

457 Plans - An Overview 1-2015

457 plans are nonqualified deferred compensation plans maintained by tax-exempt organizations or state and local governmental organizations. They are labeled “457 plans” since IRS Code Section 457 governs the rules for establishing and maintaining such plans.

There are two basic categories of 457 plans: “Eligible Plans” or 457(b) plans, and “Ineligible Plans” or 457(f) plans.

Structure

457(b) plans are typically of the Account Balance type (although they could be structured as a Defined Benefit type) and resemble 401(k) plans in structure. Contributions could be either employer contributions only, employee salary deferrals only, or a combination of both. Salary deferrals are limited to the same amount that may be electively deferred under a 401(k) plan (\$18,000 for 2015). 457(b) plans permit catch-up contributions: (1) an “over 50” 401(k) type; and (2) a “special catch-up” when near the plan normal retirement age. Both types of catch-ups are permitted for governmental plans (“greater of”), while only the “special catch up” is permitted for tax-exempt plans.

All 457(b) plans must follow the “required minimum distribution rules” similar to those found in 401(k) and other qualified plans.

Tax-exempt 457(b) plans may only be maintained for a “select group of management or highly compensated employees” (the top hat group), or independent contractors, in order to avoid the full application of ERISA. Governmental plans may cover any common law employee or independent contractor.

457(f) plans may be either an “Account Balance Plan” (typically only employer contributions) or a “Defined Benefit Plan” (a defined benefit payable at some age or upon an event, such as death) and resemble nonqualified deferred compensation plans offered by “for profit” companies. There are generally no limits on the size of the contributions or the size of the benefits that may be provided (other than “reasonable compensation” issues). As with tax-exempt 457(b) plans, 457(f) plans may only be maintained for a “select group of management or highly compensated employees” (the top hat group), or independent contractors, in order to avoid the full application of ERISA.

Funding

Governmental 457(b) plans must be “funded” with plan assets set aside in trust.

Tax-exempt 457(b) plans and 457(f) plans must be “unfunded” with no assets formally set aside beyond the claims of the creditors of the sponsoring organization, in order to avoid immediate taxation to the participants upon vesting. Since there are no shielded assets, benefits from the unfunded plans are not guaranteed to be paid in case of employer default or bankruptcy.

Tax-exempt 457(b) plans are most often “informally” funded with sponsor owned mutual funds. 457(f) plans most commonly utilize employer owned life insurance, annuities or mutual funds as the informal funding vehicle.

Distribution Provisions

457(b) plan distributions are permitted to be paid to plan participants no earlier than: (a) termination of employment; (b) death; or (c) in the event of an “unforeseeable emergency” for the participant or the beneficiary. 457(b) plans are subject to the qualified plan required minimum distribution rules, which require a minimum distribution beginning no later than April 1st following the year of attaining age 70 ½. All 457(b) plans are exempt from IRS Code Section 409A (“Section 409A”) and therefore do not require a time and form of payment to be pre-selected.

457(f) plans are subject to the rules of Section 409A (unless it qualifies for certain exemptions - i.e., Short Term Deferral, etc.) and therefore require a time and form of payment to be pre-selected for each of the permissible payment events: (1) specified time/age; (2) death; (3) disability; and/or (4) termination of employment (involuntary). Due to income tax issues, benefits are usually paid out in lump sum (see below).

Vesting and Taxation

457(b) plans may have any vesting schedule desired, or be 100% vested immediately. Benefits are not taxed until received or made available*, even if vested. Benefits are taxed as ordinary income.

Under a 457(f) plan, benefits are taxed when a “substantial risk of forfeiture” no longer exists. In other words, benefits will be subject to tax at the point of vesting, even if the benefit is not paid until a later date. As a result, benefits under 457(f) plans are typically paid out in the form of a lump sum, with no vesting prior to: (a) the attainment of a certain age; (b) the occurrence of death or disability; or (c) an involuntary termination. Benefits are taxed as ordinary income.

SUMMARY

	457(b)	457(f)
Eligible Employees	For tax-exempt plans, select group of management or highly compensated employees, or independent contractors. For governmental plans, common law employees or independent contractors.	Select group of management or highly compensated employees, or independent contractors
Contribution Limits	Yes. See above.	No limit on employee or employer contributions
Catch Up Contributions	Yes. See above.	N/A
Distributions	Employment termination, death, disability, unforeseeable emergency. Required minimum distributions at age 70 ½. Benefits taxed when received or made available*.	Specified age or time, involuntary employment termination, death, disability. Taxable when no substantial risk of forfeiture.
409A applicable	No	Yes
Funding	Unfunded for tax-exempt plans; funded for governmental plans	Unfunded – employer owned mutual funds, life insurance, annuities

* “Made available”- such as upon separation from service after retirement.