BANK
COMPENSATION CONSULTING

Taxation of Salary Continuation Plans / Supplemental Executive Retirement Plans

In a salary continuation plan (also known as a supplemental executive retirement plan or SERP), an executive is paid a retirement benefit that is tied to a fixed amount or a percentage of the executive's pay. In most cases, the total cost of the plan is borne by the employer with no employee contribution.

Federal Income Taxes – In a properly designed and administered salary continuation plan (e.g., one that complies with Internal Revenue Code Section 409A), employees should pay no income tax until the payout period begins. Payments from such a plan are taxable to the recipient and subject to federal income tax withholding when received.

Social Security and Medicare Taxes (FICA) – Amounts deferred under a nonqualified deferred compensation plan, such as a salary continuation plans or SERPs, are required to be taken into account as wages for purposes of Social Security and Medicare taxes on the date on which there is no substantial risk of forfeiture with regard to the employee's right to receive the benefit. Because vested benefits are not subject to a substantial risk of forfeiture, amounts that become vested during the calendar year should generally be included as wages for FICA tax purposes.

Once the benefits are included as wages, the nonduplication rule states that neither that amount nor the interest attributable to that amount is again treated as FICA wages.

Compensation in excess of the Social Security wage base ($118,500 for 2016) is not subject to Social Security tax. The Medicare tax does not have a wage base limitation; therefore, all amounts deferred and vested are generally subject to Medicare tax.

Example:
Assume a 50-year-old participates in a salary continuation plan that will pay $40,000 per year for 15 years, beginning at age 65. The benefit agreement stipulates that the employee is 100% vested in the annual amounts accrued by the bank for financial statement purposes. The annual accruals include a principal component and an interest component. The amount to be included as wages for FICA tax purposes would be the principal portion of the annual benefit accrual and the interest attributable to this principal portion; the interest portion attributable to amounts previously subject to FICA wages is excluded from current FICA wages. If the principal and interest portion of the annual accrual subject to FICA wages was equal to $10,000 and the executive's other wages were equal to $140,000 the reporting requirements on IRS Form W-2 for 2016 would be as follows:

Box 1 *(Wages, tips and other compensation) would equal $140,000*

Box 3 *(Social Security wages) would equal the ceiling amount of $118,500*

Box 5 *(Medicare wages and tips) would equal $150,000 ($140,000 + $10,000) vested amount under the salary continuation plan).*

Box 11 *(Nonqualified plans) would be left blank for 2016 since there is no prior year vesting and no distribution of NQDC funds was made.*

The combined FICA tax paid by the employee would be $9,522.00 [(.062 x $118,500) + (.0145 x $150,000)].