

Payroll taxation of employee deferrals and employer contributions for Section 457(b) plans

Federal income-tax withholding

Amounts deferred by employees or amounts contributed by employers to nonqualified defined contribution deferred compensation plans generally are **not** subject to income taxes until benefit payments are considered received. Income taxes are withheld only when (1) payments are made to the employee or (2) the plan becomes funded (i.e., the plan assets are segregated in a separate fund for the benefit of the employee, and the employee is deemed to be in constructive receipt of the benefit¹).

State income-tax withholding

Most states follow the federal rules for income-tax withholding. Check with your state for any differences from federal rules.

Social Security and Medicare withholding (FICA), and Federal Unemployment Taxes

Employee deferrals into nonqualified deferred compensation plans are subject to FICA taxes currently, as if the employee had received the compensation. The employer must withhold FICA taxes and pay the FICA match at the time of deferral. These deferrals are subject to FUTA at this time. However, 501(c)(3) organizations are exempt from FUTA.

Employer contributions are subject to FICA taxes at the later of:

- When the services are performed.
- When the employee no longer has a substantial risk of forfeiting the deferred compensation. This usually occurs when employer contributions become vested.

Since employer contributions to Section 457(b) plans are normally immediately 100% vested, FICA taxes are due when employer contributions are made to the participant's account. Once the employee becomes 100% vested in their employer contribution account, FICA taxes are due only on additional employer contributions to the account, not on any earnings in the account.

Since FICA have already been paid, when distributions from the plan are made to the participant, no FICA taxes are due at that time.

State unemployment taxes

State unemployment tax may vary, so check with your state for any differences.

1099 independent contractors

Independent contractors subject to Form 1099-NEC reporting may be eligible to participate in a nonqualified Section 457(b) plan. No income tax or self-employment (SECA) taxes are due on employee deferrals, employer contributions, or earnings in the plan. Any distributions from the plan to the participant are reported on Form 1099-NEC in the tax year of distribution, and all taxes are paid at that time.

¹ See IRC Sec. 457(a)(1); Treas. Reg. §1.457-4(a).



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