Can Not-for-Profit Organizations Establish Nonqualified Plans for their Executives?

Situation: Not-for-profit organizations, like for-profit companies, can establish deferred compensation plans for their executives. However, nonqualified deferral plans for executives of tax-exempt organizations face limitations.

Advisors to tax-exempt organizations must understand the additional limitations on nonqualified deferred compensation arrangements to ensure proper tax-deferral. Unfortunately, this author has seen several arrangements in the not-for-profit setting where the additional limitations were not understood, resulting in improper administration. Consequently, this *Counselor's Corner* explores the additional limitations imposed on a nonqualified plan established for an executive employed by a tax-exempt organization under IRC § 457(f).

Solution: Nonqualified deferred compensation arrangements maintained by both taxable and tax-exempt employers must comply with a broad range of rules under the Internal Revenue Code.[1] However, unlike the taxable employers, nonqualified deferred compensation plans maintained by tax-exempt entities face additional requirements under IRC § 457, which can make their deferred compensation planning more complex.

Code §457 distinguishes between two types of nonqualified deferral plans:

- "Eligible" deferred compensation plans under §457(b), which limit the amount that can be deferred on behalf of a participant as well as rules governing the timing of plan distributions; and
- "Ineligible" plans under §457(f) which permit the deferral of unlimited amounts[2]

Typically, highly compensated executives employed by tax-exempt organizations establish a § 457(f) plan to avoid the contribution limitations imposed by §457(b). With a 457(f) plan, taxation is deferred, but only during the time the executive's rights to the deferred amount is subject to a "substantial risk of forfeiture." In contrast, executives of for-profit companies can be vested and continue to benefit from tax deferral. Consequently, the risk of forfeiture requirement distinguishes nonqualified plans in tax-exempt from their for-profit counterpart and makes planning more complex.

An executive's compensation is subject to a substantial risk of forfeiture if the right to the deferred compensation is conditioned upon the future performance of substantial services by the executive. Once an executive of a tax-exempt organization is vested, s/he is no longer subject to a substantial risk of forfeiture, so the benefit is immediately taxable. Immediate taxation occurs in a 457(f) plan even if the pay-out period is spread over several years. Consequently, the preferred design is a lump sum distribution at the vesting event. In addition, 457(f) plan can be established where the executive defers a portion of their income, but because of the concerns of losing benefits under the risk of forfeiture requirement, the more typical plan has the employer providing the executive with additional/ supplemental compensation in the form of non-elective deferred compensation.

Role of Life Insurance in 457(f) Plans

Frequently, a 457(f) plan will provide the executive a promise to pay his designated beneficiary a benefit in the event the executive dies prior to the date s/he becomes vested. The employer may consider acquiring a life insurance policy on the life of the executive with the

tax-exempt organization the owner and beneficiary. In the event of the executive's death prior to vesting the employer will have a source of funds, the insurance death proceeds, which can be used to provide the promised benefit to the executive's beneficiary. If a permanent policy is acquired by the tax-exempt organization, the cash value in the policy can be an informal funding source of the promised benefit. In which case, at the point the employee vests the insurance policy can be distributed to the executive instead of relying totally on the general assets of the tax-exempt organization.

In Summary.
Advisors to tax-exempt organizations must understand the additional limitations on nonqualified deferred compensation arrangements maintained by tax-exempt organizations to ensure proper tax deferral. To further preserve the tax deferral for amounts scheduled to be paid out in later years, plan sponsors may consider informally funding the future benefit by acquiring life insurance contracts on the participants with the tax-exempt organization as the owner and beneficiary.

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[1] For example, all such arrangments are subject to: (1) the tax principles of constructive receipt and economic benefit, and (2) the requirements for exemption from many of the substantive requirements of ERISA by virtue of meeting the requirements for being a top-hat plan that is maintained primarily for the purpose of providing deferred compensation to a select group of management or highly compensated employees. In addition, arrangements, other than eligible 457(b) plans, are subject to the restrictions imposed by IRC § 409A.
[2] The focus of this Counselor's Corner is on the 457(f) plans. Two other deferral plans tax-exempt employers might establish are the 403(b) or 457(b). All three plans are considered salary deferral plans and have the impact of allowing pre-tax contributions from the executive, employer, or both. The 457(b) plan is a nonqualified plan designed for the highly compensated employee (often called a top-hat plan), so this plan can target the benefit to the executive. However as noted in the body of this article, the plan limits the amount that can be contributed. The 403(b) plan is not a top-hat plan, so company contributions must benefit all eligible employees and again the plan limits the amount that can be deferred. It should be noted that the rules for 457(b) plans vary depending on whether the employer is a public state/governmental entity or a private not-for profit organization.