veldkamp

In our October 2017 Benefits News¹, we described the new contraceptive regulations that provide employers exemptions from providing no-cost contraceptive coverage due to religious or moral convictions. Now that the regulations have been in effect for two months, we can explore legal challenges and how the regulations interact with state law. For California employers, state law may further limit which employers can take advantage of the exemptions.

Interaction with California Law

California passed the Contraceptive Coverage Equity Act in 2014, which requires health plans and policies regulated by state insurance regulators, including insured health plans and Medi-Cal managed care plans, to provide no-cost coverage for all FDA-approved contraceptives for women. These rules continue to be in effect, so many women covered by California insured plans will still receive no-cost contraceptive coverage, despite the new federal regulations. Self-insured plans are not subject to California's mandate, so some women enrolled in self-insured plans sponsored by objecting employers may lose coverage as a result of the new regulations.

Certain religious employers may be exempt from California’s contraceptive mandate if:

(i) the employer’s purpose is the inculcation of religious values,
(ii) the employer primarily employs persons who share its religious tenets,
(iii) the employer serves primarily persons who share its religious tenets, and
(iv) the employer is a nonprofit organization that is a church, a church’s integrated auxiliary, a convention or association of churches, or a religious order.

These conditions are more stringent than the requirements for religious exemption under the new federal regulations. Religious employers invoking the state exemption must also provide notice to prospective enrollees listing the contraceptive health services the employer does not cover for religious reasons.

California does not have an exemption for moral conviction. Therefore, some plans will not be able to claim exemption from contraceptive coverage based on moral conviction without violating state law.

Implementation of New Regulations

At least one employer’s attempt to utilize the new regulations has come under public scrutiny. The University of Notre Dame announced that it would no longer provide no-cost birth control coverage to students and employees in early November. However, after lawsuits were filed by plaintiffs that included three of the university’s students, Notre Dame decided that it would continue to offer no-cost contraceptive coverage to employees and students via a plan that is funded and administered independently of the university.

It is not clear how many other employers will take advantage of the new regulations. Whether or not employers do use the new exemptions will not necessarily be public knowledge, since there is no longer a filing requirement associated with the exemptions.

Challenges to New Regulations

The California and Massachusetts Attorneys General, as well as the American Civil Liberties Union, the National Women’s Law Center, and the Americans United for Separation of Church and State have already filed lawsuits challenging these new regulations.

The lawsuits allege that the regulations violate both the Establishment Clause of the First Amendment and the Equal Protection Clause of the Fifth Amendment by authorizing and promoting discrimination against women seeking reproductive health care. California’s suit also alleges that because there is no longer a certification requirement or an automatic means for a woman to receive contraceptive coverage (e.g., from a third-party administrator or insurer) when her employer opts out, the state will face an additional administrative and fiscal burden on state-funded programs through which women may seek contraceptive coverage.

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**Building Blocks of ERISA**

**What is a QSLOB?**

This month’s Building Block provides basic information about “qualified separate lines of business” (QSLOB).

Click here to view this month’s Building Blocks of ERISA

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**Firm News & Events:**

**Sherrie Boutwell and Evan Giller's Article Published in Tax Notes**

The article, *Proposed Changes for the Operation of Employee Annuities*, was published in Volume 157, Number 8 of *Tax Notes*. It identifies several issues in the operation section of 403(b) plans and proposes changes that would ease the administrative burden on the IRS as well as plan sponsors, simplify the correction of errors, and increase flexibility in section 403(b) plan operation.
Sherrie Boutwell's Article Published in ABA's *Law Practice Today*

Sherrie's article, *Be the Missing Piece: Marketing Your Niche Law Practice*, was published in *Law Practice Today*. Follow the link to read the full article: http://www.lawpracticetoday.org/article/marketing-niche-law-practice/

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**Holiday Hours for Boutwell Fay LLP**

Please be advised that Boutwell Fay LLP will be closed on Monday, December 25th. We will resume normal business hours on Tuesday, December 26th. We will also be closed on Monday, January 1st. We will resume normal business hours on Tuesday, January 2nd.

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