

New Proposed Regulations for Section 457(f) Nonqualified Deferred Compensation Arrangements of Non-Profit and Governmental Entities

The Internal Revenue Service recently released long anticipated proposed regulations (the "Proposed Regulations") governing deferred compensation arrangements maintained by tax-exempt organizations and governmental entities under Section 457 of the Internal Revenue Code (the "Code"). The Proposed Regulations provide important interpretive guidance and clarifications on key issues around the design and operation of deferred compensation plans and arrangements that are subject to Code Section 457(f) ("Section 457(f)"). Helpfully, the Proposed Regulations permit some design features whose permissibility previously had been unclear, and liberalize certain positions previously taken by the IRS with respect to 457(f) Arrangements.

457 Deferred Compensation Arrangements Generally

Under Section 457, a deferred compensation arrangement can either be an "eligible plan" under 457(b), which must satisfy certain qualifications and is subject to annual limits on deferrals (currently, \$18,000 for 2016), or an "ineligible plan" under 457(f) (referred to in this Alert as a "457(f) Arrangement"). A 457(b) plan, which can defer compensation until after termination of employment without taxation upon vesting, is a very useful tool for not-for-profit employers who want to provide additional deferred compensation in excess of legal limits under 403(b), 401(k) and other qualified pension plans for a select group of their management and highly compensated employees¹, but is limited in its utility because of the \$18,000 maximum annual deferral limit. Section 457(f) governs other deferrals of compensation of employees and independent contractors by not-for-profit employers and governmental entities. Section 457(f) Arrangements, which can be provided through formal plans or as terms of employment or other agreements, do not have a similar dollar cap but are subject to taxation upon vesting, a rule that does not apply to deferred compensation arrangements of for-profit employers.

Similar to the approach under the Code Section 409A² ("Section 409A"), the Proposed Regulations provide that a plan or arrangement provides for deferral of compensation under Section 457(f) if, under the facts and circumstances, the participant has a legally binding right to compensation in one calendar year that is, pursuant to its terms, payable in a later calendar year. However, a participant does not have a legally binding right if the compensation can be unilaterally reduced or eliminated by the eligible employer in its discretion after the services creating the right to the compensation are performed.³ Unless excepted, the 457(f) rules can apply to voluntary salary and bonus deferrals, traditional deferred compensation plans, supplemental executive retirement plans (SERPs), plans providing for allocations in excess of 401(k) or 403(b) limits, retention plans or arrangements, severance arrangements and many other types of deferred compensation. While the reach of 457(f) is broad, more planning opportunities will now arise in light of the Proposed Regulations.

¹ Other rules apply for 457(b) arrangements for governmental employers.

² Code Section 409A rules also generally apply to 457(f) Arrangements and can become especially important to note in light of some of the 457(f) liberalizations in the Proposed Regulations. Violation of 409A rules can trigger an extra 20% tax on an employee or non-exempt independent contractor.

³ The Proposed Regulations provide that if the participant has effective control of the person retaining the discretion to reduce or eliminate the compensation, or has control over any portion of the compensation of the person retaining such discretion, or is a member of the family of the person retaining such discretion, then the discretion to reduce or eliminate the compensation is deemed to not have substantive significance and a legally binding right to compensation exists.

Under Section 457(f), the present value of the deferred compensation under a 457(f) Arrangement is includible in income on the later of (i) the date the legally binding right is created and (ii) if the compensation is subject to a substantial risk of forfeiture (commonly referred to as a vesting condition), the first date on which the substantial risk of forfeiture lapses (regardless of when the compensation is scheduled to be paid). Section 457(f), which therefore provides for taxability upon vesting, differs from Section 409A in that deferred compensation under an arrangement that complies with Section 409A's strict rules, generally is not subject to income taxes upon vesting⁴, but instead when later paid.

Arrangements Exempt From Section 457(f)

Section 457(f) and the Proposed Regulations exempt certain arrangements that would otherwise constitute a deferral of compensation under the broad definition described above, including the following categories of plans (several of which are discussed in more detail below):

- short term deferrals;
- bona fide separation pay plans;
- certain recurring part year compensation;
- bona fide death benefit plans;
- bona fide disability pay plans;
- bona fide sick and vacation leave plans;
- certain, limited taxable reimbursements of expenses, medical benefits or in-kind benefits;
- 403(b) annuity plans and contracts and qualified plans and trusts (such as 401(k) plans and other qualified pension plans);
- transfers of property under Code Section 83;
- employment retention plans of certain local educational agencies and education associations under Section 457(f)(4); and
- taxable education assistance benefits for an employee (solely) under Code Section 127(c)(1).

Short Term Deferrals. In a manner not suggested by previous guidance, the Proposed Regulations adopt the same short term deferral exception as that under Section 409A, but using Section 457(f)'s definition for "substantial risk of forfeiture" (described in more detail below). An arrangement is not subject to Section 457(f) if the compensation is required to be paid, and is actually paid, on or before the 15th day of the third month following the end of the later of (i) the calendar year or (ii) the eligible employer's tax year in which the participant's right to the compensation becomes vested (i.e., is no longer subject to a substantial risk of forfeiture).

Bona Fide Severance Pay Plans. A bona fide severance pay plan is not treated as providing for a deferral of compensation for Section 457(f) purposes if it satisfies the following requirements: (i) the benefits are payable only upon an involuntary severance from employment (which may include a voluntary severance from employment for good reason, as discussed below); (ii) the amount payable does not exceed two times the participant's prior year annual compensation⁵; and (iii) under the terms of the severance arrangement, the entire severance benefit is paid out no later than the last day of the second calendar year following the calendar year in which the severance from employment occurs.

Recurring Part Year Compensation. Recurring part-year compensation⁶ (e.g., compensation for a teacher working

⁴ FICA taxes generally apply upon vesting, even when income taxes are delayed, however.

⁵ We note that the severance exception under the Proposed Regulations departs from the corresponding separation pay exception under Section 409A in this regard because it is not limited to two times the Code Section 401(a)(17) limit (currently, \$265,000 for 2016; thus with two times that limit equal to \$530,000 for 2016).

⁶ The Proposed Regulations adopt the definition for recurring part-year compensation from the Section 409A regulations, which defines this as compensation paid for services in a position that the eligible employer and the participant reasonably anticipate will continue on similar terms in subsequent years, and will require services to be provided during successive periods each of which is less than 12 months, and each of which periods begins in one taxable year and ends in the next taxable year of the participant.

over a 10 month school year period from September to June but paid over 12 months), is exempt from Section 457(f) if (i) the plan does not defer payment of any of the recurring part-year compensation beyond the last day of the 13th month following the first day of the service period and (ii) the amount of such compensation does not exceed the annual compensation limit under 401(a)(17) (currently, \$265,000 for 2016) for the calendar year in which the service period commences.

Substantial Risk of Forfeiture

If an arrangement providing for the deferral of compensation is subject to Section 457(f), the concept of a substantial risk of forfeiture is critical to the design of the 457(f) Arrangement because it determines when the income will be taxable. The Proposed Regulations borrow many concepts from the Section 409A regulations to define what constitutes substantial risk of forfeiture for Section 457(f) purposes but also depart from Section 409A in a few important areas. Under both Section 457(f) and Section 409A, whether or not a substantial risk of forfeiture exists is based on the relevant facts and circumstances.⁷

Future performance of substantial services. Compensation is subject to a substantial risk of forfeiture if it is conditioned on the future performance of substantial services, or upon the occurrence of a condition that is related to the purpose of the compensation (e.g., achievement of individual or the eligible employer's tax-exempt activities or organizational performance goals) if the possibility of forfeiture is substantial.

- In determining whether the future services are substantial, the Proposed Regulations state that one inquiry is whether the hours required to be performed during the relevant period are substantial in relation to the amount of compensation (which appears to be more restrictive than the corresponding Section 409A regulation requirements). For example, a post-retirement arrangement primarily intended to reward past service that conditions compensation on the future performance of a nominal level of ongoing consulting services may not be respected as a vesting condition for Section 457(f) purposes if the amount of compensation subject to forfeiture is disproportionately large relative to the level of consulting services contemplated.

Involuntary Severance without Cause / Voluntary Severance for Good Reason. An amount payable upon an involuntary severance from employment without cause or a voluntary severance from employment for "good reason" may each be treated as being subject to a substantial risk of forfeiture until that severance occurs. A voluntary severance for "good reason" means the participant's resignation occurred only after a unilateral action by the eligible employer that caused a material negative change to the participant's relationship with the eligible employer (e.g., a material reduction in duties, conditions or compensation). The Proposed Regulations also provide a safe harbor definition of "good reason" and for several other requirements that must be met for a voluntary severance for good reason to be eligible for this special treatment. These provisions in the Proposed Regulations closely track their counterparts in the Section 409A regulations.⁸

Non-Competition Arrangements. In a surprise departure from the Section 409A regulations, the Proposed Regulations allow a participant's refraining from future performance of certain services to constitute a substantial

⁷ The Proposed Regulations also indicate that to be treated as a substantial risk of forfeiture there needs to be a real expectation that the forfeiture condition will be enforced, which can include consideration of prior employer actions where forfeiture conditions applied, as well as the level of influence or control of the employee or independent contractor with regard to the organization and its decision makers.

⁸ The Proposed Regulations provide that the requirement of involuntary severance from employment does not apply to certain window programs (which are programs established by an eligible employer for a limited period of time, typically no longer than 12 months, to provide separation pay to participants who incur a severance from employment during that period or under specified conditions during that period) but with special rules limiting this treatment in some instances involving multiple programs that when viewed together would not satisfy this limited definition.

risk of forfeiture if the following conditions are met:

- (i) the right to payment is expressly conditioned upon the participant refraining from the future performance of services under a written and enforceable⁹ agreement (e.g., a non-competition agreement);
- (ii) the eligible employer makes reasonable ongoing efforts to verify compliance with the non-competition agreement; and
- (iii) at the time the non-competition agreement becomes binding, the facts and circumstances demonstrate that the eligible employer had a substantial and bona fide interest in preventing the participant from performing the prohibited services (e.g., adverse financial impact on the eligible employer if the prohibited services are provided, marketability of the participant based on specialized skills, reputation, etc.) and the participant had a bona fide interest in, and ability to, engage in the prohibited competition (e.g., participant's financial need and ability to engage in prohibited services).

Rolling Risk of Forfeiture / Voluntary Deferrals of Current Compensation. Another helpful provision in the Proposed Regulations are rules permitting what is commonly referred to as a "rolling risk of forfeiture", which permits participants and an eligible employer to extend a risk of forfeiture (i.e., extend a vesting condition) on deferred compensation under a 457(f) Arrangement if the following four conditions are met:

- (i) the present value of the compensation to be paid upon satisfying the extended vesting condition must be materially greater (i.e., at least 25% greater) than the amount that the participant would have received absent such extension;
- (ii) the extended vesting condition must be based on the future performance of substantial services (or compliance with a non-competition agreement) – it cannot be related to the purpose of the compensation (e.g., cannot be a performance goal);
- (iii) the extension period during which the future services are performed (or non-competition requirement is met) must not be less than two years (but early payment may be made in the event of death, disability or involuntary severance from employment); and
- (iv) the extension must be pursuant to a written agreement made at least 90 days before the date on which the existing vesting condition would have been satisfied absent such extension.

Corollary rules permit the initial voluntary deferral of current compensation (e.g., salary or bonus) to be subject to a vesting condition (i.e., a substantial risk of forfeiture) so long as the following requirements (similar to those for a rolling risk of forfeiture) are met: (i) the amount to be paid upon vesting has a present value at least 25% greater than the amount of current compensation being deferred (thus requiring an additional substantial "match" payment by the eligible employer); (ii) the vesting condition must be based on the future performance of substantial services (or compliance with a non-competition agreement); (iii) the vesting period must not be less than two years (with the same early payment exceptions as above); and (iv) the initial deferral election must be made in writing by December 31 of the year preceding the year the services giving rise to the compensation are performed (with a special rule permitting some later elections for certain new hires).¹⁰

⁹ The enforceability of a non-compete is typically a matter of state law. The ability to meet this requirement may depend on the laws of the jurisdiction that applies to the non-competition agreement in question.

¹⁰ It is noted that some voluntary deferrals of salary or bonus might not be treated as imposing a vesting condition or delaying vesting

The non-competition provision and the rolling risk of forfeiture provisions, along with the provisions permitting certain elective salary and bonus deferrals, each provide eligible employers new planning opportunities to structure 457(f) Arrangements (particularly where it is desired to provide for post-termination deferred payments) in a manner that is broader than what had generally been previously understood, based on prior IRS pronouncements, to be permitted.

Calculation of Present Value of Amounts Includible in Income

As noted above, when compensation under a 457(f) Arrangement becomes vested (i.e., when the substantial risk of forfeiture lapses), the present value of amounts deferred is includible in income (regardless of whether or not the compensation is then payable). The Proposed Regulations provide that, generally, the present value is determined by multiplying the amount of a future payment (or the amount of each payment in a series of payments) by the probability that any condition(s) on which payment is contingent will be satisfied¹¹ and discounting such amount(s) using an assumed rate of interest to reflect the time value of money. If any actuarial assumption or method used to determine present value is determined by the IRS to be unreasonable, then the IRS will make its own determination of present value using reasonable actuarial assumptions and methods (including applicable mortality tables under the Code and the mid-term applicable federal rate).

The Proposed Regulations also contain rules for specific types of 457(f) Arrangements.

- For severance arrangements, if the date of payment depends on the date the participant terminates employment (and the participant has not yet terminated by the vesting date), any reasonable assumed termination date in the five year period following the vesting date may be used.
- For account balance plans to which earnings are credited at least annually, the present value generally is equal to the amount credited to the participant's account, including both the principal amount and any earnings or losses that have been credited to the account.¹²
- For formula amounts (which are amounts dependent on factors that are not determinable as of the vesting date / date of income inclusion), the present value is based on all the facts and circumstances and must be based on reasonable, good faith assumptions for any contingencies as to the amount of the payment.

Additional earnings credited on amounts deferred under a 457(f) Arrangement after the date of income inclusion (the vesting date) are includible in income when paid. If the participant forfeits¹³ all or a portion of the amounts under a 457(f) Arrangement after the participant has included such amounts in income, then the participant may be entitled to a tax deduction in the year of the forfeiture equal to the difference between the excess (if any) of the amount previously included in income over the total amount actually received that is treated as a return on "investment in the contract" for tax purposes.

for Section 409A purposes and, therefore, such arrangements may still need to comply with the more restrictive rules regarding changes in timing of payment under Section 409A. Similar concerns can arise with regard to some delays in vesting under the Section 457(f) rolling risk of forfeiture rules in the Proposed Regulations.

¹¹ In discounting for the probability of contingencies, the probability of a participant's death may be taken into account only if the payment is forfeitable upon death. However, the following may not be taken into account in determining present value: (i) the probability that the payment will not be made due to the unfunded status of the plan; (ii) the risk any deemed or actual investment of deferred amounts; (iii) the risk of the eligible employer's unwillingness or inability to pay; (iv) the possibility of future plan amendments and changes in law; and (v) other similar risks or contingencies.

¹² For an account balance plan that credits earnings and losses that are not based on either a predetermined actual investment or a reasonable rate of interest, the present value will be the amount credited to the participant's account plus the present value of the excess (if any) of (i) the earnings to be credited under the 457(f) Arrangement over (ii) the earnings that would be credited through the projected payment date using a reasonable rate of interest.

¹³ The Proposed Regulations state that a deemed investment loss, actuarial reduction or other decrease in the amount deferred is not treated as a forfeiture if the participant retains the right to any payment under the 457(f) Arrangement (whether or not vested).

Interaction of Section 457 with Section 409A

The Proposed Regulations also make clear that an arrangement that is subject to Section 457(f) may also be subject to Section 409A. This means that the design and operation of a 457(f) Arrangement needs to be analyzed for compliance with (or, if applicable, exemption from) the requirements of both Code provisions and related regulatory guidance, with the rules under Section 409A generally being more restrictive than those under Section 457(f).

For example, a 457(f) Arrangement may rely on the rolling risk of forfeiture rules under Section 457(f) to extend the vesting condition of non-exempt severance benefits that would have otherwise been payable upon an involuntary termination of employment by increasing the severance benefits (e.g., by at least 25% on a present value basis) and subjecting such enhanced amount to a new two year post-termination non-competition covenant, but such compensation may still be considered vested under Section 409A upon an involuntary severance from employment. In addition, the ability to modify the payment date of the severance benefits may be subject to the strict timing and form of payment rules of Section 409A, and accordingly, while the 457(f) rules may permit a 2-year payment delay, pursuant to only a 90-day advance action, to avoid a 409A violation, the delay may need to last for 5 years and be agreed to at least 12 months in advance.

Effective Date and Action Items

The Proposed Regulations state that these new rules will apply to compensation deferred under 457(f) Arrangements for calendar years beginning after the IRS adopts the final regulations, but specifically include any deferred amounts to which the legally binding right arose during prior calendar years that were not previously included income during such prior calendar years (with limited exceptions for delayed applicability for certain collectively bargained arrangements and governmental plans). This means that existing 457(f) Arrangements that were adopted or agreed to prior to the effective date of the final regulations and that have deferred compensation that is not yet vested are not expected to be "grandfathered" and exempt from compliance with the final regulations.

It is recommended that eligible employers who sponsor deferred compensation plans or similar arrangements take the opportunity prior to the adoption of the final regulations to (i) review their existing 457(f) Arrangements for compliance with the new Proposed Regulations, (ii) determine if design changes are warranted, and (iii) review other deferral arrangements that are intended to be exempt from Sections 457(f) and 409A to confirm they continue meet the requirements of exemption. While the Proposed Regulations are not yet effective and may be modified before they are finalized, the IRS has stated that in the interim, they may be relied upon.

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