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**Report to The Congress on
The Tax Treatment of
Deferred Compensation Under Section 457**



**Department of the Treasury
January 1992**

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DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

January 1992

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

Section 6064(d)(4) of Public Law 100-647, the Technical and Miscellaneous Revenue Act of 1988, provides that the Secretary of the Treasury or his delegate shall conduct a study of the tax treatment of deferred compensation paid by State and local governments and tax-exempt organizations.

Pursuant to that directive, I hereby submit the "Report to The Congress on the Tax Treatment of Deferred Compensation Under Section 457."

I am sending a similar letter to Representative Bill Archer.

Sincerely,

Kenneth W. Gideon
Assistant Secretary
(Tax Policy)

1992
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Enclosure



DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

January 1992

The Honorable Lloyd Bentsen
Chairman
Committee on Finance
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

Section 6064(d)(4) of Public Law 100-647, the Technical and Miscellaneous Revenue Act of 1988, provides that the Secretary of the Treasury or his delegate shall conduct a study of the tax treatment of deferred compensation paid by State and local governments and tax-exempt organizations.

Pursuant to that directive, I hereby submit the "Report to The Congress on the Tax Treatment of Deferred Compensation Under Section 457."

I am sending a similar letter to Senator Bob Packwood.

Sincerely,

Kenneth W. Gideon
Assistant Secretary
(Tax Policy)

Enclosure

I. INTRODUCTION

Section 457¹ governs the tax treatment of unfunded deferred compensation provided by a State or local government or a tax-exempt organization. The Technical and Miscellaneous Revenue Act of 1988 (TAMRA) directed the Treasury Department to study the tax treatment of deferred compensation arrangements under section 457.² During the deliberations under TAMRA, amendments were proposed that would have repealed the application of section 457 to tax-exempt organizations and retained the provision only for governmental employers. Although TAMRA ultimately did not include such an amendment, concerns arose that section 457 may unduly restrict tax-exempt employers. This study examines the appropriateness of limiting the deferred compensation of tax-exempt and governmental employers through the application of section 457. Because the proposals considered under TAMRA primarily concerned tax-exempt employers, this study particularly focuses on the application of section 457 to tax-exempt employers other than State or local governments.

II. BACKGROUND

Under section 457, amounts in an "eligible deferred compensation plan" of a State or local government or a tax-exempt organization are not includable in income for Federal tax purposes until paid or otherwise made available to the individual.³ If a plan does not meet the statutory definition of an eligible plan, however, the amounts held are not deferred for tax purposes and instead are taxable to the individual in the year that the amounts are no longer subject to a substantial risk of forfeiture. For purposes of section 457, an amount is subject to a substantial risk of forfeiture if payment is conditioned upon the performance of future services.

¹ Unless otherwise specified, all statutory references are to the Internal Revenue Code of 1986, as amended (the Code).

² P.L. 100-647, section 6064(d)(4).

³ Section 457 applies to deferred compensation provided to both employees and independent contractors, excluding certain nonelective arrangements covering independent contractors. See § 457(e)(12).

Thus, once an individual has performed all services necessary to receive payment at any point in the future, the amount of the deferral is taxed currently.

Section 457 limits an eligible deferred compensation plan to deferrals⁴ that are made prior to the beginning of the month in which the individual earns such compensation and that do not exceed the lesser of \$7,500 or 33-1/3 percent of the individual's compensation per year.⁵ In addition, an eligible deferred compensation plan must be an unfunded plan in which all amounts remain subject to the creditors of the employer. The amounts held under an eligible deferred compensation plan must not be distributed earlier than upon separation from service, attainment of age 70-1/2, or an "unforeseeable emergency," but they must begin no later than as required by the minimum distribution rules applicable to tax-qualified plans.⁶

Section 457 does not apply to a plan of deferred compensation that is described under sections 401(a) and 403(b) (tax-qualified plans) or under section 402(b) (non-exempt trusts), or to any transfer subject to section 83 (property transferred for performance of services). Certain grandfathered plans⁷ as well as plans that provide bona fide vacation, sick leave, severance, disability, or other similar benefits also are not subject to section 457. Additionally, section 457 does not apply to the plan of a church or church-controlled organization, as defined under section 3121(w)(3).

⁴ For this purpose, "deferrals" include both elective and nonelective deferred compensation.

⁵ Under a special catch-up rule, the plan may provide for an increase in the applicable limit (up to \$15,000) for one or more of the last 3 years preceding normal retirement age. See § 457(b)(3).

⁶ Section 401(a)(9) requires that a participant must begin distributions from a plan under section 457 generally no later than the attainment of age 70-1/2.

⁷ For example, section 1107(c)(3) of the Tax Reform Act of 1986 excludes from section 457 any deferral arrangement of a tax-exempt organization that was in writing on August 16, 1986, and provides a fixed formula or amount to be deferred for each year. Any modification to the formula or amount under the plan will cause the plan to come within section 457. Certain deferred compensation plans for state judges are also excluded from section 457. See § 252 of the Tax Equity and Fiscal Responsibility Act of 1982.

In contrast to tax-qualified plans, a plan under section 457 is not subject to nondiscrimination requirements as to the group of employees covered under the plan or the relative amounts of deferred compensation provided to highly compensated employees⁸ over non-highly compensated employees.⁹ With the exception of certain distribution timing requirements,¹⁰ other tax-qualified plan rules do not apply under section 457, including the section 415 limitations on aggregate contributions or benefits.

Section 457 generally is not excluded, however, from the requirements of Title I of the Employee Retirement Income Security Act of 1974 (ERISA). In particular, all plans that are subject to Title I of ERISA¹¹ must meet certain funding requirements, unless the plan is an "excess" plan that is designed to provide benefits above the qualified plan limits, or the plan is a "top hat" plan that covers only a select group of management or highly compensated employees.¹² As a result of the ERISA funding rules, a tax-exempt employer generally cannot provide an eligible section 457 plan (which must be unfunded) to employees other than those in the "top hat" group.

III. DISCUSSION

Legislative History

Section 457 originally was added to the Code by the Revenue Act of 1978 (the 1978 Act) to cover the deferred compensation plans of State or local governments. As indicated in the

⁸ "Highly compensated employee" is defined under section 414(q).

⁹ See §§ 410(b) (nondiscriminatory coverage) and 401(a)(4) (nondiscriminatory benefits).

¹⁰ Section 401(a)(9) requires that a participant must begin distributions from a plan under section 457 generally no later than the attainment of age 70-1/2.

¹¹ Section 4(b) of ERISA excludes governmental plans, church plans, and certain other types of plans from Title I.

¹² ERISA sections 301(a)(3) and (a)(9).

legislative history to the 1978 Act,¹³ section 457 imposed limitations on State or local governments because, unlike private, taxable employers, a State or local government otherwise would not be restrained from providing excessive deferred compensation.¹⁴ A taxable employer may prefer to pay current compensation over deferred compensation in order to avoid the deferral of its deduction. An employee, however, may prefer to receive compensation in future years in order to defer taxation. If, for example, a taxable employer provided a dollar of deferred compensation to an employee, the employer's deduction for that dollar also would be deferred until the tax year that the employee included the dollar in income.¹⁵ This "tax tension" between the deferral desired by employees and the current deduction desired by the employer was viewed by Congress as an inherent limitation on the amount of deferred compensation that a taxable employer would be willing to provide.

In contrast, State or local governments or tax-exempt organizations do not have a tax incentive to pay current compensation over deferred compensation. For these employers there is a greater incentive to defer compensation because such payments are taxable when paid to the employee but not taxable when held by the employer. As a result of their tax status, these employers would be able to offer savings opportunities similar to a tax-qualified plan,¹⁶ albeit through an unfunded arrangement, in which deferrals are held tax free until they are received by the employee. Moreover, this tax savings would be achieved without the attendant nondiscrimination rules and other limitations that are applicable to tax-qualified plans. Thus, the restrictions under section 457 were intended to preclude employers from providing these tax advantages on an unlimited basis.

¹³ H. R. Rep. No. 1445, 95th Cong., 2d Sess. 53; see also S. Rep. No. 1263, 95th Cong., 2d Sess. 65; Joint Committee on Taxation, General Explanation of the Revenue Act of 1978 68 (March 12, 1979).

¹⁴ For purposes of this study, "deferred compensation" or "deferred compensation plan" refers to an unfunded arrangement to provide deferred compensation to an employee or an independent contractor.

¹⁵ See § 404(a)(5) and Temp. Reg. § 1.404(b)-1T.

¹⁶ In a tax-qualified plan, plan assets are held in a tax-exempt trust and are not taxable until received by the participant.

Prior to the Tax Reform Act of 1986 (the 1986 Act), section 457 applied only to the plans of State or local governments and the deferred compensation plans of nongovernmental, tax-exempt organizations were not explicitly governed by any statutory provision in the Code.¹⁷ In the 1986 Act, however, Congress amended section 457 to cover the deferred compensation arrangements of all tax-exempt organizations,¹⁸ in addition to State or local governments. As indicated in the legislative history,¹⁹ the basis for limiting the deferred compensation of State or local governments applies equally to all tax-exempt organizations for which there is no tax incentive to otherwise limit deferred compensation. Thus, Congress viewed the limitations under section 457 as appropriate for nongovernmental, tax-exempt employers, as well.

Given that there previously had been no explicit statutory limitation on the deferred compensation of tax-exempt organizations, the extension of section 457 in the 1986 Act was significant. Congress subsequently revisited section 457 in TAMRA, and proposals were made at that time to reverse the change in the law under the 1986 Act and repeal the statute as to tax-exempt employers.²⁰ Although the efforts to undo the 1986 Act amendment were not successful in TAMRA, Congress indicated that further consideration of section 457 was merited and directed this study by the Department of the Treasury.

Policies for Applying Section 457 to Tax-Exempt Employers

The deliberations under TAMRA indicated a significant level of concern as to the appropriateness of applying section 457 to tax-exempt employers. Critics of section 457 have maintained that repeal is appropriate for tax-exempt employers because the tax tension theory underlying section 457 is illusory. Under this view, section 457 creates an undesirable

¹⁷ Proposed regulations had been issued, however, that would have treated any deferral of compensation made at the "taxpayer's individual option" as received in the year that the amount otherwise would have been payable, absent the election. See Prop. Reg. § 1.61-16.

¹⁸ Church plans, however, are excluded under section 457(e)(13).

¹⁹ H. R. Rep. No. 426, 99th Cong., 1st Sess. 700; Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986 654 (May 4, 1987).

²⁰ See § 350 of H.R. 4333, as passed by the House of Representatives.

distinction, with respect to deferred compensation, solely on the basis of the employer's tax status. Proponents of this view argue further that the lack of explicit limits on the deferred compensation provided by taxable employers allows these employers to offer deferred compensation programs that have a greater value than those offered by a State or local government or a tax-exempt employer. Accordingly, the section 457 limits are viewed as creating a competitive disadvantage to these employers, particularly to tax-exempt employers that compete with taxable employers for the same pool of employees.

Section 457 also has been criticized on the theory that other factors would limit deferred compensation, particularly in the case of a tax-exempt employer, and that the rules in section 457 are unnecessary. Under this view, because tax-exempt employers generally provide deferred compensation only to the level necessary to match the benefits provided by taxable employers, tax-exempt employers would limit their deferred compensation without regard to the lack of tax tension. In addition, others have argued that the structure of typical tax-exempt employers serves as an effective restriction because the boards of directors of tax-exempt employers generally are reluctant to offer excessive compensation packages to employees. Or, in the case of charitable organizations, it is argued that excessive deferred compensation is unlikely given the greater scrutiny of organizations that rely upon contributions from the public.

Although there may be restraints on particular tax-exempt employers that would serve as some limit on their deferred compensation, no limitation cited by the critics would apply equally to all tax-exempt employers. There may be, for example, individual plans that do not meet the requirements of section 457 and that do not appear abusive, per se. Critics of section 457 might argue that such is the case where a tax-exempt employer designs a plan that exceeds the limits provided under section 457 but that is intended solely to match the benefits provided by a taxable employer. In these circumstances, critics would argue that section 457 is inappropriate because the tax-exempt employer already is subjecting the deferred compensation to certain limits, i.e., the level of benefits provided by the taxable employer. Such limitations, however, are idiosyncratic to particular tax-exempt employers and do not consistently apply across the spectrum of all tax-exempt employers.

Current law provides tax-exempt employers with a broad range of compensation options, including the delivery of benefits through tax-qualified plans. Without the limits under section 457, tax-exempt employers, unlike a taxable employer, would have less incentive to maintain tax-qualified plans. A taxable employer has an incentive to utilize tax-qualified plans because of the tax benefits provided with respect to such plans. In a qualified plan, employees can maximize their deferral of compensation while the employer can preserve its current deduction for compensation. In addition, the earnings in the trust for the tax-qualified plan are not currently taxable and are deferred until distribution to the participants. A tax-exempt employer, however, is indifferent both to the timing of deductions and to the taxation of earnings on the deferrals. Accordingly, no tax benefit inures to a tax-exempt employer for maintaining a tax-qualified plan.

Absent section 457, employees of a tax-exempt employer could achieve unlimited deferrals and the employer would be unaffected by either the change in timing of the compensation payment or the accumulation of the earnings on the deferrals. Because section 457 limits deferred compensation, it creates an incentive for a tax-exempt employer that desires to provide deferred compensation to deliver more benefits through a tax-qualified plan.²¹ This result is commensurate with broader pension policy because tax-qualified plans are designed to ensure both broad coverage of employees and benefits that do not discriminate in favor of the highly compensated employees. By contrast, deferred compensation plans under section 457 are not subject to nondiscrimination requirements and, as noted above, inherently favor highly compensated employees in tax-exempt organizations because of the ERISA funding conflict.

Under current law, however, certain tax-exempt employers are effectively precluded from offering plans to their employees that include a salary reduction feature. Section 401(k) explicitly precludes both governmental and tax-exempt employers from maintaining a qualified cash or deferred arrangement,²² and the ERISA funding requirement also precludes tax-exempt

²¹ Participants in an "excess" plan that provides benefits above the levels of a qualified plan will nevertheless be limited by section 457.

²² See § 401(k)(4).

employers from maintaining a broad-based salary reduction feature under section 457. Certain tax-exempt employers, such as public schools and charitable organizations under section 501(c)(3), generally can provide a salary reduction annuity plan under section 403(b),²³ but tax-exempt employers that are not described in section 501(c)(3) have no such option under current law.

Review of Empirical Data on Section 457

In the legislative history to TAMRA, Congress directed the Department of the Treasury to review the deferred compensation provided under section 457 in comparison with the deferred compensation provided by private, taxable employers. Specifically, Congress requested that this study compare both the amounts of deferred compensation provided and the levels of coverage of highly compensated employees versus non-highly compensated employees in each type of plan.²⁴

Such comparisons necessarily are limited, however, by the lack of reliable data on the deferred compensation plans maintained under section 457. The absence of data occurs primarily because there is no established reporting mechanism for these plans. Deferred compensation is not subject to a reporting requirement with the Internal Revenue Service or the Department of Labor.²⁵ In addition, governmental and tax-exempt employers are not subject to other reporting requirements, such as filings with the Securities and Exchange Commission, from which information is often obtained with regard to taxable employers.²⁶ Other sources of reliable information also have not proven useful for purposes of section 457. For example, the Census Population Survey, Employee Benefit Supplement does not include data from which coverage

²³ Section 403(b) provides for certain tax-deferred annuities. Elective contributions generally may be made under a section 403(b) plan in amounts up to \$9,500 annually. See § 402(g)(4).

²⁴ H. R. Rep. No. 795, 100th Cong., 2d Sess. 551.

²⁵ In contrast, section 6058(a) and ERISA section 101(b)(4) require that a tax-qualified plan or any funded plan file annual reports.

²⁶ Employers that are subject to the reporting requirements of the Securities and Exchange Commission would disclose significant deferred compensation arrangements on their annual reports (Form 10-K), for example.

under a section 457 plan could be definitely determined. Similarly, such data is not included in the Statistics of Income of Tax-Exempt Organizations that is maintained by the Internal Revenue Service. As a result, there is no reliable data base from which to extrapolate information as to the aggregate amounts of deferred compensation provided under section 457.

With regard to the coverage of employees under section 457, the limited data that is available focuses almost exclusively upon plans maintained by governmental employers. In addition, this data typically does not differentiate between benefits provided under section 457 and benefits provided through other plans, such as tax-qualified plans.²⁷ With regard to governmental employers, there is anecdotal evidence suggesting that plans under section 457 provide significant levels of coverage to non-highly compensated employees.²⁸ Such results would not be unexpected, given that governmental employers are not precluded by the ERISA funding requirements from offering broad-based coverage under section 457.

In contrast to the governmental employers, if data were available for tax-exempt employers, it would not likely indicate that a large percentage of the employees of tax-exempt organizations are participating in deferred compensation plans subject to section 457. As stated above, unfunded plans under section 457 generally are restricted by ERISA to excess plans or plans that cover only a "top hat" group of employees. However, because this ERISA limitation applies equally to unfunded plans of taxable and tax-exempt employers, at least a rough parity should exist between the relative number of employees who receive deferred compensation in a taxable employer and the employees who are covered under a section 457 plan in a tax-exempt employer.

²⁷ For example, the Bureau of Labor Statistics recently issued statistics on the retirement benefits provided to certain employees of State and local governments. This information does not identify those benefits that are provided pursuant to section 457. See News Release, Bureau of Labor Statistics, Department of Labor, October 31, 1991.

²⁸ See, e.g., National Association of Government Deferred Compensation Administrators and Council of State Governments, 1989 Survey of 457 Plans (1990), p. 8 (indicating that no surveyed plans imposed minimum age or salary requirements for employees to participate in plans under section 457) and Data on State and local government deferred compensation plans, submitted by Nationwide Life Insurance Company and Public Employees Benefit Service Corp. (November 19, 1991).

IV. CONCLUSION

Section 457 appropriately limits the deferred compensation of State or local governments and tax-exempt organizations. Without such a statutory provision, there would be no tax incentive for these employers to limit the deferred compensation offered to their employees. In contrast, such limitations are not necessary for private, taxable employers because the tax tension between the employers' preference for a current deduction and the employees' incentive for deferral will provide inherent restraints on the amount of deferred compensation that is provided. Moreover, to the extent that section 457 limits deferred compensation, it creates a greater incentive for tax-exempt employers to provide tax-qualified plans.

Under current law, however, certain tax-exempt organizations that are subject to section 457 are effectively precluded from offering section 401(k) salary reduction plans that generally are available in the private sector. The extension of section 401(k) plans would not offend the general policy concerns described in the prior paragraph because section 401(k) requires a broad base of employee participation and because a per-participant cap (\$8,475 currently) is imposed in addition to nondiscrimination rules. Accordingly, the Department of the Treasury has supported legislation to extend section 401(k) plans to tax-exempt organizations if appropriate revenue offsets are provided.²⁹ Given the options that are available currently to State and local governments that wish to offer broad-based salary reduction plans, the Department of the Treasury gives priority to providing such plans to nongovernmental, tax-exempt organizations.

²⁹ See, e.g., Testimony of Kenneth W. Gideon, Assistant Secretary (Tax Policy), Department of the Treasury, before the Subcommittee on Select Revenue Measures, Committee on Ways and Means, United States House of Representatives, February 21, 1990; Testimony of Kenneth W. Gideon, Assistant Secretary (Tax Policy), Department of the Treasury, before the Subcommittee on Select Revenue Measures, Committee on Ways and Means, United States House of Representatives, July 25, 1991; and Testimony of Kenneth W. Gideon, Assistant Secretary (Tax Policy), Department of the Treasury, before the Subcommittee on Taxation, Committee on Finance, United State Senate, September 10, 1991. In addition, proposals to extend section 401(k) were contained in the POWER pension simplification proposal announced on April 30, 1991, by Secretary of Labor Martin.

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Washington, D.C. 20220

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