A Game Plan for Retaining and Rewarding Valued Collegiate Coaches in a Recessionary Time

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In today’s world of collegiate coaching, recruiting, retaining and rewarding valued coaches and key athletic personnel for a fixed or stated period of time is a priority for colleges and universities. This important objective is particularly difficult to achieve in a recessionary time; however, it may be realized by using a financial tool known as a nonqualified deferred compensation arrangement. Such an arrangement could be structured to attract a coach to an available position by deferring compensation, retain a valued coach by providing a valuable future benefit, or reward a coach for services performed by providing deferred incentive compensation. This financial tool, structured properly, would also provide a coach or key athletic personnel with the desire and the incentive to form a long-term relationship with an institution, clearly a successful game plan providing winning formula.

In general, a nonqualified deferred compensation arrangement is merely an unsecured, unfunded promise to pay compensation in the future. Each arrangement is likely to vary greatly from another arrangement in design and structure to achieve the desired objectives regarding the payment of future compensation. Considerations that may affect the structure of an arrangement...
include the current and future income needs of the key employee, the purpose and amounts to be deferred, the desired tax treatment of deferred amounts, and the desired objectives of the employer to be achieved with respect to the arrangement (e.g., payment based upon a future event or the performance of services). The arrangement may also be structured to involve an employer owned trust or investment vehicle or other mechanism to provide the desired incentive for the employee and a level of security for the employee.

**Nonqualified Deferred Compensation Arrangements Generally**

A nonqualified deferred compensation arrangement is a contractual arrangement between the employer and the employee, or employees, covered by the arrangement. A nonqualified deferred compensation arrangement may be structured in whatever form achieves the goals of the parties; as a result, the arrangements vary greatly in design and structure. Considerations that may affect the structure of the arrangement are the current and future income needs of the employee, the desired tax treatment of deferred amounts, and the desired objectives of the employer to be achieved with respect to the arrangement.

In its simplest form, a nonqualified deferred compensation arrangement is merely an unsecured, unfunded promise to pay a stated dollar amount at some point in the future. However, in most cases, such a simple arrangement does not meet the needs of the parties to the arrangement; thus, the typical nonqualified deferred compensation arrangement is more complicated and may involve a funding vehicle or other mechanism to provide the desired level of security for the covered coach.

A nonqualified deferred compensation arrangement may provide for the deferral of base compensation (i.e., salary), incentive compensation (e.g., compensation for achieving performance objectives, tenure objectives, academic objectives), or other compensation (e.g.,
retirement, royalties). The arrangement may permit the coach to periodically elect, generally on an annual basis, whether to defer current compensation to a future year or to receive it currently, similar to a salary reduction or cash-or-deferred section 401(k) plan. Alternatively, the arrangement may be structured to provide for compensation that is payable only upon the occurrence of a future event, and not currently.

A nonqualified deferred compensation arrangement may be structured as an account balance plan or as a defined benefit plan that provides for specified benefits to be paid in the future. Under an account balance plan structure, depending upon whether the arrangement is unfunded or funded, a hypothetical or actual account is maintained for the coach, to which specified amounts, adjusted by a factor for earnings or losses, are credited. The coach may be permitted to participate in the investment of the amounts credited to the hypothetical or actual account to achieve a desired level of benefit with respect to the amounts credited to that account. The benefits to which the coach may be entitled are based upon the amount credited to the account. Under a defined benefit plan structure, the terms of the nonqualified deferred compensation arrangement specify the amount of benefits (or formula for determining benefits) that may be paid to the coach in the future. No account is established for the coach; instead, an actuary determines the amounts to be set aside or invested to achieve the promised benefit payable in the future as a lump sum or as a schedule of payments.

**Top-Hat Plans**

The structure of a nonqualified deferred compensation plan is commonly in the form of a “top-hat” plan. A top-hat plan is a term reserved for certain nonqualified deferred compensation plans that are exempt from most of the substantive requirements of the Employee Retirement
Income Security Act of 1974.\(^1\) A top-hat plan is a plan that is “unfunded and is maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees.”\(^2\) ERISA does not provide statutory definitions of the terms “select group,” “management,” or “highly compensated employees,” and the Department of Labor has not issued regulations defining those terms. Employees sometimes claim ERISA protection (e.g., vesting or funding) for a benefit under a nonqualified deferred compensation arrangement by arguing that it is not a top-hat plan because the arrangement does not satisfy the terms of a top-hat plan; however, most nonqualified deferred compensation arrangements are intended to fall under the top-hat plan exemption.

A top-hat plan is exempt from the ERISA requirements relating to participation and vesting, funding, and fiduciary responsibility. A top-hat plan is not exempt from the reporting and disclosure requirements or the administration and enforcement provisions of ERISA, although simplified reporting procedures are available.

**Section 409A**

Section 409A of the Internal Revenue Code (the “Code”) was added to the Code by section 885 of the American Jobs Creation Act of 2004\(^3\), which generally provides that unless certain requirements are met, amounts deferred under a nonqualified deferred compensation plan for all taxable years are currently includable in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income.

Section 409A generally requires that a nonqualified deferred compensation plan provide that compensation for services performed during a taxable year of a service provider may be deferred at the election of a service provider only if the election to defer such compensation is

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\(^1\) Public Law 93-406.

\(^2\) Sections 201(2), 301(a)(3), and 401(a)(1) of ERISA.

\(^3\) Public Law 108-357 (118 Stat. 1418).
made and becomes irrevocable no later than the end of the preceding taxable year, or at such other time as provided in Treasury regulations. An important exception to this general rule is for “performance-based compensation,” a term to be defined in regulations issued by the IRS. In the case of performance-based compensation based on services performed over a period of at least 12 months and written performance criteria established no later than 90 days after the start of the service period, an initial election to defer performance-based compensation may be made on or before the date that is six months before the end of the performance period, provided that the service provider performs services continuously from the later of the beginning of the performance period or the date the performance criteria are established through the date an election is made, and provided further that in no event may an election to defer performance-based compensation be made after such compensation has become readily ascertainable. This will not, however, override the constructive receipt doctrine and the constructive receipt rules will continue to apply.

Distributions from a nonqualified deferred compensation plan may be allowed only upon separation of service, death, a time or a fixed schedule specified under the plan, change in the ownership or effective control of the corporation, occurrence of an unforeseeable emergency, or if the service provider becomes disabled.

No acceleration of distributions may be allowed except as provided in the regulations issued by the IRS. Therefore, an early distribution to a plan participant of deferred amounts

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5 Section 1.409A-2(a)(8) of the Treasury Regulations.
6 Section 1.409A-3(a)(1) of the Treasury Regulations.
7 Section 1.409A-3(a)(3) of the Treasury Regulations.
8 Section 1.409A-3(a)(4) of the Treasury Regulations.
9 Section 1.409A-3(a)(5) of the Treasury Regulations.
10 Section 1.409A-3(a)(6) of the Treasury Regulations.
11 Section 1.409A-3(a)(2) of the Treasury Regulations.
12 Section 1.409A-3(j) of the Treasury Regulations.
associated with a plan suspension or a financial penalty (commonly referred to as “haircut” provisions) will generally not be permitted. Also, changes in the form of distribution that accelerate payments will generally be prohibited.

A nonqualified deferred compensation plan may allow changes in the time and form of distributions subject to certain requirements. A plan may allow a subsequent election to delay the timing or change the form of distributions only if: (1) the plan requires that the election cannot be effective for at least 12 months after the date of the election; (2) in the case of an election related to a payment that is not a payment on account of disability or on account of death or on account of the occurrence of an unforeseeable emergency, the plan requires that the additional deferral with respect to which such election is made is for a period of not less than five years from the date such payment would otherwise have been made; and (3) in the case of any election related to a payment at a specified time or pursuant to a fixed schedule, the plan requires that an election related to a distribution to be made at a specified time may not be made less than 12 months prior to the date of the first scheduled payment.  

Section 457 Plans

Section 457 of the Code governs the tax treatment of nonqualified deferred compensation plans maintained by a state, political subdivision of a state (i.e., a local government), and any agency or instrumentality of a state or political subdivision of a state, and any other tax-exempt organization other than a governmental unit (i.e., the federal government). Section 457(a) provides that any amount of compensation deferred by an employee or an independent contractor under an “eligible deferred compensation plan,” as defined in section 457(b), of a state or local government or a tax-exempt organization is includable in income for federal tax purposes only.

13 Section 1.409A-2(b)(1) of the Treasury Regulations.
for the taxable year in which such compensation is paid or otherwise made available to such individual.

If a plan does not meet the statutory definition of an eligible deferred compensation plan, the amounts held are not deferred for tax purposes and instead are taxable to the individual in the year the amounts are no longer subject to a substantial risk of forfeiture pursuant to section 457(f). For this purpose, the rights of a person to compensation are subject to a substantial risk of forfeiture if such person’s rights to such compensation are conditioned upon the future performance of substantial services. Accordingly, under an “ineligible plan,” once an individual has performed all services necessary to receive payment at any point in the future, the deferred amount is taxed.

The explanation of the provisions in both section I of the preamble to the proposed regulations issued by the Internal Revenue Service and the Department of the Treasury with respect to the application of section 409A\textsuperscript{14} and section II of the preamble to the final regulations issued by the Internal Revenue Service and the Department of the Treasury regarding deferred compensation plans as defined under section 409A\textsuperscript{15} provide that section 409A does not apply to eligible deferred compensation plans under section 457(b). However, section 409A does apply to nonqualified deferred compensation plans to which section 457(f) applies, separately and in addition to the requirements applicable to such plans under section 457(f). Section 409A(c) provides that nothing in section 409A prevents the inclusion of amounts in gross income under any other provision of the Code. Section 409A(c) further provides that any amount included in gross income under section 409A will not be required to be included in gross income under any other Code provision later than the time provided in section 409A. Accordingly, if in a taxable

\textsuperscript{14} 70 Fed. Reg. 57930, October 4, 2005.  
year an amount subject to section 409A (but not required to be included in income under section 409A) is required to be included in gross income under section 457(f), that amount must be included in gross income under section 457(f) for that taxable year. Correspondingly, if in a taxable year an amount that would otherwise be required to be included in gross income under section 457(f) has been included previously in gross income under section 409A, that amount will not be required to be included in gross income under section 457(f) for that taxable year.

Generally, amounts deferred under a nonqualified deferred compensation arrangement of a state and local government and a tax-exempt employer are currently included in an employee’s income unless the arrangement is an eligible deferred compensation plan described in section 457(b) of the Code. The maximum annual deferral under eligible deferred compensation plan is the “applicable dollar amount” under section 457(e)(15), which is $16,500 for 2009 (adjusted for cost of living adjustments at the same time and in the same manner as under section 415(d) of the Code, and any increase which is not a multiple of $500 will be rounded to the next lowest multiple of $500), or the employee’s total includable compensation, if less.\(^\text{16}\) In general, amounts deferred under a section 457(b) plan may not be made available to a plan participant before the earlier of: (1) the calendar year in which the participant attains age 70½, (2) when the participant has a severance from employment with the employer, or (3) when the participant is faced with an unforeseeable emergency.\(^\text{17}\) Amounts deferred under an eligible deferred compensation plan of a state and local government and a tax-exempt employer are includable in the income of the participant when paid or otherwise made available to the participant. And, except for a state and local governmental entity, amounts deferred under a section 457(b) plan must remain the property of the employer, subject only to the claims of the general creditors of the employer.

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\(^{16}\) Section 457(b)(2) of the Code.

\(^{17}\) Section 457(d)(1) of the Code.
If compensation is deferred under a plan of a tax-exempt employer that is not an eligible deferred compensation plan (an “ineligible plan” subject to section 457(f)), the deferred amounts are includable in the income of a participating employee when the deferred compensation is not subject to a substantial risk of forfeiture, even if the deferred compensation is not funded. An ineligible plan has more flexibility with regard to the amount that may be deferred (so long as the compensation is reasonable and not excessive, which would then subject the deferred amounts to intermediate sanctions under the Code), but compensation deferred under the ineligible plan is includable in the gross income of the employee for the first taxable year in which there is no substantial risk of forfeiture of the right to such compensation. An employee’s right to such deferred compensation is subject to a substantial risk of forfeiture if the employee’s right to full enjoyment of the deferred amount is conditioned upon the future performance of substantial services by the employee.

An ineligible plan is typically used to provide a significant benefit amount to a participating employee, such as a valuable coach, if that employee remains with the employer for stated period of time and provides substantial services in the achievement of specific performance objectives during that period of time. If the participating employee terminates employment prior to the fulfillment of the performance objectives, the benefit amount is forfeited. Consequently, an ineligible plan is generally the plan used to structure the desired financial arrangement for a coach.

Importantly, as stated earlier, an eligible plan that satisfies the requirements of section 457(b) of the Code will not be subject to the new rules under section 409A of the Code, but an ineligible plan described in section 457(f) of the Code will generally be subject to the new rules under section 409A of the Code.
Section 457(b) Plans, Section 401(k) Plans, and Section 403(b) Plans

For some time, tax-exempt organizations, such as colleges and universities, have been concerned that the limitations imposed on them with respect to qualified plans and non-qualified plans place them at a competitive disadvantage when it comes to attracting and retaining talent.

The Economic Growth and Tax Relief Reconciliation Act of 2001\(^\text{18}\) repealed the provision of the Code which required deferrals under a plan described in section 401(k) of the Code or a plan described in section 403(b) of the Code and a plan described in section 457(b) of the Code to be combined for purposes of the deferral limits, opening the door to a very useful planning opportunity for tax-exempt organizations. As a result, amounts deferred under a section 457(b) plan are not required to be combined with amounts deferred under a section 403(b) plan or a section 401(k) plan for purposes of applying the deferral limits under the Code. For example, in 2009, a participant in a section 401(k) plan and a section 457(b) plan could elect to defer up to $16,500 under the section 401(k) plan and an additional $16,500 under the eligible section 457 plan, thereby deferring up to $33,000 for 2009. Additional “catch-up” deferrals may be available for a participant who is at least 50 years old.

To pursue this planning opportunity, a tax-exempt organization that has already adopted a section 401(k) plan or a section 403(b) plan would need to adopt a section 457(b) plan and allow management level highly compensated employees to participate in both plans.

An ineligible employee benefit plan described in section 457(f) of the Code may also be adopted along with an eligible plan described in section 457(b), a section 401(k) plan or a section 403(b) plan when designing compensation arrangements for a coach.

\(^{18}\) Public Law 107-16.
Intermediate Sanctions

The intermediate sanctions of section 4958 of the Code are particularly important in the consideration of the plans that may be adopted and put into effect and the compensation provided to highly compensated or management level employees pursuant to those plans.

In general, under section 4958 of the Code, any “disqualified person” who benefits from an excess benefit transaction with an “applicable tax-exempt organization” is liable for a tax of 25% of the excess benefit. The person is also liable for a tax of 200% of the excess benefit if the excess benefit is not corrected by a certain date. A “disqualified person” is generally defined as a person in a position to exercise substantial influence over the affairs of the applicable tax-exempt organization. A disqualified person is defined in section 53.4958-3 of the Treasury Regulations to include any person who, regardless of title, has ultimate responsibility for implementing the decisions of the governing body or for supervising the management, administration, or operation of the organization. A person who serves as president, chief executive officer, or chief operating officer would generally have this ultimate responsibility. An “applicable tax-exempt organization” is an organization described in section 501(c)(3) of the Code or section 501(c)(4) of the Code and exempt from tax under section 501(a) of the Code.

The IRS announced in News Release 2004-106, issued August 10, 2004, that it has launched a new enforcement effort to identify and halt abuses by tax-exempt organizations that pay excessive compensation and benefits to their officers or other insiders. As part of the Tax Exempt Compensation Enforcement Project, the IRS said that it would contact nearly 2,000 charities and foundations to seek more information about their compensation practices and procedures. The IRS said that the enforcement project would consist of examinations as well as other contacts. The stated purposes of the project were to: (i) address the compensation of
specific individuals or instances of questionable compensation practices, (ii) increase awareness of tax issues as organizations set compensation in the future, and (iii) learn more about the practices organizations are following as they set compensation and report it to the IRS and the public on their annual Form 990 returns.

The IRS said that the initiative would focus on particular areas including the compensation of specific officers and various kinds of insider transactions, such as loans and the sale, exchange or leasing of property to officers and others. The IRS also said that it would focus on Form 990 reporting regarding compensation, including how organizations answered the question about excess benefit transactions. Accordingly, in the determination of the plans to be adopted and implemented with respect to providing deferred compensation to a coach to take into account the concerns of the IRS, careful consideration should be given to the design of the plans to provide the desired benefits, the total compensation and benefits to be payable, and the proper approval and documentation of the benefit plans.

**Section 457 Requirements**

Under section 457, individuals who provide services for a state or local government or a tax-exempt organization that has an eligible deferred compensation plan described in section 457(b) are able to defer the inclusion in income as long as the deferral does not exceed the prescribed annual limitations. Section 457(b) establishes specific guidelines that the plan must meet in order to attain eligibility status and receive the tax advantage afforded such plans. For those that meet the requirements, section 457(b) allows exclusion of deferred compensation from income until it is paid or otherwise made available to the participant.
The IRS stated in the preamble to the proposed regulations issued by the IRS under section 457 on May 8, 2002,\textsuperscript{19} that an eligible plan must satisfy the requirements of section 457(b) and related provisions both in form and in operation. An eligible plan must be established in writing, must include all of the material terms for benefits under the plan, and must be operated in compliance with the requirements reflected in the regulations. The IRS also stated in the proposed regulations that, of course, plan sponsors retain flexibility in determining whether to provide certain design options permitted under section 457(b). For example, although the proposed regulations permit certain in-service distributions of smaller account balances in accordance with section 457(e)(9), an eligible plan is not required to offer participants this distribution option. However, any optional features incorporated into an eligible plan must meet the applicable requirements of section 457 and the regulations in both form and operation.

The IRS also commented in the preamble to the proposed regulations that all amounts deferred under an eligible governmental plan are required to be set aside in a trust, custodial account, or annuity contract for the exclusive benefit of participants and their beneficiaries. However, under section 457(b)(6), all amounts deferred under an eligible plan of a tax-exempt employer are required to be “unfunded.” This requirement for an eligible plan of a tax-exempt employer does not alter any provision of Title I of ERISA.\textsuperscript{20} Accordingly, an eligible plan of a tax-exempt employer may be subject to certain of the requirements of Title I. In the case of an eligible plan of a tax-exempt employer that is subject to Title I of ERISA, compliance with the exclusive purpose, trust, funding, and certain other rules will cause the plan to fail to satisfy section 457(b)(6).

\textsuperscript{19} 67 Fed. Reg. 30826, 30827 (May 8, 2002).
Section 457(a) provides that any amount of compensation deferred under an eligible deferred compensation plan, and any income attributable to the amount so deferred, will be includable in gross income only for the taxable year in which the compensation or other income (i) is paid to the participant or other beneficiary, in the case of a plan of an eligible employer that is a state, political subdivision of a state, or any agency or instrumentality of a state or political subdivision of a state, and (ii) is paid or otherwise made available to the participant or other beneficiary in the case of a plan of an eligible employer that is any other tax-exempt organization.

Sections 457(b) and 457(e)(1) of the Code provide that the plan must be established and maintained by (a) a state, political subdivision of a state, or agency or instrumentality of a state or political subdivision of a state, or (b) any other organization (other than a governmental unit) exempt from tax under subtitle A (Income Taxes).

In Notice 2005-58, the IRS stated that section 457 provides rules regarding the taxation of a nonqualified deferred compensation plan of an eligible employer. For this purpose, the term “eligible employer” is defined in section 457(e)(1)(A) as a state, a political subdivision of a state, and any agency or instrumentality of a state or political subdivision of a state. In addition, section 457(e)(1)(B) includes as an eligible employer “any other organization (other than a governmental unit) exempt from tax under” subtitle A of the Internal Revenue Code. Section 1.457-2(e) of the Income Tax Regulations provides that the term “eligible employer” does not include “the federal government or any agency or instrumentality thereof.” Therefore, the IRS stated that agencies or instrumentalities of the federal government are not eligible employers described in section 457(e)(1)(A) or (B).
Section 457(b)(2) provides that the maximum amount that may be deferred under an eligible deferred compensation plan is the lesser of (i) 100% of the participant’s includable compensation, or (ii) “the applicable dollar amount.” Section 457(e)(15) provides that “the applicable dollar amount” is an amount determined in accordance with a prescribed schedule; for taxable years beginning after December 31, 2006, the amount is $15,000 which is adjusted for cost-of-living increases at the same time and in the same manner as under section 415(d), except that the base period shall be the calendar quarter beginning July 1, 2005, and any increase which is not a multiple of $500 shall be rounded to the next lowest multiple of $500 (for 2009, $16,500).

Section 1.457-4 of the Treasury Regulations explains the annual limits that apply to annual deferrals under eligible plans. The contribution limits are sometimes referred to as “plan ceilings.” Generally, the basic annual limit or plan ceiling for a year may not exceed a specified dollar amount for the year or, if less, 100% of a participant’s “includable compensation.” After 2006, the annual limit of $15,000 is adjusted for cost-of-living. As a result of the enactment of the Job Creation and Worker Assistance Act of 2002\textsuperscript{21} on March 9, 2002, the calculation of includable compensation is no longer reduced by the exclusions from gross income under sections 402(g), 125, 132(f), and 457 of the Code. Therefore, for years beginning after December 31, 2001, includable compensation is no longer reduced by elective deferrals to an eligible plan. If a participant’s includable compensation is less than the applicable dollar limit, the dollar amount equal to 100% of includable compensation is the basic annual limit for the participant.

An eligible plan may also permit certain “catch-up” contributions. First, in accordance with section 414(v) of the Code, a plan may allow a participant who attains age 50 by the end of the year to elect to have an additional deferral for the year. The additional amount permitted

\textsuperscript{21} Public Law 107-147, 116 Stat. 21.
under the age 50 catch-up for 2009, $5,500. Final regulations issued by the IRS under section 414(v) were published in the Federal Register on July 8, 2003, 68 Fed. Reg. 40510.

An eligible plan may also permit a larger catch-up amount in the last three years ending before the participant attains normal retirement age pursuant to section 457(b)(3). The amount of this special section 457 catch-up is two times the basic annual limit (e.g., an additional $16,500 for 2009), but only to the extent the participant has not previously deferred the maximum amount under an eligible plan or similar tax-deferred retirement plan (referred to as the underutilized amount or underutilized limitation in the regulations). Alternatively, the age 50 catch-up is available in the last three years ending before the participant attains normal retirement age if the age 50 catch-up amount is larger than the special section 457 catch-up amount. Under the regulations, a participant may not elect to have the special section 457 catch-up apply more than once, unless the participant is covered by a plan of another employer.

For purposes of the special section 457 catch-up, the final regulations provide that the plan must specify the normal retirement age under the plan. A plan may define normal retirement age as any age that is on or after the earlier of age 65 or the age at which participants have the right to retire and receive, under the basic defined benefit pension plan of the state or tax-exempt entity without actuarial or similar reduction and age 70½. Alternatively, a plan may provide that a participant is allowed to designate a normal retirement age within those ages. The regulations provide a special rule for defining normal retirement age in eligible plans of qualified police or fire fighters as defined in section 415(b)(2)(H)(ii)(I), taking into account that those participants are often eligible for retirement at a younger age than other workers.

Section 457(b)(4) of the Code provides that compensation may be deferred for any calendar month only if an agreement providing for such deferral has been entered into before the
beginning of such month. The proposed regulations issued by the IRS clarify that the rules concerning agreements for deferrals operate on a cash basis. Therefore, under section 1.457-4(b) of the final Treasury Regulations issued on July 11, 2003,\textsuperscript{22} an agreement to defer compensation is valid if it is made before the first day of the month in which compensation is paid or made available. A new employee may defer compensation payable in the calendar month during which the 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 performs services for the eligible employer. An eligible plan may provide that if a participant enters into an agreement providing for deferral by salary reduction under the plan, the agreement will remain in effect until the participant revokes or alters the terms of the agreement. Nonelective employer contributions are treated as being made under an agreement entered into before the first day of the calendar month.

In *Revenue Ruling 2000-33*, the IRS addressed the question of whether a deferred compensation plan would fail to be an “eligible deferred compensation plan” described in section 457(b) of the Code merely because deferrals would be made under an arrangement whereby a fixed percentage of an employee’s compensation would be deferred on the employee’s behalf under the plan unless the employee affirmatively elected to receive the amount in cash.

Under that ruling, County M, a political subdivision of a state, maintained an eligible deferred compensation plan described in section 457(b); proposed to implement an automatic election feature in the plan under which, if a newly hired or current employee had not affirmatively elected to receive cash compensation or to have at least 2% of compensation deferred under the plan, his or her compensation would automatically be reduced by 2%; and this amount would be credited to the employee’s account in the plan. An election not to make deferrals or to defer a different percentage of compensation could be made at any time. Elections

\textsuperscript{22} 68 Fed. Reg. 41230, 41236.
filed at a later date would be effective for the month next following the date the election was filed.

In the case of a new employee, the election not to make deferrals would be effective for the first month after the individual first became an employee and for subsequent months, until superseded by a subsequent election, if filed within a reasonable period of time ending before the beginning of the month. Therefore, if a new employee filed an election to receive cash in lieu of making deferrals and the election was filed within a reasonable period ending before the beginning of the first month after the individual first became an employee, then no deferrals for that, or any subsequent, month would be made on the employee’s behalf to the plan until the employee made a subsequent affirmative election to reduce his or her compensation.

The proposed amendment would also provide that, with respect to current employees, if the employee filed an election to receive cash in lieu of making deferrals and the election was filed during the reasonable period ending on the effective date, then no deferrals for the period beginning on or after the effective date would be made on the employee’s behalf under the plan until the employee made a subsequent affirmative election to reduce his or her compensation. At the beginning of the reasonable period ending on the effective date, each current employee would receive a notice that explained the new automatic election and the employee’s right to elect to have no such deferrals made under the plan or to alter the amount of those deferrals, including the procedure for exercising that right and the timing for implementation of any such election.

Thereafter, each employee would be notified annually of his or her deferral percentage, and of his or her right to change the percentage or to elect not to make deferrals, including the procedure for exercising that right and the timing for implementation of any such election.
The IRS determined that the automatic election procedure described in the ruling would not cause a plan to fail the requirements of section 457(b)(4). The IRS stated that in the absence of an affirmative election to the contrary entered into before the beginning of the month, deferrals with respect to compensation for the month would be made pursuant to the automatic election procedure. Alternatively, if an employee made an affirmative election to change the automatic election and received a corresponding amount in cash, the employee’s affirmative election would govern any deferrals for the month. In either case, the IRS stated that deferrals for a month with respect to an employee would be clearly established before the beginning of the month, and the requirements of section 457(b)(4) would be satisfied.

Sections 457(b)(5) and 457(d) of the Code provide that amounts may not be made available to participants or beneficiaries earlier than (a) the calendar year in which the participant attains age 70½, (b) the participant’s separation from service with the employer, or (c) the participant is faced with an unforeseeable emergency (described in section 1.457-6(c) of the Treasury Regulations) and the plan satisfies the distribution requirements of section 401(a)(9). Section 457(b)(6) of the Code provides that all amounts of compensation deferred under the plan, all property and rights purchased with such amounts, and all income attributable to such amounts, property, or rights shall remain (until made available to the participant or other beneficiary) solely the property and rights of the employer, subject only to the claims of the employer’s general creditors.

If the plan fails to meet the eligibility requirements under section 457(b), then the plan is an ineligible plan and the deferred compensation is includable in income as soon as there is no substantial risk of forfeiture pursuant to section 457(f).\(^\text{23}\) However, section 457(f) excludes certain ineligible arrangements from the otherwise inevitable application of this rule and its

\(^{23}\) See Private Letter Ruling 9713014, dated December 24, 1996.
unfavorable treatment. Section 457(f)(2) lists those plans that are excluded. The list includes a plan described under section 401(a) which includes a trust exempt from tax under section 501(a), an annuity plan described in section 403, the portion of any plan which consists of a trust which is subject to section 402(b), and any property transfer subject to section 83 (property transferred for performance of services).

Section 1.457-2(k) of the Treasury Regulations provides that the term “plan” includes any agreement or arrangement between an eligible employer and a participant or participants under which the payment of compensation is deferred, whether by salary reduction or by nonelective employer contribution. The following types of plans are not treated as agreements or arrangements under which compensation is deferred: a bona fide vacation leave, sick leave, compensatory time, severance pay, disability pay, or death benefit plan described in section 457(e)(11)(A)(i) and any plan paying length of service awards to bona fide volunteers (and their beneficiaries) on account of qualified services performed by such volunteers as described in section 457(e)(11)(A)(ii). Section 1.457-4(d) of the Treasury Regulations provides, however, that an eligible plan may provide that a participant may elect to defer accumulated sick pay, accumulated vacation pay, and back pay under an eligible plan if the requirements of section 457(b) are satisfied. For example, the plan must provide that the amounts may be deferred for a calendar month only if an agreement providing for the deferral is entered into before the beginning of the month in which the amounts would otherwise be paid or made available and the participant is an employee in that month.

Section 1448 of the Small Business Job Protection Act of 1996 amended section 457 by adding a subsection (g) to section 457 which provides that a plan maintained by an eligible employer that is a state, political subdivision of a state and any agency or instrumentality of a

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24 Public Law 104-188.
state or political subdivision of a state shall not be treated as an eligible deferred compensation plan unless all assets and income of the plan are held in trust for the exclusive benefit of participants and their beneficiaries. This trust shall be treated as an organization exempt from tax under section 501(a), and notwithstanding any other applicable provision of the Internal Revenue Code, amounts in the trust shall be includable in the gross income of participants and beneficiaries only to the extent, and at the time, provided in section 457 (which over rides the economic benefit doctrine and section 83 of the Code). For purposes of this provision, custodial accounts and contracts described in section 401(f) will be treated as trusts under the rules similar to the rules under section 401(f).

Thus, all amounts deferred under a section 457 plan maintained by a state and local governmental employer have to be held in trust (or custodial account or annuity contract) for the exclusive benefit of employees. The trust (or custodial account or annuity contract) is provided tax-exempt status. Amounts are not considered made available merely because they are held in a trust, custodial account or annuity contract. This requirement does not apply to a plan in existence on the date of the enactment of the Small Business Job Protection Act of 1996 before January 1, 1999. Accordingly, under this transition rule deferrals under such a plan prior to and after the date of enactment (and earnings thereon) do not have to be held in trust (or custodial account or annuity contract) until January 1, 1999.

As a result, funds set aside in a trust used with a section 457 plan for a state or local government are not subject to tax under the economic benefit doctrine and section 83 of the Code even though the funds are to be held for the exclusive benefit of employees. Also, funds set aside in a trust in this manner would cause the section 457 plan to be considered “funded” for ERISA
purposes and subject to the requirements of Title I of ERISA but for the exclusion from Title I for governmental plans in section 4(b)(1) of ERISA.

Section 1.457-8(a) of the Treasury Regulations specifically provides that to be an eligible governmental plan, all amounts deferred under the plan, all property and rights purchased with such amounts, and all income attributable to such amounts, property, or rights, must be held in trust for the exclusive benefit of participants and their beneficiaries. The trust must be established pursuant to a written agreement that constitutes a valid trust under state law. The terms of the trust must make it impossible, prior to the satisfaction of all liabilities with respect to participants and their beneficiaries, for any part of the assets and income of the trust to be used for, or diverted to, purposes other than for the exclusive benefit of participants and their beneficiaries. Custodial accounts and annuity contracts described in section 401(f) that satisfy the requirements of section 1.457-8(a)(3) of the Treasury Regulations regarding such custodial accounts and annuity contracts are treated as trusts under the rules similar to the rules of section 401(f).

It is important to note that section 1.457-8(b) of the Treasury Regulations provides that to be an eligible plan of a tax-exempt entity, the plan must be “unfunded” and plan assets must not be set aside for participants or their beneficiaries.

In an earlier ruling issued by the IRS, Private Letter Ruling 199916037, dated January 25, 1999, the IRS addressed issues raised regarding a proposed deferred compensation plan under which an employer intended to provide benefits under section 457(b) and section 457(f) of the Code and the related trusts thereunder. The employer, a governmental entity hospital described in section 457(e)(1)(A), created the plan in order to attract and maintain primary and specialty care physicians to its area. The plan covered five physicians and each plan
participant entered into an identical employment agreement with the employer, except that certain agreements covered a 4-year period of employment while other of the agreements required a 5-year commitment. The participants agreed to be covered by the plan rather than to participate in the State retirement system where the employer was located. Under the section 457(b) portion of the plan, the participants were eligible to defer up to the limit established by section 457 for eligible plans. In addition, under the section 457(f) portion of the plan, the employer would contribute an amount totaling 6.7% of each participant’s salary, which was subject to a substantial risk of forfeiture.

Under the portion of the plan providing eligible deferred compensation benefits under section 457(b), the amounts which could be deferred by participants were within the limits set out in section 457(b), adjusted for the calendar year to reflect increases in the cost of living under sections 457(e)(15) and 415(d) of the Code, including the section 457(c) coordination of deferral provisions. A participant’s election to defer compensation under the plan was required to be filed prior to the beginning of the month in which his or her salary reduction agreement became effective.

Distribution of a participant’s deferred benefits would commence 60 days after the participant ceased to be an employee of the employer, unless the participant irrevocably elected to defer the commencement of benefits to a later date. A participant could choose among distribution options including a lump sum cash payment, periodic payments over a specified period of time made not less frequently than annually, or periodic payments over the life of the participant or beneficiary, or the joint lives of the participant and his or her beneficiary. The time and manner of benefit payout was required to meet the distribution requirements of sections
457(d) and 401(a)(9) of the Code. If the participant failed to make a timely election, distribution would commence at the time and in the manner set forth in the plan.

The plan further provided that the trustee of its assets would hold all of the section 457(b) plan assets for the exclusive benefit of the participants and their beneficiaries, and that all amounts deferred under the plan were required to be transferred to a trust meeting the requirements of section 457(g) of the Code within an administratively reasonable period of time (i.e., within 15 business days after the end of the month in which such amounts were deferred). The rights of any participant or beneficiary to payments pursuant to the plan, with respect to the benefits provided under section 457(b), were generally nonassignable and not subject to attachment, garnishment, or pledge.

The employer created a trust by an agreement in writing to hold the section 457(b) plan assets. Under the terms of the trust, all assets and income of the trust would be held for the exclusive benefit of the participants and their beneficiaries and no assets would be subject to the claims of the employer’s general creditors. The terms of the trust made it impossible, prior to the satisfaction of all liabilities with respect to plan participants and their beneficiaries, for any part of the assets and income of the trust to be used for, or diverted to, purposes other than the exclusive benefit of plan participants and their beneficiaries. The trust was a valid trust under state law.

The plan also provided benefits to the participants under section 457(f) of the Code. Under the section 457(f) portion of the plan, a participant received from the employer an annual benefit totaling 6.7% of a participant’s total salary, excluding bonuses or other compensation, only if the participant’s employment ended due to full completion of the employment contract with the employer, death, total disability, retirement at age 70½ or termination of employment by
the employer other than for cause. The employer represented that none of the participants in the plan were members of the board of directors of the employer. The board of directors of the employer had also been represented to be independent from the employer and provided with the sole legal authority of the affairs of the employer pursuant to County and State law.

To assist the employer in providing assets from which to pay the section 457(f) benefit obligations to the participants, the employer established a trust, drafted to conform to the requirements of Revenue Procedure 92-64, with an independent third party trustee, a trust to which the employer intended to contribute funds or other property from which the retirement benefits could be paid. The trustee had the duty to invest the trust assets in accordance with the terms of the trust agreement. At all times, the trust assets under the section 457(f) provisions of the plan would be subject to the claims of the employer’s general creditors if the employer became insolvent, as defined in the trust agreement. The employer’s chief executive officer and its board of trustees had the duty to inform the trustee of the employer’s insolvency. Upon receipt of such notice or other written allegations of the employer’s insolvency, the trustee would suspend the payment of the benefits with respect to the participants in the employer’s plan. If the trustee determined in good faith that the employer was not insolvent or was no longer insolvent, the trustee would resume the payment of benefits.

After a careful review of sections 83, 457, 671, and 677 of the Code, the IRS concluded that the portion of the plan providing deferred compensation under section 457(b) was an eligible deferred compensation plan as defined in section 457(b) of the Code. All assets and income of the plan described in section 457(b)(6) would be held in trust for the exclusive benefit of the participants and their beneficiaries. The IRS also concluded that the amounts of compensation deferred in accordance with the plan under section 457(b), including any income attributable to
the deferred compensation, would be includible in the recipient’s gross income for the taxable
year or years in which the amounts were paid or otherwise made available to a participant or
beneficiary in accordance with the terms of the plan.

The IRS also concluded that the trust, established with respect to the employer’s section
457(b) plan assets, was treated under section 457(g) as an organization exempt from taxation
under section 501(a).

Also, the IRS concluded that the trust, established with respect to the portion of the plan
that provided for deferred compensation under section 457(f), would be classified as a trust
under section 301.7701-4(a) of the Procedure and Administration Regulations. Because the
principal and income of the trust could be applied in discharge of legal obligations of the grantor,
the employer would be treated as the owner of the trust under section 677 of the Code.
Accordingly, there would be included in computing the taxable income and credits of the
employer all items of income, deductions, and credits against tax of the trust pursuant to section
671.

The IRS also concluded that neither the creation nor maintenance of the portion of the
plan that provided deferred compensation under section 457(f) and the trust usgd with respect to
that portion of the plan, nor the contribution of assets to the trust, would result in a transfer of
property to any participant or beneficiary nor create taxable income to any participant or
beneficiary under section 83 of the Code or section 1.83-3(e) of the Regulations. The benefits
under the portion of the plan that provided deferred compensation under section 457(f) were
subject to a substantial risk of forfeiture until the participant ended employment with the
employer under the terms of the employment contract with the employer or death, total
disability, retirement at age 70½ or termination of employment by the employer other than for
cause. Accordingly, under section 457(f)(1)(A), amounts credited by the employer under the plan were included in the gross income of a participant or his or her beneficiary in the first taxable year in which the participant ended employment with the employer under the terms of the employment contract with the employer, or because of death, total disability, retirement at age 70½ or termination of employment of the participant by the employer other than for cause.

**ERISA Requirements**

In Notice 87-13, the IRS stated that, with respect to section 457, that section 1107 of the Tax Reform Act of 1986 did not amend any provision of Title I of ERISA. Accordingly, a deferred compensation plan of a tax-exempt organization may be subject to certain of the requirements of Title I. In the case of plans that are subject to Title I of ERISA, compliance with the exclusive purpose, trust, funding and other rules will cause the plans to fail to satisfy section 457(b)(6).

This was confirmed in the preamble to the proposed regulations issued by the IRS under section 457 on May 8, 2002. In the preamble, the IRS stated that under section 457(b)(6), all amounts deferred under an eligible plan of a tax-exempt employer are required to be unfunded. This requirement for an eligible plan of a tax-exempt employer does not alter any provision of Title I of ERISA. Accordingly, an eligible plan of a tax exempt employer may be subject to certain of the requirements of Title I. In the case of an eligible plan of a tax-exempt employer that is subject to Title I of ERISA, compliance with the exclusive purpose, trust, funding, and certain other rules will cause the plan to fail to satisfy section 457(b)(6).

In *Spacone v. Atwood (In re Atwood)*, the United States Bankruptcy Appellate Panel of the Ninth Circuit held that funds held in a debtor’s section 457(b) plan account were exempt

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27 259 B.R. 158 (BAP 9th Cir. 2001).
from the debtor’s bankruptcy estate. In that case, Atwood, an employee of the City of Sacramento for more than ten years, contributed to three retirement accounts: (1) the California Public Employees Retirement System Plan (the “CALPERS Account”); (2) a deferred compensation plan pursuant to section 401(k) of the Code (the “Section 401(k) Account”); and (3) a deferred compensation plan pursuant to section 457(b) of the Code (the “Section 457(b) Account”).

The Section 457(b) Account was established pursuant to the section 457(b) plan established by the City as “a deferred compensation program for its employees that serves the interest of the City by enabling it to promote reasonable retirement security for its employees by providing increased flexibility in its personnel management system, and by assisting in attraction and retention of competent personnel.” A trust was also established and used in connection with the section 457(b) plan pursuant to section 457(g) of the Code, which provides in pertinent part that, “[a] plan . . . shall not be treated as an eligible deferred compensation plan unless all assets and income of the plan described in subsection (b)(6) are held in trust for the exclusive benefit of participants and their beneficiaries.” The trust was administered by the ICMA Retirement Corporation and the City was the trustee of the trust.

On December 20, 1999, Chariton and Jana Atwood (the “Debtors”) filed their chapter 7 petition for bankruptcy under the Bankruptcy Code. The Debtors listed as exemptions, claiming that they were “not property of [the] estate,” the Section 401(k) Account, the CALPERS Account, and the Section 457(b) Account. The bankruptcy trustee filed an objection and, after a hearing, the bankruptcy court overruled the objection and held that the Section 457(b) Account was not property of the estate. The bankruptcy trustee appealed. The issue for consideration on
appeal was whether the bankruptcy court erred in holding that the Section 457(b) Account was not property of the estate.

The bankruptcy court held that the Section 457(b) Account was not property of the estate because: (1) the section 457(b) plan established a valid trust; (2) the trust was administered by the ICMA Retirement Corporation; (3) “[o]nce an employee elects to participate in the . . . [457(b) Plan], the election is irrevocable”; and (4) participants had only limited access to the funds held in the trust pursuant to section 457 of the Code.

On appeal, the United States Bankruptcy Appellate Panel of the Ninth Circuit first reviewed the decision in *Patterson v. Shumate,* 28 in which the United States Supreme Court applied a three-part test for determining whether an interest is excluded under section 541(c)(2) of the Bankruptcy Code. Section 541(c)(2) provides that the Bankruptcy Code excludes from property of the estate interests that contain a “restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law.” First, the Court in Patterson determined that the interest was held in a valid trust. Second, the Court determined that the transfer restriction was contained in a trust instrument. Third, the Court determined that applicable nonbankruptcy law provided a means to enforce the transfer restriction. The third prong of this test could be satisfied under either federal or state law.

In this case, the court determined that it was clear that a valid trust was created. The document creating the trust expressly stated that, “[a] Trust is hereby created to hold all the assets of the Plan for the exclusive benefit of Participants and Beneficiaries.” Moreover, the trust had an anti-alienation clause expressly preventing any assignment or transfer of any payments or rights under the section 457(b) plan. Therefore, according to the court, the key issue was whether

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the transfer restriction was enforceable under California law, which in turn, depended upon the degree of control the Debtors had over the trust res.

The court determined that, in this case, the Debtors did not exercise excessive control over the trust. First, the trust was not a self-settled trust because the City, not the Debtors, was the settlor of the trust. Second, the City created the trust. Third, ICMA administered the trust. Fourth, the Debtors did not have the ability to terminate or amend the section 457(b) plan. Finally, a participant had access to the trust funds only: (1) when the participant reached the age of 70½ years; (2) at the time of separation of service; (3) upon death; or (4) in the case of an unforeseeable emergency.

Accordingly, the court held that the bankruptcy court was correct in holding that the Debtors did not have excessive control over the Section 457(b) Account and that the section 457(b) plan was a valid spendthrift trust.

However, certain plans are exempt from most or all of the provisions of Title I, such as excess benefit plans (which are nonqualified deferred compensation plans “maintained by an employer solely for the purpose of providing benefits for certain employees in excess of the limitations on contributions and benefits imposed by section 415 of the Internal Revenue Code of 1986 on plans to which that section applies, without regard to whether the plan is funded”), or top-hat plans (which are described as unfunded nonqualified deferred compensation plans “maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees”). As a result of the ERISA funding rules, a nongovernmental tax-exempt employer generally may not provide an eligible
section 457 plan (which is required to be unfunded pursuant to section 457(b)) to employees other than those in the top-hat group.²⁹

Furthermore, certain plans are not subject to Title I of ERISA. Section 4(b)(1) of ERISA specifically exempts governmental plans from ERISA requirements. Also, section 4(b)(2) specifically exempts church plans, as defined under section 3(33) of ERISA, from ERISA requirements (however, section 457(e)(13) of the Code provides that the term “eligible employer” shall not include a church (as defined in section 3121(w)(3)(A)) or qualified church controlled organization (as defined in section 3121(w)(3)(B))).

Deferral of Compensation

Generally, under section 457(b)(4), and section 1.457-4(b) of the Treasury Regulations, a section 457(b) plan must provide that compensation may be deferred for any calendar month by salary reduction only if an agreement providing for the deferral has been entered into before the first day of the calendar month in which the compensation is paid or made available. A new employee may defer compensation payable in the calendar month during which the participant first becomes an employee if an agreement providing for such deferral of compensation is entered into on or before the first day on which the participant performs services for the eligible employer.

As previously noted, section 457(b)(6) provides that all amounts of compensation deferred under the plan, all property and rights purchased with such amounts, and all income attributable to such amounts, property, or rights must remain, until made available to the participants or their beneficiaries, 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

²⁹ Sections 3(36), 4(b), 201(2) and (7), 301(x)(3) and (9), 401(x)(1) of ERISA; and DOL News Release 86527 (December 19, 1986).
employer’s general creditors. Under section 457(e)(8), gains from the disposition of property are to be treated as income attributable to that property.

Subsections (b)(2)(A) and (c)(1) of section 457 provide for a limit or ceiling of “the applicable dollar amount” which means, taxable years beginning after December 31, 2006, $15,000 adjusted for cost-of-living at the same time and in the same manner as under section 415(d), except that the base period shall be the calendar quarter beginning July 1, 2005, and any increase which is not a multiple of $500 shall be rounded to the next lowest multiple of $500 (for 2009, “the applicable dollar amount” is $16,500).

Section 1.457-4(c)(3) of the Treasury Regulations provides that, except with respect to the coordination of the section 457 catch-up and the age 50 catch-up described in section 414(v) of the Code, an eligible plan may provide that, for one or more of the participant’s last three taxable years ending before the participant attains “normal retirement age,” which term is required to be specified in the plan pursuant to section 1.457-4(c)(3)(v), the plan deferral amount, or plan ceiling, is an amount not in excess of the lesser of: twice the dollar amount in effect under section 457(b)(2); or the underutilized limitation determined under the regulations. The underutilized amount is the sum of. the plan ceiling under section 1.457-4(c)(1) regarding the maximum deferral limitation; plus the plan ceiling under section 1.457-4(c)(1) (or section 457(b)(2) for any year before the applicability date) for any prior taxable year or years, less the amount of annual deferrals under the plan for such prior taxable year or years (disregarding any annual deferrals under the plan permitted under the age 50 catch-up).

Section 1.457-4(c)(2) of the Treasury Regulations provides that in accordance with section 414(v) of the Code and the regulations thereunder, an eligible governmental plan may provide for catch-up contributions for a participant who is age 50 by the end of the year,
provided that such age 50 catch-up contributions do not exceed the catch-up limit under section 414(v)(2) for the taxable year. The maximum amount of age 50 catch-up contributions for a taxable year under section 414(v) is: $5,500 for 2009, this amount is adjusted for cost-of-living.

Section 1.457-4(c)(2) further provides that in accordance with section 414(v)(6)(C) and section 457(e)(18), the age 50 catch-up does not apply for any taxable year for which a higher limitation applies under the special section 457 catch-up. Therefore, the special section 457 catch-up described above and in section 1.457-4(c)(3) applies for any taxable year if and only if the plan ceiling taking into account sections 1.457-4(c)(1) (regarding the maximum deferral limitations) and 1.457-4(c)(3) (regarding the special section 457 catch-up) is larger than the plan ceiling taking into account section 1.457-4(c)(1) and the age 50 catch-up. Therefore, a participant who is eligible for the age 50 catch-up for a year and for whom the year is also one of the participant’s last three taxable years ending before the participant attains normal retirement age is entitled to the larger of the plan ceiling under section 1.457-4(c)(1) and the age 50 catch-up, or the plan ceiling under sections 1.457-4(c)(1) and (3) (and disregarding the age 50 catch-up).

Section 1.457-4(e) of the Treasury Regulations provides that any amount deferred under an eligible plan for the taxable year of a participant that exceeds the maximum deferral limitations provided under sections 1.457-4(c)(1) through 1.457-4(c)(3), and any amount that exceeds the individual limitation for combined annual deferrals under multiple eligible plans in section 1.457-5, constitutes an excess deferral taxable in accordance with the requirements of section 1.457-11, the tax treatment of participants under an ineligible plan described in section 457(f), for that taxable year. Therefore, an excess deferral is includable in gross income in the taxable year deferred or, if later, the first taxable year in which there is no substantial risk of forfeiture.
Section 1.457-4(e) further provides that in order to be an eligible governmental plan, the plan must provide that any excess deferrals resulting from a failure of a plan to apply the limitations of sections 1.457-4(c)(1) through 1.457-4(c)(3) to amounts deferred under the eligible plan will be distributed to the participant, with allocable net income, as soon as administratively practicable after the plan determines that the amount is an excess deferral. If a plan of a tax-exempt employer fails to comply with the limitations of sections 1.457-4(c)(1) through 1.457-4(c)(3), the plan will be an ineligible plan described in section 457(f) under which benefits are taxable in accordance with section 1.457-11.

The provisions of section 1.457-4(e) regarding deferrals under an eligible plan and the elimination of the coordination limitation may be illustrated by some examples provided in the regulations.

Example 1. (i) Facts. In 2006, the eligible plan of State Employer X in which Participant H participates permits a maximum deferral of the lesser of $15,000 or 100 percent of includible compensation. In 2006, H, who has compensation of $28,000, nevertheless defers $16,000 under the eligible plan. Participant H is age 45 and normal retirement age under the plan is age 65. For 2006, the applicable dollar limit under paragraph (c)(1)(i)(A) of this section is $15,000. Employer X discovers the error in January of 2007 when it completes H’s 2006 Form W-2 and promptly distributes $1,022 to H (which is the sum of the $1,000 excess and $22 of allocable net income).

(ii) Conclusion. Participant H has deferred $1,000 in excess of the $15,000 limitation provided for under the plan for 2006. The $1,000 excess must be included by H in H’s income for 2006. In order to correct the failure and still be
an eligible plan, the plan must distribute the excess deferral, with allocable net income, as soon as administratively practicable after determining that the amount exceeds the plan deferral limitations. In this case, $22 of the distribution of $1,022 is included in H’s gross income for 2007 (and is not an eligible rollover distribution). If the excess deferrals were not distributed, the plan would be an ineligible plan with respect to which benefits are taxable in accordance with section 1.457-11.

Example 3. (i) Facts. The facts are the same as in Example 1, except that H’s deferral under the eligible plan is limited to $11,000 and H also makes a salary reduction contribution of $5,000 to an annuity contract under section 403(b) with the same Employer X.

(ii) Conclusion. H’s deferrals are within the plan deferral limitations of Employer X. Because of the repeal of the application of the coordination limitation under former paragraph (2) of section 457(c), H’s salary reduction deferrals under the annuity contract are no longer considered in determining H’s applicable deferral limits.

In addition, an employer may establish a trust to hold the assets required to pay the benefits, under a section 457 plan without causing the benefits to be includable in a participant’s income. Indeed, a trust is required for eligible state and local government plans. In Private Letter Ruling 9410013, dated December 2, 1993, the IRS examined the income tax treatment of the benefits provided under a nonqualified deferred compensation plan under section 457 of the Code and its trust established to pay benefits under the plan. The IRS determined that the Company was an eligible employer within the meaning of section 457(e)(1)(A) of the Code and
that the employer’s plan was an eligible deferred compensation plan as defined in section 457 of the Code. The plan was established to provide deferred income to certain employees of the company. Any employee who had been designated as eligible to participate under the plan by the Board of Directors of the company could become a participant in the plan upon the completion of six consecutive years of service with the company. The amount of the contributions was determined by the company and designated on the certificate of eligibility to participate. In addition, the company adopted a trust to accept sums of money or other property as from time to time may be paid or delivered to the trustee to aid the company in satisfying the amounts promised the employee under the agreement. The trust conformed to the model language contained in section 5 of Revenue Procedure 92-64.\textsuperscript{30}

The IRS concluded that the trust was classified as a trust within the meaning of section 301.7701-4(a) of the Procedure and Administration Regulations. Neither the creation of the trust nor the contribution of assets by the company to the trust would constitute a transfer of property for purposes of section 83 of the Code or section 1.83-3(e) of the Regulations. Also, neither the creation of the plan or the trust, nor the contribution of assets to the trust, would create taxable income for the participants or their beneficiaries under the cash receipts and disbursements method of accounting. Further, benefits payable from the trust would be includable as compensation in the gross income of the participants or their beneficiaries in the taxable year or years in which such amounts were actually distributed or otherwise made available, whichever was earlier.

In Private Letter Ruling 9517026, dated January 27, 1995, the IRS stated that neither the adoption of the section 457 plan, nor the creation of the trust, nor the contribution of assets to the trust, nor the receipt of earnings by the trust would cause any amount to be included in the gross

income of a participant or his or her beneficiary under the cash receipts and disbursements method of accounting, pursuant to either the constructive receipt doctrine or the economic benefit doctrine.

The IRS reached a similar conclusion in Private Letter Ruling 9624003, dated February 26, 1996, regarding a trust, which met the requirements of Revenue Procedure 92-64, used in connection with a plan of a governmental entity.

It should be noted, however, that the IRS has ruled that the restoration of the participants’ account balances under an eligible section 457(a) plan to offset losses caused by a public official who pleaded guilty to six felony counts of misappropriating public funds, falsifying documents, and misleading investors in an investment fund, would not be considered to create or constitute “compensation deferred under the plan” within the meaning of section 457(a) of the Code.

Distributions

Sections 457(b)(5) and 457(d) provide that amounts deferred under an eligible section 457 plan may not be paid or made available to a participant or beneficiary earlier than:

1. the calendar year in which the participant attains age 70½,
2. when the participant has a severance from employment with the employer, or
3. when the participant is faced with an unforeseeable emergency (defined under section 1.457-6(c) of the Treasury Regulations), and
4. the plan meets the minimum distribution requirements of section 401(a)(9) of the Code and certain other distribution rules under section 457(d)(2).

Section 1.457-6(a) of the Treasury Regulations provides that except with respect to distributions on account of an unforeseeable emergency, distributions of small accounts, plan

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33 Section 457(d) of the Code; see Private Letter Ruling 9348007, dated August 26, 1993.
terminations, or distributions regarding domestic relations orders, amounts deferred under an eligible plan may not be paid to a participant or beneficiary before the participant has a severance from employment with the eligible employer or when the participant attains age 70½, if earlier. Section 1.457-6(b) provides that an employee has a severance from employment with the eligible employer if the employee dies, retires, or otherwise has a severance from employment with the eligible employer. An independent contractor is considered to have a severance from employment with the eligible employer upon the expiration of the contract (or in the case of more than one contract, all contracts) under which services are performed for the eligible employer, if the expiration constitutes a good-faith and complete termination of the contractual relationship.

The phrase “is separated from service” formerly in section 457 has been replaced by the phrase “has a severance from employment.” This change is intended to permit distributions upon a separation from employment and eliminate the application of the “same desk” rule which might otherwise prevent a distribution upon a severance from employment. Prior to this change in the law, a question was raised as to the meaning of the phrase “separated from service” for purposes of the distribution rules. Section 1.457-2(h)(2) of the prior Treasury Regulations provided that, in general, an employee is separated from service with the employer if there is a separation from service within the meaning of section 402(e)(4)(A)(iii) (which was moved to section 402(d)(4)(A)(iii) under the Unemployment Compensation Amendments of 1992,34 relating to lump-sum distributions, and on account of the participant’s death or retirement. The term “separation from service” is not further defined in the Code or the regulations. However, the Tax Court has interpreted separation from service to mean when an employee severs his or her connection with the employer. A separation generally will not be found “unless there is a change

in the employment relationship in more than a formal or technical sense.” Accordingly, a
reduction in work schedule or change in employment status that is anything less than a complete
severance from the employer will not constitute a “separation from service.” See Revenue Ruling
81-26,35 and General Counsel Memorandum 39824, dated August 15, 1990 (which discusses
“severance from employment” for purposes of determining whether a pension plan qualified
under section 401(a) may make distributions and “separation from service” for purposes of tax
treatment under section 402); Edwards v. Commissioner;36 Reinhardt v. Commissioner37.

The IRS indicated that the term “severance from employment” for purposes of
determining whether a pension plan qualified under section 401(a) may make distributions, did
not have the same meaning as “separation from the service,” as used in section 402(e)(4)(A)(iii)
(section 402(d)(4)(A)(iii)) for purposes of determining whether a distribution was a lump sum
distribution. The IRS stated that an employee would be considered separated from service within
the meaning of section 402(e)(4)(A) (which was moved to section 402(d)(4)(A)) only upon an
employee’s death, retirement, resignation, or discharge, and not when the employee continued on
the same job for a different employer as a result of the liquidation, merger, or consolidation of
the former employer.38

The IRS also addressed the issue of when a separation from service occurred in a stock
165911, updating and restating Revenue Ruling 58-99, 1958-1 C.B. 202, 1958 WL 10949, the
IRS indicated that control of S Corporation was obtained by other interests that continued to
operate it as a taxable entity. The profit sharing plan maintained by S Corporation was at that

time discontinued as to the employees of S Corporation. The ruling provided that the employees who remained employees of S Corporation had not separated from service for purposes of section 402(e) because the employees did not retire or resign and were not discharged from employment.\textsuperscript{39}

However, in \textit{Private Letter Ruling 9443041}, dated August 4, 1994, the IRS took the position that an employee could receive a distribution of elective deferrals based upon a “separation from service” only if the employee would be considered separated from service within the meaning of section 402(e)(4)(A) regarding lump sum distributions.

Section 1.457-6(c) of the Treasury Regulations provides that an eligible plan may permit a distribution to a participant or beneficiary faced with an unforeseeable emergency. An unforeseeable emergency must be defined in the plan as a severe financial hardship of the participant or beneficiary resulting from an illness or accident of the participant or beneficiary, the participant’s or beneficiary’s spouse or the participant’s or beneficiary’s dependent (as defined in section 152(a) without regard to sections 152(b)(1), (b)(2), and (d)(1)(B)); loss of the participant’s or beneficiary’s property due to casualty; or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant or the beneficiary. Finally, the need to pay for the funeral expenses of a spouse or a dependent of a participant or beneficiary may also constitute a unforeseeable emergency. The regulations further provide that distributions on account of an unforeseeable emergency must be limited to the amount reasonable necessary to satisfy the emergency need (which may include any amounts necessary to pay any federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution).

\textsuperscript{39} See General Counsel Memorandum 39824 (August 15, 1990).
A question also was raised as to the method of the payment of the benefits once the benefits become payable. In *Private Letter Ruling 9443015*, dated July 20, 1994, the IRS responded to a request for a ruling on a plan that permitted an employee to elect to defer compensation he or she would have received for services to the local governmental entity in any taxable year until attainment of age 70½, death, separation from service with the employer, or until the occurrence of an unforeseeable emergency. The election to defer compensation was required to be made prior to the beginning of the month for which the compensation was earned.

The plan also provided that, with certain limitations, a participant or his or her beneficiary could elect the manner in which his or her deferred amounts would be distributed. The election was required to be made prior to the date any such payment was required to commence to the participant or the beneficiary. If the participant or his or her beneficiary failed to make a timely election concerning distribution of the deferred amounts, he or she would receive the amounts on the date and in the manner prescribed by the plan. The manner and time of the benefit payout was required to satisfy the distribution requirements of sections 401(a)(9) and 457(d) of the Code.

The IRS determined that the deferred compensation plan was an eligible deferred compensation plan as defined in section 457 of the Code. Also, amounts of compensation deferred in accordance with the plan, including any income attributable to the deferred compensation, would be includable in the gross income for the taxable year or years in which the amounts were paid or otherwise made available to an employee or an employee’s beneficiary in accordance with the terms of the plan.

In *Private Letter Ruling 9631034*, dated February 2, 1996, an employer intended to amend the eligible section 457 plan to provide participants with the option of electing certain
forms of payment that included an automatic annual cost-of-living adjustment, and the option of splitting the method of payout so long as the distribution requirements were satisfied. The IRS stated that the term “substantially non-increasing amounts” was not defined under the regulations. However, under the plain meaning of that term, amounts distributed need not be equal but they also should not be radically or unexplainably dissimilar. A specified and generally recognized cost-of-living index used to provide an inflation adjustment to payments that would not otherwise be made in substantially increasing amounts would not create radically or unexplainably dissimilar increasing payments. Additionally, the IRS noted that the economic reality of a reasonable adjustment for inflation would not provide participants with increased purchasing power that could cause the new payout amounts to be construed as substantially increasing a participant’s prior purchasing power. Thus, the plan’s provision to permit cost-of living indexing of payout amounts would not cause the indexed payments to violate the “substantially non-increasing” requirement of section 457(d)(2)(C).

With respect to a split distribution from an eligible plan, however, section 457 does not permit a lapse of time between the time of commencement of payment of various payout options that may be available to participants. For purposes of section 457(d)(2), a split distribution is a single distribution system made up of several different payment options. There can be only one benefit payout commencement date. Accordingly, to avoid violating the requirement of section 457(d)(2)(C) that any distribution payable over a period of more than one year can only be made in amounts paid not less frequently than annually, there can be no time lapse between payments that equal or exceed two years. Thus, if a participant elects to have a series of periodic payments follow the distribution of a partial lump sum payment, the first payment of the series must be made no later than within the first year after the year in which the initial lump sum was paid.
Because the proposed amended plan limited the flexibility and distribution, options provided so as not to violate the requirements of section 457(d)(2), and because the cost-of-living adjustment option did not violate the substantially non-increasing rule of section 457(d)(2)(C), the IRS concluded that the amendments to the plan would not cause the plan to become other than an eligible plan for purposes of section 457.

Section 1.457-7(a) of the Treasury Regulations provides that the rules for determining when an amount deferred under an eligible plan is includable in the gross income of a participant or beneficiary depend on whether the plan is an eligible governmental plan or an eligible plan of a tax-exempt entity. Section 1.457-7(b) provides that, except as provided under sections 1.457-7(b)(2) (regarding rollovers), 1.457-7(b)(3) (regarding amounts of any loan from an eligible governmental plan taxable under section 72(p)), and 1.457-10(c) (regarding payments to a spouse or former spouse pursuant to a qualified domestic relations order) amounts deferred under an eligible governmental plan are includable in the gross income of a participant or beneficiary for the taxable year in which paid to the participant or beneficiary under the plan.

Section 1.457-7(c)(1) provides that amounts deferred under an eligible plan of a tax-exempt entity are includable in the gross income of a participant or beneficiary for the taxable year in which paid or otherwise made available to the participant or beneficiary under the plan. Thus, amounts deferred under an eligible plan of a tax-exempt entity are includable in the gross income of the participant or beneficiary in the year the amounts are first made available under the terms of the plan, even if the plan has not distributed the amounts deferred. Amounts deferred under an eligible plan of a tax-exempt entity are not considered made available to the participant or beneficiary solely because the participant or beneficiary is permitted to chose among various investments under the plan.
Section 1.457-7(c)(2) provides that, except as provided under section 1.457-7(c)(2)(ii) through (iv) (regarding initial elections to defer commencement of distributions), amounts deferred under an eligible plan of a tax-exempt entity are considered made available (and includable in gross income) at the earliest date, on or after severance from employment, on which the plan allows distributions to commence, but in no event later than the date on which distributions must commence pursuant to section 401(a)(9). For example, in the case of a plan that permits distribution to commence on the date that is 60 days after the close of the plan year in which the participant has a severance from employment with the eligible employer, amounts deferred are considered to be made available on that date. Section 1.457-7(c)(2)(ii) provides that an eligible plan of a tax-exempt entity may provide a period for making an initial election during which the participant or beneficiary may elect, in accordance with the terms of the plan, to defer the payment of some or all of the amounts deferred to a fixed or determinable future time.

Section 457(d)(2) (relating to distribution requirements) provides that: “A plan meets the minimum distribution requirements of this paragraph if such plan meets the requirements of section 401(a)(9).” This provision ties the distribution requirements to the minimum distribution requirements applicable to tax-qualified plans described in section 401(a). Furthermore, section 457(a) (relating to year of inclusion in gross income) provides that any amount of compensation deferred under an eligible deferred compensation plan, and any income attributable to the amounts so deferred, will be includable in gross income only for the taxable year in which the compensation or other income (i) is paid to the participant or other beneficiary, in the case of a plan of an eligible employer described in subsection (e)(1)(A) (a governmental entity), and (ii) is paid or otherwise made available to the participant or other beneficiary, in the case of a plan of an eligible employer described in subsection (e)(1)(B) (a tax-exempt organization other than a
governmental entity). Additionally, to the extent provided in section 72(t)(9), section 72(t) (regarding a 10% excise on certain early distributions) will apply to any amount includable in gross income under section 457(a).

In addition, the total amount payable to a participant under the plan will not be treated as made available because the participant may elect to receive the amount if the amount does not exceed the dollar limit in section 411(a)(11)(A), and the amount may be distributed only if no amount has been deferred under the plan with respect to the participant during the two year period ending on the date of the distribution, and there has been no prior distribution under the plan to the participant to which this provision applied. Also, the total amount payable to a participant under the plan will not be treated as made available because the participant may elect to defer commencement of distributions under the plan if the election is made after amounts may be made available under the plan in accordance with the provisions of section 457(d)(1)(A) and before commencement of such distributions, and the participant may make only one such election.

Section 1.457-6(d) of the Treasury Regulations provides that in order to be an eligible plan, a plan must meet the distribution requirements of section 457(d)(1) and (2). Under section 457(d)(2), a plan must meet the minimum distribution requirements of section 401(a)(9). Section 401(a)(9) requires that a plan begin lifetime distributions to a participant no later than April 1 of the calendar year following the later of the calendar year in which the participant attains age 70½ or the calendar year in which the participant retires.

Section 457(e) and section 402 permit rollovers among various types of plans including rollovers from and to section 457 plans of governmental entities (government plans have been developing to appear similar to section 401(k) plans and, as a result, Congress included

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40 See section 1.457-6(e) of the Treasury Regulations.
government section 457 plans in the changes to enhance portability). Under section 457(e)(16), in the case of an eligible deferred compensation plan established and maintained by an employer described in subsection (e)(1)(A) (a governmental entity), if any portion of the balance to the credit of an employee in the plan is paid to the employee in an eligible rollover distribution (within the meaning of section 402(c)(4)), the employee transfers any portion of the property such employee receives in such distribution to an eligible retirement plan described in section 402(c)(8)(B), and in the case of a distribution of property other than money, the amount so transferred consists of the property distributed, then the distribution, to the extent so transferred, will not be includable in the gross income of the employee for the taxable year in which it is paid. Rollovers made in accordance with this provision will be reported to the Secretary of the Treasury in the same manner as rollovers from qualified retirement plans.

Rollovers are allowed to and from section 457 plans of governmental entities described in section 457(e)(1)(A), provided that separate accounting is required for rollovers to such a plan and early distributions from such a plan are subject to the 10% excise tax under section 72(t).

Section 1.457-7(b)(2) of the Treasury Regulations provides that a trustee-to-trustee transfer in accordance with section 401(a)(31) (generally referred to as a direct rollover) from an eligible government plan is not includable in gross income of a participant or beneficiary in the year transferred. In addition, any payment made in the form of an eligible rollover distribution (as defined in section 402(c)(4)) is not includable in gross income in the year paid to the extent the payment is transferred to an eligible retirement plan (as defined in section 402(c)(8)(B)) within 60 days, including the transfer to the eligible retirement plan of any property distributed from the eligible governmental plan.
Section 829 of the Pension Protection Act of 2006 amended section 457 to provide that benefits of a beneficiary other than a surviving spouse may be transferred directly to an IRA. The IRA is treated as an inherited IRA of the non-spouse beneficiary. Thus, for example, distributions from the inherited IRA are subject to the distribution rules applicable to beneficiaries. The provision applies to amounts payable to a beneficiary under a qualified retirement plan, governmental section 457 plan, or a tax-sheltered annuity. To the extent provided by the Secretary, the provision applies to benefits payable to a trust maintained for a designated beneficiary to the same extent it applies to the beneficiary.

Section 1.457-10(c) of the Treasury Regulations provides that an eligible plan does not become an ineligible plan described in section 457(f) solely because its administrator or sponsor complies with a qualified domestic relations order as defined in section 414(p), including an order requiring the distribution of the benefits of a participant to an alternate payee in advance of the general rules for eligible plan distributions under section 1.457-6.

The tax treatment of the division of benefits upon divorce has been clarified under section 635 of the Economic Growth and Tax Relief Reconciliation Act of 2001. Any amounts separately accounted for under a section 457(b) plan for the benefit of an alternate payee pursuant to a qualified domestic relations order as described under section 414(p) of the Code will be subject to tax in the same manner as amounts separately accounted for under a qualified plan for an alternate payee pursuant to a qualified domestic relations order (in other words, taxable income to the recipient of the distribution).

Section 1.457-6(f) of the Treasury Regulations provides rules governing loans from eligible plans. If a participant or beneficiary receives (directly or indirectly) any amount deferred as a loan from an eligible plan of a tax-exempt entity, that amount will be treated as having been

41 Public Law 109-280.
paid or made available to the individual as a distribution under the plan, in violation of the
distribution requirements of section 457(d). The determination of whether the availability of a
loan, the making of a loan, or a failure to repay a loan made from a trustee (or a person treated as
a trustee under section 457(g)) of an eligible governmental plan to a participant or beneficiary is
treated as a distribution (directly or indirectly) for purposes of this section, and the determination
of whether the availability of the loan, the making of the loan, or a failure to repay the loan is in
any other respect a violation of the requirements of section 457(b) and the regulations, depends
on the facts and circumstances.

While section 457(g) does not directly address the issue of whether, or under what
circumstances, loans may be made available from trusteeed eligible plans, the legislative history
to the Small Business Job Protection Act indicates that the statutory provisions should be
interpreted as permitting participant loans from the eligible plan trust under the rules applicable
to loans from qualified plans. Accordingly, under the proposed regulations, for loans from an
eligible governmental plan, the proposed regulations include a facts and circumstances general
standard. This general standard is intended to apply to determine whether the loan is bona fide
and for the exclusive purpose of benefiting participants and beneficiaries under section 457(g).

Ineligible Section 457 Plans

If compensation is deferred under a plan that is not an eligible deferred compensation
plan (an “ineligible plan”), deferred amounts are includible in income when the deferred
compensation is not subject to a substantial risk of forfeiture, even if the deferred compensation
is not funded.

A tax-exempt or governmental deferred compensation plan that is not an eligible deferred
compensation plan is not a qualified employer plan for purposes of section 409A of the Code and
is, therefore, generally subject to section 409A. Section 409A provides that all amounts deferred under a nonqualified deferred compensation plan for all taxable years are currently includable in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income, unless certain requirements are met.

Under section 409A, distributions from a nonqualified deferred compensation plan may be allowed only upon separation from service (defined in section 1.409A-1(h) and in accordance with section 1.409A-3(i)(2), under section 1.409A-3(a)(1) of the Treasury Regulations), death (section 1.409A-3(a)(3) of the Treasury Regulations), a time or a fixed schedule specified under the plan (in accordance with section 1.409A-3(i)(1), section 1.409A-3(a)(4) of the Treasury Regulations), a change in the ownership or effective control of a corporation, or in the ownership of a substantial portion of the assets of the corporation (in accordance with section 1.409A-3(i)(5), section 1.409A-3(a)(5) of the Treasury Regulations), the occurrence of an unforeseeable emergency (in accordance with section 1.409A-3(i)(3), section 1.409A-3(a)(6) of the Treasury Regulations), or if the service provider becomes disabled (in accordance with section 1.409A-3(i)(4), section 1.409A-3(a)(2) of the Treasury Regulations). A nonqualified deferred compensation plan may not allow distributions other than upon the permissible distribution events and, except as provided in regulations issued by the Department of Treasury, may not permit acceleration of a distribution. 42

In general, changes in the form of distribution that accelerate payments are subject to the rule prohibiting acceleration of distributions. However, a plan subject to section 457(f) may provide for an acceleration of time or schedule of payment to a service provider, or a payment may be made under such a plan, to pay federal, state, local, and foreign income taxes due upon a vesting event, provided that such amount is not more than an amount equal to the federal, state,

42 See section 1.409A-3(j) of the Treasury Regulations.
local, and foreign income tax withholding that would have been remitted by the employer if there had been a payment of wages equal to the income includable by the service provider under section 457(f) at the time of the vesting.\textsuperscript{43}

Section 457(f) was included in section 457 when it was added to the Code in 1978 for governmental employees, and extended to employees of tax-exempt organizations (other than churches or certain church-controlled organizations) in 1986, because unfunded amounts held by a tax-exempt entity compound tax free like an eligible plan, a qualified plan described in section 401(a) of the Code, or a section 403(b) contract. Section 457(f) was viewed as essential in order to provide an incentive for employers that are not subject to income taxes to adopt an eligible plan, a qualified plan, or a section 403(b) contract. Section 457(f) generally provides that, in the case of an agreement or arrangement for the deferral of compensation, the deferred compensation is included in gross income when deferred or, if later, when the rights to payment of the deferred compensation cease to be subject to a substantial risk of forfeiture. Section 457(f) does not apply to an eligible plan, a qualified plan, a section 403(b) contract, a section 403(c) contract, a transfer of property described in section 83, a trust to which section 402(b) applies, or a qualified governmental excess benefit arrangement described in section 415(m) of the Code.\textsuperscript{44}

Section 457(f)(1) of the Code and section 1.457-11(a) of the Treasury Regulations provide, in general, that if a plan of an eligible employer provides for the deferral of compensation and the plan is not an eligible deferred compensation plan, the compensation 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. Section 457(f)(1)(B) and section 1.457-11(a) provide that the tax treatment of any amount made

\textsuperscript{43} Section 1.409A-3(j)(4)(iv) of the Treasury Regulations.
\textsuperscript{44} Preamble to proposed regulations issued by the IRS on May 8, 2002, under section 457 of the Code, 67 Fed. Reg. 30826, 30831 (May 8, 2002).
available under the plan to a participant or beneficiary shall be determined under section 72
(related to annuities).\footnote{See Private Letter Ruling 9546015, dated August 16, 1995.}

Section 457(f)(3)(B) provides that the rights of a person to compensation are subject to a
substantial risk of forfeiture if such person’s rights to such compensation are conditioned upon
the future performance of substantial services by any individual. The IRS has indicated\footnote{See Private Letter Ruling 9212011.} that
section 83 and the extensive interpretive regulations under section 83 (i.e., section 1.83-3(c) of
the Treasury Regulations) are applicable under section 457(f).

While not defining the term “substantial risk of forfeiture,” Congress offered some
guidance as to its meaning in section 83(c)(1) and in the legislative history of that section.
Section 83(c)(1) is a “special rule” that states “[t]he rights of a person in property are subject to a
substantial risk of forfeiture if such person’s rights to full enjoyment of such property are
conditioned upon the future performance of substantial services by any individual.” The
Committee Reports on the Bill enacting section 83 explain that “[i]n other cases the question of
Accordingly, Congress left further definition of the term to the Treasury Department and the
courts.

The Treasury regulations issued pursuant to section 83 do not specifically define what
constitutes a substantial risk of forfeiture. The regulations state that it depends upon the facts and
circumstances and then add an additional rule: “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.” Section 1.83-3(c)(1) of the Treasury Regulations. Satisfaction of either the section 83(c)(1) special rule or the Treasury Regulation additional rule indicates a substantial risk of forfeiture. In other cases, the “facts and circumstances” may still be such that there is a substantial risk of forfeiture.

In Notice 2005-1, guidance issued with respect to the application of section 409A, compensation is subject to a substantial risk of forfeiture if entitlement to the amount is conditioned on the performance of substantial future services by any person or the occurrence of a condition related to a purpose of the compensation, and the possibility of forfeiture is substantial. For purposes of Notice 2005-1, Q&A-10, a condition related to a purpose of the compensation must relate to the service provider’s performance for the service recipient or the service recipient’s business activities or organizational goals (for example, the attainment of a prescribed level of earnings, equity value or a liquidity event). Any addition of a substantial risk of forfeiture after the beginning of the service period to which the compensation relates, or any extension of a period during which compensation is subject to a substantial risk of forfeiture, in either case whether elected by the service provider, service recipient or other person (or by agreement of two or more of such persons), is disregarded for purposes of determining whether such compensation is subject to a substantial risk of forfeiture. An amount is not subject to a substantial risk of forfeiture merely because the right to the amount is conditioned, directly or indirectly, upon the refraining from performance of services. For purposes of section 409A, an amount will not be considered subject to a substantial risk of forfeiture beyond the date or time at which the recipient otherwise could have elected to receive the amount of compensation, unless
the amount subject to a substantial risk of forfeiture (ignoring earnings) is materially greater than the amount the recipient otherwise could have elected to receive.\textsuperscript{48}

The requirements of sections 409A and 457(f) apply separately and must be independently met. For purposes of section 1.409A-1(d) of the Treasury Regulations, compensation is subject to a substantial risk of forfeiture if entitlement to the amount is conditioned on the performance of substantial future services by any person or the occurrence of a condition related to a purpose of the compensation, and the possibility of forfeiture is substantial. For purposes of this provision, a condition related to a purpose of the compensation must relate to the service provider’s performance for the service recipient or the service recipient’s business activities or organizational goals (for example, the attainment of a prescribed level of earnings or equity value or completion of an initial public offering). An amount will not be considered subject to a substantial risk of forfeiture merely because the right to the amount is conditioned, directly or indirectly, upon the refraining from performance of services. For purposes of interpreting the application of “substantial risk of forfeiture” with respect to section 457(f), a review of current guidance issued under section 409A and earlier IRS rules and court decisions is useful.

The final regulations issued by the Department of the Treasury and the Internal Revenue Service under section 409A\textsuperscript{49} states that the final regulations generally adopt the definition of substantial risk of forfeiture set forth in the proposed regulations. Although commentators on the proposed regulations requested that the definition of substantial risk of forfeiture be the same as the definition of substantial risk of forfeiture in section 1.83-3(c). However, the preamble to the final regulations provides that the definition of substantial risk of forfeiture for purposes of

compensatory transfers of property under section 83 reflects different policy concerns from those involved in section 409A, and there are also practical differences between transfers of restricted property and promises to pay deferred compensation.

The preamble to the proposed regulations issued by the Department of the Treasury and the Internal Revenue Service under section 409A\(^\text{50}\) states that the proposed regulations generally adopt the same definition of substantial risk of forfeiture as provided in Notice 2005-1, Q&A-10. The definition of substantial risk of forfeiture in the proposed regulations contains certain restrictions. Certain amendments of an arrangement to extend a substantial risk of forfeiture will not be recognized. The ability to periodically extend, or roll, the risk of forfeiture is sufficiently suspect to question whether the parties ever intended that the right be subject to any true substantial risk, or rather whether the period is being extended through periods in which the service recipient can be reasonably assured that the forfeiture condition will not occur. Similarly, the preamble to the proposed regulations provides that the risk that a right will be forfeited due to the violation of a noncompete agreement can be illusory, such as where the service provider has no intent to compete or to provide such services. In addition, a rational service provider normally would not agree to subject amounts that have already been earned, such as salary payments, to a condition that creates a real possibility of forfeiture, unless the service provider is offered a material inducement to do so, such as an additional amount of compensation. Accordingly, the preamble to the proposed regulations provides that these provisions will not be treated as creating a substantial risk of forfeiture for purposes of section 409A.

In *Robinson v. Commissioner*,\(^\text{51}\) Mr. Robinson held an option to purchase stock; at a below market price, in Centronics Data Computer Corporation. A significant feature of the stock

\(^{50}\) 70 Fed. Reg. 57930, 57943, October 4, 2005.

\(^{51}\) 805 F.2d 38 (1st Cir.1986).
option agreement was a provision that required Mr. Robinson to sell his shares back to Centronics, at his original cost, if he wished to dispose of them in less than one year from the day he exercised the stock option. The effect of this sell-back provision was similar to the insider trading rule of the Securities Exchange Act of 1934, which requires the insider to disgorge to the corporation any profit made on a short term sale.

The court reviewed section 83 and the regulations under that section and determined that neither the statutory nor the regulatory rule fit this particular situation. Therefore, the court was left with the question of whether, in the facts and circumstances of the case, the risk of forfeiture was “substantial.” The court stated that whether a condition creates a substantial risk of forfeiture was not a function of time, nor, as the Commissioner urged in the appeal, was it a function of the likelihood of triggering the event that would require the forfeiture to take place. To the extent that the substantiality of the risk depends upon probability, the probability should be measured by the likelihood of the forfeiture taking place once the triggering event occurred. In this case, the likelihood of the triggering event (sale of the stock in less than a year) was very low; Mr. Robinson would not be so foolish as to risk the forfeiture. But, if he had sold the stock in less than a year, the probability of Centronics enforcing the sellback provision was very high. The company had a fiduciary duty to its shareholders to do so.

The court noted that the probability alone would not satisfy section 83(a). The use of the modifier “substantial” indicates that the risk must be real; it must serve a significant business purpose apart from the tax laws. In this case, the court found that Mr. Robinson’s stock was subject to a substantial risk of forfeiture until the sell-back provision elapsed. The Tax Court found that the officers of Centronics wanted to prevent Mr. Robinson from using his knowledge
of the company to make a profit on a short term change in the corporation’s position. Therefore, the sellback condition served a significant business purpose.

Also, the IRS has indicated that in the case where a participant has an unconditional right to receive a benefit payment only if the participant remains employed by the employer for a period of time, fulfilling the “continuous service condition” in the plan, the imposition of such service condition constitutes a substantial risk of forfeiture. However, the fact that deferred amounts are subject to the claims of the employer’s creditors does not constitute a substantial risk of forfeiture for purposes of section 457(f).52

In Private Letter Ruling 9627007, dated April 2, 1996, the IRS reviewed a plan that was adopted by an employer in order to provide retirement benefits for a participant over and above the limitations set by sections 401(k), 415, and 457 of the Code. The employer had established the plan with the intention that it would be continued for the term of five continuous plan years unless terminated earlier due to the death or disability of the participant. The participant would forfeit the entire amount that was credited to his book account under the plan if the participant did not complete five continuous years of service, except in the case of his death or disability. The IRS concluded that the imposition of the continuous service condition under the plan constituted a substantial risk of forfeiture within the meaning of section 457(f)(3)(B) of the Code. Furthermore, the participant would become taxable on the amounts deferred pursuant to the plan when the participant’s right to benefits under the plan ceased to be subject to a substantial risk of forfeiture which would occur upon the earlier of: (1) the participant’s completion of five continuous years of service with the employer commencing February 1, 1996; (2) death; or (3) termination of services due to disability.

In *Private Letter Ruling 9628011*, dated April 11, 1996, the IRS reviewed a plan that was designed to provide supplemental deferred compensation and retirement benefits to certain employees in a “select group of management or highly compensated employees” designated by the employer’s board of directors. The plan provided for a risk of forfeiture by stating that a participant generally vested in the deferred benefits only upon his or her remaining in the employer’s employ until the earliest of his or her retirement with an immediate benefit, his or her death, his or her separation from service due to disability or his or her attainment of age 70½. The plan also required its participants to be in the plan for at least two years in order to be eligible to receive the benefits under the plan. The IRS concluded that the benefits under the plan were subject to a substantial risk of forfeiture until the participant retired from continuous service with the employer as provided under the plan, attained age 70½, died, or terminated employment due to disability.

In *Private Letter Ruling 9705009*, dated January 31, 1997, the IRS concluded that ruling number one provided to the entity in *Private Letter Ruling 9628011* concerning the application of section 457(f) to the ineligible deferred compensation plan of the entity was not consistent with the ruling guidelines of the Internal Revenue Service under section 457 of the Code. Therefore, the letter ruling covering the plan and the trust was revoked as of the date of *Private Letter Ruling 9705009*, with respect to amounts accrued in the accounts of the participants in the plan on and after the first day of the month after the date of the ruling. It is not clear from *Private Letter Ruling 9705009* why *Private Letter Ruling 9628011* was inconsistent with the guidelines of the IRS and was therefore revoked. Possibly, the future performance of services by a participant was not “substantial” based upon the facts and circumstances of the plan and the information provided.
In *Private Letter Ruling 9815039*, dated January 7, 1998, the IRS responded to a request from a section 501(c)(3) organization regarding the application of the constructive receipt doctrine with respect to its unfunded nonqualified deferred compensation plan for a select group of its management or highly compensated employees.

According to the ruling, a participant could elect to defer a percentage of his or her compensation by means of a salary reduction agreement. Except for the initial year of eligibility, participation was effective at the start of the calendar year following entry into the salary reduction agreement. All deferral elections were required to be made prior to the period of service when the deferred compensation was earned. The employer made a contribution of 3% of a participant’s compensation each year.

The participant was required to irrevocably elect a period of from two to ten whole years under the salary reduction agreement during which a deferral would be operative. If no period of deferral was elected, the participant was deemed to have elected a deferral period of two years. A participant would be vested in the deferred amounts if he or she was still employed by the employer when the deferral period ended. A participant could not enter into a new salary reduction agreement during the two year period immediately preceding his or her retirement age (age 65 or some other age selected by him or her in his or her first salary deferral agreement).

The employer maintained a deferred compensation account for each participant to record deferred compensation and the employer’s contributions. This account was a bookkeeping account used solely to credit deferrals plus adjustments for deemed investments. A participant could select and revise the selection of investments in which his or her account was deemed to be invested from among a variety of investment options, but the employer was not required to accept the participant’s selections.
The plan provided for a risk of forfeiture by limiting vesting in deferred benefits. That is, a participant would vest in deferrals only if he or she was still employed by the employer at the end of a deferral period. If a participant voluntarily terminated employment or was terminated for cause prior to completion of the deferral period, the participant forfeited deferrals that had not yet vested. No forfeiture occurred if a participant terminated employment due to death, disability, attainment of retirement age under the plan, or involuntary termination other than for cause. No forfeiture occurred if the plan terminated prior to the end of a deferral period.

A participant could select the benefit commencement date on his or her salary deferral agreement. Benefits could not commence prior to the end of a deferral period. If no benefit commencement date was selected, benefits would commence no later than 60 days after the end of the plan year when the participant reached retirement age.

The IRS determined that the plan was an ineligible deferred compensation plan under section 457(f). Pursuant to section 457(f), deferred compensation credited to a participant’s account under the plan was includable in income by the participant or his or her beneficiary in the first taxable year when the rights of the participant or beneficiary ceased to be subject to a substantial risk of forfeiture. This would be the year when the participant became vested in the deferred compensation, even if the participant had elected a subsequent year for receiving payment of the plan benefits.

The IRS also determined that a participant’s right to designate the investment of deferred amounts and to change those designations would not cause the amounts to be includable in income by the participant until the year when the deferred amounts ceased to be subject to a substantial risk of forfeiture or were actually distributed or made available, whichever was earlier.
The IRS also ruled that the amounts made available to a participant or beneficiary under the plan would be includable in the gross income of the participant or beneficiary in accordance with the rules of section 72 of the Code. Amounts would be made available when the participant or beneficiary became entitled to receive them under the plan. Therefore, no portion of the deemed earnings credited to a participant’s account under the plan would be included in gross income until the taxable year in which the participant or beneficiary became entitled to receive them. The portion of any installment distribution includable in gross income would be determined under section 72.

This ruling is interesting in that the deemed earnings are included in the gross income of a participant when they are made available even though the tax consequences of benefits deferred under a section 457(f) plan are governed not by the constructive receipt doctrine but by the economic benefit doctrine.

In a subsequent ruling by the IRS, Private Letter Ruling 9822030, dated February 25, 1998, the IRS responded to a request for a ruling regarding the proper income tax treatment of the benefits provided pursuant to a nonqualified deferred compensation plan and the associated grantor trust under sections 83, 402(b), and 457(f) of the Code.

The plan provided nonqualified deferred compensation benefits to certain key officers and management employees designated by the employer’s board of directors. The benefits payable to the participant or his beneficiary were determined in accordance with the plan. The plan provided for a risk of forfeiture by stating that a participant generally vested in the deferred benefits only upon his remaining in the employer’s employ until the earliest of his normal retirement age or his early retirement date if one was designated for the participant under the plan.
Generally, if the participant’s employment with the employer was terminated prior to his attaining the normal retirement age set by the plan or his early retirement date, all his rights and benefits under the plan would be forfeited and the employer had no further obligation to him under the plan. However, a participant’s accrued benefit also vested and became nonforfeitable if the employee died while employed by the employer or if he separated from service due to disability as set forth in the plan. In addition, the plan provided that the participants who were still employed by the employer became vested if the employer’s board decided to terminate the plan; in that case, the participants’ account balances would be distributed to them or their beneficiaries immediately after the plan’s termination. The plan also provided that when a participant’s accrued benefit became nonforfeitable (and taxable), the employer would pay his accrued benefit under the plan to him (or to his beneficiary after his death) in a lump-sum.

To assist the employer in providing assets from which to pay the benefit obligations to the participants, the employer had established a trust that was drafted to conform to the requirements of Revenue Procedure 92-64, 1992-2 C.B. 422, 1992 WL 509838 with an independent third party.

The IRS ruled that neither the adoption of the plan, nor the designation of plan participants, nor the creation of the trust, nor the employer’s contribution of assets to the trust would cause any amount to be included in the gross income of a participant or his or her beneficiary under the cash receipts and disbursements method of accounting, pursuant to either the constructive receipt doctrine of section 451, the economic benefit doctrine, or section 457(f). The benefits under the plan were subject to a substantial risk of forfeiture until the participant attained normal retirement age or the early retirement date under the plan, died or terminated employment due to disability, or the employer terminated the plan. Accordingly, the IRS ruled
that, under section 457(f)(1)(A), amounts credited by the participant’s employer under the plan, including deemed earnings thereupon, were included in the gross income of the participant or his beneficiary in the first taxable year in which the employer terminated the plan, or the participant attained normal retirement age under the plan or the early retirement date if one was set for him in the plan, died or separated from service due to disability.

Under this ruling, the amounts credited to the accounts of the participants and the earnings credited on those amounts would be taxed upon the lapse of the substantial risk of forfeiture. This ruling seems to be consistent with the requirements of section 457(f), but inconsistent with Private Letter Ruling 9815039.

Section 1.457-11(a) of the Treasury Regulations provides that compensation deferred under any agreement or arrangement that is an ineligible plan is includable 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. This position is consistent with prior rulings. In Private Letter Ruling 9444028, dated August 3, 1994, the IRS responded to a request for a ruling on a nonqualified deferred compensation plan maintained for a select group of management or highly compensated employees of a tax-exempt organization under section 501(c)(3) of the Code. The plan was intended to be an ineligible deferred compensation plan to which section 457(f) applied. Under the plan, the employer would designate the plan year in which a participant would become vested in the amounts credited to the account of the participant. The participant would become vested if he or she was still employed by the employer on January 1 of the designated plan year, which could be no earlier than the third plan year beginning after the plan year in which the amount was credited. The participant also became vested in his or her entire account when he or she became disabled and his or her beneficiary became vested if the
participant died while employed by the employer. A participant was fully vested in any deemed earnings when they were added to his or her account. If the participant’s employment was terminated (other than because of death or disability), and the participant was not reemployed by the employer within 90 days, the participant forfeited all amounts in which he or she was not yet vested.

A participant was entitled to a distribution of the deferred compensation amount (and the related deemed earnings) in his or her account when he or she became vested in it. A participant’s designated beneficiary was entitled to a distribution of the entire account balance when the participant died. Before each plan year, a participant was required to elect whether amounts credited to his or her account for that plan year would be distributed as a lump sum or in annual installments over a period of ten years or less.

The IRS ruled that, under section 457(f), the amounts of deferred compensation credited to a participant’s account under the plan were includable in the gross income of the participant (or, in the case of the participant’s death, the gross income of his or her beneficiary) for the first taxable year for which the participant’s or beneficiary’s rights to these amounts were not subject to a substantial risk of forfeiture. This would be the taxable year of the participant or beneficiary in which the participant became disabled, died, or became vested in the amounts of deferred compensation. The entire amount of deferred compensation was includable in gross income for that taxable year even if the participant elected to receive installment distributions.

Also, a rabbi trust may be established by an employer and used in connection with an ineligible deferred compensation plan covered by section 457(f) to assist the employer in fulfilling its obligations under the plan. A rabbi trust was used in connection with a section
457(f) plan in *Private Letter Ruling 9212011*, and the model rabbi trust has been used in more recent private letter rulings.

In *Private Letter Ruling 9212011*, dated December 19, 1991, a health care organization, a nonprofit corporation exempt from tax under section 501(c)(3), entered into an agreement with an executive, effective as of January 1, 1991, which created a supplemental account to which the employer credited five percent of the executive’s monthly base salary. The executive was not able to make additional contributions to this account. The benefits would vest at the rate of ten percent per year for ten years, but if the executive terminated employment with the employer at any time within that ten-year period, the executive would forfeit the nonvested portion of his benefits. If the executive did not terminate employment with the employer within this period, payment of his benefits would commence within 60 days of the date of the executive’s termination of employment and would be paid out in equal monthly installments over two years. The benefits could not be assigned, alienated, or encumbered by voluntary or involuntary action.

The employer established a trust for the sole purpose of paying benefits under the agreement, unless the employer became insolvent. The executive or the executive’s beneficiary received only the employer’s unsecured promise to pay benefits and had no rights against the trust assets other than the rights of a general unsecured creditor of the employer. Also, the trust provided that the rights of the executive or the executive’s beneficiary were not subject to assignment, attachment, or other legal or equitable process.

Section 1.83-3(c) of the Treasury Regulations provides that for purposes of section 83 and the regulations thereunder, whether a risk of forfeiture is substantial or not depends upon the facts and circumstances. Section 1.83-3(c)(4), Example 1, 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 or she terminates 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.

Based upon the facts, the IRS determined that the executive’s benefits were subject to a substantial risk of forfeiture until he vested in that percentage of benefits to which he was entitled under the agreement. Therefore, under section 457(f), no plan contributions or benefits were taxable to the executive until the executive vested in those benefits under the terms of the agreement. Further, the IRS noted that the trust established by the employer was a rabbi trust. In the event of the employer’s insolvency the assets were fully within the reach of the employer’s general creditors. Therefore, the creation of the trust and the transfer of property to the trust did not constitute a transfer of property to the executive under section 83 of the Code, a contribution to a nonexempt employees’ trust under section 402(b) of the Code, or income to the executive under the economic benefit or constructive receipt doctrines of sections 61 and 451 of the Code. Accordingly, the taxation of the executive’s compensation under the agreement was governed by section 457(f).

The IRS concluded that, if the creation of the trust did not cause the plan created by the agreement to be other than “unfunded” for purposes of Title I of ERISA, and if the trust provision requiring use of trust assets to satisfy the claims of the employer’s general creditors in the event of the employer’s insolvency was enforceable by the creditors under state and federal law, then the benefits under the agreement would be treated as subject to a substantial risk of
forfeiture until the executive vested in the benefits to which he was entitled under the terms of the agreement.

Accordingly, under section 457(f)(1)(A), amounts credited to the executive’s account under the agreement were includable in income by the executive or the executive’s beneficiary in the taxable year in which there was no substantial risk of forfeiture of the rights to such amounts. The benefits were includable in income at their value at the time in which they were no longer subject to a substantial risk of forfeiture. The tax treatment of any amount made available under the agreement would be determined under section 72, pursuant to section 457(f)(1)(B).

In Private Letter Ruling 9422038, dated March 4, 1994, an employer established an ineligible deferred compensation plan subject to section 457(f) to provide supplemental retirement benefits for a select group of management or highly compensated employees. Each participant accrued a benefit under the plan based on the participant’s salary during his or her years of service with the employer before the date of his or her participation in the employer’s retirement plan. A participant’s plan benefit became nonforfeitable upon the participant’s completion of five years of full-time employment with the employer after the participant was designated by the Board of Directors of the employer to participate in the plan, except that a participant who was terminated for cause at any time would forfeit any unpaid benefits under the plan.

In addition, a participant’s plan benefits became nonforfeitable upon the participant’s death while in the employ of the employer. If the participant separated from the service of the employer, other than on account of the participant’s death, before the five year period ended, the participant forfeited all rights under the plan. The employer would pay the participant’s entire accrued benefit under the plan to the participant upon the participant’s request at any time after
the participant had participated in the plan for five years. In the case of the participant’s death while in the employ of the employer, the employer would pay the participant’s entire accrued benefit under the plan to the participant’s beneficiary within 30 days of the participant’s death.

The employer would establish a trust to set aside funds for the purpose of providing benefits under the plan. The trust agreement conformed to the model trust contained in Revenue Procedure 92-64, 1992-2 C.B. 422, 1992 WL 509838, including the order in which the sections of the model trust language appeared.

The IRS ruled that the trust would be classified as a trust under section 301.7701-4(a) of the Regulations and that the employer would be treated as the owner of the trust under section 677(a) of the Code and section 1.677(a)-1(d) of the Regulations. The IRS also ruled that neither the adoption of the plan, the creation of the trust, nor the contribution of assets by the employer to the trust would result in a transfer of property for purposes of section 83 of the Code or section 1.83-3(e) of the Regulations.

Also, the IRS ruled that when a participant’s right to benefits under the plan ceased to be subject to a substantial risk of forfeiture, all amounts deferred under the plan, including any accumulated earnings, would be includable in the gross income of the participant or beneficiary for the taxable year in which the substantial risk of forfeiture ended. A participant’s right to benefits under the plan ceased to be subject to a substantial risk of forfeiture upon the earlier of (1) the participant’s completion of five years of service with the employer after beginning participation in the plan, or (2) the participant’s death while in the employ of the employer.

It should be noted that section 457(f)(2) of the Code provides that section 457(f)(1) will not apply to a plan described in section 401(a) which includes a trust exempt from tax under section 501(a), an annuity plan or contract described in section 403, that portion of any plan
which consists of a transfer of property described in section 83, that portion of any plan which consists of a trust to which section 402(b) applies and a qualified governmental excess benefit arrangement described in section 415(m), effective for years beginning after December 31, 1994, pursuant to section 1444 of the Small Business Job Protection Act of 1996.

**Intermediate Sanctions Under Section 4958**

In general, for purposes of determining reasonableness regarding the compensation and benefits payable to highly compensated, management level employees for the performance of services, compensation deferred under a plan subject to section 457 of the Internal Revenue Code is taken into account along with other compensation and benefits provided to the employee. Excise taxes may be imposed under section 4958 in the event that the value of the services performed by the employee do not exceed the benefits and compensation provided to that employee under the plan when aggregated with other benefits and compensation.

Under section 53.4958-4(a) of the Treasury Regulations, an excess benefit transaction is defined to mean any transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of any disqualified person, and the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing the benefit. For purposes of this requirement, all consideration and benefits (with certain exceptions) exchanged between a disqualified person and the applicable tax-exempt organization are taken into account. For example, in determining the reasonableness of compensation that is paid (or vests, or is no longer subject to a substantial risk of forfeiture) in one year, services performed in prior years may be taken into account. The rules in section 3.4958-4 of the Treasury Regulations apply to all transactions with disqualified
persons, regardless of whether the amount of the benefit provided is determined, in whole or in part, by the revenues of one or more activities of the organization.

For purposes of determining reasonableness regarding the compensation and benefits payable to a disqualified person for the performance of services, section 53.4958-4(b) of the Treasury Regulations provides that the value of services is the amount that would ordinarily be paid for like services by like enterprises (whether taxable or tax-exempt) under like circumstances (i.e., reasonable compensation). Section 162 of the Code provides standards that apply in determining reasonableness of compensation, taking into account the aggregate benefits (other than benefits specifically disregarded under the regulations) provided to a person and the rate at which any deferred compensation accrues. The fact that a compensation arrangement is subject to a cap is a relevant factor in determining the reasonableness of compensation. In general, compensation for purposes of determining reasonableness under section 4958 includes all economic benefits provided by an applicable tax-exempt organization in exchange for the performance of services. These benefits include, but are not limited to: (1) all forms of cash and non-cash compensation, including salary, fees, bonuses, severance payments, and deferred and non-cash compensation; (2) unless excludable from income as a de minimis fringe benefit pursuant to section 132(a)(4), the payment of liability insurance premiums far, or the payment or reimbursement by the organization of, (a) any penalty, tax, or expense of correction owed under section 4958; (b) any expense not reasonably incurred by the person in connection with a civil judicial or civil administrative proceeding arising out of the person’s performance of services; or (c) any expense resulting from an act or failure to act with respect to which the person has acted willfully and without reasonable cause; and (3) all compensatory benefits, whether or not included in gross income for income tax purposes, including payments to welfare benefit plans,
such as plans providing medical, dental, life insurance, severance pay, and disability benefits, and both taxable and non-taxable fringe benefits (other than fringe benefits described in section 132), including expense allowances or reimbursements, and the economic benefit of a below-market loan.

Section 53.4958-6 of the Treasury Regulations provides that payments under a compensation arrangement are presumed to be reasonable, and a transfer of property, or the right to use property, is presumed to be at fair market value, if the following conditions are satisfied: (1) the compensation arrangement or the terms of the property transfer are approved in advance by an authorized body of the applicable tax-exempt organization composed entirely of individuals who do not have a conflict of interest with respect to the compensation arrangement or property transfer; (2) the authorized body obtained and relied upon appropriate data as to comparability prior to making its determination; and (3) the authorized body adequately documented the basis for its determination concurrently with making that determination. If these three requirements are satisfied, then the Internal Revenue Service may rebut the presumption that arises under the Treasury Regulations only if it develops sufficient contrary evidence to rebut the probative value of the comparability data relied upon by the authorized body.

Section 53.4958-6(c)(2) of the Treasury Regulations provides that an authorized body has appropriate data as to comparability if, given the knowledge and expertise of its members, it has information sufficient to determine whether the compensation arrangement in its entirety is reasonable or the property transfer is at fair market value. In the case of compensation, relevant information includes, but is not limited to, compensation levels paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions; the availability of similar services in the geographic area of the applicable tax-exempt organization;
current compensation surveys compiled by independent firms; and actual written offers from similar institutions competing for the services of the disqualified person.

The provisions of section 53.4958-6 of the Regulations may be illustrated by examples provided under the regulations.

Example 1. Z is a university that is an applicable tax-exempt organization for purposes of section 4958. Z is negotiating a new contract with Q, its president, because the old contract will expire at the end of the year. In setting Q’s compensation for its president at $600x per annum, the executive committee of the Board of Trustees relies solely on a national survey of compensation for university presidents that indicates university presidents receive annual compensation in the range of $100x to $700x; this survey does not divide its data by any criteria, such as the number of students served by the institution, annual revenues, academic ranking, or geographic location. Although many members of the executive committee have significant business experience, none of the members has any particular expertise in higher education compensation matters. Given the failure of the survey to provide information specific to universities comparable to Z, and because no other information was presented, the executive committee’s decision with respect to Q’s compensation was not based upon appropriate data as to comparability.

Example 2. The facts are the same as Example 1, except that the national compensation survey divides the data regarding compensation for university presidents into categories based on various university-specific factors, including the size of the institution (in terms of the number of students it serves and the
amount of its revenues) and geographic area. The survey data shows that university presidents at institutions comparable to and in the same geographic area as Z receive annual compensation in the range of $200x to $300x. The executive committee of the Board of Trustees of Z relies on the survey data and its evaluation of Q’s many years of service as a tenured professor and high-ranking university official at Z in setting Q’s compensation at $275x annually. The data relied upon by the executive committee constitutes appropriate data as to comparability.

In *Technical Advice Memorandum 200244028*, the IRS provided an extensive analysis of the application of the provisions of section 4958 of the Code and the regulations thereunder. In that *TAM*, the IRS addressed several related issues, whether B, an individual who performed services for M, an organization described in section 501(c)(3) of the Code, should be classified as a disqualified person within the meaning of section 4958(f)(1) of the Code, whether a consulting agreement constituted a written contract that was binding on September 13, 1995, within the meaning of section 53.4958-1(f)(2) of the Regulations, whether the consulting agreement was subsequently materially changed within the meaning of section 53.4958-1(f)(2) of the Regulations, whether the requirements under section 53.4958-6 of the Regulations for establishing a rebuttable presumption have been satisfied with respect to the compensation arrangement under the amended consulting agreement, whether the appropriate method was used for measuring the value of the consideration B provided to M in return for the amounts M provided to B under the amended consulting agreement, and whether any “excess benefit” analysis should be based on the value of the combined services of B and A (B’s spouse) relative to the combined consideration paid by M to A and B.
Under the TAM, effective February 25 of a certain year, M and A entered into an employment agreement for a term of five years pursuant to which A agreed to work full time as President and Chief Executive Officer of M. Effective February 26, M and A entered into another employment agreement for a term of four years pursuant to which A agreed to work full time as President and Chief Executive Officer of M. The agreement provided that the term of employment was four years, subject to the right of A to extend the term for an additional year at his option, and subject to further extension upon mutual agreement of M and A.

On February 26, A and B entered into a consulting and noncompetitive agreement with M, which provided that it would become effective upon the expiration of the employment agreement, and pursuant to which A and B would perform specified services for M in accordance with a specified work schedule. The agreement provided that A and B were required to work no more than half a normal work schedule and that the term of the agreement would be for five years. The annual compensation to be paid to A and B collectively, or to the survivor individually, for the consulting services would be 60x for each of the first three years and 55x for each of the last two years. The compensation, payable monthly, would be divided between A (60%) and B (40%). The agreement also included a covenant not to compete covering the same term as the consulting part of the agreement.

On November 20, the Board of Directors of M went into an executive session to discuss executive compensation matters. At this meeting, the Chairman explained that Q, an executive compensation firm, was hired to evaluate M’s compensation package in comparison to other state and national nonprofit health care institutions. Q prepared a report evaluating the compensation package. The personnel committee of M was an authorized executive committee established by M’s Board of Directors and it held a meeting at which it relied on the data
provided by Q to establish that the amounts payable under the consulting agreement were reasonable.

The personnel committee held a meeting on April 4 at which three of its five members were present. At that meeting, among other matters, the personnel committee considered the amended consulting agreement and those proceedings were recorded in the personnel committee’s written minutes. The minutes did not refer to the November compensation report by Q. On April 19, the personnel committee held a meeting at which three of its five members were present and at that meeting, among other matters, the personnel committee approved the amended consulting agreement and instructed the committee chairman to sign the documents on behalf of M. None of the members of the personnel committee who were present at the April 4 and April 19 meetings either directly or indirectly benefited from the agreements approved, none was in an employment relationship with A or B or subject to the direction or control of either A or B, none received compensation or other payments subject to the approval of either A or B, and none approved the agreements because A or B had approved a transaction providing economic benefits to the member.

The amended consulting agreement was entered into on April 19. The amended consulting agreement stated that it was “an amendment and restatement of an agreement entered into as of February 26.” The agreement modified the services to be performed, the work schedule of A and B and the compensation for the services to be performed.

In applying the applicable law to the facts and circumstances presented in the TAM, the IRS noted that section 4958 was added to the Internal Revenue Code by section 1311 of the Taxpayer Bill of Rights 2, P.L. 104-168, 110 Stat. 1452, enacted July 30, 1996. The section 4958
excise taxes generally apply to excess benefit transactions occurring on or after September 14, 1995.

The IRS then reviewed the requirements of section 4958 of the Code and sections 53.4958-1 through 53.4958-6 of the Regulations.

The IRS determined that under the employment agreement, M employed A as its President and Chief Executive Officer. In that capacity, A was the most senior officer of the organization responsible for the day-to-day operations of M. In addition, A served as a member of the Board of Directors of M. Therefore, A had sufficient authority over M so that he was in a position to exercise substantial influence over its affairs and was therefore a disqualified person within the meaning of section 4958(f)(1). Section 53.4958-3(b)(1) of the Regulations provides that a person is a disqualified person with respect to any transaction with an applicable tax-exempt organization if the person is the spouse of a person who is a disqualified person with respect to any transaction with the same organization. Since A was a disqualified person with respect to M, and B was the spouse of A, B was also a disqualified person with respect to M.

The IRS then examined the issue of whether the consulting agreement constituted a written contract that was binding on September 13, 1995, under section 53.4958-1(f)(2) of the Regulations. The IRS determined that the consulting agreement was a written agreement that, presumably, was enforceable under state law, and did constitute a written contract that was binding under section 53.4958-1(f)(2) of the Regulations. The IRS next addressed the issue of whether the consulting agreement was materially changed by the amended consulting agreement. Based upon a review and an analysis of the provisions of the amended consulting agreement, pursuant to section 53.49581(f)(2) of the Regulations, the IRS determined that the amended consulting agreement made material changes to the consulting agreement. Under section
53.4958-1(f)(2), if a binding written contract is materially changed, it is treated as a new contract entered into as of the date the material change is effective. As a result, the amended consulting agreement constituted a new contract that was effective May 1.

The IRS then addressed the issue of whether the requirements of section 53.4958-6 of the Regulations establishing a rebuttable presumption had been satisfied with respect to the compensation arrangement under the amended consulting agreement. The IRS determined that: (i) the compensation arrangement was approved in advance by an authorized body of the organization, composed entirely of individuals who did not have a conflict of interest as to the compensation arrangement, (ii) the authorized body adequately documented the basis for its determination concurrently with making a determination, and (iii) the authorized body did not, however, obtain and rely upon appropriate data as to comparability prior to making a determination with respect to the compensation arrangement as required under section 53.4958-6(c)(2)(i) of the Regulations. Since all three conditions for establishing a rebuttable presumption must be satisfied, the failure to consider appropriate comparability data precluded defining that all three requirements had been met.

The IRS then examined the issue of the appropriate method of measuring the value of the consideration B provided to M in return for payments by M to B under the amended consulting agreement. The IRS stated that under section 53.49584(b)(1)(ii)(A) of the Regulations, the value of the services B provided to M, including the value of the non-compete covenant, over the five-year term of the amended consulting agreement was the amount that would ordinarily be paid for like services by like enterprises under like circumstances using the standards under section 162 of the Code. Related to this was the consideration of the issue of whether any “excess benefit” analysis should be based on the value of the combined services of A and B, the spouse of A,
relative to the combined consideration paid by M to A and B. The IRS stated that since A and B are each separate disqualified persons with respect to M, to determine whether any portion of their compensation constituted an excess benefit, it would be necessary to determine the value of the services performed by each person, not the value of the services they performed as a unit.

The analysis provided by the IRS and TAM 200244028 is instructive in the manner in which the requirements of section 4958 of the Code and the regulations issued hereunder would be interpreted and applied by the IRS.

The intermediate sanctions of section 4958 of the Code are particularly important in the consideration of the plans that may be adopted and put into effect and the compensation provided to highly compensated or management level employees pursuant to those plans. The IRS announced in News Release 2004-106, issued August 10, 2004, that it has launched a new enforcement effort to identify and halt abuses by tax-exempt organizations that pay excessive compensation and benefits to their officers or other insiders. As part of the Tax Exempt Compensation Enforcement Project, the IRS will contact nearly 2,000 charities and foundations to seek more information about their compensation practices and procedures. The IRS said that the enforcement project will consist of examinations as well as other contacts. Because part of the project’s objective is to gather information regarding current practices, contact by the IRS should not necessarily imply improper activity by the organization. However, the stated purposes of the project are to: (i) address the compensation of specific individuals or instances of questionable compensation practices, (ii) increase awareness of tax issues as organizations set compensation in the future, and (iii) learn more about the practices organizations are following as they set compensation and report it to the IRS and the public on their annual Form 990 returns.
The IRS stated that the initiative will focus on particular areas including the compensation of specific officers and various kinds of insider transactions, such as loans and the sale, exchange or leasing of property to officers and others. The IRS will also focus on Form 990 reporting, including how organizations answered question 89(b) on their Form 990-about excess benefit transactions-and other compensation information. The IRS stated that this enforcement project began in July and it will continue into year 2005. Accordingly, in the determination of the plans to be adopted and implemented with respect to providing deferred compensation to officers or other highly compensated management level employees, careful consideration must be given to the plans to be adopted and implemented, the design of the plans to provide the desired benefits, the total compensation and benefits to be payable to these individuals, and the proper approval and documentation of the benefit plans.

Conclusion

The cash-equivalence and assignment of income doctrines require that the interest of a plan participant, such as a coach, in the deferred compensation be not available to sell or transfer and non-assignable. The benefit is only available if the terms of the nonqualified deferred compensation plan are satisfied for the payment of the benefit. With the proper game plan and structure for the non-qualified deferred compensation plan, the requirements of the tax laws can be met with the consequences desired by the college or university, and with good corporate governance and accountability in the administration and operation of the deferred compensation plan the desired consequence for the institution can be achieved and the desired benefit for the participating coach can be realized.