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Practical Issues for “Ineligible” Plans of Tax-Exempt Employers Under Proposed Code Section 457(f) Regulations

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INTRODUCTION:

- **What is an “ineligible plan”?**
 - **An “ineligible plan” is a plan subject to section 457(f) of the Internal Revenue Code of 1986, as amended (“Section 457(f”).**
 - **An ineligible plan provides for deferral of tax on the participant on compensation that exceeds annual contribution limits for Section 403(b), 457(b) or 401(k) plans for nonprofit employees.**
 - **Commonly, an ineligible plan otherwise is referred to as a Supplemental Executive Retirement Plan (“SERP”), meaning, the additional deferrals effectively supplement the benefits accrued under 457(b), 403(b) or 401(k) plans, in which the nonprofit executive may participate.**



INTRODUCTION (cont'd):

- **What does Section 457(f) require of ineligible plans?**
 - ***Basic Rule:*** There is inclusion in gross income of the participant on the first day the payment of accruals under the plan is not subject to a substantial risk of forfeiture (“SRF”).
 - ***Section 409A also applies:*** Timing and form of payment:
 - **May not defer or accelerate the payment date or change the form of payment of the compensation without meeting certain criteria.**
 - **Must pay the deferrals only on certain dates or on the occurrence of certain events allowable under the statute and regulations.**
 - **Income inclusion by the participant in the tax year of failure, additional 20% tax and interest accrued since initial deferral result from noncompliance.**



NEW RULES UNDER SECTION 457(f) PROP. REG'S:

- **Correcting document failures:**
 - **Background:** If the plan document does not meet the written plan requirement and does not satisfy Section 457(f) or Section 409A vesting, timing or form of payment criteria, immediate income inclusion, additional taxes and penalties would apply.
 - **Previous rule:** Internally could correct a plan at any time prior to vesting, or lapse of SRF of the deferred compensation.
 - **Proposed Rule:** May correct an ineligible plan to comply with Section 409A at any time prior to the vesting date.
 - **Note:** Correcting amendment rule varies for for-profit plan sponsors, which have to correct the plan prior to the beginning of the tax year in which the deferred amounts vest.



- **Calculating amount of compensation includible in income of participant under an account balance plan:**
 - **Background:** Present value of accrued amounts on the vesting date is includible in income of the participant for that tax year. Both the premiums (contributions) and accrued earnings are includible in income.
 - **Previous Rule:** Regulations did not define present value.
 - **Proposed Rule:**
 - Present value of accrued earnings must be based on a predetermined actual investment or a reasonable rate of interest. Also, earnings must be credited based on one investment or interest rate or the lower of the two rates.
 - If there requirements are not met, the present value of post-vesting earnings or of the right to future earnings expected to accrue and be paid also is includible in income “as of the applicable date” (vesting date).
 - **Note:** If either requirement is not met, the employer may have to determine amounts taken into account as wages for FICA purposes under a separate calculation, using different rules.



- **Deferral of Compensation:**

- **Background:**

- **Deferral of compensation occurs on the date during a tax year on which a participant acquires a contractual (“legally binding”) right to compensation payable in a later tax year.**
- **But there is no deferral if the amount may be reduced unilaterally or eliminated by the employer after services creating the right were performed.**
- **Previous Rule: So long as amounts remained nonvested, they were not deferred compensation and could be eliminated without violating Section 409A, if the anti-abuse rule were not triggered.**
- **Proposed Rule: Once the employer establishes an ineligible plan, the deferral feature may not be removed even as amounts remain nonvested. Amounts that were deemed substituted or eliminated would continue to be subject to Section 457(f), taxable at vesting.**
- **Note: Amending the ineligible plan not to provide for deferral of compensation would result in violation of Section 409A, an immediate tax event and additional taxes for the employee.**



- **SRF (“Golden Handcuffs”) and Section 409A:**
 - **Background:** Compensation is nonvested, and therefore not subject to Section 409A(a) penalties, if the right to payment is conditioned on the future performance of substantial services or upon the occurrence of a condition that is related to a purpose of the compensation if the possibility of forfeiture is substantial.
 - **Previous Rule:** Rule was unclear, it was generally accepted among practitioners that extension of an SRF was not permitted under Section 457(f) and would be disregarded under Section 409A.
 - **Proposed Rule:** Extended (“rolling”) risk of forfeiture is expressly permitted if extended for a minimum of 2 years, in writing 90 days before expiration and the present value of compensation is materially greater (125%) than otherwise would have been paid.
 - **Note:** Employer may extend SRF by 2 years but deferral of the payment date generally would have to be a minimum of 5 years and otherwise would have to comply with Section 409A. SRF extension would benefit a participant in a plan under the terms of which vesting would occur significantly earlier than payment.



CONCLUSION:

- **Effective Date:** Currently, the proposed rules would apply to any plan with deferred amounts as of the date final regulations were published. Thus, absent a transition period provided by the IRS, not-for-profit employers should review their ineligible plans and ensure compliance with the proposed rules.
- **Summary of Changes: The Proposed Section 457(f) Regulations:**
 - Provide flexibility with respect to addition or extension of an SRF and conformity with Section 409A rules.
 - But increasingly incorporate a facts-and-circumstances analysis.
 - Also require in-depth understanding of the Section 409A proposed anti-abuse rule to amend an ineligible plan.
 - Incentivize a thorough approach to compliance and planning to avoid immediate tax and penalties on participants and possible employment tax liabilities for employers.



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**FOR MORE INFORMATION, QUESTIONS OR COMMENTS
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