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Report to the Chairman, Subcommittee on Social Security, Committee on Ways and Means, House of Representatives

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# SOCIAL SECURITY:

# Taxing Nonqualified Deferred Compensation



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**United States**
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**Human Resources Division**

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The Honorable Andrew Jacobs, Jr.
Chairman, Subcommittee on Social Security
Committee on Ways and Means
House of Representatives

Dear Mr. Chairman:

You asked us to determine whether self-employed taxpayers use deferred income arrangements that achieve similar income tax treatment as plans called "nonqualified deferred compensation plans" used by employers and employees. These nonqualified plans are basically employer IOUs to pay employees future benefits in return for current services. You asked how the imposition of the social security tax on employees using these kinds of plans differs from its imposition on self-employed taxpayers for similar types of income. You also asked several questions about the nature and effects on social security tax revenues resulting from changes in the taxing of nonqualified deferred income for employees.

Simply stated:

- Employees currently participating in nonqualified plans to defer income are subject to social security tax on the deferred amount in the year income is earned.
- Self-employed taxpayers who defer income through contractual arrangements with their customers or clients pay social security tax on the deferred amount in the year income is received.

The difference in tax treatment between these two categories of workers can be traced to the enactment of section 3121(v)(2) of the Internal Revenue Code, which changed the social security tax treatment of nonqualified deferred compensation for employees.

The effect of this difference in social security tax treatment depends on whether an individual's other earnings are above or below the social security wage base ($51,300 in 1990) in the year the deferred income is earned. Generally, those earning above this maximum taxable amount are better off if the deferred amounts are considered taxable in the year earned. Since they must pay the maximum tax anyway, no additional tax results from recognizing the deferred income promise. In contrast, those with earnings below the wage base in the year the deferred

income is earned are generally better off if the deferred income is subject to the tax in the year received. They are going to have to pay additional social security taxes at some point, and would probably rather pay later than sooner.

Section 3121(v)(2) of the code resulted in different social security tax treatment of employee income deferred through nonqualified plans than self-employed income deferred through contractual arrangements with customers. On one hand, the different treatment can be viewed as burdensome by some of the self-employed because their inability to recognize for social security purposes deferred income earlier ultimately can increase their social security tax payments. On the other hand, the different treatment can be helpful to some self-employed individuals who may need additional quarters of coverage to be eligible for social security benefits.

Self-employed taxpayers do not seem to make extensive use of contractual arrangements to defer income. We were unable to determine the specific reasons why they do not use these arrangements more often. One possible reason is that self-employed persons may experience risks in collecting payments substantially later, especially from customers with whom they have not had continuous business relationships. Also, there have been a number of tax decisions involving the deferral of income by self-employed taxpayers where the Internal Revenue Service (IRS) or federal courts held that taxes had to be paid on alleged deferred income before payments were actually received. Such conditions may discourage the self-employed from using contractual income deferral arrangements more often.

Four groups of self-employed professionals (medical doctors, ministers, insurance agents, and directors of corporations) who use deferred income arrangements that achieve similar income tax treatment as nonqualified deferred compensation are discussed in appendix IV. It is possible, however, that other self-employed professionals also defer income. Further, if the code is changed to provide the same social security tax treatment for income deferred under contractual arrangements with customers, higher income self-employed taxpayers willing to assume the associated risks may have a financial incentive to increase use of these deferral arrangements.

You also asked us to describe (1) the origin and development of section 3121(v)(2), (2) its effect on social security tax revenues, and (3) any problems that have arisen from its implementation. You indicated that

this information would be useful in deciding if social security taxes should be imposed similarly on the self-employed and employees.

## Background

The social security tax is imposed on employment-related earnings and self-employment earnings in order to finance the social security Old Age and Survivors' Insurance and Disability Insurance programs as well as part of the Medicare program. It is imposed on all earnings up to the social security wage base, which is $51,300 in 1990, except for amounts specifically excluded from taxation by the code.

### Deferred Compensation Plans Can Be Qualified or Nonqualified

Deferred compensation plans refer to compensation arrangements in which employers pay in the future for current services provided by employees. Employers offer deferred compensation plans to provide work incentives or retirement income or to limit employees' current income tax liability.

Under the tax code, deferral plans are either "qualified" or "nonqualified" for special income tax treatment.[1] To be qualified, the deferral must be made under a plan meeting numerous code requirements. Some of these requirements, such as the requirement that the plans cannot favor employees who are officers or shareholders or only the highly compensated, are designed to encourage employers to allow all employees to participate in plans. Other requirements are intended to protect the interests of employees who participate in such plans. For example, employers must place amounts promised to employees in trusts that are restricted to the sole purpose of paying benefits.

Nonqualified deferred compensation plans are ones that have not met code qualification requirements. Nonqualified deferrals may be offered to employees to provide the same type of benefits as qualified deferrals. However, nonqualified deferred compensation arrangements frequently fail code requirements for qualification because employers do not establish trusts to pay amounts promised to employees.

[1]Essentially, the special income tax treatment allows (1) employers to deduct their contributions to the trust fund of a qualified plan as current expenses even though the amounts have not been paid to employees and (2) employees to defer paying income taxes on these amounts and any investment earnings until the amounts are paid to them.

## How Section 3121(V)(2) Changed Taxing of Nonqualified Deferred Compensation

Section 3121(v)(2), enacted as part of the Social Security Amendments of 1983, changed the tax year in which employee earnings under nonqualified deferred compensation plans are subject to the social security tax. Before this provision became law, amounts owed to employees under nonqualified plans were subject to the tax in the year received, but payments made under these plans could escape taxation if they met one of several code exclusions. For example, some of these exclusions made specific retirement-related payments not subject to the social security tax. After enactment of section 3121(v)(2), income under these plans was subject to the social security tax either in the year services were performed or in the year that conditions[2] required for payment were met.

## Self-Employed Can Defer Income

Self-employed taxpayers can defer income in various ways. They can use qualified arrangements comparable to those used by employees, or they can enter into contractual arrangements with their customers to delay receipt of payment for goods or services. If the contractual arrangement meets certain tax code prerequisites, self-employed taxpayers defer recognition of the income and the social security taxes until they receive payments from customers. This is the same way deferred income from nonqualified plans was treated for employees before enactment of section 3121(v)(2).

## Tax Advantages Can Arise From Income Deferrals

The tax year in which the social security tax is imposed on deferred income can be important to taxpayers because the social security wage base limits the amount of wages subject to this tax in a given year. If taxpayers are assessed the tax on deferred amounts in a year in which they have other income exceeding the wage base, they pay no social security taxes on the deferred amount.

For example, assume that for tax year 1990, an employee taxpayer had $51,300 (the wage base) in social security-covered income and the employer promised to pay an additional $10,000 later under a nonqualified deferral plan. The plan is designed to pay the taxpayer $10,000 after retirement, when presumably the taxpayer will have no other earned income. Under current rules, the taxpayer would recognize $61,300 as social security-covered wages for tax year 1990, but the tax

[2]Employees may risk forfeiture of benefits if payment is conditioned upon future events. For example, a common provision provides for an employee to forfeit benefits if the employee begins working for a competitor.

would be imposed on only $51,300—the wage base. Since the remaining $10,000 was recognized for social security tax purposes in 1990, it would not be subject to this tax when received.

Assume a self-employed taxpayer also earned $61,300 in 1990. Of this amount, the self-employed taxpayer deferred $10,000 under a contractual arrangement with a customer to receive the deferred amount at a time the taxpayer presumably would have no other earned income. Under current rules, the self-employed taxpayer would pay the social security tax on the entire $61,300. The social security tax would be imposed on $51,300 in 1990 and on the deferred $10,000 when it is received.

The tax advantage decreases, however, when current income is below the wage base. For example, if an employee taxpayer received a $10,000 deferred income promise and had current 1990 income of only $31,300, the employee taxpayer would have to pay taxes on the entire $41,300 in 1990. In contrast, the self-employed taxpayer defers taxes on the entire $10,000 until payment is received.

## Origin and Development of Section 3121(V)(2)

The Congress enacted section 3121(v)(2) as part of the Social Security Amendments of 1983. It was intended to conform the social security tax treatment of income deferred under nonqualified plans to income deferred under qualified plans.

Specifically, the Congress was concerned that employees could avoid paying the social security tax on wages they contributed to 401(k) plans (qualified deferral plans) and therefore control the amount of their wages subject to social security tax. To rectify this condition, the Congress decided to tax employee wage contributions to 401(k) plans at the time the amounts were earned. It was hoped that taxing these employee wage contributions would prevent the possible erosion of the social security wage base in the future. In considering nonqualified deferred compensation, it was felt that amounts associated with these plans should be taxed. It decided that the tax should be imposed on these amounts when earned just as in the case of wage contributions to 401(k) plans. Detailed information on the origin of this section of the code can be found in appendix I of this report.

## Revenue Effect of Section 3121(V)(2)

The effect of section 3121(v)(2) cannot be measured because of limited reporting on nonqualified plans. Although neither IRS nor the Social Security Administration (SSA) has data to determine the revenue effect, representatives at both agencies believe that the provision has had marginal effects. IRS officials believe that the trust funds have lost some revenues, while SSA representatives believe the trust funds have gained some. Appendix II contains details on their rationales.

## Problems in Implementing Section 3121(V)(2)

IRS officials believe the code's broad definition of nonqualified deferred compensation plans makes it difficult to distinguish the type of pay arrangements covered by section 3121(v)(2). They are concerned by positions taken by some taxpayers who used this provision. Officials said IRS has devoted extensive time to developing regulations for section 3121(v)(2), but higher priority tax legislation and technical problems have delayed completion. Appendix III discusses in greater detail the regulatory problem arising from enactment of the provision.

## Scope and Methodology

Our work was performed between July and December 1989 at IRS and SSA headquarters in Washington, D.C., and Baltimore, respectively. It consisted primarily of interviewing agency representatives; reviewing available guidance, such as SSA policy statements, IRS revenue rulings, and court decisions; and contacting various representatives of the self-employment and financial services community. Appendix V provides more information on our scope and methodology.

As agreed with your office, we did not obtain written agency comments on a draft of this report. However, in meetings with IRS and SSA representatives, we sought their views on a draft of this report and refined it accordingly. Agency representatives expressed general agreement with its content.

As agreed with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from its issue date. At that time, we will send copies to the Commissioner of Social Security, the Commissioner of Internal Revenue, congressional committees with oversight responsibilities for IRS and SSA operations, and other groups with an interest in this matter. We also will make copies available to others upon request.

If you have any questions or would like additional information, please call me on (202) 275-6193. Other major contributors to this report are listed in appendix VI.

Sincerely yours,

Edward a Densmore

for Joseph F. Delfico
Director, Income Security Issues

# Contents

**Abbreviations**

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|---|---|
| IRS | Internal Revenue Service |
| SSA | Social Security Administration |

# Origin and Development of Section 3121(V)(2) of the Internal Revenue Code

Section 3121(v)(2) of the Internal Revenue Code was enacted by the Social Security Amendments of 1983. It was one of many provisions in the amendments and, in the overall context of the law, a relatively minor feature. Most of the amendments, including this provision, were developed from recommendations made by the National Commission on Social Security Reform. The Commission was appointed to help find a solution to serious financial problems faced by the social security programs in the early 1980s. The Commission's recommendation to tax employee wage contributions to employer-sponsored 401(k) plans (qualified deferral arrangements) appears to have been the basis of section 3121(v)(2).

## Recommendations of the National Commission on Social Security Reform

The Social Security Amendments of 1983 were designed primarily to address serious short- and long-range financing problems facing the Old Age and Survivors' Insurance program. Since 1975, program expenditures had exceeded revenues, resulting in an estimated short-term revenue shortfall of $150 to $200 billion. The shortfall was so severe that it was anticipated that SSA would be unable to pay benefits on time beginning in July 1983. The social security programs also faced a long-range deficit over the next 75 years.

In December 1981, the President appointed a bipartisan group, the National Commission on Social Security Reform, to review all options to address the financing problems and develop a plan to insure the fiscal integrity of the social security trust funds while maintaining full social security benefits for recipients. It was hoped that the Commission could recommend a package of corrective measures that would be acceptable to the Congress and the administration.

On January 20, 1983, the Commission issued its report, which contained numerous recommendations for both limiting the future growth in expenditures and increasing revenues. Estimates prepared for the Commission showed that the proposals would (1) reduce the short-range revenue/expenditure gap by $168 billion for 1983-89 and (2) substantially reduce the long-range deficit.

One change recommended by the Commission concerned the taxing of certain deferred compensation, which we believe was the forerunner of section 3121(v)(2). The Commission was concerned that current law allowed employees to contribute amounts from their wages to 401(k) plans beyond those contributed by employers. For tax purposes, these

additional contributions were treated the same as employer contributions, which were excluded from the social security wage base. This allowed employees to avoid paying the social security tax on their wage contributions.

A perception existed that there was no difference between employees saving part of their compensation through a 401(k) plan and saving through other types of available arrangements, such as passbook savings accounts. In both cases, employees were choosing to save a portion of their incomes. As wages employees saved through traditional arrangements, the amounts were subject to social security tax at the time earned. The Commission recommended in effect that the law be amended to make wages that employees contributed to 401(k) plans subject to social security tax when earned.

In discussing this recommendation, the Commission stated that the proposal would not produce significant additional tax revenue because few plans that allowed for employee contributions had been put into effect yet. However, since the enactment of tax laws designed to encourage employers to establish qualified plans (such as 401(k) plans), participation in such plans had been steadily increasing. The Commission was concerned that elective wage contributions to 401(k) plans would increase considerably and feared that if its recommendation was not followed, the social security wage base could possibly be undermined, causing considerable decreases in social security tax revenue.

The President, the Speaker of the House, and other members of the House and Senate leadership endorsed the Commission's package. The Congress used the Commission's recommendations as a starting point for its deliberations about the problems facing the social security programs.

## Congressional Action Expands Commission's Proposal

Shortly after the Commission's report was issued, the House and the Senate considered the proposals and expanded on them under bills H.R. 1900 and S.1, respectively. As passed by the House, H.R. 1900 included a provision to cover not only employee wage contributions to 401(k) plans, but also employee wage contributions to (1) "cafeteria" plans authorized under section 125 of the code[1] and (2) tax-sheltered

[1]Under a cafeteria plan, an employee may choose among a variety of fringe benefits offered under the employer's plan. Deferred compensation cannot be included in such a plan except for 401(k) plans.

annuities authorized under section 403(b) of the code.[2] The bill required that employee wage contributions to these types of qualified deferral plans be added to the employee's taxable social security wage base in the year the wages were earned. There was no provision in the House bill concerning the taxing of nonqualified deferred compensation.

The Senate bill reported out of the Finance Committee contained similar provisions to tax employee wage contributions made to 401(k) plans, cafeteria plans, and tax-sheltered annuities when earned. It also had the effect of providing that all amounts related to nonqualified deferred compensation plans be subject to social security tax in the year the wages were received. The Finance Committee said it did not believe that favored social security tax treatment should be extended to plans that did not qualify for tax-favored treatment under income tax rules.

During the Senate floor discussion, Senator Lloyd Bentsen offered an amendment to the bill's proposed social security tax treatment of nonqualified deferred compensation plans. Its purpose was to correct what he believed was an unintended result reached by the Finance Committee. The Senator said that many small employers used nonqualified deferred compensation arrangements to provide their employees with retirement income and that amounts distributed under such plans were not subject to social security tax under the existing law. He said the Committee's proposed treatment would subject recipients to an added social security tax burden when they were retired and receiving social security benefits.

To avoid this result, Senator Bentsen proposed that nonqualified deferred compensation be subject to social security tax either when earned or when it was no longer subject to substantial risk of forfeiture. He noted that this approach was similar to the treatment proposed by the Commission for taxing employee-elected wage deferrals made to 401(k) plans. As such, he believed the proposal to tax nonqualified deferred compensation addressed the underlying concern that the social security wage base be preserved.

The Senate voted to amend the measure to reflect Senator Bentsen's proposal. The amendment was enacted as section 3121(v)(2) of the code as part of the Social Security Amendments of 1983. Neither Treasury nor

[2]Section 403(b) governs tax-exempt organizations' purchases of tax-sheltered annuities for employees.

the Department of Health and Human Services commented on this provision during congressional deliberations.

# Effect of Section 3121(V)(2) on Social Security Revenues Cannot Be Measured

Information with which to measure the effect of section 3121(v)(2) on the amount of social security tax revenues collected yearly is unavailable. No definitive assessment can be made because of limited (1) reporting to the government by employers about their nonqualified plans and (2) accounting for tax revenues by type of compensation. Although IRS and SSA do not have data to measure the effect of section 3121(v)(2) on social security tax revenues, both believe any change in revenues was marginal.

## Limited Reporting and Accounting Requirements Prevent Measurement of Revenue Effects

The revenue effects of section 3121(v)(2) could be measured if the government required detailed reporting on either all nonqualified plans or the source of social security tax revenues. Such information is currently unavailable.

For instance, detailed reporting on plans would include (1) the number of plans in use, (2) the number of employees participating in these plans, (3) a profile of the annual social security-covered wages paid to employees participating in the plans, and (4) the amount of compensation being deferred for each of the plan participants. In addition, to measure tax receipts under these plans before enactment of section 3121(v)(2), information is needed on whether payments made under plans qualified for the wage exclusions then existing in the code.

With this information, the amount of compensation subject to social security tax both before and after enactment of section 3121(v)(2) could be determined. By comparing the two amounts, the net tax effects could be assessed. However, employer reporting on nonqualified plans is limited.

According to IRS officials, most nonqualified plans are exempt from reporting because they are unfunded—plan participants have only the employer's promise to pay future benefits. IRS officials said reporting to federal agencies is not required in cases where nonqualified plans are unfunded. When employers establish nonqualified plans, they often do not set aside funds restricted for the sole purpose of paying benefits. Instead, employers' liability for the future payment of deferred wages is contingent on their ability to pay when the benefits are due.

Employers report only limited information to IRS, the Department of Labor, and the Pension Benefit Guaranty Corporation on the number of nonqualified plans and the number of plan participants. These agencies receive reports for nonqualified plans that are funded. However, these

reports do not itemize the amount of employee earnings and their elective wage contributions or provide information to determine whether payments from plans met retirement-related exclusions existing in the code.

Another approach would be to examine the change in the social security tax revenues associated with nonqualified deferred compensation. Annually, employers must report (on form W-2) to SSA the wages paid to their employees so that SSA can record each worker's social security earnings for eligibility and benefit purposes. However, these reports show total aggregate wages only, not the amount of the wages attributable to a nonqualified deferral. Thus, examining changes in the tax revenues would not show the effect of section 3121(v)(2).

## IRS and SSA Representatives Believe the Effects Were Marginal

In the absence of information needed to measure the revenue effects of section 3121(v)(2), we discussed the issue with IRS and SSA representatives. In general, both agencies believed that the section had a marginal effect on the amount of social security tax revenues. However, they differed as to whether the relatively small net effect on such revenues was positive or negative.

For two reasons, IRS officials believed that the section had a small adverse effect on social security tax revenues:

1. Before enactment of section 3121(v)(2), IRS officials said payments to most participants in nonqualified deferred compensation plans would have been subject to social security tax when received. IRS did not believe that exclusions existing in the code at that time for retirement-related payments had broad application. They said this was because the retirement-related exclusions required payments to be made under plans that provided benefits for employees in general or for a class of employees. Essentially, from their experience, IRS officials did not believe that most nonqualified deferred compensation plans met this requirement.

2. Recognizing nonqualified deferred wages when they were earned would not result in the collection of additional tax revenues, IRS officials believe. In their opinion, nonqualified plans are offered primarily to higher paid executives and managers of corporations rather than rank-and-file or lower paid classes of employees. As a result, most of the employees in these plans would have wage amounts above the social security wage base. Adding the deferred amount to their wages would

not produce any further tax revenues. In effect, the new legislation shielded these deferred amounts from later taxation.

SSA representatives, on the other hand, believe that the section had a small positive effect on tax revenues. Before section 3121(v)(2), they asserted, most of the payments to employees under nonqualified plans were excluded from the social security wage base by the retirement-related exclusions existing in the code at that time. Thus, SSA representatives conclude, only limited social security tax revenues were collected from payments made under nonqualified deferred compensation plans before the enactment of section 3121(v)(2).

Also, SSA representatives believe that nonqualified plans were offered to employees in general, including rank-and-file workers. As a result, some plan participants had wages below the wage base during their working years. Thus, taxing the deferred amount in the year in which it was earned would generate a small increase in tax revenues.

Some IRS revenue rulings on deferred compensation issues were rendered before the enactment of section 3121(v)(2); the rulings supported both agencies' positions. But these rulings cannot be used to generalize about whether payments from most plans were subject to the social security tax. If anything, these rulings show that the taxing of compensation under nonqualified plans should be judged on a case-by-case basis because the plans and circumstances of each case can vary.

# Implementation Problems Arising From the Enactment of Section 3121(V)(2)

One potentially significant tax administration problem in implementing section 3121(v)(2) is that IRS has not yet issued regulations or other guidance for it. IRS gave priority to implementation of major tax legislation enacted after the 1983 amendments. Also, IRS said two major conceptual problems have caused delays in developing regulations:

- defining which pay arrangements section 3121(v)(2) covers and
- determining the amount deferred for the tax year.

Without regulations, there are no criteria, beyond the statute, for employers to follow in making consistent and correct tax decisions relative to section 3121(v)(2). This has affected a limited but important number of cases, IRS officials said. The lack of regulations undermines IRS's ability to question taxpayer decisions and protect the interests of the social security trust funds. Some taxpayers have already asserted that certain arrangements, which IRS officials believe represent current rather than deferred compensation, are sheltered from social security taxes by section 3121(v)(2).

## Purpose of IRS Guidelines

In administering the federal tax system, IRS issues various types of guidelines to aid taxpayers in interpreting the code. The two most important of these guidelines are the regulations of the Internal Revenue Code and IRS revenue rulings.

The Commissioner of Internal Revenue issues tax regulations with the approval of the Secretary of the Treasury. The regulations amplify, supplement, and interpret the statutory provisions. In addition, they give examples of the application of code provisions to particular tax situations to help taxpayers meet their legal obligations.

IRS also issues many revenue rulings on tax matters. These rulings usually arise out of questions taxpayers ask IRS about particular tax situations. While the rulings are not as authoritative as the regulations, they are important guides to the position that IRS will take with respect to similar factual situations.

Although section 3121(v)(2) was enacted in April 1983, regulations for it have not yet been issued. IRS has not published any rulings on questions related to this section of the code. Lacking published guidance reflecting IRS's interpretation of this section, taxpayers have decided in their own interest which types of compensation arrangements are covered.

## Reasons Delaying IRS Regulations

IRS officials have devoted extensive time and attention, they said, to developing regulations under section 3121(v)(2). Since May 1984, they told us, at least seven drafts of proposed regulations have been prepared, circulated internally, and modified as a result of review comments. The latest set of proposed regulations was circulated in June 1989. Three basic problems that have contributed to delays in issuing these regulations were identified by the officials: (1) the enactment of subsequent legislation, (2) the need to define coverage under section 3121(v)(2), and (3) the need to develop uniform procedures for the complex calculations required to determine the amount of wages deferred.

## Subsequent Tax Legislation Enacted

Three major tax laws, including the substantial changes in the tax system under the Tax Reform Act of 1986, affected priorities for issuing regulations on section 3121(v)(2). Beyond affecting priorities, the new tax laws also amended other statutory provisions related to the proposed regulations for the section and necessitated changes to the draft.

## Pay Arrangements Covered Need Definition

The regulations need to define the types of plans or pay arrangements covered under section 3121(v)(2), IRS officials said. Failure to properly define the extent of coverage could result in taxpayers shielding current payments from social security taxes. The shielding of certain types of compensation from such taxes could occur in a specific situation, the officials pointed out. This is when (1) the wages received are alleged to have been subject to the tax in an earlier year and (2) the employee had earnings above the wage base in that year.

For example, when a bonus is paid in 1989 based on an employee's 1988 performance, IRS officials said some taxpayers assert that additional social security taxes were not due for the bonus. The bonus is a nonqualified deferred compensation payment, the taxpayers contend. If it is considered paid under a nonqualified deferred compensation plan, and the employee had earnings above the wage base in 1988, social security taxes are not due on the 1989 bonus under the provisions of section 3121(v)(2).

Early retirement incentive programs also have resulted in questions about when this form of compensation is subject to social security taxes. Employers reducing the size of their work force may offer early retirement incentive payments to employees. Under these arrangements, employees can retire early and receive payments for several years to

supplement their retirement benefits. Such employees will receive compensation when they are no longer working. If the payments are considered paid under a nonqualified deferred compensation plan, no social security taxes would be due on deferred amounts assigned to tax years when the retired worker had earnings above the social security wage base. IRS officials believe that payments under these types of programs usually represent current rather than deferred compensation. This is because the compensation is not related to services performed in a previous tax year. Therefore, it would be taxable up to the social security wage base in the year received.

This problem in defining the scope of coverage exists because of the broad definition of a nonqualified deferred compensation plan. Section 3121(v)(2)(C) defines it as "any plan or other arrangement for deferral of compensation other than a plan described in subsection 3121(a)(5)." Subsection (a)(5) specifically exempts from social security taxes wage payments made under various types of qualified deferrals or other tax-favored plans.

Although the code definition describes the boundaries of what constitutes a nonqualified plan, it does not describe the types of pay arrangements that constitute deferred compensation. Given that compensation is typically paid after services are rendered, it is unclear whether certain types of compensation are subject to section 3121(v)(2). Without an IRS interpretation of what constitutes a nonqualified deferred compensation plan, taxpayers have been left to decide when the social security tax should be imposed on certain payments.

## Determining Amount of Wages Deferred Can Be Complex

To determine how much in deferred wages is included in the social security wage base for the year the deferral is earned, the amount of such wages must be determined. Calculating the amount deferred, IRS officials said, can require complex present-value calculations. Also the regulations need to provide uniform procedures for determining present value. Developing uniform procedures has proved difficult given the unlimited range of payment deferral options an employer can establish. For example, employers could base the deferral on a percentage of the employees' highest salary when they retire, making it difficult to determine how much compensation currently is being deferred.

In addition to other priorities impeding issuance of regulations on section 3121(v)(2), IRS officials called the latter two conceptual problems a

significant cause of delays. Issuing regulations is a priority item, they advised us.

Because of the limited reporting on nonqualified deferred compensation, we could not determine how the absence of regulations has affected social security tax revenues. However, in the absence of specific guidance, it appears reasonable to assume that taxpayers will interpret the law to their advantage where possible.

# The Use of Deferred Income by Taxpayers Subject to Self-Employment Tax

How taxpayers subject to the self-employment tax (self-employed taxpayers) use deferred income arrangements is discussed in this appendix. The information is intended to aid the Committee in its deliberations about whether to provide tax treatment similar to section 3121(v)(2) for this group of taxpayers.

Self-employed taxpayers do use contractual arrangements to defer income owed from customers, but probably not extensively. Business-related risks and certain tax prerequisites appear to discourage and complicate use of these arrangements. We identified four professions subject to the self-employment tax in which at least some members had contractual arrangements to defer, until subsequent tax years, income owed to them. The four were medical doctors, ministers, insurance agents, and directors of corporations. Our survey of the self-employed community and review of IRS and federal court rulings was limited. Thus, it is possible that other self-employed taxpayers also may have deferred income arrangements.

## Deterrents to Income Deferral Found

The self-employment tax is imposed on earnings that self-employed individuals derive from operation of their own trades or businesses. Most individuals subject to this tax are considered self-employed. However, certain individuals engaged in employer/employee relationships, such as ministers, are by statute explicitly subject to the self-employment tax. Risks of noncollection and certain tax prerequisites appear to discourage these taxpayers from using income deferral arrangements.

## Income Deferral Can Carry Risks

Some self-employed individuals may encounter risks in collecting payments from customers substantially later. Included are those whose income is derived from many different sources (i.e., by selling goods or rendering services to a variety of customers rather than just one or a select few). The risk derives from the nature of this type of payment arrangement. Since the taxpayer would accept no payment or only partial payment immediately and collect the remaining income due substantially later, collection problems could occur in the future. For example, the customer may have died, may no longer be willing or able to pay, or may not be easily located.

These risks could be mitigated if the deferral arrangement involves a customer with whom the taxpayer has a longstanding business relationship or who is judged to be very reliable. Under such conditions, the

risks of collecting deferred payments could be reduced, and the use of nonqualified income deferral arrangements made more attractive.

## Certain Tax Doctrines Seen as Obstacles

Certain tax doctrines associated with deferred income arrangements can be obstacles in deferring tax liabilities. These are the constructive receipt and economic benefit doctrines, which are discussed below. Under them, income need not be actually received before it is subject to current taxation.

These doctrines are applied to determine whether the taxpayer has effectively deferred the tax liabilities on the income involved. Their application is complex and involves considering such questions as the following:

- Does the taxpayer risk forfeiture of the deferred income?
- Is the deferred income inaccessible to creditors of the indebted party?
- Was the deferral arrangement established before the income was earned?
- Can a current value for the deferred income be established with some exactness?

These doctrines could discourage self-employed taxpayers from establishing deferred income arrangements.

### Constructive Receipt Precludes Taxpayers' Option

Under the constructive receipt doctrine, taxpayers cannot deliberately "turn their back" on income to select the tax year for which they will report the income. For example, in Llewellyn v. Commissioner of Internal Revenue, 295 F.2d 649 (7th Cir. 1961), the court ruled on an issue involving constructive receipt. The case concerned an income deferral arrangement established by a doctor who was the director of each of two hospitals' clinical and pathological laboratories. The hospitals originally paid the doctor a stated percentage of the monthly gross receipts of their laboratories.

At the doctor's request, the hospitals amended their initial employment contracts to reduce the monthly amount of payments due to the doctor. The reduced amount was used by the hospitals to purchase a retirement income annuity policy for the doctor.

IRS did not believe the arrangement represented a deferral of income, and the case eventually was litigated. The doctor argued that by virtue of the amended employment agreement, his income had been decreased,

and that the annuity contracts were paid for by the hospitals. Thus, the annual cost of the annuity policy was not current income. IRS argued that the doctor's income in question was not reduced but, at the doctor's option, was diverted to be used for a specific purpose. The court ruled that the deductions in the doctor's income were not employers' contributions. Rather, the deductions used to purchase the annuity were income that was constructively received, the court said. As such, they constituted taxable income to the doctor in the year they were earned.

## Economic Benefit Can Be Currently Taxed

Under the economic benefit doctrine, in certain circumstances, promises to pay deferred compensation constitute an economic benefit. This economic benefit can be taxed currently, if it can be valued with some exactness.

IRS Revenue Ruling 69-50 demonstrates the application of this doctrine. The ruling concerns a nonprofit corporation that insures the medical expenses of its subscribers. The medical services are provided to the corporation's subscribers at agreed-upon fees by self-employed physicians under contract with the corporation.

As part of the payment arrangement, the corporation offered a deferral plan to the physicians. Under the plan, the physicians could elect to defer a stated percentage of the payments due from the corporation for services provided to its subscribers. The corporation invested these deferred amounts and established an accounts payable on its books for the physicians.

The ruling concerns one physician who elected to defer 30 percent of such compensation—$3,000 for the tax year in question. IRS ruled that the physician's right to the amounts credited to his account by the corporation emanated from the medical services rendered to the corporation's subscribers. Under the agreement, IRS reasoned, the subscribers had compensated the physician for his services by investing him with the right to be paid by the corporation. As such, the subscribers had given the physician an economic or financial benefit. Thus, IRS ruled that the physician had to include the $3,000 in gross income for the year the services were rendered rather than defer it to a later year(s).

## Use of Deferred Income Arrangements by the Self-Employed

Despite the aforementioned disincentives to using deferred income arrangements, some medical doctors, ministers, insurance agents, and directors of corporations use deferral arrangements. Although their deferral arrangements are structured differently, they are similar in one respect. In each case, the risk associated with the deferral may have been reduced because the taxpayer had a continuous relationship with the party involved in the deferral arrangement.

### Medical Doctors

Various court cases and IRS revenue rulings[1] evidence the use of income deferral arrangements by medical doctors. In some of these cases, IRS or the courts found the taxpayer had deferred tax liability on the income in question. In others, it was found the tax liabilities had not been deferred because the income in question was constructively received or provided a current economic benefit to the taxpayer.

### Ministers

Although ministers are generally employees of religious organizations, they are subject to the self-employment tax for social security purposes. Under code provisions, churches with whom they are affiliated may establish qualified tax-sheltered annuities that may be payable upon ministers' retirement. The disbursements received from these plans represent qualified rather than nonqualified deferred compensation.

In addition, churches may offer other pay arrangements to defer income to ministers until after they retire because many retired ministers have incomes inadequate to meet living expenses. It is a common practice, an attorney told us, for churches to provide ministers with financial assistance during retirement. Whether these payments would be considered deferred or current income for social security purposes would depend on several questions. For example, was there an understanding between the church and the minister that additional income would be provided at retirement? Did the church set aside assets for the exclusive purpose of making the additional payments to the minister?

### Self-Employed Insurance Agents

Some insurance agents are recognized as self-employed even though they sell the policies of only one insurance company. These agents earn income as commissions from the sale of new policies and the renewal of

[1]Rulings on medical doctors' income deferral practices that we identified were: Goldsmith v. United States, 586 F.2d 810 (1978); United States v. Basye, 410 U.S. 441; Minor v. United States, 772 F.2d 1472 (9th Cir. 1985); Llewellyn v. Commissioner of Internal Revenue, 295 F.2d 649 (7th Cir. 1961); Revenue Ruling 69-50; Revenue Ruling 69-474; and Revenue Ruling 77-420.

existing policies. When these agents retire or otherwise terminate their business, they are likely to have policies that are still in effect and on which they are entitled to renewal commissions. It is a common practice for insurance companies, after agents terminate their business, to compensate them over a period of years based on the renewal value of their policies.

Whether these payments represent deferred compensation or current income depends on how the pay arrangements are structured. For example, if the agent chose to receive the commissions derived from actual renewals each year, the payments would likely be considered by IRS to be current income.

However, insurance companies can offer the agents the option of deferring the renewal commissions over a period of time, such as 15 years. Under such arrangements, the insurance companies estimate the expected value of renewals from the agent's customer base and provide a level payment to the agent over the deferral period. IRS attorneys said such payments can represent deferred income.

### Directors of Corporations

Persons who serve as directors on corporate boards pay the self-employment tax on this income and may defer the income through contractual arrangements. Revenue Ruling 71-419 describes a situation in which the director's fees were deferred pursuant to a corporation's unfunded deferred compensation plan. As the director elected to defer his fee before it was earned and the plan was unfunded, IRS ruled the deferred fees did not have to be included in the director's current income. A mere promise to pay, not represented by notes or secured in any way, is not receipt of income to a cash-basis taxpayer, the ruling states.

## Potential for Others to Have Deferral Arrangements

Although we identified only four types of taxpayers subject to the self-employment tax who have attempted to establish deferred income arrangements, others may also have such arrangements in place. It was difficult to identify such arrangements because we could not identify a single voice that speaks for the 10.5 million self-employed persons on such matters. Further, people tend to consider their compensation to be a private matter.

# Scope and Methodology

The Subcommittee on Social Security of the House Committee on Ways and Means requested that we provide information on the following four specific matters:

- The origin and development of section 3121(v)(2) of the Internal Revenue Code.
- The section's effect on social security revenues.
- Problems that arose from the section's enactment.
- Taxpayers subject to the self-employment tax who currently participate in income deferral arrangements.

Our work was conducted between July and December 1989 at IRS and SSA headquarters in Washington, D.C., and Baltimore, respectively. We reviewed legislative materials related to the enactment of the Social Security Amendments of 1983, IRS and court rulings on the tax treatment of deferred income, and various tax-related documents on deferred income. In addition, we examined SSA policies and procedures related to the enactment of section 3121(v)(2) and correspondence that SSA prepared in response to questions raised by various taxpayers about this section.

We also interviewed current and former government officials who had knowledge about either the origins of the section or its current operation. These officials included employees of IRS, SSA, and the Department of Labor and congressional staff members.

To identify self-employed taxpayers who may have business income deferral arrangements, we pursued several leads based on discussions with IRS and SSA representatives. The representatives told us that professions in which members customarily have longstanding relationships with their customers lend themselves to these arrangements. Accordingly, we contacted such groups as firms that offer assistance in setting up benefit programs; accounting firms; certain companies that franchise business opportunities to self-employed taxpayers; and trade associations that represent the interests of the legal profession, small businesses, the insurance industry, and automotive dealers.

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