

BENEFITS FUNDAMENTALS: A REFRESHER ON 457 PLANS

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Do you occasionally wonder about 457 Plans? Exactly what are they, anyway, as opposed to 403(b) plans or 401(a) plans? This Friday email will review some of the important details about 457 plans.

Deferred compensation for state and local governments and for tax exempt organizations is subject to Internal Revenue Code Section ("Code Section") 457. Code Section 457(a) gives the carrot, allowing income tax to be deferred. If the plan is an "eligible" plan, such deferred compensation is includable in gross income only for the taxable year in which such compensation is paid.

Code Section 457(b) defines the term, "eligible deferred compensation plan," to mean a plan which meets the enumerated requirements of Section 457(b).

The following are some of the significant requirements that must be met by a 457(b) plan:

1. Only individuals who perform service for the employer may be participants: Code Section 457(b)(1);
2. The maximum amount which may be deferred is the lesser of the "applicable dollar amount" (\$16,500 for 2010) or 100% of the participant's compensation; Code Section 457(b)(2); and governmental plans can make a catch up contribution for participants over age 50 (\$5,500 in 2010): Code Section 457(e)(18);
3. A special near retirement (the last three taxable years ending before the participant attains normal retirement age) catch up contribution is allowed which is equal to twice the yearly maximum limit or, if less, the sum of previously unused yearly maximum limits: Code Section 457(b)(3);
4. A deferred compensation agreement must be entered into before the beginning of the month of deferral: Code Section 457(b)(4);

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5. Minimum distribution requirements must be met (the age 70 1/2 distribution requirements): Code Section 457(b)(5) and Code Section 457(d), Code Section 401(a)(9);
6. Distributions cannot be made earlier than age 70 1/2, when the participant has a severance from employment or for an unforeseeable emergency: Code Section 457(d)(i), (ii) and (iii);
7. Special distributions are allowed for certain minimal accruals under a governmental plan: Code Section 457(d)(3), Code Section 457(e)(9) (A);
8. Governmental plans must hold assets in trust: Code Section 457(g).

If an arrangement meets the requirements of Code Section 403(b), then that plan is a 457(b) plan. If it does not meet those requirements, and if the plan is not a 403(b) plan or a 401(a) plan, then it is governed by Code Section 457(f). The plan of a government or tax exempt organization which is not a 403(b) plan or a 401(a) plan, and which is a deferred compensation plan which does not meet the requirements of Section 457(b), is sometimes called a 457(f) plan.

One of the consequences of being a 457(f) plan is that such a plan is also subject to Code Section 409A. A 457(b) plan is expressly not subject to Code Section 409A. Code Section 409A has teeth and penalizes deferred compensation plans which are covered by and do not qualify under Code Section 409A. Section 457(f) importantly provides that the income promised under that plan shall be included in the gross income of the participant or beneficiary "for the first taxable year in which there is no substantial risk of forfeiture of the rights to such compensation."

What this means is that a Section 457(f) plan cannot provide vested benefits the way other tax favored arrangements can. If a 457(f) plan vests the benefits to an individual (meaning the benefits are not subject to a substantial risk of forfeiture), that individual has income tax, because that moment of vesting was enough to cause the income to be includable in the taxable income of the individual (this is referred to as "constructive receipt").

This is not the rule which applies under Section 409A to taxable employers. A taxable employer can promise to pay on a particular day (a "specified time (or pursuant to a fixed schedule) specified under the plan at the date of the deferral of such compensation"), and the pay day is the tax day, even if the right to receive that payment is "vested." See Code Section 409A(a)(2) re earliest distribution events. Not so for a 457(f) plan.

Pursuant to a Section 457(b) only a limited amount of money can be deferred and sheltered each tax year (\$16,500 for 2010). Catch-up contributions (for individuals over age 50, \$5,500 for 2010) are allowable only for governmental 457(b) plans. A tax exempt organization 457(b) plan cannot allow such catch up contributions. This should not be confused with another kind of near retirement catch-up contribution which is specifically provided

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under Section 457(b)(3). Section 457(b)(3) permits a participant, for one or more of the participant's last three taxable years before she attains normal retirement age under the plan (usually age 65) to defer twice the amount of the annual limit, or, if less, whatever is remaining in terms of unmet limits in previous years.

Governmental 457(b) plans must be trustee. That is, an unrelated entity with trust powers must be the trustee of a governmental 457(b) plan. On the other hand, non-governmental tax exempt organization 457(b) plans cannot be funded, and are subject to the employer's insolvency risk. That is, if the employer becomes insolvent, then the monies available to pay the 457(b) obligations get no special treatment. Participants under such a 457(b) plan are treated as general creditors of the employer.

Although, as qualified plans go, the Section 457(b) plan requirements are not the most complicated, it is important to understand when Section 457 does and does not apply, and to know that a 457(f) plan is subject to Section 409A.

Any time there is deferred compensation, one must realize that the subject is a regulated area, requiring careful attention to tax law. Deferred compensation is easy to spot: Someone works and pay is promised in a future tax year. That would be deferred compensation. The question is, when will it be paid? Another question is, when will it be vested? Another question is, when will it be taxed? It depends on the deferred compensation plan.

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