Published on *The National Law Review* https://natlawreview.com

Code §457 Plans: Making the Best Choice for Your Nonprofit Organization

Article By:

Belinda S. Morgan

If we've said it once, we've said it a hundred times (ok, maybe just that one time) – recruiting and retaining top talent can be a headache for nonprofit organizations forced to compete against for-profit organizations offering sought-after executives hefty base salaries *and* generous equity packages. For one thing, nonprofits must comply with IRS rules mandating compensation paid to their employees be both "reasonable" and not "excessive," and for another, nonprofits don't typically issue stock or other equity.

To tempt top talent to their teams, nonprofit organizations may elect to include nonqualified deferred compensation (NQDC) plan benefits in their executive compensation packages. Non-governmental nonprofit organizations[1] can sponsor both "eligible" NQDC plans under Code §457(b) (457(b) plans) and "ineligible" NQDC plans under Code §457(f) (457(f) plans).

While both 457(b) plans and 457(f) plans offer eligible participants a way to defer receipt of current compensation, they do so in different ways. To help you determine which Code §457 NQDC plan would be best suited to the needs of your non-governmental nonprofit organization, the chart below compares (at an admittedly high level) some of the features and limitations of 457(b) and 457(f) plans.

	Code §457(b) Plans	**Code §457(f) Plans**
Who can participate?	Participation must be limited to a select group of management or highly compensated employees (a "top-hat" group). (The smaller the top-hat group, the better – courts have typically held that the top range for a top-hat group is no more than 15% of all employees.)	Participation must be limited to a top-hat group. (The smaller the top-hat group, the better – courts have typically held that the top range for a top-hat group is no more than 15% of all employees.)
Will the plan be subject to ERISA?	If participation is limited to a top-hat group, the plan is "unfunded," and the employer files the needed "top-hat notice"	If participation is limited to a top-hat group, the plan is "unfunded," and the employer files the needed "top-hat notice"

	with the Department of Labor (DOL), then a 457(b) plan will not be subject to ERISA's funding, participation, and vesting rules. ERISA's claims and appeals rules still apply, however.	with the DOL, then a 457(f) plan will not be subject to ERISA's funding, participation, and vesting rules. ERISA's claims and appeals rules still apply, however.
What do you mean the plan must be "unfunded"?	A 457(b) plan will be viewed as "unfunded" if it is (i) a bookkeeping account the nonprofit employer uses to track the benefits owed to participants, or (ii) if the nonprofit employer sets assets aside to fund benefits under the plan, those assets remain subject to the claims of the employer's general creditors. Nonprofit employers wishing to give participants a greater sense of security regarding the payment of 457(b) plan benefits may, however, establish a "rabbi" trust. Using a rabbi trust will protect the 457(b) plan's assets from the employer's unfettered use while ensuring those assets remain subject to the claims of the employer's creditors (if the employer becomes insolvent).	A 457(f) plan will be viewed as "unfunded" if it is (i) a bookkeeping account the nonprofit employer uses to track the benefits owed to participants, or (ii) if the nonprofit employer sets assets aside to fund benefits under the plan, those assets remain subject to the claims of the employer's general creditors. Nonprofit employers wishing to give participants a greater sense of security regarding the payment of 457(f) plan benefits may, however, establish a "rabbi" trust. Using a rabbi trust will protect the 457(f) plan's assets from the employer's unfettered use while ensuring those assets remain subject to the claims of the employer's creditors (if the employer becomes insolvent).
Must the plan be in writing, or can we just wing it?	The plan must be in writing – do not "wing" it.	The plan must be in writing – do not "wing" it.
Are deferrals under the plan subject to the requirements imposed by Code §409A?[2]	Provided a 457(b) plan is structured correctly and administered in accordance with those terms, it will be exempt from Code §409A. If it's not, however, the plan will no longer be treated as a 457(b) plan. Instead, it will be viewed as a 457(f) plan, and will be subject to Code §409A. Moral of the story?: If you have a 457(b) plan, be sure you understand and follow its requirements.[3]	Generally, yes. Some 457(f) plans may, however, be structured to be exempt from Code §409A.
Are employee deferrals to the plan permitted?	Yes. Any amounts the employee defers will, however, be subject to the claims of the nonprofit employer's creditors if the nonprofit employer became insolvent.	They're permitted, but employee deferrals aren't typical in 457(f) plans. Under Code §457(f), amounts contributed to a 457(f) plan must be subject to a "substantial risk of forfeiture" (SROF) to avoid being

		immediately included in a participant's taxable income. Most 457(f) plans impose vesting requirements (see below) on participants to ensure the SROF rule is met. Complying with the SROF requirements would require participants to place their own employee deferrals at risk if they don't meet the 457(f) plan's vesting requirements.
Are contributions to the plan (whether employee or employer) subject to vesting?	Typically, no. Employee deferrals to a 457(b) plan aren't subject to vesting. While it's possible to impose vesting requirements on employer contributions to a 457(b) plan, that can complicate the administration of the plan. That's because employer contributions subject to vesting will only be taken into account as contributions for purposes of Code §457(b)'s annual contribution limit (see below) when they vest. If participants and plan sponsors aren't aware of this requirement, they may inadvertently exceed the annual contribution limit.	Yes. As noted above, contributions to 457(f) plans must be subject to a SROF. This is typically accomplished by imposing time-based or event-based vesting on contributions. Once the 457(f) plan's vesting requirements are met, the vested amounts must be included in the participant's taxable income.
Are there any limits on contributions to the plan?	Yes. Total contributions to a 457(b) plan (employer, participant, or any combination thereof) are limited to $23,000 for 2024. Contributions to a 457(b) plan do not, however, need to be coordinated with contributions to any Code §403(b) or §401(k) plans sponsored by the nonprofit employer. A participant's total compensation – including contributions to the 457(b) plan – must still be "reasonable" when compared to the participant's title/duties.	There are no limits on contributions to a 457(f) plan. A participant's total compensation – including contributions to the 457(f) plan – must still be "reasonable" when compared to the participant's title/duties.
Can age 50 "catch-up" contributions be made to the plan?	No, not for 457(b) plans sponsored by non-governmental nonprofit organizations.[4]	Not applicable.
Are in-service distributions permitted from the plan?	Employers may allow participants to take in-service distributions for "unforeseeable emergencies"	Employers may allow participants to take in-service distributions for "unforeseeable emergencies"

	(as defined by the regulations implementing Code §457(b)).	(as defined by the regulations implementing Code §409A).
How are distributions of benefits from the plan taxed?	Amounts deferred under a 457(b) plan will be taxable to the participant when distributed, or otherwise made available, to the participant. While 457(b) plans can be designed to pay out over time, the default is usually to pay a participant's benefits in a single lump sum payment. The participant is typically permitted to elect (during a short time following termination/retirement) to defer payment (to the extent legally permitted under the required minimum distribution rules) or to select another form of payment.[5] Payments from a 457(b) plan are reported as income to the participant on Form W-2.	Amounts deferred under a 457(f) plan are treated as taxable as soon as they are no longer subject to an SROF (*i.e.*, when they vest). Payments from a 457(f) plan are reported as income to the participant on Form W-2.

[1] Such organizations include (but aren't limited to) Internal Revenue Code (Code) §501(c)(3) organizations, private universities, and certain healthcare organizations. This article focuses on plans offered by non-governmental nonprofits – NQDC plans sponsored by federal, state, or local governmental entities or by churches or church-associated organizations are subject to different rules and are not covered.

[2] Code §409A imposes strict requirements on "nonqualified deferred compensation." Violating the requirements of Code §409A can lead to significant adverse tax consequences for affected participants, including immediate taxation of amounts intended to be deferred, substantial penalties, and additional reporting requirements.

[3] Having a 457(b) plan be treated as a 457(f) plan, and subject to both Code §457(f) and §409A is not a good thing.

[4] Governmental 457(b) plans may permit such contributions, however.

[5] Such elections must be made with care and follow the 457(b) plan's requirements. *See* fn. 3.

© 2025 Foley & Lardner LLP

National Law Review, Volume XIV, Number 199

Source URL:https://natlawreview.com/article/code-ss457-plans-making-best-choice-your-nonprofit-organization