



Credit union  
executives,  
IRS examining  
457 plans

## Top Hat Plans Net Renewed Attention



**T**hanks to a recent notice from the Internal Revenue Service, executive compensation plans offered by credit unions under Section 457 of the tax code have become a hot topic in recent weeks. The fact that all Section 457 plans are not the same has complicated this swirl of discussion, and has contributed to the confusion surrounding the likely future for these plans, based on recent IRS communication.

Basically, credit union 457 plans fall into two categories: “eligible” 457(b) plans and “ineligible” 457(f) plans, which fail (intentionally or unintentionally) to meet the 457(b) requirements. The major characteristic shared by the two 457 plan types is that both are nonqualified deferred compensation plans offered exclusively to a select group of highly compensated employees or key employees. Beyond that, the structure of the plans is markedly different.

### 457(b) Plans

The eligible 457(b) plan is similar in structure to the 401(k) and 403(b) plans. The 457(b) also carries a yearly contribution cap that mirrors those of the other types of plans. In 2005, that cap is \$14,000 but the limit rises to \$15,000 in 2006. Special

“catch-up” provisions may allow employees nearing retirement to contribute even more.

At one time, contributions to 457(b) plans were coordinated with those made to 403(b) and 401(k) plans. The Economic Growth and Tax-Relief Reconciliation Act of 2001 (EGTRRA) changed that, however. Consequently, an executive employed by a credit union that offers both a 401(k) and 457(b) plan can defer as much as \$28,000 this year, and more if “catch up” provisions designed to assist those who are nearing retirement age apply.

Distribution requirements for 457(b) plans also echo those of 401(k) plans to an extent. Vesting privileges can apply to employer contributions, although assets in any Section 457 plan remain under the employer’s control and are available to its creditors in the event of the employer’s insolvency. In general, distributions from a 457(b) plan will not be made available to beneficiaries until:

- The calendar year in which the participant attains age 70 1/2
- The participant has a severance of employment with the employer
- The participant is faced with an “unforeseeable emergency” falling within the applicable definition (which includes severe

financial hardships resulting from unexpected illness or property loss due to casualty, but excludes circumstances such as paying a child's educational expenses or purchasing a home).

### 457(f) Plans

In contrast, contributions to 457(f) plans are unlimited. However, funds in this type of account must remain "at substantial risk of forfeiture" to the intended beneficiary in order to maintain their tax deferred status. The substantial risk of forfeiture requirement is typically fulfilled through a requirement for performance of future work or for the accomplishment of certain activities or organizational goals. Once funds are "vested" they become includible in the beneficiary's taxable income.

The rules covering 457(f) plans were altered substantially in late 2004 by the passage of the American Jobs Creation Act, from which 457(b) plans were specifically excluded. Among other things, the Act imposed new restrictions for 457(f) plans on the timing of deferral elections and limited an account beneficiary's ability to defer the timing or change the form of a planned distribution.

For credit union executives, distributions from a 457(f) are typically permissible only at the following times: at the participant's death or disability; at separation from the credit union; or at a time specified according to a fixed schedule (e.g., at a set date five years from the commencement of the plan).

The Act severely limits the situations under which the acceleration of payments from a 457(f) is permissible. It also provides stiff financial penalties for plans that do not meet its requirements. Plans that existed prior to passage of the Act should be amended by year-end 2005 to conform to its requirements.

### The IRS Changes

It is 457(b) plans sponsored by federal credit unions that are the primary subject of the most recent IRS notice. Employers eligible to establish 457 plans according to the U.S. Code include:

## Comparing the 457 plan types

457(b)	457(f)
Allows contributions of up to \$14,000 in 2005, \$15,000 in 2006. Additional "catch-up" contributions may be available for those nearing retirement.	Contributions are generally unlimited and are typically made by the employer only. Regulatory reporting is minimal.
May serve as a "make whole" depository for highly compensated executives, allowing them to replace income at a percentage basis comparable to those 401(k) or 403(b) plans offer for other employees.	May serve as a "make whole" depository for highly compensated executives, allowing them to replace income at a percentage basis comparable to those 401(k) or 403(b) plans offer for other employees.
Vesting provisions can apply to employer contributions.	No vesting without taxation.
Can serve as a tool for recruiting and retirement.	Serves as a tool for recruiting, retention and retirement, "make whole" depository for post-retirement health care.

(A) a State, political subdivision of a State, and any agency or instrumentality of a State or political subdivision of a State, and

(B) any other organization (other than a governmental unit) exempt from tax under this subtitle.

Because federal credit unions are considered instrumentalities of the federal government, a consideration brought to light by a private letter ruling in 2004, they fit into neither of these categories. The IRS has promised additional guidance for transitioning to an appropriate plan. However, until that guidance is published, plans existing prior to August 15, 2005, the date the notice was published in the Internal Revenue Bulletin, will not fail to be considered a 457(b) plan solely because the employer that established and maintains it is a federal credit union.

The IRS notice also states that should future guidance provide that a federal credit union is not an eligible employer under Section 457, it "will include a reasonable transition period during which any federal credit union that has consistently claimed the status of a non-governmental tax-exempt organization will be permitted to revise its arrangements in order to avoid possible adverse tax consequences for par-

ticipants" in its plan intended to be eligible under Section 457(b).

In addition, the notice provides that until further guidance becomes available, federal credit unions that have "consistently claimed the status of a non-governmental tax-exempt organization for all employee benefit plan purposes" may consider that Section 457(f) applies to any nonqualified plans providing deferral of compensation they maintain, with the exception of 457(b) plans.

Although some modifications may affect the structure of nonqualified deferred compensation plans for credit unions, it seems certain this tool will remain available. DHA's research and experience shows that all credit unions need to monitor their plans regularly to ensure continued compliance with IRS rules, and to avoid unintended negative tax consequences for themselves and the executives they seek to benefit, as well as to ensure that their executive compensation programs remain competitive in the marketplace.