M. SECTION 457 DEFERRED COMPENSATION PLANS OF STATE AND LOCAL GOVERNMENT AND TAX-EXEMPT EMPLOYERS

by
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1. Introduction

Section 457 plans are nonqualified, unfunded deferred compensation plans established by state and local government and tax-exempt employers. These employers can establish either eligible (covered by 457(b)) or ineligible (covered by 457(f)) plans, and are subject to the specific requirements and deferral limitations of section 457 of the Internal Revenue Code of 1986 ("Code"). Certain other types of plans established by state and local government and tax-exempt employers are not subject to the requirements of section 457, however. The purpose of this article is to provide an overview of section 457, identify the differences between an eligible and an ineligible section 457 plan, and discuss those plans which are excepted from the rules and requirements articulated in section 457 and the regulations thereunder. This article will also try to highlight specific situations where plans may not be in compliance with section 457.

As originally enacted, the rules governing section 457 plans were developed based on nonqualified plan concepts. Section 457 plans therefore are subject to different, and often less stringent regulations than are funded, qualified plans, which must comply with complex rules to assure parity in who they cover, and how much can be deferred. An attendant feature of section 457 plans is that they may provide less security to participants than do qualified plans.

2. Section 457(b) "Eligible" Deferred Compensation Plans

Section 457(a) of the Code permits a participant to defer compensation to a deferred compensation plan of an "eligible employer," provided that the plan satisfies the eligibility requirements of section 457. Under section 457(a), compensation deferred pursuant to an eligible plan and the income attributable to such deferred compensation, are taxable in the year in which the deferred amounts are paid or made available to a plan participant or other beneficiary.

A. Eligible Employers

An eligible deferred compensation plan is defined as any plan, agreement or other arrangement that is established and maintained by an "eligible employer". Sections 457(b), 457(f)(3)(A). The term eligible employer is defined as a State (including the District of Columbia), political subdivision of a State, any agency or instrumentality of a State or political subdivision of a State, and any other organization (other than a government unit) exempt from tax under subtitle A of the Code. Section 457(e)(1), Section 1.457-2(c) of the Regulations. Section 457 therefore applies to all tax-exempt employers that maintain a deferred compensation plan, except churches, which are specifically excluded under section 457(e)(13). The application of section 457 to deferred compensation plans of exempt organizations became effective under the Tax Reform Act ("TRA") of 1986. Deferred compensation plans of agencies and instrumentalities of the Federal Government are not subject of Section 457.

B. Who May Participate in an Eligible Plan under Section 457(b)(1)?

(1) In General

Only individuals who perform services for the entity, either as employees or independent contractors, may be participants in a section 457 plan. Section 457(e)(2), 1.457-2(d). Corporations cannot be participants in a plan.

(2) Select Group of Employees of Non-governmental Tax-exempt Entities

While any employee or independent contractor of a governmental entity can be a participant, tax-exempt organizations that are non- governmental must limit participation to management and highly compensated employees . This is because of the rules under the Employee Retirement Income Security Act of 1974 ("ERISA"), which contains the applicable pension regulations under the jurisdiction of the Department of Labor.

ERISA generally requires that a plan which provides retirement benefits to employees must be funded by an irrevocable trust. Section 457 plans also provide such benefits. However, the rules of section 457 require such plans to be unfunded in order to obtain tax benefits. Therefore, an entity cannot attain tax deferral for its employees under a section 457 plan unless an exception to the funding requirement applies. Government plans are expressly exempt from the funding requirements of ERISA. Other tax-exempt employers may maintain section 457 plans, but only for management and highly compensated

employees, as the funding rules under ERISA do not apply to a "top hat" plan, a type of plan which specifically covers these types of employees. If the covered employees do not fall into these exceptions, the plans must be funded plans subject to the rules of ERISA.

Section 457 plans are not subject to the nondiscrimination rules, with which funded, qualified plans must comply. These rules are designed to insure that the highly compensated employees of an employer do not receive a disproportionate share of the benefits under qualified plans maintained by the employer. Neither the ERISA coverage rules nor the Code's coverage and nondiscrimination rules apply to unfunded top-hat plans, and no discrimination issue is raised by eliminating all rank and file employees from coverage under eligible 457 plans. In fact, section 457 plans of tax-exempt employers must do just that in order to be eligible plans. In contrast, qualified plans are developed for the rank and file as well as for highly compensated employees.

C. Maximum Deferral Limitations under Sections 457(b)(2) and (3); Coordination Limitation under Section 457(c)(2)

(1) General Rule

Under section 457(b)(2), a plan must provide that the annual amount that can be deferred is limited to the lesser of $7500, or 33 1/3% of a participant's "includible compensation". The $7500 limit includes both employer contributions and employee salary reduction deferrals.

(2) "Includible Compensation"

"Includible Compensation" for a taxable year includes only compensation attributable to services performed for the employer which is currently included in the participant's gross income for the taxable year, after taking into account amounts deferred (or otherwise not currently included in gross income) under section 457 and other provisions of the Code. Section 457(e)(5), Section 1.457-2(e)(2) of the Regulations. These other Code sections under which compensation is not includible in gross income include section 401(k) cash or deferred arrangements (CODAs or 401Ks), section 402(h)(1)(B) simplified employee pensions (SEPs) and section 403(b) tax-sheltered annuities (TSAs). The legislative history of section 457 indicates that in a typical arrangement, the 33 1/3% of includible compensation limitation is equal to 25% of the compensation that would have been received but for the salary reduction agreement. The amount of includible compensation is determined without regard to any community property laws. Section 457(e)(7).

Amounts payable on separation from service for unused sick and vacation leave accrued in prior years may not be deferred under an eligible plan pursuant to an election made in the final year of service, although these amounts would be used for determining includible compensation.

(3) Example

The following brief example illustrates how the deferral limitation operates to limit the amount of includible compensation that may be deferred under section 457(b). An employee who is scheduled to receive $24,000 during a taxable year could enter into a salary reduction agreement and elect to defer $6,000 for that year and be within the deferral limitation under 457(b), because this amount is equal to 25% of the employee's gross compensation of $24,000 and 33 1/3% of his or her includible compensation of $18,000 ($24,000 - $6,000).

(4) Catch-up Rule

An exception to the general deferral limitation under section 457(b)(2) does exist, however. Under section 457(b)(3), an eligible plan may provide that for one or more of a participant's last three taxable years ending before the attainment of retirement age, the amount which may be deferred is increased to the lesser of (A) $15,000, or (B) the sum of (i) the plan ceiling for purposes of 457(b)(2), plus (ii) so much of the plan ceiling established for purposes of 457(b)(2) for taxable years before the taxable year as has not previously been used under 457(b)(2) or 457(b)(3). (Catch-up Limitation).

With respect to the underutilized limitations and the limited catch-up rule, section 1.457-2(f)(2) of the Regulations provides, in part, that a prior year is taken into account only if (A) it begins after December 1, 1978, (B) the participant was eligible to participate in the plan during all or a portion of the taxable year, and (C) compensation deferred (if any) under the plan during the taxable year was subject to the plan ceiling established under 1.457-2(e)(1).

Section 1.457-2(f)(3) of the Regulations requires that the plan may not permit a participant to elect to have the limited catch-up provision apply more than once, whether or not the limited catch-up is utilized in less than all of the three taxable years ending before the participant attains normal retirement age, and whether or not the participant or former participant rejoins or participates in another eligible plan after retirement. An example found in the regulation points out that if the participant elects to utilize the limited catch-up for only one taxable year before normal retirement age, and after retirement at that age the participant renders services for the State as an independent contractor or otherwise, the plan may not permit the participant to utilize that limited catch-up for any taxable years subsequent to retirement.

(5) Normal Retirement Age

Section 1.457-2(f)(4) of the Regulations provides that a plan may define normal retirement age as any range of ages ending no later than age 70 1/2 and beginning no earlier than the earliest age at which a participant has the right to retire under the plan. If no normal retirement age is specified in the plan, then the normal retirement age is the later of the latest retirement age specified in the basic pension plan of the employer, or age 65. Where participants work past normal retirement age, the plan, within limits, may permit them to designate another normal retirement age for catch up purposes.

(6) Coordination Limitation

Under Section 457(c)(2), amounts excluded from income under certain types of plans must be treated as amounts deferred under section 457, and therefore counted against the $7500 annual limitation, or the 457(b)(3) $15,000 catch-up limitation. These plans are other section 457 plans, section 401(k) cash or deferred arrangements (CODAs), section 402(h)(1)(B) simplified employee pensions (SEPs), section 403(b) tax-sheltered annuities (TSAs), and plans for which a deduction is allowed because of a contribution to an organization described in section 501(c)(18).

Generally, the effect of section 457(c)(2) is that an individual who defers compensation in both an eligible section 457 plan and in another plan such as a CODA, SEP, or TSA is limited to a total combined deferral of $7500 annually if the individual is to enjoy tax deferral on the combined amounts. If the combined deferral exceeds this amount, the amounts treated as excess in the eligible section 457 plan are taxable currently under section 457. However, an individual who, although eligible, does not defer any compensation under the 457 plan in any given year, is not subject to the $7500 annual limit of section 457(c)(2), even though the individual defers compensation under one of the other coordinated plans.

Section 457(c)(2) works as follows. Suppose that individual A participates in both an eligible section 457 plan and a section 401(k) arrangement. A defers the maximum amount of $7500 under the section 457 plan and $2000 under the 401(k) arrangement in 1996, for a total of $9500. A will have an excess deferral of $2000 under the 457 plan because of section 457(c)(2). The $2000 deferred under the 401(k) plan will first be applied towards the $7500 limit, and the amount deferred under the section 457 plan, $7500, will exceed the $7500 limit by $2000.

(7) Plans with Delayed Vesting Provisions

Another issue raised by the limitation requirement is found in plans with benefits that vest on a delayed basis. If the compensation deferred is subject to a substantial risk of forfeiture, then compensation deferred is taken into account at its present value in the plan year in which the compensation is no longer subject to a substantial risk of forfeiture. 1.457-2(e)(3) of the Regulations. Therefore, amounts deferred under an eligible plan over several years subject to a delayed vesting schedule will be combined for purposes of the maximum deferral limit in the year the amounts vest, i.e., are no longer subject to a substantial risk of forfeiture.

For example, if an employer sets aside $3000 per year for five years for a certain employee, and the employee's rights to these amounts vests only in year 5, the employee will be treated as having deferred $15,000 ($3000 x 5 years) in year 5, when the amounts vest. Because the employee may only defer $7,500 in year 5 under section 457(b), the aggregate of the amounts deferred, $15,000, is in excess of the limitation by $7,500, and the excess amount is includible in the gross income of the employee in that same year 5. Moreover, the excess deferral must remain in the section 457 plan because section 457 has no mechanism for distributing excess deferrals in advance of the normal distribution events listed in section 457(d).

(8) Present Value Requirement

Section 457(e)(6) requires that compensation deferred under a plan be taken into account at its present value in the plan year in which deferred. Thus, for example, an employer cannot use unreasonable actuarial assumptions or interest rates to calculate the present value of benefits or the increase in benefits for a defined benefit plan.

(9) Conclusion

In summary, whether a plan meets the requirements of section 457(b) and (c) of the Code will require a review of (1) whether the amounts being deferred under the plan are within the eligible plan limitations, (2) whether any of these amounts are subject to a substantial risk of forfeiture, and (3) whether the employees are participating in another plan requiring a coordination of benefits under section 457(c)(2). A pattern of continuous excess deferrals or other inconsistencies will require a further examination into whether the plan is being administered in compliance with section 457 of the Code.

D. The Plan Must be Unfunded Under Section 457(b)(6)

(1) Generally

Another of the requirements of eligibility is articulated in section 457(b)(6), which mandates that a section 457 plan be unfunded and that plan assets not be set aside for participants. Section 457(b)(6) states that an eligible plan must provide that:

> (A) all amounts of compensation under the plan, (B) all property and rights purchased with such amounts, and (C) all income attributable to such amounts, property or rights, shall remain (until made available to the participant or beneficiary) solely the property and rights of the employer (without being restricted to the provision of benefits under the plan) subject only to the claims of the employer's general creditors.

This is true whether the funds deferred originate with the employee or the employer. Therefore, amounts credited to an employee's section 457 account are legally considered to be funds belonging to the state (or local) governmental unit or tax-exempt entity until such amounts have been paid or made available to the employee. Any funding arrangement that sets aside assets for the exclusive benefit of participants is in violation of section 457 and will trigger immediate taxation under sections 402(b) and 83 of the Code. Any language in a plan that either contradicts or appears to contradict this requirement should result in a thorough review of the plan document. Section 457 plans may use a so-called "rabbi" trust arrangement, however, without violating this requirement.

(2) Proposed Legislation

Proposed legislation now before Congress would mandate that government plans be funded and amounts be set aside from the claims of the employer's creditors, while leaving other unfunded aspects of plans intact.

E. Timing of Elections/Constructive Receipt Issues

(1) Constructive Receipt

The tax consequences of nonqualified deferred compensation plans are governed by the constructive receipt doctrine embodied in the regulations under section 451 of the Code, and, in the case of state and local government and tax-exempt entities, by section 457.

Section 451(a) of the Code and section 1.451-1(a) of the regulations provide that under the cash receipts and disbursements method of accounting, an item of gross income is includible in gross income for the taxable year in which the taxpayer actually or constructively receives it. Section 1.451-2(a) of the regulations provides that income is constructively received in the taxable year during which it is credited to the taxpayer's account, set apart for him, or otherwise made available so that he may draw upon it at any time. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

(2) Election to Defer Under Section 457

A section 457 plan must provide that compensation for any month may be deferred only if the agreement providing for the deferral is entered into before the beginning of that month. However, with respect to a new employee, a plan may provide that compensation may be deferred for the calendar month during which that participant first becomes an employee, if an agreement providing for the deferral is entered into on or before the first day on which the participant becomes an employee. Section 457(b)(4), 1.457-2(g).

Generally, a participant or beneficiary may elect the manner in which the deferred amounts will be distributed. Moreover, amounts deferred under an eligible section 457 plan will not be considered made available solely because the participant is permitted to choose among various investment modes under the plan for the investment of such amounts whether before or after payments have begun under the plan. While the employer can give the participant a choice of investment methods, the employer is not required to do so.

Section 1.457-1(b) of the regulations states, in part, that for purposes of section 457(a) of the Code, amounts deferred under an eligible plan will not be considered made available if, under the plan, the participant may irrevocably elect prior to the time these amounts become payable (under the distribution provisions of the plan) to defer the payment of some or all of these amounts to a fixed and determinable future time. In order for the Service, as well as plan participants (or their beneficiaries) to ascertain when deferred amounts become payable, an eligible plan must specify a fixed or determinable time of payment by reference to the occurrence of an event (for example, retirement) that triggers the individual's right to receive or begin to receive the amounts deferred under the plan. A participant cannot change this election once a participant is otherwise eligible to receive a distribution under the plan.

Section 1.457-1(b) of the Regulations and the examples that follow provide some guidance as to when amounts deferred will or will not be considered to have been made available to the participant or beneficiary.

(3) Restriction on Distributions and Constructive Receipt

A participant in a section 457 plan cannot withdraw the deferred amounts at any time prior to the occurrence of a payout event set out in section 457(d)(1)(A). (See section 4 below on Timing of Distributions.) Under section 457 of the Code and the regulations thereunder, as well as under the long established doctrine of constructive receipt of income, if a plan participant were able to receive his deferred compensation at any time without restriction after he retired, he would be in constructive receipt of any amounts subject to being withdrawn in the taxable year of his retirement, even though these amounts were not actually paid. Under section 457(a) of the Code, the participant's ability to control the time when he would receive these amounts would make the deferred amounts available to him and includible in gross income for the year in which he retired, or if already retired, in the current taxable year.

F. Permitted Distributions Under 457(d)(1)

(1) Generally

Section 457(b)(5) provides that an eligible section 457 plan must meet the distribution requirements of section 457(d). Section 457(d)(1) provides that the plan must require that the amounts deferred under the plan will not be made available to participants or beneficiaries earlier than (i) the calendar year in which the participant attains age 70 1/2, (ii) when the participant is separated from service with the employer, or (iii) when the participant is faced with an unforeseeable emergency, determined in the manner prescribed by the Secretary in regulations. The first option (age 70 1/2) requires no further explanation. This section discusses separation from service, unforeseeable emergencies, and a series of other issues related to when distributions may be made. The next section discusses when distributions must be made.

(2) Separation from Service

a. Generally

A participant's separation from service with the employer is another event which may give rise to the distribution of amounts from the plan to the employee.

b. What Constitutes Separation From Service

Under the regulations, an employee is separated from service with the State if there is a separation from service within the meaning of section 402(d)(4)(A)(iii) (formerly section 402(e)(4)(A)(iii)), relating to lump sum distributions. Generally, an employee is not separated from service where the participant continues the same job in the same work environment with a different employer as a result of a merger, liquidation or other similar circumstances and the new employer continues the plan (so-called "same desk" rule). An employee is generally considered to be separated from service if the employee's job duties with the new employer are substantially different from the job duties performed for the old employer. A distribution is also considered to be made due to separation from service if it is made on account of the participant's death or retirement. Section 1. 457-2(h)(2).

c. Special rules for Independent Contractors

Separation from service with respect to an independent contractor is discussed in section 1.457-2(h)(3) of the regulations, which provides that:

> an independent contractor is considered separated from service with the State upon the expiration of the contract or in the case of more than one contract, all contracts under which services are performed for the State, if the expiration constitutes a good-faith and complete termination of the contractual relationship. An expiration will not constitute a good faith and complete termination of the contractual relationship if the State anticipates a renewal of a contractual relationship or the independent contractor becoming an employee. For this purpose, a State is considered to anticipate the renewal of the contractual relationship with an independent contractor if it intends to again contract for the services provided under the expired contract, and neither the State nor the independent contractor has eliminated the independent contractor as a possible provider of services under any such new contract. Further, a State is considered to intend to again contract for the services provided under an expired contract, if the State's doing so is conditioned only upon the State's incurring a need for the services, or the availability of funds, or both.

The regulations go on to set out a safe harbor rule providing that no amounts payable under a plan will be considered to be paid or made available to the participant before the participant separates from service with the State if the plan provides that:

> (A)No amount shall be paid to the participant before a date at least 12 months after the day on which the contract expires under which services are performed for the State (or in the case of more than one contract, all such contracts expire), and
>
> (B)No amount payable to the participant on that date shall be paid to the participant if, after the expiration of the Contract (or contracts) and before that date, the participant performs services for the State as an independent contractor or an employee.

Be careful to examine whether there has been an actual separation from service and not just an insignificant change in the nature of the services performed. For example, contracts between doctors and state or tax-exempt hospitals may deem there to have been a separation from service where the nature of the services performed has changed somewhat, but in fact the doctor has never left the service of the hospital. Look beyond the contract involved and to the individual facts and circumstances of each arrangement.

(3) Unforeseeable Emergencies

There is one exception to this general rule prohibiting withdrawals. The plan may permit a participant to accelerate the payment of an amount remaining payable in the event of an "unforeseeable emergency," as defined in section 1.457-2(h)(4) of the regulations. A Plan does not have to provide for emergency withdrawals. However, benefits would not be considered made available merely because the plan contained such a provision. IT IS IMPORTANT TO REALIZE THAT A WITHDRAWAL FOR AN 'UNFORESEEABLE EMERGENCY' IS MORE DIFFICULT TO OBTAIN AND DIFFERS SUBSTANTIALLY FROM A 'HARDSHIP WITHDRAWAL' UNDER A SECTION 401K PLAN.

Section 1.457-2(h)(4) defines "unforeseeable emergency" as a severe financial hardship to the participant resulting from a sudden and unexpected illness or accident of the participant or of a dependent of the participant, loss of the participant's property due to casualty, or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant. The circumstances that will constitute an unforeseeable emergency will depend on the facts of each case, but in any case, payment may not be made to the extent that such hardship is or may be relieved: (i) through reimbursement or compensation by insurance or otherwise, (ii) by liquidation of the participant's assets, to the extent the liquidation of the assets would not itself cause severe financial hardship, or (iii) by cessation of deferrals under the Plan. Examples of what are not considered to be unforeseeable emergencies include the need to send a child to college or the desire to purchase a home.

Withdrawals of amounts because of an unforeseeable emergency must only be permitted to the extent reasonably required to satisfy the emergency need.

Any plan that has a large number of hardship withdrawals should be reviewed to determine whether the withdrawals are being administered in compliance with the hardship regulations. If the plan permits an employee to draw down the accounts virtually at will, this is a clear violation of the rules. A section 457 account balance should not be treated as though it were a bank account balance; it belongs to the employer until the employee becomes entitled to a distribution by the occurrence of an event specified in section 457(d)(1).

(4) Loans

Unlike the statutory scheme for qualified employer plans, which are authorized to make loans that will not be treated as plan distributions in certain circumstances, loans from or against section 457 plan assets are not authorized by statute and are **NEVER** permitted. THIS IS ANOTHER SIGNIFICANT DIFFERENCE FROM WHAT IS PERMITTED UNDER A 401K PLAN.

(5) Offsets

To the extent a plan does not contain anti-alienation language and does contain a provision permitting the employer to offset an employee's interest in a plan against amounts owed to the employer, an issue arises as to whether an offset provides the participant with a right to assign an interest in plan assets in violation of section 457(b)(6), which requires that all amounts deferred under the Plan, all property and rights purchased with such amounts, and all income attributable to such amounts, property, or rights will remain (until made available to the participant or beneficiary) solely the property and rights of the Employer, subject only to the claims of the Employer's general creditors.

Another issue raised by an offset is whether an employee has received an economic benefit equal to the amount of the offset, thus causing current taxation of that amount under the cash equivalency theory. See Cowden v. Commissioner, 32 T.C. 853 (1959), rev'd and rem'd, 289 F.2d 20 (5th Cir. 1961), on remand, 20 T.C.M. 1134 (1961).

(6) Transfers and Rollovers

Unlike the situation under a qualified plan, a participant who receives a distribution under a section 457 plan cannot further defer the funds tax free. The sole exception is transfers of the funds to another eligible 457 deferred compensation plan as is permitted under section 457(e)(10) of the Code. Under

section 457(e)(10), a participant is not required to include in gross income any amount payable to the participant just because there is a transfer of funds from one eligible deferred compensation plan to another eligible deferred compensation plan. No similar exception is provided for a rollover or transfer of funds to any other type of plan or arrangement, including an IRA. See Rev. Rul. 86-103, 1986-2 C.B. 62.

(7) Penalty and Excise Taxes

The 10% penalty tax of section 72(t) on early distributions from a tax-qualified plan, IRA or tax sheltered annuity does **not** apply to section 457. Neither does the 15% excise tax on excess distributions from these kinds of arrangements under section 4980A.

G. Minimum Distribution Requirements of 457(d)(2)

(1) In General

Section 1107 of the Tax Reform Act of 1986 added the minimum distribution requirements of 457(d)(2) in order to ensure that the tax-favored savings provided through section 457 are used primarily for retirement purposes. In general, the provisions are similar but not identical to those that apply to qualified plans and to arrangements under section 403(b) of the Code.

(2) Statutory Provisions

Section 457(d)(2)(A) provides that a plan meets the minimum distribution requirements for purposes of section 457 if the plan meets the minimum distribution requirements of section 401(a)(9). The general rule under section 401(a)(9) requires that a participant begin distribution of certain amounts under a plan not later than April 1 of the calendar year following the calendar year in which the employee attains age 70 1/2. In the case of a governmental plan, but not the plan of a tax-exempt organization, the required beginning date is the LATER of the general rule state above or April 1 of the calendar year following the calendar year in which the employee retires.

Section 457(d)(2)(B) of the Code provides that in the case of a distribution beginning before the death of the participant, the plan must provide that the distribution will be made in a form under which the amounts payable with respect to the participant will be paid at times specified by the Secretary, which are not later than the time determined under section 401(a)(9)(G) (relating to incidental death benefits), and that any amounts distributed to the participant

during his life will be distributed after the death of the participant at least as rapidly as under the method of distribution being used under the previous rule as of the date of his death. In the case of a distribution which begins after the death of the participant, the entire amount payable with respect to the participant must be paid during a period that does not exceed 15 years, or the life of the surviving spouse, if the spouse is the beneficiary. Finally, the plan must meet the nonincreasing benefit requirement of section 457(d)(2)(C). Both the section 401(a)(9)(G) rule and the nonincreasing benefit requirement are discussed below.

a. Section 401(a)(9)(G) Rule

i. Legislative History

Prior to being amended by section 1101(e)(10) of the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA"), section 457(d)(2)(B)(i)(I) required that, in the case of a distribution beginning before the death of the participant, the distribution be made in a form under which "at least 2/3 of the total amount payable with respect to the participant will be paid during the life expectancy of such participant (determined as of the commencement of the distribution),..."

As amended by section 1011(e)(10) of TAMRA, the above quoted provision of section 457(d)(2)(B)(i)(I) now requires the distribution to be made in a form under which "the amounts payable with respect to the participant will be made at times specified by the Secretary which are not later than the times determined under section 401(a)(9)(G) (relating to incidental death benefits),..." The Senate Finance Committee Report accompanying TAMRA explains the above amendments by stating that the Secretary is instructed to "issue tables that implement the incidental death benefit rule [provided in section 457(d)(2)(B)(i)(I)]...that are similar to those applicable under section 401(a)(9) but require more rapid distributions. Generally, the extent to which more rapid distributions are to be required is to be similar to the extent to which the former section 457(d)(2)(B)(i)(I) rule required more rapid distributions than the former version of the incidental benefit rule." These tables have not yet been issued. However, as noted below, the tables applicable to qualified plans may be used pending issuance of section 457 tables.

ii. Section 401(a)(9) Regulations

Section 401(a)(9)(G) of the 1986 Code provides for an incidental death benefit rule designed to apply uniformly to the various types of plans designed to qualify under section 401(a). This rule replaces the incidental benefit rule

stated in section 1.401-1(b)-1 of the Income Tax Regulations, adopted under the 1954 Code, which requires that a plan qualified under section 401(a) be designed to provide benefits primarily to employees, but may provide for the payment of incidental death benefits by insurance or otherwise.

The minimum distribution tables found in section 1.401(a)(9)-2 of the Proposed Regulations are intended to implement the incidental death benefit rule required by section 401(a)(9)(G) of the Code by providing a simple and uniform method of determining the amount of benefits payable to employees during their expected lifetimes.

A section 457 plan now providing an incidental benefit rule based on the "at least 2/3" requirement may be liberalized to adopt the somewhat less rapid distribution rule provided under the section 1.401(a)(9)-2 table. Bear in mind, however, that if temporary or final regulations adopted are more restrictive than the 401(a)(9)(G) tables, the more liberal incidental death benefit rule would be required to be amended once again.

b. Substantially Nonincreasing Amounts

One of the distribution requirements, section 457(d)(2)(C), provides that when distributions under an eligible section 457 plan are payable over a period longer than one year, they must be paid in "substantially nonincreasing amounts" and paid not less frequently than annually. The committee reports accompanying the Tax Reform Act of 1986 offer no explanation for or discussion of this particular requirement.

The Service has not yet defined what constitutes "substantially nonincreasing amounts." Nor has the Service mandated that complex actuarial computations must support a distribution schedule of "substantially nonincreasing amounts." Until the section 457 regulations are revised with respect to section 457(d)(2)(C) or until Congress legislates a definition of "substantially nonincreasing amounts," the plain meaning of that phrase applies. Under the plain meaning, amounts distributed need not be equal but they also should not be too disparate. For example, we would likely conclude that a benefit increase from $1,750 to $3,500 a month, or $21,000 to $42,000 a year is a substantial increase under the plain meaning of the language, and would be a violation of section 457(d)(2)(C) of the Code.

An increase in the amount distributed each year that reflects earnings on the deferred amounts is acceptable.

(3) Penalty

In the event a participant (or beneficiary) fails to receive, or receives less than, the minimum distribution required, a penalty may be imposed by section 4974(a) of the Code. The penalty amounts to 50% of the difference between the distribution actually received, if any, and the required minimum distribution under section 457(d)(2). This penalty can be waived by the Service under appropriate circumstances such as an inadvertent error or good-faith effort on the part of the participant (or beneficiary) to comply with the requirements.

H. Correction Period

Under section 457(b)(6), a section 457 plan maintained by a government employer which is not administered by the employer in accordance with the requirements of section 457 ceases to be an eligible plan on the first day of the first plan year beginning more than 180 days after the date of written notification by the Internal Revenue Service that the requirements are not satisfied, unless the inconsistency is corrected before the first day of that plan year. This grace period does not, by its terms, apply to the plans of tax-exempt entities.

I. Employment Taxes

Section 3121(v) controls the timing of the payment of FICA taxes for purposes of section 457(b) plans. Section 3121(v)(2) provides, generally, that any amount deferred under a nonqualified deferred compensation plan is be taken into account for purposes of these employment taxes as of **the later of** when the services are performed, or when there is no substantial risk of forfeiture of the rights to such amounts.

Amounts deferred (both elective and nonelective) under eligible plans are generally subject to FICA taxes at the time of deferral (when the services are performed) because at that time the amounts are no longer subject to a substantial risk of forfeiture. The fact that section 457 plans are unfunded plans and amounts credited under the plans are subject to the claims of the general creditors of the entity does not make the amounts subject to a substantial risk of forfeiture. On the other hand, amounts which are subject to a delayed vesting schedule (see section C.iii of this article) are subject to FICA taxes only when the amounts vest under the provisions of the plan.

3. Section 457(f) "Ineligible" Deferred Compensation Plans

Section 457(f)(1) of the Code governs the tax treatment of most nonqualified plans that are not eligible deferred compensation plans under section 457(b). However, transfers subject to section 83 are not subject to either set of section 457 rules. Generally, employers use an ineligible plan when they want to provide a benefit in an amount greater than the $7500 limit imposed on eligible plans or want to condition that benefit on the employee's future performance of services to the employer, or both. These are often called "golden handcuff" plans.

Section 457(f)(1) does not apply to that portion of any plan consisting of a transfer of property described in section 83 or to that portion of any plan consisting of a trust to which section 402(b) applies.

In general, section 457(f)(1)(A) of the Code provides that the amount of compensation that is deferred under a plan subject to section 457(f)(1) is included in the participant's or beneficiary's gross income for the first taxable year in which there is no substantial risk of forfeiture of the rights to the compensation.

A. What is a Substantial Risk of Forfeiture?

Section 457(f)(3)(B) provides that the rights of a person to compensation are subject to a substantial risk of forfeiture if the participant's rights to the amounts deferred are conditioned upon the future performance of substantial services. Section 83 of the Code and the regulations thereunder provide additional assistance in determining what is a substantial risk of forfeiture and what kind of services are substantial for purposes of section 457(f).

Section 1.83-3(c)(1) of the Regulations provides that **whether a risk of forfeiture is substantial or not depends upon the facts and circumstances.** A substantial risk of forfeiture exists where rights in property that are transferred are conditioned, directly or indirectly, upon the future performance (or refraining from performance) of substantial services by any person, or the occurrence of a condition related to a purpose of the transfer, and the possibility of forfeiture is substantial if such condition is not satisfied.

For example, the regulations point out that requirements that the property be returned to the employer if the employee is discharged for cause or for committing a crime will not be considered to result in a substantial risk of forfeiture.

For ruling purposes, a risk of forfeiture based upon the employee's death, living to a specified age or the employer's insolvency, fall short of the section 83 requirement.

B. Are the Services Substantial?

Section 83 also requires that the future services to be performed in connection with the transfer of rights in property be substantial. Section 1.83-3(c)(2) provides illustrations of substantial risks of forfeiture and states that "**the regularity of the performance of services and the time spent in performing such services tend to indicate whether services required by a condition are substantial**. The fact that the person performing services has the right to decline to perform such services without forfeiture may tend to establish that services are insubstantial."

Generally, any requirement for the performance or nonperformance of services over a period of less than twenty-four months tends to indicate that the services required are not substantial.

Section 1.83-3(c)(4), Example (1) of the regulations provides, that where a corporation transfers to an employee 100 shares of stock in the corporation, at $90 per share, and the employee is obligated to sell the stock to the Corporation at $90 per share if he terminates his employment with the Corporation for any reason prior to the expiration of a two year period of employment, the employee's rights to the stock are subject to a substantial risk of forfeiture during such two year period. If the conditions on transfer are not satisfied, it is assumed that the forfeiture provision will be enforced. Thus, requiring two years of service before vesting would generally be a substantial risk of forfeiture.

The regulations provide at least two additional examples where the services performed (or not performed) may not be substantial:

(1) Covenant Not To Compete

A covenant not to compete or a noncompetition clause which requires an employee not to compete with the employer once the employee separates from service often falls short of the section 83 requirement. Section 1.83-3(c)(2) provides that factors which may be taken into account in determining whether a covenant not to compete constitutes a substantial risk of forfeiture are the age of the employee, the availability of alternative employment opportunities, the likelihood of the employee's obtaining such other employment, the degree of skill possessed by the employee, the employee's health, and the practice (if any) of

the employer to enforce such covenants. Thus, a requirement that an employee not accept a job with a competing firm will not ordinarily be considered to result in a substantial risk of forfeiture unless the particular facts and circumstances indicate to the contrary.

(2) Incidental Consulting Services

A second area mentioned by the regulations is incidental consulting services. The regulations state that rights in property transferred to a retiring employee subject to the sole requirement that the property be returned unless he renders consulting services upon the request of the employer will not be considered subject to a substantial risk of forfeiture unless he is in fact required to perform such services. Another question raised in this analysis is whether the services to be performed are substantial or merely incidental. A facts and circumstances analysis is required to determine this. The example below provides such an analysis.

C. Sample Plan

The following sample plan exemplifies how difficult it can be to determine whether a substantial risk of forfeiture exists for purposes of section 83 and section 457(f), and why each case necessitates its own facts and circumstances analysis. Under the terms of a section 457(f) plan recently reviewed for ruling purposes, a participant doctor is entitled to receive benefits from a tax-exempt hospital upon the completion of certain employment requirements. Specifically, the doctor is required to 1) review cases and 2) provide consulting with regard to a department of the hospital. The Plan states that the doctor will be entitled to benefits only if he or she completes the services as reflected in this agreement. These services are not the regular services of the physicians, which are listed in each doctor's individual employment contract with the hospital. The case file did not reflect the regularity with which the consulting services required in the plan were to be performed or the actual amount of time spent, if any, in the performance of these services.

In this case, we questioned whether the amounts deferred were truly subject to a substantial risk of forfeiture. From the information contained in the file, there was no way for us to substantiate the regularity or amount of time to be spent in the performance of the services listed, or if, indeed, any time would be spent on the performance of these services. Even if the employee were performing the services listed, if the services required little time they might be NOT SUBSTANTIAL, and the risk of forfeiture would therefore also be NOT SUBSTANTIAL. The requirement is that substantial future services be required to

be provided. We believe this refers to the quantity of services rendered during a specific time period. Full-time services are definitely not required. However, mere consulting availability or sporadic consulting are not substantial and neither is a cursory review of a few patient's files.

The final determination, however, is based on a facts and circumstances analysis. Thus, each individual arrangement must be reviewed separately. Our position in this case was that absent detailed evidence with regard to the amount of time spent on these services, these services are not substantial, and that the income deferred should be currently taxable to the doctor-participant. In summary, such an arrangement should be reviewed very thoroughly to determine whether the purported substantial risk of forfeiture actually exists.

D. Salary Reduction Ineligible Plans

Another area of concern is ineligible arrangements funded purely by salary reduction. Typical 457(f) plans are used as a means of placing "golden handcuffs" on executives by conditioning retirement benefits on long term service or bonuses for shorter periods of service. These amounts are usually additional compensation to the employee and do not place the employee's regular compensation at risk.

Salary reduction 457(f) plans, however, must be placed under closer scrutiny because few employees would find such arrangements to be an acceptable alternative to current compensation, unless they are very near retirement and feel secure in their jobs. Even a doctor who is highly compensated is unlikely to place a substantial amount of his income at risk. Each such type of arrangement requires looking behind the documents and reviewing very carefully what services are being rendered, in order to determine whether there is truly a substantial risk of forfeiture involved.

E. Rolling Risk of Forfeiture

Another feature of an ineligible arrangement worth close scrutiny is what is known as a rolling risk of forfeiture. A rolling risk of forfeiture is essentially a provision in an arrangement which permits a voluntary extension of the period of forfeiture. Generally, when the period of risk lapses with respect to an employee arrangement, the deferred compensation will be includible in the gross income of that employee. The ability to extend the period of risk period would permit the employee to further defer the receipt of compensation to a future date, and avoid taxation on the amounts until that future date.

These plans should be subject to a higher level of scrutiny to determine whether a risk really exists. This is particularly true where the employee has the option to extend the risk period and does so shortly before the risk lapses.

F. Multiple Plans

An employer may simultaneously maintain several different types of plans. For example, an employer may sponsor a death benefit plan and a severance pay plan, which, if "bona fide," are excepted from the provisions of section 457(b), in addition to a section 457(f) plan. However, when viewed together, it may become apparent that the benefits paid from one plan offset benefits lost under the provisions of one of the others. If this is the case, while it may appear that there is a substantial risk of forfeiture, it is unlikely that a true risk of forfeiture exists since a participant can receive benefit payments under one or another of the plans in all events.

G. Taxation of Section 457(f) Plans

(1) Income Tax

Compensation deferred under 457(f) arrangements is includible in the gross income of the participant or beneficiary for the first taxable year in which there is no substantial risk of forfeiture. The tax treatment of any amount subsequently paid or made available under the plan to a participant or beneficiary is determined under section 72 of the Code, relating to the taxation of annuities. The legislative history of section 457 and the regulations provide that earnings credited on compensation deferred under the agreement or arrangement are includible in the gross income of the participant or beneficiary only when paid or made available, provided that such interest in the assets (including amounts deferred under the plan) of the entity or employer is not senior to the entity or employer's general creditors. Section 1.457-3(a)(1),(2) and (3) of the Regulations.

Section 457(e)(6) states that compensation deferred is taken into account at its present value.

(2) Employment Taxes

Section 3121(v) controls the timing of the payment of FICA tax for purposes of section 457(f) plans. Section 3121(v)(2) provides generally that any amount deferred under a nonqualified deferred compensation plan is taken into account for purposes of these employment taxes as of the later of when the services are performed, or when there is no substantial risk of forfeiture of the rights to such amounts.

4. Grandfathered Plans of Tax Exempt Organizations

A. Section 1107 Exception From the Section 457 Rules

Section 1107 of the TRA of 1986 amended section 457 of the Code to apply its restrictions and limitations to the unfunded deferred compensation plans maintained by non-governmental tax-exempt organizations, effective for taxable years beginning after December 31, 1986, except as provided under section 1107(c) of the Act. Section 1107(c)(3)(B) addresses non-governmental tax-exempt organizations only and provides that section 457 does not apply to amounts deferred under a deferred compensation plan of such an organization that:

(i) were deferred from taxable years beginning before January 1, 1987, or

(ii) are deferred from taxable years beginning after December 31, 1986, pursuant to an agreement that

(I) was in writing on August 16, 1986, and

(II) on such date, provides for a deferral for each taxable year covered by the agreement of a fixed amount or of an amount determined pursuant to a fixed formula.

Section 1107(c)(3)(B) further provides that if there is any modification of the fixed amount or fixed formula, section 457 applies to any taxable year ending after the date on which the modification is effective.

B. Notice 87-13 Guidance

Notice 87-13, 1987-1 C.B. 432, gives guidance, in the form of questions and answers, with respect to certain provisions of the Act, including section 1107.

A deferral with respect to an individual is treated as fixed on August 16, 1986, to the extent that a written plan on such date provided for such deferral for each taxable year of the plan and such deferral was determinable on such date under written terms of the plan as a fixed dollar amount, a fixed percentage of a fixed base amount (e.g., regular salary, commissions, bonus, or total compensation) or an amount to be determined by a fixed formula. An example of a fixed formula is a deferred compensation plan that is in the nature of a defined benefit plan under which the deferred compensation to be paid to an employee in the future (e.g., on or after separation from service) is in the form

of an annual benefit equal to 1 percent of each of the employee's years of service with the employer times the employee's final average salary.

Q&A-28 of Notice 87-13 further provides that an amount of deferral pursuant to a written plan on August 16, 1986, will cease to be treated as fixed on such date, and thus will be subject to section 457, as of the effective date of any modification to the written plan that directly or indirectly alters the fixed dollar amount, the fixed percentage, the fixed base amount to which the percentage is applied, or the fixed formula.

Certain plan amendments do not affect the grandfathered status of a plan. For example, the election by a participant of an alternative payout option that does not alter the total amount credited to a participant under the plan for any fiscal year or the allocation of the total credits among the participants for any fiscal year is not a violation of this requirement. Additionally, changes to a plan's benefit commencement date or in the timing of certain elections, or modifications or clarifications to plan definitions would not cause a plan to lose its grandfathered status. We have also allowed changes to the plan that reduce the amount to be paid to a participant under the plan.

C. New Participants Not Grandfathered

Section 1011(e)(6) of TAMRA amended section 1107(c)(3) of TRA '86. The TAMRA amendment clarified that: (1) the grandfather rule applies to any deferred compensation plan of a tax-exempt employer that otherwise meets the requirements described above, whether or not the plan would be an "eligible deferred compensation plan" within the meaning of section 457(b); and (2) the grandfather rule applies only to individuals who were covered under the plan and agreement on August 16, 1986, and not to new employees or participants. S. Rep. No. 445, 100th Cong., 2d Sess. 148 (1988).

D. Reviewing Grandfathered Plans

When reviewing a so-called grandfathered plan, it is important to determine whether there have been any amendments to the plan that affect the fixed amount or formula requirement. For example, any election, annual or otherwise, which permits the participant to change the amount of his salary reduction deferral, obviously violates this requirement. Also, note whether the plan has new participants and whether they are participating in the grandfathered plan.

5. Bona Fide Vacation, Sick Leave, Compensatory Time, Severance Pay, Disability Pay and Death Benefit Plans Excepted From Section 457 Under Section 457(e)(11) of the Code

A. The Issue

Section 457 applies to all plans, both elective and nonelective, providing for the deferral of compensation. Since TRA '86, this has focussed attention on whether it should apply to a variety of plans that arguably defer compensation yet are not typically considered deferred compensation plans. These include a bona fide vacation leave, sick leave, compensatory time, severance pay, disability pay, or death benefit plan maintained by a state or local government or tax-exempt organization.

B. Service Guidance

In Notice 88-8, 1988-1 C.B. 477, the Service stated that:

> [A] bona fide vacation leave, sick leave, compensatory time, severance pay, disability pay, or death benefit plan maintained by a state or local government or tax-exempt organization will not be subject to the provisions of section 457 for taxable years of employees beginning before the issuance of guidance describing the extent to which these forms of compensation are subject to section 457. The exemption applies to such plans whether they are elective or nonelective.

In Notice 88-68, 1988-1 C.B. 556, the Service announced that the types of plans described in Notice 88-8, including bona fide severance pay plans, would not be treated as deferred compensation plans subject to section 457 when regulations were issued. The Notice also stated that this rule would apply without regard to whether such plan is elective or nonelective in nature. The Notice concluded with a comment that "{a} number of issues remain with respect to section 457, including when a vacation leave, sick leave, compensatory time or severance pay plan is bona fide, and not a mere device to provide deferred compensation." (Emphasis added).

C. Advantages of Bona Fide Plan

The advantage of having a plan qualify as a "bona fide" plan excepted from section 457 is that it may provide benefits in excess of the $7,500 deferral limit for eligible 457(b) plans and the amounts deferred need not be subject to a substantial risk of forfeiture as is otherwise required under 457(f). In fact, the benefits provided may amount to 10 to 20 times the annually permitted deferral

under an eligible section 457 plan, or even more. However, if such a plan is found to be a deferred compensation plan subject to section 457(f), then all amounts not subject to a substantial risk of forfeiture are currently taxable to the employees, for both income and employment tax purposes.

D. Section 457(e)(11)

Section 457(e)(11) of the Code, enacted as part of TAMRA, provides that "{a}ny bona fide vacation leave, sick leave, compensatory time, severance pay, disability pay, or death benefit plan shall be treated as a plan not providing for the deferral of compensation." The legislative history of TAMRA indicates that this section was intended to codify Notice 88-68, but provides no further explanation. The Service has not yet provided any interpretative guidance, either in the form of regulations or otherwise, with respect to Section 457(e)(11).

Remember, however, that the substance is what matters. Thus, the mere designation of one of these plans as "bona fide" under 457(e)(11) is meaningless if the benefit package provided, as well as the spirit of the plan, is more in the nature of a deferred compensation plan.

E. Review of Plans

Any arrangement of a state or local government or tax exempt employer that is clearly equivalent to a nonqualified deferred compensation plan should be viewed as being subject to section 457 regardless of whether the plan is labelled otherwise. When reviewing section 457 plans generally, be sure to inquire as to whether the employer has a sick leave, vacation leave, severance, disability or death benefit plan, in addition to any section 457 plans. A review of the plan documents may indicate that these plans are not really excepted from the provisions of section 457. Look beyond what the plan says and see what it does. If the plan resembles a section 457 plan, question its status a plan exempted from section 457.

For a detailed article on severance pay plans and how to distinguish between severance pay plans and plans of deferred compensation, please see the article entitled, Severance Pay Plans of State and Local Government and Tax-Exempt Employers, found in the Exempt Organizations Continuing Professional Education, Technical Instruction Program for FY 1996, Topic H, page 182.

6. Section 457(e)(12) Nonelective Plans for Independent Contractors

Section 457(e)(12)(A) provides that section 457 does not apply to nonelective deferred compensation attributable to services not performed as an employee. For purposes of subparagraph (A), deferred compensation is to be treated as nonelective only if all individuals (other than those who have not satisfied any applicable initial service requirement) with the same relationship to the payor are covered under the same plan **with no individual variations or options under the plan.** Section 457(e)(12)(B).

In the absence of regulations interpreting this section, a literal reading should be applied. For example, no individual variations or options in the plan can exist. Furthermore, when looking at the relationship of the independent contractors to the entity, make sure the same classes of independent contractors are grouped together, and not arbitrarily separated. For example, one case we reviewed separated every medical subspecialty of doctors into a different subgroup for purposes of applying individual variations and options under the plan. However, there were only one or two doctors with each subspecialty on staff, and not a whole group of specialists. We viewed each individual doctor as having the same relationship to the hospital, and no individual variations or plan options should have been permitted. This plan, therefore, should have been subject to section 457. A different conclusion might have been reached if each subspecialty consisted of several doctors and there were rational, objective differences in these relationships, such as may be the case at a large hospital.

7. Conclusion

There are several kinds of plans of state and local government and tax-exempt employers that fall under the requirements of section 457. A thorough review of all the factors discussed in this article will be necessary to determine whether the plans are in compliance with section 457. If the provisions of the plan appear to be in compliance with the requirements of section 457, a review of the administration of the plan may still uncover problems which merit a further analysis of the tax effects of the plan. If the plans of these employers purport not to be subject to section 457, it is still necessary to determine whether they are truly exempt from section 457 or exempt in name only. If a plan looks like a plan which should be subject to the requirements of section 457, question it's status as a plan other than a section 457 plan.