Why Is There No IRS Correction Program for Non-Governmental 457(b) Plans?

by William D. Jewett on May 1, 2024

This post examines excess deferrals under non-governmental 457(b) plans, including the approved method for correcting them and the penalty for failing to correct them, to make the case for a change in IRS policy on correcting administrative errors in such plans.

Non-governmental 457(b) plans are sometimes called "eligible deferred compensation plans" of tax-exempt employers because, if the requirements of section 457(b) of the Internal Revenue Code are met, such plans are "eligible" to provide fully vested compensation to management or highly compensated employees on a tax-deferred basis, up to specified annual limits. There is no IRS-approved correction program for non-governmental 457(b) plans. The regulations under Code section 457(b) provide a correction for only one type of error—namely, deferrals that exceed the annual dollar limit—and severe consequences are imposed for failure to correct excess deferrals on a timely basis.

As background, a variety of IRS-approved correction methods are available under the Employee Plans Compliance Resolution System (EPCRS) for mistakes that occur in operating qualified retirement plans, 403(b) plans, and governmental 457(b) plans. These methods include opportunities for self-correction, which have been dramatically expanded by Section 305 of the SECURE 2.0 Act. However, the EPCRS Revenue Procedure states expressly that EPCRS is "generally" unavailable to non-governmental 457(b) plans.[1]

If your non-governmental 457(b) plan has accepted deferrals exceeding the IRS-prescribed annual dollar limit (or the limit on catch-up deferrals, if applicable), the good news is that the regulations outline an approved correction method. The method is similar to the method that applies to 401(k) plans, as we have described in a previous post, with a few differences not relevant here. Generally, the excess deferral must be distributed, with all earnings attributable to the deferral, by April 15 of the year after the year the deferral was made. The excess deferral amount is income for the year it was earned, and the earnings are income for the year they are distributed.

The bad news is that if an excess deferral under a non-governmental 457(b) plan is not distributed by April 15 of the following year, with earnings, there is no further opportunity for correction. If an excess deferral *under a 401(k) plan* is distributed after the April 15 deadline, it is

[1] Rev. Proc. 2021-30 does state that "the IRS may consider a submission for such a plan where, for example, the plan was erroneously established to benefit the entity's non-highly compensated employees and the plan has been operated in a manner that is similar to a Qualified Plan." This would appear to be a very unlikely scenario, and it is not clear what other plan failures, if any, might be considered in a submission to the IRS.

taxed twice, once in the year of deferral and again in the year of distribution. That is undoubtedly an unfavorable tax consequence for the participant, but the plan retains its tax-qualified status. In contrast, if an excess deferral *under a non-governmental 457(b) plan* is not distributed by the April 15 deadline, then, according to the regulations, the plan becomes an "ineligible" plan, meaning that all vested interests in the plan—including the interests of participants not involved in the error—are taxable on April 16.

More generally, the regulations for non-governmental 457(b) plans say that an "eligible" plan becomes an "ineligible" plan—and thus, all vested interests become taxable—on the first day that the plan fails to satisfy one or more of the requirements of the regulations. It is tempting to describe this cynically as the "technical" answer to the question of what happens if a plan has a compliance failure for which there is no approved correction. But that is the law. A tax-exempt employer with an operational error that causes its 457(b) plan to fail to satisfy the requirements of the regulations must treat all vested accounts under the plan as immediately taxable.

As an aside, there is a quirk in the regulations that permits certain excess deferrals to remain uncorrected, raising questions of fairness regarding the otherwise applicable plan-wide penalty. If a participant exceeds the annual deferral limit applicable to the participant by contributing no more than the plan limit to multiple 457(b) plans of more than one non-governmental employer, the regulations say that the plans may give effect to provisions calling for the excess deferrals to be distributed, but they do not have to. If such amounts are not distributed, the plans are not penalized. The only penalty is that the participant must include the excess amount in income for the deferral year. Moreover, there is no rule saying that earnings on the excess amount are taxable. In the absence of guidance on the question, it appears that earnings can continue to accumulate on a tax-deferred basis. Thus, a participant in two unrelated non-governmental employers' 457(b) plans could defer the maximum to each plan in the same year, include one plan's deferrals in income for that year, and leave all deferrals in both plans to grow on a tax-deferred basis. In other words, under the regulations, the severe plan-wide penalty for excess deferrals in a single employer plan is, surprisingly, paired with a penalty for excess deferrals in unrelated employer plans that is so lax that it actually facilitates tax-deferred investment exceeding the annual legal limit.

Given the harshness of the plan-wide penalty for uncorrected excess deferrals arising under a single plan, is there any way for an employer to ensure that its plan is not ruined by an inadvertent excess deferral that is not timely corrected? EPCRS and the regulations do not offer any help. However, it is worth considering the outcome if one of the following strategies were implemented.

- Suppose a non-governmental employer sets up not one 457(b) plan for all eligible employees but a separate 457(b) plan for each eligible employee. In such an arrangement, an uncorrected excess deferral in one plan would not appear to result in an excess deferral in the other plans. To be sure, there is a provision in the regulations saying that if an employer uses multiple plans to avoid or evade the requirements of the regulations, the rules may be applied as if the plans were a single plan. However, the aim here is not to avoid or evade the annual deferral limit but to prevent the penalty from falling on all participants if one participant

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has an uncorrected excess deferral. This multiple-plan structure, whether the IRS respects it or not, would succeed in shifting the burden of imposing the plan-wide penalty because it would be up to the IRS, not the employer, to determine that an uncorrected excess deferral causes all benefits under all the plans to be taxable.

- Now suppose the employer memorializes this multiple-plan arrangement in a single document with a provision that each participant will be treated as the sole participant in a separate plan for tax purposes. If the IRS respected this provision, an uncorrected excess deferral would not result in a plan-wide penalty affecting all participants. Even if it were not respected, its existence would not cause the plan to fail to satisfy the requirements of the regulations.

These strategies are offered not as recommended plan designs but as thought exercises to help show why the existing rules are problematic. If an awkward but permissible plan structure or drafting approach might avoid the plan-wide penalty, shouldn't the penalty be reconsidered?

Indeed, it seems fair to ask why the IRS should not reconsider more generally the inapplicability of the IRS-approved correction program to non-governmental 457(b) plans, especially given that it has posted a web page describing certain "common errors" in such plans. If certain errors in such plans are "common," would it not enhance compliance to have IRS-approved correction methods available, as presumably it enhances compliance in plans for which such methods are available? It is hard to see what distinguishes non-governmental 457(b) plans from other plans for which EPCRS is not only readily available but also, in light of SECURE 2.0, expected to expand dramatically in the near future. If there is a crucial distinction, it would be helpful to hear from the IRS what it is.

The lack of correction opportunities for non-governmental 457(b) plans is baffling. If one didn't know better, it would seem to imply that the IRS prefers to leave employers to their own self-help remedies or that the IRS relishes the prospect of asserting on audit that all benefits under a non-governmental 457(b) plan are immediately taxable. But these conjectures must be off base. Surely the IRS would prefer that plan sponsors use approved corrections rather than improvised self-help. And just as surely, the IRS cannot wish to be in the position of having no penalty to impose other than the immediate taxability of all plan benefits. Given that the IRS must make substantial changes to EPCRS to reflect the expansion of self-correction opportunities and other provisions of SECURE 2.0, perhaps there is reason to think that the IRS may reconsider the inapplicability of EPCRS to non-governmental 457(b) plans.

If you maintain a non-governmental 457(b) plan and need assistance in thinking through what to do about issues that may arise or have arisen in the administration of the plan, please contact a member of Verrill's Employee Benefits & Executive Compensation Group.

William D. Jewett
Partner
T (617) 292 2856
email