# Executive Retirement Plans for Public Education Institutions

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The Internal Revenue Code (the Code) allows governmental employers, including colleges, universities and public school districts, to sponsor several types of executive retirement plans for their employees and to designate contributions as employer or employee contributions.

The choice of the right type of plan involves how much the employer wants to contribute, plan design issues (e.g., vesting) and tax advantages and disadvantages of each type of plan. Listed below is a brief description of how each of these plans works. It is important to note that state laws vary dramatically and may limit what is allowable under federal law, since for most retirement plan issues (other than certain tax rules) state law prevails. Note that not all states allow public employers to have all of these plan types so it is important to check local laws before implementing a plan.

We can help you and your organization design and implement the type of plan that will best fit your needs. Also, whether a contribution is designated as an employer or employee compensation affects the amount education leaders can contribute and whether the contributions are creditable compensation for retirement benefits.

# 1. 403(b) Plan

The 403(b) plan is an ideal vehicle for creating a special executive retirement plan for governmental 501(c)(3) / educational organizations. However, prior to 1997, Section 403(b)(12) of the Internal Revenue Code there was concern that such plans could be subject to many of the same nondiscrimination rules that apply to retirement plans in the corporate sector. In 1997, Congress amended Section 403(b)(12) to remove most of these restrictions.

For this reason, plans can be set up that provide benefits only for certain individuals. These plans can include most of the features of a qualified retirement plan, including vesting rules, plan loans, service requirements and many other items. The complex Maximum Exclusion Allowance has been repealed by Congress but the calculation of how much can be contributed by the employer vs. the employee must be handled carefully. In addition, documentation of the plan is critical to allowing employer contributions to the plan. The good news is that in most cases the employer can contribute much more to this plan than the individual can contribute through salary deferrals.

### BEST PRACTICES

Establishing an executive retirement plan for a school leader is a common benefit, but the process of establishing and implementing the plans can be challenging. It is important that the following Best Practices be followed when adopting and implementing employer-paid tax deferred plans to ensure the District and Participant ensure the plans are compliant with Local Policies and Federal regulations.

One of the best uses of these plans is to purchase additional years of service with state retirement systems. Federal law and most state laws now allow an employee to transfer funds from a 403(b) plan to the state retirement system to purchase service while the employee is still working. This right applies to "earned service," which usually includes service with another state in an education related position and military service. Some states allow the purchase of "unearned service." Funds can be transferred or rolled over from a 403(b) plan to purchase unearned service but usually this can only be done after the employee terminates employment. It is critical to plan for any purchase of service from a state retirement system well in advance due to the complexity of these rules.

**Under federal laws, distributions from these plans can be rolled over to an Individual Retirement Account, another 403(b) plan, 401(a) plan, a 457(b) plan and other retirement plans.**

The limit on contributions by an employer to a 403(b) plan is the lesser of 100% of compensation or $69,000 (2025 limit) less employee deferrals to a 403(b) plan with the same employer, excluding the "age 50+ catchup" amount; and the contribution may not exceed 100% of compensation. This means that the effective limit for such a plan can be as much as $76,500 (2025 limit) including the age 50+ catch up.

**BEST PRACTICE #1 – KNOW WHAT THE PARTICIPANT IS CURRENTLY SAVING**

It is important to know the amount the Participant is currently saving in tax deferred plans as each plan has different limits and regulations. If a Participant over contributes, then at the end of the year the excess contributions will be returned and taxes will be owed, which may pose a challenge to the Participant. This can be avoided if it is known upfront what is currently being saved by the Participant and if the language in the contract is crafted to provide "spillover" language for applicable plans.

In order to use the higher limits, it is very important that the individual's employment contract specify that the payments to the 403(b) plan are non-elective and cannot be paid to the individual in cash. An elective deferral to the plan is referred to in tax terms as a "CODA" – a cash or deferred arrangement. This means that when the individual is paid compensation they can either receive it as taxable cash or they can defer it to the plan. These payments are subject to the lower limit for elective deferrals. The higher limit is only available when the payment is a non-elective contribution by the employer and cannot be paid as cash. In addition to the higher limit, this also makes the payment exempt from FICA and Medicare tax, and not reportable on the individual's W-2 form (we can supply a cite from the W-2 form instructions if requested to support this.)

### BEST PRACTICE #2 – SPECIFIC CONTRACT LANGUAGE ADDRESSING THE ACCOUNT TYPE, INVESTMENT AUTHORITY, DATE OF PAYMENT, AND VESTING

It is important that the contract language outlining the contribution be specific and address several key issues; including the type of account (403(b), 457(b), 401(a)), who has investment authority (the District or Participant), the date of the payment, and when the Participant is vested in the funds. If the language does not address these issues, then it can lead to confusion during implementation and frustration for all parties if an adversarial situation arises. This language can be highly customized, making it important to determine the goal(s) of establishing the plan(s) to craft the language, so it accomplishes the intended aim.

An additional item that is occasionally raised is where the "age 50+ catchup option" fits in an employer payment. The key is that the Code Section 414(v) refers to these payments as "elective deferrals." It is not uncommon for organizations to make a contribution for an employee to their 403(b) plan and treat this as an elective deferral. This can be done as long as the contribution is reported correctly on the employee's W-2, and they pay FICA and Medicare tax on this. The 50+ catch up is technically an elective deferral but there is nothing that prohibits the employer from reimbursing the executive for this amount. With some vendors or third party administrators, it may be necessary to specify in the executive's contract that this deferral will be paid to the executive by the employer.

It should be noted that the Internal Revenue Service (IRS) treats contributions to a 403(b) plan as elective deferrals by default. In order to take advantage of the higher limits for employer contributions, the payment must be documented as a non-elective contributions with no cash option and must not be reported on the individual's W-2 form. Otherwise, the IRS may disallow contributions to the plan in excess of the elective deferral limit.

Finally, a word of caution about vesting. Vesting for 403(b) accounts is a concept that is not in the IRC. It is a "tradition" that was finally codified by the 2009 final IRS 403(b) regulations. These require that any nonvested funds be held in type of bookkeeping account in the plan. It has to be handled correctly under the regulations. So it is important that the funds be held by a 403(b) company that knows how to handle this and documents it correctly.

### BEST PRACTICE #3 – REVIEW AND/OR UPDATE DISTRICT PLAN DOCUMENTS

It is likely that the Plan Documents for a school system were crafted years ago under a different set of regulations and circumstances and if they have not been updated, then the plans outlined in the employment agreement may not be doable. Common items that need to be updated include allowing employer contributions, specific deferred compensation plans, and new participants.

# 2. 401(a) Plan

Most governmental and corporate retirement plans are qualified under Section 401(a) of the Code. This includes most state teacher retirement systems. The Code and the Employee Retirement Income Security Act of 1974 (ERISA) exempts these plans from pension nondiscrimination rules and most of the complex reporting requirements that apply to non-governmental organizations.

**The limit on contributions by an employer to a 401(a) plan is the lesser of 100% of compensation or $70,000 (may not exceed 100% of compensation; 2025 limits). A public education institution may contribute the maximum amount to both a 401(a) and a 403(b) plan.**

There are advantages and disadvantages to the 401(a) plan when compared to the 403(b) plan. Administration can be more complex and less flexible with a 401(a) plan. Under federal laws, distributions from these plans can be rolled over to an Individual Retirement Account, 403(b) plan, another 401(a) plan, a 457(b) plan and other retirement plans. These plans can also be used to purchase state retirement plan service similar to 403(b) plans (see description above). However, funds in these plans can generally only be used to purchase service credit after the employee terminates employment or qualifies for an in-service rollover (e.g. age 59 ½), no matter what type of service is involved. Also, once an employee salary reduction agreement is implemented with a 401(a) is implemented, it can not be adjusted while the employee is with the same employer.

A 401(a) plan can also be used to set up a supplemental "defined benefit plan" that would pay a guaranteed income at retirement. This can be useful when the organization wants to make a contribution to one or more plans that exceeds the limits for contributions to 401(a), 403(b) and 457(b) defined contribution plans. It can also be useful for education executives who have had mobile careers with small retirement benefits in multiple states. A defined benefit can allow an organization to set up a single plan that makes up the difference between the total accrued retirement benefits for the individual in all of the states and what he or she would have had if (a) all of the years had been earned in the final state and (b) the education executive fulfills his or her contract with the institution.

## BEST PRACTICE #4 – KNOW YOUR THIRD-PARTY ADMINISTRATOR (TPA) AND RECORD KEEPER'S ABILITY

Some TPAs and record keepers of retirement plans are not familiar with employer contributions and may not agree to process the payments. Others are not familiar with the additional contributions an employer can make in addition to the Participant's own deferrals. This can prove to be problematic and does not preclude the District for working with a separate provider on these individual plans. It is important the provider is familiar with these plans to provide the necessary compliance and establish a process to invoice for the contributions; especially if these are recurring payments.

## BEST PRACTICE # 5 – UNDERSTAND THE DOCUMENTATION THAT IS REQUIRED

Establishing these plans is different than simply having the Participant enroll in a plan as an employee would for their own deferrals. While schools are not subject to Federal ERISA laws, there are still compliance issues that need to be addressed. These forms will vary depending on the capabilities of your TPA, but typical forms include Adoption, Advisory, Custodial, and Administrative agreements. This also means that it can take between five and ten business days to establish these plans and have them prepared to receive the contributions.

# 3. 457(b) Plan

Section 457 of the Code covers several types of non-qualified deferred compensation plans for governmental and non-profit organizations. Section 457(b) requires that governmental employers hold the plan assets in trust or that the assets be held by an insurance company. Section 457(b) was amended effective January 1, 2002 to allow the maximum contribution to this plan, to a 403(b) plan and to a 401(a) plan. Thus, the employer or the individual may contribute up to the lesser of 100% of compensation or $23,500 per year or $31,000 if the individual is age 50 or older, to a 457(b) plan each year (2025 limits). As with the other types of plans described above, governmental employers may set up such without being subject to the federal reporting, discrimination and other compliance rules applicable to qualified pension plans in the corporate sector. There are other special rules that these plans must meet to keep funds in the plan exempt from income tax. Note that unlike 403(b) plans, there are no separate or different limits for employer vs. employee contributions; the limit described above applies to all funds received during the year.

These plans can also be used to purchase state retirement plan service under rules identical to 403(b) plans (see description above). In addition, distributions from these plans can be rolled over to an Individual Retirement Account, 403(b) plan, 401(a) plan, another 457(b) plan and other retirement plans. A special rule applicable to 457(b) plans that does not apply to 403(b) and 401(a) plans involves “vesting” of employer contributions. With a 457(b) plan non-vested contributions do not count toward plan contribution limits. However, when the contributions and earnings on this money become vested, this amount all counts against the contribution limit in the year the funds become vested. The plan can easily “blow up” and exceed all of the limits in the year the individual becomes vested. This provision requires very careful planning if a vesting schedule is used with a 457(b) plan.

One additional advantage for the 457(b) plan is that there is no 10% premature distribution tax on early withdrawals. With 403(b) and 401(a) plans, a distribution in-service prior to age 59 ½ or at termination of employment after age 55 is subject to this 10% tax, in addition to ordinary income tax. This additional tax does not apply to 457(b) plans.

# 4. 457(f) Plan

Section 457 allows governmental employers to set up non-qualified deferred compensation plans that are not subject to the reporting, discrimination and other compliance rules applicable to qualified pension plans. There are special rules that these plans must meet to keep funds in the plan exempt from income tax.

The biggest problem with a 457(b) plan is that the limit on total annual contributions is low. However, this limit can be eliminated by establishing the plan under Section 457(f) of the Code. As with many items under the Code, with such a generous rule come significant other restrictions.

**BEST PRACTICE # 6 – BE CAREFUL ABOUT HOW THE FUNDS ARE INVESTED**

The type of investment used should be appropriate for the type of plan and they intended use of the funds. If the funds are going to be used to purchase service from a state retirement system then a short term investment (e.g., money market fund) with no surrender or withdrawal penalties should be used. If the funds are for long term retirement needs and the individual is relatively young, then the money should be invested in high quality, well diversified equities. It is also important to avoid investments that typically have high fees which can eat away at retirement savings (e.g., variable annuities) or provide low returns relative to long term markets (e.g., fixed annuities). You should always know what you are paying in fees and these are not always well disclosed. Good sources of information include www.403bwise.com and the www.403bcompare.com.

One of the most important requirements is that the funds in the plan be owned by the employer and subject to the general creditors of the organization in the event of bankruptcy. Although the Small Business Job Protection Act of 1996 requires that 457(b) plans of governmental employers hold all assets in a trust, custodial account or annuity contract, this requirement does not apply to 457(f) plans.

However, the plan can be made more secure by used of a "Rabbi Trust." This is not subject to the same protection as a trust used in a qualified plan established under ERISA. The most important use of such a Rabbi Trust is to protect the participants against a future "change of heart" by the employer. Other aspects of these plans are listed below.

## A. SUBSTANTIAL RISK OF FORFEITURE AND IMMEDIATE TAXATION AT DISTRIBUTION:

This is the most challenging aspect of designing a 457(f) plan. To allow the contribution limitations of Section 457(b) to be exceeded and to avoid taxation of the amount as income, the plan must provide that the funds are paid to the participant upon the performance of specified service by the individual (e.g., completing 5 years of service with the organization) or a specified event (e.g., reaching the age of 65). If this service is performed or the event is reached, all contributions and earnings are subject to immediate taxation. If the not, then the individual must forfeit all funds. In Private Letter Ruling 9215019, the Internal Revenue Service ruled that a plan that provided for the payment of funds upon the completion of three years of service was a valid 457(f) plan. Thus, if the participant completed the three years, he or she received the funds as taxable income. If the individual left the organization prior to the completion of three years, all funds were forfeited. There are many ways to define the completion of service.

The primary rules are that

- the service requirement must be "definitely determinable,
- the service must occur after the date the plan is started,
- the funds must be forfeited if the service requirement is not met and
- the funds must become immediately taxable as income if the requirement is met.

In another Private Letter Ruling the IRS stated that if the individual's employment was terminated without cause by the organization, then the funds could become immediately vested. Note that the IRS warns that Private Letter Rulings cannot be cited as precedent but from a practical view they often show the IRS's internal position on tax matters.

## B. LIMITATIONS ON ELIGIBILITY:

As a practical matter, the substantial risk of forfeiture requirement and the rule that the funds become subject to immediate taxation on a given date should be handled with great caution. Much ill will can be generated for the plan sponsor if these rules are not clearly understood by employees, particularly if they perceive the program as a salary deferral arrangement. Thus, most employers limit such plans to key executives who negotiate such an arrangement as a part of their compensation package.

**IMPORTANT NOTE:**

The American Jobs Creation Act of 2004 ("AJCA") added Internal Revenue Code Sec. 409A, which can be applicable to deferred compensation arrangements of public education institutions. The interplay between Sec. 457(f) and Sec. 409A is complex. A deferred compensation plan that violates Sec. 409A can be subject to immediate taxation of plan funds plus a 20% penalty tax, plus other severe tax consequences. Thus, it is critical that any deferred compensation plan be carefully structured in a manner that does not make the plan subject to penalties.

# 5. Other Nonqualified Tax Deferred Plans

This document is meant to be used by governmental educational organizations. Private non-profit educational organizations are subject to the Employee Retirement Income and Security Act of 1974 (ERISA). This makes their plans under Sections 401(a) ad 403(b) subject to pension nondiscrimination rules that can make these plans impractical for executive-only incentives. However, nonqualified tax deferred plans can be used to reward executives because these plans are exempt from the nondiscrimination rules of ERISA. The rules of 457(f) are basically the same for these organizations as described herein. The rules of 457(b) are quite different. For-profit educational organizations may be able to use plans under Section 409A. Attached in an overview of these plans.

# 6. General Plan Design Issues

It is very important that other issues be addressed in designing the right plan for the employer and the employee. In our experience, this is best spelled out in a separate plan document that is incorporated by reference in the employee's contract. Listed below are items that need to be covered in the plan and contract design. If these are left ambiguous, and there is a disagreement later, either or both parties to the agreement may be unhappy with the outcome.

## PLAN DESIGN ISSUES

### Type of Contribution
- Dollar Amount
- Percentage of Pay
- Effect of Performance Bonuses

### Timing of Contribution
- Beginning of Year
- End of Year
- Payroll

### Plan Year
- Contract Year
- Calendar Year
- Academic Year

### Vesting
- Number of Years
- "Cliff" vs. Gradual
- Percentage
- Service Determination
- Early Vesting if Die or Disabled
- Involuntary Termination

### Investment of Funds
- What Kind
- Who Decides
- Who Can Change & How Often

### Access to Funds
- Vested vs. Non Vested Funds
- Loans
- Hardship & In-service Withdrawal

# 7. Contract Issues

Proper documentation is critical. The institution's attorney must be sure that the contract language meets state requirements and protects all parties.

Either the contract or a separate document (usually incorporated by reference) must document the compliance of the plan with federal tax rules and cover all of the other documentation issues listed above.

Remember that to the IRS, "All compensation is considered taxable until proven otherwise."

An education executive's contract should usually define (a) the type of plan and/or trust created, (b) how much the Board will contribute, (c) any performance issues that must be obtained in order to receive the contribution, (d) vesting issues and (e) Incorporate the terms of the plan document by reference.

Although the law presents many challenges in designing executive retirement plans for public education institutions, it is still possible to provide substantial benefits through careful plan design and implementation.

All work is performed in the context of compensation and benefits consulting.* It is not intended to constitute legal advice.

The education executive should review all items discussed above with legal counsel before taking any action.

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# Comparison of 457/NQDC Plans

### Overview of Plans

| | Tax-Exempt 457(b) plan | Governmental 457(b) plan | 457(f) Plan | 409A Plan |
|---|---|---|---|---|
| Eligible employer | Tax-exempt employer that isn't a state or local government (or political subdivision, instrumentality, agency), including certain church controlled organizations | State or local government or political subdivision or instrumentality or agency | Tax-exempt employer or a state or local government (or political subdivision, instrumentality, agency) | some church controlled organizations |
| Written plan document required? | Yes | Yes | Yes | Yes |
| Eligible participants | Limited to select management or highly compensated employees; independent contractors may participate | Employees or independent contractors who perform services for the employer may participate | Limited to select management or highly compensated employees | Limited to select management or highly compensated/ highly paid group of employees |
| Coverage; nondiscrimination testing | No | No | No | No |
| Salary reduction contributions (employee deferrals) | Yes | Yes | Yes. Under current rules, but not allowed under proposed IRS rules | Yes |
| Ability to designate all or portion of salary reduction as a Roth contribution | No | Yes | No | No |
| Employer contributions permitted? | Yes | Yes | Yes | Yes |

# More Details on 457(b) Plans

| | Tax-Exempt 457(b) plan | Governmental 457(b) plan |
|---|---|---|
| Salary reduction contribution limit, in general | Lesser of applicable dollar limit ($23,500 in 2025; $23,000 in 2024; $22,500 in 2023) or 100% of participant's includible compensation | Lesser of applicable dollar limit ($23,500 in 2025; $23,000 in 2024; $22,500 in 2023) or 100% of participant's includible compensation |
| Increased salary reduction limit for final 3 years before attaining normal retirement age | Lesser of:<br><br>• 2x applicable dollar limit ($45,000 in 2023; $41,000 in 2022; $39,000 in 2020 and in 2021) or<br><br>• applicable dollar limit plus sum of unused deferrals in prior years (only if deferrals made were less than the applicable deferral limits) (Note: age 50 catch up contributions not allowed; no coordination needed) | Lesser of:<br><br>• 2x applicable dollar limit ($45,000 in 2023; $41,000 in 2022; $39,000 in 2020 and in 2021) or<br><br>• applicable dollar limit plus sum of unused deferrals in prior years (to the extent that deferrals made were less than the applicable limits on deferrals; age 50 catch up contributions aren't counted for this purpose)<br><br>Note: Can't use the increased limit if using age 50 catch up contributions. Therefore, in years when an employee is eligible to take advantage of both, the employee can use the higher of the two increases to the limit. |
| Salary reduction contribution limits- Age 50 catch-up contributions (for individuals who are age 50 or over at the end of the taxable year) | Not permitted | Salary reduction dollar limit increased by $7,500 in 2023 up to a total of $30,000; ($6,500 up to a total of $27,000 in 2022; $26,000 in 2020 and in 2021)<br>Note: See above. Can't use in years that a participant is taking advantage of the increased limit during the final 3 years before attaining normal retirement age. |

# More Details on 457(b) Plans

| | Tax-Exempt 457(b) plan | Governmental 457(b) plan |
|---|---|---|
| Timing of election to make salary reduction contribution | Before the first day of the month in which the compensation is paid or made available | Before the first day of the month in which the compensation is paid or made available |
| Total contribution limits (both salary reduction and employer contributions) | Same as limit for salary reduction contributions. So, any employer contribution limits the amount of salary reduction contribution an employee can make (and vice versa) | Same as limit for salary reduction contributions. So, any employer contribution limits the amount of salary reduction contribution an employee can make (and vice versa) |
| Correcting excess elective deferrals | Distribute excess (plus allocable income) by April 15 following the close of the taxable year of excess deferral | Distribute excess (plus allocable income) as soon as administratively practicable after the plan determines that the amount is an excess deferral |
| Contributions to trust? | No | Yes |
| Participant loans permitted? | No | Yes |
| Hardship distributions permitted? | Yes, if both:<br><br>1. the distribution is required as a result of an unforeseeable emergency, for example, illness, accident, natural disaster, other extraordinary and unforeseeable circumstances arising from events beyond the participant's (or beneficiary's) control, and<br><br>2. the participant exhausted other sources of financing and the amount distributed is necessary to satisfy the emergency need (and tax liability arising from distribution) | Yes, if both:<br><br>1. the distribution is required as a result of an unforeseeable emergency, for example, illness, accident, natural disaster, other extraordinary and unforeseeable circumstances arising from events beyond the participant's (or beneficiary's) control and<br><br>2. the participant exhausted other sources of financing and the amount distributed is necessary to satisfy the emergency need (and tax liability arising from distribution) |

# More Details on 457(b) Plans

| | Tax-Exempt 457(b) plan | Governmental 457(b) plan |
|---|---|---|
| Automatic Enrollment permitted? | No | Yes |
| Taxation | Earlier of when made available or distribution | Distribution |
| Distributable events | • Attainment of age 72<br>• Severance from employment<br>• Unforeseeable emergency (see above)<br>• Plan termination<br>• Qualified domestic relations order<br>• Small account distribution (notto exceed $5,000) | • Attainment of age 72<br>• Severance from employment<br>• Unforeseeable emergency (see above)<br>• Plan termination<br>• Qualified domestic relations order<br>• Small account distribution ($5,000 or less) Age 59 1/2 for in-service distributions |
| Required minimum distributions under Internal Revenue Code Section 401(a) (9) | Yes | Yes |
| Rollovers to other eligible retirement plans (401(k), 403(b), governmental 457(b), IRAs) | No | Yes |
| Availability of statutory period to correct plan for failure to meet applicable requirements | No | Yes, until 1st day of the plan year beginning more than 180 days after notification by the IRS |
| Availability of IRS correction programs including the Employee Plans Compliance Resolution System (EPCRS) under Rev. Proc. 2021-30 | Generally, not available to correct failures for an unfunded plan benefiting selected management or highly compensated employees. May consider closing agreement proposals when nonhighly compensated employees are erroneously impacted. | Can apply for a closing agreement with a proposal to correct failures. Proposal is evaluated according to EPCRS standards. |

# Updated Retirement Plan Contribution Limits for 2025

KEY CHANGES FOR SAVERS AGED 60-63

### INCREASED CATCH-UP CONTRIBUTIONS FOR AGES 60-63:

Under SECURE 2.0, beginning in 2025, individuals ages 60 to 63 eligible for increased catch-up contributions in their retirement plans. The catch-up contribution limit will increase by $4,250 in 2025, bringing the total allowable contribution to $34,750. This 14% increase provides an excellent opportunity to significantly enhance the retirement

### STEADY CONTRIBUTION INCREASES FOR OTHER AGE GROUPS:

While those under age 50 and those aged 50-59 or 64+ will see smaller increases, each age group will benefit from higher contribution limits.

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