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Code 457(b) Plans

Top-Hat Retirement Benefit Plans for Tax-Exempt Organizations

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Internal Revenue Code Section 457 governs the rules and taxation for all non-qualified deferred compensation arrangements maintained by state or local governments or tax-exempt organizations (other than churches). Code Section 457(b) plans for non-governmental tax-exempt employers (referred below as "tax-exempt 457(b) plans") have unique differences and advantages for executives comparing to the "governmental 457(b) plans". Below we are going to describe only the provisions of "tax-exempt 457(b) plans" for non-governmental organizations. Recent limitation changes in these plans should be getting more attention as they now offer much better incentives for executive employees. They have much less restrictions and compliance requirements than qualified plans, more favorable taxation than other non-qualified plans and much less risk of forfeitures of the accumulated benefits.

Advantages of 457(b) Plans for Tax-exempt Organizations?

- Tax-exempt 457(b) plans are designed to benefit only a selected group of top-paid executives employed by the organization ("top-hat employees"). Contributions could be either employer contributions only, employee salary deferrals only, or a combination of both.

- Effective as of 2002, the contributions the 457(b) plans are no longer part of the total annual limit for all retirement plans of the employer. A plan participant could have an additional tax-deferred contribution of up to the annual salary deferral limit, which is $17,500 for 2014. This is in addition to any salary deferrals or employer contributions made to other retirement plans of the employer (such as 403(b), 401(k), profit sharing, money purchase, SEP or SIMPLE plans). Prior to 2002 the annual contribution and salary deferral limit was for all plans combined.

- Special Catch-up contribution: In the 3 years prior to Normal Retirement Age a participant could elect to defer an additional amount of up to the annual deferral limit for the year ($17,500 for 2014), if they haven't maximized their contributions in prior years. This in effect could double their contribution in the plan for those three years.

- Participant benefits could be immediately 100% vested, which would not subject them to a substantial risk of forfeitures unlike other non-qualified plans.

- The benefits are generally not taxed until payment.

- Non-discrimination rules do not apply – each executive could have a different amount of employer contribution each year, no testing is required. The plan is totally discriminatory.

- Annual plan reporting (Form 5500) is not required if an exemption statement is filed with the Department of Labor upon adoption of the plan.

- The compliance and administration work is fairly simple. A trust account and participant notifications are not required. The fiduciary responsibilities are not as cumbersome as those for qualified plans.

General Information About 457(b) Plans

Contribution Types and Limits:

Types of contributions: Tax-exempt 457(b) plans are permitted to provide for elective salary deferrals, non-elective (employer determined) and matching contributions. The employer contribution could be allocated to each participant either based on specified formula or it could be a different discretionary amount for each "eligible employee".

Limits: The maximum contribution limit for all contributions per participant (elective, non-elective and match) is the lesser of: the "applicable dollar amount" of salary deferrals as indexed each year ($17,500 for 2012), or 100% of gross compensation. This amount is in addition to the salary deferrals made to the 403(b) and 401(k) plans of the employer. The total annual contribution limit (Code Sec. 415) does not apply here either. So if the employee receives the maximum deferrals, match and profit sharing contribution from other qualified plans and reaches the annual limit ($52,000 for 2014), he or she could still have a contribution (employee or employer) of up to $17,500 (2014 limit) made to the 457(b) plan. This amount would only be offset by contributions made to another 457(b) plan.

Unique Catch-up Contributions: There is a special catch-up contribution provision that is available only for tax-exempt 457(b) plans – it allows for acceleration of salary deferrals in the last 3 years prior to Normal Retirement Age (NRA). The participant can choose what would be his/her Normal Retirement Age (NRA) is - generally between age 65 and no-later than age 70.5. During the three years prior to attaining such NRA the participant could elect to make catch-up salary deferral contributions of up to the deferral limit ($16,500 for 2010 and 2011, $17,000 for 2012, and $17,500 for 2013 and 2014) in addition to the regular contributions made to the 457(b) plan – if the plan had started in prior years and he didn't participate with the maximum allowed contribution in some years. This in effect could double the participant's annual contributions for those 3 years in the 457(b) plan alone! For example, a participant who is 62 years old in 2012 and had elected his NRA to be age 65, would be able to have contribution of up to $34,000 for 2012, $35,000 for 2013 and $35,000 for 2014, if he/she didn't maximize the salary deferrals in prior years of the plan.

Vesting and Payment Provisions:

Vesting: 457(b) plans could have a vesting schedule or be 100% vested immediately. The immediate vesting would eliminate the substantial risk of forfeitures, which is a more beneficial feature than other non-qualified plans.

Distributions: Benefits are permitted to be paid to the participants not earlier than: (a) retirement; attainment of age 70.5 (required minimum distribution rules); (b) severance of employment; (c) death; or (d) in the event of an "unforeseeable emergency" for the participant or the beneficiary. In-service distributions of small balances of inactive participants could be permitted.

Rollovers from tax-exempt 457(b) plans to an IRA or another plan are not permitted. Distributions could be made in a form of a lump sum, periodic installments or annuity payments.

Taxation and Reporting:

Contributions under an eligible 457(b) plan are not subject to income tax or FICA/Medicare taxes until payment. The employer must report contributions to the plan on its annual Form 990 in the year in which the contributions are made.

Upon payment, the distribution amounts are reported as compensation on Form W-2 and taxed as regular income, and the income tax withheld is reported on IRS Form 990 series in the year the payment is made to the plan participant. Income earned from investing such contributions are also reported and taxed as regular income upon payment.

Form 5500 (Annual return filing required under ERISA) is not required to be filed each year, if the employer files a one-time-statement ("top-hat compliance statement") with the Department of Labor within 120 days of adopting the plan.

Funding and Investments:

Tax-exempt 457(b) plans must be "unfunded". All amounts deferred, income earned and any property purchased with the deferred amounts are property of the employer and are subject only to the employer's general creditors. However, the employer could set up an account for the plan and invest the participant contributions. Participant investment direction could also be permitted. To ensure that the plan assets would not incur unreasonable losses, it is advisable that the employer limits and monitors the participant directed investments.

Other Considerations:

Tax-exempt 457(b) plan must be established for a select group of management or highly compensated employees ("top-hat employees"), which generally includes up to 5% of the employees. Otherwise, non-discrimination and compliance rules (Title I of ERISA) would apply.

If a participant exceeds the annual 457(b) deferral limit, the excess must be distributed back to the participant on time. Otherwise, the plan would become an ineligible plan under Code Sec. 457(f), for which different, less favorable taxation rules apply.

Since the assets are employer property and subject to the general creditors, if the Employer allows participant directed investments in the Plan, then it is advisable that the investment options are elected and monitored by the Plan Administrator, in order to assure that the assets are not subject to unreasonable losses.

For more information please contact Doneva, QPA, QKA
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