WRMarketplace
An AALU Washington Report

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The *WRMarketplace* is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

TOPIC: Deferred Compensation for Tax-Exempt Organizations (Part II) – Non-Qualified Arrangements.

MARKET TREND: Higher tax rates have increased interest in deferring compensation, including among tax-exempt employers and their employees. Compared to taxable companies, however, employees of tax-exempt employers face some additional limitations in implementing tax-effective deferred compensation arrangements.

SYNOPSIS: Internal Revenue Code ("Code") §457 imposes special rules for nonqualified arrangements maintained by tax-exempt employers. As a result, the employee of a tax-exempt employer may be able to defer less compensation than an employee of a taxable employer for the same period or may be taxed on previously deferred amounts at a time earlier than that applicable under a taxable employer's plan. For example, "eligible" deferred compensation plans under Code §457(b) are subject to limits on the amount that may be deferred during any year. "Ineligible" plans under Code §457(f) do not impose such a limit, but require taxation on the deferred amounts when the participant's rights to those amounts cease to be subject to a substantial risk of forfeiture.

TAKE AWAYS: Advisers to tax-exempt organizations must understand the additional limitations on nonqualified deferred compensation arrangements maintained by tax-exempt employers to ensure proper tax-deferral. To further preserve the tax deferral for amounts scheduled to be paid out in later years, plan sponsors may consider acquiring and distributing insurance contracts to the participant. This type of insurance arrangement may be less burdensome to the employer than maintaining a stream of annuity payments out of its general assets over the life of the participant (or other payment term promised under the plan).

***MAJOR REFERENCES:** Code §457.*

PRIOR REPORTS: 2013-41; 2013-45; 2013-38.

Unlike for taxable employers, nonqualified deferred compensation plans maintained by tax-exempt employers face additional requirements under Code §457, which can make their deferred compensation planning significantly more complicated.

OVERVIEW: PLANS OF TAXABLE vs. NONTAXABLE EMPLOYERS

Nonqualified deferred compensation arrangements maintained by both taxable and tax-exempt employers must comply with a broad range of rules under the Code.[1] Tax-exempt employer plans also must also comply with Code §457, which distinguishes between two types of nonqualified deferred compensation plans:

(1) "Eligible" deferred compensation plans under Code §457(b),[2] which are subject to limitations on the amounts that can be deferred by or on behalf of a participant during any year as well as rules governing the timing of plan distributions; and

(2) "Ineligible" plans under Code §457(f), which allow deferral of unlimited amounts but only defer taxation until such time as a participant's rights to the deferred amounts cease to be subject to a "substantial risk of forfeiture."

The following chart summarizes and highlights differences in the various requirements of nonqualified plans maintained by taxable and tax-exempt employers.

PRINCIPAL REQUIREMENTS OF VARIOUS NON-QUALIFIED PLANS			
	Taxable Employer Plans	**Code §457(b) "Eligible" Plans**	**Code §457(f) "Ineligible" Plans**
Limits on Amounts Deferred	Only as provided under terms of plan.	***$17,500 (2014) (inflation indexed). Additional "catch-up" contributions can be made based on amounts eligible, but unused, for deferral in prior years, up to two times the otherwise applicable deferral limit***	Only as provided under terms of plan.
Limits on Timing of Distributions	Restricted by Code §409A: • Separation from service • Death • Disability • Change in control • Unforeseeable financial emergency • Specified time/schedule	• No distribution before age 70½ if participant not separated from service or does not have unforeseeable financial emergency • Must satisfy minimum distribution requirements once participant attains age 70½ or dies	Restricted by Code §409A: • Separation from service • Death • Disability • Change in control • Unforeseeable financial emergency • Specified time/schedule
Timing of Taxation on Deferred Amount	Assuming no Code §409A violation, upon actual or constructive receipt by participant or beneficiary (*i.e.*, when paid or made available)	Upon actual or constructive receipt by participant or beneficiary (*i.e.*, when paid or made available)	***Assuming no Code §409A violation, when participant's rights to deferred amounts no longer subject to a substantial risk of forfeiture (i.e., generally accelerated to when vesting occurs)***

PRACTICAL PLANNING CONSIDERATIONS

Generally

"Ineligible" plans typically are used when an employer wants to provide executives with additional compensation in the form of nonelective deferred compensation. A common form of "ineligible" plan is the supplemental defined benefit retirement plan, pursuant to which an employer provides an annuity or similar form or periodic payment to a participant following the participant's retirement or attainment of retirement age. Because the taxation of the deferred amount relates to when the participant becomes vested in his or her deferred compensation benefit, the payment date is typically tied to a vesting date based on the attainment of a specified age (rather than the date on which the participant terminates employment).

"Eligible" plans generally are used for arrangements that allow the participant to electively defer compensation, because, with "ineligible" plans, the amount must remain subject to a substantial risk of forfeiture to remain tax-deferred. Most participants in an elective plan would prefer the freedom to cease employment without forfeiting deferrals of their own money.

Defined Benefit Arrangements

Structure. If using a defined benefit-type arrangement, employers must take care to properly define the payout so as to match the amount distributable to the participant with the amount that is includible in the participant's taxable income. For example, if a plan merely provides for an annual payment of $X starting at the participant's attainment of age 65, assuming the participant remained actively employed until that time, the amount taxable upon the participant's attainment of age 65 would be the present value of the annuity payable to him or her, which would likely be more than $X. Amounts distributed in subsequent years would not be subject to taxation. As a result, the participant would likely have an income tax inclusion greater than the amount distributable to him or her in the first year. Thus, it might be preferable to structure the payout to provide for a payment in the first year equal to the expected taxable amount, with a reduced payment in each of the subsequent years.

To take advantage of this structure, the employer must factor in the impact of Code §409A, which requires specification of the timing of payments of deferred compensation at the outset of the deferred compensation program. Payment times cannot subsequently be accelerated. Thus, the employer must accurately determine the expected taxable amount at creation of the deferred compensation arrangement.

Using Life Insurance. As a practical matter, an employer establishing this type of ***"ineligible" 457 plan may wish to consider purchasing an insurance or annuity contract at the time of distribution*** that: (1) has a cash value at the time of payment approximately equal to the amount includible in income; and (2) provides for annual payment approximately equal to those due to the participant in subsequent years under the terms of the plan. ***This arrangement may be less burdensome to the employer than maintaining a stream of annuity payments out of its general assets over the life of the participant (or other payment term promised under the plan).*** Again, the provision for the distribution of an insurance or annuity contract in full satisfaction of the plan's benefit-payment obligation would need to be specified in the plan at its inception, because the distribution of a such a contract could be seen as an acceleration of the payment obligation in the form of an annuity that could constitute a violation of Code §409A.

TAKE AWAYS

- Advisers to tax-exempt organizations must understand the additional limitations on nonqualified deferred compensation arrangements maintained by tax-exempt employers to ensure proper tax-deferral.

- To further preserve the tax deferral for amounts scheduled to be paid out in later years, plan sponsors may consider acquiring and distributing insurance contracts to the participant.

- This type of insurance arrangement may be less burdensome to the employer than maintaining a stream of annuity payments out of its general assets over the life of the participant (or other payment term promised under the plan).

NOTES

[1] For example, all such arrangements are subject to: (1) the tax principles of constructive receipt and economic benefit (see *WR Marketplace No.* 2013-41); and (2) the requirements for exemption from many of the substantive requirements of ERISA by virtue of meeting the requirements for being considered a "top-hat plan" that is maintained primarily for the purpose of providing deferred compensation to a select group of management or highly compensated employees (see *WR Marketplace No.* 2013-38). In addition, arrangements other than eligible 457(b) plans are subject to the restrictions imposed by Code § 409A (see *WR Marketplace No.* 2013-45).

[2] This *WR Marketplace* discusses only Code §457(b) plans maintained by ***private*** tax-exempt employers, not those maintained by tax-exempt employers that are state or local governmental entities. Those public plans, which are subject to different rules and are treated in many ways like tax-qualified arrangements, are beyond the scope of this *WR Marketplace*.

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