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June 2011

LEGAL UPDATES AND NEWS

Credit Union Update on Code Section 457 Supplemental Executive Retirement Plans

Two major developments are pending that will significantly affect Supplemental Executive Retirement Plans ("SERPs") for Credit Unions. One is expected to occur in Fall, 2011, but the timing for the other is still unknown.

First, in an April 2011 webcast, an IRS official stated that proposed regulations under Code Section 457 are in the "clearance process" and could be published as early as September, 2011. These regulations would synchronize the "substantial risk of forfeiture" definition in Code Section 457(f) with the definition in Code Section 409A.

No More Salary Deferrals

Most likely, the new rules would eliminate the ability of executives to defer their own base salary into a 457(f) SERP. The IRS's position is that employees have a current right to receive base salary, so the only reason to delay payment of the base salary is to delay taxation by allegedly subjecting the base salary to a "substantial risk of forfeiture" that does not (in the IRS's view), actually exist. The new rules may permit elective salary deferrals into a 457(f) SERP only if the Credit Union also provides a "matching contribution" on the deferrals or if somehow the amount "at risk" otherwise exceeds the amount of base salary that was deferred.

Severance Plans

The new rules are also expected to clarify what types of arrangements qualify as "bona fide severance plans" under Code Section 457(e)(11). For the past 40 years, there has been no definition at all. The IRS believes that tax-exempt organizations may be providing significant severance pay to executives that should be considered "deferred compensation" subject to Code Section 457(f). The new definition of "severance plan" is expected to parallel the definition of severance payments under Code Section 409A, which are permitted solely upon "involuntary separation from service." The new rules may limit the amount of severance pay to two times the lesser of (i) actual annual compensation or (ii) the IRS tax-qualified plan limit for annual compensation (i.e., 2011, $245,000). The new rules are also likely to prevent long payouts because the IRS believes that severance pay should be completed by the end of the second taxable year following the year in which the employment ended.

Substantial Risk of Forfeiture

Finally, the new rules are likely to formally declare that 457(f) plans cannot use a "rolling risk of forfeiture" to extend the payment date and cannot use non-compete clauses as the "substantial risk of forfeiture." These provisions have generally not been used by Credit Unions since January 1, 2005, which was the effective date of Code Section 409A. However, old IRS rulings allowed these concepts for 457(f) plans, so the IRS will overturn the old rulings.

Conclusion

We believe that the new 457(f) rules will not be much of a surprise to Credit Unions, since the IRS telegraphed what the new rules would look like when they published Notice 2007-52. Even after the Notice was published, many Credit Unions continued to permit deferrals of base salary, because the Notice did not change the law. However, since the advanced warning was given four years ago, Credit Unions may have forgotten that the IRS provided early warning about the rule change.

Second, since 2005, Credit Unions and their advisers have been holding their collective breath waiting for the IRS to clarify whether Credit Unions in general and Federal Credit Unions (FCUs) in particular are or are not "eligible employers" that are permitted to sponsor deferred compensation plans under Code Section 457.

Can FCUs Have 457 Plans?

Over the past six years, we have been using our contacts with IRS officials in Washington DC to informally monitor developments on this very important issue for our clients. On several occasions

this year, we were told "off the record" that guidance is not likely to be issued anytime soon, because health care reform has bumped all other guidance projects to a lower priority. In addition, we were told that this guidance is not "quick and easy" because it involves several other federal agencies (such as the DOL and PBGC) who must all agree, "once and for all" on what it means to be a "governmental plan." This definition is key to whether Credit Unions can or cannot sponsor 457(b) and 457(f) deferred compensation plans and 457(e)(11) "bona fide severance plans." Our IRS contacts have told us that, while they are keenly aware of Credit Unions' interest in having an answer, the definition of "governmental plan" goes way beyond Credit Union 457 plans and affects many other federal laws, including many issues that affect other types of tax-exempt organizations, such as Indian tribal governments.

When Will We Know?

Therefore, Credit Unions and their advisers must continue to be patient while the IRS and several other federal regulatory agencies sort out the proper boundaries of the "governmental plan" definition. Our best guess is that it will be at least several years until proposed rules are issued. Currently, "governmental plan" guidance is merely in the "pre-ruling stage" on the IRS's business plan. On one hand, it is a positive sign that this project is at least on the IRS's radar screen. We continue to remind our IRS contacts that Credit Unions have been waiting for an answer since the IRS made 457 plans a hot issue for FCUs in Notice 2005-58. On the other hand, it is a negative sign that the project has been given such a low priority on the IRS's list of upcoming guidance. Plus, given the complexity of involving other federal agencies and expected budget cuts for those agencies, we think progress on this project will move forward at a glacier's pace.

What Caused the Debate?

As many Credit Unions may recall, IRS Notice 2005-58 put a chill on FCUs setting up new 457 plans. Specifically, the Notice said that until the "governmental plans" guidance is issued, an already-existing plan (as of 2005) maintained by a FCU may be treated as if the FCU is permitted to sponsor a 457 plan only if the FCU has consistently claimed the status of non-governmental tax exempt organization for all employee benefit plan purposes. The Notice was in response to Private Letter Ruling (PLR) 200430013, which concluded that the particular FCU who requested the PLR was ***not*** eligible to sponsor a 457 plan. The PLR was based on IRS Revenue Ruling 69-283, which indicated that FCUs chartered under the Federal Credit Union Act are federal instrumentalities for purposes of Code Section 501(c)(1), and therefore FCUs are ***not*** "eligible employers" with respect to Code Section 457 plans.

Conclusion

On the bright side, Notice 2005-58 stated that, if future guidance concludes that FCUs are not "eligible employers" and therefore cannot sponsor Code Section 457 arrangements, the future guidance will include a reasonable transition period during which FCUs can revise their 457 arrangements in order to avoid possible adverse tax consequences for participants.

Despite Notice 2005-58 and Notice 2007-62, which both discussed planned future changes to Credit Unions' 457 plans, it appears that most Credit Unions are simply carrying on with "business as usual" with respect to implementing new 457 plans and revising existing 457 arrangements. Since the "governmental plans" definition project (now six years overdue) is moving even slower than the 457(f) salary deferral and bona fide severance project (now four years overdue), that seems to be a reasonable approach, given that transition rules are likely to apply to both sets of new rules.

If you have any questions regarding Code Section 457 SERPs, please do not hesitate to contact any of our partners below.

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