

PART 10—ADMINISTRATIVE PRACTICES AND PROCEDURES

6. The authority citation for 21 CFR part 10 continues to read as follows:

Authority: Secs. 201–903 of the Federal Food, Drug, and Cosmetic Act (21 U.S.C. 321–394); 21 U.S.C. 41–50, 141–149, 467f, 679, 821, 1034; secs. 2, 351, 354, 361 of the Public Health Service Act (42 U.S.C. 201, 262, 263b, 264); secs. 2–12 of the Fair Packaging and Labeling Act (15 U.S.C. 1451–1461); 5 U.S.C. 551–558, 701–721; 28 U.S.C. 2112.

Subpart C [Removed]

7. Subpart C consisting of §§ 10.200 through 10.206 is removed.

PART 50—PROTECTION OF HUMAN SUBJECTS

8. The authority citation for 21 CFR part 50 continues to read as follows:

Authority: Secs. 201, 406, 408, 409, 502, 503, 505, 506, 507, 510, 513–516, 518–520, 701, 721, 801 of the Federal Food, Drug, and Cosmetic Act (21 U.S.C. 321, 346, 346a, 348, 352, 353, 355, 356, 357, 360, 360c–360f, 360h–360j, 371, 379e, 381); secs. 215, 301, 351, 354–360F of the Public Health Service Act (42 U.S.C. 216, 241, 262, 263b–263n).

§ 50.3 [Amended]

9. Section 50.3 *Definitions* is amended by removing paragraph (j), and redesignating paragraphs (k), (l), and (m) as paragraphs (j), (k), and (l), respectively.

§ 50.21 [Removed]

10. Section 50.21 *Effective date* is removed from subpart B.

Subpart C [Removed]

11. Subpart C consisting of §§ 50.40 through 50.48 is removed.

Dated: January 18, 1996.

William K. Hubbard,

Associate Commissioner for Policy Coordination.

[FR Doc. 96–1142 Filed 1–24–96; 8:45 am]

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 31

[EE–142–87]

RIN 1545–AF97

FICA Taxation of Amounts Under Employee Benefit Plans

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations under section 3121(v)(2) of the Internal Revenue Code of 1986, relating to when amounts deferred under or paid from certain nonqualified deferred compensation plans are taken into account as “wages” for purposes of the employment taxes imposed by the Federal Insurance Contributions Act (FICA). The regulations provide guidance to taxpayers who must comply with section 3121(v)(2), which was added to the Code by section 324 of the Social Security Amendments of 1983.

DATES: Written comments and requests for a public hearing must be received by April 24, 1996.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (EE–142–87), room 5228, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (EE–142–87), Courier’s Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: David N. Pardys, (202) 622–4606 (not a toll-free number), concerning the regulations, and Michael Slaughter, (202) 622–7190 (not a toll-free number), concerning submissions.

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Employment Tax Regulations (26 CFR part 31) under section 3121(v)(2) of the Internal Revenue Code of 1986 (the “Code”) relating to the employment tax treatment of amounts deferred under or paid from certain nonqualified deferred compensation plans. These amendments are proposed to reflect the statutory changes made by section 324 of the Social Security Amendments of 1983 (the “1983 Amendments”), which added section 3121(v)(2) to the Code, and section 2662(f)(2) of the Deficit Reduction Act of 1984 (DEFRA), which amended section 324 of the 1983 Amendments.

Explanation of Provisions

Sections 3101 and 3111 of the Code impose FICA tax on employees and employers, respectively. FICA tax consists of the Old-Age, Survivors, and Disability Insurance (OASDI) tax and the Hospital Insurance (HI) tax, and generally is computed as a percentage of wages (as defined in section 3121(a)) with respect to employment. Subject to specific exceptions, section 3121(a)

defines “wages” as all remuneration for employment. Existing regulations (§ 31.3121(a)-2(a)) provide that FICA tax is imposed at the time the remuneration is actually or constructively paid.

Prior to the 1983 Amendments, benefits under a nonqualified deferred compensation plan generally were wages subject to FICA tax at the time they were actually or constructively paid, unless certain retirement-related exclusions applied. These exceptions (former section 3121(a)(2)(A), (a)(3), and (a)(13)(A)(iii)) were repealed by the 1983 Amendments. Thus, under the 1983 Amendments, which generally apply to remuneration paid after December 31, 1983, “retirement” payments are no longer excluded from wages. Instead, the 1983 Amendments added section 3121(v)(2), which provides a special timing rule for wages (within the meaning of section 3121(a)) that constitute an amount deferred under a nonqualified deferred compensation plan.¹

Under section 3121(v)(2)(A), any “amount deferred” under a nonqualified deferred compensation plan must be taken into account as wages for FICA purposes as of the later of (1) when the services are performed, or (2) when there is no substantial risk of forfeiture of the rights to such amount. This special timing rule may result in imposition of FICA tax before the benefit payments under the plan begin, thus accelerating the imposition of FICA tax on benefits under a nonqualified deferred compensation plan.

Section 3121(v)(2)(B) provides a special exclusion (the “nonduplication rule”) that prevents double taxation. Once an amount deferred under a nonqualified deferred compensation plan is “taken into account” as wages under the special timing rule, the nonduplication rule provides that neither that amount nor the “income attributable to that amount” is again treated as FICA wages. Thus, benefit payments under a nonqualified deferred compensation plan are not subject to FICA tax when actually or constructively paid (i.e., under the general timing rule for wage inclusion) if the benefit payments consist of amounts deferred under the plan that were previously taken into account as FICA wages under the special timing rule plus the attributable income.

¹ The 1983 Amendments did not amend the definition of net earnings from self-employment under section 1402(a) of the Code or the timing of the tax on self-employment income under section 1401 of the Code. Accordingly, the special timing rule under section 3121(v)(2) does not apply to nonqualified deferred compensation that constitutes net earnings from self-employment.

Conversely, benefits under a nonqualified plan are subject to FICA tax when actually or constructively paid to the extent the benefits relate to an amount deferred that was not previously taken into account under the special timing rule.

Section 3121(a)(1) imposes a dollar limit on the annual amount of wages that is subject to the OASDI portion of FICA tax. Section 13207 of the Omnibus Budget Reconciliation Act of 1993 repealed the dollar limit on annual wages subject to the HI portion of FICA tax, effective for 1994 and later years.

Overview of Regulations

In contrast to most FICA wages, nonqualified deferred compensation is subject to FICA tax not when paid, but earlier—generally when the related services are performed. (FICA taxation is deferred if the compensation is subject to a substantial risk of forfeiture.) A benefit that was subject to FICA tax at this earlier date generally is not subject to tax again when paid to the participant. Applying these statutory rules often requires difficult valuations of future benefits.

Recognizing the practical administrative problems that can be encountered by taxpayers in this area, the proposed regulations are designed to be workable, to minimize complexity, and to provide appropriate flexibility for taxpayers. For example, the regulations:

- *Permit use of any reasonable assumptions.* For the purpose of calculating the present value of a benefit earned in a given year (an “amount deferred” under the statute), the regulations do not prescribe specific actuarial assumptions or methods that must be used. Instead, the regulations simply allow taxpayers to determine present value using any reasonable actuarial assumptions and methods.

- *Establish a reasonably ascertainable rule.* In some cases, uncertainties pertaining to future benefits make it especially difficult to determine the present value of a benefit (for example, where a benefit can fluctuate depending on the varying amount of a qualified plan benefit). In such cases, under the regulations, the present value of the benefit need not be included in FICA wages (“taken into account”) until it becomes reasonably ascertainable.

- *Provide flexibility with respect to withholding.* The regulations ease the administrative burdens of withholding by permitting payors to delay the inclusion of any deferred compensation in wages until the end of the year. In addition, where amounts deferred cannot be readily calculated by year-

end, the payor may either estimate the amounts (and make later adjustments without interest or penalties) or postpone the inclusion in wages until the first quarter of the following year.

- *Provide reasonable, good faith transition relief.* The regulations provide transition relief for actions taken before the effective date of the regulations based on a reasonable, good faith interpretation of the statute.

Structure of the Regulations

The regulations generally consist of three parts. The first part of the regulations, paragraphs (a) and (b), describes the special timing rule and the related nonduplication rule of section 3121(v)(2), defines a nonqualified deferred compensation plan, and specifies the types of benefits that are subject to the special timing rule. The second part of the regulations, paragraphs (c), (d), and (e), describes how the special timing rule and the nonduplication rule operate. In the remainder of the regulations, paragraph (f) provides withholding rules, paragraph (g) contains the regulatory effective date and the transition rules, and § 31.3121(v)-2 sets forth the statutory effective dates.

The most significant items included in these regulations are discussed below.

Definition of Nonqualified Deferred Compensation Plan

In general. Section 3121(v)(2)(C) of the Code defines a “nonqualified deferred compensation plan” as any plan or arrangement established and maintained by an employer for one or more of its employees that provides for the deferral of compensation, other than a plan described in section 3121(a)(5) (such as qualified plans and certain other plans and arrangements). The regulations provide that a “nonqualified deferred compensation plan” is a plan that is “established” by an employer for one or more of its employees, and that provides for the “deferral of compensation.” A plan may constitute a nonqualified deferred compensation plan under section 3121(v)(2), regardless of whether it is an employee benefit plan under section 3(3) of the Employee Retirement Income Security Act of 1974, as amended (ERISA), whether deferrals under the plan are made pursuant to the employee’s election, or whether the amounts deferred are treated as deferred for income tax purposes.

Requirement that the plan be established. The regulations provide that an amount deferred may not be taken into account as FICA wages before

the plan is established, and that a plan is considered “established” on the latest of the date on which the plan is adopted, the date on which it is effective, or the date on which its material terms are set forth in writing. Transition relief is provided for unwritten plans that were adopted and effective before March 25, 1996. Such a plan is treated as established with respect to an employee as of the later of the date on which it was adopted or became effective, provided that it is set forth in writing within six months after publication of the final regulations.

Requirement that the plan provide for the deferral of compensation. In general, the regulations specify that a plan provides for the “deferral of compensation” only if an employee has a legally binding right to compensation that has not been actually or constructively received and that is payable in a later year. However, the regulations provide that there is no “deferral of compensation” merely because compensation is paid after the last day of a calendar year pursuant to the employer’s customary payment scheme for compensation. Thus, if one week of an employer’s customary two-week payroll period falls in one year and the second week of the period falls in the next year, the compensation paid at the end of the two-week period on account of the services rendered in the first week is not considered deferred compensation and is not subject to the special timing rule.

The regulations also provide a rule of administrative convenience for “short-term” deferrals. Under this rule, an employer may choose to treat an amount that is deferred from one calendar year to a date that is no more than a brief period of time after the end of that calendar year as if it were subject to the general timing rule (i.e., treated as FICA wages when actually or constructively paid) instead of the special timing rule.

Plans, arrangements, and benefits that do not provide for the deferral of compensation. Consistent with the legislative history relating to section 3121(v)(2), certain types of plans, arrangements, and benefits are not covered by the special timing rule of section 3121(v)(2), even though they may be viewed in other contexts as providing for the deferral of compensation.

The regulations provide that stock options, stock appreciation rights (described in Revenue Ruling 80-300, 1980-2 C.B. 165), and certain other stock-related rights do not provide for the deferral of compensation for FICA tax purposes, even though there may be no amount recognized for income tax

purposes until after the calendar year of grant. In contrast, the regulations specify that a "phantom" stock plan that awards a right to a fixed payment equal to the value of a specified number of shares of employer stock may be treated as providing benefits that result from the deferral of compensation for purposes of section 3121(v)(2). Such a plan typically involves the employer's unfunded, unsecured promise to pay compensation in the future that is measured by the value of a specified number of shares of stock on the date of payment. A phantom stock plan is a nonqualified deferred compensation plan under which the earnings portion of the future compensation is based on the change in the value of the employer's stock, rather than, for example, an equity mutual fund or a specified rate of interest.

The regulations provide that certain welfare benefits, including vacation benefits, sick leave, compensatory time, disability pay, severance pay, and death benefits, do not result from the deferral of compensation for FICA purposes. Neither section 3121(v) nor the legislative history relating to section 3121(v) indicates that Congress intended to modify the long-established FICA tax treatment of such benefits.

Nothing in the regulations is intended to determine the amount or the timing of an employer's deduction for contributions to any type of welfare benefit plan, including a plan that provides severance benefits. Similarly, although the regulations include a severance pay plan under a heading titled "certain welfare benefits," no inference is intended that a severance plan is treated as a welfare benefit plan under any other section of the Code.

The regulations provide that certain other payments are not subject to the special timing rule of section 3121(v)(2). In describing the Senate Finance Committee proposal on golden parachutes, the Conference Report to DEFRA states that "payments under golden parachute contracts, like *termination pay*, are to be subject to FICA taxes when paid." (Emphasis added.) Conf. Rpt. 98-861, p. 85. Consistent with this legislative history, the regulations provide that excess golden parachute payments and window benefits do not result from the deferral of compensation and, thus, are not subject to the special timing rule.

Similarly, certain benefits established within 12 months prior to an employee's termination of employment are treated as termination pay that is not subject to the special timing rule. This provision is intended to ensure that termination pay is subject to FICA tax

when it is paid, even where there is no explicit agreement to terminate employment. The regulations provide that a benefit established within 12 months prior to an employee's termination of employment is treated as termination pay only if the facts and circumstances indicate that the benefit was provided in contemplation of the employee's impending termination of employment.

Benefits established after termination of employment also do not result from the deferral of compensation. In addition, there is no deferral of compensation where the facts and circumstances indicate that the compensation is paid for current services.

Determination of the Amount Deferred

The "amount deferred" under a nonqualified deferred compensation plan for a period is the amount that must be taken into account as wages for that period under the special timing rule of section 3121(v)(2)(A). Under the regulations, the manner in which the amount deferred for a period is determined depends upon whether the nonqualified deferred compensation plan is an account balance plan or a nonaccount balance plan.

Account balance plans. The regulations provide that, if benefits for an employee are provided under an account balance plan, the amount deferred equals the principal amount credited to the employee's account for the period, increased or decreased by any income attributable to that amount through the date such amount is required to be taken into account as FICA wages. For purposes of the regulations, a nonqualified deferred compensation plan is an "account balance plan" only if, under the terms of the plan, (1) principal amounts are credited to an individual account for an employee, (2) the income attributable to the principal amounts is credited (or debited) to the individual account, and (3) the benefits payable to the employee are based solely on the balance credited to the individual account.

Nonaccount balance plans. If a nonqualified deferred compensation plan is not an account balance plan, the regulations provide that the amount deferred for a period equals the present value of the additional future payments to which the employee has obtained a legally binding right during that period. For purposes of determining present value, the regulations give employers the flexibility to use any reasonable actuarial assumptions and methods.

"Taken Into Account" Defined

An amount deferred is treated as "taken into account" when it is included in computing the amount of FICA wages, but only if any additional FICA tax for the year (including any interest and penalties due if the payment is late) that results from the inclusion is actually paid before the period of limitations is closed for the year. For years before 1994, the amount deferred is treated as taken into account even if its inclusion does not result in any additional FICA tax liability. For example, if, in 1993, an employee participating in a nonqualified deferred compensation plan had other wages that were at least equal to the applicable OASDI and HI wage bases for 1993, the inclusion in wages of an amount deferred would not have resulted in any additional FICA tax liability for that year. Nonetheless, the amount deferred would have been considered taken into account as wages for purposes of section 3121(v)(2).

Nonduplication Rule

As noted above, under the nonduplication rule of section 3121(v)(2)(B), if an amount deferred is taken into account as wages under the special timing rule, neither the amount deferred nor the related income is included in FICA wages when benefits attributable to that amount are paid.

If an amount deferred is not taken into account as wages under the special timing rule, then benefits attributable to that amount are required to be included as wages when actually or constructively paid in accordance with the general timing rule. For this purpose, a Form W-2 (Wage and Tax Statement) for an earlier (post-1993) year showing FICA wages in excess of taxable income for the year and an explanation showing that the payment is attributable to the excess could, for example, be used by a taxpayer to demonstrate that the payment is attributable to an amount deferred that was previously taken into account as wages under the special timing rule. If a payment is attributable to an amount deferred only a portion of which was previously taken into account, the portion of the payment that is excluded from wages pursuant to the nonduplication rule and the portion that is included in wages under the general timing rule are generally determined on a pro rata basis.

Income Attributable to an Amount Deferred

Account balance plans. In the case of an account balance plan, the regulations

define "income attributable to the amount taken into account" as any increase or decrease in the amount credited to an employee's account that, under the terms of the plan, is attributable to an amount previously taken into account, but only if the income is based on a rate of return that does not exceed either (1) the actual rate of return on a predetermined actual investment, or (2) if no predetermined actual investment has been specified, a reasonable rate of interest. If the rate of return credited under the plan is not reasonable, the income attributable to the amount taken into account is limited to the mid-term applicable federal rate (as defined in section 1274(d)) for the first day of the calendar year (the "AFR"). However, in the case of a predetermined actual investment, if the actual rate of return on that investment is lower than the AFR, the income attributable to the amount taken into account is limited to the that actual rate of return. Any excess of the income credited under the plan over the income determined using the AFR (or the actual rate of return, if applicable) is considered an additional amount deferred in the year credited, and is required to be taken into account in that year under the special timing rule.

Nonaccount balance plans. In the case of a nonaccount balance plan, the regulations define the "income attributable to the amount taken into account" as the increase, due solely to the passage of time, in the present value of any future payments to which the employee has obtained a legally binding right, determined using reasonable actuarial assumptions and methods. Thus, if an amount deferred for a period is determined using a reasonable interest rate and other reasonable actuarial assumptions and methods, and that amount is taken into account when required under the special timing rule, none of the future payments attributable to that amount will be subject to FICA tax when paid.

If any actuarial assumption or method is not reasonable, then the income attributable to the amount taken into account is limited to the income that would result from the application of the AFR and, if applicable, the applicable mortality table under section 417(e) of the Code, both determined as of January 1 of the calendar year in which the amount was taken into account. If the present value of the future benefit payments (determined using the AFR and the section 417(e) mortality table) exceeds the amount taken into account plus attributable income (as limited by using those same assumptions), a portion of each benefit payment will be

excluded from wages under the nonduplication rule and a portion will be included in wages under the general timing rule.

Time Amounts Deferred Are Taken Into Account

Under the special timing rule, an amount deferred is required to be taken into account as FICA wages as of the later of when (1) the services are performed or (2) the right to the amount deferred is no longer subject to a substantial risk of forfeiture. However, the regulations allow an amount deferred to be taken into account at a later date if all or a portion of the amount deferred is not "reasonably ascertainable" until that later date. In addition, consistent with Notice 94-96, 1994-2 C.B. 564, the regulations provide that no amount deferred under a nonqualified deferred compensation plan may be taken into account as FICA wages before the plan is established.

Services creating the right to an amount deferred. The regulations provide that services creating the right to an amount deferred are considered performed when, under the terms of the plan and the relevant facts and circumstances, the employee has performed all of the services necessary to obtain a legally binding right to the amount deferred, disregarding any substantial risk of forfeiture.

Substantial risk of forfeiture. In accordance with the legislative history relating to section 3121(v)(2), the regulations define a substantial risk of forfeiture for purposes of the special timing rule of section 3121(v)(2) in accordance with the principles of section 83. Thus, in general, whether or not a substantial risk of forfeiture exists will depend on the facts and circumstances. See § 1.83-3(c) of the regulations.

Amounts deferred that are not reasonably ascertainable. A number of commentators have emphasized the problems that would arise if certain amounts deferred were required to be taken into account while still highly uncertain and subject to fluctuation. For example, under a nonaccount balance plan, an amount deferred (and taken into account as wages) for a year might decrease, or even be eliminated, in a later year on account of changes in the limitations on contributions and benefits imposed on qualified plans under section 401(a)(17) or 415, the amount of an employee's future compensation, the date on which payments commence, or the form of benefit elected by an employee. (The possibility that benefits may decrease because of these contingencies does not,

however, generally cause the benefits to be subject to a substantial risk of forfeiture within the meaning of section 83 or, therefore, section 3121(v)(2).)

Because these types of contingencies generally cannot be predicted with a high degree of certainty for an individual employee, the regulations provide that an amount deferred under a nonaccount balance plan is not required to be taken into account as wages until the earliest date on which the amount deferred is reasonably ascertainable (the "resolution date"). An amount deferred is "reasonably ascertainable" when there are no actuarial or other assumptions needed to determine the amount deferred, other than interest, mortality, or cost-of-living assumptions.

Thus, for example, if assumptions relating to qualified plan offset variables, future pay, or the time or form of benefit payments are needed to determine the amount deferred at the time the services are performed (or, if applicable, when the benefit is no longer subject to a substantial risk of forfeiture), the employer may choose to delay taking the amount deferred into account until the only assumptions needed to determine the amount deferred are those relating to interest, mortality, and cost of living. An employer may choose to use this rule for all of an amount deferred, even if only a portion of the amount deferred is not reasonably ascertainable. For example, if the only portion of an amount deferred that is not reasonably ascertainable is an early retirement subsidy, no portion of the amount deferred is required to be taken into account until the contingency relating to early retirement has been resolved.

On the resolution date, the amount deferred and the related income must be determined in accordance with the rules that generally apply to determine those amounts under a nonaccount balance plan. The rules that generally apply to determine whether an amount deferred is actually taken into account as wages, and the consequences if it is not so taken into account, also apply.

An employer may choose to take an amount into account on a date (the "early inclusion date") that precedes the resolution date. However, if the amount taken into account at the early inclusion date (plus related income through the resolution date) is less than the resolution date amount, then the employer must "true up" by taking the balance of the resolution date amount into account as of the resolution date. If the amount taken into account at the early inclusion date (plus related income) exceeds the resolution date

amount, the taxpayer may claim a refund or credit, in accordance with sections 6402 and 6413, for any overpayment of FICA tax in open years.

Rule of administrative convenience. The regulations provide that an employer may treat an amount deferred as required to be taken into account on a date that is later than, but within the same calendar year as, the actual date on which the amount deferred is otherwise required to be taken into account. Thus, for example, if an employee obtains a legally binding right to an amount deferred mid-year, the employer may take the amount deferred into account on any later date within the same year (e.g., December 31).

Withholding

For purposes of withholding and depositing FICA tax, an amount deferred under a nonqualified deferred compensation plan generally is treated as wages paid by the employer and received by the employee at the time it is taken into account under section 3121(v)(2) and these regulations. However, in certain situations, the employer may be unable to readily calculate the amount deferred for a year by December 31 of that year. The regulations provide two alternative methods for withholding and depositing FICA tax in these situations.

Under the "estimated method," an employer may treat a reasonably estimated amount as wages paid on the last day of the calendar year (the "first year"). If the employer underestimates the amount deferred that should have been taken into account and, therefore, deposits less FICA tax than the amount due, the employer may choose to treat the shortfall as wages either in the first year or in the first quarter of the next year. If the employer treats the shortfall as wages in the first year and the shortfall was not included on the employee's Form W-2, the employer must issue Form W-2c. In addition, the employer must correct the information on the Form 941 for the last quarter of the first year. In such a case, the shortfall will not be considered a late deposit subject to penalty if it is deposited by the employer's first regular deposit date following the first quarter of the next year. Conversely, if the employer overestimates the amount deferred that should have been taken into account as wages on the last day of the year, the employer may claim a refund or credit in accordance with sections 6402 and 6413.

Under the second alternative method, the "lag method," an employer may calculate the end-of-year amount deferred on any date in the first quarter

of the next calendar year. The amount deferred will be treated as wages on that date, and the amount deferred that would otherwise have been taken into account on the last day of the year must be increased by income through the date on which the amount is taken into account.

Effective Date of the Regulations

Proposed effective date. These regulations generally are proposed to be effective for amounts deferred and benefits paid on or after January 1, 1997.

Consistent with Notice 94-96, the regulations confirm that, in determining FICA tax liability for amounts deferred and benefits paid before the effective date of the regulations, an employer may rely on a reasonable, good faith interpretation of section 3121(v)(2) (which, of course, includes a determination in accordance with the regulations). Thus, for any open year, an employer can choose to adjust its FICA tax determination in a manner consistent with the regulations. For example, if an employer took into account an amount deferred under a nonaccount balance plan in 1994, but that amount was not reasonably ascertainable within the meaning of these regulations, the employer may apply for a refund or credit for any FICA tax paid on that amount in 1994 and, instead, take the amount deferred into account when it becomes reasonably ascertainable. In addition, consistent with Notice 94-96, an employer's treatment of amounts deferred under a plan will not be considered to be in accordance with a reasonable, good faith interpretation of section 3121(v)(2) if the employer treats the amounts as taken into account before the plan is established.

Transition rules. The regulations provide four transition rules, which apply only if the taxpayer's determination of FICA tax treatment was based on a reasonable, good faith interpretation of section 3121(v)(2).

Under the first transition rule, if a plan is not a nonqualified deferred compensation plan under the regulations but was treated as such by the employer before the effective date of the regulations, no additional FICA tax will be owed on pre-effective date payments. However, on or after the regulatory effective date, benefits actually or constructively paid under the plan must be taken into account as FICA wages under the general timing rule. If FICA tax was actually paid on the amounts that were taken into account under section 3121(v)(2) before the regulatory effective date, the employer may claim a refund or credit

for FICA tax paid for open years in accordance with sections 6402 and 6413, to the extent that the FICA tax paid exceeds the FICA tax that would have been owed on benefit payments if those payments had been subject to FICA tax when paid.

The second transition rule applies to a plan that is a nonqualified deferred compensation plan under the regulations but that was not treated as such before the regulatory effective date. Under this transition relief, post-effective date benefit payments will not be subject to FICA tax when paid if they are attributable to amounts that would have been required to be taken into account under section 3121(v)(2)(A) in a year that is closed as of the regulatory effective date. This rule does not apply to amounts deferred that are required to be taken into account in years that are open as of the effective date. Amounts deferred in those open years will be treated as having been taken into account for purposes of applying the nonduplication rule to post-effective date benefit payments only if actually taken into account in accordance with these regulations.

The third transition rule provides relief where the pre-effective date amount deferred under a nonaccount balance plan was determined in accordance with a reasonable, good faith interpretation of section 3121(v)(2), but that amount was less than the amount deferred as determined under these regulations. In this case, no additional FICA tax will be owed for the pre-effective date period. In addition, when applying the nonduplication rule to the post-effective date benefit payments, the shortfall between the amount that was taken into account in a year closed as of the regulatory effective date and the amount that would have been required to be taken into account in that year under the regulations will be treated as if it had actually been taken into account under the special timing rule.

The fourth transition rule applies to a situation in which an amount deferred was taken into account as FICA wages before the regulatory effective date, but, under the regulations, that amount deferred would have been taken into account on or after the effective date. In this case, for periods after the effective date, the employer must determine the amount deferred, and the time when the amount deferred should be taken into account as wages, in accordance with the regulations. However, the employer may claim a refund or credit, in accordance with sections 6402 and 6413, for any overpayment of FICA tax in open years.

Statutory Effective Date

Section 3121(v)(2) is generally effective for amounts deferred and benefits paid after December 31, 1983. However, the 1983 Amendments provide, in the case of an agreement in existence on March 24, 1983 between a nonqualified deferred compensation plan and an individual, that the 1983 Amendments (and section 3121(v)(2)) apply only with respect to services performed after 1983. Accordingly, amounts deferred that relate to services performed before 1984 are subject to the general timing rule and the definition of wages in section 3121(a) as in effect on April 19, 1983 (including the retirement-related exclusions), and are not subject to the special timing rule. DEFRA amended the 1983 Amendments to provide further that amounts deferred under an agreement adopted after March 24, 1983 (but before 1984) that relate to pre-1984 services may, at the payor's election, be taken into account as wages either when paid or in accordance with section 3121(v)(2).

The regulations provide guidance on these statutory effective dates and rules for distinguishing benefits relating to pre-1984 services from those relating to post-1983 services. In determining the portion of total benefits that represents such pre-1984 benefits and the portion of each pre-regulatory-effective-date benefit payment that consists of such pre-1984 benefits, employers may use any reasonable allocation method that is consistent with the terms of the plan. Employers must treat payments made on or after the regulatory effective date as consisting of pro-rata portions of pre-1984 and post-1983 benefits, unless such an allocation is inconsistent with the terms of the plan.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f), this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying. A public hearing may be scheduled if requested in writing by a person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the Federal Register.

Drafting Information

The principal author of these regulations is David N. Pardys, Office of the Associate Chief Counsel (Employee Benefits and Exempt Organizations), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 31

Employment taxes, Income taxes, Penalties, Pensions, Railroad retirement, Reporting and recordkeeping requirements, Social Security, Unemployment tax, Withholding.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 31 is proposed to be amended as follows:

PART 31—EMPLOYMENT TAXES AND COLLECTION OF INCOME TAX AT SOURCE

Paragraph 1. The authority citation for part 31 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Sections 31.3121(v)(2)-1 and 31.3121(v)(2)-2 are added to read as follows:

§ 31.3121(v)(2)-1 Treatment of amounts deferred under certain nonqualified deferred compensation plans.

(a) *Timing of wage inclusion*—(1) *General timing rule for wages.* Remuneration for employment that constitutes wages within the meaning of section 3121(a) of the Internal Revenue Code generally is taken into account for purposes of the Federal Insurance Contributions Act (FICA) taxes imposed under sections 3101 and 3111 of the Internal Revenue Code at the time the remuneration is actually or constructively paid. See § 31.3121(a)-2(a).

(2) *Special timing rule for an amount deferred under a nonqualified deferred compensation plan*—(i) *In general.* To

the extent that remuneration deferred under a nonqualified deferred compensation plan constitutes wages within the meaning of section 3121(a), the remuneration is subject to the special timing rule described in this paragraph (a)(2). Remuneration is considered deferred under a nonqualified deferred compensation plan within the meaning of section 3121(v)(2) and this section only if it is provided pursuant to a plan described in paragraph (b) of this section. The amount deferred under a nonqualified deferred compensation plan is determined under paragraph (c) of this section.

(ii) *Special timing rule.* Except as otherwise provided in this section, an amount deferred under a nonqualified deferred compensation plan is required to be taken into account as wages for FICA purposes as of the later of—

(A) The date on which the services creating the right to that amount are performed (within the meaning of paragraph (e)(2) of this section); or

(B) The date on which the right to that amount is no longer subject to a substantial risk of forfeiture (within the meaning of paragraph (e)(3) of this section).

(iii) *Inclusion in wages only once (nonduplication rule).* Once an amount deferred under a nonqualified deferred compensation plan is taken into account (within the meaning of paragraph (d)(1) of this section), then neither the amount taken into account nor the income attributable to the amount taken into account (within the meaning of paragraph (d)(2) of this section) is treated as wages for FICA purposes at any time thereafter.

(iv) *Benefits that do not result from a deferral of compensation.* If a nonqualified deferred compensation plan (within the meaning of paragraph (b)(1) of this section) provides both a benefit that results from the deferral of compensation (within the meaning of paragraph (b)(3) of this section) and a benefit that does not result from the deferral of compensation, the benefit that does not result from the deferral of compensation is not subject to the special timing rule described in this paragraph (a)(2).

(v) *Remuneration that does not constitute wages.* If remuneration deferred under a nonqualified deferred compensation plan does not constitute wages within the meaning of section 3121(a), then that remuneration is not taken into account as wages for FICA purposes under either the general timing rule described in paragraph (a)(1) of this section or the special timing rule described in this paragraph (a)(2). For

example, benefits under a death benefit plan described in section 3121(a)(13) of the Internal Revenue Code do not constitute wages for FICA purposes. Therefore, these benefits are not included as wages under the general timing rule described in paragraph (a)(1) of this section or the special timing rule described in this paragraph (a)(2), even if the death benefit plan would otherwise be considered a nonqualified deferred compensation plan within the meaning of paragraph (b)(1) of this section.

(b) *Nonqualified deferred compensation plan*—(1) *In general*—(i) *Defined*. For purposes of this section, the term “nonqualified deferred compensation plan” means any plan or other arrangement that is established (within the meaning of paragraph (b)(2) of this section) by an employer for one or more of its employees, and that provides for the deferral of compensation (within the meaning of paragraph (b)(3) of this section), other than a plan described in section 3121(a)(5). A nonqualified deferred compensation plan may be adopted unilaterally by the employer or may be negotiated between or agreed to by the employer and one or more employees or employee representatives. A plan may constitute a nonqualified deferred compensation plan under this section without regard to whether the deferrals under the plan are made pursuant to an election by the employee or whether the amounts deferred are treated as deferred compensation for income tax purposes (e.g., whether the amounts are subject to the deduction rules of section 404). In addition, a plan may constitute a nonqualified deferred compensation plan under this section whether or not it is an employee benefit plan under section 3(3) of the Employee Retirement Income Security Act of 1974, as amended.

(ii) *Plan includes plan or other arrangement*. For purposes of this section, except where the context indicates otherwise, the term “plan” includes a plan or other arrangement.

(2) *Plan establishment*—(i) *Date plan is established*. For purposes of this section, a plan is “established” on the latest of the date on which it is adopted, the date on which it is effective, or the date on which the material terms of the plan are set forth in writing. For purposes of this section, a plan also will be deemed to be set forth in writing if it is set forth in any other form that is approved by the Commissioner. The material terms of the plan include the amount (or the method or formula for determining the amount) of deferred compensation to be provided under the

plan and the time when it may or will be provided.

(ii) *Plan amendments*. In the case of an amendment that increases the amount deferred under a nonqualified deferred compensation plan, the plan is not considered established with respect to the additional amount deferred until the plan, as amended, satisfies the requirements of paragraph (b)(2)(i) of this section.

(iii) *Transition rule*. For purposes of this section, an unwritten plan that is adopted and effective before March 25, 1996 is treated as established under this section as of the later of the date on which it was adopted or became effective, provided that it is set forth in writing not later than [Date that is six months after the date of publication of final regulations in the Federal Register].

(3) *Plan must provide for the deferral of compensation*—(i) *Deferral of compensation defined*. A plan provides for the “deferral of compensation” with respect to an employee only if, under the terms of the plan and the relevant facts and circumstances, the employee has a legally binding right during a calendar year to compensation that has not been actually or constructively received and that, pursuant to the terms of the plan, is payable in a later year. An employee does not have a legally binding right to compensation if that compensation may be unilaterally reduced or eliminated by the employer. For this purpose, compensation is not considered subject to unilateral reduction or elimination merely because it may be reduced or eliminated by operation of the objective terms of the plan, such as the application of a provision creating a substantial risk of forfeiture (within the meaning of section 83). Similarly, an employee does not fail to have a legally binding right to compensation merely because the amount of compensation is determined under a formula that provides for benefits to be offset by benefits provided under a plan that is qualified under section 401(a) of the Internal Revenue Code.

(ii) *Compensation payable pursuant to the employer's customary payment timing arrangement*. There is no deferral of compensation (within the meaning of this paragraph (b)(3)) merely because compensation is paid after the last day of a calendar year pursuant to the timing arrangement under which the employer ordinarily compensates employees for services performed during a payroll period described in section 3401(b).

(iii) *Short-term deferrals*. If, under a nonqualified deferred compensation plan, there is a deferral of compensation

(within the meaning of this paragraph (b)(3)) that causes an amount to be deferred from a calendar year to a date that is no more than a brief period of time after the end of that calendar year, then, at the employer's option, that amount may be treated as if it were not subject to the special timing rule described in paragraph (a)(2) of this section. An employer may apply this option only if the employer does so for all employees covered by the plan and all substantially similar nonqualified deferred compensation plans. For purposes of this paragraph (b)(3)(iii), whether compensation is deferred to a date that is not more than a “brief period of time” after the end of a calendar year is determined in accordance with § 1.404(b)-1T, Q&A-2, of this chapter.

(4) *Plans, arrangements, and benefits that do not provide for the deferral of compensation*—(i) *In general*. Notwithstanding paragraph (b)(3)(i) of this section, an amount or benefit described in any of paragraphs (b)(4)(ii) through (viii) of this section is not treated as resulting from the deferral of compensation for purposes of section 3121(v)(2) and this section and, thus, is not subject to the special timing rule of paragraph (a)(2) of this section.

(ii) *Stock options, stock appreciation rights and other stock value rights*. Amounts received as a result of a stock option, or as a result of a stock appreciation right or other stock value right, do not result from the deferral of compensation for purposes of section 3121(v)(2). For purposes of this paragraph (b)(4)(ii), a “stock value right” is a right granted to an employee with respect to one or more shares of employer stock that, to the extent exercised, entitles the employee to a payment for each share of stock equal to the excess, or a percentage of the excess, of the value of a share of the employer's stock on the date of exercise over a specified price (greater than zero). Thus, for example, the term “stock value right” does not include a phantom stock or other arrangement under which an employee is awarded the right to receive a fixed payment equal to the value of a specified number of shares of employer stock.

(iii) *Restricted property*. If an employee receives property from, or pursuant to a plan maintained by, an employer, there is no deferral of compensation (within the meaning of section 3121(v)(2)) merely because the value of the property is not includible in income (under section 83) in the year of receipt by reason of the property being nontransferable and subject to a substantial risk of forfeiture. However, a

plan under which an employee obtains a legally binding right to receive property (whether or not the property is restricted property) in the future may provide for the deferral of compensation within the meaning of paragraph (b)(3) of this section and, accordingly, may constitute a nonqualified deferred compensation plan, even though benefits under the plan are or may be paid in the form of property.

(iv) *Certain welfare benefits.* Vacation benefits, sick leave, compensatory time, disability pay, severance pay, and death benefits do not result from the deferral of compensation for purposes of section 3121(v)(2), even if those benefits constitute wages within the meaning of section 3121(a). Benefits provided under a severance pay plan that is not an employee pension benefit plan pursuant to 29 CFR 2510.3-2(b) are considered "severance pay" for purposes of this paragraph (b)(4)(iv). If a plan is an employee pension benefit plan pursuant to 29 CFR 2510.3-2(b), then whether benefits payable upon an employee's termination of employment are considered severance pay for purposes of this paragraph (b)(4)(iv) depends upon the relevant facts and circumstances. Notwithstanding the preceding sentence, a plan that is an employee pension benefit plan pursuant to 29 CFR 2510.3-2(b) is in all cases considered to provide severance pay for purposes of this paragraph (b)(4)(iv) if benefits payable under the plan upon an employee's termination of employment are payable only if that termination is involuntary.

(v) *Certain benefits provided in connection with impending termination—(A) In general.* Benefits provided in connection with impending termination of employment under paragraph (b)(4)(v)(B) or (b)(4)(v)(C) of this section do not result from a deferral of compensation within the meaning of section 3121(v)(2).

(B) *Window benefits—(1) In general.* For purposes of this paragraph (b)(4)(v), a window benefit is provided in connection with impending termination of employment. For this purpose, a "window benefit" is an early retirement benefit, retirement-type subsidy, social security supplement, or other form of benefit made available by an employer for a limited period of time (no greater than one year) to employees who terminate employment during that period or to employees who terminate employment during that period under specified circumstances.

(2) *Special rule for recurring window benefits.* A benefit will not be considered a window benefit if an employer establishes a pattern of

repeatedly providing for similar benefits in similar situations for substantially consecutive, limited periods of time. Whether the recurrence of these benefits constitutes a pattern of amendments is determined based on the facts and circumstances. Although no one factor is determinative, relevant factors include whether the benefits are on account of a specific business event or condition, the degree to which the benefits relate to the event or condition, and whether the event or condition is temporary or discrete or is a permanent aspect of the employer's business.

(C) *Termination within 12 months of establishment of a benefit or plan.* For purposes of this paragraph (b)(4)(v), a benefit is provided in connection with impending termination of employment, without regard to whether it constitutes a window benefit, if—

(1) An employee's termination of employment occurs within 12 months of the establishment of the benefit or the plan providing the benefit; and

(2) The facts and circumstances indicate that the benefit or plan is established in contemplation of the employee's impending termination of employment.

(vi) *Benefits established after termination of employment.* Benefits established with respect to an employee after the employee's termination of employment do not result from a deferral of compensation within the meaning of section 3121(v)(2).

(vii) *Excess parachute payments.* An excess parachute payment (as defined in section 280G(b)) under an agreement entered into or renewed after June 14, 1984, in taxable years ending after such date, does not result from the deferral of compensation within the meaning of section 3121(v)(2). For this purpose, any contract entered into before June 15, 1984, that is amended after June 14, 1984 in any relevant significant aspect, is treated as a contract entered into after June 14, 1984.

(viii) *Compensation for current services.* A plan does not provide for the deferral of compensation within the meaning of section 3121(v)(2) if, based on the relevant facts and circumstances, the compensation is paid for current services.

(5) *Examples.* This paragraph (b) may be illustrated by the following examples:

Example 1. (i) In December of 1997, Employer M tells Employee A that, if specified goals are satisfied for 1998, Employee A will receive a bonus on July 1, 1999 equal to a specified percentage of 1998 compensation. Because Employee A meets the specified goals, Employer M pays the

bonus to Employee A on July 1, 1999, consistent with its oral commitment.

(ii) This arrangement is not a nonqualified deferred compensation plan under this section because its terms were not set forth in writing and, therefore, it was not established in accordance with paragraph (b)(2) of this section.

Example 2. (i) Employer N establishes a compensation arrangement for Employee B in 1997. Before the beginning of 1998, Employee B and Employer N enter into a legally binding salary reduction agreement to defer a specified percentage of Employee B's salary that would otherwise be payable in 1998. The amounts deferred remain a general asset of Employer N, and are payable in 2008.

(ii) Employee B has a legally binding right during 1998 to an amount of compensation that has not been actually or constructively received and that, pursuant to the terms of the arrangement, is payable in a later year. Therefore, the arrangement provides for the deferral of compensation.

Example 3. (i) Employer O establishes a nonqualified deferred compensation plan (within the meaning of paragraph (b)(1) of this section) for Employee C in 1984. The plan is amended on January 1, 1999 to increase benefits, and the amendment provides that the increase in benefits is on account of Employee C's performance of services for Employer O from 1985 through 1998.

(ii) The additional benefits that resulted from the plan amendment cannot be taken into account as amounts deferred for 1985 through 1998, even though the plan was established before then. Pursuant to paragraphs (b)(2)(ii) and (e)(1) of this section, the additional benefits cannot be taken into account before the latest of the date on which the amendment is adopted, the date on which the amendment is effective, or the date on which the plan, as amended, is set forth in writing.

Example 4. (i) In 1997, Employer P, a state or local government, establishes a plan for certain employees that provides for the deferral of compensation and that is subject to section 457(a).

(ii) Paragraph (b)(1)(i) of this section provides that "nonqualified deferred compensation plan" means any plan that is established by an employer and that provides for the deferral of compensation, other than a plan described in section 3121(a)(5). Section 3121(a)(5) lists, among other plans, an exempt governmental deferred compensation plan as defined in section 3121(v)(3). Under section 3121(v)(3)(A), this definition does not include any plan to which section 457(a) applies. Thus, the plan established by Employer P is not an exempt governmental deferred compensation plan described in section 3121(v)(3) and, consequently, is not a plan described in section 3121(a)(5). Accordingly, the plan is a nonqualified deferred compensation plan within the meaning of section 3121(v)(2) and paragraph (b)(1) of this section.

(iii) However, the general timing rule of paragraph (a)(1) of this section and the special timing rule of paragraph (a)(2) of this section apply only to remuneration for "employment" that constitutes wages. Under

section 3121(b)(7), certain service performed in the employ of a state, or any political subdivision of a state is not "employment." Thus, even though the plan is a nonqualified deferred compensation plan, the extent to which section 3121(v)(2) applies to a participating employee will depend on whether or not the service performed for Employer P is excluded from the definition of employment under section 3121(b)(7).

Example 5. (i) In 1997, Employer Q establishes a plan that provides for bonuses to be paid to employees based on a specified formula that takes into account the employees' performance for the year. The bonus is not actually calculated until March 1 of the following year, and is paid on March 15 of that following year.

(ii) The plan provides for the deferral of compensation because the employees have a legally binding right, as of the last day of a calendar year, to an amount of compensation that has not been actually or constructively received and, pursuant to the terms of the plan, that compensation is payable in a later year. However, because the bonuses under the plan are paid within a brief period of time after the end of the calendar year from which they are deferred, Employer Q may choose, pursuant to paragraph (b)(3)(iii) of this section, to treat the bonuses as if they are not subject to the special timing rule of paragraph (a)(2)(ii) of this section.

Example 6. (i) Employer R establishes a plan under which bonuses based on performance in one year may be paid on February 1 of the following year at the discretion of the board of directors. The board of directors meets in January of each year to determine the amount, if any, of the bonuses to be paid based on performance in the prior year.

(ii) Because an employee does not have a legally binding right to a bonus until January of the year in which the bonus is paid, any bonus paid under the plan in that year will not be considered deferred from the preceding calendar year, and the plan will not be treated as providing for the deferral of compensation within the meaning of paragraph (b)(3)(i) of this section.

Example 7. (i) Employer S maintains a plan for employees that provides nonqualified stock options described in § 1.83-7(a) of this chapter. Under the plan, employees are granted in 1997 the option to acquire shares of employer stock at the fair market value of the shares on the date of grant (\$50 per share). The options can be exercised at any time from the date of grant through 2006. The options do not have a readily ascertainable fair market value for purposes of section 83 at the date of grant, and shares issued upon the exercise of the options are not subject to a substantial risk of forfeiture within the meaning of section 83. In 2002, when the fair market value of a share of employer stock is \$100, Employee D exercises an option to acquire 1,000 shares.

(ii) Under paragraph (b)(4)(ii) of this section, amounts received as a result of a stock option do not result from the deferral of compensation for purposes of section 3121(v)(2). Thus, the \$50,000 spread between the amount paid for the shares (\$50,000) and the fair market value of the shares on the date

of exercise (\$100,000) is taken into account as wages for FICA purposes in the year of exercise.

(iii) If the options had been granted at \$45 per share, \$5 per share below the fair market value on date of grant, the \$55,000 spread between the amount paid for the shares (\$45,000) and the fair market value of the shares on the date of exercise (\$100,000) would similarly be taken into account as wages for FICA purposes in the year of exercise.

Example 8. (i) Employer T establishes a "phantom stock" plan for certain employees. Under the plan, an employee is credited on the last day of each calendar year with a dollar amount equal to the fair market value of 1,000 shares of employer stock. Upon termination of employment for any reason, each employee is entitled to receive the value, in cash or employer stock, of the shares with which he or she has been credited.

(ii) Because compensation to which the employee has a legally binding right as of the last day of one year is paid in a subsequent year, the phantom stock plan provides for the deferral of compensation. The phantom stock plan does not provide stock value rights within the meaning of paragraph (b)(4)(ii) of this section because it provides for awards equal in value to the full fair market value of a specified number of shares of Employer T stock, rather than the excess of that fair market value over a specified price.

Example 9. (i) Employer U establishes a plan which provides for payments solely upon an employee's dismissal from employment, death, or disability. The amount of the payments to an employee is based on the length of continuous active service with Employer U at the time of dismissal, and is paid in monthly installments over a period of three years.

(ii) Because benefits payable under the plan upon termination of employment are payable only upon an employee's involuntary termination, the plan is a severance pay plan within the meaning of paragraph (b)(4)(iv) of this section. Thus, the benefits are not treated as resulting from the deferral of compensation for purposes of section 3121(v)(2).

Example 10. (i) On January 1, 1997, Employer V establishes a plan that covers only Employee E, who owns a significant portion of the business and who has 30 years of service as of that date. The plan provides that, upon Employee E's termination of employment at any time, he will receive \$200,000 per year for each of the immediately succeeding five years. Employee E terminates employment on March 1, 1997.

(ii) Because Employee E terminates employment within 12 months of the establishment of the plan and the facts and circumstances set forth above indicate that the plan was established in contemplation of impending termination of employment, the plan is considered to be established in connection with impending termination within the meaning of paragraph (b)(4)(v) of this section. Therefore, the benefits provided under the plan are not treated as resulting from the deferral of compensation for purposes of section 3121(v)(2).

Example 11. (i) Employer W establishes a plan on January 1, 1998 to supplement the qualified retirement benefits of recently hired 55-year-old Employee F who forfeited retirement benefits with her former employer in order to accept employment with Employer W. The plan provides that Employee F will receive \$50,000 per year for life beginning at age 65, regardless of when she terminates employment. On April 15, 1998, Employee F unexpectedly terminates employment.

(ii) The facts and circumstances indicate that the plan was not established in contemplation of impending termination. Thus, even though Employee F terminated employment within 12 months of the establishment of the plan, the plan is not considered to be established in connection with impending termination within the meaning of paragraph (b)(4)(v) of this section. Benefits provided under the plan are treated as resulting from the deferral of compensation for purposes of section 3121(v)(2).

Example 12. (i) Employer X establishes a plan to provide supplemental retirement benefits to a group of management employees who are at various stages of their careers. All employees covered by the plan are subject to the same benefit formula. Employee G is planning to (and actually does) retire within six months of the date on which the plan is established.

(ii) Even though Employee G terminated employment within 12 months of the establishment of the plan, the plan is not considered to have been established in connection with Employee G's impending termination within the meaning of paragraph (b)(4)(v) of this section because the facts and circumstances indicate otherwise.

Example 13. (i) Employee H owns 100 percent of Employer Y, a corporation that provides consulting services. Substantially all of Employer Y's revenue is derived as a result of the services performed by Employee H. In each of 1997, 1998, and 1999, Employer Y has gross receipts of \$180,000 and expenses (other than salary) of \$80,000. In each of 1997 and 1998, Employer Y pays Employee H a salary of \$100,000 for services performed in each of those years. On December 31, 1998, Employer Y establishes a plan to pay Employee H \$80,000 in 1999. The plan recites that the payment is in recognition of prior services. In 1999, Employer Y pays Employee H a salary of \$20,000 and the \$80,000 due under the plan.

(ii) The facts and circumstances described above indicate that the \$80,000 paid pursuant to the plan is based on services performed by Employee H in 1999 and, thus, is paid for current services within the meaning of paragraph (b)(4)(viii) of this section. Accordingly, the plan does not provide for the deferral of compensation within the meaning of section 3121(v)(2), and the \$80,000 payment is included as wages in 1999 under the general timing rule of paragraph (a)(1) of this section.

(c) *Determination of the amount deferred—(1) Account balance plans—(i) General rule.* For purposes of this section, if benefits for an employee are

provided under a nonqualified deferred compensation plan that is an account balance plan, the "amount deferred" for a period equals the principal amount credited to the employee's account for the period, increased or decreased by any income attributable to the principal amount through the date the principal amount is required to be taken into account as wages under paragraph (e) of this section. A nonqualified deferred compensation plan is an account balance plan for purposes of this section only if, under the terms of the plan, a principal amount (or amounts) is credited to an individual account for an employee, the income attributable to each principal amount is credited (or debited) to the individual account, and the benefits payable to the employee are based solely on the balance credited to the individual account. A plan does not fail to be an account balance plan merely because, under the terms of the plan, benefits payable to an employee are based solely on a specified percentage of an account maintained for all (or a portion of) plan participants, under which principal amounts and income are credited (or debited) to such account.

(ii) *Income defined.* For purposes of this section, "income" means any increase or decrease in the amount credited to an employee's account that is attributable to amounts previously credited to the employee's account, regardless of whether the plan denominates that increase or decrease as income.

(2) *Nonaccount balance plans—(i) General rule.* For purposes of this section, if benefits for an employee are provided under a nonqualified deferred compensation plan that is not an account balance plan (a "nonaccount balance plan"), the "amount deferred" for a period equals the present value of the additional future payment or payments to which the employee has obtained a legally binding right (as described in paragraph (b)(3)(i) of this section) under the plan during that period.

(ii) *Bifurcation permitted.* An employer may treat a portion of a nonaccount balance plan as a separate account balance plan if that portion satisfies the requirements of paragraph (c)(1) of this section and the amount payable to employees under that portion is determined independently of the amount payable under the other portion of the plan.

(iii) *Present value defined.* For purposes of this section, "present value" means the value as of a specified date of an amount or series of amounts due thereafter, where each amount is

multiplied by the probability that the condition or conditions on which payment of the amount is contingent will be satisfied, and is discounted according to an assumed rate of interest to reflect the time value of money. For purposes of this section, the present value must be determined as of the date the amount deferred is required to be taken into account as wages under paragraph (e)(1) of this section using actuarial assumptions and methods that are reasonable as of that date. For this purpose, a discount for pre-retirement mortality is permitted, but only to the extent that benefits will be forfeited upon death. In addition, the present value cannot be discounted for the risk that payments will not be made (or will be reduced) because of the unfunded status of the plan, the risk associated with any deemed or actual investment of amounts deferred under the plan, the risk that the employer, the trustee, or another party will be unwilling or unable to pay, the possibility of future plan amendments, the possibility of a future change in the law, or similar risks or contingencies.

(3) *Separate determination for each period.* The amount deferred under this paragraph (c) is determined separately for each period for which there is an amount deferred under the plan. In addition, paragraphs (d) and (e) of this section are applied separately with respect to the amount deferred for each such period. Thus, for example, the fraction described in paragraph (d)(1)(ii)(A) of this section and the resolution date amount described in paragraph (e)(4)(ii) of this section are determined separately with respect to each amount deferred.

(4) *Examples.* This paragraph (c) may be illustrated by the following examples:

Example 1. (i) Employer M establishes a nonqualified deferred compensation plan for Employee A. Under the plan, 10 percent of annual compensation is credited on behalf of Employee A on December 31 of each year. In addition, a reasonable rate of interest is credited quarterly on the balance credited to Employee A as of the last day of the preceding quarter. All amounts credited under the plan are 100 percent vested, and the benefits payable to Employee A are based solely on the balance credited to Employee A's account.

(ii) The plan is an account balance plan. Thus, pursuant to paragraph (c)(1) of this section, the amount deferred for a calendar year is equal to 10 percent of annual compensation.

Example 2. (i) Employer N establishes a nonqualified deferred compensation plan for Employee B. Under the plan, 2.5 percent of annual compensation is credited quarterly on behalf of Employee B. In addition, a reasonable rate of interest is credited

quarterly on the balance credited to Employee B's account as of the last day of the preceding quarter. All amounts credited under the plan are 100 percent vested, and the benefits payable to Employee B are based solely on the balance credited to Employee B's account. As permitted by paragraph (e)(5) of this section, any amount deferred under the plan for the calendar year is taken into account as wages on the last day of the year.

(ii) The plan is an account balance plan. Thus, pursuant to paragraph (c)(1) of this section, the amount deferred for a calendar year equals 10 percent of annual compensation (i.e., the sum of the principal amounts credited to Employee B's account for the year) plus the interest credited with respect to that 10 percent principal amount through the last day of the calendar year. If Employer N had not chosen to apply paragraph (e)(5) of this section and, thus, had taken into account 2.5 percent of compensation quarterly, the interest credited with respect to those quarterly amounts would not have been treated as part of the amount deferred for the year.

Example 3. (i) Employer O establishes a nonqualified deferred compensation plan for a group of employees. Under the plan, each participating employee has a fully vested right to receive a life annuity, payable monthly beginning at age 65, equal to the product of (a) 2 percent for each year of service and (b) Employee C's highest average annual compensation for a three-year period. The plan also provides that, if Employee C dies before age 65, the present value of the future payments will be paid to his or her beneficiary. As permitted under paragraph (e)(5) of this section, any amount deferred under the plan for a calendar year is taken into account as FICA wages as of the last day of the year. As of December 31, 1998, Employee C has 25 years of service and high three-year average compensation of \$100,000 (the average for the years 1996-98). As of December 31, 1999, Employee C is age 61, has 26 years of service, and has high three-year average compensation of \$104,000. As of December 31, 2000, Employee C is age 62, has 27 years of service, and has high three-year average compensation of \$105,000. The assumptions that Employer O uses to determine the amount deferred for 1999 (a 7 percent interest rate and, for the period after commencement of benefits, the GAM 83 (male) mortality table) and for 2000 (a 7.5 percent interest rate and, for the period after commencement of benefits, the GAM 83 (male) mortality table) are assumed, solely for purposes of this example, to be reasonable actuarial assumptions.

(ii) As of December 31, 1998, Employee C has a legally binding right to receive lifetime payments of \$50,000 (2 percent x 25 years x \$100,000) per year. As of December 31, 1999, Employee C has a legally binding right to receive lifetime payments of \$54,080 (2 percent x 26 years x \$104,000) per year. Thus, during 1999, Employee C has earned a legally binding right to additional lifetime payments of \$4,080 (\$54,080-\$50,000) per year beginning at age 65. The amount deferred for 1999 is the present value, as of December 31, 1999, of these additional payments, which is \$27,426 (\$4,080 x the

present value factor for a deferred annuity payable at age 65, using the specified actuarial assumptions). Similarly, during 2000, Employee C has earned a legally binding right to additional lifetime payments of \$2,620 (2 percent x 27 years x \$105,000-\$54,080) per year beginning at age 65. The amount deferred for 2000 is the present value, as of December 31, 2000, of these additional payments, which is \$18,149 (\$2,620 x the present value factor for a deferred annuity payable at age 65, using the specified actuarial assumptions).

(d) *Amounts taken into account and income attributable thereto*—(1) *Taken into account*—(i) *Taken into account defined*. For purposes of this section, an amount deferred under a nonqualified deferred compensation plan is “taken into account” as of the date it is included in computing the amount of “wages” as defined in section 3121(a), but only to the extent that any additional FICA tax that results from such inclusion (including any interest and penalties for late payment) is actually paid no later than the expiration of the applicable period of limitation for the year in which the amount deferred was required to be taken into account under paragraph (e) of this section. Because an amount deferred for a calendar year is combined with the employee’s other wages for the year for purposes of computing FICA taxes with respect to the employee for the year, if the employee has other wages that equal or exceed the wage base limitations for the Old-Age, Survivors, and Disability Insurance (OASDI) or Hospital Insurance (HI) portions of FICA for the year, no portion of the amount deferred will actually result in additional OASDI or HI tax, respectively. However, because there is no wage base limitation for the HI portion of FICA for years after 1993, the entire amount deferred (in addition to all other wages) is subject to the HI tax for the year and, thus, will not be considered taken into account for purposes of this section unless the HI tax relating to the amount deferred is actually paid. In determining whether any additional FICA tax relating to the amount deferred is actually paid, any FICA tax paid in a year is treated as paid with respect to an amount deferred only after FICA tax is paid on all other wages for the year.

(ii) *Amounts not taken into account*—(A) *Failure to take an amount deferred into account under the special timing rule*. If an amount deferred for a period (as determined under paragraph (c) of this section) is not taken into account, then the nonduplication rule of paragraph (a)(2)(iii) of this section does not apply, and benefits attributable to that amount deferred are included as

wages in accordance with the general timing rule of paragraph (a)(1) of this section. For example, if an amount deferred is required to be taken into account in a particular year under paragraph (e) of this section, but the employer fails to pay the additional FICA tax on that amount, then the amount deferred and the income attributable to that amount must be included as wages when actually or constructively paid.

(B) *Failure to take a portion of an amount deferred into account under the special timing rule*. If only a portion of an amount deferred (as determined under paragraph (c) of this section) is taken into account, then a portion of each benefit payment attributable to that amount deferred is excluded from wages pursuant to the nonduplication rule of paragraph (a)(2)(iii) of this section and the balance is subject to the general timing rule of paragraph (a)(1) of this section. The portion that is excluded from wages is fixed when the attributable benefits commence and is determined by multiplying each such payment by a fraction, the numerator of which is the amount that was taken into account (plus income attributable to that amount) and denominator of which is the present value of the future benefit payments attributable to the amount deferred. If the amount deferred was determined using reasonable actuarial assumptions, the present value is determined using those assumptions.

(2) *Income attributable to the amount taken into account*—(i) *Account balance plans*. For purposes of the nonduplication rule of paragraph (a)(2)(iii) of this section, in the case of an account balance plan, the “income attributable to the amount taken into account” means any amount credited on behalf of an employee under the terms of the plan that is income (within the meaning of paragraph (c)(1) of this section) attributable to an amount previously taken into account (within the meaning of paragraph (d)(1) of this section), but only if the income is based on a rate of return that does not exceed either the actual rate of return on a predetermined actual investment (whether or not assets associated with the plan or the employer are actually invested therein) or, if no predetermined actual investment has been specified for the period, a reasonable rate of interest. For purposes of this paragraph (d)(2)(i), an actual investment includes an investment identified by reference to any stock index with respect to which there are positions traded on a national securities exchange described in section 1256(g)(7)(A). The actual rate of return

includes any decrease as well as any increase in the value of the investment.

(ii) *Nonaccount balance plans*. For purposes of the nonduplication rule of paragraph (a)(2)(iii) of this section, in the case of a nonaccount balance plan, the “income attributable to the amount taken into account” means the increase, due solely to the passage of time, in the present value of the future payments to which the employee has obtained a legally binding right, the present value of which constituted the amount taken into account (determined as of the date such amount was taken into account), but only if the amount taken into account was determined using reasonable actuarial assumptions and methods. Thus, each year there will be an increase (determined using the same interest rate used to determine the amount taken into account) resulting from the shortening of the discount period before the future payments are made, plus, if applicable, an increase in the present value resulting from the employee’s survivorship during the current year. As a result, if the amount deferred for a period is determined using a reasonable interest rate and other reasonable actuarial assumptions and methods, and the amount is taken into account when required under paragraph (e) of this section, then, under the nonduplication rule of paragraph (a)(2)(iii) of this section, none of the future payments attributable to that amount will be subject to FICA tax when paid.

(iii) *Unreasonable rates of return*—(A) *Account balance plans*. If, under an account balance plan, the rate of interest credited is not reasonable, as determined by the Commissioner, or the rate of return credited otherwise exceeds the applicable limitation in paragraph (d)(2)(i) of this section, then the income attributable to the amount taken into account is limited to the income that would result from application of the mid-term applicable federal rate (as defined pursuant to section 1274(d) for January 1 of the calendar year, compounded annually (the “AFR”). However, in the case of a predetermined actual investment, if the actual rate of return on that investment is lower than the AFR, then the income attributable to the amount taken into account is limited to the income that would result from application of that actual rate of return. Any excess of the income credited under the plan over the income determined using the AFR (or, if applicable, the actual rate of return) is considered an additional amount deferred in the year the income is credited, and is required to be taken into account under the special timing rule of

paragraph (a)(2) of this section. If the excess is not taken into account as an additional amount deferred in the year credited, then, pursuant to paragraph (d)(1)(ii) of this section, the excess and any income attributable to the excess are subject to the general timing rule of paragraph (a)(1) of this section.

(B) *Nonaccount balance plans.* If any actuarial assumption or method used to determine the amount taken into account under a nonaccount balance plan is not reasonable, as determined by the Commissioner, then the income attributable to the amount taken into account is limited to the income that would result from the application of the AFR and, if applicable, the applicable mortality table under section 417(e)(3)(A)(ii)(I) (the "417(e) mortality table"), both determined as of the January 1 of the calendar year in which the amount was taken into account. In addition, paragraph (d)(1)(ii)(B) of this section applies and, in calculating the fraction described in that paragraph, the numerator is the amount taken into account plus income (as limited under this paragraph (d)(2)(iii)(B)), and the present value in the denominator is determined using the AFR, the 417(e) mortality table, and reasonable assumptions as to cost of living, each determined as of the time the amount deferred was taken into account.

(3) *Examples.* This paragraph (d) may be illustrated by the following examples:

Example 1. (i) In 1997, Employer M establishes a nonqualified deferred compensation plan for Employee A under which all benefits are 100 percent vested. In 1998, Employee A has \$200,000 of current annual compensation from Employer M that is subject to FICA tax. The amount deferred under the plan on behalf of Employee A for 1998 is \$20,000. Thus, Employee A has total wages for FICA purposes of \$220,000. Because Employee A has other wages that exceed the OASDI wage base for 1998, no additional OASDI tax is owed as a result of the \$20,000 amount deferred. Because there is no wage base limitation for the HI portion of FICA, additional HI tax liability results from the \$20,000 amount deferred. However, Employer M fails to pay the additional tax.

(ii) Under paragraph (d)(1)(i) of this section, an amount deferred is considered taken into account as wages for FICA purposes as of the date it is included in computing FICA wages, but only if any additional FICA tax liability that results from inclusion of the amount deferred is actually paid. Because the HI tax resulting from the \$20,000 amount deferred was not paid, that amount deferred was not taken into account within the meaning of paragraph (d)(1) of this section. Thus, pursuant to paragraph (d)(1)(ii) of this section, benefits attributable to the \$20,000 amount deferred will be included as wages in accordance with the general timing rule of paragraph (a)(1) of this section.

Example 2. (i) The facts are the same as in *Example 1*, except that Employer M takes all actions necessary to correct its failure to pay the additional tax before the applicable period of limitation expires for 1998 (including payment of any applicable interest and penalties).

(ii) Because the HI tax resulting from the \$20,000 amount deferred is paid, that amount deferred is considered taken into account for 1998. Thus, in accordance with paragraph (a)(2)(iii) of this section, neither the amount deferred nor the income attributable to the amount taken into account will be treated as wages for FICA purposes at any time thereafter.

Example 3. (i) Employer N establishes a nonqualified deferred compensation plan under which all benefits are 100 percent vested. Under the plan, an employee's account is credited with a contribution equal to 10 percent of salary on December 31 of each year. The employee's account balance also is increased each December 31 by "interest" on the total amounts credited to the executive's account as of the preceding December 31. The interest rate specified in the plan results in an increase that is not based on the return on a predetermined actual investment within the meaning of paragraph (d)(2)(i) of this section, and that is greater than the increase that would result from application of a reasonable rate of interest within the meaning of paragraph (d)(2)(i) of this section.

(ii) Pursuant to paragraph (d)(2)(iii)(A) of this section, the excess over the AFR is considered an additional amount deferred in the year credited and is required to be taken into account in the year credited.

Example 4. (i) The facts are the same as in *Example 3*, except that the annual increase is based on Moody's Average Corporate Bond Yield.

(ii) Because this index reflects a reasonable rate of interest, it is considered income attributable to the amount taken into account within the meaning of paragraph (d)(2)(i) of this section.

Example 5. (i) The facts are the same as in *Example 3*, except that the annual increase or decrease is equal to the greater of the rate of return on a specified aggressive growth mutual fund or the rate of return on a specified income-oriented mutual fund.

(ii) Because the increase or decrease is based on the greater of the two investment returns and, thus, is not based on the actual rate of return on either specific investment, the increase is not based on the return on a predetermined actual investment within the meaning of paragraph (d)(2)(i) of this section. Thus, if the resulting increase exceeds the AFR, the excess is not considered income attributable to the amount taken into account within the meaning of paragraph (d)(2)(i) of this section and, pursuant to paragraph (d)(2)(iii)(A) of this section, is considered an additional amount deferred.

Example 6. (i) The facts are the same as in *Example 5*, except that the annual increase or decrease with respect to 50 percent of the employee's account is equal to the rate of return on a specified aggressive growth mutual fund and the annual increase or decrease with respect to the other 50 percent

of the employee's account is equal to the increase or decrease in the Standard & Poor's 500 Index.

(ii) Because the increase or decrease attributable to any portion of the employee's account is based on the return on a predetermined actual investment, the increase or decrease does not exceed a reasonable rate of return within the meaning of paragraph (d)(2)(i) of this section. Thus, the entire increase or decrease is considered income attributable to the amount taken into account within the meaning of paragraph (d)(2)(i) of this section.

Example 7. (i) The facts are the same as in *Example 3*, except that, pursuant to the terms of the plan, before the beginning of each year, the board of directors of Employer N designates a specific investment on which the following year's annual increase or decrease will be based. The board is authorized to switch investments more frequently on a prospective basis. Before the beginning of 1998, the board designates Company A stock as the investment for 1998. Before the beginning of 1999, the board designates Company B stock as the investment for 1999. At the end of 1999, the board determines that the return on Company B stock was lower than expected and changes its designation for 1999 to a stock that had a higher return during 1999.

(ii) The annual increase or decrease for 1998 is based on the return of a predetermined actual investment. Although the annual increase or decrease for 1999 is based on an actual investment, the actual investment is not predetermined since it was designated after its return was known. In addition, the increase or decrease for 1999 is greater than the actual rate of return on the actual investment that was predetermined. Thus, pursuant to paragraph (d)(2)(iii)(A) of this section, the income attributable to the amount taken into account is limited to the AFR or, if lower, the actual rate of return on the predetermined actual investment that was designated for 1999.

Example 8. (i) Employer O establishes a nonqualified deferred compensation plan for Employee B. Under the plan, if Employee B survives until payment is to be made, he has a fully vested right to receive a lump sum payment at age 65, equal to the product of (a) 10 percent per year of service and (b) Employee B's highest average annual compensation for a three-year period. As permitted under paragraph (e)(5) of this section, any amount deferred under the plan for the calendar year is taken into account as wages as of the last day of the year. As of December 31, 1998, Employee B has 25 years of service and Employee B's high three-year average compensation is \$100,000 (the average for the years 1996-98). As of December 31, 1998, Employee B has a legally binding right to receive a payment at age 65 of \$250,000 (10 percent \times 25 years \times \$100,000). As of December 31, 1999, Employee B is age 63, has 26 years of service, and has high three-year average compensation of \$104,000. As of December 31, 1999, Employer O has a legally binding right to receive a payment at age 65 of \$270,400 (10 percent \times 26 years \times \$104,000). Thus, during 1999, Employee B has earned

a legally binding right to an additional payment at age 65 of \$20,400 (\$270,400–\$250,000). The assumptions that Employer O uses to determine the amount deferred for 1999 are a 7 percent interest rate and the GAM 83 (male) mortality table, which, solely for purposes of this example, are assumed to be reasonable actuarial assumptions. The amount deferred for 1999 is the present value, as of December 31, 1999, of the \$20,400 payment, which is \$17,353.

Employer O takes this amount into account by including it in Employee B's FICA wages for 1999 and paying the additional FICA tax.

(ii) Under paragraph (d)(2)(ii) of this section, the income attributable to the amount that was taken into account is the increase in the present value of the future payment due solely to the passage of time, because the amount deferred was determined using reasonable actuarial assumptions and methods. As of the payment date at age 65, the present value of the future payments earned during 1999 is \$20,400. The entire difference between the \$20,400 and the \$17,353 amount deferred (\$3,047) is the increase in the present value of the future payment due solely to the passage of time, and thus falls within the definition of "income attributable to the amount taken into account." Because the amount deferred was taken into account, the entire payment of \$20,400 represents either an amount deferred that was previously taken into account (\$17,353) or income attributable to that amount (\$3,047). Accordingly, pursuant to the nonduplication rule of paragraph (a)(2)(iii) of this section, none of the payment is included in wages.

Example 9. (i) The facts are the same as in *Example 8*, except that, instead of providing a lump sum equal to 10 percent of average compensation per year of service, the plan provides Employee B with a fully vested right to receive a life annuity, payable monthly beginning at age 65, equal to the product of (a) 2 percent for each year of service and (b) Employee B's highest average annual compensation for a three-year period. The plan also provides that, if Employee B dies before age 65, the present value of the future payments will be paid to his or her beneficiary. As of December 31, 1998, Employee B has a legally binding right to receive lifetime payments of \$50,000 (2 percent \times 25 years \times \$100,000) per year. As of December 31, 1999, Employee B has a legally binding right to receive lifetime payments of \$54,080 (2 percent \times 26 years \times \$104,000) per year. Thus, during 1999, Employee B has earned a legally binding right to additional lifetime payments of \$4,080 (\$54,080–\$50,000) per year beginning at age 65. The amount deferred for 1999 is the present value, as of December 31, 1999, of these additional payments, determined using reasonable actuarial assumptions and methods. Employer O takes this amount into account by including it in Employee B's FICA wages for 1999 and paying the additional FICA tax.

(ii) Under paragraph (d)(2)(ii) of this section, the income attributable to the amount that was taken into account is the increase in the present value of the future payment due solely to the passage of time,

because the amount deferred was determined using reasonable actuarial assumptions and methods. Because the amount deferred was taken into account, the entire benefit stream of \$4,080 attributable to the amount deferred in 1999 represents either an amount deferred that was previously taken into account or income attributable to that amount.

Accordingly, pursuant to the nonduplication rule of paragraph (a)(2)(iii) of this section, none of the payments are included in wages.

Example 10. (i) The facts are the same as in *Example 9*, except that no amount is taken into account for 1999 because Employer O fails to pay the additional FICA tax.

(ii) Under paragraph (d)(1)(ii)(A) of this section, if an amount deferred for a period is not taken into account, then the benefits attributable to that amount deferred are included as wages in accordance with the general timing rule of paragraph (a)(1) of this section. In this case, assuming that the amounts deferred in other periods were taken into account, \$4,080 of each year's total benefit payment will be included in wages when paid.

Example 11. (i) Employer P establishes a nonqualified deferred compensation plan on January 1, 1998 under which all benefits are 100 percent vested. The plan provides that amounts deferred will be credited annually with interest beginning in 1999 at a rate that is greater than a reasonable rate of interest. Pursuant to paragraph (d)(2)(iii)(A) of this section, Employer P treats the excess over the AFR as an additional amount deferred for 1999 and in each year thereafter, and takes the additional amount into account by including it in FICA wages and paying the additional FICA tax for the year.

(ii) Consequently, in accordance with paragraph (a)(2)(iii) of this section, the excess over the AFR and any income (at the AFR) attributable to the excess will not be treated as wages for FICA purposes in any subsequent year.

Example 12. (i) The facts are the same as in *Example 11*, except that Employer P does not treat the excess over the AFR as an additional amount deferred and, accordingly, does not take the excess into account as FICA wages for 1999 and years thereafter.

(ii) Because this excess was not taken into account as an additional amount deferred for 1999 and years thereafter, the excess and any amount attributable to the excess are subject to the general timing rule of paragraph (a)(1) of this section and will be included as wages for FICA purposes when actually or constructively paid.

Example 13. (i) The facts are the same as in *Example 8*, except that, in determining the amount deferred, Employer P uses a 15 percent interest rate, which, solely for purposes of this example, is assumed not to be a reasonable interest rate. Employer P determines that the amount deferred is the present value, as of December 31, 1999, of this payment, which is \$15,023. Employer P includes this amount in wages and pays any resulting FICA tax. Assume that the AFR as of January 1, 1999, is 7 percent.

(ii) Under paragraph (d)(2)(iii)(B) of this section, if any actuarial assumption or method is not reasonable, then the income attributable to the amount taken into account

is limited to the income that would result from application of the AFR and, if applicable, the 417(e) mortality table. Because the 15 percent interest rate is unreasonable, the income attributable to the amount taken into account is limited to the income that would result from using a 7 percent interest rate and, in this case, an increase for survivorship using the 417(e) mortality table. Under these assumptions, the income attributable to the \$15,023 amount deferred is \$1,199 in the year 2000 and \$1,313 in the year 2001. Under paragraph (d)(1)(ii) of this section, the sum of these amounts (\$17,535) is excluded from Employee B's wages pursuant to the nonduplication rule of paragraph (a)(2)(iii) of this section, and the balance of the payment (\$2,865) is subject to the general timing rule of paragraph (a)(1) of this section and, thus, is included in Employee B's wages when actually or constructively paid.

(iii) The same result can be reached by multiplying the attributable benefits by a fraction, the numerator of which is the amount taken into account, and the denominator of which is the amount deferred that would have been taken into account at the same time had the amount deferred been calculated using the AFR, the 417(e) mortality table, and a reasonable assumption as to cost of living. All three assumptions are determined as of January 1 of the calendar year in which the amount was taken into account. In this *Example 13*, the fraction would be \$15,023 divided by \$17,478, which equals .85954. The \$20,400 payment is multiplied by this fraction to determine the amount of the payment that is excluded from wages pursuant to the nonduplication rule of paragraph (a)(2)(iii) of this section. Thus, \$17,535 ($\$20,400 \times .85954$) is excluded from wages and the balance (\$2,865) is subject to FICA tax when actually or constructively paid.

Example 14. (i) The facts are the same as *Example 9*, except that Employer O calculates the amount deferred for 1999 as \$18,252 and takes that amount into account by including this amount in wages and paying any resulting FICA tax. The assumptions that Employer O uses to determine the amount deferred are a 15 percent interest rate and, for the period after commencement of benefits, the GAM 83 (male) mortality table. The 15 percent interest rate is assumed, solely for purposes of this example, not to be a reasonable actuarial assumption. Assume that the AFR as of January 1, 1999, is 7 percent.

(ii) Under paragraph (d)(2)(iii)(B) of this section, if any actuarial assumption or method used is not reasonable, then the income attributable to the amount taken into account is limited to the income that would result from application of the AFR and, if applicable, the 417(e) mortality table. Because the 15 percent interest rate is not reasonable, the income attributable to the amount taken into account is equal to the income that would result from using a 7 percent interest rate and the amount taken into account is treated as if it represented a portion of the amount deferred for purposes of applying paragraph (d)(1)(ii)(B) of this section. Under these assumptions, the

income attributable to the \$18,252 amount deferred is \$1,278 in the year 2000 and \$1,367 in the year 2001. Under paragraph (d)(1)(ii)(B) of this section, the portion of each of benefit payment attributable to the amount deferred that is excluded from wages pursuant to the nonduplication rule of paragraph (a)(2)(iii) of this section is determined at benefit commencement by multiplying each benefit payment by a fraction, the numerator of which is the amount taken into account (plus income attributable to that amount) and the denominator of which is the present value of future benefit payments attributable to the amount deferred. Because the interest rate assumption is not reasonable, not only is the income limited to the application of the AFR, but the present value in the denominator must be determined using the AFR and (if applicable) the 417(e) mortality table. In this case, the present value is \$40,283 and thus the fraction is $\$20,897/\$40,283$, or .51875. Thus, $\$2,116$ ($.51875 \times \$4,080$) of each year's benefit payment is excluded from wages and the balance of each year's payment (\$1,964) is subject to the general timing rule of paragraph (a)(1) of this section and is included in wages when actually or constructively paid.

(iii) The same result can be reached by multiplying the attributable benefits by a fraction the numerator of which is the amount taken into account, and the denominator of which is the amount deferred that would have been taken into account at the same time had the amount deferred been calculated using the AFR, the 417(e) mortality table, and a reasonable assumption as to cost of living. All three assumptions are determined as of January 1 of the calendar year in which the amount was taken into account. In this *Example 14*, the fraction would be $\$18,252$ divided by $\$35,165$, which equals .51875. The $\$4,080$ annual payment is multiplied by this fraction to determine the amount of the payment that is excluded from wages pursuant to the nonduplication rule of paragraph (a)(2)(iii) of this section. Thus, $\$2,116$ ($\$4,080 \times .51875$) is excluded from wages and the balance (\$1,964) is subject to FICA tax when actually or constructively paid.

(e) *Time amounts deferred are taken into account*—(1) *In general*. Except as otherwise provided in this paragraph (e), an amount deferred under a nonqualified deferred compensation plan must be taken into account as wages for FICA purposes as of the later of the date on which services creating the right to the amount deferred are performed (within the meaning of paragraph (e)(2) of this section), or the date on which the right to the amount deferred is no longer subject to a substantial risk of forfeiture (within the meaning of paragraph (e)(3) of this section). However, in no event may any amount deferred under a nonqualified deferred compensation plan be taken into account as wages for FICA purposes prior to the establishment of the plan providing for the amount deferred (or, if

later, the plan amendment providing for the amount deferred). Therefore, if an amount is deferred pursuant to the terms of a legally binding agreement that is not put in writing until after the amount would otherwise be taken into account under this paragraph (e)(1), the amount deferred (including any attributable income) must be taken into account as wages for FICA purposes as of the date the plan is put in writing.

(2) *Services creating the right to an amount deferred*. For purposes of this section, services creating the right to an amount deferred under a nonqualified deferred compensation plan are considered to be performed as of the date on which, under the terms of the plan and all the facts and circumstances, the employee has performed all of the services necessary to obtain a legally binding right (as described in paragraph (b)(3)(i) of this section) to the amount deferred.

(3) *Substantial risk of forfeiture*. For purposes of this section, the determination of whether a substantial risk of forfeiture exists must be made in accordance with the principles of section 83 and the regulations thereunder.

(4) *Amount deferred that is not reasonably ascertainable under a nonaccount balance plan*—(i) *In general*. Notwithstanding any other provision of this paragraph (e), an amount deferred under a nonaccount balance plan is not required to be taken into account as wages under the special timing rule of paragraph (a)(2) of this section until the first date on which all of the amount deferred is reasonably ascertainable (the "resolution date"). In this case, the amount deferred, determined as of the resolution date in accordance with paragraph (c)(2) of this section (the "resolution date amount"), must be taken into account as of the resolution date. For purposes of this paragraph (e)(4), an amount deferred is considered reasonably ascertainable on the first date on which the only actuarial or other assumptions regarding future events or circumstances needed to determine the amount deferred are interest, mortality, and cost-of-living assumptions. If these assumptions are the only assumptions regarding future events or circumstances that are needed to determine the amount deferred as of a particular date, then the amount deferred will not fail to be reasonably ascertainable merely because the exact amount deferred cannot be readily calculated as of that date.

(ii) *Earlier inclusion permitted*—(A) *In general*. With respect to an amount deferred that is not reasonably ascertainable, an employer may choose

to take an amount into account at a date (the "early inclusion date") before the resolution date (but not before the date otherwise described in paragraph (e)(1) of this section). If the amount taken into account at the early inclusion date with respect to an amount deferred for a period (plus income attributable to the amount taken into account through the resolution date) is less than the resolution date amount for that period, then the balance of the resolution date amount must be taken into account as of the resolution date. For purposes of determining the income attributable to an amount taken into account as of an early inclusion date, the employer must use an interest rate and, if applicable, a mortality assumption that would have been reasonable as of the early inclusion date.

(B) *Treatment of benefits paid before the resolution date*. If a benefit payment is attributable to an amount deferred that is not reasonably ascertainable at the time of payment, and the employer has previously taken an amount into account with respect to the amount deferred, then, in lieu of the pro rata rule provided in paragraph (d)(1)(ii)(B) of this section, a first-in-first-out rule applies in determining the portion of the payment attributable to the amount taken into account. Under this first-in-first-out rule, the benefit payment is included as wages under the general timing rule of paragraph (a)(1) of this section only to the extent that it exceeds the amount previously taken into account plus income attributable to that amount. However, in determining the additional amount that must be taken into account on the resolution date (under paragraph (e)(4)(ii)(A) of this section), to the extent benefit payments were not included as wages when paid pursuant to the preceding sentence, those payments (plus income attributable to those payments) must be added to the resolution date amount. For purposes of determining the income attributable to such payments, the employer must use an interest rate and, if applicable, a mortality assumption that would have been reasonable as of the early inclusion date.

(5) *Rule of administrative convenience*. For purposes of this section, an employer may treat an amount deferred as required to be taken into account under this paragraph (e) on any date that is later than, but within the same calendar year as, the actual date on which an amount deferred is otherwise required to be taken into account under this paragraph (e). For example, if services creating the right to an amount deferred are considered performed under paragraph (e)(2) of this

section periodically throughout a year, the employer may nevertheless treat the services creating the right to that amount deferred as performed on December 31 of that year.

(6) *Portions of an amount deferred required to be taken into account in more than one year.* If different portions of an amount deferred are required to be taken into account under paragraph (e)(1) of this section in more than one year (e.g., on account of a graded vesting schedule), then each such portion is considered a separate amount deferred for purposes of this section.

(7) *Examples.* This paragraph (e) may be illustrated by the following examples:

Example 1. (i) Employer M establishes a nonqualified deferred compensation plan for Employee A on November 1, 1996. Under the plan, which is an account balance plan, Employee A obtains a legally binding right on the last day of each calendar year (if Employee A is employed on that date) to be credited with a principal amount equal to 5 percent of compensation for the year. In addition, a reasonable rate of interest is credited quarterly. Employee A's account balance is nonforfeitable and is payable upon Employee A's termination of employment. For 1997, the principal amount credited to Employee A under the plan (which, in this case, is also the amount deferred within the meaning of paragraph (c) of this section) is \$25,000.

(ii) Under paragraph (e)(2) of this section, the services creating the right to the \$25,000 amount deferred are considered performed as of December 31, 1997, the date on which Employee A has performed all of the services necessary to obtain a legally binding right to the amount deferred. Thus, in accordance with paragraph (e)(1) of this section, the \$25,000 amount deferred must be taken into account as of December 31, 1997, which is the later of the date on which services creating the right to the amount deferred are performed, or the date on which the right to the amount deferred is no longer subject to a substantial risk of forfeiture.

Example 2. (i) The facts are the same as in *Example 1*, except that the principal amount credited under the plan on the last day of each year (and the attributable interest) is forfeited if the employee terminates employment within five years of that date.

(ii) Under paragraph (e)(3) of this section, the determination of whether the right to an amount deferred is subject to a substantial risk of forfeiture is made in accordance with the principles of section 83. Under § 1.83-3(c) of this chapter, a substantial risk of forfeiture generally exists where rights in property that are transferred are conditioned, directly or indirectly, upon the future performance of substantial services. Because Employee A's right to receive the \$25,000 principal amount (and attributable interest) is conditioned on the performance of services for five years, a substantial risk of forfeiture exists with respect to that amount deferred until December 31, 2002.

(iii) December 31, 2002 is the later of the date on which services creating the right to the amount deferred are performed, or the date on which the right to the amount deferred is no longer subject to a substantial risk of forfeiture. Thus, in accordance with paragraph (e)(1) of this section, the amount deferred (which (pursuant to paragraph (c)(1) of this section) is equal to the \$25,000 principal amount credited to Employee A's account on December 31, 1997, plus the interest credited with respect to that principal amount through December 31, 2002) must be taken into account as of December 31, 2002.

Example 3. (i) The facts are the same as in *Example 2*, except that the principal amount credited under the plan on the last day of each year (and the attributable interest) becomes nonforfeitable according to a graded vesting schedule under which 20 percent is vested as of December 31, 1998; 40 percent is vested as of December 31, 1999; 60 percent is vested as of December 31, 2000; 80 percent is vested as of December 31, 2001; and 100 percent is vested as of December 31, 2002. Because these dates are later than the date on which the services creating the right to the amount deferred are considered performed (December 31, 1997), the amount deferred is required to be taken into account as of these dates that fall in five different years.

(ii) Paragraph (e)(6) of this section provides that, if different portions of an amount deferred are required to be taken into account under paragraph (e)(1) of this section in more than one year, then each such portion is considered a separate amount deferred for purposes of this section. Thus, \$5,000 of the principal amount, plus interest credited through December 31, 1998, is taken into account as an amount deferred on December 31, 1998; \$5,000 of the principal amount, plus interest credited through December 31, 1999, is taken into account as a separate amount deferred on December 31, 1999; etc.

Example 4. (i) In 1997, Employer N establishes a nonqualified deferred compensation plan under which all benefits are 100 percent vested. The plan provides for Employee B (who is age 45) to receive a lump sum benefit of \$500,000 at age 65. This benefit will be forfeited if Employee B dies before age 65.

(ii) Because the only assumptions needed to determine the amount deferred are interest and mortality, the amount deferred is reasonably ascertainable within the meaning of paragraph (e)(4)(i) of this section.

Example 5. (i) The facts are the same as in *Example 4*, except that the \$500,000 is payable to Employee B at the later of age 55 or termination of employment.

(ii) Because the present value of the future benefit is contingent on when Employee B terminates employment, the determination of the amount deferred requires the use of assumptions other than interest, mortality, and cost-of-living assumptions. Thus, the amount deferred is not reasonably ascertainable within the meaning of paragraph (e)(4)(i) of this section.

Example 6. (i) The facts are the same as in *Example 4*, except that Employee B may elect to take the benefit in the form of a life annuity of \$50,000 per year (commencing at

age 65) with a present value that is different than the amount payable under the lump sum option.

(ii) Because the present value of the future benefit is contingent on the form of benefit elected by Employee B, the determination of the amount deferred requires the use of assumptions other than interest, mortality, and cost-of-living assumptions. Thus, the amount deferred is not reasonably ascertainable within the meaning of paragraph (e)(4)(i) of this section.

Example 7. (i) Employer O establishes a nonqualified deferred compensation plan. The plan is a supplemental executive retirement plan (SERP) that provides Employee C with a fully vested right to receive a pension, in the form of a straight life annuity payable monthly, beginning at age 65, equal to the excess of (a) 3 percent of Employee C's final three-year average pay for each year of participation up to 15 years, over (b) the amount payable to Employee C from Employer O's qualified pension plan. The amount payable under the qualified pension plan is equal to 1.5 percent of final three-year average pay for each year of employment, excluding pay in excess of the section 401(a)(17) compensation limit. Employee C becomes a participant in the SERP on January 1, 2001, at age 44. As permitted by paragraph (e)(5) of this section, any amount deferred under the SERP for the calendar year is taken into account as wages as of the last day of the year. However, the amount deferred under the SERP for any year is not reasonably ascertainable prior to termination of employment because the determination of such amount requires assumptions other than interest, mortality, and cost-of-living (e.g., an assumption as to Employee C's average pay for the final three years of employment). As permitted by paragraph (e)(4)(i) of this section, Employer O chooses not to take any amount into account for any year before the resolution date. Employee C terminates employment on December 31, 2018.

(ii) As of the date Employee C terminates employment, the only actuarial or other assumptions needed to determine the amount deferred is an interest rate and mortality assumption. At that time, the amount deferred in each past year becomes reasonably ascertainable, and Employer O is able to determine that during 2001 Employee C earned a legally binding right to a life annuity of \$4,000 per year. Employer O determines the present value of Employee C's future benefit payments under the SERP as of this resolution date (December 31, 2018), using an 7 percent interest rate and the UP-84 mortality table, which, solely for purposes of this example, are assumed to be reasonable actuarial assumptions for the year 2018. The resulting present value, \$26,950, is taken into account in accordance with paragraph (d)(1) of this section.

Example 8. (i) The facts are the same as in *Example 7*, except that, as permitted under paragraph (e)(4)(ii) of this section, Employer O chooses to take an amount into account before the amount deferred for each year is reasonably ascertainable. For the year 2001, Employer O chooses to assume that Employee C has earned a legally binding

right to a benefit of \$1,000 per year from the SERP. Employer O determines the present value of this benefit stream using an 8 percent interest rate and the UP-84 mortality table, which, solely for purposes of this example, are assumed to be reasonable actuarial assumptions for the year 2001. The resulting present value, \$1,853, is taken into account for 2001. Employer O does not take any other amount into account before the resolution date.

(ii) In accordance with paragraph (e)(4)(ii)(B) of this section, Employer O determines the additional amount required to be taken into in the year 2008 to be \$20,212 (the excess of \$26,950 present value of the stream of benefit payments to which Employee C obtained a legally binding right during 2001, determined as of the resolution date, over \$6,738 (which is the sum of the \$1,853 that was taken into account for 2001, and \$4,885 in income attributable to that amount through the resolution date)).

Example 9. (i) The facts are the same as in *Example 8*, except that Employer O determines that Employee C actually had obtained a legally binding right in 2001 to payments under the SERP that have a present value at the 2018 resolution date of \$6,000.

(ii) No additional amount is required to be taken into account as of the resolution date. Employer O may claim a refund or credit for the overpayment of FICA tax with respect to amounts taken into account prior to the resolution date to the extent permitted by sections 6402 and 6413.

Example 10. (i) In 1997, Employer P establishes a nonqualified deferred compensation plan for Employee D. The plan provides that, in consideration of Employee D's services to be performed on Project X in 1998, Employee D will receive 1 percent per year of Employer P's net profits associated with Project X for each of the immediately succeeding three years. The 1 percent amount payable for net profits each year will be paid on March 31 of the immediately succeeding year. One percent of net profits associated with Project X is \$750,000 in 1999, \$400,000 in 2000, and \$90,000 in 2001.

(ii) Because the services creating the right to all or the amount deferred are performed in 1998, the benefit payments based on the 1999, 2000, and 2001 net profits are all attributable to the amount deferred in 1998. However, because the present value of D's future benefit is contingent on future profits, the determination of the amount deferred requires the use of assumptions other than interest, mortality, and cost-of-living. Thus, the amount deferred in 1998 will not be reasonably ascertainable within the meaning of paragraph (e)(4)(i) of this section until December 31, 2001 (which is the resolution date). Employer P does not choose to take any amount into account prior to the amount deferred becoming reasonably ascertainable.

(iii) Paragraph (d)(1)(ii) of this section provides that a benefit attributable to an amount deferred under a nonqualified deferred compensation plan must be included as wages when actually or constructively paid if it is so paid before the amount deferred has been taken into account as wages under the special timing rule of paragraph (a)(2)(ii) of this section. Thus, the

benefit payments in 2000 and 2001 (on account of 1999 and 2000 net profits) must be included as wages when paid.

(iv) As of December 31, 2001, the amount deferred under the plan becomes reasonably ascertainable. This is because the \$90,000 future benefit payment is a knowable quantity, albeit not readily calculable, and the only assumption needed to determine the present value of the future benefits is interest. Thus, the present value of the payment to be made in 2002 is required to be taken into account as of the resolution date (December 31, 2001) under the special timing rule of paragraph (a)(2)(ii) of this section. Using an interest rate of 10 percent per year (which, solely for purposes of this example, is assumed to be reasonable), Employer P determines that the present value of the future benefits is \$87,881, and Employer P includes that amount in wages for 2001. (Note that Employer P can choose to use the lag method of withholding described in paragraph (f)(3) of this section, which allows the resolution date amount to be taken into account in the first quarter of 2002, provided that an adjustment for income is made.)

Example 11. (i) The facts are the same as in *Example 10*, except that Employer P chooses the early inclusion option permitted by paragraph (e)(4)(ii) of this section to take \$1,000,000 into account on December 31, 1998, before the amount deferred for 1998 is reasonably ascertainable.

(ii) Pursuant to paragraph (e)(4)(ii)(B) of this section, in applying the nonduplication rule of paragraph (a)(2)(iii) of this section, a first-in-first-out rule applies in determining the benefits that are attributable to amounts previously taken into account. Using the 10 percent interest rate, Employer P determines that the \$750,000 benefit payment on March 31, 2000, and the March 31, 2001 benefit payment of \$400,000 are attributable to the \$1,000,000 previously taken into account and, therefore, are not included in wages when paid.

(iii) Under paragraph (e)(4)(ii) of this section, if an employer chooses to take an amount into account before the resolution date, the amount taken into account (plus income attributable to that amount) must be compared with the resolution date amount, and any shortfall must be taken into account as an additional amount deferred as of the resolution date. Pursuant to paragraph (e)(4)(ii)(B) of this section, the benefits paid in 2000 and 2001 that were excluded from wages because they were attributable to the amount that was taken into account (plus income attributable to those payments) must be added to the resolution date amount for purposes of this computation. Thus, Employer P must compare the \$1,000,000 taken into account in 1998 (plus income attributable to that amount) to the sum of the \$87,881 resolution date amount and the two benefit payments (\$750,000 and \$400,000) excluded from wages (plus income attributable to each of those benefit payments). Using an interest rate of 10 percent, Employer P determines that the additional amount that is required to be taken into account as of December 31, 2001 is \$72,653 (\$1,331,000 - (\$87,881 + \$886,132 + \$429,640)).

(f) *Withholding*—(1) *In general.* Unless an employer applies an alternative method described in paragraph (f)(2) or (f)(3) of this section, an amount deferred under a nonqualified deferred compensation plan for any employee is treated, for purposes of withholding and depositing FICA tax, as wages paid by the employer and received by the employee at the time it is taken into account in accordance with paragraph (e) of this section. The alternative methods described in paragraphs (f)(2) and (f)(3) of this section may be used for a calendar year with respect to an amount deferred for an employee only if the amount deferred cannot be readily calculated by the last day of the year. An employer may, from year to year, change between the alternatives described in this paragraph (f).

(2) *Estimated method*—(i) *In general.* Under the alternative method provided in this paragraph (f)(2), the employer may make a reasonable estimate of the amount deferred that cannot be readily calculated and take that estimated amount into account as wages paid by the employer and received by the employee on the last day of the calendar year (the "first year").

(ii) *Underestimate of the amount deferred.* If the employer underestimates the amount deferred (as determined after calculating the actual amount deferred that should have been taken into account by the last day of the first year), the employer may treat the shortfall as wages in the first year or in the first quarter of the next year (the "second year"). In either case, the shortfall does not include the income credited to the amount deferred after the first year. If the employer chooses to treat the shortfall as wages in the first year, the employer must reflect the shortfall on Form W-2 or Form W-2c for the first year, and must correct the information on the Form 941 for the last quarter of the first year. In addition, the shortfall will not be considered a late deposit if it is deposited no later than the employer's first regular deposit date after the close of the first quarter of the second year.

(iii) *Overestimate of the amount deferred.* If the employer overestimates the amount deferred (as determined after calculating the actual amount deferred that should have been taken into account as of the last day of the calendar year) and deposits more than the amount required, the employer may claim a refund or credit in accordance with sections 6402 and 6413.

(3) *Lag method.* Under the alternative method provided in this paragraph (f)(3), the amount deferred that is

described in the last sentence of paragraph (f)(1) of this section may be calculated on any date in the first quarter of the succeeding calendar year and treated as wages paid by the employer and received by the employee on that date. For purposes of applying paragraph (c) of this section, the amount deferred includes income attributable to the amount deferred through the date on which that amount is taken into account under this paragraph (f)(3).

(4) *Examples.* This paragraph (f) may be illustrated by the following examples:

Example 1. (i) Employer M maintains a nonqualified deferred compensation plan that is an account balance plan. The plan provides for annual bonuses based on current year profits to be deferred until termination of employment. Employer M's profits for 1998, and thus the amount deferred, cannot be readily calculated until February 15, 1999.

(ii) In accordance with the alternative method described in paragraph (f)(2) of this section, Employer M makes a reasonable estimate that the amount deferred that must be taken into account as of December 31, 1998 for Employee A is \$20,000, and withholds and deposits FICA tax on that amount as if it were wages paid by Employer M and received by Employee A on that date. Employer M subsequently determines that the actual amount deferred that should have been taken into account on December 31, 1998 was \$22,000.

(iii) In accordance with the alternative method described in paragraph (f)(2)(ii) of this section, Employer M may treat the additional \$2,000 as wages paid to and received by Employee A either in 1998 or in the first quarter of 1999. If Employer M chooses to treat the additional \$2,000 as wages in 1998, Employer M must pay the FICA tax on the \$2,000 difference no later than its first regular deposit date occurring after March 31, 1999. In addition, Employer M must file a Form W-2c for Employee A and must correct the information on Form 941 for the last quarter of 1998. If Employer M complies with these conditions, the FICA tax on the \$2,000 difference is not considered a late deposit.

Example 2. (i) The facts are the same as in *Example 1*, except that Employer M subsequently determines that the actual amount deferred that should have been taken into account on December 31, 1998 was \$19,000.

(ii) Under paragraph (f)(2)(iii) of this section, Employer M may, in accordance with sections 6402 and 6413, claim a refund or credit for the overpayment of tax resulting from the overestimate.

Example 3. (i) The facts are the same as in *Example 1*, except that Employer M does not make a reasonable estimate of the amount deferred that must be taken into account as of December 31, 1998. Instead, Employer M withholds and deposits FICA tax on the amount deferred plus income on that amount (determined under the terms of the plan) as if it were wages paid by Employer M and received by Employee A on March 15, 1999.

(ii) Under the alternative method described in paragraph (f)(3) of this section, the amount taken into account on March 15, 1999 (including the income) will be treated as wages paid to and received by Employee A in 1999.

(g) *Effective date and transition rules—(1) General effective date—(i) Effective date.* Except as otherwise provided in this paragraph (g) or in § 31.3121(v)-2, this section is effective for amounts deferred and benefits paid on or after January 1, 1997.

(ii) *Reasonable, good faith interpretation—(A) in general.* In determining FICA tax liability for amounts deferred and benefits paid before the effective date of this section, an employer may rely on a reasonable, good faith interpretation of section 3121(v)(2), taking into account pre-existing guidance. For example, an employer will be deemed to have determined FICA tax liability and satisfied FICA withholding requirements in accordance with a reasonable, good faith interpretation of section 3121(v)(2) if that liability is determined in accordance with paragraphs (a) through (e) of this section, and the withholding method and timing comply with paragraph (f) of this section. Whether an employer has made a reasonable, good faith interpretation of section 3121(v)(2) will be determined based on the relevant facts and circumstances, including consistency of treatment by the employer.

(B) *Optional adjustment for open years.* If an employer determined FICA tax liability for amounts deferred or benefits actually or constructively paid in any year before the effective date of this section for which the applicable period of limitation has not expired ("pre-effective-date open years"), in a manner that was not in accordance with this section, the employer may adjust its FICA tax determination for that year. In this case, any amount deferred that would have been taken into account (within the meaning of paragraph (d)(1) of this section) in that year under this section must actually be taken into account as if this section were effective for that year. Thus, for example, appropriate adjustments for the prior period must be reflected on Form 941, Employer's Quarterly Federal Tax Return, and Form 941c, Supporting Statement to Correct Information, and Form W-2c must be filed for any affected employee in order that the Social Security Administration may correctly post the amount deferred to the employee's earnings record. Similarly, if an amount was taken into account under a nonaccount balance

plan for any pre-effective-date open year, but the amount deferred was not reasonably ascertainable (within the meaning of paragraph (e)(4)(i) of this section), the employer may claim a refund or credit for any FICA tax paid on that amount in accordance with Internal Revenue Code sections 6402 and 6413 and, thereafter, take the amount deferred into account when it first becomes reasonably ascertainable.

(iii) *Plan must be established or adopted.* If amounts are deferred under a plan before the effective date of this section and benefits are paid on or after the effective date of this section, then in no event will an employer's treatment of amounts deferred under the plan be considered to be in accordance with a reasonable, good faith interpretation of section 3121(v)(2) if the employer treats these amounts as taken into account as wages for FICA purposes prior to the establishment of the plan (within the meaning of paragraph (b)(2) of this section) providing for the deferred compensation (or, if later, the plan amendment providing for the deferred compensation). (If all amounts are deferred and all benefits are paid before the effective date of this section, "adoption" is substituted for "establishment" in the preceding sentence.) For example, awards, bonuses, raises, incentive payments, and other similar amounts granted under a plan as compensation for past services may not be taken into account under section 3121(v)(2) prior to the establishment (or, if applicable, the adoption) of the plan.

(2) *Transition rule for plans that are not subject to section 3121(v)(2).* If a plan is not a nonqualified deferred compensation plan within the meaning of paragraph (b)(1) of this section, but, for a period prior to the effective date of this section and pursuant to a reasonable, good faith interpretation of section 3121(v)(2)(A), an amount under the plan was taken into account (within the meaning of paragraph (d)(1) of this section) as an amount deferred under a nonqualified deferred compensation plan, then, pursuant to paragraph (g)(1) of this section, the following rules shall apply:

(i) With respect to benefits actually or constructively paid before the effective date of this section that are attributable to amounts previously taken into account under the plan, no additional FICA tax will be owed;

(ii) On or after the effective date of this section, benefits under the plan must be taken into account as wages when actually or constructively paid in accordance with paragraph (a)(1) of this section; and

(iii) To the extent FICA tax was actually paid on the amount taken into account prior to the effective date of this section, the employer may claim a refund or credit to the extent permitted by sections 6402 and 6413. However, if any benefits were actually or constructively paid to an employee under the plan before the effective date of this section and these payments were not subject to FICA tax by reason of the employer's treatment of the plan as a nonqualified deferred compensation plan and the application of paragraph (g)(2)(i) of this section, then the employer may claim a refund or credit for pre-effective-date open years only to the extent that the FICA tax paid on amounts deferred in those years exceeds the FICA tax that would have been owed on the benefits actually or constructively paid to the employee in those years if (notwithstanding paragraph (g)(2)(i) of this section) those benefits had been subject to FICA tax when paid.

(3) *Transition rules for plans that are subject to section 3121(v)(2)*—(i) *Plans that were treated as not subject to section 3121(v)(2)—closed years.* If, for a period prior to the effective date of this section and in accordance with a reasonable, good faith interpretation of section 3121(v)(2), an employer treated a plan as if it were not a nonqualified deferred compensation plan within the meaning of section 3121(v)(2), but that plan is a nonqualified deferred compensation plan within the meaning of paragraph (b)(1) of this section, then, for purposes of determining whether benefits actually or constructively paid on or after the effective date of this section were previously taken into account as wages for purposes of applying the nonduplication rule of section 3121(v)(2)(B), any amount deferred that would have been required to have been taken into account under this section in a year for which the applicable period of limitation has expired as of the effective date of this section (a "section 3121(v) closed year") will be treated as if it had been taken into account within the meaning of paragraph (d)(1) of this section. For purposes of this paragraph (g)(3)(i), an employer will be considered to have treated a plan as if it were not a nonqualified deferred compensation plan for a period prior to the effective date of this section only if the employer withheld and deposited any FICA tax due on any benefits actually or constructively paid under the plan during that period. The rule of this paragraph (g)(3)(i) does not apply to any amount deferred in a year that is not a

section 3121(v) closed year that would have been required to have been taken into account under this section (if this section had been in effect for that year). Thus, such an amount deferred will be treated as having been taken into account for purposes of applying the nonduplication rule to benefits paid after the effective date of this section only if the amount deferred was actually taken into account within the meaning of paragraph (d)(1) of this section.

(ii) *Undervaluation of the amount deferred.* If, for a period prior to the effective date of this section, an employer determined the amount deferred for an employee under a nonaccount balance plan in accordance with a reasonable, good faith interpretation of section 3121(v)(2), but that amount is less than the amount that would have been considered the amount deferred under paragraph (c) of this section, the following rules shall apply:

(A) No additional FICA tax will be owed for that period; and

(B) The difference between the amount that was taken into account in a section 3121(v) closed year and the amount that would have been taken into account in that year had the amount deferred been determined under paragraph (c) of this section is treated as if it had been taken into account within the meaning of paragraph (d)(1) of this section. In the case of an amount deferred (in a section 3121(v) closed year) that was not reasonably ascertainable, the difference between the amount taken into account (if any) and the amount that would have been taken into account had the employer taken an amount into account using a method permitted in paragraph (c) of this section and actuarial assumptions that matched the actual experience is treated as if it had been taken into account within the meaning of paragraph (d)(1) of this section.

Accordingly, with respect to such an amount deferred, the employer is not required to take any additional amount into account when the amount deferred becomes reasonably ascertainable, and no additional FICA tax will be owed when the benefits attributable to the amount deferred are actually or constructively paid. The rule of this paragraph (g)(3)(ii)(B) does not apply to any amount deferred that would have been required to have been taken into account under this section in a pre-effective-date open year.

(iii) *Overinclusion of the amount deferred.* If an amount deferred for an employee under a nonaccount balance plan was taken into account before the effective date of this section in accordance with a reasonable, good faith

interpretation of section 3121(v)(2), but, under this section, that amount would have been taken into account on or after the effective date of this section, the following rules apply:

(A) The determination of an amount deferred for any period beginning on or after the effective date of this section must be made in accordance with paragraph (c) of this section, and the time when that amount deferred is required to be taken into account must be determined in accordance with paragraph (e) of this section, without regard to any amount deferred that was taken into account for any period before the effective date of this section; and

(B) The employer may claim a refund or credit for an overpayment of tax caused by the pre-effective-date overinclusion of wages to the extent permitted by sections 6402 and 6413.

(4) *Examples.* This paragraph (g) may be illustrated by the following examples:

Example 1. (i) In 1994, Employer M establishes a nonqualified deferred compensation plan that is a nonaccount balance plan for Employee A. All benefits under the plan are 100 percent vested. In order to determine the amount deferred on behalf of Employee A under the plan for 1994 and 1995, Employer M must make assumptions as to the date on which Employee A will retire and the form of benefit Employee A will elect, in addition to interest, mortality, and cost-of-living assumptions. Based on assumptions made with respect to all of these contingencies, Employer M determines that the amount deferred for 1994 is \$50,000 and the amount deferred for 1995 is \$55,000. No OASDI tax is owed with respect to those amounts deferred. However, Employer M withholds and deposits HI tax on those amounts. Because Employee B does not retire before the effective date of this section, Employer R will still need to make assumptions for the date of retirement and the form of benefit through the effective date. Employer M chooses to apply this section before its effective date to 1994 and 1995.

(ii) Under the regulations in this section, the amounts deferred in 1994 and 1995 are not reasonably ascertainable (within the meaning of paragraph (e)(4)(i) of this section) before the effective date of this section. Thus, assuming the applicable period of limitation has not expired for 1994 and 1995, Employer M may, in accordance with paragraph (g)(1)(ii)(B) of this section, apply for a refund or credit for the HI tax paid on the amounts deferred for 1994 and 1995 in accordance with sections 6402 and 6413 and, in accordance with paragraph (e)(4) of this section, take into account the amounts deferred when they become reasonably ascertainable.

Example 2. (i) Employer N adopts a plan on January 1, 1994 that covers Employee B, who has 10 years of service as of that date. The plan provides that, in consideration of Employee B's outstanding services over the

past 10 years, Employee B will be paid a \$500,000 lump sum distribution upon termination of employment at any time. On January 15, 1996, Employee B terminates employment with Employer N. Employer N determines, based on a reasonable, good faith interpretation of section 3121(v)(2), that the plan is a nonqualified deferred compensation plan under that section. Employer N treats the \$500,000 as having been taken into account as an amount deferred in 1993 and earlier years.

(ii) Under paragraph (g)(1)(iii) of this section, if all amounts are deferred and all benefits are paid under a plan before the effective date of this section, then in no event will an employer's treatment of amounts deferred under the plan be considered to be in accordance with a reasonable, good faith interpretation of section 3121(v)(2) if the employer treats these amounts as taken into account as wages for FICA purposes prior to the adoption of the plan. Accordingly, Employer N's treatment is not in accordance with a reasonable, good faith interpretation of section 3121(v)(2) because Employer N treated amounts as taken into account in years before the adoption of the plan.

Example 3. (i) Employer O adopts a bonus plan on December 1, 1993 that becomes effective and legally binding on January 1, 1994. Under the plan, which is not set forth in writing, a specified bonus amount (which is 100 percent vested) is credited to Employee C's account each December 31. A reasonable rate of interest on Employee C's account balance is credited quarterly. Employee C's account balance will begin to be paid in equal annual installments over ten years beginning on January 1, 1999. Employer O determines, based on a reasonable, good faith interpretation of section 3121(v)(2), that the bonus plan is a nonqualified deferred compensation plan under that section and, therefore, treats the amounts credited on December 31, 1994, 1995, and 1996 as amounts deferred and takes those amounts deferred into account as wages for FICA purposes as of those dates. The bonus plan is set forth in writing on February 1, 1997, which for purposes of this example is assumed to be prior to the date that is six months after the publication of the final regulations, and, thus, is treated as established as of January 1, 1994.

(ii) Under paragraph (g)(1)(iii) of this section, if all amounts are deferred and all benefits are paid under a plan before the effective date of this section, then in no event will an employer's treatment of amounts deferred under the plan be considered to be in accordance with a reasonable, good faith interpretation of section 3121(v)(2) if the employer treats these amounts as taken into account as wages for FICA purposes prior to the establishment of the plan (within the meaning of paragraph (b)(2) of this section). Because the bonus plan is treated as established on January 1, 1994 (pursuant to the transition rule provided in paragraph (b)(2)(iii) of this section), the amounts deferred are not treated as having been taken into account prior to the establishment of the plan, even though the plan was not set forth in writing until February 1, 1997.

Example 4. (i) In 1985, Employer P establishes a compensation arrangement for

Employee D that provides annual payments over a number of years after termination of employment. Prior to the effective date of this section, and in accordance with a reasonable, good faith interpretation of section 3121(v)(2), Employer P treats the arrangement as a nonqualified deferred compensation plan under section 3121(v)(2). Each year, consistent with this treatment, Employer P determines the amount deferred that must be taken into account as FICA wages for the year. Employer P also determines that Employee D's total wages (without regard to the amount deferred) for each year from 1985 through 1993 exceed the applicable wage base for each of those years and, consequently, there is no FICA tax liability with respect to the amounts deferred for those years. In 1994, Employee D's total wages (without regard to the amount deferred) exceed the OASDI wage base. However, because there is no limit on the HI wage base, the amount deferred for 1994 results in additional HI tax liability of \$290, which is timely paid by Employer P.

(ii) Employee D terminates employment with Employer P in 1995 and receives a plan payment of \$50,000. In that year, Employee D also receives wages of \$60,000 from Employer P. In accordance with its treatment of the plan as a nonqualified deferred compensation plan under section 3121(v)(2), Employer P does not treat the payment in 1995 as wages for FICA purposes in that year. Although Employer P made a reasonable, good faith determination that the plan is a nonqualified deferred compensation plan under section 3121(v)(2), the plan is not a nonqualified deferred compensation plan within the meaning of paragraph (b)(1) of this section. Both 1994 and 1995 are pre-effective-date open years.

(iii) Because amounts under a plan were taken into account (within the meaning of paragraph (d)(1) of this section) as amounts deferred under a nonqualified deferred compensation plan pursuant to a reasonable, good faith interpretation of section 3121(v)(2)(A), but that plan is not a nonqualified deferred compensation plan within the meaning of paragraph (b)(1) of this section, the transition rule provided in paragraph (g)(2) of this section applies. Thus, no additional FICA tax will be owed on benefits paid in 1995. However, on or after the effective date of this section, benefits under the plan must be taken into account as wages when actually or constructively paid in accordance with the general timing rule of paragraph (a)(1) of this section.

(iv) Because \$290 of HI tax was paid on the amount deferred in 1994, Employer P is entitled to a refund or credit for that amount—but only to the extent that \$290 exceeds the FICA tax that would have been owed on the \$50,000 annual payment in 1995 if those benefits had been subject to FICA tax when paid (i.e., if the regulation had been effective for those years). In 1995, Employee D had other wages of \$60,000. Thus, only \$1,200 (the \$61,200 OASDI wage base, less the \$60,000 of other wages) of the \$50,000 payment would have been subject to OASDI; the full \$50,000 would have been subject to HI. This would have resulted in \$148.80 of OASDI tax ($\$1,200 \times 12.4$ percent) and \$1,450

of HI tax ($\$50,000 \times 2.9$ percent). Employer P is not entitled to a refund or credit under the transition rule of paragraph (g)(2) because the \$290 of HI tax paid in 1994 is less than the total \$1,598.80 of FICA tax liability that would have resulted if this section had applied for 1995.

Example 5. (i) In 1985, Employer Q establishes a compensation arrangement for Employee E that is a nonqualified deferred compensation plan within the meaning of paragraph (b)(1) of this section. However, prior to the effective date of this section, Employer Q determines, based on a reasonable, good faith interpretation of section 3121(v)(2), that the arrangement is not a nonqualified deferred compensation plan within the meaning of that section. Thus, when payments under the arrangement begin in 1995, Employer Q withholds and deposits FICA tax on the amounts paid to Employee E. Payments under the arrangement continue after the effective date of this section. Employer Q does not choose (under paragraph (g)(1)(ii)(B) of this section) to adjust its FICA tax determination for pre-effective-date open years by treating this section as in effect for all amounts deferred and benefits actually or constructively paid for those years.

(ii) Under paragraph (g)(3)(i) of this section, for purposes of determining whether benefits actually or constructively paid on or after the effective date of this section were previously taken into account for purposes of applying the nonduplication rule of section 3121(v)(2)(B), any amount that would have been required to have been taken into account in a section 3121(v) closed year will be treated as if it had been taken into account within the meaning of paragraph (d)(1) of this section. Under the nonduplication rule, benefits attributable to an amount that has been so taken into account is not treated as wages for FICA purposes at any later time (such as upon payment).

(iii) Because Employer Q does not adjust its FICA tax determination for pre-effective-date open years by treating this section as in effect for all amounts deferred for those years, any benefits attributable to those amounts will be included in wages when actually or constructively paid in accordance with the general timing rule of paragraph (a)(1) of this section.

Example 6. (i) The facts are the same as in *Example 5*, except that Employer Q chooses (in accordance with paragraph (g)(1)(ii)(B) of this section) to adjust its FICA tax determination for all pre-effective-date open years by treating this section as in effect for all amounts deferred for those years.

(ii) In accordance with the nonduplication rule of paragraph (a)(2)(iii) of this section, any benefits attributable to the amounts deferred that were taken into account for pre-effective-date open years in accordance with paragraph (d)(1) of this section will not be included as wages when actually or constructively paid.

Example 7. (i) The facts are the same as in *Example 5*, except that Employer Q does not withhold and deposit the FICA tax due on benefits actually or constructively paid prior to the effective date of this section.

(ii) Because Employer Q did not withhold and deposit the FICA tax due on benefits

actually or constructively paid during that period, the transition rule provided in paragraph (g)(3)(i) of this section does not apply. Therefore, any amount that would have been required to have been taken into account under this section in a pre-effective-date closed year is not treated as if it had been so taken into account, and benefits attributable to any such amount are treated as FICA wages when actually or constructively paid in accordance with the general timing rule of paragraph (a)(1) of this section.

Example 8. (i) In 1993, Employer R establishes a nonqualified deferred compensation plan for Employee F. In accordance with a reasonable, good faith interpretation of section 3121(v)(2), Employer R determines that, for 1993, there is an amount deferred of \$2.5 million that must be taken into account as wages for FICA purposes. However, because Employee F has other wages in 1993 that exceed the applicable OASDI and HI wage bases for that year, no additional FICA tax is actually owed as a result of that amount deferred being taken into account for 1993. Under this section, \$2 million of the amount taken into account in 1993 would have been taken into account for years beginning on or after the effective date of this section because Employee F did not have a legally binding right to that amount until after that date.

(ii) In accordance with paragraph (g)(3)(iii)(A) of this section, the determination of the amount deferred under the plan for any period beginning on or after the effective date of this section must be made in accordance with paragraph (c) of this section, and the time when that amount deferred is required to be taken into account must be determined in accordance with paragraph (e) of this section. In addition, these determinations must be made without regard to any amount deferred that was taken into account for any period before the effective date of this section. Thus, the \$2 million that, under this section, would have been taken into account for years beginning on or after the effective date of this section must be taken into account under this section for those years. Because no FICA tax was actually paid on that \$2 million in 1993, no overpayment of tax was caused by the overinclusion of wages in 1993 and, thus, Employer R is not entitled to a refund or credit.

§ 31.3121(v)(2)-2 Effective dates and transition rules.

(a) **General effective date.** Except as otherwise provided in paragraphs (b) through (e) of this section, section 3121(v)(2) and the amendments made to section 3121(a)(2), (3), and (13) by the Social Security Amendments of 1983 (Pub. L. 98-21, 97 Stat. 65 (1983)), as amended by section 2662(f)(2) of the Deficit Reduction Act of 1984 (Pub. L. 98-369, 98 Stat. 494 (1984)), apply to amounts deferred and benefits paid after December 31, 1983.

(b) **Definitions.** For purposes of § 31.3121(v)(2)-1 and paragraphs (a)

through (e) of this section, the following definitions apply:

FICA. FICA means the Federal Insurance Contributions Act (26 U.S.C. 3101 *et seq.*).

457(a) plan. A 457(a) plan means an eligible deferred compensation plan of a State or local government or of a tax-exempt organization to which section 457(a) of the Internal Revenue Code applies.

Gap agreement. Gap agreement means an agreement adopted after March 24, 1983, and on or before December 31, 1983.

March 24, 1983 agreement. March 24, 1983 agreement means an agreement in existence on March 24, 1983 between an individual and a nonqualified deferred compensation plan within the meaning of § 31.3121(v)-1(b). For this purpose only, any plan (or agreement) to make payments that qualify for one of the retirement payment exclusions is treated as a nonqualified deferred compensation plan, regardless of whether the plan (or agreement) is treated as a nonqualified deferred compensation plan within the meaning of § 31.3121(v)-1(b). For example, § 31.3121(v)-1(b)(4)(v) provides that certain benefits established in connection with impending termination do not result from the deferral of compensation and thus are not considered deferred under a nonqualified deferred compensation plan. However, a plan that provides such benefits and that was in existence on March 24, 1983 is treated as a nonqualified deferred compensation plan for purposes of this paragraph (b) to the extent it provides benefits that would have satisfied one of the retirement payment exclusions had the benefits been paid on April 19, 1983.

Post-amendment. Post-amendment means after December 31, 1983.

Pre-amendment. Pre-amendment means on or before December 31, 1983.

Retirement payment exclusions. Retirement payment exclusions are the exclusions from wages (for FICA tax purposes) for retirement payments under sections 3121(a)(2)(A), (a)(3), and (a)(13)(A)(iii), as in effect on April 19, 1983.

Transition benefits. Transition benefits are post-amendment payments attributable to pre-amendment services.

(c) **Transition rules—(1) In general.** The general effective date described in paragraph (a) of this section applies to post-amendment payments attributable solely to post-amendment services, whether or not paid under a March 24, 1983 agreement or a gap agreement. Thus, section 3121(v)(2) applies, and the retirement payment exclusions do

not apply, to these benefits. Special effective dates apply to transition benefits under a March 24, 1983 agreement and transition benefits under a gap agreement. These special effective dates are set forth in paragraphs (c)(2) and (c)(3) of this section, respectively.

(2) **Transition benefits under a March 24, 1983 agreement.** Transition benefits under a March 24, 1983 agreement (except for those under a 457(a) plan) are not subject to the special timing rule of section 3121(v)(2) and remain subject to section 3121(a) as in effect on April 19, 1983. Thus, transition benefits under a March 24, 1983 agreement (except for those under a 457(a) plan) are excluded from wages (for FICA tax purposes) only if they qualify for any of the retirement payment exclusions (or any other exclusion provided under section 3121(a) as in effect on April 19, 1983).

(3) **Transition benefits under a gap agreement.** The payor of transition benefits under a gap agreement must choose to either—

(i) Take the transition benefits into account as wages when paid; or

(ii) Take the amount deferred (within the meaning of § 31.3121(v)-1(c)) with respect to the transition benefits into account as wages under section 3121(v)(2) (as if section 3121(v)(2) had applied before its general effective date).

(d) **Determining transition benefit portion.** For purposes of determining the portion of total benefits under a nonqualified deferred compensation plan that represents transition benefits, if, under the terms of the plan, benefits are not attributed to specific years of service, the employer may use any reasonable method. For example, if a plan provides that the employee will receive benefits equal to two percent of high three-year average compensation multiplied by years of service, and the employee retires after 25 years of service, nine of which are before 1984, the employer may determine that 9/25 of the total benefits to be received beginning in 2000 are transition benefits attributable to services performed before 1984.

(e) **Order of payment.** If an employer determines, in accordance with paragraph (d) of this section, that a portion of the total benefits under a nonqualified deferred compensation plan constitutes transition benefits, then, for purposes of determining the portion of each benefit payment that constitutes transition benefits—

(1) For a payment made before the effective date of this section, the employer may use any reasonable allocation method to determine the portion of a payment that consists of transition benefits, provided that the

allocation method is consistent with the terms of the plan; and

(2) For a payment made on or after the effective date of this section, the employer must treat each payment as consisting of transition benefits in the same proportion as the transition benefits that have not been paid (as of the effective date of this section) bear to total benefits that have not been paid (as of the effective date of this section), unless such allocation is inconsistent with the terms of the plan.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

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BILLING CODE 4830-01-U

26 CFR Part 31

[EE-55-95]

RIN 1545-AT99

FUTA Taxation of Amounts Under Employee Benefit Plans

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations under section 3306(r)(2) of the Internal Revenue Code, relating to when amounts deferred under or paid from certain nonqualified deferred compensation plans are taken into account as "wages" for purposes of the employment taxes imposed by the Federal Unemployment Tax Act (FUTA). The regulations provide guidance to taxpayers who must comply with section 3306(r)(2), which was added to the Code by section 324 of the Social Security Amendments of 1983.

DATES: Written comments and requests for a public hearing must be received by April 24, 1996.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (EE-55-95), room 5228, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to CC:DOM:CORP:R (EE-55-95), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: David N. Pardys, (202) 622-4606 (not a toll-free number), concerning the regulations, and Michael Slaughter, (202) 622-7190 (not a toll-free number), concerning submissions.

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Employment Tax Regulations (26 CFR part 31) under section 3306(r)(2) of the Internal Revenue Code of 1986 (the "Code") relating to the employment tax treatment of amounts deferred under or paid from certain nonqualified compensation plans. These amendments are proposed to reflect the statutory changes made by section 324 of the Social Security Amendments of 1983 (the "1983 Amendments"), which added section 3306(r)(2) to the Code, and section 2662(f)(2) of the Deficit Reduction Act of 1984 (DEFRA), which amended section 324 of the 1983 Amendments.

Explanation of Provisions

These proposed regulations provide guidance under section 3306(r)(2) of the Internal Revenue Code, relating to when amounts deferred under or paid from certain nonqualified deferred compensation plans are taken into account as wages for FUTA purposes. These rules are substantially similar to the rules applicable to the FICA (Federal Insurance Contributions Act) tax treatment of such amounts deferred under section 3121(v)(2) of the Internal Revenue Code. Thus, these regulations cross-reference the proposed regulations under section 3121(v)(2).

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying. A public hearing may be

scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the Federal Register.

Drafting Information

The principal author of these regulations is David N. Pardys, Office of the Associate Chief Counsel (Employee Benefits and Exempt Organizations), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 31

Employment taxes, Income taxes, Penalties, Pensions, Railroad retirement, Reporting and recordkeeping requirements, Social security, Unemployment compensation.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 31 is proposed to be amended as follows:

PART 31—EMPLOYMENT TAXES AND COLLECTION OF INCOME TAX AT SOURCE

Paragraph 1. The authority citation for part 31 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 31.3306(r)(2)-1 is added to read as follows:

§ 31.3306(r)(2)-1 Treatment of amounts deferred under certain nonqualified deferred compensation plans.

(a) *In general.* Section 3306(r)(2) provides a special timing rule for the tax imposed by section 3301 with respect to any amount deferred under a nonqualified deferred compensation plan. Section 31.3121(v)(2)-1¹ contains rules relating to when amounts deferred under certain nonqualified deferred compensation plans are wages for purposes of sections 3121(v)(2), 3101, and 3111. Those rules also apply to the special timing rule of section 3306(r)(2). For purposes of applying those rules to section 3306(r)(2) and this paragraph (a), references in those rules to the Federal Insurance Contributions Act are considered references to the Federal Unemployment Tax Act (26 U.S.C. 3301 *et seq.*), references to FICA are considered references to FUTA, references to section 3101 or 3111 are considered references to section 3301, references to section 3121(v)(2) are considered references to section

¹ This section appears as a notice of proposed rulemaking published elsewhere in this issue of the Federal Register.