TAX ALERT

Tax-Exempt Entity 457(b) Plans & the Tax Consequences of Non-Compliance

October 2020

The Internal Revenue Service recently issued a reminder in the form of FAQs of the tax implications to participants and employers when a 457(b) plan becomes an ineligible plan and, as a result, is governed by Internal Revenue Code (IRC) Section 457(f). This latest IRS publication on 457(b) plans stems from the concern that there is an historical and ongoing pattern of noncompliance with respect to these programs and serves as a warning to employers that there are risks and costs associated with noncompliance.

IRC SECTION 457 SUMMARY

Section 457 is home to the rules for nonqualified compensation plans established by eligible employers. Eligible employers include certain governmental and tax-exempt entities, including states, cities, towns or political subdivisions, and generally any organizations exempt from federal income tax, except for churches and synagogues.

There are two types of 457 plans: eligible plans that satisfy the requirements under the IRC Section 457(b); and ineligible plans that are subject to IRC Section 457(f).

If the following 457(b) plan requirements are met, then, in general, the participants will not pay income tax on the deferrals until they are distributed from the plan:

- restricting participation to employees and independent contractors performing services for an eligible employer (see above);
- limiting annual deferrals under the plan ($19,500 for 2020);
- meeting specific distribution events, as well as timing rules (i.e. age 70½ or separation from service);
- requiring that deferral elections be made for the month prior to the deferral taking effect; and,

- treating the amounts deferred as an asset of the employer subject to the reach of creditors in the case of a non-governmental employer.

Please note: even if the 457(b) eligibility requirements have been satisfied, and the income tax on the deferral is postponed until the distribution date, social security and Medicare taxes are due when the deferrals are no longer subject to a substantial risk of forfeiture.

If a plan does not satisfy the requirements under 457(b), then the Section 457(f) rules on the taxation of deferred compensation apply. Under Code Section 457(f), plan participation must be limited to a select group of managers or highly compensated employees and deferred compensation is taxable in the first year in which the deferrals are no longer subject to a substantial risk of forfeiture.

In the FAQs, the IRS stressed that any vested deferrals for years the plan becomes subject to 457(f), and where the statute of limitations is open, are taxable to the participant in those open years. This may result in a discrepancy adjustment to the Form 1040 and additional tax for the years involved as well as penalties and interest. If the deferrals become vested in a year in which the plan is subject to 457(f), the earnings on the deferrals should be calculated through the date of vesting to determine the additional amount includible in gross income for the year. Any attempted rollovers to an IRA of amounts distributed from a 457(f) plan (or a tax-exempt 457(b) plan) will be subject to excise taxes.

Lastly, the FAQs remind employers that federal income tax withholding applies to deferrals under a 457(f) at the point in time when they are no longer subject to a substantial risk of forfeiture and in the event there is a failure to properly withhold penalties and interest may apply.

COMMON ERRORS TO WATCH FOR

In light of the IRS's heightened interest in 457(b) programs, the prevalence of noncompliance and risk of IRS audit, it is worthwhile to consider the following list of some commonly reported plan compliance issues:

- failure to follow the provisions of the Section 457(b) deferred compensation plan agreement;
- failure to limit eligibility to a select group of management or highly compensated employees under for a 457(f) plan;
- failure to limit the deferrals to the annual contribution maximums;

- failure to report the employer contribution on behalf of a participant for payroll taxes (i.e., FICA and Medicare);
- failure to title the investment account in the name of the employer;
- failure to recognize that a distribution from a 457(b) plan is a W-2 transaction;
- failure to file a top hat compliance statement with the Department of Labor;
- failure to prevent loans to plan participants of non-governmental tax-exempt employers.

THE TAKEAWAY

The axiom that prevention is better than the cure is apropos in many circumstances and is particularly true in the case of employer deferred compensation plans. The longer a plan's compliance issues remain outstanding, the more severe the organizational and financial consequences. Therefore, we recommend a thorough review of your 457(b) plans as a prudent course of action. If compliance issues are discovered during the review process, then remedies for curing these compliance matters may be available.

CONTACT

If you have questions about 457(b) plans, including assistance through a compliance review process and applicable corrective strategies, please contact a member of our Tax Law Practice.