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Private Foundations Bulletin

Deferred Compensation Plans – 457(b) and 457(f)

The Internal Revenue Service (IRS) issued proposed regulations intended to provide guidance with respect to the application of Internal Revenue Code (IRC) Section 457 to nonqualified deferred compensation arrangements. The proposed regulations and explanations issued by the IRS represent the first issuance of substantial guidance since final 457 regulations were issued in 2003.

Specific matters addressed in the regulations include: rules for determining when amounts deferred under these plans are included in income; the amounts that are includable in income; and the types of plans sponsored by State or local governments or tax-exempt organizations that provide for a deferral of compensation.

The proposed regulations would affect participants, beneficiaries, sponsors, and administrators of certain plans sponsored by State or local governments or tax-exempt organizations that provide for a deferral of compensation.

Although the proposed regulations are not effective until they become finalized, the IRS has indicated that they can be relied on immediately.

Background

Section 457 of the IRC provides that a deferred compensation arrangement can either be an "eligible plan" under 457(b) which is subject to annual limits on deferrals (e.g., $18,000 for 2017), ***or*** an "ineligible plan" under Section 457(f).

A 457(b) plan, which can defer compensation until after termination of employment without taxation upon vesting, is the primary plan used by many not-for-profit employers who want to provide additional deferred compensation in excess of the dollar limits under 403(b), 401(k) and other qualified retirement plans for a select group of management and highly compensated employees. Another common name used for an "eligible plan" maintained by a tax-exempt organization is a "top hat" plan. There are other specific and unique characteristics of an "eligible plan" that pertain to the contribution catch-up rules, distributions from the plan, and annual reporting requirements.

Section 457(f) governs other deferrals of compensation of employees by not-for-profit employers and governmental entities. Section 457(f) arrangements can be provided through formal plans or in employment agreements that have no dollar limitation, but are subject to taxation upon vesting. These types of plans differ from for-profit employers where the taxation occurs upon distribution.

Plans Not Subject to New Regulations

The proposed rules clarify that the following plans are not treated as providing for the deferral of compensation and, therefore, are not subject to Section 457:

- Bona fide severance pay plans (which include involuntary severance from employment, severance from employment for good reason, window programs and voluntary early retirement incentive plans);
- Bona fide death benefit plans;
- Bona fide disability pay plans; and
- Bona fide sick leave and vacation leave plans.

Ineligible Plans under Section 457(f): Timing of Inclusion of Income

Deferred compensation under an ineligible plan is includable in the gross income of the participant/beneficiary on the later of the:

- date the participant/beneficiary obtains a legal binding right to the compensation, ***or***
- date the substantial risk of forfeiture (SROF) lapses.

For an account balance type of deferred compensation arrangement, the amount to include in income is, generally, the account balance with earnings on the date the SROF lapses.

For non-account balance plans, the proposed regulations provide that the present value of the deferred compensation is calculated as the value as of the date of the lapse of the substantial risk of forfeiture.

Any actuarial assumptions used in this calculation must be reasonable. The amounts are includable in income regardless of whether or not the compensation is paid.

Distributions from either a 457(b) plan maintained by a tax-exempt employer or from a 457(f) plan are not permitted to be rolled over into another type of retirement plan. A limited exception applies for a 457(b) plan that is maintained by a governmental employer, and a transfer by a participant in a non-governmental plan may only be made following severance from service.

Other Key Provisions in the Regulation

- Rolling risk of forfeiture

  A common practice for a 457(f) plan recipient was to extend the date when a risk of forfeiture would lapse in order to delay the taxation of deferred compensation.

  The IRS has made it clear that rolling risks of forfeiture can continue to be permitted, as long as all the conditions (summarized below) are satisfied.

    - The substantial future performance of services, or compliance with a non-compete agreement, must generally be for a minimum period of 2 years;
    - The present value of the compensation to be paid upon satisfaction of the extended vesting condition must be more than 125% of the present value of the amount the employee would have received if the extension had not occurred;
    - The extension must be made pursuant to a written notice/agreement that is executed at least 90 days prior to the date on which the existing forfeiture would have lapsed.

- Employee elective deferrals rules

  Have been clarified and are permitted in a 457(f) plan. However, conditions previously provided for the “rolling risk of forfeiture” provision will also be applicable for salary or bonus deferrals.

  This includes that an agreement between the employee and employer must be entered into before the beginning of the calendar year in which the services are to be performed.

For new employees, an exception allows that a salary reduction agreement must be entered into within 30 days after the commencement of employment.

Overview

While the new regulations do provide needed guidance, the rules and regulations covering deferred compensation plans remain complex. Care must be taken to ensure that all the governmental directives are being followed so as to avoid any negative tax or legal consequences now or in the future.

Contact Us

We welcome the opportunity to speak with you about any questions you may have regarding this newsletter. Please contact us:

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