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Amendments to Tax Exempt Organization's Deferred Compensation Plan Will Not Cause Grandfathered Deferrals to Be Subject to Code § 457

Major References: PLR 201117001
Related Reports: 92-61
MDRT: 2400.00, 6410.00

SEE THE CIRCULAR 230 DISCLAIMERS APPENDED TO THE CONCLUSION OF THIS WASHINGTON REPORT.

Under the facts presented in recently issued PLR 201117001, a 501(c)(3) tax-exempt organization maintained grandfathered deferred compensation plans that were established sometime on or before August 16, 1986. The employer has proposed amending the plans to specify the time of payment following a distributable event and to provide participants the opportunity to change the time and/or form of payment under the plans. The Internal Revenue Service has ruled that such amendments would not cause the plans to lose their grandfathered status and subject the deferrals to Revenue Code § 457.

Under § 457(b), state and local governments and tax-exempt entities may establish and maintain "eligible deferred compensation plans" for the benefit of their employees. These 457(b) plans may be maintained in addition to 401(a), 403(a) and 403(b) plans. They must, however, satisfy certain conditions, including an annual limit on the amount that may be deferred by each participant. If the conditions are satisfied, amounts deferred under the plans are not includible in income until they are paid to the participant. Generally, if a deferred compensation plan maintained by a governmental or tax-exempt entity is not a 401(a), 403(a) or 403(b) plan and does not satisfy the conditions of § 457(b), it is considered a 457(f) plan under which deferred amounts will be includible in income in the first year in which no substantial risk of forfeiture exists, regardless of when such amounts are actually distributed to the participant. For these purposes, a substantial risk of forfeiture exists so long as rights to compensation are conditioned upon the future performance of substantial services by any individual.

Prior to 1986, deferred compensation plans and arrangements maintained by tax-exempt entities were not subject to the requirements of § 457. Rather, such plans and arrangements were treated

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similarly to deferred compensation plans and arrangements maintained by for-profit entities, under which no annual limitation on deferred amounts exists. So long as a promise to pay deferred compensation in the future is unsecured, the deferred amounts are not includible in the employee's income. The Tax Reform Act of 1986 ("TRA '86"), however, extended the rules of § 457 to deferred compensation plans maintained by tax-exempt organizations for tax years beginning after 1986. "Grandfathered" plans of tax-exempt employers, though, are not subject to the requirements of § 457.

A deferred compensation plan maintained by a tax-exempt organization is considered "grandfathered" to the extent that deferrals under that plan were fixed pursuant to a written document on August 16, 1986. For this purpose, a deferral was considered fixed on that date if the deferral was then determinable under the written terms of the plan as a (i) fixed dollar amount, (ii) a fixed percentage of a fixed base amount (e.g., amount of regular salary, commissions, bonus or total compensation), or (iii) an amount to be determined under a fixed formula. Additionally, even if the plan, by its terms, did not contain a fixed deferral amount on August 16, 1986, the deferrals continue to be treated as though they were fixed if the deferral formula was not changed after August 16, 1986. Provided the deferred compensation plan remained grandfathered, all deferrals made pursuant to the formula in existence on August 16, 1986, even if made in subsequent tax years, remain exempt from § 457.

A plan, however, will lose its grandfathered status and will be subject to § 457(b) (or 457(f) if the conditions of 457(b) are not satisfied) as of the effective date of any modification to the plan that directly or indirectly alters the (i) fixed dollar amount, (ii) the fixed percentage or (iii) the fixed base amount to which the percentage is applied or the fixed formula.

Because these grandfathered plans do not fall within any exceptions under § 409A, they (unlike 457(b) plans) are subject to the requirements of that section. It appears that in this instance the employer is amending the plan to ensure that its terms are in compliance with § 409A, particularly with regard to the timing of payments and the participant's right to change the time or form of payment. Without expressing any opinion regarding § 409A, the Service ruled that the proposed amendments would not affect the grandfathered status of the plans in question.

This ruling is the first in this area in over twelve years and was probably triggered by the Treasury regulations and guidance existing under § 409A. For an example of a ruling issued in 1992 on this subject, see our Bulletin No. 92-61. Although PLRs cannot be used or cited as precedent, PLR 201117001 provides employers of grandfathered deferred compensations plans with some comfort that amendments to such a plan to comply with the § 409A time and form of payment requirements will likely not cause the plan to be subject to the current requirements of § 457.

Any AALU member who wishes to obtain a copy of ***PLR 201117001*** may do so through the following means: (1) use hyperlink above next to “Major References,” (2) log onto the AALU website at http://www.aalu.org/ and enter the *Member Portal* with your last name and birth date

and select *Current Washington Report* for linkage to source material or (3) email Anthony Raglani at raglani@aalu.org and include a reference to this *Washington Report*.

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