Retiree Tax Planning for Eligible Retirement Plans of Tax-Exempt Entities

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Tax-exempt entities may establish as many as three types of tax-favored retirement plans. They may, of course, establish qualified retirement plans. They may also establish Sec. 403(b) plans, generally known as tax-sheltered annuities. The tax law treats distributions from qualified plans and tax-sheltered annuities similarly, a treatment generally familiar to tax practitioners.

Less familiar, though, is the tax treatment of distributions from eligible deferred compensation plans (eligible exempt entity plans) that most types of tax-exempt entities can establish.[1] These are unfunded plans[2] designed for select groups of management or highly compensated individuals ("top-hat" plans).[3]

Though unfunded, eligible exempt entity plans may involve related trusts or other vehicles that invest amounts deferred under the plans and may give plan participants the right to choose among selected investments. However, all property rights in the deferred funds and related income (whether or not segregated or invested) must belong exclusively to the

1 Governmental units and churches, though tax exempt, may not establish the type of unfunded eligible exempt entity plans discussed in this article (Secs. 457(a)(1), (b)(6), (e)(1), (e)(13), and (g)). However, state and local governments may establish *funded* eligible government plans under Sec. 457 that are subject to somewhat different rules (Secs. 457(a)(1)(A), (e)(1)(A), and (g)).

2 Sec. 457(b)(6).

3 The Employee Retirement Income Security Act of 1974 (ERISA) generally requires that employers fund retirement plans through a trust or custodial account. A top-hat plan is the only exception to the ERISA funding requirement that is consistent with the requirement in the tax law that eligible exempt entity plans be unfunded. Thus, eligible exempt entity plans are limited to top-hat plans (29 U.S.C. §1081(a)(3); see also IRS Letter Ruling 8950056 (12/15/89)).

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eligible exempt entity and must be subject to the claims of the entity's creditors.[4]

Note that traditional nonqualified retirement plans are not a feasible alternative for eligible exempt entities. Unlike unfunded deferred compensation payable by a taxable entity, deferred compensation payable by an exempt entity under an ineligible plan is generally taxable as soon as it vests.[5]

Taxation of Plan Benefits

A retiree or beneficiary must include in gross income the entire amount of a payment from an eligible exempt entity plan in the year received. In addition, he or she must generally include amounts the plan makes available, whether or not actually paid.[6] However, the tax law limits how soon the plan may make amounts available and how late the plan may commence payments.

Earliest Date Payments May Begin

An eligible plan may generally make payments available to a participant only after:

- The date the participant is no longer employed by the eligible entity;
- The calendar year in which the participant reaches age 70½; or
- The date the participant is faced with an "unforeseeable emergency."

The plan may also make payments available to a beneficiary after the participant's death.[7]

The terms of the plan should specify the exact date that plan funds first become payable on or after the occurrence of one of the above events. For example, many plans provide a date of payment that is a specified number of days after a triggering event (e.g., 90 days after retirement). Available funds are generally includible in gross income at that time, even if not paid then.[8]

> ***Example 1:*** *C* retires on June 15, 2012, when she is age 65. Her plan provides for payment of the entire benefit 90 days after retirement. *C* does not make an election to further defer payment, and the plan does not provide a default payment schedule in the absence of an election. The entire benefit becomes taxable on September 13, 2012 (90 days after retirement), even if payment is delayed.

Unforeseeable Emergencies

A special rule applies to unforeseeable emergencies. A participant need not include any amount in gross income merely because he or she may elect to receive plan funds for an unforeseeable emergency, if the participant does not actually make the election.[9]

An unforeseeable emergency is a severe financial hardship suffered by the participant or beneficiary due to accident or illness of the participant or beneficiary or that person's spouse or dependent. It also includes hardship due to casualty or other similar circumstances beyond the participant's control.[10]

For example, medical expenses or funeral expenses incurred by the participant or foreclosure on the participant's residence may give rise to an unforeseeable emergency.[11] Significant damage to the participant's home from a water leak is an unforeseeable emergency, as are expenses incurred for the funeral of an adult child

EXECUTIVE SUMMARY

- Most types of tax-exempt entities, other than churches and governmental units, may establish unfunded eligible deferred compensation plans under Sec. 457. These are sometimes called "top-hat" plans because they are designed for members of management and highly compensated individuals.
- Under these eligible exempt entity plans, amounts distributed are taxable to the participant or beneficiary when received or made available. Payments may not begin until separation, age 70½, death, or an "unforeseeable emergency." Participants generally may specify a triggering fixed and determinable event or specified date or age for payments to begin.
- Payments generally must begin by April 1 of the calendar year after the year in which the participant either retires or turns 70½, whichever occurs later.
- Elections may be tailored to retirees' and beneficiaries' needs and goals, including a steady cashflow, continuing deferral of payments, disability, and other contingencies. Eligible exempt entity plans may also offer greater flexibility than other plans with respect to qualified domestic relations orders and community property laws.

4 Regs. Sec. 1.457-8(b). Note that if the plan invests the funds in life insurance, distribution of the insurance proceeds on death (or distribution of the life insurance contract during life) will be taxable to the recipient, even though life insurance proceeds are otherwise generally exempt from income taxation (IRS Letter Ruling 9008043 (2/23/90)).

5 Secs. 83, 402(b), 403(c), and 457(f). In treating eligible exempt entities differently, Congress showed it was aware of the absence of the usual restraints that are imposed on deferred compensation payable by taxable entities. Taxable entities cannot deduct deferred compensation until it is includible in the recipient's gross income. Exempt entities, of course, need not be concerned about the timing of deductions.

6 Sec. 457(a)(1)(B).

7 Sec. 457(d)(1)(A); Regs. Sec. 1.457-6(b)(1). A plan may also make earlier distributions due to a plan termination, qualified domestic relations orders, or small inactive account balances (Regs. Sec. 1.457-6(a)).

8 Regs. Sec. 1.457-7(c)(2)(i).

9 Regs. Sec. 1.457-7(c)(2)(i)(A).

10 Regs. Sec. 1.457-6(c)(2).

11 Id.

(even if the child was not a dependent). However, the need to pay accumulated credit card debt is not an unforeseeable emergency.[12]

Note that distributions are allowed for an unforeseeable emergency only if they are necessary after taking into account all other reasonably available financial resources of the participant.[13]

Elections to Further Delay Payments

An eligible exempt entity may allow a retiree to elect an additional deferral of plan payments if the retiree makes the election before any payments are available.[14] A plan may also allow a second election to further delay payments if the retiree makes the second election before any payments are available under the initial election.[15] In addition, a plan may allow a retiree to elect the form of payment (i.e., the number and amount of payments) at any time before the payments begin under the elections.[16]

If the retiree does not make an initial election or does not elect the form of payment, the plan may provide for a default payment schedule.[17] Imposition of such a default payment schedule will not prevent a retiree from making a second deferral election.[18]

Plan benefits will not be taxable until they are available under the elections (or under the plan terms in the absence of an election).[19] Nevertheless, a plan participant may not use the elections to accelerate payments.[20] On the other hand, a participant may cancel or revise an initial deferral election within the election period allowed by the plan.[21]

> ***Example 2:*** *E* retires on June 15, 2012, when he is age 60. His plan provides for payment of the entire benefit 91 days after retirement unless, within the 90-day period following retirement, *E* elects a later or different form of payment. On July 1, 2012 (16 days after retirement), *E* elects to defer the payment of benefits until age 62. However, *E* later changes his mind, and on September 1, 2012 (78 days after retirement), he makes a revised initial election to receive installment payments beginning at age 65.

E made both the initial election and the revised initial election within the 90-day period following retirement. Consequently, the revised initial election is valid and the installment payments will be taxable when due, commencing on *E*'s 65th birthday. Then, if the plan allows, *E* may make a second election at any time before payment is due under the initial election.[22]

> ***Example 3:*** The facts are the same as in Example 2, except that *E*'s plan also permits him to make a second election to delay payments. One week before *E*'s 65th birthday (i.e., before installment payments are to begin under the revised initial election), he elects to further delay the start of payments until the day he reaches age 68. Under this second election, the installment payments will be taxable when due, beginning on *E*'s 68th birthday.

In Example 3, the plan could also provide that at any time before payments commence under the elections, the retiree may change the form of payment (e.g., from installment payments to a lump sum payable at age 68).[23] Furthermore, a plan may provide for the acceleration of installment payments in the event of an unforeseeable emergency.[24] However, if a retiree has an unconditional right to accelerate installment payments, he or she must immediately include all unpaid installments in gross income.[25]

Latest Date Distributions May Begin

An eligible plan must begin making minimum distributions to a retiree by a specified date, regardless of the plan's terms or the retiree's wishes. Normally, the specified date is April 1 of the year following the calendar year the retiree reaches age 70½.[26] However, if he or she retires after age 70½, the retiree's required beginning date is generally April 1 of the year following the calendar year of retirement.[27] Nevertheless, a plan may by its terms eliminate this retirement alternative altogether (reverting to age 70½ in all events).[28]

The plan must also begin making minimum distributions to a beneficiary by a specific date, usually the end of the calendar year following the retiree's death.[29] However, if the retiree dies before reaching age 70½ and a surviving spouse is the sole beneficiary, payments may begin by the end of the calendar year the retiree would have reached age 70½.[30] Nevertheless, if the retiree dies before his or her required beginning date, the plan terms might require payment of the entire plan benefit to the beneficiary by the end of the fifth full calendar year following the retiree's death.[31]

Retiree Tax Planning with Deferral Elections

Much of the tax planning for retirees in eligible exempt entity plans involves the use of elections to further defer the

12 Rev. Rul. 2010-27, 2010-45 I.R.B. 620.
13 Regs. Sec. 1.457-6(c)(2)(ii).
14 Regs. Sec. 1.457-7(c)(2)(ii).
15 Regs. Sec. 1.457-7(c)(2)(iii).
16 Regs. Sec. 1.457-7(c)(2)(iv).
17 Regs. Secs. 1.457-7(c)(2)(ii) and (iv).
18 Regs. Sec. 1.457-7(c)(2)(iii).
19 Regs. Sec. 1.457-7(c)(2)(i).
20 Sec. 457(e)(9)(B); Regs. Sec. 1.457-7(c)(2)(iii).
21 Regs. Secs. 1.457-7(c)(2) and (3), Example (6).
22 Id.
23 Regs. Sec. 1.457-7(c)(2)(iv).
24 Regs. Sec. 1.457-7(c)(3), Example (4).
25 Regs. Sec. 1.457-7(c)(3), Example (3).
26 Secs. 401(a)(9)(C)(i)(I) and 457(d)(2); Regs. Sec. 1.401(a)(9)-2, Q&A-2(a).
27 Sec. 401(a)(9)(C)(i)(II); Regs. Sec. 1.401(a)(9)-2, Q&A-2(a).
28 Regs. Sec. 1.401(a)(9)-2, Q&A-2(e). For a comprehensive explanation of minimum distribution requirements, see Blankenship, "Maximizing Tax Deferral for Funds in Tax-Favored Retirement Plans and IRAs," 9 *J. Retirement Plan.* 15 (January–February 2006).
29 Regs. Secs. 1.401(a)(9)-2, Q&A-5, and 1.401(a)(9)-3, Q&A-3(a).
30 Regs. Sec. 1.401(a)(9)-3, Q&A-3(b).
31 Regs. Sec. 1.401(a)(9)-3, Q&A-2.

distribution of benefits. The plans in the above examples allowed additional deferrals until specific dates or ages, consistent with the examples in the regulations. However, the regulations state that a plan may permit a retiree to elect to defer payments to a "fixed or determinable future time."[32] The IRS long ago interpreted this phrase to mean that a retiree may defer payments until the occurrence of an event of uncertain but determinable time (e.g., death or disability).[33]

The examples below presume that plan terms permit deferrals to either determinable events or fixed dates, or to such dates or events in the alternative (e.g., the earlier of age 65 or disability). They also presume that the plans permit different forms of payment for alternative payment dates or events (e.g., a lump sum at age 65 or installment payments on earlier disability).

Clearly, the time of a well-defined triggering event upon which a payment or payments become available is determinable. Furthermore, in other contexts the regulations generally allow different forms of payment for different events or recipients. Compare, on the one hand, installment payments triggered by retirement with, on the other hand, a lump sum or other form of payment triggered by unforeseeable emergencies, qualified domestic relations orders (discussed below), required minimum distributions, plan terminations, etc.[34] Ultimately, though, an employer would be wise to obtain a private letter ruling that specifically confirms the validity of plan provisions allowing particular types or combinations of payment events, dates, and schedules.

Retirees with Retirement Income Needs

Generally, a retiree will want to defer plan payments for as long as possible, consistent with retirement income needs. Some retirees will want a stream of income that is steady but no greater than their cash needs. If the plan permits, such a retiree could elect to immediately begin receiving installment payments in an amount consistent with his or her needs. The retiree would also likely want to provide for acceleration of the installment payments upon the occurrence of an unforeseeable emergency.

Alternatively, if the plan allows, the retiree may want to elect an immediately commencing life annuity. Bear in mind, though, that life annuity payments to the retiree must depend entirely on the unsecured promise of the employer. If, instead, the employer purchases and transfers a commercial annuity to the retiree, the annuity's fair market value is immediately taxable to the retiree. However, this rule should not prevent the employer from purchasing and owning a commercial annuity to fund payments to the retiree, as long as the retiree receives no right or interest in the commercial annuity.[35]

Retirees Wanting Maximum Deferrals

Retirees with substantial financial resources may want to defer the maximum amount of plan benefits for as long as possible. However, such retirees will also generally want to provide for contingencies such as death, disability, and unforeseeable emergencies.

> ***Example 4:*** *J* retires on June 15, 2011, when she is age 60. *J*'s eligible plan provides for payment of the entire benefit 91 days after retirement. However, within the preceding 90-day period, it allows *J* to elect to defer commencement of payments until a fixed or determinable future time. *J* may also change the form of payment any time before payments commence.
>
> *J* elects to receive a lump sum on April 1 of the year following the later of the calendar year she reaches age 70½ or retires. In addition, the plan or *J*'s election provides for the receipt of installment payments earlier upon the occurrence of death, disability, or an unforeseeable emergency. In this scenario, *J* has elected the maximum deferral period consistent with the required beginning date for minimum distributions. She has also provided for unexpected contingencies. Furthermore, at any time before payment is available, *J* may change the lump-sum payment on the April 1 date to another form of payment consistent with the required minimum distribution rules.

Retirees Wary of Irrevocable Maximum Deferrals

A retiree may wish to defer plan payments as long as possible but might not be sure how much deferral his or her financial resources will allow. To deal with this problem, the retiree may hedge by judiciously using both the initial and the second deferral elections.

> ***Example 5:*** The facts are the same as in Example 4, except *J* makes an initial election to receive a lump-sum payment of her benefit at age 65 or installment payments earlier upon death, disability, or an unforeseeable emergency. Shortly before her 65th birthday, *J* determines that she has sufficient other funds to continue indefinite deferral of plan benefits. Consequently, she makes a second election under the plan to receive a lump sum on April 1 of the year following the later of the calendar year

32 Regs. Sec. 1.457-7(c)(2)(ii).

33 Rev. Rul. 55-423, 1955-1 C.B. 41, obsoleted by Rev. Rul. 91-8, 1991-1 C.B. 281. The revenue ruling is obsolete because it relates to old statutory language (subsequently deleted by legislation) governing qualified plans. However, there is no reason to think that the IRS has changed its long-standing interpretation of the phrase itself.

34 For nonqualified plans of taxable entities, elections of specific multiple payment events and forms of payment are authorized in some detail in the Code and regulations. See Sec. 409A(a)(2)(A) and Regs. Sec. 1.409A-3. Also see Blankenship, "Retirement Planning for Unfunded Deferred Pay Under Section 409A," *Prac. Tax Strategies* 14 (July 2008).

35 Sec. 457(b)(6); Regs. Secs. 1.457-7(c)(1) and 1.457-8(b)(2); IRS Letter Rulings 8840011 (9/30/88) (annuity contract) and 9008043 (2/23/90) (life insurance contract). Although these letter rulings involve eligible government plans, they were issued when such plans were required to be unfunded. Thus, such plans were then very much like eligible exempt entity plans. Note, though, that back-to-back annuities might not be an attractive alternative due to the required annual taxation of increases in the value of the employer's commercial annuity (unless the employer is a natural person) (Sec. 72(u)).

she reaches age 70½ or retires. In addition, the plan or *J*'s second election provides for the receipt of installment payments earlier upon the occurrence of death, disability, or an unforeseeable emergency.

In this way, *J* has allayed her concerns about having insufficient funds during her retirement years. In addition, her combined elections have given her the maximum deferral period consistent with the required beginning date for minimum distributions. *J* has also provided for unexpected contingencies. Furthermore, at any time before she receives payment on April 1, *J* may change the lump-sum payment to another form of payment consistent with the minimum distribution rules.

Acceleration of Payments Prohibited

As noted above, a retiree may not use an election to accelerate payments. Specifically, a second election may not make payments available any earlier than provided in the first election.

Example 6: The facts are the same as in Example 5, except *J* makes an initial election to receive a lump-sum payment of her benefit at age 65, or installment payments earlier upon death or an unforeseeable emergency (but not for disability). However, at age 63 *J* determines that she has sufficient other funds to continue indefinite deferral of plan benefits. Thus, she makes a second election at that time to receive a lump sum on April 1 of the year following the later of the calendar year she reaches age 70½ or retires. *J*'s second election also provides for the receipt of installment payments upon earlier disability, as well as upon death or unforeseeable emergency. However, the election also provides that, if *J* is disabled before age 65, payments for the disability will commence at age 65.

If *J* had not delayed payments for disability until age 65, the second election would have contained a forbidden acceleration of payments. Because the initial election did not provide for payments for disability prior to age 65, the second election cannot override the terms of the initial election to allow such accelerated payments. On the other hand, payments upon death or unforeseeable emergency have not been accelerated, since both the initial and the second elections provided for commencement of payments on the occurrence of those events.

Disability and Unforeseeable Emergencies

A disability or an unforeseeable emergency might not be considered a determinable event unless the term is carefully defined in the plan or in a retiree's election. For unforeseeable emergencies, the plan or election should use the definition found in the regulations governing eligible plans.[36] For disability, the plan or election might use the Social Security definition or the definition in Sec. 72(m)(7), which is frequently used in the context of various types of retirement plans.[37]

Observation: Making payment of a retiree's deferred compensation dependent on post-retirement disability is not as strange as it may sound. Large medical expenses may accompany disability. Those medical expenses may constitute a severe financial hardship justifying unforeseeable emergency payments. However, a plan can generally make such emergency payments only after the retiree has liquidated and used other investment assets to pay medical expenses.[38] Thus, the retiree may need disability payments to replace the retirement income no longer generated by the liquidated investment assets.

Deferral Elections by Beneficiaries

An eligible exempt entity may also generally allow a beneficiary to elect to delay the payment and taxation of benefits, provided the beneficiary makes the election before any payments are available.[39] In addition, the plan may give a beneficiary a second election to further delay the payment of benefits, provided the beneficiary makes the second election before any amounts are available under the first election.[40] A plan may also allow a beneficiary to elect the form of payment at any time before the first payment is due.[41]

However, a beneficiary may not make an initial or second deferral election if plan funds were paid or made available to the retiree before the retiree's death (other than payments for an unforeseeable emergency). Nor may the beneficiary make such elections if the retiree died after the expiration of the initial election period. However, it is unclear whether a beneficiary may make the elections if the retiree died after severance from employment but before expiration of the initial election period.[42]

Plan Payments After Divorce or Separation (QDROs)

If a retiree and his or her spouse divorce or legally separate, they ordinarily attempt to work out a property settlement. A divorce court may or may not take an active role in structuring the settlement, but the court normally must formally approve the ultimate property division. Benefits accrued in an eligible exempt entity plan are normally included in the settlement. The court will usually issue a domestic relations order that directs the payment of some portion of the benefits to the retiree's spouse or dependents.

The tax law uses the term "qualified domestic relations order" (QDRO) to refer to a domestic relations order directing a tax-favored retirement plan to pay benefits to a retiree's spouse, former spouse, children, or other dependents. However, QDROs under eligible exempt entity plans are subject to much less stringent requirements and conditions than those under most other types of retirement plans.[43] For example, a QDRO under an eligible plan, unlike other plans, can require the plan to make distribu-

36 Regs. Sec. 1.457-6(c)(2).
37 See, e.g., Secs. 402(e)(4)(D)(i)(IV), 408A(d)(2)(A)(iii), and 403(b)(7)(A)(ii).
38 Regs. Sec. 1.457-6(c)(2)(ii).
39 Regs. Sec. 1.457-7(c)(2)(ii).
40 Sec. 457(e)(9)(B); Regs. Sec. 1.457-7(c)(2)(iii).
41 Regs. Sec. 1.457-7(c)(2)(iv).
42 Regs. Sec. 1.457-7(c)(2)(ii).
43 Secs. 414(p)(11) and (p)(1)(A)(i).

tions to an alternative payee even though the participant is not yet eligible for distributions.[44]

A retiree is not liable for income tax or gift tax on benefits paid to his or her spouse or former spouse under a QDRO. Instead, the spouse will pay income tax on the benefits as if he or she were a participant in the plan.[45] The terms of a QDRO cannot change this result,[46] nor can state community property laws.[47] However, distributions a retiree actually receives are taxable to the retiree even if a court order requires the retiree to pay the distributed amounts over to his or her spouse. Such a court order cannot constitute a QDRO because the court has not ordered the plan to make the payments directly to the spouse.[48]

The QDRO rules do not apply to pre-2002 domestic relations orders under eligible exempt entity plans.[49] If the QDRO rules do not apply, payments to a retiree's spouse or former spouse continue to be taxable to the retiree.[50] Note also that QDRO payments received by individuals other than the retiree's spouse or former spouse (e.g., the retiree's children) are taxable to the retiree as if he or she had received them.[51]

Applicability of State Community Property Laws

If a retiree resided in a community property state while working, the retiree's spouse may have acquired a 50% ownership interest in amounts the retiree earned. Although these state community property laws generally do not apply to participants in qualified plans, they do apply to participants in eligible plans.[52] Thus, if a retiree participated in such a plan while residing in a community property state, his or her spouse may have acquired a community property interest in plan benefits as they accrued. The community property states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin.

Plan Participants Who Are Independent Contractors

Independent contractors who provide services to an eligible entity may generally participate in the entity's eligible plan to the same extent as an employee.[53] However, such a plan generally cannot cover *nonelective* deferred compensation of individual independent contractors who have identical relationships with the entity. Such deferred compensation may be covered only if the plan provides the contractors with individual variations or options (other than merely requiring an initial service period).[54]

As discussed above, payments under an eligible plan generally may not begin until after separation from employment. For this purpose, an independent contractor separates from employment upon the good-faith termination of all his or her service contracts with the eligible entity.

A termination is not in good faith if the eligible entity expects to renew the relationship in the form of either an employee or independent contractor arrangement.[55]

Fortunately, the regulations provide a safe harbor if the deferred compensation is not payable to the terminating contractor until after 12 months following termination. However, the safe harbor is lost if the independent contractor renders any additional services to the exempt entity before the payment date and the deferred compensation is nevertheless paid.[56]

Retiree Contributions of Sick, Vacation, and Back Pay

A retiree may generally elect to transfer the amount of his or her accumulated

44 Regs. Sec. 1.457-10(c).

45 Sec. 402(e)(1)(A); IRS Publication 504, *Divorced or Separated Individuals* (2010).

46 *Mitchell*, 131 T.C. 215 (2008).

47 Secs. 414(p)(11) and 402(e)(1)(A); *Seidel*, T.C. Memo. 2005-67.

48 *Amarasinghe*, T.C. Memo. 2007-333, aff'd *per curiam*, 282 Fed. Appx. 228 (4th Cir. 2008).

49 Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16, §§635(a)(1), (2); Sec. 414(p)(11).

50 *Platt*, T.C. Memo. 2008-17.

51 Secs. 72(t)(2)(C) and 402(e)(1)(A).

52 29 U.S.C. §§1003(b)(1), 1051(2), and 1081(a)(3); *Boggs v. Boggs*, 520 U.S. 833 (1997).

53 Regs. Sec. 1.457-2(e).

54 Regs. Sec. 1.457-2(k)(1).

55 Regs. Sec. 1.457-6(b)(2).

56 Id.

sick, vacation, and back pay to an eligible plan that accepts such transfers. However, the election must be made before the month in which the amount is otherwise payable. In addition, the amount must be otherwise payable before the later of 2½ months after retirement or the end of the calendar year of retirement.[57]

Example 7: *R*'s eligible plan and its sick leave and vacation pay program allow retirees to contribute amounts of accumulated sick and vacation pay to the eligible plan. *B* retires on January 12, 2011, when he has accumulated sick and vacation pay of $12,000, payable on March 15, 2011. On February 4, 2011, *B* elects to contribute the accumulated sick and vacation pay to the eligible plan.

The transfer is a valid deferral of compensation (subject to normal deferral limits), because *B* made the deferral election before March 2011, the month the sick and vacation amounts were otherwise payable. Further, the amounts were payable on March 15, 2011, before the later of 2½ months after retirement or the end of 2011 (the calendar year of retirement).[58]

Tax-Free Restorative Contributions

As noted above, payments to participants in an eligible plan may be measured by the performance of the entity's investment of deferred amounts.[59] Unfortunately, in some cases those investments may be dissipated by negligence or fraud. If so, the IRS has ruled, participants are not taxed on:

- The entity's subsequent recovery of some or all of the investment; and
- The preservation of the plan's liability in the entity's bankruptcy proceedings.

However, the plan must remain unfunded. That is, the restored investments must remain the property of the eligible entity and must remain subject to the claims of the entity's general creditors.[60]

Exemption from Forfeiture in Bankruptcy

Funds in an eligible plan are generally exempt from forfeiture in the retiree's bankruptcy proceedings.[61] However, it is not entirely clear whether the exemption depends on the existence of specific anti-alienation provisions in the plan or whether the retiree must alternatively choose a particular exemption regime under the bankruptcy law.[62]

Transition from a Taxable Entity to an Exempt Entity

A taxable entity that is converting to an exempt entity may have existing qualified and nonqualified retirement plans. The conversion should generally not affect the qualified plans since both taxable and exempt entities may adopt such plans. However, the rules applicable to nonqualified plans are generally different for an eligible exempt entity.

Fortunately, the IRS has ruled that an eligible exempt entity may solve the nonqualified plan problem by freezing its old plans so that participants make no additional deferrals under the plans. Participants may then enjoy existing benefits from these plans under the old rules. More particularly, though, retirees may continue receiving and reporting their plan benefits without change.[63]

Plan Terminations and Conversions

An eligible exempt entity may generally terminate an eligible plan in accordance with its terms if the plan distributes all deferred compensation as soon as administratively practical.[64] If an eligible entity becomes a taxable entity, the benefits of participants in an eligible plan will become taxable to them under the rules applicable to unfunded nonqualified plans of taxable entities unless the entity chooses to terminate the plan.[65]

Tax Withholding from Plan Distributions

An eligible exempt entity plan must withhold income tax on payments made to a retiree who was an employee, or made to his or her beneficiary, at the rates applicable to wages.[66] However, plans are not required to withhold Social Security, Medicare, and FUTA taxes from plan distributions. Instead, the sponsoring employer must withhold these taxes at the time of deferral of the compensation or, if later, when the compensation is no longer subject to a substantial risk of forfeiture.[67]

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EditorNotes

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57 Regs. Sec. 1.457-4(d); IRS Letter Ruling 201024011 (6/18/10).

58 This example is based on Regs. Sec. 1.457-4(d)(2), Example (1).

59 Regs. Sec. 1.457-8(b).

60 IRS Letter Ruling 9601038 (1/5/96) is another ruling involving an eligible government plan that was issued when such plans were required to be unfunded and thus were very much like eligible exempt entity plans. Note also that the result in the ruling is analogous to the treatment of the recovery by a funded tax-favored plan of funds lost due to fraud, breach of fiduciary duty, or violation of federal securities laws (Rev. Rul. 2002-45, 2002-2 C.B. 116 (qualified plan); IRS Letter Ruling 200852034 (12/26/08) (IRA)).

61 Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, P.L. 109-8, §224 (amending 11 U.S.C. §522).

62 *In re Braulick*, 360 B.R. 327 (Bankr. D. Mont. 2006).

63 IRS Letter Ruling 200302015 (1/10/03).

64 Regs. Sec. 1.457-10(a)(1).

65 Regs. Sec. 1.457-10(a)(2).

66 Temp. Regs. Sec. 35.3405-1T, Q&A A-23; Notice 2003-20, 2003-1 C.B. 894.

67 Secs. 3121(a)(5), (v)(2), and (v)(3); Notice 2003-20, 2003-1 C.B. 894; IRS Letter Ruling 200748003 (11/30/07).