

Federal Income Tax Withholding/Reporting Requirements for Section 457 Distributions

Prior to January 1, 1999, all section 457(b) plans were considered unfunded. As a result, plan assets were considered property of the employer which was subject to the claims of the general creditors of the employer, and the participant possessed a contractual claim against the employer. Amounts became taxable to the participant when they were paid or made available. Distributions to plan participants were treated for income tax and withholding and reporting purposes as wages under section 3402.

The unfunded nature of the plans changed after events in Orange County. In 1996, the Small Business Job Protection Act of 1996 ("SBJPA") changed the rules for governmental section 457(b) plans (but not 457(b) plans sponsored by private tax exempt employers), making them funded plans by requiring that plan contributions and earnings be held a trust, an annuity contract, or a custodial account, for the exclusive benefit of the participant or their beneficiary. In 2001, The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") provided that distributions to participants from a governmental section 457(b) plan was no longer treated as wages. Instead, reporting was aligned with reporting for distributions from qualified plans and 403(b) annuities, with distributions reported on IRS Form 1099-R. The provisions of EGTRRA are currently subject to a sunset provision for years after December 31, 2010, at which time reporting could revert to wages on form W-2.

IRS Notice 2003-20 describes the withholding and reporting requirements applicable to both funded and unfunded eligible section 457(b) deferred compensation plans. Also, see IRS Publication 575, Pension and Annuity Income, and The Instructions to IRS Form[s] W-2 and 1099-R. The notice updates the withholding and reporting requirements relating both public and private sector section 457(b) deferred compensation plans, for periods after December 31, 2001. Generally Notice 2003-20 clarifies the pre-SBJPA reporting and withholding rules for unfunded tax-exempt nongovernmental plans. Unfunded tax-exempt nongovernmental plan distributions continue to be taxable when the amounts are paid or otherwise made available to the participant or beneficiary. Accordingly, unfunded tax-exempt nongovernmental annual deferrals are reportable to the IRS on form W-2 Wage and Tax Statement. The Notice also clarifies that after December 31, 2001, distributions to an individual from a governmental section 457(b) plan are subject to income tax withholding and reporting under section[s] 3405, Pension and Annuity Withholding and 6047, Information Relating to Certain Trusts and Annuity Plans, respectively and are reported on IRS form 1099-R rather than on form W-2.

As a general matter, a 457(g) trust for a governmental plan is not required to file annual tax returns for the trust itself, including Forms 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. However, a 457(g) trust would appear to be required to file a Form 990-T in any year that it has more than \$1,000 of unrelated business taxable income (UBTI). In practical terms, it is unlikely that most individually-directed 457(g) trusts will have UBTI. An example of UBTI in a retirement

plan trust could be if a plan trustee obtained a loan from an annuity contract held in the trust and invested the loan proceeds into other investments that are also within the trust.

The Notice also provides guidance on certain related reporting and withholding issues for employees (but not independent contractors) and beneficiaries. For example:

- The Notice clarifies that EGTRRA made plan administrators of eligible governmental plans, rather than the payor of the designated distribution, generally liable for withholding from such plan. However, under section 3405, the 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 required information.
- The Notice also clarifies the appropriate EIN used on form 945 when reporting governmental section 457 distributions. The plan administrator or payor may use their individual EIN or may supply a separate EIN for each trust or custodial account or insurance contract.
- Additionally, the Notice clarifies the reporting of death benefit payments to a beneficiary of a deceased participant from all 457(b) plan distributions is still reported on form 1099-R.
- FICA tax applies to employees of state and local governments only if they are subject to social security or Medicare tax. Generally, FICA applies to tax-exempt organizations. FUTA does not apply to employees of state and local governments.
- The Notice provides some general guidance for previously existing mandatory withholding requirements as applicable to governmental section 457(b) distributions after 2001.
- Additional information not relevant to this discussion was also provided in Notice 2003-20.