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FAQs

Nonqualified Benefit Plans and Social Security

Question: Can a participant in a nonqualified deferred compensation (NQDC) plan lose Social Security Benefits as a result of receiving NQDC benefit payments during the retirement years?

Answer: The receipt of NQDC benefits will only result in lost Social Security benefits where a retiree has not reached full retirement age and the NQDC benefits are considered "excess earnings."

How Work Affects Your Benefits. A retiree can receive Social Security retirement benefits and work at the same time. However, depending on the retiree's age, Social Security benefits (SS benefits) can be reduced if earnings exceed a certain amount during the retirement years.

A law that went into effect January 1, 2000, changed the way a retiree's benefits are affected when they continue to work and receive SS benefits. The benefit amount received on or after 1/1/2000 is reduced for "excess earnings" only until the retiree reaches full retirement age (FRA) not up to age 70 as previous law required. FRA depends on the retiree's year of birth. Beginning with persons born in 1938, the FRA gradually increases from age 65, eventually reaching age 67. Thus, if an individual does not receive SS benefits until he/she reaches FRA, NQDC benefits will never reduce his/ her Social Security Benefits.

Let's take a closer look at what happens prior to FRA …

Excess Earnings Test. Social Security benefits are reduced for earnings as follows:

- ***Under full retirement age.*** If a retiree is under FRA and begins receiving SS benefits, $1.00 in benefits will be deducted for each $2.00 earned above an annual limit. The annual limit is an inflation-adjusted number, which for 2004 is $11,640.

- ***In the year of FRA.*** $1.00 in benefits will be deducted for each $3.00 earned above a dollar limit, but only for the months before the month of FRA. For 2004, this dollar limit is $31,080.

  In addition, in the first year in which an individual is entitled to receive SS benefits, a monthly rather than an annual earnings test may be used if it gives better results. During this first year, beginning with the month of entitlement, a retiree can receive SS benefits for any month where earnings do not exceed more than 1/12 of the earnings limit.

The important questions becomes, do NQDC payments count as earnings for this "excess earnings" calculation?

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Payments under a NQDC arrangement will be considered earnings under the excess earnings test at the later of:

- When the services are performed, or
- When there is no substantial risk of forfeiture

Therefore, if a NQDC arrangement imposes no "substantial risk of forfeiture" on the benefits, the NQDC benefits will be treated as wages for purposes of the excess earnings test when the services are performed. For example, a true deferral plan (employee deferred dollars only) generally doesn't include a substantial risk of forfeiture. Additionally, where there are employer-matching dollars, such NQDC plans typically provide a vesting schedule that brings the amounts into earnings for FICA purposes at the vesting date. Under either scenario, assuming the participant will not apply for SS benefits until he/she has actually retired (i.e. at a later date), the NQDC benefits will not reduce the employee's SS benefits as they are not considered excess earnings in the retirement years as they were "earned" in previous years.

Even where a NQDC plan contains a "substantial risk of forfeiture" (more commonly found with tax-exempt organizations due to IRC § 457 rules) SS benefits need not be reduced as long as the risk lapses on or before the employee/participant's retirement date. Under this approach, the entire accrued NQDC benefit will be treated as earnings at that date.

Generally this would result in a huge amount of earnings and would reduce SS benefits. However, retirees receive special treatment for the first year in which they are entitled to SS benefits. During this "grace year", a monthly earnings test applies, rather than an annual earnings test. Under the monthly test, all the earnings attributable to the NQDC plan will be received in a month prior to retirement, and will not reduce the employee's SS benefits in subsequent months and years.

Summary: So in theory, yes NQDC benefits can result in reduction of SS benefits if taken in years before a participant reaches full retirement age. However, with proper plan design this undesirable result can be avoided.

For information on how Social Security taxes are withheld from NQDC benefits please consult Prudential Financial's Frequently Asked Question: IFS-A066909, Nonqualified Deferred Compensation Plans and FICA Taxes.