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# Nonqualified Deferred Compensation

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# Case 1 – "Messed Up University"

- In 2005, coach promised deferred payment
  - – $500,000
  - – Plus earnings
- Vesting
  - – Continued service to normal retirement age of 65 (2006)

# Case 1 – "Messed Up University"

- Payment
  - Lump sum within 30 days after retirement (retired in 2014)

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# Case 1 – "Messed Up University"

- Early 2014
  - In anticipation of coach's retirement, MUU inquires as to proper tax reporting
- MUU has never reported anything

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## Analysis of the tax treatment

- Types of nonqualified deferred compensation plans for tax-exempt and government entities
  - – § 457(b) plans
  - – § 457(f) plans
  - – § 415(m) plans (government only)
  - – Separation pay plans under § 457(e)(11)

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## § 457(b) and (f) plans

| Plan | Contribution Limit | Distribution Timing | Included in Income |
|---|---|---|---|
| 457(b) | • $17,500 in 2014<br>• Age 50 $5,500 catch-up (gov't entities) | • Severance from employment<br>• Unforeseeable emergency<br>• Attainment of age 70½ (OK even if still employed)<br>• Required minimum distributions at age 70½ (unless still employed) | • FICA – Upon vesting (except for gov't employees exempt from FICA)<br>• Income tax – When paid |
| 457(f) | • Unlimited | • No restrictions | • FICA and income tax – Upon vesting (except for gov't employees exempt from FICA) |

Section 457 provides the rules governing the deferral of compensation by an individual participating in a deferred compensation plan of an eligible employer. Section 457(e)(1) provides that an eligible employer includes a State, political subdivision of a State, and any agency or instrumentality of a State or political subdivision of a State, and any other organization (other than a governmental unit) exempt from tax under Subtitle A of the Code.

Section 457 and the regulations thereunder provide limited guidance on what is considered a deferred compensation plan. A deferred compensation plan "includes any agreement or arrangement between an eligible employer and a participant or participants (including individual employment agreements) under which the payment of compensation is deferred (whether by salary reduction or by nonelective employer contributions)."[1]

Section 457 provides rules for compensation deferred through two types of plans: an "eligible" plan under § 457(b) and an "ineligible" plan under § 457(f). The federal income tax consequences of compensation deferred under these plans are discussed below.

Eligible Deferred Compensation – § 457(b)

Section 457(a) provides tax favorable rules for compensation deferred under an "eligible" § 457(b) plan. Section 457(a) provides, in general, that in the case of a participant in a § 457(b) plan, any amount of compensation deferred under the plan and any income attributable to the amounts deferred is includible in the gross income of the employee only for the taxable year in which the compensation or other income is paid or otherwise made available to the participant.

Section 457(b) requires the deferred compensation plan to meet certain requirements in order to qualify as an eligible plan. These requirements are discussed in general below.

Only individuals who perform services for the employer may participate in the plan.[2] This includes employees and independent contractors of the organization.

There is a limit on the amount of compensation that may be deferred under the plan each taxable year. The maximum amount that may be deferred under the plan for a taxable year may not exceed the lesser of: (1) 100 percent of the participant's compensation, or (2) an applicable dollar amount.[3] This is referred to as the "plan ceiling." The applicable dollar amount is provided under § 457(e)(15) and is subject to a cost of living adjustment. For 2014, the applicable dollar amount is $17,500.[4]

The limitation on deferrals applies to both employee elective deferrals and employer deferrals to the plan. Thus, the aggregate amount of employer and employee elective deferrals for a year may not exceed the applicable dollar amount.

The amount deferred under the plan is taken into account for purposes of applying the plan ceiling in the taxable year of the deferral, or if later, the taxable year that it is no longer subject to a substantial risk of forfeiture (i.e., no longer subject to a vesting condition).[5] For example, assume an employer credits $10,000 to the employee's account in 2014, but the amount is subject to a substantial risk of forfeiture until 2015. The $10,000 counts towards the plan ceiling

[1] Reg. § 1.457-2(k).
[2] § 457(b)(1).
[3] § 457(b)(2).
[4] Notice 2013-73, 2013-49, I.R.B. 598.
[5] Reg. § 1.457-2(b)(1).