

Eligible Deferred Compensation Plans under Section 457 Notice 2003-20

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 ("§ 457(b) plans") for periods after December 31, 2001.

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, including changes for a § 457(b) plan established by a state or local government employer enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), Pub. L. No. 107-16;
- 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).

The rules provided in this notice apply to deferrals and distributions from eligible § 457(b) plans made after December 31, 2001. 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. Notice 2000-38, 2000-2 C.B. 174, applies to § 457(b) plan distributions made before January 1, 2002, but see Section IX of this notice concerning its effective date provisions.

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 § 457(f).

EGTRRA made numerous revisions to § 457, most of them effective after December 31, 2001. EGTRRA § 641(a)(1)(D)(i) added new § 3401(a)(12)(E) which provides that remuneration paid to an employee or beneficiary from a § 457(b) plan maintained by a state or local governmental employer (a governmental § 457(b) plan) is no longer treated as wages for purposes of income tax withholding under section 3402(a), but is now subject to income tax withholding under section 3405. This change is effective for distributions made after December 31, 2001. However, EGTRRA did not revise the provision of Chapter 21 of the Internal Revenue Code treating amounts deferred under a § 457(b) plan as subject to FICA taxes. See § 3121(v)(2) and (3). FICA taxes include both the Old Age, Survivors, and Disability Insurance (OASDI) tax and the Hospital Insurance (HI) tax, which are referred to in federal tax forms as social security and Medicare tax, respectively. This notice includes guidance under these new provisions regarding income tax withholding and reporting upon distributions from governmental § 457(b) plans.

Section 1448 of the Small Business Job Protection Act of 1996 ("SBJPA"), Pub. L. 104-188, 1996-3 C.B. 155, 212, amended § 457 by adding § 457(g), which requires that

governmental § 457(b) plans 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) does not apply to a § 457(b) plan established by a tax-exempt organization that is not a state or local governmental entity. Notice 2000-38 provided guidance in response to inquiries concerning withholding and reporting upon § 457(b) plan distributions in light of this SBJPA amendment and certain changes made by the Taxpayer Relief Act of 1997, Pub. L. No. 105-34.

This notice updates and supersedes Notice 2000-38 for contributions and distributions made after December 31, 2001.

III. INCOME TAX WITHHOLDING AND REPORTING ON ANNUAL DEFERRALS

As amended by EGTRRA, § 457(a)(1)(A) provides that annual deferrals under a governmental § 457(b) plan and any income attributable to the amounts so deferred are not includible in a participant's gross income until that amount is paid to the participant or beneficiary. Section 457(a)(1)(B) retains the pre-EGTRRA rule that annual deferrals under a § 457(b) plan of a tax-exempt entity and any income attributable to the amounts so deferred are not 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 § 457(b), and in compliance

with the annual maximum deferral limitation under the plan, whether by elective deferral or nonelective employer contribution, during a taxable year. Deferrals in a single employer's eligible plan or plans in excess of the § 457(b) limitations are not annual deferrals and thus are subject to income tax withholding rules.

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

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

“Distributions” from a governmental § 457(b) plan to a participant or beneficiary (including an alternate payee) include all amounts that are paid from the governmental § 457(b) plan. See Section V for provisions regarding income tax withholding on distributions from a § 457(b) plan of a non-governmental tax-exempt organization.

EGTRRA revises Chapter 24 of the Code, to provide that, effective after December 31, 2001, distributions to an individual from a governmental § 457(b) plan are subject to income tax withholding in accordance with the income tax withholding requirements of § 3405 applicable to distributions from qualified plans, annuities, and individual retirement arrangements (IRAs). Thus, EGTRRA extends the § 3405(c) direct rollover and mandatory 20 percent withholding rules to governmental § 457(b) plan distributions that qualify as eligible rollover distributions as defined under § 402(c)(4).

In addition, EGTRRA provides that the § 3405(a) and (b) elective withholding rules applicable to distributions from qualified plans, § 403(b) annuities, and IRAs that are not eligible rollover distributions are also extended to distributions from governmental § 457(b) plans. Thus, periodic distributions from governmental § 457(b) plans that are

not eligible rollover distributions are subject to withholding under § 3405(a) as if the distribution were wages, and nonperiodic distributions from such plans that are not eligible rollover distributions are subject to withholding under § 3405(b) at a 10-percent rate. In either case (periodic or nonperiodic distributions), the recipient may elect not to have withholding apply under § 3405(a) or (b) to a distribution that is not an eligible rollover distribution from a governmental § 457(b) plan. For additional information regarding the provisions of § 3405 and related sections, see § 35.3405-1 of the Employment Taxes and Collection of Income Tax at Source Regulations under the Tax Equity and Fiscal Responsibility Act of 1982, § 31.3405(c)-1 of the Employment Taxes and Collection of Income Tax at Source Regulations, and §§ 1.401(a)(31)-1, 1.402(c)-2, and 1.402(f)-1 of the Income Tax Regulations.

B. Person Responsible for Income Tax Withholding on Distributions

EGTRRA amended § 3405(d) of the Code to make plan administrators of eligible governmental plans, rather than the payor of the designated distribution, generally liable for withholding under § 3405 upon distributions from such plans. However, under § 3405(d)(2)(A), a plan administrator is not liable for withholding if the administrator directs the payor to withhold income tax under § 3405 and provides the payor with the necessary information required by regulations at § 35.3405-1T, E 2 - 5. In that case, the payor is liable for withholding income tax. Subsections C, D, and E of this Section IV provide additional information on the withholding, deposit, and reporting obligations of the plan administrator or payor.

C. Reporting Governmental § 457(b) Plan Distributions on Form 1099-R

Distributions to an individual during a taxable year under a governmental § 457(b) plan are reported on Form 1099-R, Distributions from Pensions, Annuities, Retirement or

Profit-Sharing Plans, IRAs, Insurance Contracts, etc., in the manner described in the instructions to that form. Income tax withheld from governmental § 457(b) plan distributions is reported annually on Form 945, Annual Return of Withheld Federal Income Tax.

D. EINs and Income Tax Deposits for Section 457(g) Trust Accounts

Generally, the income tax withheld on distributions should be reported on the Form 945 of the person responsible for withholding, usually the plan administrator, as described in section IV-B of this notice. The income tax withheld must be aggregated with other amounts reported by that person on Form 945 to determine the frequency of federal tax deposits under § 31.6302-4. This is the same as the first alternative described in Announcement 84-40, 1984-17 IRB 31. Alternatively, the IRS will permit the plan administrator (or payor) of § 457(g) trusts, or custodial accounts or insurance contracts treated as trusts under § 457(g)(3) to use the other two alternatives contained in Announcement 84-40 for the tax administration of such withholdings:

1. The plan administrator or payor may request and use 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 945 accordingly.

2. The plan administrator or payor may request and use a separate EIN for each § 457(g) trust (or custodial account or insurance contract), making deposits and filing Form 945 accordingly.

The plan administrator or payor 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 1099-R and Form 945. That is, the plan administrator or payor must use the same name and

EIN on Forms 1099-R as that under which the tax was deposited and the annual Form 945 return filed. The plan administrator or payor must aggregate and deposit all taxes pursuant to § 31.6302-4 under the EIN chosen. The above-described options relate only to trusts, annuity contracts, or custodial accounts established pursuant to § 457(g) for amounts deferred under a governmental § 457(b) plan. For information on the remittance of social security, Medicare, and FUTA taxes by the employer, see section VI-D below.

V. INCOME TAX WITHHOLDING AND REPORTING ON TAX-EXEMPT EMPLOYERS' § 457(b) PLAN DISTRIBUTIONS

A. Income Tax Withholding on Tax-Exempt Employer's § 457(b) Plan Distributions

"Distributions" from a § 457(b) plan of a non-governmental tax-exempt entity to a participant include all amounts that are paid or made available under the § 457(b) plan. Distributions to a participant from a tax-exempt employer's § 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 to distributions from a tax-exempt employer's § 457(b) plan. See § 35.3405-1T, Q&A-23. See Section IV of this notice for provisions regarding income tax withholding on distributions from a governmental § 457(b) plan.

Income tax withholding on distributions to a participant under a tax-exempt employer's § 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 tax-exempt employer or its agent is paying wages to the participant in addition to the distribution from the § 457(b)

plan, see § 31.3402(g)-1(a) 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, § 101(c)(11) of EGTRRA provides that this flat rate became 27 percent in 2002, then becomes 26 percent in 2004, and 25 percent in 2006 and thereafter.

B. Person Responsible for Income Tax Withholding on Distributions

When distributions are made under a tax-exempt employer's § 457(b) plan, the tax-exempt organization or other person having control of the payment of the distributions, as determined under § 3401(d)(1), is responsible for income tax withholding on the distributions.

C. Reporting Tax-Exempt Employer's § 457(b) Plan Distributions on Form W-2

Distributions to a participant during a taxable year under a tax-exempt employer's § 457(b) plan are wages and 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 a tax-exempt employer's § 457(b) plan distributions is deposited in accordance with § 31.6302-1 and 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.

VI. FICA AND FUTA TAXES AND REPORTING

A. Scope

The rules described in this Section VI 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 § 3121(u) (relating to Medicare), § 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 § 3121(b)(7)(F) (relating to state and local government employees who are not members of a state or local retirement system). As previously noted, EGTRRA did not revise the provision of Chapter 21 of the Internal Revenue Code treating § 457(b) plan distributions as “wages” for purposes of subjecting them to social security and Medicare taxes. The FICA rules discussed in this section generally apply to employees of tax-exempt organizations, unless a specific exclusion is applicable. The FICA tax discussed in this section includes the employer’s share of the FICA tax imposed under § 3111 as well as the employee’s share imposed under § 3101. Any FICA tax imposed on an employee’s § 457(b) plan deferrals or distributions must be reported on a Form W-2 for that employee.

The rules described in this Section VI relating to the Federal Unemployment Tax Act (FUTA) do not apply to service for a state or local governmental entity because § 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 section relating to FUTA apply to service for a tax-exempt organization other than a tax-exempt organization described in § 501(c)(3). See § 3306(c)(8).

B. Timing of Social Security, Medicare, and FUTA Taxes

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 VI-A, above). If social security, Medicare, or FUTA taxes apply, §§ 3121(v)(2) and 3306(r)(2) contain special timing rules that apply in determining when amounts deferred under a nonqualified deferred compensation plan (including employers’ contributions) 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, to the extent a § 457(b) plan provides that annual deferrals are immediately vested, the annual deferrals are subject to social security, Medicare, and FUTA taxes at the time of deferral. However, to the extent the annual deferrals are subject to a substantial risk of forfeiture, the annual deferrals (plus 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 § 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 that are attributable to those deferrals generally 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 in which benefits are not based solely 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. Because the elective deferrals 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 deferral.

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 § 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.

VII. ANNUAL REPORTING FOR § 457 PLANS

A. § 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.

B. 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.

VIII. 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 revisions enacted in EGTRRA.

IX. EFFECTIVE DATE

This notice is applicable with respect to deferrals and distributions made after December 31, 2001. However, for deferrals or distributions made after December 31, 2001, and before January 1, 2004, the Internal Revenue Service (IRS) will not assert that there has been a failure to comply with applicable reporting and withholding requirements if the applicable reporting and withholding requirements set forth in Notice 2000-38 have been satisfied. Thus, for example, in any case in which a series of distributions commenced before January 1, 2002 and the distributions are eligible rollover distributions (as defined in § 402(f)(2)(A)) that are payable over a specified period of less than 10 years, the IRS will not assert that there has been a failure to comply with applicable withholding requirements through December 31, 2003, if the applicable withholding requirements set forth in Notice 2000-38 have been satisfied.

X. REQUEST FOR COMMENTS

The IRS requests comments concerning this notice, and welcomes comments on any other useful approaches the Service might consider regarding the administration of § 457(b) plans. Comments can be addressed to the Internal Revenue Service, Office of Division Counsel/Associate Chief Counsel (TEGE), 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: notice.comments@irs.counsel.treas.gov and specifying that the comments concern Notice 2003-20.

DRAFTING INFORMATION

The principal author of this notice is John Tolleris of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury participated in its development. For further

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information regarding this notice, contact John Tolleris at (202) 622-6060 (not a toll-free number).