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GUIDEPOST

Section 457 Plans for Non-Profit Organizations

Nonqualified Deferred Compensation Plans for Nonprofit Organizations – IRC Section 457 Plans

A nonqualified deferred compensation plan (NQDC) is an agreement between an employer and a key employee to pay income in the future. The future event might be death, disability, retirement, or simply the arrival of a specified date. Non-governmental plans limit eligibility to a select group of management or highly compensated employees ("top hat" plan) to avoid ERISA funding requirements. Rank and file employees are not permitted to participate in the plan.

An employer may consider implementing a nonqualified deferred compensation plan if the employer wishes to:

- Attract, retain, and reward key employees who are important to the company's success.
- Provide an incentive to key employees to remain with the company and motivation to contribute to the company's success.
- Create "golden handcuffs" for key employees making it costly for them to leave or become a competitor of the company.
- Provide key employees with supplemental retirement benefits in addition to other retirement plans currently in place.

Internal Revenue Code (IRC) Section 457 provides the rules that govern NQDC plans sponsored by:

- A governmental unit (a state or political subdivision of a state, or an agency or instrumentality of one of these), or
- An entity exempt from income tax under IRC Section 501(c).

It does not apply to the federal government of any agency or instrumentality thereof.

Plan Types

There are two main types of plans allowed under IRC Section 457. The first is referred to as an Eligible Section 457(b) plan and the second is referred to as an Ineligible Section 457(f) plan. Both are described below.

Eligible Section 457(b) Plan

- Contributions limited to lessor of:
  1) 100% of gross compensation, or
  2) Applicable dollar limit ($22,500 for 2023, adjusted annually for inflation).
- Contribution limit includes both employer contributions and employee deferrals.
- Catch-up contributions allowed for participants who are within three years of retirement age if allowed by plan. Amount limited to unused deferrals from previous years.
- Subject to minimum distribution rules like those for qualified plans.
- Distributions allowed at severance from employment, retirement, disability, an unforeseen emergency (if plan document allows), or employee reaching age 72.
- Not eligible for rollovers but transfers to another non-governmental 457(b) plan may be possible.
- Distribution amounts are taxed when "made available" to the participant.
- IRC Section 409A does not apply.

Ineligible Section 457(f) Plan

- No contribution limits.
- Deferred compensation and its earnings are includable in gross income of the participant on the later of the date the participant obtains a legal binding right to the compensation, or the date the substantial risk of forfeiture lapses. Substantial risk of forfeiture is defined as a right to compensation "conditioned upon the future performance of substantial services."[1] The IRS requires that the risk of forfeiture be valid and substantial.
- Plans typically hold employer contributions only, no employee deferrals.
- When benefits vest, the full amount of the vested benefit is taxed as ordinary income even if the benefit is not paid until a later date.
- Benefit generally paid as a lump sum due to IRC Section 457(f) taxation.
- Plan is subject to IRC Section 409A

2016 Proposed Regulations

Key Provisions

Not yet finalized, the 2016 proposed regulations for IRC Section 457(f) plans include provisions for:

- **Rolling risk of forfeiture** – Allows for extension of risk of forfeiture (vesting) if the following conditions are met:
  - The substantial future performance of services must be for a minimum period of two 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 agreement executed at least 90 days prior to the date on which the existing forfeiture would have lapsed.
- **Voluntary deferral of current compensation** – Subject to a substantial risk of forfeiture. Allowed if:
  - The amount to be paid upon vesting has a present value at least 25% greater than the amount of current compensation being deferred (requires additional substantial "match" payment by the employer).
  - Vesting must be based on the future performance of substantial services.
  - Vesting period must be not less than two years.
  - Initial deferral election must be made in writing by December 31st of the year preceding the year the services are performed.

Funding

Nonqualified deferred compensation 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 fund a nonqualified arrangement; however, the nonprofit may want to informally fund the plan to ensure funds are available to provide the eventual payments. The funds must remain assets of the nonprofit and are subject to the organization's creditor claims. Three basic options to meet the benefit liability are to pay obligations out of cash flow as necessary; borrow to meet the obligations as they occur; or pre-fund.

[1] IRC Section 457(f)(3)(B)

Various investment vehicles can be used to informally fund the plan such as savings accounts, bonds, stocks, mutual funds, and annuities. Possible limitations:

- Funds subject to market fluctuation.
- Insufficient or no cost recovery.
- Insufficient or no survivor benefit.
- Lack of guarantees.

Permanent life insurance can be used to informally fund the plan. Benefits include:

- Employer is the owner and beneficiary of the policy on the life of the key employee and may access the policy cash values to fund the promised benefit to the key employee.
- The policy could be distributed in kind to the key employee who could then use the policy values to provide a tax-free income stream using policy withdrawals and loans or could keep the policy intact to provide valuable survivor protection.
- Cash values may be credited based on a guaranteed crediting rate (product dependent).
- The death benefit may provide both cost recovery to the employer as well as the funds needed to provide the promised survivor benefit.

If the employer purchases life insurance on the lives of the participants, the employer must comply with the notice and consent and exception requirements under IRC Section 101(j).

Taxation

Deferrals, contributions, and interest earnings are taxed at the employee's ordinary income tax rate upon payout, or in the case of the IRC Section 457(f) plan, when the risk of forfeiture lapses. Employer recognizes the payments made as compensation expense.

ERISA Considerations

Top hat plans are maintained "primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees" and are exempt from the eligibility, vesting, funding, and fiduciary rules under ERISA.

- Government IRC Section 457 plans are not subject to ERISA.
- Non-government IRC Section 457 plans may be exempt from ERISA requirements if they fall within the "top-hat exemption." 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 Cuts and Jobs Act - IRC Section 4960

Effective for taxable years after December 31, 2017, tax exempt organizations are subject to a 21% excise tax on excessive "remuneration" in excess of $1,000,000 (other than an excess parachute payment) and "excess parachute payment" paid to a "covered employee" in any tax year.

- Covered employee is defined as being one of the five highest compensated employees in a given tax year including former employees for any preceding year starting in 2017 even if not one of the five highest compensated employees in the current year.

- Remuneration includes W-2 wages, bonuses, commissions, taxable fringe benefits, and vested amounts under Section 457(f). Excluded amounts are Roth elective deferrals, 401(k) distributions, 403(b) distributions, and government Section 457(b) plan distributions. It appears that distributions from non-governmental Section 457(b) plans are not excluded from remuneration but are excluded from the definition of an excess parachute payment.
- Excess parachute payment is defined as any payment contingent on the employee's separation from employment where the separation payment exceeds three times the employee's average pay over the preceding five years. If exceeded, the tax applies to everything over one times the employee's five-year average.
- The excess parachute payment excise tax is limited to employees who are highly compensated employees under the qualified plan rules (those earning over $150,000 per year for 2023.)
- Excess parachute payments do not have to reach $1,000,000 before becoming subject to the excise tax, which is separate from the $1,000,000 excise tax.
- Neither tax applies to payments made to a licensed medical professional to the extent that such payment is for the performance of medical services.

Employers should be aware that the arrangements described herein may be subject to the Employee Retirement Income Security Action of 1974, as amended (ERISA) and Internal Revenue Code Section 409A (Section 409A), the tax rule applicable to non-qualified deferred compensation. ERISA imposes certain requirements on employee benefit plans and their sponsors, including but not limited to, fiduciary, disclosure, and reporting requirements. These requirements depend on the type of plan ("retirement or welfare plan;" or "top hat retirement" or "top hat welfare plan"). Section 409A imposes certain requirements that, if not satisfied, can result in adverse tax consequences to employees. New York Life Insurance Company and its employees, agents, and affiliates do not provide tax or legal advice. Employers should consult with their legal and tax advisors regarding the implications of ERISA and Section 409A on adopting these arrangements in their particular circumstances.

This tax-related discussion reflects an understanding of generally applicable rules and was prepared to assist in the promotion or marketing of the transactions or matters addressed. It is not intended (and cannot be used by any taxpayer) for the purpose of avoiding any IRS penalties that may be imposed upon the taxpayer. New York Life Insurance Company, its agents and employees may not provide legal, tax or accounting advice. Individuals should consult their own professional advisors before implementing any planning strategies.

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