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Newly Issued 457(f) Proposed Regulations Clarify Rules for Nonqualified Deferred Compensation Provided by Non-Profit and Governmental Entities

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The long-awaited Internal Revenue Service ("IRS") proposed regulations regarding implementation of Section 457(f) of the Internal Revenue Code ("Section 457(f)") are finally here. The proposed Section 457(f) regulations (the "Proposed Regulations") provide some guidance that was expected, but also provide surprising new developments that tax-exempt non-profit and governmental[1] employers ("eligible employers") may use in developing nonqualified deferred compensation programs for their executives.[2]

Background

Under Section 457 of the Internal Revenue Code (the "Code"), eligible employers may generally offer two types of plans for deferred compensation: (1) a Section 457(b) plan, referred to as an "eligible plan"; and (2) a Section 457(f) plan, referred to as an "ineligible plan." Under a Section 457(b) plan, participants are limited in the amount of compensation that may be deferred each year. In addition, deferred compensation under a Section 457(b) plan is taxed when paid or made available to the participant or beneficiary, as applicable.[3]

Under a Section 457(f) plan, participants are *not* limited in the amount of compensation that may be deferred each year. In addition, the compensation deferred under a Section 457(f) plan (or an ineligible plan) is included in the participant's or beneficiary's gross income on the later of the date the

[1] Under Code Section 457, an eligible employer means a State, political subdivision of a State, and any agency or instrumentality of a State or political subdivision of a state. Code Section 457(f) does not apply to the federal government or its subdivision, agencies and instrumentalities.

[2] The rules under 457(f) apply to deferred compensation paid to both employees and independent contractors. While this alert generally refers to employees or executives, the Proposed Regulations also apply to independent contractors.

[3] Proposed rules for Section 457(b) plans are included in the same doclument as the Proposed Regulations. See Federal Register, Vol. 81, No. 120, starting at page 40548.

participant or beneficiary obtains the legally binding right to the compensation or the date that the compensation is no longer subject to a substantial risk of forfeiture.

The Proposed Regulations make certain changes to the final regulations under Code Section 457 that the IRS issued in July 2003. The Proposed Regulations would become applicable 90 days after the final regulations are published in the Federal Register. Eligible employers and taxpayers may rely on the Proposed Regulations until the applicability date.

Of note is the fact that the Proposed Regulations do not generally provide grandfathered status to current Section 457(f) plans. While there are special rules for delayed applicability of the regulations for collectively bargained plans and plans of governmental entities that would be required to be amended by legislative action, the current provisions regarding the applicability of Section 457(f) regulations would not just apply prospectively but would apply to plans and other arrangements (unless specifically exempt from Section 457(f)) adopted before the date the regulations are finalized.

Substantial Risk of Forfeiture

The main guidance that we have been waiting for from the IRS is a definition of a "substantial risk of forfeiture" that specifically applies to Section 457(f). Previously, the IRS and practitioners had looked to the definitions of a substantial risk of forfeiture under regulations for Code Sections 83 and 409A to interpret what the term might mean under Section 457(f). In IRS Notice 2007-62, the IRS had stated that it expected to issue regulations under Section 457(f) defining substantial risk of forfeiture similar to the definition under Code Section 409A ("Section 409A") and its applicable regulations. As expected, the proposed definition of substantial risk of forfeiture in the Proposed Regulations mostly follows the definition from the Section 409A regulations, but, as explained below, the Proposed Regulations also provide some specific flexibility for Section 457(f) plans that is not available for Section 409A plans.

The Proposed Regulations define a substantial risk of forfeiture as follows:

> An amount of compensation is subject to a substantial risk of forfeiture only if entitlement to the amount is conditioned on the future performance of substantial services, or upon the occurrence of a condition that is related to a purpose of the compensation if the possibility of forfeiture is substantial.

Whether or not there is a substantial risk of forfeiture is determined based on the relevant facts and circumstances. Under a basic Section 457(f) plan, the deferred payment vests (*i.e.*, a lapse of the substantial risk of forfeiture) if the participant provides full-time employment until a specific date or age. Therefore, we expect that the terms of many Section 457(f) plans may already comply with the definition of substantial risk of forfeiture under the Proposed Regulations.

However, we recommend that all eligible employers double check their Section 457(f) plans to ensure that vesting does require substantial services, or completion of a condition that is related to the purpose of the compensation, and that the risk of forfeiture is real. For example, eligible employers should check whether their Section 457(f) plan designates the level of services (*e.g.*, full-time, half-time, or part-time) that are required for vesting. If the level of services permitted for vesting is less than full-time, the employer should analyze whether the level of services required is substantial in relation to the amount of deferred compensation paid under the Section 457(f) plan. Factors that will be considered for purposes of determining whether the risk of forfeiture is real (*i.e.*, likely to be enforced) include

(1) past practices of the employer, (2) level of control or influence of the employee with respect to the individuals that would be responsible for enforcing the forfeiture, and (3) the enforceability of the provision under applicable law.

Non-Compete Agreements

While the general definition of "substantial risk of forfeiture" above is very similar to the Section 409A definition, in certain limited areas the Proposed Regulations provide non-profit and governmental entities with significant flexibility that is not available under the Section 409A regulations. For example, unlike the Section 409A regulations, the Proposed Regulations provide that compliance with a noncompete agreement may constitute a substantial risk of forfeiture if (1) the right to the deferred compensation is expressly conditioned, in an enforceable written agreement, upon the employee refraining from the future performance of services, (2) the employer makes reasonable ongoing efforts to verify compliance with the noncompetition agreement, and (3) the facts and circumstances demonstrate that the employer has a substantial and bona fide interest in preventing the employee from performing the prohibited services and the employee has a bona fide interest in, and ability to, engage in the prohibited compensation.

The above provisions require the terms of a noncompete agreement to be more than mere form over substance in order to delay taxation on post-termination deferred compensation. We would recommend that eligible employers include well-drafted representations regarding the facts and circumstances that demonstrate the bona fide interest of the employer and employee in enforcing any noncompete agreement that provides for deferred compensation and a process that will be used for periodically verifying the former employee's compliance with the noncompete agreements.

In California, noncompete agreements are generally not enforceable, and therefore, the terms of a noncompete agreement would not constitute a substantial risk of forfeiture because the proposed forfeiture for noncompliance would not be enforceable under applicable law. However, in states where noncompete agreements are enforceable, a properly structured noncompete agreement could be used pursuant to Section 457(f) to structure post-termination deferred compensation.

Rolling Risk of Forfeiture

In Notice 2007-62, the IRS had stated specifically that if a participant had already attained a legally binding right to compensation, then adding or extending the period of a substantial risk of forfeiture (a "rolling risk of forfeiture") under Section 409A would be disregarded and also that the IRS expected the Section 457(f) regulations to adopt substantially similar rules. For that reason, it was surprising that the Proposed Regulations contain a limited right to add or extend the period of a substantial risk of forfeiture.

Specifically, the Proposed Regulations state that after the date the legally binding right to deferred compensation arises, a substantial risk of forfeiture cannot be added or extended unless (1) the present value of the amount made subject to the additional or extended substantial risk of forfeiture is materially greater (*i.e.*, 125% or more) than the amount the employee would have received without the additional or extended substantial risk of forfeiture, (2) the employee is required to perform substantial future services, or refrain from competing, for a minimum of two years after the date the employee would have been entitled to receive the deferred compensation absent the addition or extension, (3) the agreement to the addition or extension is in writing, and (4) the written agreement must be entered into (a) in the calendar year before the calendar year in which the services are performed to earn the compensation with respect to an initial addition and (b) within at least 90 days before an existing substantial risk of forfeiture would have lapsed with respect to an extension.

The IRS also added a new employee exception to the prohibition against a rolling risk of forfeiture. Under that exception, if an employee had not been providing services to an employer for at least 90 days prior to the addition or extension, then the addition or extension may be agreed to in writing within 30 days after the employee begins employment, but only with respect to amounts earned based on services rendered after the date of the addition or extension. In the preamble to the Proposed Regulations, the IRS emphasized that under requirement (2) above, the addition or extension of a substantial risk of forfeiture may not be added based solely on the occurrence of a condition that is related to the purpose of the compensation – such as completion of an organizational goal.

Elective Deferrals of Base Salary

Another surprise in the Proposed Regulations is the IRS's reversal of its position regarding deferrals of current compensation. As part of the discussion in the preamble to the Proposed Regulations, the preamble clearly states that if the requirements relating to adding an initial substantial risk of forfeiture apply (as discussed above), then current compensation may be deferred under a Section 457(f) plan.

Plans that Do Not Provide For a Deferral of Compensation

Code Section 457(e)(11) provides a list of plans and other arrangements that are treated as not providing for the deferral of compensation, including any bona fide severance pay, bona fide vacation, sick leave, compensatory time, disability and death benefit plans. However, the IRS had never issued regulations defining when any of these plans would be considered bona fide and exempt from application of Code Section 457. The Proposed Regulations finally provide proposed definitions for these plans.

Bona Fide Severance Pay Plan

In Notice 2007-62, the IRS had stated that it intended to issue regulations defining a bona fide severance pay plan similar to the definition of a "separation pay plan" under the Section 409A regulations. The definition in the Proposed Regulations is substantially similar to the definition in the Section 409A regulations, but it also has some significant differences. Under the Proposed Regulations, a "bona fide severance pay plan" means any arrangement that meets the following requirements:

(1) The benefits are payable solely upon an "involuntary severance from employment";

(2) The amount payable under the arrangement does not exceed two times the participant's annualized compensation based upon the annual rate of pay for services provided to the eligible employer in the prior calendar year (or the current calendar year if the participant had no compensation from the eligible employer in the prior calendar year) adjusted for any increase during the year used to measure the rate of pay that was expected to continue indefinitely if the participant had not had a severance from employment; and

3) Pursuant to a written plan document, the entire severance benefit must be provided to the participant no later than the end of the second calendar year following the calendar year in which occurred the participant's severance from employment.

The most significant difference between the separation pay plan exemption under the Section 409A regulations and a bona fide severance pay plan under Code Section 457 is that that the amount of benefit that can be paid to a participant under a bona fide severance pay plan is not limited to two times the Code Section 401(a)(17) compensation limit (currently $265,000 in 2016). Under a Section 409A separation pay plan, if a participant had earned an annualized base rate of pay of $300,000 in the 2015 calendar year and separated from service in 2016, the separation pay plan exemption would not exempt from Section 409A a payment of two times the participant's prior year compensation because it would exceed $530,000 (two times the Code Section 401(a)(17) compensation limit for 2016). However, under a Code Section 457(e)(11) bona fide severance pay plan, the plan could provide for full payment of two times the participant's prior year annualized base compensation (*i.e.*, $600,000) and such payment (or payments) would not be considered deferred compensation for purposes of Sections 409A or 457(f).

Involuntary Severance from Employment. The Proposed Regulations also define when an "involuntary severance from employment" occurs. In order to be an involuntary severance from employment, a severance from employment must be due to the independent exercise of the eligible employer's unilateral authority to terminate the participant's employment when the employee was willing and able to continue employment. The termination cannot be due to the employee's implicit or explicit request to terminate employment. An involuntary severance from employment may include an eligible employer's failure to renew a contract at the time the contract expires, provided the employee remained willing and able to execute a contract with terms substantially similar to those in the expiring contract and to continue providing such services.

The determination of whether there has been an involuntary severance from employment is based on the relevant facts and circumstances and without regard to the characterization of the reasons for the payment by the employer or employee. Interestingly, in the Section 409A regulations, the characterization of the type of separation from service (involuntary or voluntary) by the employer and employee is presumed to be correct unless the presumption is rebutted by facts and circumstances to the contrary. Not only did the IRS fail to include a similar presumption in the Proposed Regulations, but the Proposed Regulations specifically state that the employer and employee characterizations will be disregarded in making the determination. The preamble to the Proposed Regulations is silent about this difference between substantially similar definitions.

Severance from Employment for Good Reason. A voluntary severance from employment for "good reason" (as defined below) will be treated under the Proposed Regulations as an involuntary severance from employment. To be a severance from employment for good reason, the severance from employment must occur pursuant to certain pre-specified bona fide conditions in a written agreement, and the avoidance of application of Code Section 457(f) may not be the primary reason for including the conditions in the agreement or for the actions of the employer in connection with satisfying the conditions. The definition of good reason under the Proposed Regulations is substantially similar to the definition under the Section 409A regulations.

Under the Proposed Regulations, a severance from employment for good reason means that the relevant facts and circumstances demonstrate that the employer unilaterally took action that caused a material negative change to the participant's relationship with the employer. Significant factors that will be considered in whether there has been a bona fide severance from employment for good reason are (1) whether the payments to be made upon a severance from employment for good reason are the same amount, and made in the same time and form, as payments to be made upon an involuntary severance from employment, (2) whether the employee is required to provide the employer reasonable notice of the existence of the condition that would result in termination for good reason, and (3) whether the employer has a reasonable opportunity to remedy the condition.

Similar to the definition in the Section 409A regulations, the Proposed Regulations also set forth a safe harbor for when the terms and conditions in a written agreement will constitute a severance from employment for good reason. Under the safe harbor, a severance from employment will be deemed to be for good reason if it occurs under the following conditions:

(1) The severance from employment occurs during a limited period of time not to exceed two years following the initial existence of one of the following conditions:

   a. A material diminution in the participant's base compensation;

   b. A material diminution in the participant's authority, duties, or responsibilities;

   c. A material diminution in the authority, duties or responsibilities of the supervisor to whom the participant is required to report, including the requirement that a participant report to a corporate officer or employee instead of reporting directly to the board of directors (or similar governing body) of the organization;

   d. A material diminution in the budget over which the participant retains authority;

   e. A material change in the geographic location at which the participant must perform services; or

   f. Any other action or inaction that constitutes a material breach by the eligible employer of the agreement under which the participant provides services.

(2) The participant is required to provide notice to the eligible employer of the existence of an applicable condition within a period not to exceed 90 days of the existence of the condition and the employer must be provided with a period of at least 30 days to remedy the condition and not be required to pay the severance benefits.

Window Programs. The requirement that a bona fide severance pay plan only applies to benefits payable upon an involuntary severance from employment does not apply if the severance benefits are provided in accordance with the terms of a "window program." A severance program that an employer establishes to provide severance benefits with respect to pending severance from employment is considered a window program if the program is made available to eligible participants for a period of time not exceeding 12 months and the participants have a severance from employment during that limited period of time. The employer can limit participation in a window program to participants who are terminated under specified circumstances. However, a severance program will not be considered a window program if it is part of a pattern of multiple similar programs that, if offered as a single program, would not be considered a window program. In determining whether multiple programs are considered a pattern of offering similar programs, the relevant facts and circumstances are considered including, but not limited to, whether the severance benefits are provided on account of a specific reduction in force, the degree to which the separation pay relates to an event or condition, and whether the event or condition is temporary or discrete or is a permanent aspect of the employer's practices.

Taxable Reimbursements of Expenses, Medical Benefits or In-Kind Benefits. The Proposed Regulations incorporate by reference the exemptions of the Section 409A regulations for severance pay relating to expense reimbursements (such as taxable moving expenses), medical benefits and in-kind benefits (such as employer-provided outplacement benefits) and provide that to the extent a plan provides for these payments or benefits, then these payments or benefits are not a deferral of compensation. Instead, these listed severance pay and benefits can be provided in addition to the severance pay and benefits provided under a bona fide severance payment plan. Therefore, it appears that these exemptions could be "stacked" similar to exemptions under the Section 409A regulations if the terms of the plan are properly drafted to provide for stacking of applicable exemptions from Section 457(f).

Finalization of the Proposed Regulations relating to bona fide severance pay plans could result in very significant changes to the design of severance benefits currently offered by non-profit and governmental employers. Because the term "bona fide severance pay" under Code Section 457(e)(11) had not previously been defined by regulation, many non-profit and governmental entities have taken a much more flexible approach regarding what severance pay and benefits could be provided under a bona fide severance pay plan. Eligible employers should now review their severance plans to determine if their plans must be revised to comply with the strict definition of bona fide severance pay plan under the Proposed Regulations.

Other Plans that Do Not Create a Deferral of Compensation

Because of the length of this alert and breadth of information in the Proposed Regulations, below is a brief summary of some of the other plans that are not considered to provide for a deferral of compensation under Code Section 457. In a later alert we will provide a more detailed analysis of how the new regulatory definitions of these other plans may affect the way eligible employers currently provide these benefits.

Disability Pay Plans. With respect to disability pay plans, the Proposed Regulations adopted rules similar to the provisions in Section 409A, except that the value of any taxable disability insurance coverage under the plan is disregarded if it is included in gross income.

Death Benefits. The Proposed Regulations define a bona fide death benefit plan as a death benefit plan under Treasury Regulation § 31.3121(v)(2)-1(b)(4)(iv)(C) (applicable FICA tax regulations). The applicable FICA tax regulations basically treat a payment as a death benefit if the payment is not merely a replacement of the lifetime nonqualified plan benefit upon the participant's death.

Sick and Vacation Benefits. The Proposed Regulations provide substantial guidance about what will now be considered a bona fide sick and vacation leave plan, and that guidance could significantly affect leave cash out programs offered by eligible employers.

Summary of Additional Significant Rules Under the Proposed Regulations

Below is also a quick summary of additional rules that we believe would significantly affect the way some eligible employers compensate their employees if the Proposed Regulations are finalized in their current form. We will also expand on the importance of these additional rules in subsequent client alerts.

Short-Term Deferrals

The definition of "short-term deferral" under the Section 409A regulations is incorporated by reference into the Proposed Regulations, except that the definition is applied using the Section

457(f) definition of substantial risk of forfeiture. Under the short-term deferral rule, a payment is not considered a deferral of compensation if the payment must be paid to the employee no later than 2 ½ months after the end of the taxable year (of the employer or the employee) in which the legally binding right to the compensation arose or, if later, the date the compensation is no longer subject to a substantial risk of forfeiture.

Substitutions

The Proposed Regulations clarify that if an amount which is subject to a substantial risk of forfeiture is forfeited or relinquished and then replaced, in whole or in part, with a right to another amount or benefit in substitution for the forfeited or relinquished amount, then any substantial risk of forfeiture applicable to the substituted amount or benefit will be disregarded unless the rules relating to the addition or extension of a substantial risk of forfeiture are also satisfied.

Determination of Present Value of Section 457(f) Benefits

When a Section 457(f) benefit becomes includible in gross income, the amount includible is the present value of the Section 457(f) benefit regardless of the time or form of payment of the Section 457(f) benefit. An eligible employer has generally had discretion to use actuarial factors and methods that it found reasonable to determine the amounts includible in gross income. Upon finalization of the Section 457(f) regulations, eligible employers will need to use the methods outlined in the regulations for determining the present value of Section 457(f) benefits.

Limitation on the Economic Value of Section 409A Tails

Historically, with respect to account balance Section 457(f) plans, generally on the date the account balance vested, the present value of the account balance was considered to be the contributions credited to the plan and the amount of any earnings credited to the account balance as of the date of vesting. Once the present value of the account was taken into gross income, any amount credited to the participant's account that was not distributed could continue to be credited with earnings, and the future earnings would not be taxed until actually paid. However, because a Section 457(f) plan is subject to Section 409A separately and in addition to Section 457(f), the amount that was left in the account had to be paid in accordance with the election rules and time-and-form-of-payment rules under the Section 409A regulations. These post-vesting account balances therefore were nicknamed "409A tails." Many times these Section 457(f) plans with a 409A tail have earnings credited to the 409A tail account based on various hypothetical investment options such as a selection of mutual funds. However, under the Proposed Regulations if the earnings are credited based on more than one interest rate or investment crediting option, the present value of the account must now include the "right to future earnings." This change in the calculation of the present value of the Section 457(f) account balance plan with a 409A tail could increase the present value of a Section 457(f) benefit and could decrease the desirability of offering a 409A tail feature to employees of an eligible employer.

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