NEW PINNACLE
CONSULTING GROUP, LLC

Nongovernmental 457(b) Taxation

Background

A nongovernment 501(c)(3) organization may offer a 457(b) deferred compensation plan to a select group of employees, usually to top administrator(s) at the institution. Such plans are often referred to as 'top hat' plans.

Contributions to the plan are typically made entirely by the institution although employee contributions are permitted and are generally made on a salary reduction basis. Investments are usually similar to those found in the institution's retirement plan. A major distinction however, is that the funds are 'owned' by the institution and are subject to the claims of creditors if the institution declares bankruptcy.

Distributions

Generally, amounts cannot be distributed from the plan until the employee has a severance from employment, attains age 70 ½, or has an unforeseen emergency. The funds become taxable to the participant upon distribution or when otherwise made available. A plan typically states a default distribution method at termination of employment (usually cash) and gives the employee the right to defer and change the form of distribution during a window period after separation (i.e. 60 days) and before the amount is payable. After termination of employment, the participant is only allowed to make one change after the initial election is made and that change can only be made to defer the distribution.

The funds are considered 'deferred compensation' and as such the tax reporting upon distribution is done on a W-2. The institution usually gives official permission for the investment vendor to act as their agent for tax withholdings and reporting. Often the agent will only handle federal and state taxes. All other taxes must be administered by the institution (i.e. local taxes, FICA, FUTA).

Taxation

A distribution is subject to taxation the same as any other earned income. The institution however has a choice on when to subject the funds to FICA and FUTA taxation. They can tax the funds when earned or when the 'substantial risk of forfeiture' provision is satisfied. In most arrangements, both requirements are essentially met at the time the funds are remitted to the investment provider. Hence, FICA and FUTA taxation should occur in the participant's tax-year when the funds are earned and remitted.

FICA and FUTA Taxation

FICA has two components, Social Security and Medicare. This Social Security tax is currently 6.2% for income up $118,500 (2016). The Medicare tax is 1.45% with an additional .9% for those earning above a certain threshold (based on tax filing status). There is no earnings limit for Medicare taxes.

The 457(b) contribution should be added to the corresponding boxes on the W-2. It will not impact the participants' or the institutions' Social Security tax since the wage base has been met. Taxes will need to be withheld for Medicare. Additionally, the payroll vendor should include the code G in box 12 for plan participation.

FUTA tax rules are beyond the scope of this information. Please contact your payroll vendor regarding the submission of FUTA taxes.

Resource: www.irs.gov/pub/irs-pdf/iw2w3.pdf (W-2 instructions)