

*Compensation Planning Portfolios: Pensions & Retirement
Portfolio 373-4th: Employee Benefits for Tax-Exempt Organizations
Detailed Analysis
IV. Unfunded Deferred Compensation Plans Governed by §457
H. Additional Issues for §457 Plans*

5. Grandfather and Transition Rules

Generally, §457 does not apply to amounts deferred under an unfunded deferred compensation arrangement sponsored by a tax-exempt employer other than a rural electric cooperative in participants' taxable years beginning before January 1, 1987,¹⁰⁶⁹ or to nonelective deferred compensation plans of tax-exempt organizations until taxable years beginning after 1987.¹⁰⁷⁰

¹⁰⁶⁹ 1986 TRA, P.L. 99-514, §1107(c)(3)(A) and (B)(i).

¹⁰⁷⁰ TAMRA, P.L. 100-647, §6064(d)(3); Notice 88-8, 1988-1 C.B. 477. In PLR 9211018, the IRS ruled that an individual who became a participant in such a plan on Oct. 3, 1986, was not covered by the grandfather rule. The IRS also ruled, however, citing Notice 88-8, that compensation deferred by the participant that is allocable to years before 1988 is not subject to §457. The IRS stated that a reasonable actuarial method must be used to determine the portion of benefits allocable to those years and described certain assumptions that should be included in such a method.

Deferrals in a participant's taxable years beginning after December 31, 1986, are not subject to the restrictions of §457 if the deferrals with respect to the participant¹⁰⁷¹ were fixed pursuant to a written plan in existence on August 16, 1986.¹⁰⁷² Similarly, if an employee earns additional deferred compensation amounts for each year of service with the employer under a formula set forth in a written plan in existence on August 16, 1986, deferrals attributable to years of service after December 31, 1986, are protected under the grandfather rule, so long as deferrals continue to be determined under the formula in effect on August 16, 1986.¹⁰⁷³

¹⁰⁷¹ TAMRA §1011(e)(6). TAMRA clarified that the grandfather rule only applies to employees covered under a plan on Aug. 16, 1986. Employees who become eligible after that date are not covered.

¹⁰⁷² 1986 TRA §1107(c)(3)(B)(ii). Deferrals are treated as fixed on Aug. 16, 1986, to the extent that a written plan in existence on Aug.

16, 1986, provided for the deferral for each taxable year of the plan and the amount of the deferral was determinable under the written terms of the plan in existence on Aug. 16, 1986, as a fixed dollar amount, a fixed percentage of a fixed base amount, or an amount to be determined under a fixed formula. For example, if under a written plan in existence on Aug. 16, 1986, an employee could elect to defer up to 5% of regular salary and the employee had a 5% deferral election in effect on Aug. 16, 1986, subsequent deferrals of the employee's regular salary are protected under the grandfather rule, so long as the employee's deferrals continue at the rate of 5% of regular salary.

¹⁰⁷³ Notice 87-13, 1987-1 C.B. 432, Q&A-28.

A deferral that is fixed or determinable under a written plan in existence on August 16, 1986, will cease to be protected by the grandfather rule as of the effective date of any modification to the written plan that directly or indirectly alters the fixed dollar amount, the fixed percentage, the fixed base amount to which the percentage is applied, or the fixed formula. A deferral will not fail to be treated as fixed on August 16, 1986, merely because the written plan also provided for a deferral that was not fixed on that date. In addition, a deferral will not fail to be treated as fixed on August 16, 1986, merely because the tax-exempt organization and the individual have the right under the plan to renegotiate the plan and, thus, to alter the deferral (whether or not the plan is part of an employment contract) or merely because the individual has the right under the plan to vary the amount of the deferral in the future. So long as the formula for determining the amount deferred for a year is not changed, the IRS has approved ongoing grandfather treatment for plans which are amended after August 16, 1986, to provide for: a rabbi trust to hold the deferred compensation; ¹⁰⁷⁴ adoption of the grandfathered plan by a successor employer; ¹⁰⁷⁵ renewal of an existing agreement that expired by its terms after August 16, 1986; ¹⁰⁷⁶ changes in the time or mode of distribution ¹⁰⁷⁷ or the right to designate beneficiaries; ¹⁰⁷⁸ a reduction in the amount of future deferrals; ¹⁰⁷⁹ changes in investment media that serve as the measure of benefits under the plan by the employee's election ¹⁰⁸⁰ or otherwise; ¹⁰⁸¹ and the exercise of a board's discretion to continue deferrals. ¹⁰⁸² However, if at any time after August 16, 1986, these rights are exercised to modify the dollar amount, percentage of a specified base amount, or specified formula, deferrals after the effective date of any such modification will fail to be treated as fixed on August 16, 1986, and will be subject to §457. ¹⁰⁸³ Also, the grandfathered deferrals are taken into account in determining the maximum amount of other deferrals that are subject to favorable treatment under §457. ¹⁰⁸⁴

¹⁰⁷⁴ PLRs 9144022, 8822052, 8820031, 8813033.

¹⁰⁷⁵ PLRs 9030029, 8836014.

1076 PLRs 9144022, 8945049.

1077 PLRs 201117001, 9437018, 9146031, 8844026, 8813033.

1078 PLR 9019031.

1079 PLRs 9538021, 9401012, 9334021.

1080 PLRs 9350008 and 8947044.

1081 PLRs 9149032, 9016071. See PLR 9548006 (Section 457 does not apply to deferred compensation plan where participant, who was transferred within hospital system, performs essentially same services as before transfer is to be paid by different member of preexisting hospital structure).

1082 PLR 9221033.

1083 PLRs 9629022, 9538021. Compare PLR 201150020, in which a plan amendment limited the amount of the monthly benefit payable under the plan to not more than the greater of a certain dollar amount or the normal monthly benefit payable to the participant assuming he or she was age 55 at his or her employment termination. The IRS ruled that the deferral was grandfathered and that the reduction in the total benefit resulting from the amendment would not constitute a modification to the fixed formula and would not cause the plan to be subject to §457.

1084 Notice 87-13, Q&A 28.

In an effort to eliminate an open question as to whether the grandfather rule applied to nonelective plans, §457 was amended in 1988 to provide that §457 does not apply to amounts deferred on or after July 14, 1988, pursuant to nonelective plans maintained by state and local governments, if there was a written agreement on that date that provided for annual deferral of a fixed amount or an amount determined pursuant to a fixed formula. The exemption applies to all eligible plans under agreements in effect on July 14, 1988, if subsequent modifications to the plans do not increase benefits. ¹⁰⁸⁵

¹⁰⁸⁵ TAMRA §6064(d)(3); PLR 9149032; PLR 9250008 (amendment to §501(c)(3) organization's retirement plan did not affect grandfathered status of plan where amendment had effect of reducing benefits under plan, did not increase deferral beyond the extent fixed as of Aug. 16, 1986, and did not change basic formula of plan); H.R. Rep. No. 1104, 100th Cong. 2d Sess. at 154 (1988). In PLR 9334021, the IRS noted that TAMRA §6064(d)(3) is silent as to the legal effect of a post-1988 modification that does not increase benefits for participants in a pre-1987 plan that would otherwise be covered under §457. The IRS concluded that the legislative history of TAMRA §6064 demonstrates that Congress intended the grandfather rule to endure such plan modifications. Accordingly, the IRS ruled that an unfunded nonqualified deferred compensation plan established in 1983 for the

benefit of a key executive of a §501(c)(6) organization, as revised by a proposed amendment, would continue to be exempt from §457 under §1107(c)(3)(B) of 1986 TRA, as modified by §6064(d)(3) of TAMRA, and future deferrals under the plan would not be subject to §457.

Nonelective collectively bargained plans in existence on December 31, 1987, also are exempt from §457.¹⁰⁸⁶ For this purpose, a nonelective plan is one that covers a broad group of employees and under which the covered employees earn nonelective deferred compensation under a definite fixed and uniform benefit formula. A nonelective plan is subject to this exemption if at least 25% or more of the participants in the plan on December 31, 1987, were members of collective bargaining units covered by the collective bargaining agreement. The exemption is terminated as of the effective date of any material modification of the plan agreed to after December 31, 1987.¹⁰⁸⁷ A plan is materially modified if the benefit formula is changed or the class of participants expanded. A plan is not materially modified if an employer maintains a qualified plan which is an offset to the deferred compensation plan and the qualified plan is modified.¹⁰⁸⁸

¹⁰⁸⁶ TAMRA §6064(d)(2). Because §457 plans cannot be funded, this grandfather rule only applies to nonelective collectively bargained plans that are not subject to ERISA's funding requirements.

¹⁰⁸⁷ Notice 88-98, 1988-2 C.B. 421.

¹⁰⁸⁸ *Id.* In PLR 9210009, the IRS ruled that a collectively bargained deferred compensation plan that replaces mandatory employee contributions with employer contributions via employee salary reduction is not materially modified and will continue to be exempt from §457.

If a deferred compensation plan satisfies the grandfather rules, the plan need not satisfy any of the rules set forth in §457. This means that a grandfathered plan is exempt from all of §457, not merely the deferral amount limitation. This leaves open the question as to which rules apply to a properly grandfathered plan. While there is no guidance on this question, the rules applicable to nonqualified deferred compensation plans sponsored by taxable organizations presumably apply. These rules generally rely on application of the constructive receipt or economic benefit doctrine to determine the timing of taxation.

On violation of the grandfather rules, a plan becomes subject to §457. If the plan does not contain a proper substantial risk of forfeiture provision, then amounts deferred after violation of the grandfather rules are includible in the participant's gross income for the year of deferral.

There are specific exemptions for deferrals respecting individuals eligible to participate on August 16, 1986, in two plans as to which the IRS issued rulings in 1975 and 1976.¹⁰⁸⁹

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