Overview

Section 457 of the Tax Code provides the rules that govern all NQDC plans sponsored by "eligible employers." The term "eligible employer" is defined to include states, their instrumentalities (e.g. schools, police departments, etc.) and tax-exempt organizations, but does not include "the federal government or any agency or instrumentality thereof." A plan sponsored by a state or local government entity does not have to meet a specific ERISA exemption.

A NQDC plan is basically an agreement between an employer and an executive or professional to pay income in the future. The future event might be death, disability, or simply the arrival of a specified date.

In most NQDC arrangements, benefits are generally not taxable to the employee until received, and the employer would receive an income tax deduction at that time. However, because §457 plans involve tax-exempt organizations, additional requirements apply.

Amounts deferred under a §457 plan maintained by a state or local government must be held in a trust, custodial account, or an annuity contract for the exclusive benefit of plan participants and their beneficiaries. For a tax-exempt non-government entity, the deferred amounts and their earnings remain the property of the employer, subject to the employer's general creditors, until paid to the plan participants.

Details & Operations

Generally, there are two types of plans available: Eligible and ineligible plans.

Eligible Plans

Eligible plans are generally not flexible enough to accommodate selective compensation arrangements for key executives. Contributions are limited to the lessor of (1) 100% percent of gross compensation or (2) the applicable dollar limit ($18,500 for 2018, adjusted annually for inflation). For non-governmental eligible plans, participants may also be allowed to make "catch up" contributions for one or more of the last three years before reaching normal retirement age if allowed by the plan. Additionally, eligible plans are subject to the minimum distribution rules like those of qualified plans. Eligible plans allow distributions no earlier than the

employee's age 70½, severance from employment, or an unforeseen emergency. (IRC §457(d)(1)). The provisions of IRC §409A do not apply to eligible §457(b) plans. The rules, definitions and requirements regarding eligible plans are contained in §457(b)–(e).

Ineligible Plans

"Ineligible plans" or "§457(f)" plans can be tax-deferred and exceed the employee deferral limits of §457(b) and other defined contribution plans, providing the non-profit with the opportunity to retain valuable key employees by allowing for a more substantial benefit. However, to avoid current taxation to the key employee, the promised benefit must be subject to a "*substantial risk of forfeiture*." Substantial risk of forfeiture is defined as a right to compensation "conditioned upon the future performance of substantial services." §457(f)(3)(B). The IRS requires that the risk of forfeiture be valid and substantial. The IRS has clarified this to mean that the money must be available to the organization's general creditors, or is not vested if the employee does not stay with the employer for the full vesting period.

When there is no longer a substantial risk of forfeiture, the deferred compensation and the earnings are *fully taxable* to the employee *whether the full amount is actually then paid*. Therefore, the plans must be carefully created so that the participant does not incur tax liability prior to the time benefits are actually received. A mechanism may be built into the plan that preserves the possibility that the executive might at some point lose his rights to those benefits. For example, a provision that the executive will not receive the deferred amount upon death or termination of employment prior to retirement is usually considered a substantial risk of forfeiture. However, if the risk of forfeiture is unlikely to occur, it would not be considered substantial. For instance, if the employee must relinquish benefits if he or she commits embezzlement would probably not be considered a substantial risk of forfeiture because it is unlikely to occur and is within the employee's control.

Section 457(f) plans are subject to the provisions of IRC §409A. If the plan does not meet the requirements of §409A, compensation deferred under the plan will be included in income and subject to a 20% penalty.

Funding

Non-qualified plans cannot be formally funded without potentially adverse consequences, such as the potential loss of income tax deferral for the employee and heightened ERISA requirements. There is no requirement that the employer actually fund a non-qualified arrangement; however, the non-profit may want to informally fund the plan to ensure funds are available to provide the eventual payments. The funds remain assets of the non-profit and are subject to the organization's creditors.

To informally fund the arrangement, the employer basically has three options:

(1) Pay obligations out of cash flow as necessary;

(2) Borrow to meet the obligations as they occur; or

(3) Pre-fund.

An employer can use a variety of vehicles for informally pre-funding non-qualified plans, such as mutual funds, annuities, and life insurance. For tax-exempt organizations, assets do not create taxable income to the employer; so although the tax-deferred growth of life insurance may not be as compelling as it typically is for the tax-paying employer, unlike other types of assets, life insurance provides a death benefit and income tax advantages for the employee.

If a §457 plan is funded by permanent life insurance, the non-profit generally maintains ownership of the policy until the executive's retirement date. At that point, the policy could be distributed in kind to the employee. The employee could then access the cash surrender value by taking tax-free loans or making withdrawals tax-free up to the cost basis.

ERISA Considerations

- Government §457 plans are not subject to ERISA.
- Non-government §457 plans may be exempt from ERISA requirements if they fall within the "top-hat exemption." In order to qualify for the top-hat exemption, the plan must be unfunded and established and maintained for a "select group of management or highly compensated employees." If the plan is exempt, there is no annual reporting to the Department of Labor or the IRS other than a one-time filing with the Department of Labor within 120 days of the formation of the plan. The "unfunded" requirement means that no separate fund can be set apart from the general assets of the employer. Plan participants have the status of general unsecured creditors of the employer.

Tax Implications

Until benefits are paid, NQDC plans grow tax-deferred. Deferrals, contributions and interest earnings are taxed at the employee's ordinary income tax rates upon payout, or in the case of an ineligible plan, once the employee is vested.

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