

# Internal Revenue Service Government Retirement Plans Toolkit

Available at: <http://www.irs.gov/Government-Entities/Federal,-State-&-Local-Governments/FSLG-Toolkit#3>

## Government Retirement Plans Toolkit

Retirement plans established for the benefit of governmental employees generally function in ways similar to those covering private employers. However, in many cases, different sections of the Internal Revenue Code determine the tax treatment of these plans. Depending on the statutory basis for the plan and how it operates, employer and employee contributions may be subject to Federal income tax at the time of contribution, or tax-deferred until distributed; and they may be taxable or excluded from social security and Medicare taxes (FICA).

### Public Retirement Systems (FICA Replacement Plans)

Effective July 2, 1991, Congress made social security coverage mandatory for state and local government employees who are neither covered by a Section 218 Agreement nor qualifying participants in a public retirement system. Under this provision, states can provide these mandatorily covered employees with membership in a public retirement system as an alternative to mandatory social security coverage. Employees may also be covered by both a public retirement system and social security under a section 218 Agreement.

A governmental retirement plan must meet certain minimum benefit or contribution standards to qualify as a public retirement system, and thereby serve as a “replacement” plan exempting the participants from mandatory social security coverage. These standards are based solely on meeting a minimum benefit level provided (defined benefit plan), or a minimum amount contributed (defined contribution plan) to the participant. Whether a plan meets the standard to exempt employees from mandatory FICA has no bearing on the rules discussed below, and a public retirement system is not necessarily a “qualified plan” within the meaning of Employee Retirement Income Security Act (ERISA). For a detailed discussion of the requirements for public retirement systems, see Chapter 6 of [Publication 963](#), Federal-State Reference Guide.

### Types of Public Employer Plans

The following types of retirement plans are discussed here (sections refer to the Internal Revenue Code)

- Section 401(a) - Qualified Plan
- Section 403(b) – Annuity for public schools and 501(c)(3) organizations
- Section 457(b) – Nonqualified, eligible deferred compensation plans for state and local governments and tax-exempt organizations
- Section 457(f) – Nonqualified, ineligible deferred compensation plans

Note: After May 6, 1986, state and local governments are not eligible to adopt Section 401(k) plans except for rural cooperatives, Indian tribal entities. Under grandfather provisions, plans established prior to that date may continue to operate and add new participants.

Almost all governmental plans are covered under one of these sections. They are discussed individually below.

### Key Terms and Concepts

The following are some important terms that are used in discussing the features of public employer plans.

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**Constructive Receipt:** Under the provisions of sections 451 and 457 of the Internal Revenue Code, generally all amounts employees receive are taxable when received or made available to the employee. However, numerous code sections provide exceptions to either defer or exempt amounts from current employee income. They are discussed below as they apply to governmental plans.

**Employer Contributions:** Amounts credited to individual employee retirement accounts paid in addition to salary; the employee does not have the option to receive these amounts in cash. These amounts are always tax deferred, because the employee does not have constructive receipt. Except for section 457(b) deferrals and section 457(f) contributions, employer contributions are exempt from FICA.

**Tax-Deferred:** Refers to amounts set aside or credited to the employee retirement account are not included in gross income at the time of the transaction. They are included in income when they are distributed to or constructively received by the employee. Generally, they are subject to withholding requirements at that time also.

**Salary Reduction Agreement:** An arrangement that provides for amounts recognized as a cash or deferred election because the employee either (a) elects to reduce cash compensation, or (b) elects to forego an increase in cash compensation.

**Mandatory Employee Contributions:** Amounts deducted from employee salary and credited to a retirement account.

**Employer “Pick-Up” Contributions:** Section 414(h)(2) allows state or local government entities with section 401(a) plans to treat certain contributions designated as employee contributions, but which are “picked up” (paid) by the employer, to be treated as employer contributions, and therefore as exempt from income tax. This does not include contributions made under a salary reduction agreement. For purposes of FICA, the term “salary reduction” relates to amounts treated as an employer contribution under Code §414(h)(2) that would have been included in wages for FICA tax purposes, but for the employer contribution.

For more information on the requirements to treat contributions as employer pick-ups, see the article in the [January 2007 FSLG Newsletter](#). For more information on pick-up contributions and FICA, see the article in the [July 2007 FSLG Newsletter](#).

### Section 401(a) Qualified Plans

Generally, any public employer may set up a 401(a) plan. Under this plan:

Employer contributions not made pursuant to a salary reduction agreement, but including employer “pick-up” contributions, are deferred from income tax until distribution, and exempt social security and Medicare tax.

Employer contributions made under a salary reduction agreement are deferred from income tax, but are subject to FICA tax.

Employee contributions pursuant to a salary reduction agreement are subject to income tax and FICA.

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### Section 403(b) Plans

Plans under IRC section 403(b), also called tax-sheltered annuities, are available to certain employees of public schools, employees of certain tax-exempt organizations, and certain ministers. To maintain a section 403(b) plan, a governmental employer must be a public school of a state, political subdivision of a state, or an agency or instrumentality of one or more of these. Many public school employees are covered by 403(b) plans in addition to social security coverage under section 218.

403(b) plans resemble “qualified” (i.e., 401(k)) plans in many respects. Eligible participants may defer amounts from income tax up to an annual limit (\$16,500 in 2009). This amount may be increased for certain employees with more than 15 years service. In addition, additional tax-deferred “catch-up” contributions may be made to employees age 50 or older.

Employer contributions (within dollar limitations) are tax-deferred and exempt from FICA.

**Employee elective contributions** to 403(b) plans that are considered employer contributions pursuant to a salary reduction agreement are deferred from income tax, but taxable for FICA.

For more information on catch-up contributions to 403(b) plans, see [Publication 571](#).

### Section 457(b) Plans

Section 457 addresses nonqualified plans. Many public employees participate in nonqualified, or section 457, plans. These plans can be established by state and local governments or tax-exempt organizations. If they meet the requirements of IRC section 457(b), they are considered “eligible” plans; if not they are considered “ineligible” and are governed by IRC section 457(f).

Governmental 457(b) plans must be funded, with assets held in trust for the benefit of employees. Plan assets and income of all other eligible plans must remain the property of the employer.

Plans eligible under 457(b) may defer amounts from income tax up to an annual limit (\$16,500 in 2009). In addition, “catch-up” contributions may be made to employees age 50 or older. Social security and Medicare taxes generally apply to all employer and employee contributions. For further information regarding social security and Medicare tax withholding and reporting on amounts deferred into eligible deferred compensation plans, see [Notice 2003-20](#) and the [IRS.gov Employee Plans site](#).

**Employer contributions** to 457(b) plans are tax deferred up to annual limits. They are subject to FICA when no longer subject to substantial risk of forfeiture.

**Substantial risk of forfeiture.** The rights of a person to compensation are subject to substantial risk of forfeiture if such person's rights to such compensation are conditioned upon the future performance of substantial services by any individual.

Section 1.83-3(c)(1) of the regulations provides that whether a risk of forfeiture is substantial or not depends upon the facts and circumstances

“A substantial risk of forfeiture exists where rights in property that are transferred are conditioned, directly or indirectly, upon the future performance (or refraining from performance) of substantial services by any person, or the occurrence of a condition related to a purpose of the transfer, and the possibility of forfeiture is substantial if such condition is not satisfied.”

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Section 1.83-3(c)(2) of the regulations point out that requirements that the property be returned to the employer if the employee is discharged for cause or for committing a crime will not be considered to result in a substantial risk of forfeiture.

**Employee elective contributions** are deferred from income tax. They are subject to FICA. However, see [IRS Notice 2003-20](#), VI B, "Timing of social security and Medicare taxes."

### Section 457(f) Plans

Nonqualified state or local government plans that do not meet the tests of 457(b) are ineligible, or 457(f), plans. There is no limit on the annual deferrals on these plans, but to defer taxation all amounts must be subject to substantial risk of forfeiture (see above). Distributions are generally subject to social security and Medicare taxes at the later of the time 1) when the services giving rise to the related compensation are performed, or 2) when there is no substantial risk of forfeiture of the rights to the amounts.

**Employer contributions** to 457(f) plans are includible in income in the year they are no longer subject to any substantial risk of forfeiture. They are subject to income tax withholding in the year they are actually or constructively paid.

**Note:** IRC §457(f)(1)(A) requires that the contributions be included in the gross income of the participant in the first taxable year in which there is no substantial risk of forfeiture, whereas, IRC §3402(a)(1) requires withholding of federal income tax when the contributions are actually or constructively paid. Thus, while the contributions must be reported as income taxable wages on Form W-2 in the first year in which there is no substantial risk of forfeiture, there may be no income tax withholding requirement at that time. Contributions to funded plans (not meeting the requirements of §457(b)) are constructively paid in the "taxable year in which amounts attributable to employer contribution amounts first become nonforfeitable."

IRC 547(e)(11)(A)(i) provides exceptions to the above treatment may apply to plans involving bona fide vacation, sick leave, involuntary severance pay, disability or death benefits. For information on the treatment of severance pay plans, see [Notice 2007-62](#).

457(f) contributions are subject to FICA at the later of:

1. When the services are performed, or
2. When there is no substantial risk of forfeiture and when the amounts are reasonably ascertainable.

### Form W-2 Reporting

- Box 1: Income taxable contributions.
- Box 12: Elective salary reduction deferrals to §§401(k), 403(b), 408(k)(6), 408(p); elective deferrals and employer contributions (including nonelective deferrals) to §457(b) unless subject to substantial risk of forfeiture.
- Box 14: Employer may enter the following: (a) nonelective employer contributions made on behalf of an employee, (b) voluntary after-tax contributions that are deducted from an employee's pay, (c) required employee contributions, and (d) employer matching contributions.

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**Resources for Further Information**

[Publication 963](#), Federal-State Reference Guide  
[Publication 571](#), Tax-Sheltered Annuity Plans (403(b) Plans)  
[Instructions for Forms W-2 and W-3](#)

See also the following IRS web pages:

[IRC 403\(b\) Deferred Compensation Plans](#)  
[IRC 457\(b\) Deferred Compensation Plans](#)