TRUCKER ✦ HUSS

A PROFESSIONAL CORPORATION

ERISA AND EMPLOYEE BENEFITS ATTORNEYS

135 Main Street, 9th Floor
San Francisco, California 94105-1815

15760 Ventura Blvd, Suite 910
Los Angeles, California 91436-3019

329 NE Couch St., Suite 200
Portland, Oregon 97232-1332

Tel: (415) 788-3111
Fax: (415) 421-2017
Email: info@truckerhuss.com
www.truckerhuss.com

**This article is the second in a series. Part 1 appeared in the Sept 2023 *Benefits Report* (download PDF here). Those working with 457 plans may also be interested in Scott E. Galbreath's October 31 webinar: *Deferred Compensation Plans for Tax Exempt Organizations — The Tricks and Treats of 457 Plans* (register here).**

# There's a Lot to Consider When Designing and Operating Deferred Compensation Plans for Executives of Tax Exempt Organizations—Part 2

SCOTT E. GALBREATH

OCTOBER 2023

Part 1 of this two-part article discussed some of the considerations tax exempt organizations (EOs) have to take into account when designing deferred compensation plans for their executives. It also discussed 457(b) Plans of EOs (referred to herein as 457(b) Plans). Here, Part 2 of the article will discuss in more detail ineligible 457(f) Plans that don't meet the requirements to be a 457(b) Plan (referred to herein as 457(f) Plans), and how Internal Revenue Code (Code) sections 4958 and 4960 excise taxes apply to EO deferred compensation plans.

## 457(f) Plans Can Be Frustrating

As mentioned in Part 1, 457(b) Plans have an annual limit on the amount that can be deferred into them annually (currently $22,500). Some well-paid EO executives (for example, a football coach at a Division 1 private university, the Administrator of a large tax-exempt hospital, or the Executive Director of a large private foundation) may find this limit insufficient to allow them to save enough for retirement, even when added to their benefits under the EO's 401(k) or 403(b) plan. Therefore, the EO might adopt a 457(f) Plan to supplement the 457(b) Plan and allow for deferred compensation above the annual 457(b) Plan limit.

Code section 457(f) provides that deferred compensation in a plan that does not meet the requirements of an eligible 457(b) Plan is taxable income to the executive as of the later of the time the executive has a legally binding right to such compensation or when the right to such compensation is no longer subject to a substantial risk of forfeiture (i.e., vested). Compensation is subject to a substantial risk of forfeiture if its receipt is conditioned upon the future performance of substantial services or upon the occurrence of a condition related to a purpose of the compensation. The possibility of forfeiture must be substantial. A condition is related to a purpose of the compensation only if the condition relates to the employee's performance of services for the EO or the organization's tax-exempt activities or goals (for example, reaching a certain fundraising goal or spending a certain dollar amount on exempt activities, such as grants, scholarships or aid to the poor).

This taxation on vesting rule can be misunderstood and lead to errors in operation. For example, if a 457(f) Plan provides only for employer contributions and states that the executive will receive a distribution upon separating from service — without any other limitation — the executive is currently vested and would be taxed in the year of the contribution. The executive is vested because he or she could resign at any time and be paid the deferred compensation; it is not conditioned upon future services. Thus, it would not defer taxation.

On the other hand, if a 457(f) Plan provides that the executive will forfeit all employer contributions if his or her employment terminates before the 10th anniversary of the original contribution to the plan, the executive will not vest or pay income tax on the deferrals until the 10th anniversary. In that case, the executive will pay income tax on the entire deferred compensation account balance, in the year of the 10th anniversary. The entire account balance will be taxable in such year regardless of when paid. If the deferred compensation is payable in installments over a period of years, the executive will still pay tax on the entire account balance in the year of vesting. Earnings credited on contributions after they are taxed will be taxed upon distribution. This is another area where operational errors can occur, with the EO only reporting as income to the executive (and withholding income tax on) the amount of the installment. For ease of administration, 457(f) Plans are often drafted to distribute the entire account balance in a lump sum upon vesting. When distributions are actually made, the tax consequences are governed by Code section 72, and the executive will not be subject to income tax again to the extent he or she has already paid tax on the deferred compensation and/or earnings. Under Code section 72, if distributions are made in installments, each installment payment consists of a proportionate share of tax-free return of basis and taxable earnings.

## Pay Me Now or Pay Me *More* Later

Elective deferrals of salary or bonus compensation do not, in themselves, work to defer taxation under a 457(f) Plan. Generally, such compensation will not be considered subject to a substantial risk of forfeiture and will, therefore, be taxed when the employee's right to the compensation accrues. However, under proposed regulations that can be relied on, deferrals of current compensation will be considered subject to a substantial risk of forfeiture if the present value of the amount to be paid upon vesting is more than 125% of the amount the employee would be paid in absence of the risk of forfeiture, i.e, the current compensation deferred. Additionally, the substantial risk of forfeiture must be conditioned on performance of future services for at least two years (not on a purpose of the compensation), and the agreement subjecting the current compensation to the risk of forfeiture must be made in writing before the beginning of the year in which any services giving rise to the compensation are performed.

Generally, under an account balance plan where the executive's benefit is his or her account balance at distribution, the present value of the benefit will be the total account balance (contributions plus earnings). Therefore, if an executive elects to defer $10,000 of salary to a 457(f) Plan in 2023 which will be forfeited unless the executive continues to be employed until 2026, the vested benefit on January 1, 2026 will have to be more than $12,500 or else the $10,000 elective deferral will be taxable in 2023. For example, if the plan provided that the employer would provide a 30% match to the executive's elective deferrals upon vesting, the present value would be 130% of the initial deferral and provide for a substantial risk of forfeiture.

The tax consequences of 457(f) Plans are generally worse than under 457(b) Plans because the executive can't both have a nonforfeitable right to the deferred compensation — and avoid taxation until the deferred compensation is actually received. Additionally, the taxation can be complicated. However, a 457(f) Plan can still be quite useful to help executives save more for retirement.

## Code Section 409A

As if being taxed on vesting weren't enough, 457(f) Plans must also comply with the document and operational requirements of Code section 409A (Section 409A). Section 409A was enacted in response to the abuses of executives with respect to their deferred compensation plans during the early 2000s. It governs nonqualified deferred compensation plans, regulating how amounts can be electively deferred, the time and form of distributions, and generally prohibits accelerating distributions. The consequences of failing to comply with Section 409A are that the participant is taxed on his or her entire vested benefit, which is then subject to an additional 20% federal tax (California has its own additional 5% tax); further, interest is due from vesting at a rate that is a full percentage point higher than the going rate for taxes.

Certain plans, such as qualified plans and 457(b) Plans, are exempt from Section 409A as they are not currently considered deferred compensation. However, 457(f) Plans are subject to Section 409A. This makes mistakes in a 457(f) Plan that much more problematic. Often, the same mistake that violates Section 457 will also violate Section 409A. For example, often when 457(f) Plan participants are approaching the year of vesting they want to push vesting out further to delay taxation of their benefit. This is permissible under proposed Section 457(f) regulations that can be relied upon, provided certain requirements are met. First, the present value of the deferred compensation at the subsequent vesting date must be at least 125% of the present value of the benefit at the original vesting date. Second, the subsequent vesting date must be at least 2 years later than the original vesting date. Finally, the written extension of the vesting date must be entered into at least 90 days before the original vesting date. On the other hand, Section 409A only allows payments to be subsequently deferred if the election to subsequently defer is made at least a year before the payment was scheduled to be made and the deferral is for at least 5 years.

For example, assume a plan provides that the executive vests on her 65th birthday, and the benefit is to be paid on separation from service. But a month before her 65th birthday the executive approaches her employer, explaining that she is in a high tax bracket and asking that the plan be amended so she won't vest until January 1 of the year after she turns 65. In this hypothetical, she could retire on that date and begin receiving benefits when she no longer has taxable salary. However, this change, if made, would violate both Code sections 457(f) and 409A. Under Section 457(f) the second vesting date is not 2 years after the first vesting date and the benefit is not increased to 125% of the value of the benefit on the first vesting date. Under Section 409A, the election to defer payment was not made a year before the payment was to be paid and did not defer payment for 5 years.

Additionally, as mentioned, if a deferred compensation plan of an EO does not meet the requirements of Code section 457(b), it becomes a 457(f) Plan and subject to Section 409A. Certain provisions allowed under 457(b) would violate Section 409A, if subject to it. Therefore, becoming a 457(f) Plan by violating 457(b) when the plan contains one of these provisions will automatically violate Section 409A.

Plans can be exempt from Section 409A under the short-term deferral rule if all the deferred compensation is paid within 2½ months after the end of the year in which the right to the compensation vests. Such a design is also exempt from Section 457(f), meaning it wouldn't be subject to income tax upon vesting, but rather upon receipt. This is a useful design to simplify administration.

## Nothing in Excess

As mentioned in Part 1, Code section 4958 imposes certain excise taxes against individuals involved in an "excess benefit transaction" with an organization exempt from income tax under Code sections 501(c)(3) or 50l(c)(4) ("Applicable Organization"). An excess benefit transaction is any transaction in which an economic benefit is provided by an Applicable Organization directly or indirectly to — or for — the use of a "disqualified person," and the value of the benefit exceeds the value of any consideration given for it. Board members, officers and other people with the ability to exert substantial influence over the organization, such as an executive, are disqualified persons.

Under Code section 4958, there is a tax on individuals involved in excess benefit transactions. The tax is equal to 25% of the value of the excess benefit provided and is imposed on the disqualified person. Therefore, if a disqualified person is deemed by the IRS to be paid more than reasonable compensation, he or she would be subject to a 25% tax on the overpayment above the reasonable compensation. In addition, if an organization manager, such as a member of the Applicable Organization's Board, "knowingly" participates in an excess benefit transaction, that person would be subject to a 10% tax on the overpayment. However, an organization manager's participation will not be considered "knowing" if after full disclosure of the factual situation to a professional, the organization manager relies on a reasoned written opinion with respect to elements of the transaction within the professional's expertise. Thus, it is in the personal interest of members of the authorized body to seek an opinion letter from legal counsel, accountants, or consultants to limit their personal risk. The organization manager will avoid the 10% tax even if the professional turns out to be wrong, as long as he or she relied in good faith on the professional's advice.

Should an organization be found to have entered into an excess benefit transaction, a second-level tax may be imposed on a disqualified person if there is no correction of the excess benefit on or prior to the earlier of: (1) the mailing of a deficiency notice with respect to the 25% tax or (2) the date of assessment. The second-level tax is 200% of the amount of the excess benefit. This second-level tax can be avoided if the transaction is cured within the above prescribed time frame.

An Applicable Organization may obtain a rebuttable presumption that compensation is reasonable by following certain procedures. The compensation arrangement must: (1) be approved in advance by an authorized body of the organization consisting of individuals without a conflict of interest; (2) the approval must be given after obtaining and relying on appropriate comparability data[1] to determine the compensation is reasonable; and (3) the body must document its decision, including (i) the terms of the transaction, (ii) which members of the body debated and voted on the transaction, (iii) the data relied on, and (iv) how any conflicts of interest were handled. If this procedure is followed, the IRS would have the burden to prove that the compensation was unreasonable to establish that an excess benefit transaction had occurred.

By definition, "reasonable compensation" paid for services rendered is not an excess benefit transaction. Conversely, unreasonably high compensation will be an excess benefit transaction. Compensation includes all economic benefits provided by an applicable tax exempt organization in exchange for the performance of services, including salary and bonuses and deferred compensation. Deferred compensation under a 457(b) or 457(f) Plan is considered a transaction for these purposes when the right to the compensation vests.

Applicable Organizations should always obtain comparable data with respect to current and deferred compensation and follow the procedures to get the rebuttable presumption of reasonableness. They should also obtain an opinion from a professional that the compensation is reasonable to avoid the 10% penalty on organization managers. However, even if the transaction escapes the excise tax of Code section 4958, it could still be subject to an excise tax if compensation exceeds $1,000,000 in a given year.

## Who Wants to Be a Millionaire?

Code section 4960 imposes an excise tax of 21% on an applicable tax exempt organization that pays compensation to an individual in excess of $1 million in any year. The amount of deferred compensation included for purposes of Code section 4960 in a year is the present value of any deferred compensation upon vesting. Thus, the vested portion of a 457(b) or 457(f) Plan will count against the $1,000,000 threshold in the year of vesting. While the Code section 4958 excise tax on excess benefit transactions only applies to organizations exempt from tax under Code sections 501(c)(3) or 501(c)(4), the Code section 4960 excise tax applies to all organizations exempt from taxation under Code section 501(a).

Contributions to 457 plans are also subject to FICA taxes upon vesting.[2] Often 457(f) Plans are designed to have the deferred compensation vest late in the year to save Social Security taxes because the executive will have already reached the Social Security Taxable Wage Base limit (currently $160,200) and paid the maximum Social Security tax for the year from salary. However, when deferred compensation vests late in the year, when added to the salary of the executive, it could push the executive's total compensation over the $1 million threshold. Plans can be drafted to reduce the benefit amount to ensure total compensation is under $1 million for the year or to reduce the benefit by the amount of the excise tax the employer is subject to. Also, or alternatively, the plan could be drafted so that vesting occurs early in the year; then, if the executive retires early in that year, she won't have her entire annual salary to add to the vested deferred compensation which might exceed the threshold.

For example, assume a 457(f) Plan provides that the executive vests on the January 1 following her 65th birthday, if still employed on that date, and will be distributed within 2½ months after the end of that year. In this case, the entire 457(f) account balance will be subject to income tax on the January 1 after the executive's 65th birthday. However, if she retires on January 15, she will only have two weeks of salary to add to the 457(f) Plan account balance to determine if the $1 million threshold has been reached.[3]

## Conclusion

As this 2-part article demonstrates, there is a lot to consider when designing and operating a deferred compensation program for executives of EOs: whether to have a 457(b) Plan alone or also a 457(f) Plan (See Part 1); whether to use a Rabbi Trust (See Part 1); the effect of the Code sections 4958 and 4960 excise taxes on the deferred compensation; and compliance with Section 409A. These issues highlight the importance of working with competent advisors in designing and operating such plans. While there is a lot to consider, all the issues can be addressed with proper drafting and operation. The best way for an EO to avoid costly mistakes with its 457 Plan is to know and understand the terms of the plan, and to review operations annually so that any issues can be addressed timely.

EOs with 457(b) Plans are reminded that such plans are subject to the Required Minimum Distribution (RMD) rules and that the age for beginning RMDs was recently increased from 70½ to 72 by the SECURE Act, and then from 72 to 73 by the SECURE Act 2.0. Plans need to be amended for these changes by the end of the first plan year beginning on or after January 1, 2025. However, they must be operated in compliance with these laws now.

***For more on 457 Plans, you are invited to register for Scott Galbreath's October 31 webinar here.***

---

1 There is also a special rule for smaller organizations regarding comparable data. If the organization has average annual gross receipts less than $1 million, data on compensation paid by three comparable organizations will be sufficient.

2 See the article in our July 2022 Benefits Report at page 6, *FICA Tax Withholding and Reporting for Section 457(b) and 457(f) Nonqualified Deferred Compensation Plans*.

3 The deferred compensation would be subject to Social Security taxes up to $160,200 but the combined employee and employer Social Security tax rate is 12.4%, much lower than the 21% excise tax.

---

The Trucker ✦ Huss Benefits Report is published monthly to provide our clients and friends with information on recent legal developments and other current issues in employee benefits. Back issues of Benefits Report are posted on the Trucker ✦ Huss web site (www.truckerhuss.com).

Editor: Nicholas J. White, nwhite@truckerhuss.com

TRUCKER ✦ HUSS


**Jahiz Noel Agard**
jagard@truckerhuss.com
415-277-8022

**Sarah Bowen**
sbowen@truckerhuss.com
415-277-8059

**Mia Butzbaugh**
mbutzbaugh@truckerhuss.com
415-277-8073

**Adrine A. Cargill**
acargill@truckerhuss.com
415-277-8012

**Nicolas D. Deguines**
ndeguines@truckerhuss.com
415-277-8009

**Joseph C. Faucher**
jfaucher@truckerhuss.com
213-537-1017

**Scott E. Galbreath**
sgalbreath@truckerhuss.com
415-277-8080

**Angel Garrett**
agarrett@truckerhuss.com
415-277-8066

**Robert R. Gower**
rgower@truckerhuss.com
415-277-8002

**Alaina C. Harwood**
aharwood@truckerhuss.com
(415) 277-8047

**R. Bradford Huss**
bhuss@truckerhuss.com
415-277-8007

**Zachary T. Isenhour**
zisenhour@truckerhuss.com
415-277-8005

**Ryan Kadevari**
rkadevari@truckerhuss.com
415-277-8011

**Clarissa A. Kang**
ckang@truckerhuss.com
415-277-8014

**Sarah Kanter**
skanter@truckerhuss.com
415-277-8053

**T. Katuri Kaye**
kkaye@truckerhuss.com
415-277-8064

**Elizabeth L. Loh**
eloh@truckerhuss.com
415-277-8056

**Brian D. Murray**
bmurray@truckerhuss.com
213-537-1019

**Kevin E. Nolt**
knolt@truckerhuss.com
415-277-8017

**Yatindra Pandya**
ypandya@truckerhuss.com
415-277-8063

**Barbara P. Pletcher**
bpletcher@truckerhuss.com
415-277-8040

**Mary E. Powell**
mpowell@truckerhuss.com
415-277-8006

**Catherine L. Reagan**
creagan@truckerhuss.com
415-277-8037

**Dylan D. Rudolph**
drudolph@truckerhuss.com
415-277-8028

**Robert F. Schwartz**
rschwartz@truckerhuss.com
415-277-8008

**Charles A. Storke**
cstorke@truckerhuss.com
415-277-8018

**Joelle Tavan**
jtavan@truckerhuss.com
415-277-8030

**Jennifer Truong**
jtruong@truckerhuss.com
415-277-8072

**Nicholas J. White**
nwhite@truckerhuss.com
213-537-1018


## PARALEGALS


**Jenna McHenry**
jmchenry@truckerhuss.com
415-277-8020

**Susan Quintanar**
squintanar@truckerhuss.com
415-277-8069


TRUCKER ✦ HUSS

A PROFESSIONAL CORPORATION

ERISA AND EMPLOYEE
BENEFITS ATTORNEYS


135 Main Street, 9th Floor
San Francisco, California 94105-1815

15760 Ventura Blvd, Suite 910
Los Angeles, California 91436-2964

329 NE Couch St., Suite 200
Portland, Oregon 97232-1332

Tel: (415) 788-3111
Fax: (415) 421-2017
Email: info@truckerhuss.com
www.truckerhuss.com