Principal®

Vesting and employer contributions in Non-governmental 457(b) plans

Participants in a non-governmental 457(b) plan can make annual salary deferral contributions to the plan up to the lesser of:

- 100% of the participant's includible compensation, or
- An annual indexed limit per IRC Section 457(e)(15).

As a practical matter, many 457(b) plan participants are limited to the annual indexed amount, as 100% of their includible compensation exceeds this limit.

This annual contribution limit includes both participant deferrals and vested employer contributions. To the extent employer contributions are subject to a vesting schedule (i.e., something other than 100% immediate vesting), any vested additions in a given year count towards the annual limit. This may have taxation implications. Vested additions are defined as:

- Employee deferrals,
- Vested employer contributions, and
- Market returns on the component of the employer contribution that becomes vested in the current year.

When employer contributions are subject to a vesting schedule, the potential for exceeding these contribution limits in any particular year increases, which may result in unintended tax consequences.

Because of the administrative challenges surrounding these limits, both participant and employer contributions to 457(b) plans are typically 100% vested immediately. The following two examples illustrate these challenges:

Example 1[1]

A nongovernmental 457(b) plan provides for employer contributions exclusively. The employer makes contributions annually and each contribution vests according to a three-year "rolling" cliff vesting schedule on December 31 of the third year. So, January 2021, contributions vest 100% on December 31, 2023; January 2022 contributions vest 100% on December 31, 2024, and so on. The employer makes a $19,500 contribution to the plan in January 2021. The annual limit for 2021 was $19,500.

The employer may think that since they limited the 2021 annual contribution to $19,500, the 2021 contribution limit wouldn't be exceeded, and they would not need to be concerned about this annual contribution. However, in this example, since vesting occurs in 2023, the full value (including market returns) that vests in 2023 is subject to the 2023 limit. If the contribution limit remained at $19,500, any positive investment return would exceed the limit and trigger a taxable refund. Additionally, no additional vested contributions could be made in 2023.

Example 2[1]

In this example, a plan participant deferred their compensation up to the contribution limit in 2021 and 2022, and in each of those years, the employer contributes an additional $10,000 that will cliff vest in 2023. During 2021 and 2022, contributions didn't exceed any limits because the participant deferrals were $19,500 and $20,500, respectively. However, in 2023, two years' worth of employer contributions ($20,000 plus attributable earnings) will vest. At best, this will severely limit the participant's ability to defer any compensation for 2023 and, at worst, result in unintended tax consequences.

Summary

Since participants are always 100% vested in their deferrals and may want to defer up to the annual contribution limit, company contributions subject to a future vesting schedule may limit the participant's ability to defer current income and create situations where refunds are required on positive investment returns. On the other hand, if employer contributions are immediately vested, then the participant knows the amount they may currently defer, and the employer will not need to track contributions as they vest in future years. Therefore, employers should consider the potential for unintended refunds or plan violations before using vesting schedules for employer contributions in non-governmental 457(b) plans.

[1]The dates in the example are for illustrative purposes only and do not relate to a specific tax year.

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