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Exempt Organizations Advisory

Newly Proposed Regulations Under Section 457(f) Impact Deferred Compensation Arrangements of Tax-Exempt and Governmental Entities

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The Internal Revenue Service (IRS) has issued the long-awaited proposed regulations governing deferred compensation for tax-exempt and governmental entities under section 457(f) of the Internal Revenue Code (Code). While the proposed regulations, issued on June 22, provide few surprises for practitioners, they provide new planning opportunities for tax-exempt and governmental entities to include greater flexibility in their nonqualified deferred compensation arrangements.

In particular, the proposed regulations:

- Confirm that a "substantial risk of forfeiture" includes a non-competition agreement, subject to conditions
- Add a "short-term deferral" exception for section 457(f) plans
- Provide that an "involuntary termination" may give rise to a "substantial risk of forfeiture" under section 457(f)
- Add an exception for "bona fide severance pay plans"
- Allow a "rolling risk of forfeiture"
- Provide guidance on how to treat "earnings" when calculating present value for income inclusion purposes
- Provide rules for recurring part-year compensation for governmental and tax-exempt universities and schools

The proposed regulations also clarify the rules on several technical points and provide guidance on the interaction between Code sections 457(f) and 409A. It is important for tax-exempt and governmental entities in the coming months to review their deferred compensation arrangements and determine whether additional, more flexible plan design features may be implemented. A timely review is particularly important if entities want to take advantage of extending a risk of forfeiture that will otherwise lapse at the end of the year.

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Background

Code section 457 governs deferred compensation arrangements maintained by tax-exempt and governmental entities. Section 457(b) applies to "eligible" plans, meaning defined contribution plans that satisfy certain specific requirements set forth in section 457(b) including limits on employee contributions (the basic limit is $18,000 in 2016). If a tax-exempt or governmental entity maintains a deferred compensation plan that does not satisfy the requirements of section 457(b) (e.g., because it exceeds the contribution limits or otherwise does not comply with section 457(b)), then the plan is treated as an "ineligible" deferred compensation plan under section 457(f), absent some exceptions. Such 457(f) plans generally benefit executive employees of tax-exempt and governmental entities.

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An "ineligible" deferred compensation plan is generally subject to two complex and overlapping tax regimes, section 457(f) and section 409A of the Code. Under section 457(f), an employee is taxed on deferred compensation when the right to receive the compensation is no longer subject to a substantial risk of forfeiture, regardless of whether any amounts are actually paid at that time. At the same time, section 409A applies an additional set of tax rules that significantly restrict the timing of the deferral, the timing and form of payment, and the acceleration of deferred compensation.

Code section 457 significantly predates Code section 409A. The enactment of section 409A in 2004, and its voluminous final regulations issued in 2008, seemed more restrictive than Code section 457. Although, the IRS made clear that Code section 457 regulations would be issued in the future, the 409A regulations raised many unanswered questions for Code section 457(f) plans.

The newly proposed 457(f) regulations resolve some of the inconsistencies between the two Code sections by applying similar definitions and exceptions, such as section 409A's exceptions for short-term deferrals and involuntary severance plans, and in defining deferred compensation as a "legally binding right" to an amount. In other cases, the proposed regulations clarify that some of the defined terms under section 457(f), such as "substantial risk of forfeiture," have a different meaning than those same terms under section 409A. Most importantly, the proposed regulations provide that a noncompetition agreement may, in some circumstances, give rise to a substantial risk of forfeiture, and provide a method for extending (or "rolling") a risk of forfeiture.

Deferral of Compensation and the Short-Term Deferral Exception

A plan of deferred compensation is subject to Code section 409A if it provides a legally binding right to compensation that is payable in a taxable year later than the taxable year in which it was earned. Regardless of whether an employee is "vested" in such amount, an employee will not be treated as having a legally binding right to compensation if the employer may unilaterally reduce or eliminate the compensation after the services for which the compensation is earned are performed. Further, even if a plan provides a legally binding right to compensation that is payable in a later taxable year, there may not be a deferral of compensation for purposes of Code section 409A if the compensation is paid within a limited, short-term deferral period.

To that end, the proposed 457(f) regulations adopt section 409A's short-term deferral rule, substituting the section 409A definition of "substantial risk of forfeiture" with the definition previously set forth in the proposed 457(f) regulations, as discussed further below. Code section 409A's short-term deferral rule provides that no deferral of compensation occurs if an employee actually or constructively receives the payment on or before the last day of the fifteenth day of the third month following the end of the taxable year in which the right to the payment was no longer subject to a substantial risk of forfeiture. If the payment is made within the short-term deferral period, the payment is not treated as a deferral of compensation subject to Code section 409A, and is taxed at the time of payment, rather than when the substantial risk of forfeiture lapses.

Substantial Risk of Forfeiture

The proposed 457(f) regulations retain Code section 457(f)'s broader definition of "substantial risk of forfeiture" as compared to the same term under Code section 409A regulations. Under both rules, an amount is subject to a substantial risk of forfeiture if entitlement to the amount is conditioned on the future performance of substantial services. Unlike section 409A, the proposed 457(f) regulations provide that certain conditions will give rise to a substantial risk of forfeiture under section 457(f) that would not create a substantial risk of forfeiture under section 409A. The most significant differences relate to noncompetition agreements and rolling risks of forfeiture.

Noncompetition Agreements

Unlike under section 409A, the proposed 457(f) regulations also define a substantial risk of forfeiture based on an employee's agreement to *refrain* from competitive services, not just based on an employee's performance of additional services on behalf of the employer. Under section 457(f), a payment may be treated as subject to a substantial risk of forfeiture based on a noncompetition agreement if three conditions are satisfied:

- First, the right to the compensation must be expressly conditioned on the employee's refraining from the performance of future services pursuant to a written agreement that is *enforceable under applicable law*. Since the enforceability of noncompetition agreements is generally governed by *state law*, meaning that a noncompetition agreement may be enforceable in one state but not in other states, application of this condition will vary by state. As a result, an agreement may give rise to a substantial risk of forfeiture for section 457(f) purposes in one state but not in another.
- Second, the employer must consistently make reasonable efforts to verify compliance with all of its noncompetition agreements.
- Third, at the time the noncompetition agreement becomes binding, the facts and circumstances must show that (a) the employer has a substantial and bona fide interest in preventing the employee from performing the prohibited services, and (b) the employee has a bona fide interest in, *and an ability to engage in*, the prohibited services.

These requirements for noncompetition agreements may be difficult to satisfy in many cases, particularly in states where noncompetition agreements are largely unenforceable. Even so, the treatment under section 457(f) is more flexible than under section 409A, which provides that a noncompetition arrangement is not a sufficient substantial risk of forfeiture (although section 409A does provide other mechanisms for deferring compensations beyond termination). The noncompetition provisions in the proposed regulations provide a significant plan design opportunity for employers to coordinate different aspects of sections 457(f) and 409A such that compensation may continue to be deferred after the end of employment.

Rolling Risk of Forfeiture and Initial Deferral Elections

The proposed regulations also provide some flexibility to extend the period covered by a substantial risk of forfeiture (often referred to as a "rolling risk of forfeiture") in a manner that is not available under section 409A. Prior to the adoption of section 409A in 2004, section 457(f) plans tended to include rolling risk of forfeiture features, allowing employees to defer compensation for a certain period, and then elect to defer it again for subsequent periods, without giving rise to a lapse of the risk of forfeiture. However, this practice was called into question following adoption of section 409A. The proposed regulations clarify that a risk of forfeiture may be extended, provided four requirements are met:

- First, the present value of the new amount to be paid (that is, upon the lapse of the extended substantial risk of forfeiture) must be materially greater than the amount the employee otherwise would have been paid (in the absence of the extension). For this purpose, an amount is materially greater only if the *present value* of the new amount, measured as of the date that the substantial risk of forfeiture would have otherwise lapsed in the absence of the extension, is more than 125% of the amount the participant otherwise would have received on that date. (The preamble to the proposed regulations notes that no implication is intended that this 125% standard would also apply for purposes of section 409A.)

- Second, the extended substantial risk of forfeiture must be based upon the future performance of substantial services or adherence to a noncompetition agreement. It may not be based solely on the occurrence of a condition related to the purpose of the transfer (for example, a performance goal for the organization), but that type of condition may be combined with a sufficient service condition.
- Third, the extended period for which substantial future services must be performed may not be less than two years (absent an intervening event such as death, disability, or involuntary severance from employment).
- Fourth, the extension must be reflected in a written agreement made at least 90 days before the date on which the existing substantial risk of forfeiture would have lapsed in the absence of the extension.

Nearly identical requirements apply to initial deferrals of current compensation, with some differences in the dates and timing, essentially allowing employees to make elective deferrals under section 457(f). For example, if an employee elects to defer a fixed percentage of his or her salary to a later date, the deferred benefit must be materially greater than the amount of compensation that would otherwise have been paid (e.g., pursuant to an employer match or similar enhancement) and must be conditioned upon the future performance of substantial services or adherence to a noncompetition agreement. Further, payment must be deferred for at least two years (absent an applicable intervening event). If an employee is deferring periodic payroll amounts, the two year minimum applies to *each* periodic payroll amount that would have been paid. Lastly, the written deferral agreement must be entered into before the beginning of the calendar year in which any services that give rise to the compensation are performed. In the case of new employees, the agreement may be entered into 30 days after commencement of employment.

Although the proposed regulations provide flexibility regarding initial deferrals and rolling risks of forfeiture, they do not change the payment rules under section 409A. In other words, the fact that the *risk of forfeiture* may be extended under section 457(f) does not mean that the *payment date* may be extended under section 409A. Section 409A has its own complex set of subsequent deferral rules that must be satisfied in addition the rules under section 457(f). The 409A rules are generally more restrictive than the proposed regulations, requiring subsequent deferrals to be made a year in advance and deferred for a minimum of five years. This will inevitably pose plan design challenges, but in our view, there are ways that both regimes could be satisfied and still retain needed flexibility.

Recurring Part-Year Compensation

The proposed regulations also provide greater flexibility for recurring part-year compensation. Recurring part-year compensation, which is common for teachers and professors, generally refers to recurring compensation that is earned over a period of service that is less than 12 months, but encompasses two taxable years, such as a 10 month school year. In Notice 2008-62, the IRS had provided some relief with respect to recurring part-year compensation but many tax-exempt employers found the dollar limits under that relief to be inadequate for certain teaching positions, such as those of college and university faculty members. The proposed regulations address this concern, and provide that there is no deferral of recurring part-year compensation if two requirements are satisfied. First, the recurring part-year compensation may not be deferred beyond the last day of the thirteenth month following the first day of the service period for which the recurring part year compensation is paid (e.g., the first day of the school year). Second, the amount of the recurring part-year compensation (not merely the amount deferred) may not exceed the annual compensation limit under Code section 401(a)(17), which currently is $265,000.

Severance From Employment

The proposed regulations track section 409A rules regarding severance from employment in several material ways. First, the proposed regulations provide that where entitlement to an amount is conditioned on an involuntary severance from employment without cause, and the possibility of forfeiture is substantial, the right is subject to a substantial risk of forfeiture. As under section 409A, an involuntary severance from employment is defined as a severance from employment due to the employer's independent exercise of its authority to terminate the participant's services, other than due to the participant's implicit or explicit request, provided the participant is willing and able to continue to perform services.

Further, also like 409A, an employee's *voluntary* severance from employment may be treated as an involuntary severance if the severance from employment is for "good reason." In general, termination is treated as being for good reason if it is in response to the employer's unilateral action that results in a material adverse change to the working relationship, such as a material reduction in the employee's duties, working conditions, or pay. Several requirements must be satisfied in order for a termination to be treated as being for good reason, including, among others, that the employer has established good reason conditions in advance and in writing.

In addition to treating an involuntary severance from employment as giving rise to a substantial risk of forfeiture under the conditions described above, the proposed regulations also recognize a complete exception to section 457 for a "bona fide severance pay plan." More specifically, a bona fide severance pay plan is not treated as a deferral of compensation and is not subject to section 457. Under the proposed regulations, a "bona fide severance pay plan" is similar to a separation pay plan under the section 409A regulations. The proposed regulations establish three requirements for a bona fide severance pay plan. First, the benefits must be payable only upon a participant's involuntary severance from employment (including termination for good reason, as described above) or pursuant to a window program or voluntary early retirement incentive plan. Second, the amount payable may not be more than two times the participant's annual compensation, based on the prior year's annual rate of pay (that is, the calendar year preceding the calendar year in which the severance of employment occurs), with some adjustments. (This differs from section 409A's separation pay plan exception, which also requires that the amount be no more than twice the section 401(a)(17) compensation limit.) Third, the severance benefits must be paid no later than the last day of the second calendar year following the calendar year in which the severance from employment occurs.

Present Value Calculations

Significantly, the proposed regulations also set forth rules, similar to those under section 409A, for calculating the present value of deferred compensation, based on whether the plan is an individual account plan or a defined benefit-type plan. The present value calculation is critical with respect to amounts promised to be paid in the future, regardless of the participant's performance of future services. For example, it is important in circumstances where the only risk of forfeiture is if the participant dies prior to the payment date.

The proposed regulations provide that the present value of an amount deferred under such a plan as of an applicable date is the value, as of that date, of the right to receive payment of the compensation in the future, taking into account the time value of money and the probability that the payment will be made. (Under section 409A, the calculation is determined as of the end of the employee's taxable year.) If the amount is to be paid upon a termination of employment, the employer may assume that the termination of employment is likely to occur on any date that is not later than the fifth anniversary of the applicable date, and the present value for such payment may be determined using a reasonable rate of interest over the five-year period.

Any actuarial assumptions used to calculate the present value must be reasonable as of the applicable date. Significantly, to the extent benefits are provided under an account balance plan to which earnings are credited at least annually, the present value of compensation deferred under the plan as of the applicable date is the present value of the principal, plus interest paid as of such date, provided that the rate of interest is "reasonable." If the plan's rate of interest is not "reasonable," the present value is determined by using the principal as of that date, plus the present value of the excess of any earnings to be credited under the plan, over the earnings that would have been credited through the projected payment date using a reasonable rate of interest. If the plan fails to determine a present value with earnings in this manner, the present value will be the principal, plus, the excess of any earnings to be credited under the plan through the projected payment date, over the earnings that would be credited using the applicable federal rate. Special rules apply if the present value depends on when a severance from employment will occur, or if it depends on a formula that includes factors that are indeterminable at the applicable date. The proposed regulations also include loss deduction rules, similar to those set forth under section 409A, which permit an employee to take a deduction if a forfeiture occurs after the applicable date.

Additional Issues and Next Steps

The proposed regulations also clarify that certain plans are not subject to section 457, such as bona fide vacation leave, sick leave, compensatory time, disability pay, and death benefit plans (in addition to bona fide severance pay plans, discussed above). They also confirm prior guidance providing that section 457(f) applies separately and in addition to section 409A.

These proposed regulations provide planning opportunities for tax-exempt and governmental employers to incorporate greater flexibility into nonqualified deferred compensation arrangements. Taxpayers may rely on the proposed regulations, even though they are not final. Once adopted and published, the final regulations will apply to deferred compensation that has not previously been included in income. Accordingly, tax-exempt and governmental employers should have their deferred compensation agreements reviewed well before the regulations are finalized, and consider whether changes are warranted. The IRS is soliciting comments on the proposed regulations until September 20.