



SAVING MORE THAN §403(B) ALLOWS: THE ADVANTAGE OF §457(B) FOR TAX- EXEMPT ORGANIZATIONS

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This memorandum describes a voluntary retirement device, known as an eligible 457(b) plan ("457 Plan"), which allows employees of Tax Exempt Organizations to save amounts for retirement in excess of their Code 403(b) deferrals. The 457 Plan must comply with Code 457(b), and the participants must be a "top-hat" group under ERISA, meaning a "select group of management or highly compensated employees." This memorandum does not address the special issues of governmental employees, whose savings are also regulated by Code 457.

1. EXECUTIVE SUMMARY.

Under a Tax-Exempt Organization's 403(b) plans, the individual basic savings limit in years 2004 through 2006 are \$13,000, \$14,000 and \$15,000. "Catch-Up" limits under Code 414(v) for those age 50 or more permit an extra \$3,000, \$4,000, and \$5,000 of voluntary savings in those years.

A 457 Plan allows additional voluntary retirement savings, without reduction for Code 403(b) amounts. The Code 457 savings limit in years 2004 through 2006 are \$13,000, \$14,000 and \$15,000. Code 414(v) "Catch-Up" is not permitted for a 457 Plan for a Tax-Exempt Organization, but there is a separate Catch-Up, of limited utility, described in Section (d), below.

Deferrals to a 457 Plan are typically from base salary and incentive payments, although accumulated leave time may also be converted into a 457 Plan deferral. Contributions do not have to be from salary deferrals. Tax-exempt organization contributions are allowed instead, provided that the overall limits are not exceeded.

The 457 Plan must be limited to a "select group of management or highly compensated employees" and contributed amounts must remain property of the Tax-Exempt Organization until payment, subject to claims of the Tax-Exempt Organization's creditors in the event of its insolvency. If a trust is used, it may restrict use of funds solely to paying the 457 Plan amounts, but the trust must also provide that its assets will be held for general creditors in the event of the Tax-Exempt Organization's insolvency. A limited trust of this nature adds to complexity and expense, and is not really necessary in my view.

Deferred funds held by the Tax-Exempt Organization (or by a trustee, if a trust is used) may be credited interest, or may be adjusted for earnings and losses according to performance of investment measurement funds, such as mutual funds, stock indices, etc. A sophisticated 457

Plan will provide that Participants may choose their investment measurement funds. A more simple approach is to make the rate of growth part of the 457 Plan design, i.e. credit funds with a growth rate equal to the prime rate or a 5 year T-Bill rate. The Tax-Exempt Organization will have a liability to pay at whatever rate is selected, and most likely would invest funds in a manner to “shadow” the hoped for investment performance. I recommend the simple approach, at least in the early years when the amounts in the 457 Plan can be expected to be relatively small.

Because the 457 Plan is subject to the Tax-Exempt Organization’s creditor risk, the Department of Labor requires that it be limited to a “top-hat” group, under the theory that a “select group of management or highly compensated employees” is better able to understand the risks. The ERISA reporting for a “top hat” plan, such as a 457 Plan, is limited to a simple, one time filing. Although summary plan descriptions and summary annual reports are not required, it is sensible to provide clear descriptive material to participants.

2. MORE DETAIL ABOUT 457 PLAN CONTRIBUTION LIMITS.

From 1987 through 2001, Code 457 essentially made it impossible for top-hat employees of 501(c)(3) organizations to save, on a tax deferred basis, any amounts in excess of the 403(b) limits. The Code 457 limits were smaller (\$7,500 for most years), and anything saved under Code 403(b) would offset the amounts which could be saved under Code 457. A 2001 law, known as EGTRAA, changed this. Effective in 2002, the limitations for Code 457 were decoupled from the Code 403(b) limits.

What does this mean? A 457 Plan permits an additional \$13,000 of voluntary deferrals in 2004. In 2005 and 2006, the limits will increase to \$14,000 and \$15,000 respectively, just like the increase in the Code 403(b) limits. When coupled with maximum savings limits under Code 403(b) and Code 414(v), that’s a total deferral limit, prior to a Tax-Exempt Organization’s contributions, of \$29,000, \$32,000, and \$35,000 for those who are 50 or more:

	<u>403(b)</u>	<u>414(v) Catch-Up for 403(b)</u>	<u>457</u>
2004	13,000	3,000	13,000
2005	14,000	4,000	14,000
2006	15,000	5,000	15,000

The level of a Tax-Exempt Organization’s contributions is not affected by this increased deferral under a 457 Plan. Deferrals under a 457 Plan do not count against the overall \$41,000 limit which applies to the sum of 403(b) deferrals (before 414(v) "Catch-Ups"), and Tax-Exempt Organization contributions. When determining the Tax-Exempt Organization contribution, 457 Plan deferrals are added back to compensation, just like Code 403(b) and 125 deferrals, so the employee who saves is not penalized with a smaller Tax-Exempt Organization contribution.

3. 457 SAVINGS MAY BE FROM CASH COMPENSATION OR ACCUMULATED LEAVE TIME.

The salary deferral procedure is essentially the same as with Code 403(b). A deferral election is needed before the amounts are payable.

The 457 Plan can be designed so that the cash equivalent of “banked” vacation or leave time may be deposited, provided the election is made before the amounts are payable in cash. For

vacation policies which limit carry-over, the plan can be designed so that the cash equivalent of days that would be lost is deferred automatically without election.

4. CATCH-UPS PERMITTED FOR THOSE WHO DO NOT SAVE THE MAXIMUM IN EARLIER YEARS.

In the three years prior to normal retirement age, participants who do not contribute the maximum to a 457 Plan may “Catch-Up” and contribute up to two-times the Code 457 limit. This special Code 457 Catch-Up limit may only be contributed in the three years before the Tax-Exempt Organization’s “normal retirement age.” A Code 457 Catch-Up can be used in the same year as a Code 414(v) “Catch-Up” to a 403(b) or 401(a) plan. The Code 414(v) Catch-Up is only \$3,000 this year, and in 2005 and 2006 will increase to \$4,000 and \$5,000.

Let’s assume that age 65 is the “normal retirement age” at the Tax-Exempt Organization.

Example: *The 457 Plan is installed this year and a 61 year old senior executive, already contributing the maximum to the 403(b) plan, contributes only \$5,000 to the 457 Plan instead of the \$13,000 permitted amount. She now has an \$8,000 carry-over (\$13,000 - \$5,000) which may be contributed during the plan years when she is age 62, 63, or 64. She can also contribute the 414(v) “Catch-Up” to her 403(b), which is \$3,000 this year, and will increase in \$1,000 increments in 2005 and 2006.*

Additional notes about the 457 Catch-Up:

1. There is no Catch-Up allowed for years before the 457 Plan was installed.
2. A special 457 Catch-Up contribution is NOT permitted for the year in which normal retirement age is reached or later years. Catch-Ups must be made in the three prior years.

5. FORMALITIES.

Code 457 requires a separate Plan document with certain administrative requirements which are similar to, but slightly less flexible than, those in the Tax-Exempt Organization’s 403(b) plan. The primary requirements deal with the timing of distributions, the election of distribution methods, and restricting access to funds during employment.

6. TIMING OF DISTRIBUTIONS.

In general, distribution is allowed only after separation from employment. Loans are considered a taxable form of distribution in a 457 Plan, and are, therefore, prohibited. In-service withdrawals after age 59½ also are not allowed.

Distributions during employment are allowed only:

- for hardship, or,
- if deferrals have not occurred for two years, to refund small balances for administrative convenience or at participant request. A small balance is \$5,000 or less. (Generally, 457 Plans don’t make refunds during employment, but will wait until there has been a separation from employment.)

The 457 Plan must comply with the minimum distribution rules of Code 401(a)(9), just like the Tax-Exempt Organization's 403(b) plans. This is the rule that requires distributions by April 1 following the later of the year of retirement or attainment of age 70½ .

A 457 Plan will typically say that distribution is to be made in a lump sum 60 days following separation from employment. However, at any time prior to the starting date, a Participant will be allowed two choices:

1. the starting date may be postponed, but not beyond the Code 401(a)(9) date, and
2. installments for a period certain (i.e. ten years) may be selected rather than a lump sum.

7. HARDSHIP DISTRIBUTIONS AND QDRO'S.

In-service withdrawals for hardship are permitted. In addition to certain familiar bright-line standards, administrative discretion is permitted. But it must be real, unanticipated hardship where other financial resources are not readily available. Interestingly, college tuition and purchasing a home are considered to be foreseeable expenditures which generally would not support a request for hardship withdrawal.

Qualified domestic relations orders must be respected, and distributions to divorced spouses pursuant to court order will not disqualify the 457 Plan.

8. NO ROLLOVERS EXCEPT TO OTHER NON-GOVERNMENTAL 457 PLANS.

Unlike a 403(b) plan, the 457 Plan balances may not be rolled over, except to the 457 Plan of another Tax-Exempt Organization, non-governmental entity.

9. SELECTING THE PARTICIPANTS.

Because the 457 Plan of a Tax-Exempt Organization entity must be subject to claims of the Tax-Exempt Organization's creditors, the Department of Labor rules in Title I of ERISA limit participation to a "select group of management or highly compensated employees." The natural tendency will be to extend a beneficial program of this nature to as many people as possible. If the participant group is determined, in hindsight, to be too broad, there will not be an adverse tax consequence to the truly "select" group, but refund to the others, with tax cost, would probably be required.

However, the Department of Labor provisions of ERISA would require more disclosure and reporting, and possible penalties for incorrect reporting. But that could be managed in the real world, provided that the mistake was in good faith. The main risk of including too many persons in the "top-hat" participant class would occur in the unlikely event that the Tax-Exempt Organization were to be bankrupt. In that event, the persons added to the 457 Plan who were neither "select management" nor "highly compensated" would conceivably have a cause of action, because their deferrals were not deposited into a trust that was exempt from Tax-Exempt Organization creditor claims and was instead held on a non-secured basis as required by Code 457.

There is not a lot of guidance in this area. The Internal Revenue Service has made clear that its determinations of "highly compensated" under Code 414(q) for a variety of non-discrimination rules are not binding on the Labor Department when interpreting "top hat" status under

ERISA. A Tax-Exempt Organization which uses a classification of senior officers, department heads, and highly paid employees who earn at least 125% of the Code 414(q) amount (i.e. \$112,500 in 2004, when the 414(q) limit is \$90,000) would be reasonable. In fact, even a level of compensation at the Code 414(q) level (\$90,000) would probably work in most cases, when the great majority of employees earn less. See, for example, PLR 9016071, which dealt with a pre-1986 plan benefiting faculty members and administrative employees earning \$75,000 or more in 1990.

10. INDEPENDENT CONTRACTORS MAY BE COVERED.

There may be times when an independent contractor would find additional deferral to be attractive, but the rules prohibiting payment prior to separation from “employment” will still apply. If independent contractors are added to the 457 Plan, it should have rules defining “separation from employment” in a manner consistent with the regulations. Generally, that will be the time when the independent contractor has determined he or she will not reapply for the contract, but it is a bit more complicated than that, so a facts and circumstances analysis, with the regulations in hand, is necessary.

11. SUMMARY

An “eligible” 457 plan would be a good addition to a Tax-Exempt Organization’s benefit structure, but only if the organization is sufficiently prosperous so that there is no real risk of its insolvency. Administrative costs should be reasonable, and a 457 Plan will allow key employees to save additional amounts for retirement. If the Tax-Exempt Organization was inclined to supplement employee contributions, it could do so for a relatively small group without concern for the “discrimination” issues which color contributions to broad based 403(b) plans. Supplemental Tax-Exempt Organization contributions are counted against the 457 Plan voluntary savings limit.

There are also a variety of techniques where higher contributions could be made on a taxable basis under 457, simply so that the earnings are tax-deferred. We won’t go into that in this memorandum, but such programs, “failed” because they exceed the limits of Code 457(b), are known as 457(f) plans, and can also be helpful when a Tax Exempt Organization wishes to supplement the retirement reserves of key employees.

(l) New Legislation Note

It seem likely that some of the changes to deferred compensation rules in the pending [JOBS bills](#) will also apply to 457 Plans sponsored by Tax Exempt Organizations. Based on initial prints of the two bills, now in Joint Committee, it seems that none of the major changes would lessen the attractiveness of a 457 Plan. Of course, we will follow this with interest, so stay in touch with [theworkplace.biz](#).

Special Note in 2006: The concepts of the JOBS Bill were enacted as Code Section 409A. Plans which comply with 457(b) are specifically exempted from 409A requirements

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