APPLIED KNOWLEDGE | ACCOUNTING GUIDELINES

Tax reporting of nonqualified Section 457(f) plans

Tax reporting for contributions to Internal Revenue Code Section 457(f) plans for Internal Revenue Code Section 501(c)(3) employers depends on the employment status of the plan participant. Tax information for **employees** is reported using Form W-2, while tax information for **independent contractors** (i.e., agents or members of the Board of Directors) is reported using Form 1099-NEC.

In IRC Section 457(f) plans, amounts contributed to the plan and earnings in the participant's account are not subject to income, Social Security, or Medicare taxes **until the account vests**.[1] IRC Section 457(f) plans may allow multiple participant accounts with different vesting dates. Only the balance in the account that vests is taxable to the participant at the vesting date. The vested amount doesn't have to actually be distributed to be taxable to the participant. As such, if the actual distribution occurs later, any additional earnings after vesting will be subject to income taxes, but not Social Security or Medicare taxes as of the distribution date.

Employee tax reporting (Form W-2)

- **Wage reporting**. Since IRC Section 457(f) employer contributions aren't subject to income taxes until the account vests, these amounts shouldn't be included in amounts reported in Box 1, Wages, Tips and Other Compensation at the time of contribution. **When a participant's account in the plan vests**, the total account balance, including earnings, should then be included in Box 1. If the amount actually distributed after vesting is greater than the amount originally taxed at vesting, additional income would be reported, and additional taxes would be due at the time of distribution.
- **Social Security and Medicare reporting (FICA).** *Employee and employer contributions* are subject to Social Security and Medicare taxes (FICA) 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 the employer contributions become vested.

  Since IRC Section 457(f) participant accounts vest upon a specific date, no FICA taxes are due until that date occurs. At that time, FICA taxes are due on the entire vested balance in the account. Once vesting occurs, there would be no additional FICA on any earnings on accounts actually distributed later. **Note:** IRC Section 501(c)(3) organizations are exempt from FUTA.

Social Security wages should be reported in Box 3 (up to the wage base minimum), and Social Security taxes withheld should be reported in Box 4. Medicare wages should be reported in Box 5, with Medicare taxes withheld reported in Box 6.

- **Box 11 reporting**. The purpose of Box 11 is for the Social Security Administration to determine whether any wages reported on Form W-2 were earned in prior years. Special reporting rules apply as outlined in IRS Publication 957. In Section 457(f) arrangements amounts will be reported as taxable wages for both income tax and Social Security purposes in the year of vesting. As such, this amount should not be reported in Box 11[2].

Independent contractor tax reporting (Form 1099-NEC)

No income tax or self-employment (SECA) taxes are due on contributions into the plan at the time of contribution. At the time of vesting, the amount vested is reported on Form 1099-NEC, Box 1 and all taxes are paid at that time. Additional reporting is required for plan violations (see below).

Code Internal Revenue Code Section 409A reporting (W-2 and 1099 MISC) and Notice 2008-115

Under the short-term deferral rules, IRC Section 457(f) plans that distribute plan benefits immediately upon vesting aren't normally subject to IRC Section 409A. For IRC Section 457(f) plans that defer distributions further after vesting occurs, Section IRC 409A typically applies.

IRC Section 409A of the Internal Revenue Code mandates employer reporting of certain information related to deferred comp plans. Under IRC Section 409A, employers are required to report the amount of compensation deferred for each plan participant and also report any amounts deferred that are in violation of IRC Section 409A. For employee participants, on Form W-2, the Internal Revenue Service (IRS) has specified Code Y for reporting deferral amounts and Code Z for reporting amounts taxable due to plan violations. For nonemployee participants, in addition to reporting the vested amount on Form 1099-NEC, Form 1099 MISC is used to report plan violations. The IRS has specified Box 12 to report deferred amounts and Box 14 to report amounts taxable due to plan violations.

The IRS issued Notice 2008-115 detailing W-2 reporting and Form 1099 MISC reporting requirements for employers with deferred comp arrangements.

- The IRS has suspended the reporting requirements for W-2 Code Y and 1099 MISC Box 12 (deferral) reporting until the year after final Code Y tax reporting regulations are issued. These regulations have not yet been issued.
- For any amounts subject to taxation due to a violation of IRC Section 409A, the IRS is mandating Form W-2, Box 12 Code Z and Form 1099 MISC Box 14 reporting. The notice specifies the mechanics of reporting these amounts.

In order to avoid Code Z reporting and participant tax penalties, employers should carefully scrutinize all deferred comp arrangements subject to IRC Section 409A to ensure they are in compliance.

[1] See IRC Sec. 457(f)(1)(A); Treas. Reg. §1.457-11(a)(1).

[2] If the participant is age 62 or older by year end, consider whether filing Form SSA-131 is necessary.