

**TAXATION OF DEFERRED COMPENSATION:  
OVERVIEW OF 409A AND 457**

**MCLE's *Executive Compensation Law***

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## Section 2

### TAXATION OF DEFERRED COMPENSATION: OVERVIEW OF 409A AND 457

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#### I. SCOPE NOTE

This article provides an overview of the treatment of nonqualified deferred compensation under Sections 409A and 457 of the Internal Revenue Code of 1986, as amended (the “Code”). Part II provides background information about nonqualified deferred compensation plans generally and the enactment of Code Section 409A. The related interpretive guidance issued by the Internal Revenue Service is described in Part III. The general requirements under Section 409A for nonqualified deferred compensation plans are discussed in Part IV, and the various types of arrangements which are excluded from coverage by these rules are described in Part V. Parts VI through and VIII provide an overview of Code Section 457, and its application to 457(f) plans and 457(b) plans maintained by governmental employers and tax-exempt organizations.

#### II. BACKGROUND FOR CODE SECTION 409A

##### A. Qualified Plans v. 409A Plans

A Code Section 409A plan includes any arrangement that enables an employee to defer receiving compensation to be earned until a subsequent year and thus delay taxation on the deferred compensation. Although Section 409A covers a broad array of arrangements, it does not apply to tax-qualified retirement plans (e.g., 401(k) plans), 403(b) plans, 457(b) plans, or similar tax-favored plans, even though these plans also delay taxation on the compensation deferred thereunder. The key differences between tax-favored plans and typical 409A plans include:

### Tax-Favored Plans

- Qualification rules prohibit discrimination in favor of the highly compensated and impose contribution and benefit limits.
- ERISA minimum standards apply to eligibility, participation, vesting, funding, etc.
- Plans must be funded (except non-governmental 457(b) plans).
- Employee's deferred compensation is not taxed until payment.

### 409A Plans

- Nondiscrimination rules and most other limits do not apply.
- ERISA minimum standards do not apply.
- Plan must be unfunded.
- Employee's deferred compensation is not taxed until payment or "constructive receipt."<sup>1</sup>

## **B. Pre-Section 409A Plan Design Practices**

Before Section 409A was enacted, tax practitioners had developed several techniques to soften the harder edges of the deferred compensation taxation rules. After their initial compensation deferral elections, employees could subsequently delay taxation again by making a subsequent payment deferral election before their deferred compensation was otherwise payable. Employees could easily accelerate receiving their deferred compensation without concerns about "constructive receipt," if the nonqualified deferred compensation plan imposed a "haircut" (i.e., the employee forfeited a small

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<sup>1</sup> "Constructive receipt" means that IRS treats an employee as receiving compensation when the employee has the right to currently access the compensation, even if the employee has not exercised the right to actually receive the compensation.

portion of the deferred compensation upon accessing it). Employees with unfunded deferred compensation could reduce the risk of losing their deferred compensation upon their employer's bankruptcy if the plan included financial triggers that caused the deferred compensation to be paid as the employer approached bankruptcy.

### **C. Key Concepts in Section 409A Rules**

The American Jobs Protection Act of 2004 added Section 409A to the Code to regulate compensation deferral and payment elections. The new Section 409A rules essentially bar employees from accelerating the payment of deferred compensation. They also restrict the timing of initial compensation deferral elections and subsequent payment deferral elections. The penalties for not complying with these rules are severe. Noncompliance will cause an employee's deferred compensation (and related investment earnings) to become taxable and subject to a 20% additional tax penalty with a possible assessment of interest.

## **III. IRS GUIDANCE UNDER CODE SECTION 409A**

### **A. Notice 2007-78**

On September 10, 2007, the IRS issued Notice 2007-78 to extend until the end of 2008 the deadline to make certain amendments to nonqualified deferred compensation plans in order to bring them into compliance with Code Section 409A. However, the extension was subject to two major limitations. First, 409A plans must have been amended before the end of 2007 if they did not include at least one time and form of payment provision that complies with Section 409A. Second, in a departure from its previous practice when extending the documentary deadline, IRS did not extend the current good-faith reliance period or transition rules.

### **B. Notice 2007-86**

On October 22, 2007, the IRS issued Notice 2007-86 substantially revoking the transition period guidance provided in Notice 2007-78. In the Notice the IRS removed the requirement that plans be amended before December 31, 2007 if they did not include at least one time and form of payment provision that complies with Section 409A and generally extended through December 31, 2008 the good faith compliance rules in effect before the IRS issued Notice 2007-78.

### **C. Effective Date**

Beginning January 1, 2009, plans must be operated in accordance with the final regulations. Plans must operate in “good faith compliance” with Section 409A and interim guidance from January 1, 2005, through December 31, 2008. During this period a 409A plan may rely on applicable IRS guidance, but reliance on the proposed 409A regulations is not permitted after December 31, 2007.

### **D. 2008 Plan Amendment Deadline**

Plan documents must be amended to comply with Section 409A on or before December 31, 2008. Written plan documents, at a minimum, must include:

- Conditions for initial compensation deferral elections,
- Amounts being deferred (or the formula for determining amounts deferred),
- The time and form of payment (including a six-month delay for payments to key employees of public companies upon employment termination), and
- Conditions for subsequent payment deferral elections.

The minimum content need not be included in one document. For example, compensation deferral election and payment deferral election forms may be separate from the plan design document.

## **E. Transition Payment Elections**

A 409A plan may allow employees to revise elections as to the time or form of payment of previously deferred compensation, if the revised elections:

- are made no later than December 31, 2008, and
- do not accelerate deferred compensation payments into 2008 or defer payments otherwise due in 2008 until later years.

Similar rules apply for time and form of payment elections made in 2007. Employees who fail to change their time and form of payment elections in 2008 will generally be able to do so in 2009 or later only if they comply with the re-deferral rules in the final regulations. An employer need not amend its plan retroactively to reflect actions taken during the transition period (i.e., January 1, 2005 to December 31, 2008), or amend or adopt a written plan document with regard to deferred compensation already paid.

## **F. Grandfathered Plans**

Compensation earned and vested under a nonqualified deferred compensation plan in effect on October 3, 2004, need not comply with Section 409A. However, if these grandfathered plans are materially modified after October 3, 2004, they become subject to Section 409A.

## **G. Voluntary Correction Program**

In Notice 2007-78, the IRS announced its intention to establish a voluntary compliance program that will enable employers to correct unintentional failures to comply with Section 409A in operation. To avoid adverse tax consequences under Section 409A, the voluntary compliance program would permit such failures to be corrected, but only in the year in which they occur. Later correction would result in limited amounts

becoming includible in income and subject to additional taxes under Section 409A. In Notice 2007-86, the IRS affirmed its intention to issue guidance on the voluntary compliance program as soon as possible.

## **H. Income Tax and Withholding Requirements**

On October 23, 2007, the IRS issued Notice 2007-89 which suspends the income tax reporting requirements of Section 409A for amounts deferred in 2007 under non-qualified deferred compensation plans operated in accordance with Section 409A. The Notice is similar to the suspension of the income tax reporting requirements previously granted by the IRS for 2005 and 2006. The Notice also provides interim guidance on reporting and withholding of amounts includible in income under arrangements that have violated Section 409A.

## **IV. REQUIREMENTS UNDER CODE SECTION 409A**

### **A. Compensation Deferral Elections.**

An employee generally must make a compensation deferral election prior to the year in which the compensation is earned. For example, deferral elections for compensation to be earned in 2008 must be made by December 31, 2007. However, there are many exceptions to the general rule, including the key exceptions described below.

#### ***1. Newly Eligible Participants***

Employees newly eligible to participate in a 409A plan can make their initial compensation deferral elections within 30 days of becoming eligible. However, the deferral election will apply only to compensation earned after the election.

#### ***2. Performance-Based Compensation***

Deferral elections for performance-based compensation can be made as late as six months before the end of the performance period. However, the performance period must be at least 12 months. The amount or payment of the compensation must be contingent upon the satisfaction of the performance-based objectives (e.g., bonus tied to achieving sales targets for a year) established at the beginning of the performance period. Also, whether the objectives would be achieved must be substantially uncertain when they are established.

### **3. *Ad Hoc Bonuses***

An employee may elect to defer an ad hoc bonus if:

- the employee will forfeit the bonus if he or she terminates employment within 12 months after the bonus is awarded, and
- the deferral election is made within 30 days after the bonus is awarded and at least 12 months in advance of the earliest date at which the forfeiture condition could lapse.

### **4. *Excess Plans***

Excess plans typically provide benefits based on a formula in a qualified plan that produces benefits that exceed the plan qualification limits designed to restrict benefits for the highly compensated employees. Accruing benefits under excess plans is usually automatic. The design of an excess plan may or may not allow an employee to choose the time and form of payment.

The final regulations allow an excess plan to permit employees accruing a benefit to elect the time and form of payment within the first 30 days of the plan year following the year during which they first accrue a benefit. The election applies to benefits that were accrued in the prior plan year as well as those that accrue after the payment

election. For purposes of this rule, however, all excess benefit plans are aggregated. Thus, if an employee participates in an excess 401(k) plan, the employee cannot rely on the 30-day special election rule if the employee later accrues a benefit under another excess pension plan. When an employee first accrues a benefit under any excess plan, the employee should make payment elections for all excess plans under which the employee may accrue a benefit.

## **B. Payment Elections**

When employees make compensation deferral elections under a 409A plan, they must also elect the time and form of payment. Alternatively, the plan must specify the time and form of payment. A 409A plan may allow for payment no earlier than one of the following events:

- separation from service;<sup>2</sup>
- disability;<sup>3</sup>
- death;
- change of control;
- unforeseeable emergency; and
- at a fixed date or according to a fixed schedule specified by the plan or an employee's irrevocable election.

In certain circumstances, different forms of payment can be elected for different types of payment events. For example, a participant can elect to receive a lump sum payment at disability and installment payments at separation from service.

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<sup>2</sup> Payment upon separation from service must be delayed at least six months for "specified employees." These are key employees as defined in the so-called "top-heavy" rules for qualified plans if their employer's stock is publicly traded.

<sup>3</sup> The definition of disability is strict. The employee must be unable to engage in any substantial gainful activity by reason of an impairment that can be expected to last for a continuous period of not less than 12 months or to result in death. Alternatively, the employee must be receiving disability benefits replacing lost wages for a period of not less than three months under the employer's accident and health plan.

### **C. Anti-Acceleration Rule**

Once an employee or the 409A plan has specified when the deferred compensation will be paid, the payment of the deferred compensation payment cannot be accelerated.<sup>4</sup> For example, the Section 409A regulations would treat the payment of a bonus simultaneously with the employee's relinquishment of an equivalent amount of deferred compensation under the 409A plan as a prohibited acceleration. Similarly, granting a loan to an employee that is secured by an offset under the 409A plan would also violate the anti-acceleration rule.

### **D. Beneficiary Payment Elections**

The time and form of payment election for death or survivor benefits payable to a beneficiary must generally be made at the same time as the employee's payment election (e.g., whether the employee's beneficiary will receive a lump sum or an annuity). However, the Section 409A regulations allow an employee to subsequently change beneficiaries so long as the change does not affect the time or form of payment.

### **E. Payment Deferral Elections**

Changes in payment options must be made at least 12 months prior to the first payment and postpone the first payment a minimum of five years. For example, suppose an employee initially elects to receive deferred compensation in a lump sum at age 65 but now wants to change to installment payments. The employee must make the payment deferral election by age 64 and cannot receive the first installment payment until age 70.

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<sup>4</sup> Payments made on separation from service, disability, death, change of control, etc. would not violate the anti-acceleration rule if the 409A plan provided for payments upon the occurrence of these events.

A change in the form of a payment from one type of life annuity to another life annuity with the same date for the first annuity payment is not considered a change in the time and form of payment if the annuities are actuarially equivalent. Generally, certain features (e.g., cash refund) are disregarded in determining whether the annuity is a life annuity but not in determining actuarial equivalence. However, the value of a joint and survivor annuity subsidy may be disregarded in determining actuarial equivalence if the amount of annuity, both before and after the first death, does not exceed the amount that would be paid under a single life annuity.

#### **F. 409A Plan Coordination with Qualified Plans**

409A plans are frequently linked to qualified plans. The final regulations continue to allow some coordination but restrict current practices, particularly in the area of the time and form of payment under the 409A plan.

##### ***1. Payment Linkage***

Until December 31, 2008, a 409A plan can continue to piggyback on the time and form of payment elections that an employee has made under a qualified plan. As of January 1, 2009, however, direct linkage of the time and form of payments between a qualified plan and a 409A plan is no longer permitted.

##### ***2. Amount Linkage***

An employee can increase or decrease elective deferrals (and other employee pre-tax contributions) under qualified plans up to the 401(k) salary reduction limit (\$15,500 for 2007 and 2008, plus where applicable the catch-up limit) without regard to the Section 409A rules. However, elective deferrals (or other pre-tax contributions) made under a qualified plan that cause decreases or increases in the amount of deferred compensation under a 409A plan in excess of the salary

reduction limit must conform to the Section 409A compensation deferral and anti-acceleration rules.

### ***3. Funding Restrictions***

An employer maintaining a 409A plan cannot fund the 409A plan for the top five officers (or certain other key employees) while any qualified defined benefit plan is in “at-risk” status because it is poorly funded or while the employer is in bankruptcy. The funding restriction also applies six months before or after an underfunded qualified defined benefit plan is terminated. The 409A plan funding restriction applies even to amounts set aside in a so-called “rabbi trust” whose assets remain subject to the employer’s creditors in bankruptcy.

## **G. Plan Terminations**

Employers can terminate a 409A plan without adverse tax consequences under Section 409A if:

- the plan termination is not proximate to a downturn in the employer’s financial health;
- the employer terminates all other similar 409A plans;
- payments under the plan are made no earlier than 12 months, and no later than 24 months, after the employer takes the necessary steps to terminate the plan; and
- the employer does not adopt another similar 409A plan for three years.

## **H. Split Dollar Illustration**

An equity split-dollar arrangement is subject to Section 409A if the employee earns a right to cash value that is payable in a later year. However, the Section 409A compensation deferral election rules are usually not relevant because employers typically make nonelective premium payments to the insurer. On the other hand, the Section 409A anti-acceleration rule and the restrictions on changing the time and form of payment could come into play. For example, the anti-acceleration rule

could be problematic if an employee could borrow the cash value from the insurance policy before employment termination.

## **V. CODE SECTION 409A EXCEPTIONS**

As suggested by the split dollar illustration, the Section 409A definition of nonqualified deferred compensation is broad and captures many arrangements that, until recently, were not considered to constitute nonqualified deferred compensation. To provide relief, Section 409A regulations create exceptions for many arrangements, although the exceptions are frequently packaged with their own restrictions. Several of the more noteworthy exceptions are described below.

### **A. Short-Term Deferral Exception**

The Section 409A regulations carve out an exception for deferred compensation that is paid within 2 ½ months after the employee's or employer's tax year in which the deferred compensation is earned or, if later, becomes vested. This is known as the "short-term deferral exception." Employment agreements may be modified through December 31, 2008 to comply with the exception for short term deferrals or the exceptions under the final regulations for distributions payable solely upon an involuntary termination.

### **B. Severance Pay**

Section 409A does not apply to severance pay (called "separation pay" in the Section 409A regulations) if certain conditions are satisfied, including:

- the pay is available only if the employee's separation from service is (a) involuntary or (b) voluntary for a good reason<sup>5</sup>,

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<sup>5</sup>A "good reason" includes a material diminution in the employee's (or his or her supervisor's) base compensation, duties, or budget, according to the safe harbor definition in the Section 409A regulations. It also includes a material change in

- the pay is limited to two times the employee's annualized compensation rate for the year prior to separation or, if less, two times the compensation limit for qualified retirement plans (e.g., \$225,000 in 2007, and \$230,000 in 2008) for the year in which the separation occurs, and
- the payments are completed no later than the end of the second year beginning after the employee separates from service.

### **C. Restricted Stock**

An employee who receives restricted property (e.g., employer stock) in connection with the performance of services is not subject to Section 409A, even if taxation is deferred under Section 83. Generally, the value of restricted stock is not included in an employee's gross income under Section 83 so long as the restrictions make the stock subject to a substantial risk of forfeiture.

### **D. Stock Options**

Section 409A does not apply to options granted under an employee stock purchase plan or incentive stock options (i.e., statutory stock options). Nonstatutory stock options and stock appreciation rights also are not subject to Section 409A if they are granted or are awarded at fair market value and if there is no additional tax deferral feature after employees exercise them. However, extending the exercise period for terminated employees will not be treated as an additional deferral feature

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the employee's geographic location or material breach of the employment agreement. In addition, the employee must provide the employer with notice of the good reason condition within 90 days of its initial existence, and the employer must have at least 30 days to remedy the good reason condition. The severance pay must be paid within two years following the initial existence of the good reason condition. The amount, time and form of payment for a voluntary good reason separation must be identical to the amount, time and form of payment for an involuntary separation. Finally, these good reason requirements must be incorporated into the severance plan.

if the extension does not exceed the original exercise period or, if less, 10 years from the date of grant. For publicly-traded companies, fair market value must generally be based on market prices in actual transactions. For non-publicly traded companies, a valuation expert must determine the fair market value taking into account all available relevant information, including the present value of anticipated future cash flows, recent arm's length transactions in the stock, control premiums, and discounts for lack of marketability.

Through December 31, 2008, discounted stock option and stock appreciation rights that are subject to Section 409A may be exchanged for non-discounted stock rights if the cancellation and re-issuance does not involve an exchange of cash or vested property in the year of cancellation. Such an exchange is not available for discounted rights granted to executive officers by public companies which have reported or expect to report a financial expense due to the issuance of the stock right that was not timely reported under GAAP.

## **VI. OVERVIEW OF CODE SECTION 457**

### **A. Background for Code Section 457**

Code Section 457 governs the federal tax treatment of the deferred compensation paid by any eligible employer, which is defined to include state and local governmental employers as well as tax-exempt organizations. As a matter of public policy, these special rules were deemed necessary, in part, because eligible employers are not subject to taxation and are not concerned with the tax benefits or timing of deductions. The tax treatment under Code Section 457 of an eligible employer's deferred compensation arrangement depends on whether it qualifies as a 457(b) plan or a 457(f) plan.

### **B. Definition of 457(b) Plan**

A 457(b) plan is an "eligible deferred compensation plan" under Code Section 457, which is narrowly defined to include

plans established and maintained by eligible employers that meet all the specific requirements of Section 457(b) of the Code. Because of the nature of these requirements, 457(b) plans are designed to be defined contribution arrangements.

### **C. Definition of 457(f) Plan**

Conversely, a 457(f) plan is broadly defined to encompass every type of agreement or arrangement of an eligible employer providing for the deferral of compensation, other than an eligible deferred compensation plan. For this reason, 457(f) plans are also referred to as “ineligible deferred compensation plans.” Even though a governmental employer or tax-exempt organization may not have intended to establish a formal “plan” which defers the compensation of one or more employees, any such informal arrangement will be viewed as a 457(f) plan for federal tax purposes if it does not satisfy the requirements of Code Section 457(b). Since they are often used to supplement the contributions made under 457(b) plans, 457(f) plans are often designed as defined contribution arrangements. However, 457(f) plans can also be designed as defined benefit plans, such as a supplemental executive retirement plan (a “457(f) SERP”).

### **D. Limits on Scope of Code Section 457**

Even though these arrangement involve the deferral of compensation, the rules under Code Section 457 do not apply to tax-favored plans which are qualified under Code Sections 401(a) or 403, the portion of plans which consist of a transfer of property described in Section 83, the portion of plans which consist of a 402(b) trust, qualified governmental excess benefit arrangements, and applicable employment retention plans. For purposes of Code Section 457, certain types of arrangements are treated as not providing for the deferral of compensation, including but not limited to bona fide vacation leave, sick leave, severance, disability and death benefit plans.

### **E. Interaction of 457 and 409A**

The restrictions and limitations under Code Section 409A apply to 457(f) plans to the extent any such plan provides for the “deferral of compensation” within the meaning of Code Section 409A. As clarified by the IRS in Notice 2007-62, a 457(f) plan that allows participants to defer the payment of benefits beyond their vesting date is generally subject to Code Section 409A (as further discussed in Section VII.C.1).

Conversely, if a 457(f) plan does not provide for the deferral of compensation for purposes of Code Section 409A, the 409A-related limitations on deferrals and distributions would not apply. For example, a 457(f) plan that provided for the full and immediate payment of benefits upon vesting would not be deemed to provide for the deferral of compensation within the meaning Code Section 409A.

Code Section 409A does not apply to 457(b) plans (as discussed above in Section II.A).

## **VII. OVERVIEW OF 457(f) PLANS**

### **A. Eligibility and Participation**

A tax-exempt organization must limit participation in its 457(f) plan to a “top hat” group, or a select group of management or highly compensated employees. The plan must restrict eligibility in this manner in order to avoid being subject to the participation, vesting and funding requirements under the Employee Retirement Income Security Act of 1974, as amended (“ERISA”). It is particularly important for a 457(f) plan to avoid being subject to ERISA’s funding requirement. If such plan were funded, interests in the plan would become taxable to participants in accordance with Sections 83 and 402(b) of the Code, and the favorable tax treatment of earnings would no longer be available to participants (as further discussed in Section VII.C.).

On the other hand, governmental plans are automatically exempt from ERISA. Thus, a governmental employer has the flexibility to include any employee or group of employees in its 457(f) plan.

## **B. Vesting and Taxation**

Code Section 457(f) provides that benefits are taxable to the participant in the first calendar year in which there is no substantial risk of forfeiture. However, even though 457(f) plan benefits are taxed upon vesting, any earnings on such benefits after the vesting date will accumulate on a tax-deferred basis if the applicable conditions are met. Treas. Reg. Section 1.457-11(a)(3) provides that earnings credited on such vested benefits will be subject to taxation only when paid or made available to the participant, provided that the interest of the participant in any assets of the employer (including amounts deferred under the plan) is not senior to the employer's general creditors.

## **C. Deferrals and Contributions**

457(f) plans may be designed to allow participants to make pre-tax payroll contributions, which may be supplemented with non-elective employer contributions. Alternatively, 457(f) plans can be designed to permit nonelective employer contributions only or provide for defined benefits. No contribution or benefit limits are imposed under the Code with respect to 457(f) plans.

### ***1. Deferral Restrictions Under 409A for Certain 457(f) Plans***

If a 457(f) plan provides for the deferral of compensation within the meaning of Code Section 409A, any pre-tax deferral elections made by the participants must be made in accordance with the requirements of Code Section 409A. Thus, the participants of such plan generally must make a compensation deferral election prior to the year in which the compensation is earned, and employees newly eligible to

participate in a 457(f) plan can make their initial compensation deferral elections within 30 days after becoming eligible. On the other hand, such deferral rules would not apply to a 457(f) plan that was not subject to Code Section 409A.

In Notice 2007-62, the IRS clarified that a 457(f) plan which allows participants to defer the payment of benefits beyond their vesting date, generally would be subject to Code Section 409A pursuant to the following analysis:

- Under Treas. Reg. Section 1.409A-1(b), a 457(f) plan provides for the “deferral of compensation” if the employee has a legally binding right during a calendar year to compensation that, pursuant to the terms of the 457(f) plan, is or may be payable more than 2 ½ months after the end of such year (or the employer’s taxable year, if later).
- For purposes of determining whether a “deferral” occurs for 409A purposes, a 457(f) plan participant is deemed to receive payment when amounts are taxed. Since the participant is taxed and deemed to receive payment upon vesting, a “deferral” does not occur even if actual payment is delayed beyond the vesting date.
- However, since earnings accumulate under a 457(f) plan on a tax-deferred basis after the vesting date, Code Section 409A generally would apply to such plan if it allowed participants to defer payment of such earnings beyond the year in which benefits vested (and the applicable 2 ½ month period).

## ***2. Pre-Section 409A Plan Design Practices***

Historically, many 457(f) plans were designed to allow an employee to make pretax deferrals and to defer the taxation of these amounts pursuant to a “rolling risk of forfeiture.” Under

this type of 457(f) plan, the benefit would remain subject to a substantial risk of forfeiture until the end of a stated employment period, but participants would have the ability to delay the vesting date (and taxation of benefits) indefinitely by making elections to extend the vesting period at regular intervals.

Treas. Reg. Section 1.409A-1(d)(1) provides that any extension of a period during which compensation is subject to a risk of forfeiture is generally disregarded for purposes of determining whether such compensation is subject to a substantial risk of forfeiture under Section 409A. Thus, a 457(f) plan with a rolling risk of forfeiture generally would be viewed as providing for the “deferral of compensation” for Section 409A purposes, even if by its terms it provided for the full and immediate payment of benefits immediately after the extended vesting date. As a result, such 457(f) plan would be subject to the applicable limitations on deferral elections and distributions as mandated by Code Section 409A.

In Notice 2007-62, the IRS announced that it would be issuing guidance under Code Section 457(f) regarding the definition of a “substantial risk of forfeiture” under rules similar to those set forth under Treas. Reg. Section 1.409A-1(d). Upon issuance of such guidance, which is to take effect on a prospective basis only, benefits under a 457(f) plan with a rolling risk of forfeiture would become taxable upon the lapse of the original vesting period, without regard to any extensions elected by the participant.

#### **E. Funding**

457(f) plans are legally “unfunded,” although they may be de facto funded through a “rabbi trust” arrangement. This means the contributions and investment earnings remain the property of the employer and, therefore, are subject to the claims of the employer’s creditors until paid to a participant.

#### **F. Distributions and Plan Design**

As a matter of plan design, 457(f) plans may provide for distribution of benefits in full as of the vesting date. Alternatively, they may provide for distribution at a later date, and/or may provide for the payment of benefits in installments or other payment forms. If the 457(f) plan provides for the payment of benefits after the applicable vesting date, such plan could by design provide for a limited partial distribution that is sufficient to satisfy the required income tax withholding due on such vesting date.

If a 457(f) plan provides for the deferral of compensation within the meaning of Code Section 409A (as discussed above in Section VII.C.1), any distributions from the plan must be made in accordance with the requirements of Code Section 409A.

## **VIII. OVERVIEW OF 457(b) PLANS**

### **A. Eligibility and Participation**

A governmental 457(b) plan may include any employee or group of employees without limitation.

In contrast, a tax-exempt organization must limit participation in its 457(b) plan to a “top hat” group, or a select group of management or highly compensated employees, to avoid being subject to the funding requirements under ERISA. It is critical for a 457(b) plan to avoid such funding requirements, because Code Section 457 expressly prohibits the funding of 457(b) plans maintained by tax-exempt organizations.

### **B. Deferrals and Contributions**

A 457(b) plan gives participants the ability to make pre-tax payroll deferrals. A 457(b) plan by design may also provide for non-elective contributions from the employer. Generally,

the combination of pre-tax payroll deferrals and non-elective employer contributions for a calendar year cannot exceed the IRS annual limit (\$16,500 in 2009). Because the annual limit takes into account both elective and non-elective contributions, many 457(b) plans by design only permit elective contributions. In accordance with Code Section 457(b)(4), compensation will be deferred for any calendar month only if a deferral agreement has been entered into before the beginning of such month.

During the last three calendar years ending before a participant's normal retirement age under the 457(b) plan, the limit (the "Catch-up Limit") can be increased by any unused annual limit from prior years while the plan was in effect up to an amount equal to double the IRS annual limit (\$33,000 in 2009).

With respect to governmental 457(b) plans only, a participant who is age 50 or older may make catch-up contributions in accordance with Code Section 414(v). If a participant in a governmental 457(b) plan is eligible for both the Catch-up Limit and for catch-up contributions under Section 414(v), the participant may take advantage of the higher of the two limits (which may not be combined).

### **C. Vesting**

457(b) plans customarily provide for full and immediate vesting for all elective deferrals and any non-elective contributions. Any vesting requirement with respect to non-elective employer contributions is likely to result in a violation of the IRS annual limit, since any contributions and earnings thereon vesting in the same year must be combined and counted against the IRS annual limit under the applicable Code Section 457 rules.

### **D. Funding**

Code Section 457 requires governmental 457(b) plans to be funded and held in trust for the exclusive benefit of participants.

However, 457(b) plans maintained by tax-exempt organizations must be legally unfunded, meaning that the contributions and investment earnings must remain the property of the employer and, therefore, remain subject to the claims of the employer's creditors until paid to a participant. However, a nongovernmental 457(b) plan may be informally funded through a "rabbi trust" arrangement.

#### **E. In-Service Withdrawals and Distributions**

In order to satisfy the requirements under Code Section 457, a 457(b) plan may not make benefits available to participants earlier than:

- the calendar year in which the participant attains age 70 1/2,
- severance from employment, and
- a financial hardship which constitutes an "unforeseeable emergency".

Minimum required distributions must commence under a 457(b) plan in accordance with the requirements of Code Section 401(a)(9).

Governmental 457(b) plans are also subject to the substantive requirements under Code Section 401(a)(31) for eligible rollover distributions.

#### **F. Taxation**

Benefits under a 457(b) plan maintained by a tax-exempt organization are taxed when distributed or made available,

whichever comes first. However, benefits under a governmental 457(b) plan are taxed when distributed.

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