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Compensation Planning for Tax-Exempt Entities: Navigating IRC Section 457(f)

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June 8, 2016

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Agenda

- Internal Revenue Code ("Code") Section 457(f) statutory requirements and IRS regulatory guidance
- Determining when compensation is subject to a substantial risk of forfeiture
- What is "bona fide severance pay" under Code Section 457(e)(11)?
- The interplay between Code Sections 457(f) and 409A
- A note about the Intermediate Sanctions
- Application of ERISA
- Tax withholding and reporting

Code Section 457

- Code Section 457 plans are generally nonqualified, unfunded deferred compensation plans established by state and local government and tax-exempt employers ("eligible employers") for their employees and independent contractors
  - Churches, church controlled organizations, and the federal government or any agency or instrumentality thereof are excluded from coverage under Code Section 457
- There are 2 types of plans under Code Section 457—457(b) plan or 457(f) plan

Code Section 457

- 457(b) plan is referred to as an <u>eligible</u> plan
  - Generally unfunded
    - State government plans must set aside funds in a trust or custodial account
  - Maximum deferral limited to lesser of
    - 100% of compensation
    - Code Section 457(e)(15) amount ($18,000 for 2016)
  - Taxed when paid or made available
    - May elect to defer distribution past termination of employment
    - Subject to minimum required distribution rules
  - May be rolled over to other eligible 457(b) plan
- 457(f) plan is referred to as an <u>ineligible</u> plan

Code Section 457(f)

- We will first discuss Code Section 457(f)
- Understanding the basics of Code Section 457(f) will help to understand how it works (or doesn't work) with Code Section 409A
- Later in the presentation, we will explain how Code Section 409A works with Code Section 457(f)—but not yet!

Code Section 457(f)

- The most basic rule of Code Section 457(f) is that amounts are taxable when no longer subject to a substantial risk of forfeiture ("SRF")
- The amount included in gross income is the present value of the compensation deferred under the plan as of the first taxable year in which there is no SRF
  - Any earnings that accrue after the date that the SRF lapses are taxed when paid or made available (discussed later in the presentation)
  - Need to be careful about Code Section 409A when adding this earnings component

Code Section 457(f)

- There is no limit on the amount that can be deferred under Code Section 457(f)
- There may be other issues with regard to intermediate sanctions for non-profits, which is briefly discussed later in the presentation

Code Section 457(f)

- The statute defines a SRF as follows: “The rights of a person to compensation are subject to a substantial risk of forfeiture if such person’s rights to such compensation are conditioned upon the future performance of substantial services by any individual.”
- The IRS has stated that, “Section 83 of the Code and the regulations thereunder provide additional assistance in determining what is a substantial risk of forfeiture...”

SRF Definition

- Treas. Reg. Section 1.83-3(c)(1) contains the following guidance: "... rights in property that are transferred are conditioned, directly or indirectly, upon the **future performance (or refraining from performance) of substantial services** by any person, or upon the occurrence of a condition related to a purpose of the transfer if the possibility of forfeiture is substantial..."
- This is a facts-and-circumstances determination
- The phrase "or refraining from performance" is the unique aspect of this rule

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SRF Definition—Substantial Services

- The IRS has stated that generally, any requirement for the performance or nonperformance of services over a period of less than twenty-four months tends to indicate that the services required are not substantial
- Even if the amounts only vest upon a SRF, the IRS also allows for deferred amounts to vest early upon death, disability, involuntary termination, change in control or a plan termination, so long as set forth in the plan document
- However, vesting upon a voluntary termination will not work because that is not a SRF
  - This is referred to sometimes as a “walk right”

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SRF—Example with Walk Right

- The employee is age 53. The employer provides the employee with a plan that states that if the employee remains in active employment until he reaches age 58, he will receive $100,000
  - The SRF lapses at age 58, if he remains in active service until that date
- However, the plan also states that if the employee terminates due to retirement (age 55), he will also receive the $100,000
  - The addition of the ability to voluntarily terminate at age 55 means that once the employee attains age 55, the SRF lapses, even if he does not actually terminate
  - There is no SRF once he attains age 55
  - He will be taxed on the $100,000 once he attains age 55 (assuming he is still in active employment as of that date)

Covenant Not to Compete—SRF Under 457(f)?

- The IRS has stated that a covenant not to compete or a noncompetition clause which requires an employee not to compete with the employer once the employee separates from service often falls short of being a SRF under Code Section 457(f)
- The IRS stated that the factors which may be taken into account are the age of the employee, the availability of alternative employment opportunities, the likelihood of the employee obtaining other employment, the skill possessed by the employee, the employee's health, and the practice (if any) of the employer to enforce those covenants
- Highly scrutinized by the IRS and not likely found to be a SRF under 457(f)

Post-termination Consulting Agreement—SRF Under 457(f)?

- A SRF could include the employee's performance of substantial consulting services after termination of employment
- Whether the services are substantial depends on the regularity of the performance of the services as well as the time spent performing such services
- Again, the IRS will highly scrutinize whether this is really a SRF under Code Section 457(f)

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Post-termination Consulting Agreement—SRF Under 457(f)?

- An example of this from informal IRS guidance: "...a participant doctor is entitled to receive benefits from a tax-exempt hospital upon the completion of certain employment requirements. Specifically, the doctor is required to 1) review cases and 2) provide consulting with regard to a department of the hospital. The Plan states that the doctor will be entitled to benefits only if he or she completes the services as reflected in this agreement. These services are not the regular services of the physicians, which are listed in each doctor's individual employment contract with the hospital. The case file did not reflect the regularity with which the consulting services required in the plan were to be performed or the actual amount of time spent, if any, in the performance of these services. In this case, we questioned whether the amounts deferred were truly subject to a substantial risk of forfeiture."

SRF—Rolling Risk of Forfeiture Under 457(f)

- This is a provision which permits an extension of the period of forfeiture beyond when it would otherwise lapse
- The intent is to delay payment and taxation
- For example, if the employee has the vested right to the amount in 2020 (i.e., the SRF lapses in 2020), he may elect in 2019 to defer that until 2022, so the SRF is moved to 2022
- The IRS has stated in informal guidance, "These plans should be subject to a higher level of scrutiny to determine whether a risk really exists. This is particularly true where the employee has the option to extend the risk period and does so shortly before the risk lapses."

Salary Deferral Programs—Under 457(f)

- Another concern for the IRS is plans funded purely by salary deferrals. The IRS views these as amounts that are usually additional compensation to the employee and do not place the employee's real regular compensation at risk
- From informal IRS guidance, "Salary reduction 457(f) plans, however, must be placed under closer scrutiny because few employees would find such arrangements to be an acceptable alternative to current compensation, unless they are very near retirement and feel secure in their jobs."
- These kinds of plans likely do not work under Code Section 457(f)

Severance Pay Plans

- Code Section 457(f) does not apply to a bona fide severance pay plan (Code Section 457(e)(11))
- There is no statutory definition of a bona fide severance pay plan
- The IRS has stated that it cannot constitute a mere device to defer compensation
- When a plan states that the payment is made only upon an involuntary termination, but that term is defined so broadly that the participant will receive the benefits no matter what the reason is for terminating, that is more like deferred compensation that is subject to Code Section 457(f)

Application of Code Section 409A

- Code Section 457(f) plans are subject to Code Section 409A
- As stated above, under Code Section 457(f), deferred compensation is taxed when it is no longer subject to a SRF
- In many cases, the definition of SRF under Code Section 457(f) and Code Section 409A will be the same
  - This will allow the Code Section 457(f) plan to come within an exemption from Code Section 409A, unless the plan has a "409A tail" (which is discussed later)

Application of Code Section 409A

- Under Code Section 409A, all deferred amounts are includible in income to the extent not subject to a SRF, unless the plan meets all of the requirements of Code Section 409A—which are a million rules, including very strict rules regarding the time and form of payments
- A lapse of the SRF does not cause taxation unless the Code Section 409A rules have not been met
- The failure of a plan to meet the requirements of Code Section 409A causes SUBSTANTIAL penalties on the executive (which could eat up all of the promised benefit)

Code Section 409A—SRF

- Compensation is subject to a SRF if entitlement to the compensation is conditioned on the performance of substantial services or the occurrence of a condition related to the purpose of the compensation and the possibility of the forfeiture is substantial
- An amount is not subject to a SRF merely because the right to the amount is conditioned upon refraining from the performance of services
  - Different from Code Section 457(f)

Code Section 409A—SRF

- An amount is not considered subject to a SRF beyond the date the participant could have elected to receive the compensation, unless the present value of such amount (disregarding the risk of forfeiture) is materially greater than the present value of the vested amount the participant otherwise could have elected to receive (Treas. Reg. 1.409A-1(d))
- There mere extension of the period in which compensation is subject to a SRF is disregarded in determining whether a SRF exists
  - Very different from Code Section 457(f)

Application of Code Section 409A

- Most Code Section 457(f) plans that have a SRF definition that complies with the Code Section 409A definition of SRF will come within the short-term deferral exemption from Code Section 409A
- That exemption requires that the compensation be paid within 2 ½ months after the close of the tax year in which the SRF lapses
- Example: The SRF for the Code Section 457(f) plan requires that the employee remain in active employment with the company until December 1, 2020 and if not, he will not receive any payment under the plan. The employee meets this requirement and the payment should be taxed in December—which also will allow for the plan to come within the short-term deferral exemption of Code Section 409A

Example of Rolling Risk of Forfeiture

- Employer provides plan to employee that states that if he remains in active employment until May of 2020, he will receive $100,000
- In December of 2019, he elects to move the SRF to 2022
- Very questionable under Code Section 457(f)
  - Done very close in time to when original SRF lapses
  - Likely still has income in 2020 and the new 2022 date is not recognized as the new date for the lapse of the SRF
- Does not work under Code Section 409A
  - If this was to work under Code Section 457(f) (see above), to make it work under Code Section 409A, it would need to meet the subsequent deferral rule (election made at least one year before vesting and payment date at least 5 years out)
  - Does not change when SRF lapses, but could create a deferred payment date and avoid a document or operational failure under Code Section 409A

Example—Covenant Not to Compete

- The plan states that if you agree not to compete for 18 months after your termination of employment from the company, we will pay you $100,000
- This does not work in California
  - No SRF so $100,000 immediately taxable (but may not be fully payable at that time due to Code Section 409A)
- Even if in a state where it did work, questionable if works under Code Section 457(f)
  - See earlier slide on this
- Likely does not work under Code Section 409A
  - Need an exact time and form of payment provision, such as lump sum payment on the first day of the 18th month after termination of employment

Severance Pay Plan—Code Section 457(e)(11)

- As explained earlier, a Code Section 457(e)(11) plan is exempt from Code Section 457(f)
- However, it will need to come within an exemption from Code Section 409A or comply with Code Section 409A

Section 409A Exemptions for Severance Pay

- Separation pay plan (requirements on next slide)
- Non-taxable welfare benefits
- Reimbursements and in-kind benefits (detailed requirements not listed in presentation) provided over a limited period of time (end of 2nd year after year of termination) – for example:
  - Outplacement benefits
  - Reimbursement of COBRA premiums
  - Moving expenses
- Limited payments not exceeding Code Section 402(g)(1)(B) ($18,000 for 2016)
- Short-term deferrals
- Exemptions may be stacked

Separation Pay Plan—Section 409A

- Termination of Employment
  - Involuntary
  - Voluntary termination due to "good reason" as defined under Section 409A regulations
  - Voluntary termination during a window program
- The separation pay must not exceed the lesser of
  - 2x annual rate of compensation for prior year, or
  - 2x the Code Section 401(a)(17) compensation limit ($265,000 for 2016) in year of termination
- Payment(s) must be completed no later than the end of the 2nd taxable year following the year of termination of employment

Example of 409A Exempt Severance Benefits

- Assume $200,000 annual salary in prior year
- Written employment agreement provides that upon involuntary termination of employment without cause or termination of employment for "good reason," employee will receive:
  - 2 years annual salary payable weekly for 52 weeks
    - Separation pay plan exemption
  - 6 months reimbursement of COBRA premiums
    - Medical benefits exemption (consider other issues such as nondiscrimination rules for self-funded plans)
  - Up to 1 year outplacement services by counselor paid directly by employer
    - Limited period in-kind benefit
  - Payment up to $15,000 to reimburse for moving expenses or to buy-out lease on apartment
    - Limited amount payment

IRS Notice 2007-62

- This Notice announced the intent of Treasury and IRS to issue guidance concerning the definition of a bona fide severance pay plan under Code Section 457(e)(11) and the definition of SRF under Code Section 457(f)
  - It has not been issued as of the date of this presentation

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IRS Notice 2007-62

- Treasury and IRS anticipate issuing guidance providing that an arrangement is a bona fide severance pay plan under Code Section 457(e)(11), if:
  - (1) the benefit is payable only upon involuntary severance from employment and
  - (2) the amount payable does not exceed two times the employee's annual rate of pay (taking into account only pay that does not exceed the maximum amount that may be taken into account under Code Section 401(a)(17) for the year in which the employee has a severance from employment)
  - (3) the plan provides that the payments must be completed by the end of the employee's second taxable year following the year in which the employee separates from service

IRS Notice 2007-62

- For the exemption on the previous slide, with respect to the requirement that benefits be payable only upon involuntary severance from employment, the new guidance would include exceptions for window programs, collectively bargained separation pay plans and certain reimbursement or in-kind arrangements

IRS Notice 2007-62

- The Treasury and IRS further anticipate issuing guidance regarding a SRF
- The rules will be similar to those under Code Section 409A
- This should mean that a non-compete, salary deferrals and rolling risk of forfeiture will not be a SRF under Code Section 457(f)
  - One could make an argument that some of these designs work now under 457(f), but it would be VERY aggressive—and it would be hard to make that work with Code Section 409A

The 409A Tail

- Under Code Section 457(f), an amount included in gross income is the present value of the compensation deferred under the plan as of the date in which the SRF lapses
- As described above, in most cases that will mean that the Code Section 457(f) plan is exempt from Code Section 409A under the short-term deferral rule
- However, Code Section 457(f) states that any earnings that accrue after the date that the SRF lapses are taxed when paid or made available
  - This is the 409A Tail

The 409A Tail

- The earnings continue to accrue after the SRF lapses
- The earnings do not come within any exemption from Code Section 409A
- The time and form of payment for those earnings must comply with Code Section 409A
- Any election as to when those earnings will be received must comply with Code Section 409A

The 409A Tail

- Example: In January of 2017, the employee is provided with a Code Section 457(f) plan in which $100k will be paid to him if he remains in active employment with the company until January of 2020. If not, he loses all rights to that money—it will be forfeited
- The plan states the employee can make an election to allow the earnings to remain in the plan after the SRF lapses and receive the earnings at termination of employment. He must make that election no later than January of 2018. The employees makes that election
- When January of 2020, the employee will be taxed on the $100k, even though he is not paid that amount. He is leaving it in the plan so that earnings can accrue
- When he terminates, the earnings are taxed and all amounts are paid to him

The 409A Tail

- This example works under Code Section 457(f), because the SRF is remaining in employment for 3 years
- He is taxed on the $100k when the SRF lapses—January of 2020
- He makes an election with regards to the earnings at least 13 months prior to when those amounts could first vest—which should work under Code Section 409A
- The earnings are paid upon separation from service, which is a permitted payment event under Code Section 409A

Intermediate Sanctions and Reasonable Compensation

- Compensation of employees of tax-exempt entities should be "reasonable". This is set forth in Code Section 4958 and applies to tax-exempt entities described in either Code Section 501(c)(3) or 501(c)(4)
  - There are a lot of exceptions to this rule such as what compensation is counted. This part of the presentation is only a general overview of the rule

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Intermediate Sanctions and Reasonable Compensation

- Under the IRS's intermediate sanctions regulations, the IRS imposes an excise tax on "disqualified individuals" and "organizational managers" if a disqualified person's compensation package is not reasonable
  - A **25%** excise tax on the value of the "excess benefit" (defined later) is imposed on the disqualified individual (200% if the excess benefit is not timely corrected) and;
  - A **10%** excise tax on the value of the excess benefit is imposed on organizational managers who knowingly and willfully approved the transaction (capped at $20,000 per transaction)

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Disqualified Individuals

- A "disqualified individual" is any person who was in a position to exercise substantial influence over the affairs of the organization at any time during a five-year look back period ending on the date of the excess benefit transaction
  - Also includes that person's family members, and corporations, partnerships, and trusts over which that person or a family member has at least 35% of the voting power, profits interest, or beneficial interest
- "Substantial influence" – The regulations list specific persons that are deemed to be in a position to exercise substantial influence:
  - Voting members of the organization's governing body;
  - President, CEO and COO; and
  - Treasurer and CFO

Disqualified Individuals

- Regulations also include a “facts and circumstances” test to determine if other individuals are in a position to exercise substantial influence. Some listed examples of facts and circumstances tending to show substantial influence are:
  - The person founded the organization;
  - The person is a substantial contributor to the organization;
  - The person’s compensation is primarily based on revenues derived from activities of the organization, or of a particular department or function of the organization, that the person controls;
  - The person has or shares authority to control or determine a substantial portion of the organization’s capital expenditures, operating budget, or compensation for employees; and
  - The person manages a discrete segment or activity of the organization that represents a substantial portion of the activities, assets, income, or expenses of the organization, as compared to the organization as a whole

Excess Benefit

- An “excess benefit” is the amount by which the value of the economic benefit provided by an organization, directly or indirectly, to or for the use of any disqualified person exceeds the value of the consideration received for providing such benefit
- In determining whether compensation is reasonable, the value of the services is the amount that would ordinarily be paid for the like services by like enterprises under like circumstances

Excess Benefit

- Determination must take into account all consideration and benefits exchanged between/among the disqualified person, the organization, and the entities it controls
- Includes any economic benefit received by a disqualified person from the assets of the organization, even if the transfer is not authorized under the organization's regular procedures

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Excess Benefit—Compensation Included

- All forms of cash and non-cash compensation, including salary, fees, bonuses, severance payments and deferred compensation
- The payment of liability insurance premiums or the payment by the organization to the disqualified person of certain penalties and liability-related expenses (e.g., a tax owed under Section 4958)
- All other compensatory benefits, whether included in gross income or not
- Taxable and non-taxable fringe benefits

Excess Benefit—Exception for Fixed Benefits Under Initial Contract

- Intermediate sanctions do not apply to a "fixed payment" made by an organization to a disqualified person "pursuant to an initial contract"
- An "initial contract" is a binding written contract between the organization and a person who was not a disqualified person immediately prior to entering into the contract.
  - Requires "substantial performance" by the person for a taxable year
- An initial contract is treated as a new contract (i.e. outside the scope of this exception) if the contract provides that it may be terminated or cancelled by the organization:
  - without the disqualified person's consent (other than for substantial non-performance); and
  - without penalty to the organization

Excess Benefit—Exception for Fixed Benefits Under Initial Contract

- A “fixed payment” is an amount of cash or other property specified in the contract, or determined by a fixed formula specified in the contract, which is to be paid or transferred in exchange for the provision of specified services or property
  - Does not include any amount paid to the person under a reimbursement or similar arrangement where any person has discretion regarding the amounts incurred or reimbursed
- A fixed formula can incorporate an amount that depends upon future specified events or contingencies, so long as no person exercises discretion when calculating the amount of a payment or deciding whether to make a payment (e.g., a bonus)
  - A specified event or contingency may include the amount of revenues generated by (or other objective measure of) one or more activities of the organization

Reasonable Compensation

- Rebuttable Presumption: Payments under a compensation arrangement are presumed to be reasonable if the benefit satisfies three conditions:
  - 1. The compensation arrangement or the terms of the property transfer are approved in advance by an authorized body of the tax-exempt organization composed entirely of individuals who do not have a conflict of interest;
  - 2. The authorized body obtained and relied upon appropriate data as to comparability prior to making its determination; and
  - 3. The authorized body adequately documented the basis for its determination concurrently with making that determination

Conflict of Interest

- Conflict of Interest – Recusal
  - The conflict of interest requirement applies on a transaction-by-transaction basis
  - The conflict of interest requirement applies to all voting members of the authorized body, except if the voting member:
    - Meets with other members only to answer questions;
    - Recuses himself or herself from the meeting; and
    - Is not present during debate and voting on the proposed transaction
  - Disqualified person may meet with the authorized body, but must not be present for the vote on the proposed transaction
    - Minutes should reflect that disqualified person recused herself/himself before the vote

Reasonable Compensation

- Appropriate Data
  - Compensation levels paid by similarly situated organizations, both taxable and non-taxable, for functionally comparable positions;
  - The availability of similar (urban vs. rural, size of area, cost of living) services in the geographic area of the applicable tax-exempt organization;
  - Current compensation surveys compiled by independent firms; and
  - Actual written offers from similar institutions competing for the services of the disqualified person

Reasonable Compensation

- Compensation Surveys
  - Whether the compensation surveys were performed by reputable firms having knowledge and expertise in the same industry as that of the applicable tax-exempt organization
  - Whether the firms were independent with respect to both the applicable tax-exempt organization and the disqualified person
  - Whether the compensation surveys covered the relevant periods
  - Whether the organizations included in the compensation surveys were similarly situated
  - Whether the positions considered in the surveys were functionally comparable to the position of the disqualified person
  - The number of compensation surveys and the number of different organizations included in the surveys

Reasonable Compensation

- Documentation – must note:
  - Terms of the compensation;
  - Date approved;
  - Members of authorized body present and who voted to approve
  - Description of comparability data and how it was obtained;
  - Any participation or actions of a member of authorized body who had a conflict of interest; and
  - Any determination that compensation is higher or lower than range of comparable date
- Documentation must be completed by later of next meeting of authorized body or 60 days after final action

Intermediate Sanctions—Example

- The executive director of XYZ Charity (a "disqualified person") received a compensation package of $250,000 in FY 2013. After an examination of the organization, the IRS establishes that $150,000 was the appropriate compensation for the position at that time. As a result of this determination:
  - The IRS requires the executive director to repay the $100,000 overpayment ("excess benefit") to the organization with interest;
    - If the executive director fails to repay this amount, or repays only part of it, a 200 percent excise tax may be imposed on the amount yet to be repaid
  - The IRS may require the executive director to pay an excise tax equal to 25% of the overpayment ($25,000 here); and
  - The IRS may require each board member who approved the excess benefit, or any board member who knew about the excess but failed to prevent the overpayment, to pay an excise tax equal to 10% of the overpayment, not to exceed $20,000 per transaction ($10,000 here)

Application of ERISA

- While any employee or independent contractor of a governmental entity can be a participant in a Code Section 457 plan, tax-exempt entities that are non-governmental must limit participation to <u>management and highly compensated employees</u>—the Top-Hat Group
- ERISA generally requires that a plan which provides retirement benefits to employees be funded by an irrevocable trust—but Code Section 457 requires that the plans be unfunded
  - Accordingly, the plans need an exemption from ERISA's funding requirement

Application of ERISA

- Can meet this exemption from funding by coming within the Top-Hat exemption from ERISA
- A Top-Hat plan is defined as:
  - "[A] plan which is unfunded and is maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees" *ERISA Sections 201(2), 301(a)(3) and 401(a)(1)*
- There is a lot of case law around the Top-Hat definition. In the 9th Circuit, the courts seem to believe that the top 5-8% of employees are in that group (so long as all of the other requirements are also met)
- Can have a rabbi trust (which is not discussed in this presentation)

Application of ERISA and Top-Hat Plans

- A Top-Hat plan is exempt from the ERISA requirements relating to participation and vesting, funding and fiduciary responsibility
  - Being subject to those rules would create serious issues because most Top-Hat plans could not comply with those rules—for example, the plan would fail the participation requirements because no non-highly compensated employees would be in the plan
- A Top-Hat plan is not exempt from the reporting and disclosure requirements or the administrative and enforcement provisions of ERISA although, under current law, simplified reporting procedures are available (so long as a top-hat filing is made with the US Department of Labor within a 120 days after the date the plan is subject to ERISA)
  - Very important to have ERISA claims and appeals rules and provide a copy of those to participants

Income Taxation of 457(f) Benefits

- Federal income tax on a Code Section 457(f) plan benefit is due:
  - in the calendar year in which the benefit is no longer subject to a SRF; and
  - on the present value of the benefit on the date the SRF lapses

Income Taxation of 457(f) Benefits

- Earnings after the date of the SRF lapses
  - Subject to income taxation when paid or made available to the participant or beneficiary
  - However, accrual of additional vested Code Section 457(f) benefits are immediately taxable
    - Code Section 72 applies to tax present value of current Code Section 457(f) benefit less basis in previously taxed Code Section 457(f) benefit

FICA Taxation of 457(f) Benefits

- FICA (and FUTA, if applicable) taxation applies to nonqualified deferred compensation as of the later of when the services are performed or when there is no SRF of the benefit
  - FICA taxation applies to present value
  - FICA taxation does not apply to earnings after FICA resolution date (generally date of lapse of SRF)
    - Defined Benefit Code Section 457(f) plan – If the benefit is not reasonable ascertainable on the date the benefit is no longer subject to a SRF, then FICA resolution date may be delayed until benefit is reasonably ascertainable

Tax Withholding for 457(f) Benefits

- Income Tax Withholding
  - Income tax withholding is required at the time the Code Section 457(f) benefit is actually or constructively paid
    - If Code Section 457(f) benefit is paid in installments or annuity, then income tax withholding is not required until paid (even though present value of Code Section 457(f) benefit is included in income for participant in the year benefit vests)
    - However, if plan permits distribution to pay participant tax withholding, then amount of distribution is subject to income tax withholding
- FICA (and FUTA, if applicable) tax withholding is required in the year the Code Section 457(f) benefit is includible as FICA wages

Tax Withholding and Reporting Example

- Employer's 457(f) plan provides a benefit of two times final compensation, which vests upon attaining age 55 and 20 years of service and is paid upon retirement in the form of five installments commencing on January 1 after the employee's date of retirement. Employee attains age 55 and 20 years of service on June 1, 2016, and retires on June 1, 2018.

Tax Withholding and Reporting Example

- Taxable Wages: The present value of the installments is included in income in 2016 and reported in Box 1 of the employee's Form W-2
  - No distribution from the 457(f) plan have been made in 2016
  - Participant must pay income taxes from other assets
- FICA Wages and FICA Tax Withholding: The amount of the 457(f) benefit is not reasonably ascertainable until June 1, 2018. The present value of the life annuity on June 1, 2018 is treated as FICA wages and subject to FICA tax withholding in 2018. For 2018, the present value of the 457(f) benefit is reported in Box 3 as Social Security wages (if Social Security wage base as not been met) and Box 5 as Medicare wages and appropriate Social Security, and Medicare tax withholding is reported in Boxes 4 and 6, respectively.
  - No distributions from the 457(f) plan have been made in 2018
  - Employer tax withholding obligation must be met from other employee wages or employee must write a check to employer

Tax Withholding and Reporting Example

- Income Tax Withholding:
  - Most 457(f) plans pay benefit shortly after the SRF lapses and report and withhold income taxes in the same year
  - 457(f) installment/annuity payments potentially create a mismatch in reporting and withholding years
    - In TAM 199903032, IRS concluded that income tax withholding was not required in the year the SRF lapsed (when payments are made in later tax years)
    - IRS noted that income taxation and FICA taxation are subject to special timing rules under Code 457(f) and Reg. 31.3121(v)(2)-1, but there is no special timing rule with respect to employer income tax withholding obligation under Code Section 3402.
  - Form W-2 reporting -- Lack of IRS guidance
    - Most employers withhold income taxes on present value of benefit in year SRF lapses and generally provide for an accelerated tax distribution

Employer Deduction for 457(f) Benefits

- An employer deduction for Code Section 457(f) benefits may be taken in the taxable year in which the amount is includible in the participant's income

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