

Eligible Deferred Compensation Plans under Section 457

Notice 2000-38

I. PURPOSE AND SCOPE

This notice describes the withholding and reporting requirements applicable to eligible deferred compensation plans described in ' 457(b) of the Internal Revenue Code of 1986 (" 457(b) plans").

Specifically, this notice addresses --

\$ income tax withholding and reporting with respect to annual deferrals made to a ' 457(b) plan;

\$ income tax withholding and reporting with respect to distributions from a ' 457(b) plan;

\$ Federal Insurance Contributions Act (FICA) payment and reporting with respect to annual deferrals under a ' 457(b) plan;

\$ employer identification numbers (EINs) used in connection with trusts established under ' 457(g); and

\$ the application of annual reporting requirements to ' 457(b) plan administrators and trustees holding assets of a ' 457(b) plan in accordance with ' 457(g).

This notice addresses only reporting and withholding rules that apply to ' 457(b) plan participants who are or were employees of state and local governments or tax-exempt organizations and does not cover special reporting rules that may apply to § 457(b) plan participants who are or were independent contractors.

II. BACKGROUND

Section 457 provides rules for nonqualified deferred compensation plans established by eligible employers. State and local governments and tax-exempt organizations are eligible employers. They can establish either eligible plans that meet the requirements of ' 457(b) or plans that do not meet the requirements of § 457(b) and that are therefore subject to tax treatment under ' 457(f).

Section 1448 of the Small Business Job Protection Act of 1996, ("SBJPA"), 1996-3 C.B. 155, 212, amended ' 457 by adding ' 457(g), which requires that ' 457(b) plans maintained by state or local government employers hold all plan assets and income in trust, or in custodial accounts or annuity contracts described in ' 401(f), for the exclusive benefit of participants and their beneficiaries. Section 457(g) applies generally to assets and income held by a governmental ' 457(b) plan on and after August 20, 1996. However, with respect to a governmental ' 457(b) plan in existence on August 20, 1996, a trust (or a custodial account or annuity contract) was not required to have been established before January 1, 1999. Section 457(g) does not apply to a ' 457(b) plan established by a tax-exempt organization that is not a state or local governmental entity.

Notice 98-8, 1998-1 C.B. 355, provides guidance regarding the amendments made to ' 457(b) by the SBJPA. Following publication of the 1998 notice, the Service received additional inquiries regarding the statutory changes made in ' 457(b) by the SBJPA and the Taxpayer Relief Act of 1997, Pub. L. No. 105-34. Specifically, taxpayers, employers, and plan administrators asked what employment and income tax reporting requirements apply with respect to ' 457(b) plans and whether a trustee or administrator of a trust established under ' 457(g) must file annual information returns relating to the trust, such as Form 990, Return of Organization Exempt From Income

Tax, or an appropriate version of Form 5500, Annual Return/Report of Employee Benefit Plan.

III. INCOME TAX WITHHOLDING AND REPORTING ON ANNUAL DEFERRALS

Section 457(a) provides that annual deferrals under a ' 457(b) plan and any income attributable to the amounts so deferred will not be includible in a participant's gross income until that amount is paid or made available to the participant or beneficiary. Therefore, annual deferrals under a ' 457(b) plan are not subject to income tax withholding at the time of the deferral. However, a participant's annual deferrals during the taxable year under a ' 457(b) plan are reported on Form W-2, Wage and Tax Statement, in the manner described in the instructions to that form. "Annual deferrals", as used in this notice, means the amount of compensation deferred under the plan in accordance with section 457(b) whether by salary reduction or nonelective employer contribution, during a taxable year.

IV. INCOME TAX WITHHOLDING AND REPORTING ON § 457(b) PLAN DISTRIBUTIONS

A. Income Tax Withholding on § 457(b) Plan Distributions

“Distributions” from a § 457(b) plan to a participant or former participant include all amounts that are paid or made available under a § 457(b) plan. Distributions to a participant or former participant from a § 457(b) plan are wages under § 3401(a) that are subject to income tax withholding in accordance with the income tax withholding requirements of § 3402(a). The pension withholding rules of § 3405 do not apply. See § 35.3405-1, a-23, Q&A of the Temporary Employment Tax and Collection of Income Tax at Source Regulations.

Income tax withholding on distributions to a participant or former participant under a § 457(b) plan is calculated in the same manner as withholding on other types of wage payments. For guidance on the use of the flat rate withholding method as a supplement to regular wage withholding in cases where the payor is paying wages to the participant in addition to the distribution from the § 457(b) plan, see § 31.3402(g)-1(a) of the Employment Tax Regulations and Rev. Rul. 82-46, 1982-1 CB 158. If an eligible payor uses the flat rate of withholding as an alternative to regular wage withholding on a lump sum payment, section 13273 of the Omnibus Budget Reconciliation Act of 1993, 1993-3 C.B. 1, 130 provides that a 28 percent flat rate must be used.

B. Person Responsible for Income Tax Withholding on Distributions

Section 3402(a) requires every employer making payment of wages to withhold income tax on these wages. However, § 3401(d)(1) provides that if the person for whom an individual performed services as an employee does not have control of the payment of the wages for those services, the person having control of the payment of the wages is responsible for income tax withholding on those wages. See § 31.3401(d)-1(f). Thus, if distributions are made by a ' 457(g) trustee of a plan established by a state or local government, the trustee is responsible for income tax withholding and reporting on the distributions. Similarly, if distributions are made by a ' 457(g) custodian or insurance carrier treated as a trustee under ' 457(g), the custodian or insurance carrier is responsible for income tax withholding on the distributions. Subsections C, D, and E of this Section IV provide additional information regarding how the trustee (or custodian or insurance carrier) should withhold, deposit, and report distributions.

When distributions are made under a ' 457(b) plan established by a tax-exempt organization, the tax-exempt organization or any other person having control of the payment of the distributions is responsible for income tax withholding on the distributions.

C. Reporting on Form W-2 for Distributions from a § 457(b) Plan

Distributions to a participant or former participant during a taxable year under a ' 457(b) plan are reported on Form W-2, Wage and Tax Statement, in the manner described in the instructions to that form. See also Rev. Rul. 82-46, *supra*. Income tax withheld from § 457(b) plan distributions is reported quarterly on Form 941, Employer's Quarterly Federal Tax Return.

D. Reporting Death Benefit Payments

Distributions to a beneficiary of a deceased participant under a ' 457(b) plan are reported on Form 1099-R, Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc. See Rev. Rul. 86-109, 1986-2 C.B. 196. No income tax withholding is required for distributions from ' 457(b) plans to beneficiaries. See Rev. Rul. 59-64, 1959-1 C.B. 31. The instructions for Form 1099-R describe how this form is completed for distributions made to a beneficiary from a nonqualified deferred compensation plan, such as a ' 457(b) plan.

E. EINs and Income Tax Deposits with respect to ' 457(g) Trust Accounts

Generally, the income tax withheld on distributions should be reported on the Form 941 of the person responsible for withholding, as described in section IV-B of this notice, and aggregated with other amounts reported by that person on Form 941 to determine the frequency of federal tax deposits under § 31.6302-1. This is the same as the first alternative described in Announcement 84-40, 1984-17 IRB 31. Alternatively, the IRS will permit trustees of ' 457(g) trusts, or custodians or insurance carriers treated as trustees under ' 457(g)(3) to use the other two alternatives contained in Announcement 84-40 for the tax administration of such withholdings:

1. The trustee, custodian, or insurance carrier may request an EIN solely for the purpose of reporting the aggregated withholding from the distributions of every ' 457(g) trust, custodial account, or annuity contract under its control, making deposits and filing Form 941 accordingly.

2. The trustee, custodian, or insurance carrier may request and use a separate EIN for each ' 457(g) trust (or custodial account or insurance contract), making deposits and filing Form 941 accordingly.

The trustee, custodian, or insurance carrier exercising any of the above alternatives for depositing and reporting the tax withheld from ' 457(g) trust distributions must also follow the same option in filing the related information returns, such as Forms W-2 (in the case of distributions to participants or former participants) or 1099-R (in the case of distributions to beneficiaries). That is, the trustee, custodian, or insurance carrier must use the same name and EIN on Forms W-2 or 1099-R as that under which the tax was deposited and the quarterly return filed. The trustee, custodian, or insurance carrier must aggregate and deposit all taxes pursuant to § 31.6302-1 under the EIN chosen. The above-described options relate only to trusts, annuity contracts or custodial accounts established pursuant to section 457(g) for amounts deferred under § 457(a). For information on the remittance of social security, Medicare, and FUTA taxes by the employer, see section V-D below.

V. FICA AND FUTA TAXES AND REPORTING

A. Scope

The rules described in this notice relating to FICA (social security and Medicare) tax apply to employees of state and local governments only if they are subject to social security or Medicare tax under section 3121(u) (relating to Medicare), section 3121(b)(7)(E) (relating to agreements entered into pursuant to section 218 of the Social Security Act), or other provisions of the Code, such as section 3121(b)(7)(F) (relating to state and local government employees who are not members of a state or local retirement system). The FICA rules discussed in this notice generally apply to employees of tax-exempt organizations, unless a specific exclusion is applicable. The FICA tax discussed in this Section V includes the employer's share of the FICA tax imposed under section 3111 as well as the employee's share imposed under sections 3101 and 3102.

The rules described in this notice relating to the Federal Unemployment Tax Act (FUTA) do not apply to service for a state or local governmental entity because section 3306(c)(7) provides a FUTA exemption for service performed in the employ of a state or any political subdivision thereof or any instrumentality of any one or more of the foregoing. The rules described in this notice relating to FUTA apply to service for a tax-exempt organization other than a tax-exempt organization described in section 501(c)(3). See section 3306(c)(8).

B. Time Social Security, Medicare, and FUTA Taxes Imposed

Sections 3121(a) (relating to social security and Medicare) and 3306(b) (relating to FUTA) define *wages* as all remuneration for employment, unless specifically excluded (see section V-A, above). If social security, Medicare, or FUTA taxes apply, sections 3121(v)(2) and 3306(r)(2) contain special timing rules that apply in determining when amounts deferred under a nonqualified deferred compensation plan are required to be taken into account. Under these sections, an amount deferred under a nonqualified deferred compensation plan, including a ' 457(b) plan, is required to be taken into account for purposes of social security, Medicare, and FUTA taxes as of the later of when the services are performed or when there is no substantial risk of forfeiture of the rights to such amount.

Thus, if a ' 457(b) plan provides that annual deferrals are fully and immediately vested, annual deferrals are subject to social security, Medicare, and FUTA taxes at the time of deferral. However, if the annual deferrals are not fully and immediately vested, but are subject to a substantial risk of forfeiture, the annual deferrals (and earnings thereon) are generally taken into account for purposes of social security, Medicare, and FUTA at the time such amounts are no longer subject to a substantial risk of forfeiture. For purposes of social security, Medicare, and FUTA taxes, the determination of whether a substantial risk of forfeiture exists is made in accordance with the principles of section 83 and the regulations thereunder. See ' ' 31.3121(v)(2)-1(e)(3) and 31.3306(r)(2)-1.

If amounts deferred under a ' 457(b) plan are properly taken into account as social security, Medicare, and FUTA wages when deferred (or, if later, when they cease to be subject to a substantial risk of forfeiture), the amounts subsequently paid or made

available to a participant or beneficiary under the ' 457(b) plan are not subject to social security, Medicare, or FUTA taxes. See ' ' 3121(v)(2)(B) and 3306(r)(2)(B) and ' ' 31.3121(v)(2)-1(a)(2)(iii) and 31.3121(v)(2)-1(d)(2). If an amount deferred for a period is not properly taken into account, distributions attributable to that amount, including income on the amounts deferred, may be wages for FICA purposes when paid or made available. See ' 31.3121(v)(2)-1(d)(1)(ii). Additional special rules apply to ' 457(b) plans other than plans where benefits are based on a participant's account balance. See ' 31.3121(v)(2)-1(e)(4).

C. Examples

The application of social security and Medicare tax is illustrated by the following examples:

Example 1. (i) State R's ' 457(b) plan provides for elective deferrals from current salary, as well as a one percent of salary nonelective contribution for each employee who participates in the plan and who is employed with State R during the plan year. All employees who participate in the plan are covered by an agreement under section 218 of the Social Security Act. All deferrals and contributions, including the state's contribution, are fully and immediately vested.

(ii) Because these contributions are not subject to a substantial risk of forfeiture (and the services to which they relate have already been performed), the elective deferrals are required to be taken into account as wages at the time of the deferral and State R's nonelective contribution is required to be taken into account as wages at the time of the contribution for purposes of the social security and Medicare tax.

Example 2. (i) Assume the same facts as in Example 1, except that the plan has three-year vesting for State R's nonelective contribution. Therefore, an employee's rights to the nonelective contributions (and the associated earnings) are subject to a substantial risk of forfeiture until the employee has been employed by State R for three years.

(ii) State R's nonelective contributions (and earnings thereon) are not wages for purposes of the social security and Medicare tax until the employee has completed three years of service. At that time, the aggregate amount of State R's nonelective contributions, plus earnings thereon, is required to be taken into account as wages for purposes of the social security and Medicare tax. Once an individual has met the vesting requirements, future nonelective contributions by State R are required to be taken into account as wages for purposes of the social security and Medicare tax at the time of the contribution.

D. Deposit and Reporting of Social Security, Medicare and FUTA Taxes

The employer must aggregate and deposit social security and Medicare taxes associated with a ' 457(b) plan (including the employer's share of social security and Medicare taxes under section 3111) with all other social security, and Medicare taxes and withheld income taxes paid on behalf of its employees in accordance with ' 31.6302-1 and must report these taxes on Form 941. Employers subject to FUTA must aggregate and deposit FUTA amounts associated with a ' 457(b) plan with all other FUTA amounts paid on behalf of its employees in accordance with ' 31.6302(c)-3 and must report these payments on Form 940.

VI. ANNUAL REPORTING FOR § 457 PLANS

A. Section 457(b) Plans of Tax-Exempt Organizations

Annual deferrals and payments to certain participants in a § 457(b) plan of a tax-exempt organization are reported on the organization's Form 990 in the manner described in the instructions to that form.

B. § 457(g) Trusts

A trust described in § 457(g) is not required to file Form 990, Return of Organization Exempt From Income Tax, Form 1041, U.S. Income Tax Return for Estates and Trusts, Form 1120, U.S. Corporation Income Tax Return, or Form 5500, Annual Return/Report of Employee Benefits Plans. See, for example, Rev. Proc. 95-48, 1995-2 C.B. 418, which provides that governmental units and affiliates of governmental units that are exempt from federal income tax under § 501(a) are not required to file annual information returns on Form 990, Return of Organization Exempt From Income Tax. A trust described in § 457(g) may be required to file Form 990-T, Exempt Organization Business Income Tax Return. See §§ 1.6012-2(e) and 1.6012-3(a)(5) for the requirements for filing Form 990-T.

VII. OTHER INFORMATION AVAILABLE

Further information regarding the reporting, payment and deposit of employment taxes such as social security, Medicare, FUTA, and withheld income tax can be found in Publication 15, Circular E, Employer's Tax Guide; Publication 15-A, Employer's Supplemental Tax Guide; and Publication 963, Federal-State Reference Guide: Social Security Coverage and FICA Reporting by State and Local Government Employers. These publications will be revised, as appropriate, to reflect the proper treatment of trusts under section 457(g).

VIII. EFFECTIVE DATE

This notice is applicable with respect to deferrals and distributions made after December 31, 2001. Plan sponsors, plan administrators and taxpayers may rely on this Notice for distributions and deferrals before January 1, 2002.

IX. REQUEST FOR COMMENTS

The Internal Revenue Service requests comments concerning this notice, and welcomes comments on any other useful approaches the Service might consider regarding the administration of § 457(b) plans, including alternatives to Form W-2 reporting. Comments can be addressed to the Internal Revenue Service, Office of Associate Chief Counsel, CC:TEGE:EB:QP2, Room 5201, 1111 Constitution Avenue, Washington, D.C. 20224. In addition, comments may be submitted electronically via the Internet by sending them in an e-mail to: joel.s.rutstein@m1.irs.counsel.treas.gov and specifying that the comments concern Notice 2000-38.

DRAFTING INFORMATION

The principal author of this notice is John Tolleris of the Office of the Associate Chief Counsel/Division Counsel (Tax Exempt/ Government Entities). However, other personnel from the IRS and Treasury participated in its development. For further information regarding this notice, contact John Tolleris at (202) 622-6060 (not a toll-free number).