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New Rules for Nonqualified Deferred Compensation Plans for Governmental and Tax-Exempt Employers

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NEW RULES FOR NONQUALIFIED DEFERRED COMPENSATION PLANS FOR GOVERNMENTAL AND TAX-EXEMPT ENTITIES

On June 22, 2016, the Internal Revenue Service ("IRS") issued proposed regulations under Sections 457 and 409A of the Internal Revenue Code ("Code"). The proposed regulations under Code Section 457 ("Proposed 457 Regulations"), which apply specifically to nonqualified deferred compensation plans offered by state and local governments and tax-exempt organizations, amend 2003 final regulations under Section 457. The proposed regulations under Code Section 409A ("Proposed 409A Regulations"), which apply to nonqualified deferred compensation plans in general, make relatively minor changes to 2007 and 2008 final regulations under Section 409A.

Code Section 457 governs the tax treatment of nonqualified deferred compensation arrangements offered by state and local governments and tax-exempt organizations. It divides such plans into (i) "**eligible**" deferred compensation plans (also known as "**457(b) plans**") which satisfy the stringent requirements of Code Section 457(b), and (ii) "**ineligible**" deferred compensation plans (also known as "**457(f) plans**") which do not satisfy the requirements of Code Section 457(b). Although 457(b) plans are treated more favorably than 457(f) plans for tax purposes, they are subject to a variety of rules, including deferral limitations, which make them much less flexible than 457(f) plans.

While one of the goals of the proposed regulations was to align the rules under Code Section 457(f) more closely with those under Section 409A, it is important to note that the rules, as amended by the proposed regulations, do not conform perfectly. For example, certain key concepts, such as the meaning of "deferred compensation" and "substantial risk of forfeiture," differ under the two sets of rules. As a result, each set of rules must be read carefully to assure that the terms and operation of a plan do not create unwanted tax consequences under Code Section 457 or 409A.

The Proposed 457 Regulations state that the rules under Section 457(f) plans are separate from and in addition to the rules under Section 409A.[1] Code Section 409A specifies rules applicable to the nonqualified deferred compensation plans of virtually all employers,[2] including employers subject to Section 457. The rules under Section 409A: (i) specify the timing of initial deferral elections; (ii) limit the ability of an employer or employee to change the timing or form of deferred compensation payments once they have been established; (iii) limit the times at which deferred compensation can be paid; (iv) prohibit the acceleration of deferred compensation payments; and (v) prohibit certain types of funding arrangements and practices. If the rules under Code Section 409A are not satisfied, deferrals are subject to immediate taxation and penalties at the time the employee's interest in the deferred compensation is no longer subject to a substantial risk of forfeiture. Accordingly, amounts of deferred compensation can be included in taxable income under both Section 457(f) and Section 409A.

[1] Prop. Treas. Reg. § 1.457-12(d)(5).
[2] Unless otherwise noted, the terms "employer" and "employee" refer, respectively, to "service recipients" and "service providers," even if the services are provided as an independent contractor.

This article discusses the rules, as amended by the Proposed 457 Regulations and Proposed 409A Regulations, that apply to ineligible 457(f) plans sponsored by state and local governments and tax-exempt organizations.

WHAT IS AN ELIGIBLE EMPLOYER?

Code Section 457 applies to the nonqualified deferred compensation plans offered by eligible employers. An *eligible employer* includes the following:

- A State, a political subdivision of a state, and any agency or instrumentality of a State or political subdivision of a State.[3]
- An organization, other than a governmental unit, that is exempt from tax under Subtitle A of the Code. Most of these organizations are listed in Code Section 501(c).[4]

A church or a qualified church controlled organization ("QCCO") within the meaning of Code Section 3121(w)(3) is not an eligible employer, even though a church is a tax-exempt entity.[5] Churches and QCCOs are instead subject to the rules that apply to for-profit employers sponsoring deferred compensation plans. A tax-exempt entity controlled by or associated with a church under Code Section 414(e) is an eligible employer (and, therefore, is subject to Section 457), unless it qualifies as a church or a QCCO within the meaning of Code Section 3121(w)(3).[6]

WHO CAN PARTICIPATE IN A 457 PLAN?

Any individual who performs services for an eligible employer may participate in a 457 plan. This includes an independent contractor.[7]

Most tax-exempt employers must limit participant in their 457 plans to avoid adverse tax consequences while complying with the requirements of the Employee Retirement Income Security Act of 1974 ("ERISA").[8] With certain exceptions, ERISA requires that deferred compensation plans be funded. The funding of such plans, however, generally results in immediate taxation to vested participants, even if they may not have the right to receive payments until many years in the future. ERISA exempts from its general funding requirement deferred compensation plans that are established for a select group of management or highly compensated employees (a "top hat" group). As a result, most tax-exempt employers limit participation in their 457 plans to a select group of management or highly compensated employees. Tax-exempt employers that are controlled by or associated with a church are exempt from ERISA and, therefore, can establish a broad-based 457 plans without adverse tax consequences.

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[3] Code § 457(e)(1)(A); Treas. Reg. §§ 1.457-2(e), 1.457-2(l).
[4] Code § 457(e)(1)(B); Treas. Reg. §§ 1.457-2(e), 1.457-2(m).
[5] Code § 457(e)(13); Treas. Reg. § 1.457-2(e).
[6] Treas. Reg. § 1.457-2(e).
[7] Code §§ 457(b)(1), 457(e)(2); Treas. Reg. § 1.457-2(j).
[8] ERISA does not apply to governmental plans.