THE NONQUALIFIED ADVISOR

An Independent Resource for Plan Sponsors and Participants of Nonqualified Plans

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The 3 Prongs of a Reasonable Rate of Interest

Under the Special Timing Rule, amounts deferred under a nonqualified deferred compensation plan are taken into account as FICA wages at the later of: (a) the date on which services are performed; or (b) the date on which the amount deferred vests. Generally, once an amount deferred has been taken into account as FICA wages, then neither the amount deferred nor the income on that amount is subject to FICA tax thereafter. For account balance plans, this exclusion assumes that interest credited under the plan reflects a "reasonable rate of interest".

The IRS does not define a "reasonable rate of interest," but rather sets forth guidelines for establishing a reasonable rate through the use of a three-prong test. Income credited under a plan that satisfies the test will be treated as reasonable for purposes of FICA tax. The three prongs of the test are as follows:

1. **Predetermined Investment**
A predetermined actual investment is generally the most acceptable benchmark for crediting earnings to an account balance plan. The rate of return on a predetermined actual investment is the rate that would apply if the account balance was actually invested in the investment(s) identified under the plan. The employer does not need to invest in anything and the investment does not need to be available to the general public, but the benchmark must be an actual investment or index that is subject to increase and decrease in value without limitation. Earnings based on the greater rate of return of two or more actual investments, or the greater of the rate of return on an actual investment and a rate of interest would not meet the definition of a predetermined actual investment because decreases in the value of the investment have been limited.

2. **Permissible Fixed Rate**
If an account balance plan provides for a fixed rate of interest, a plan must provide for the rate to be reset no later than the end of the fifth calendar year. Assuming the interest rate set at the beginning of the year is reasonable and the rate is not changed before the reset date, the rate will be treated as reasonable in all future periods before the reset date.

3. **Other "Reasonable" Rate**
If income is credited to an account balance plan on a basis other than the rate of return on a predetermined actual investment or a permissible fixed rate, then the employer must determine whether the income credited for the period is reasonable. Assuming income credited under the plan is reasonable at the time the amount deferred is taken into account and annually thereafter, the income will be treated as reasonable.

Unreasonable Rates

An account balance plan that disregards the three-prong test, or otherwise fails to assume a reasonable rate of interest as determined by the IRS, will be treated as a plan with an "unreasonable rate of return". It is completely acceptable for an account balance plan to provide for an unreasonable rate of return; however, plans that do not adhere to IRS guidelines are subject to an "excess earnings" calculation.

If an employer chooses to provide for an "above market" or otherwise unreasonable rate of return, the employer must calculate the excess of the amount credited under the plan over the amount that would have been credited under the plan assuming a reasonable rate of interest. Excess earnings, if any, are taken into account as an additional deferral in the year the income is credited.

In the event the employer fails to calculate and recognize excess earnings or fails to take the full amount deferred into account, the employer will be required to calculate excess earnings using the midterm applicable federal rate (AFR) as a reasonable rate of interest. Earnings credited over and above earnings calculated under the midterm AFR as of January 1 of the calendar year will be classified as an additional deferral in the period

the income was credited. Additionally, if AFR is used to determine excess earnings, both the excess and the income on excesses are taken into account as FICA wages under the General Timing Rule, which is at the time benefits are paid to the participant.

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