

New Deferred Compensation Opportunities for Key Executives & Highly Compensated Employees of Tax-Exempt Employers

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Tax-exempt employers, such as health care providers and other social service agencies, have often found it difficult to provide attractive nonqualified deferred compensation benefits to management and other highly compensated employees (such as physicians employed by taxexempt hospitals). Under special tax rules applicable to nonqualified deferred compensation plans maintained by these employers, a participating employee generally is taxed on amounts deferred in the first taxable year in which there is no longer a *substantial risk of forfeiture* of the employee's rights to the compensation. Therefore, to obtain the desired tax deferral, nonqualified plans of tax-exempt employers include a *substantial risk of forfeiture* - a feature that has never been popular with affected employees. We are happy to report, however, that partial relief is on the way.

On June 7, 2001, President Bush signed into law the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"). Title VI of EGTRRA made a number of changes to the tax laws applicable to employee benefit plans. One such change is of particular interest to tax-exempt entities. Beginning January 1, 2002, key executives, physicians and other highly paid employees of a tax-exempt employer will be able to defer up to \$11,000 per year under a nonqualified deferred compensation plan *that does not require a substantial risk of forfeiture*.

This change in the law provides a new opportunity to tax-exempt employers that have not maintained nonqualified plans in the past because key employees found the risk of forfeiture unacceptable. Also, taxexempt employers with existing nonqualified plans may either supplement or prospectively replace their existing nonqualified plans with benefits that are fully vested. (Benefits that have already accrued under existing plans must remain subject to a risk of forfeiture if taxation is to be deferred.) This new opportunity to fully vest nonqualified benefits is available because of changes made by EGTRRA to section 457(b) of the Internal Revenue Code (the "Code").

Limitations of Section 457(b) Plans Under Current Tax Law

Pursuant to Code section 457(b), a taxexempt employer or governmental agency may establish an "eligible" deferred compensation plan (an "Eligible Plan"). Under an Eligible Plan, an employee can defer the lesser of (1) \$8,500 or (2) 33-1/3% of compensation annually and avoid income tax on the amount deferred (and on the income attributable to the amount deferred) until that amount is paid or otherwise made available to the employee. A nonqualified plan that satisfies Code section 457(b) does not need to subject the deferred compensation to a substantial risk of forfeiture.

Despite the tax benefits associated with Eligible Plans, however, employers exempt from tax under Code section 501(c)(3) have not found Eligible Plans to be practical deferred compensation vehicles. This is because amounts that an employee defers under a tax-sheltered annuity ("TSA"), described in Code section 403(b), or a Code section 401(k) plan reduce the limit on the amount that an employee can defer under an Eligible Plan. For example, if an employee contributed \$8,500 or more to his/her TSA in 2001, the employee could not defer any compensation under an Eligible Plan.

New Tax Law Makes Eligible Plans a Real Option

EGTRRA makes two significant changes to the tax rules governing Eligible Plans beginning January 1, 2002. First, *amounts than an employee defers under his or her TSA or under a Code section 401(k) plan no longer reduce the limit on amounts that an employee may defer under an Eligible Plan.* Second, *the limit on amounts that may be deferred under an Eligible Plan is increased.* Effective January 1, 2002, the amount that an employee may defer annually under an Eligible Plan is increased to the lesser of: (1) 100% of compensation; or (2) the applicable dollar amount. The "applicable dollar amount" will be \$11,000 in 2002, \$12,000 in 2003, \$13,000 in 2004, \$14,000 in 2005 and \$15,000 in 2006. Thereafter, the dollar limit will be increased in \$500 increments, based upon increases in the cost of living. (These are the same dollar limits that will apply to elective deferrals under TSA and 401(k) plans.)

As a result of these changes in the law, beginning in 2002, an employee participating in an Eligible Plan can defer tax on an additional \$11,000 of compensation annually without affecting his or her benefits under a TSA, Code section 401(k) plan, or other form of qualified retirement plan. Furthermore, Eligible Plans are flexible and can be funded with employee salary reduction contributions, employer supplemental contributions or both.

Key Features of an Eligible Plan

- *Written Document.* An Eligible Plan must be set forth in a written document.
- *Cover only Select Group of Employees.* An Eligible Plan of a taxexempt employer that is not a governmental or church entity may cover only a select group of management or highly compensated employees. Governmental and church-related entities may also cover employees who are not highly compensated, but are not required to do so.
- *Maximum Deferral Limit.* As stated above, the maximum amount that an employee may defer under an Eligible Plan will be \$11,000 in 2002 and will increase \$1,000 per year until the limit reaches \$15,000 in 2006.
- *Source of Deferral.* Depending upon how the Eligible Plan is designed, deferrals under the Eligible Plan may come from employee salary reduction contributions and/or employer contributions.
- *Flexible Salary Reduction Rules.* An Eligible Plan may permit an employee to make salary reduction contributions to the plan for any calendar month if the employee enters into an agreement with the employer providing for those contributions before the beginning of that month. In contrast, elective deferral elections under other nonqualified plans must generally be made before the beginning of the employee's tax year.
- *Account Values and Investments.* Generally, a participating employee's benefit under an Eligible Plan is measured by the value of the employee's plan account. A participating employee's account generally is credited with (1) amounts contributed to the plan on the employee's behalf, and (2) investment returns on those contributions. The employer has significant flexibility in determining what the investment return will be. For example, the investment return could be a fixed rate of return specified in the plan document. Alternatively, the investment return could be calculated based upon the rate of return on investment vehicles that are either designated by the employer or selected by the employee from a group of investment alternatives (e.g., mutual funds) made available by the employer.

- *General Assets of the Employer.* Like other nonqualified deferred compensation plans, amounts deferred under an Eligible Plan remain general assets of the employer until distributed. Although the employer generally would invest the assets in the designated investments used to measure the participating employee's account balance, employees should understand that the amounts deferred could be subject to the claims of the employer's general creditors if the employer becomes insolvent.
- *No "Substantial Risk of Forfeiture" Required for Tax Deferral.* Unlike other deferred compensation plans established by taxexempt employers, tax deferral under an Eligible Plan can be achieved without subjecting the deferred compensation to a "substantial risk of forfeiture." Thus, the benefits may be fully vested. Alternatively, the employer may choose to impose a vesting schedule on the benefits as an incentive for the employee to remain with the employer.
- *Distributions.* Benefits may not be distributed for an Eligible Plan until the employee terminates employment, attains age 70-1/2, or is faced with an unforeseeable emergency. Distributions from an Eligible Plan must satisfy minimum distribution rules similar to the rules that apply to qualified plans and TSA plans.
- *Department of Labor Filing.* Plans that are not governmental or church plans must file a statement with the Department of Labor to receive the "top hat" plan exemption from certain ERISA requirements. Church-related entities might be able to avoid this filing requirement by establishing the plan as a church plan. We would be happy to explore this option further with any church-related employer who is interested in doing so.

Costs and Administration

With this change in the law, tax-exempt employers may enhance their benefits for key executives and highly compensated employees at a relatively low cost. The employer would amend its existing nonqualified plan or adopt a new Eligible Plan document with the features described above. For an employer with an existing plan, the investment and recordkeeping systems already in place for the existing plan could be used for the Eligible Plan with minor changes to track the portion of the employee's account that is not subject to a risk of forfeiture.

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