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Section 457 deferred-compensation plans are risky in this economy

Funds in those plans are available to creditors in a bankruptcy proceeding

Janet Kidd Stewart The journey

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For millions of Americans, retirement account balances are way down. But are some people at risk of losing even more if their employer files for bankruptcy?

Workplace retirement plans carry many legal protections, but all long-term savings plans at work aren't created equal.

During good economic times, tax-deferred savings plans sound great. When recession hits, however, the risks suddenly are all too real. Some plans that allow workers to put away tax-deferred savings are subject to creditors in the event of bankruptcy.

"A lot of employees simply aren't aware that [some of their savings] are subject to creditors," said George Morrison, an attorney with G.M. Morrison PC, a law firm specializing in employee benefits issues.

In particular, that applies to deferred-compensation programs known as 457 plans, named for its Internal Revenue Code section number. These plans are for government employees and non-profit organizations. They are similar in some ways to 401(k) plans, allowing workers to direct pre-tax dollars to an account, and to choose from a menu of investments to deposit the money.

In general, funds in government-employee 457 plans are protected in the event of financial default. Not so with non-profits, Morrison said. By law, funds in those plans must be at risk and available to creditors in a bankruptcy proceeding. Although investors have individual balances, the money isn't set aside as in a 401(k) plan, so the assets are available under the filing along with all other corporate assets.

"I've never seen it be a problem, but everything is different now," Morrison said, referring to the recession, which has hit non-profits hard. "It all comes down to how a bank trustee wants to distribute assets."

And it's not always just six-figure executives who participate in these plans, he said. In some cases, non-profits paying their officers just $40,000 a year have had the plans in place, he said.

Deferred compensation at for-profit companies has also reached somewhat lower into organizations in recent years, though it is still typically for executives, and some advisers are cautioning clients to steer clear. As in the non-profit world, many of these plans come with the stipulation that the money is at risk in the event of a corporate bankruptcy.

"We're recommending clients not participate" in deferred-compensation programs, said David Yeske, founding principal of Yeske Buie, a financial planning firm in Vienna, Va., and San Francisco.

"You really can't take anything for granted today," Yeske said.

"I had one client recently who works with a firm that has a substantial deferred [compensation] plan that was offering to pay out lump sums. It will be a big tax hit, but some companies are so shaky it's just not a risk worth taking," he said, advising clients in those circumstances to take the lump sum.

If you don't have the option of cashing out, at least consider putting a halt to ongoing contributions, he said.

Kathleen Campbell, a financial planner in Ft. Myers, Fla., also cautions clients to truly understand the risks involved, particularly in non-profit plans. "The difference between public and private 457 plans is huge," she said. "With private plans, I would exhaust all other options first," by contributing to traditional 401(k) or 403(b) plans, then even low-cost taxable accounts before looking at deferred compensation.

Already have a substantial sum in one of these plans? You'll have to make a decision about whether to risk putting more of your paycheck into the plan, said James Ludwick, president of MainStreet Financial Planning Inc. in Odenton, Md.

"I would look at how viable your organization is," he said. In the case of a local chapter of a non-profit, for example, is there a national umbrella organization that helps chapters that land in financial trouble?

"The bottom line is, if you're uncomfortable, stop contributing. It will help you sleep at night," he said.

Even with government plans, he said, it pays to weigh the tax-deferred advantage of a plan against its costs. Sometimes the investment choices charge so much in expenses that participants would be better off in a low-cost taxable mutual fund, he said.

"I'm just not a big fan of these plans," Ludwick said. Saving taxes is great, he said, but sometimes the need for more control outweighs the benefits.

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