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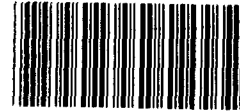

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SOCIAL SECURITY: Taxing Nonqualified Deferred Compensation

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Before the
Subcommittee on Social Security
House Committee on Ways and Means

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SUMMARY

Nonqualified deferred compensation refers to employer sponsored income deferral plans that do not qualify for favored income tax treatment. Basically, the plans are like IOUs. They represent employer promises to provide additional future income to employees for the services they currently render.

Self employed persons can also defer income through contractual arrangements with their clients. Such contractual deferrals used to face similar tax treatment as nonqualified plans until enactment of section 3121(v)(2) in the Social Security Amendments of 1983. Before the amendments were passed, both types of deferrals were subject to income and social security tax when persons received payments. After the amendments, nonqualified deferrals are subject to the social security tax before they are received. Simply stated, nonqualified deferrals are recognized as income either (1) in the year services were performed to earn them or (2) in the year when conditions associated with their payment are met and the employee no longer risks forfeiting his right to them.

Early recognition of deferred income can have tax advantages for persons with current income at or over the social security wage base and covered by section 3121(v)(2). For these people, it means that no additional social security taxes have to be paid in the year the income is recognized and the payments would not be subject to the tax when later received. Thus, self-employed persons meeting these conditions could avoid paying social security taxes on their deferred income if they had a comparable provision.

Given this situation, you asked us several questions about deferred income and section 3121(v)(2). Our answers follow.

Self-employed taxpayers use contractual arrangements to defer income but probably not extensively. Risks associated with collecting deferred income and tax prerequisites appear to be discouraging factors.

Section 3121(v)(2) evolved from concerns about how employee voluntary contributions to qualified deferred compensation plans could escape social security taxes. During deliberations the Congress also changed social security tax rules for employer sponsored nonqualified plans.

Limited reporting on nonqualified plans precludes measurement of the effects of section 3121(v)(2) on social security revenues. Both IRS and SSA believe it was marginal.

IRS officials believe the section has complicated tax administration and regulations on the use of the provision are needed. It has been unable to issue such regulations because of higher priority projects and problems in drafting regulations.

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss the social security taxation of certain types of deferred income. Last summer, you asked us whether self-employed taxpayers defer income through arrangements that can be viewed as similar to employer-sponsored nonqualified deferred compensation plans. Your interest in this matter stemmed from 1983 legislation that changed the social security tax treatment of nonqualified deferred income for employees, but did not make a similar change for comparably situated self-employed taxpayers. You also asked us about (1) the legislative history of the change, (2) the revenue effect of the change on the trust funds, and (3) problems in administering the provision.

As discussed in our report to you[1], some self-employed taxpayers do defer income through contractual arrangements with their clients, and these are similar to nonqualified plans in that they receive comparable income tax treatment. However, not many self-employed persons seem to use these arrangements. Before discussing the results of our work, I would like to explain briefly nonqualified deferred compensation plans, the taxing of these plans for income tax and social security tax purposes, and income deferrals by self-employed taxpayers.

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[1]Social Security: Taxing Nonqualified Deferred Compensation (GAO/HRD-90-82, Mar. 15, 1990).

BACKGROUND

Deferred compensation plans can be classified as either qualified or nonqualified. Nonqualified plans refer to employer-sponsored plans under which the deferred amounts do not qualify for certain favored income tax treatment under the Internal Revenue Code. Essentially, nonqualified plans are IOUs by which the employer promises to pay employees participating in such plans additional income in the future for services currently rendered. Such plans are used to provide work incentives or to supplement retirement income and limit employees' current income tax liabilities.

Self-employed taxpayers can also defer their income through contractual arrangements with their clients. These arrangements are similar to nonqualified deferred compensation plans for employees in that they (1) represent a promise (by their client) to pay in the future for goods or services currently rendered and (2) do not receive the favored income tax treatment.

Amounts deferred under nonqualified plans and contractual arrangements are subject to income tax in the year received. However, these arrangements receive different social security tax treatment. Employees have the social security tax imposed on their nonqualified deferred compensation in the year the deferred amount is earned. Self-employed taxpayers have the social

security tax imposed on their contractually deferred income in the year the deferred amount is received.

This difference in social security tax treatment resulted from enactment of section 3121(v)(2) of the code by the Social Security Amendments of 1983. This section changed the social security tax treatment for nonqualified deferred compensation. Before this section was enacted, the tax was imposed when the amounts were received. Subsequently, the tax is imposed essentially in the year the income was earned. The 1983 amendments did not affect the taxing of deferred income for the self-employed.

Earlier recognition of deferred income can have tax advantages for persons who have other current income at least equal to the social security wage base ($51,300 in 1990). For these people no additional social security taxes have to be paid on the deferred amount either (1) in the year it is considered taxable because it is above the wage base or (2) when received because it would not be subject to the tax. Thus, some self-employed persons in a similar situation could limit their social security taxes if the law was changed to treat their deferred income like nonqualified deferred compensation.

On the other hand, earlier recognition of deferred income may not have tax advantages for persons with current income below the

wage base in the year the deferred amount is earned. In these cases, persons will pay social security taxes on deferred amounts up to the wage base in the year the amounts were earned. Since early recognition does not result in a tax savings, such persons would probably want to pay the tax later (when they receive the income) rather than sooner (when they have earned but not received it).

SELF-EMPLOYED DO NOT EXTENSIVELY USE CONTRACTUAL ARRANGEMENTS TO DEFER INCOME

You asked if self-employed taxpayers use deferred income arrangements similar to those used by employees that are subject to taxation under section 3121(v)(2) of the tax code. We found that some types of self-employed taxpayers use contractual arrangements to defer income owed them by their clients, however, they do not seem to make extensive use of these arrangements. We could identify only four types of professionals paying self-employment taxes--medical doctors, ministers, insurance agents, and directors of corporations--in which some people had contractual arrangements to defer income.

Self-employed taxpayers' limited use of contractual arrangements to defer income may be related to two factors. One, they may be unwilling to incur the risk of collecting amounts owed from clients at substantially later points in time, especially if they

have not had a continuous business relationship with the clients. Two, compliance with tax code prerequisites for deferring income can be a complicated task and could discourage use of these arrangements. In a number of tax decisions involving the deferral of income by self-employed taxpayers, the Internal Revenue Service or the federal courts have held that taxes had to be paid on alleged deferred income before payments were actually received from clients.

ORIGIN AND DEVELOPMENT OF SECTION 3121(v)(2)

You asked how section 3121(v)(2) came about. The section evolved from concern that the increasing use of qualified income deferral arrangements (401(k) plans) could reduce social security tax revenues.

Before the enactment of section 3121(v)(2), employees participating in 401(k) plans could avoid paying the social security tax on their voluntary wage contributions. Under then-existing law, voluntary employee wage contributions were excluded from taxation, which had the effect of lowering aggregate wages subject to taxation. To preserve the social security tax base, the Congress proposed taxing employee wage contributions for 401(k) plans and other types of employee benefits by imposing the social security tax on employee wage contributions in the year the wages were earned.

During consideration of the act, the Congress also decided to change the tax treatment of nonqualified deferred compensation plans. After some discussion of this matter, the Congress enacted section 3121(v)(2). During the Senate debate, it was noted that the section provided similar treatment as was being proposed for voluntary wage contributions to qualified plans.

EFFECT OF SECTION 3121(v)(2) ON SOCIAL SECURITY REVENUES

You also asked what effect this section had on social security revenues. Unfortunately, the revenue effect cannot currently be measured because of limited reporting by employers on nonqualified plans. The effect on tax revenues hinges on two situations:

-- whether payments made under nonqualified plans before the 1983 amendments were included in workers' social security wage base when received or if the payments were excluded under then-existing code provisions for retirement-related payments, and

-- the extent to which plan participants' current income levels exceed the social security wage base.

Sufficient information does not exist to measure plan uses in either of these situations.

Notwithstanding these measurement problems, both the Internal Revenue Service and Social Security Administration representatives believe that the revenue effects of section 3121(v)(2) have been marginal. They differ, however, on whether the effect of this section marginally increased or decreased social security tax revenues.

PROBLEMS IN IMPLEMENTING SECTION 3121(v)(2)

Finally, you asked whether section 3121(v)(2) was difficult to administer. We found only one significant tax administration problem relating to the need for additional guidance on the types of arrangements covered by the provision. IRS representatives stated that regulations for the section are needed, but IRS has not been able to develop them despite extensive efforts. IRS attributed the delay in issuing regulations to several factors.

First, higher priority tax legislation, including the Tax Reform Act of 1986, created pressures that precluded issuance of regulations for section 3121(v)(2). Second, problems were encountered in drafting regulations. These included the difficulty in delineating which plans and arrangements the section covers and deciding how the amount deferred should be quantified. Without regulations, IRS is concerned that taxpayers may be avoiding social security taxes on deferred payments by considering the payments to be made under nonqualified plans.

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This concludes my statement Mr. Chairman. I will be happy to answer any questions that you may have about our report.