Code Section 457(f) Conundrum: How to Handle Past Year Mistakes (from Vesting)

A Practical Guidance® Article by Mark Poerio and Barry Salkin, The Wagner Law Group

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For those in the private sector, as well as those accustomed to Code Section 409A, it seems natural to allow "deferred compensation" to be vested before pay-out occurs. That is the essence of salary reduction contributions, which generally must be 100% vested when deferred. Perhaps that is why tax-exempt organizations seem to stumble at times by establishing non-qualified plans that do not defer compensation.

The culprit is Code Section 457(f), which only applies to governmental entities and tax-exempt organizations (together "Tax-exempt Employers"). They are thereby subject to a special rule — as well as Section 409A - which generally requires that 457(f) plan participants recognize ordinary income whenever their plan benefits are not subject to a substantial risk of forfeiture ("SROF"). It is commonplace as a result for Tax-exempt Employers to condition 457(f) benefits on continued employment until a fixed future date, or on an involuntary termination (or resignation for good reason). Essentially, forfeiture occurs upon a resignation without good reason or a termination for just cause. In a twist from 409A's SROF definition, a participant's risk of forfeiture from violation of a post-employment non-competition provision may establish a SROF that defers compensation for 457(f) purposes.

What happens when a Tax-exempt Employer discovers that non-qualified plan (or severance-related agreement) violates 457(f) by providing for the vesting of benefits before the year in which payments occur? The answer is somewhat easy when that discovery occurs within a few years after the 457(f) violation occurs. In those cases, the Tax-exempt Employer should issue an amended W-2 or 1099 to the plan participant, in order to report additional income reflecting amounts taxable in prior tax years. The IRS has endorsed that approach:

> "A participant's Form 1040 for open years should be adjusted by all amounts deferred under the plan, plus any earnings through to the date the substantial risk of forfeiture lapses."

Within its same webpage, the IRS addressed a thorny issue: suppose the statute of limitations has expired for filing an amended tax return on which to report 457(f) benefits that had previously vested. The IRS advice would seem straightforward:

> "If the statute of limitations has expired, no tax adjustment can be made and no basis would be earned. Any remaining amounts would be taxable when made available or distributed."

If the foregoing is applied to a simple fact pattern, a conundrum appears. Assume the following facts for a 457(f) plan that mistakenly omits any SROF from benefit accruals that were immediately vested:

Year	Employer Deferral	Earnings (at 5%)	Closing Balance	Open Tax Year for Amended W-2 or 1099 (3 year Statute of Limitations)
2018	10,000	500	10,500	No
2019	10,000	1,025	21,025	No
2020	10,000	1551	32,576	Yes
2021	10,000	2129	44,705	Yes
2022	10,000	2735	57,440	Yes
2023	0	2,763	60,312	Not yet due

At the end of 2020, which is the first open tax year, it would seem reasonable for the Tax-exempt Employer to issue an amended W-2 (or 1099) for $32,576, representing the entire balance in the participant's account, because the participant was vested in that entire amount. If that were the approach, then the amended W-2s for succeeding years would merely report income equal to the increased value in the participant's account. For example, the amended return for 2021 would report $12,129 as additional income (reflecting the excess of $44,705 over the previously reported income of $32,576).

Reverting to the IRS directive quoted above, it is unclear if the amended return for 2020 should equal the year-end balance of $32,576, or should be reduced by the $21.025 for year-end 2019 because that amount was not "made available or distributed" in 2020. Therein lies the difficult interpretive choice for Tax-exempt Employers. Should the $21.025 of 457(f) benefits for closed tax years be treated as being "made available or distributed" in the first open tax year, or when actually distributed or made available, in a future tax year, which could be several years in the future. This result is a curious one, because it allows a taxpayer to defer income by not reporting income correctly in closed tax years.

The answer may lie in focusing on when payments were due under the 457(f) plan. If the participant's termination of employment in 2022 triggered a lump sum payment right, then it seems the $21.025 from closed tax years would have been first reportable as income in 2022 because the termination of employment would have triggered constructive receipt under "made available" principles. If the income is reported for a later year when paid, then the 457(f) plan would have violated 409A by deferring income recognition until a year after payment was due.

There are other tricky permutations to the fact pattern described above. At this juncture, it suffices to close with three points. First, Tax-exempt Employers should carefully study their fact patterns, applicable 457(f) plan terms, and applicable 409A and 457(f) rules whenever they discover mistakes in how they handled the income tax reporting for 457(f) benefits that vested - and should have been taxed - in past tax years. Second, there may be more than one reasonable tax position that draws from the IRS advice quoted above. Third, and finally, it is likely important as a practical matter to bring thorny issues to the attention of affected 457(f) plan participants and their tax advisors (who are normally their personal accountants). By bearing the foregoing in mind, Tax-exempt Employers should be better positioned to correct 457(f) problems in a thoughtful manner that does not backfire when communicated to affected plan participants.

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For over 35 years, Mark has been in private practice with a focus on executive compensation, employee benefits (especially ESOPs), and retirement plan fiduciary matters, not only from a tax and labor perspective, but also from a business, governance, tax, securities, and litigation perspective. He is not only a long-term fellow in the prestigious American College of Employee Benefits Counsel, but served for years as its Treasurer, Vice-President, and then President. Mark is Chambers-rated, and has worked regularly with the American Benefits Council (where he was an executive board member for many years).

Mark's clients include public and private companies, as well as individual executives and management teams; he also has significant experience with not-for-profit organizations from both a governance and a executive compensation perspective. His business oriented pay-for-performance approach has led to his role as special counsel to compensation committees, as well as to his spearheading of projects designed to link executive compensation to corporate goals and to the enforcement of post-employment covenants relating to trade secrets and restrictive covenants (such as non-competition agreements).

Mark taught for over a decade at Georgetown Law School. His courses focused on executive compensation and governance, the design of benefit plans and employment-related agreements, and employee stock ownership plans (ESOPs). Associated with those courses is his substantively rich website found at www.executiveloyalty.org.

Prior to joining The Wagner Law Group, Mark served for almost 20 years as co-chair of the employee benefits (ERISA) practice and was a partner at a prominent international Wall Street law firm of 1,000 attorneys.

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His clients include multi-national corporations, closely-held companies, high-net-worth individuals, financial institutions, governmental agencies, investment groups, and tax-exempt organizations such as hospitals and physicians' organizations.

Barry also advises clients on all aspects of retirement plan tax-qualification requirements and the application of labor and securities laws and regulations to sponsors of employee benefit plans and executive compensation programs. Moreover, he has extensive experience in establishing, merging and terminating benefit plans and compensation agreements, and counsels clients on fiduciary responsibilities and prohibited transactions.

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