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Newly Issued Code Section 457(f) Proposed Regulations Offer Clarity and New Opportunities in Designing Executive Compensation

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Finally!

- On June 22, 2016, the IRS issued proposed regulations under Internal Revenue Code ("Code") Section 457
- The regulations will take effect in the calendar year beginning after the final regulations are issued
  - There are special effective dates for collectively bargained plans and plans of governmental entities that would be required to be amended by legislative action
- IMPORTANT: The final regulations will apply to compensation deferred in prior years that has not been included in income in a prior year
  - There is no grandfathering provision

Finally!

- Written comments to the proposed regulations are due by September 20, 2016
- A public hearing is scheduled for October 18, 2016
- Given the above dates, it seems likely that the final rules will not be issued until early 2017, in which case they will be effective as of January 1, 2018

Agenda

- Background
- What is deferred compensation
- Plans that are exempt from Code Section 457(f)
- Other exemptions from Code Section 457(f)
- Revised definition of Substantial Risk of Forfeiture
- Income inclusion rules
- ERISA

Code Section 457—Background

- Code Section 457 plans are generally nonqualified, unfunded deferred compensation plans established by state and local government and tax-exempt employers ("eligible employers") for their employees and independent contractors
  - Churches, church controlled organizations, and the federal government or any agency or instrumentality thereof are excluded from coverage under Code Section 457
- There are 2 types of plans under Code Section 457—457(b) plan or 457(f) plan

Code Section 457—Background

- 457(b) plan is referred to as an <u>eligible</u> plan
  - Generally unfunded
    - State government plans must set aside funds in a trust or custodial account
  - Maximum deferral is limited to the lesser of
    - 100% of compensation
    - Code Section 457(e)(15) amount ($18,000 for 2016)
  - Taxed when paid or made available
    - May elect to defer distribution past termination of employment
    - Subject to minimum required distribution rules
- 457(f) plan is referred to as an <u>ineligible</u> plan

Code Section 457(f)—In General

- Under Code Section 457(f), an employee is taxed on the deferred compensation when the compensation is no longer subject to a substantial risk of forfeiture ("SRF"), even if the amounts are paid at a later date
- There is no limit on the amount that can be deferred under Code Section 457(f)
  - There may be other issues with regard to intermediate sanctions for non-profits, which is not discussed in this presentation
- Note that the rules apply to employees and independent contractors, but for ease, this presentation will refer to employees

Code Section 457(f) and Code Section 409A

- A Code Section 457(f) plan is also subject to the rules under Code Section 409A, unless there is an exemption from the Code Section 409A rules
- Code Section 409A restricts timing of elections and the time and form of payment
- If the Code Section 409A rules are not met, the employee is subject to large penalties and interest payments
  - However, if the amount paid complies with an exemption under Code Section 457, then Section 409A does not apply

Deferral of Compensation

- A deferral of compensation exists when the employee has a legally binding right in one calendar year to compensation payable in a subsequent calendar year
- Whether a plan provides for a deferral of compensation is based on the facts and circumstances at the time the employee obtains the legally binding right to the compensation, or, if later, when the plan is amended to convert a right that does not provide for a deferral of compensation into a plan that does

Deferral of Compensation

- For example, if a plan providing for retiree health care does not initially provide for a deferral of compensation, but later is amended to provide the ability to receive cash in the future instead of health benefits, it provides a deferral of compensation
- This often arises in severance agreements when the employer offers to pay the COBRA premiums for the employee, unless that violates certain nondiscrimination rules in the Code, in which case the employer will provide the employee with taxable compensation
  - This type of provision will need to be carefully reviewed

Deferral of Compensation

- Code Section 457(e)(11) states that "[t]he following plans shall be treated as not providing for a deferral of compensation: (i) Any bona fide vacation leave, sick leave, compensatory time, severance pay, disability pay, or death benefit plan."
  - The proposed regulations provide definitions for most of the above listed plans
- In addition, the proposed regulations provide that payments made in accordance with the following exemptions will not be treated as providing for a deferral of compensation:
  - Short-term deferral
  - Recurring part-year compensation
  - Certain reimbursements
    - The proposed regulations contain detailed requirements for each of these exemptions

Bona Fide Severance Pay Plan

- A bona fide severance pay plan is a written plan that meets the following:
  1. benefits are payable (**a**) only upon an involuntary termination of employment OR (**b**) through a window program (explained later in this presentation); and
  2. the amount payable does not exceed 2 times the employee's annualized compensation based on the annual rate of pay for the calendar year preceding the calendar year in which the employee has a severance from employment; and
  3. the entire severance benefit is paid no later than the last day of the second calendar year following the calendar year in which the severance from employment occurs

Bona Fide Severance Pay Plan

- While this definition is similar to the one used in Code Section 409A, there is a major difference
- Under Code Section 409A, the amount can in no event exceed two times the Code Section 401(a)(17) limit ($530,000 for 2016)
  - If that amount is exceeded under the 457(e)(11) bona fide severance pay plan, the excess is not required to comply with Code Section 409A separately

Bona Fide Severance Pay Plan

- An involuntary severance from employment means a severance from employment due to the independent exercise of employer's unilateral authority to terminate the employee
- An involuntary severance from employment will also include a severance for good reason
  - Once the good reason conditions have been established, the elimination of one or more of the conditions may create tax issues
- A severance from employment for good reason must be the result of a unilateral employer action that caused a material negative change in the employee's relationship with the employer

Bona Fide Severance Pay Plan

- There is a safe harbor definition for good reason, which has 3 requirements:
- #1—The severance occurs during a limited period of time not to exceed 2 years following the initial existence of:
  - (1) a material diminution of base compensation,
  - (2) a material diminution of authority, duties or responsibilities,
  - (3) a material diminution in the authority, duties or responsibilities of the employee's direct supervisor,
  - (4) a material diminution in the budget over which he attains authority,
  - (5) a material change in geographic location at which he must perform services, or
  - (6) any action or inaction that constitutes a material breach by the employer

Bona Fide Severance Pay Plan

#2—the amount, time and form of payment upon a good reason termination is substantially the same as the amount, time and form of payment for an involuntary termination, and

#3—the employee must provide notice to the employer of the existence of the good reason condition within 90 days after the initial existence of the condition and the employer must be provided at least 30 days to remedy the condition

Bona Fide Severance Pay Plan

- Given the lack of guidance on this issue in the past, many employers adopted severance plans that had much broader definitions of an involuntary termination—and also included voluntary terminations (which do not meet the good reason definition in the proposed regulations)
- Employers will need to carefully review severance plans and look at severance provisions in other documents, such as collective bargaining agreements

Window Program

- The involuntary severance from employment requirement is not applicable to window programs
  - The other two requirements (amount and time of payment) must be met
- A window program means a program established by an employer to provide separation pay in connection with an impending severance
- The program must be for a limited period of time (typically no longer than 12 months) for participants who terminate during that time
- Generally this applies to a group RIF, reorganization or closure of a business unit

Bona Fide Death Benefit

- A bona fide death benefit plan is a plan that provides benefits upon death, whether directly or through insurance, and the amount of the benefit provided on death exceeds the possible lifetime benefits payable under the plan
- It is not that one of the payment triggers under the plan is death, but in general that the benefit is provided only upon death
- If the plan is considered a bona fide death benefit plan, it is exempt from Code Section 457(f)

Bona Fide Disability Pay Plan

- A plan is a bona fide disability pay plan if it pays benefits only in the event that the participant is disabled
- A participant is considered disabled if he meets one of the following conditions:
  - (1) he is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment that can be expected to result in death or last for a continuous period of not less than 12 months;
  - (2) he is, by reason of any medically determinable physical or mental impairment that can be expected to result in death or last for a continuous period of not less than 12 months, receiving benefits for a period of not less than 3 months under an accident and health plan covering employees; or
  - (3) he is determined to be totally disabled by the SSA

Bona Fide Disability Pay Plan

- Employers will need to review their disability pay plans for these rules
- Short-term disability pay plans will not come within this exemption, but fall within a different exemption from the rule (bona fide sick plan)

Bona Fide Sick and Vacation Leave Plan

- This is the first time that there has been a definition for this type of plan
- Employers will need to review this carefully against their sick and vacation leave plans
- In general, a plan is treated as a bona fide sick or vacation leave plan—and not an arrangement to defer compensation—if the facts show that the primary purpose is to provide employees with paid time off work because of sickness or vacation

Bona Fide Sick and Vacation Leave Plan

- The proposed regulations contain the following factors to be considered:
  - (1) if the amount of the leave provided could reasonably be expected to be used in the normal course by the employee
  - (2) the ability to exchange unused accumulated leave for cash or other benefits (including using the leave to postpone the date of termination)
  - (3) the amount and frequency of any in-service distributions of cash or other benefits offered in exchange for accumulated sick leave
  - (4) whether payment is made promptly upon termination
  - (5) whether the program is available only to a limited number of employees

Bona Fide Sick and Vacation Leave Plan

- These new rules make it questionable whether the employer can continue to provide plans which permit an employee to be cashed-out of unused sick-days at the time of retirement
- Employers should stop allowing employees to use vacation time to extend their termination dates
- Employers that allow employees to sell vacation time, outside of a Code Section 125 plan, will need to consider if that causes the plan to lose this exemption under Code Section 457(f)

Bona Fide Sick and Vacation Leave Plan

- Even if a plan meets this exemption but it allows employees to sell vacation time, the plan must comply with the vacation sell rules under Code Section 451, such as the general inability to provide employees with the election to sell already accrued vacation days
- Some employers allow employees to sell already accrued vacation time at a discount, commonly referred to as a "haircut" provision
- Haircut provisions are not allowed under Code Section 409A and it seems very unlikely that they are permitted under these proposed regulations

Other Exemptions

- There will not be a deferral of compensation (and hence, no application of Code Section 457(f)) for:
  - short-term deferrals,
  - certain recurring part-year compensation (generally applicable for teachers/professors), and
  - certain other benefits, such as:
    - (1) expense reimbursement plans, medical benefits or in-kind benefits (if applicable requirements are met);
    - (2) certain indemnification rights and liability insurance; and
    - (3) taxable education benefits to employees, as defined in Code Section 127(c)(1)

Short-Term Deferral

- The proposed regulations adopt the short-term deferral exemption from the Code Section 409A regulations—except that it uses the SRF definition from Code Section 457(f)
- The short-term deferral rule provides that no deferral of compensation occurs if the payment is made by March 15th of the calendar year following the calendar year in which the amount ceases to be subject to a SRF. (If the employer is on a non-calendar fiscal year, it must be paid by the later of the 15th day of the 3rd month following the end of the fiscal year in which the compensation ceases to be subject to a SRF or March 15th of the calendar year in which the amount ceases to be subject to a SRF.)

Short-Term Deferral

- An exciting aspect of the short-term deferral rule is that if the plan comes within this exemption, the amounts are taxed when paid and not when the SRF lapses
  - This is very different from amounts subject to Code Section 457(f), which are taxed once the SRF lapses, even if not paid until a later date
- One note: The employer must still consider other tax rules, such as Code Section 451. If the employee could receive the amounts when the SRF lapses but he elects to receive the amounts in the following year (i.e., he turns his back on income in year one and elects to receive it in year two), he will be taxed on the amounts at the earlier date because he was in constructive receipt of the amount

Short-Term Deferral

- Example: The employee will be paid a lump sum payment of $100,000 if he remains employed by the employer until November 1, 2017. The lump sum payment will be made no later than March 15, 2018
- Under Code Section 457(f), this would be exempt under the short-term deferral rule
- However, if the employee has the ability to elect to receive the amounts in 2017 or in 2018, then under Code Section 451, he is taxed on the amount in 2017 under the constructive receipt rules—even if he does not actually receive the $100,000 until 2018
  - To avoid this issue, the plan should have included:
    - the actual payment date, or
    - employer discretion pay before end of short-term deferral period

Recurring Part-Year Compensation

- Recurring part-year compensation is exempt from Code Section 457(f)
- Defined as an ongoing arrangement between an employer and an employee in which the employee is paid for services, with the payments extending over a period that is longer than the period of service and encompasses two taxable years
- Often it is compensation for a 9-month or 10-month service period that can be spread over 12 months at the election of the employee (generally for teachers/professors)

Recurring Part-Year Compensation

- There is no deferral of compensation if:
  - (1) the plan does not defer payment to a date beyond the last day of the 13th month following the first day of the service period, and
  - (2) the amount of the recurring part-year compensation does not exceed the annual limit under Code Section 401(a)(17) ($265,000 for 2016)

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Deferral of Compensation and SRF

- If the plan is subject to the Code Section 457(f) income inclusion rules—and not exempt due to one of the exemptions above—the amount set forth in the plan is includible in gross income on the first date which the employee has a legally binding right to the amount, unless the amount is subject to a SRF
- In that case, the amount is included in gross income on the first date in which the SRF lapses
- The key is SRF!
- This is generally the same as the definition under Code Section 409A, except for the limited use of a non-compete agreement and rolling risk of forfeiture

SRF

- An amount is subject to a SRF 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
- This is a facts and circumstances determination
- With regards to substantial future services, factors include whether the hours required to be performed during the relevant period are substantial in relation to the amount of compensation
- With regards to a condition related to a purpose of the compensation, it must relate to the employee's performance of services OR to the employer's activities or organization goals
  - This could include performance-based vesting conditions

SRF

- To constitute a SRF, the possibility of actual forfeiture must be substantial based on the facts and circumstances
- Factors include the extent to which the employer has enforced forfeiture conditions in the past, the level of control or influence of the employee with respect to the organization and the individuals who would be responsible for enforcing the forfeiture condition
- In the past, employers have often changed or revised the SRF to ensure that the person receives the benefit. This will not be allowed under these new regulations because it will essentially show that there never was a real SRF

SRF

- Example of SRF: On August 1, 2017, the employee is promised that he will be paid $100,000 if he remains employed until March 1, 2020. If he leaves employment prior to March 1, 2020, he will forfeit the right to the $100,000
- If, in the example above, the employee could receive the amounts if he voluntarily terminates employment prior to March 1, 2020, there is no SRF—that is a "walk right"
- If, in the example above, the employee is age 55 as of August 1, 2017 and he can receive the $100,000 when he retires—and retirement is anytime after attaining age 55—there is no SRF. Again, that is a walk right

Noncompetition Provisions

- This can be a SRF, if ALL of the following requirements are met:
  - (1) the right to payment is expressly conditioned upon the employee refraining from future performance of services pursuant to an enforceable written agreement;
  - (2) the employer makes reasonable ongoing efforts to verify compliance with noncompetition agreements; and
  - (3) the facts and circumstances show that the employer has a substantial interest in preventing the employee from performing the prohibited services and the employee has an interest and ability to engage in the prohibited competition
- Factors to be considered are the adverse economic consequences that would likely result to the employer, the marketability of the employee, the employee's interest and ability to engage in the prohibited services

Noncompetition Provisions

- This can be used to create a SRF in the event of a voluntary termination
- There is a question about the third requirement in the previous slide—that the employer has a substantial interest in preventing the employee from performing the prohibited services
  - What happens if the employer closes that line of business for which the non-compete applied to? Does that SRF lapse at that time?

Noncompetition Provisions

- Employers will need be sensitive to the length and scope of the non-compete agreement and whether applicable state law will permit the non-compete agreement to be enforced
- Noncompetition provisions are generally not enforceable in California

Deferral of Current Compensation

- The proposed regulations contain a rule regarding the ability to have an initial deferral of current compensation treated as subject to a SRF
- Current compensation is compensation paid on a current basis, such as salary or commissions
- This addition in the regulations was not expected. Previous guidance from the IRS, on an informal basis, stated that the IRS did not think this worked under Code Section 457(f)
- To make this work, three requirements must be met (explained on next slide)

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Deferral of Current Compensation

#1—benefit must be materially greater—The present value of the amount made subject to the SRF is materially greater than the present value of the amount the employee would have otherwise received absent the initial SRF. If the new amount is more than 125% of the original amount, it will be materially greater

#2—minimum two years of substantial future services—The employee must be required to perform substantial services in the future, or refrain from competing (meeting the noncompete rules described earlier) for a minimum of two years after the date the employee could have received the compensation in absence of the additional SRF, subject to permitted vesting on death, disability or involuntary termination without cause

#3—timing—A written agreement must be entered into before the beginning of the calendar year in which any services that give rise to the compensation are performed

Deferral of Current Compensation

- Notwithstanding the two-year requirement (#2 above), the plan may provide that the substantial service requirement will lapse upon death, disability or involuntary severance from employment without cause
- As an example of the two-year requirement for an employee who elects to defer a fixed percentage of his compensation from his semi-monthly payroll, the two-year minimum applies to each semi-monthly payroll amount
- There is a special timing rule (#3 above) for new hires that states if the employee was not providing services to the employer at least 90 days before the addition of the SRF, the addition may be agreed upon in writing within 30 days after the commencement of employment but only with respect to amounts attributable to services rendered after the addition is agreed to in writing

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Deferral of Current Compensation

- This rule essentially requires that the deferral of compensation contain an employer match (125%)
- This is a planning opportunity for employers
- This rule should be considered now, in the event that employers want to adopt this kind of plan for 2018 because the elections would need to occur in 2017

Additional Risk of Forfeiture—Rolling Risk of Forfeiture

- This occurs when the deferred compensation is already tied to a SRF, but the employer wants to add an additional SRF
- Previously, the IRS made informal comments that it did not think this worked. However, the proposed rules permit it.
- The new additional SRF must meet the following three rules:
  - (1) benefit must be materially greater (at least 125%),
  - (2) minimum two years of substantial future services, and
  - (3) timing—a written agreement must be entered into at least 90 days before the existing SRF would have lapsed
- Employers should consider this provision now in the event they want to take advantage of extending a risk of forfeiture that would otherwise lapse at the end of this year

Substitutions

- If an amount is forfeited and then replaced, in whole or in part, with another amount of benefit, that is a substitute
- The new risk of forfeiture will be disregarded unless the additional risk of forfeiture rules are met
- For example, assume that the employer promises the employee in 2017 that he will receive $50,000 if certain performance goals are met by January of 2020. Those performance goals are not met. However, the employer still pays him most of the amount in 2020 under a different/new agreement. That would be a substitution and likely the amounts should have been taxed in 2017, given that there was no real SRF

Example

- Facts. On January 15, 2017, an employee has a severance from employment and enters into an agreement with the employer under which the employer agrees to pay him $250,000 on January 15, 2018 if he provides consulting services to the employer until that date. The consulting services required are insubstantial in relation to the payment. The employee provides the required consulting
- Conclusion. The consulting services provided by the former employee do not constitute substantial services because they are insubstantial in relation to the payment. Accordingly, the present value of $250,000 payable on January 15, 2018 is includible in the employee's income on January 15, 2017
  - Present value is a defined term in the proposed regulations, which is described later in this presentation

Example

- Facts. On January 27, 2020, an employer agrees to pay the employee $120,000 on January 1, 2023, provided that he continues to provide substantial services to the employer through that date. In 2021, the parties enter into an agreement to extend the date through which substantial services must be performed to January 1, 2025, in which event, the employer will pay an amount that has a present value of $145,000 on January 1, 2023
- Conclusion. As of the date the initial SRF would have lapsed, the present value of the compensation subject to the extended SRF is not materially greater than the present value of the amount previously deferred ($145,000 is not more than 125% of $120,000) and, therefore, the intended extension of the SRF is disregarded.

Example

- Accordingly, the employee will recognize income on the applicable date that the first SRF lapses (January 1, 2023) in amount equal to $120,000. He will also have a taxable event in 2025, when the remaining amounts are paid

Income Inclusion—Present Value

- If the employer provides the employee with deferred compensation that is subject to Code Section 457(f), the present value of the compensation is includible on the applicable date
- The applicable date is the later of: (1) the first date on which there is a legally binding right to the compensation, or (2) the first date on which the SRF lapses
- The proposed regulations spend a lot of time on defining the "present value"

Present Value

- In many cases, the entire benefit is paid at the time that the SRF lapses. In that case, the present value rules are obvious—it generally is the amount paid to the employee
- If the deferred compensation is paid after the year of vesting, then determining the present value of the benefit that will be taken into income and taxed when the SRF lapses, becomes very important
- Present value also becomes important in the event that there is no real SRF and the amount should have been taken into income at an earlier date

Present Value

- The present value is determined by multiplying the amount of the payment by the probability that any condition on which the payment is contingent will be satisfied and discounting the amount using an assumed rate of interest to reflect the time value of money.
  - In other words, the present value is the value of the right to receive the payment in the future taking into account the time value of money and the probability that payment will be made
- The method for determining present value differs depending on the nature of the deferred compensation—account balance plan or non-account balance plan

Present Value

- An account balance plan is one where the employee’s benefit consists of a principal amount credited to his account, plus income/earnings credited to that principal amount
- A non-account balance plan is any plan that is not an account balance plan
  - This could be a defined benefit plan type of benefit, such as a SERP

Present Value

- The probability that the employee will die before a payment is made is only permitted to be taken into account to the extent the amount is forfeitable upon death
- The probability that the payment will not be made because of the unfunded status of the plan, the risk of any investments, the risk that the employer will be unwilling/unable to pay, change in future laws or other similar risks cannot be taken into account
- If the date payment is to be made is termination of employment and the employee has not terminated as of the applicable date, the termination may be treated as occurring on any date that is not later than the 5th anniversary of the applicable date, unless that assumption is unreasonable based on the facts

Present Value—Account Balance Plan

- For an account balance plan to which earnings are credited at least annually, the present value of the deferred compensation as of the applicable date is 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

Present Value—Account Balance Plan

- Unreasonable Rate of Return. The rules are different if the account balance plan under which the income is credited is based on neither a predetermined actual investment nor a rate of interest that is reasonable
  - In that case, the present value is equal to the amount credited to the participant's account plus the value of the stream of future excess earnings. Essentially, the excess earnings are treated as additional deferred compensation and not earnings
- Combination of Predetermined Actual Investments of Interest Rates. If the amount of the earnings is based on the greater of two or more rates of return, then the amount included in income on the applicable date is the sum of the amount credited to the participant's account AND the present value of the right to future earnings

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Present Value

- If the amounts are includible in income upon the lapse of the SRF, but the compensation that is subsequently paid is less than the amount previously included in income, the employee is entitled to a deduction for the tax year in which that amount is permanently forfeited
- It would generally be treated as a miscellaneous itemized deduction

409A Tail

- Historically, with regards to account balance plans, generally on the date the account balance was vested, the present value of the account was considered to be the contributions credited to the plan and the amount of earnings credited as of the vesting date. Once the present value was taken into income, any amount credited to the account that was not distributed could continue to receive earnings and those future earnings would not be taxed until paid
- These post-vesting account balances were nicknamed "409A tails" because the amounts left in the account after the SRF lapsed were subject to Section 409A

409A Tail

- These 409A Tail plans will likely need to change based on these proposed regulations
- Many of these plans have earnings credited based on various hypothetical investment options
- As stated earlier, if an account balance plan has earnings based on more than one interest rate or investment crediting option, the present value must include the right to future earnings
- This change to the way that present value is calculated may cause the death of these 409A Tail plans

Present Value—Formula Amounts

- There are special rules for determining the present value of formula amounts (such as a defined benefit type of plan)
- Formula amounts are amounts payable by reference to one or more factors that are indeterminable at the applicable date
- For determining present value as of the applicable date, this will be based on all of the facts and circumstances existing as of that date using reasonable and good faith assumptions
- A second calculation must be completed at the time of payment that is equal to the difference between the present value determined at the applicable date (vesting) and the value at the time of payment. If that is a positive amount, that amount is then taxable

Example

- On October 1, 2018, an employer agrees to pay $100,000 to an employee at severance from employment (which is not a SRF). The assumptions used to determine present value are that the participant will have a severance from employment on October 1, 2023 and that the present value will be determined using a rate of 4.5% compounded monthly
- Assuming that the severance from employment date and interest rate assumptions are reasonable, the value included in income on the applicable date (October 1, 2018) is $79,885

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Example

- On October 1, 2017, the employer establishes a plan under which it agrees to pay the amount credited to the employee's account when he has a severance from employment. There is no SRF. The account balance on October 1, 2017 is $125,000 and the employee includes $125,000 in income in 2017. The plan subsequently experiences notional investment losses, and the employee receives $75,000 from the plan as a lump sum in 2024, when he has a severance from employment. The $75,000 lump-sum payment represents all amounts due to him under the plan
- For 2024, the employee is entitled to deduct $50,000

Interaction with Code Section 409A

- The proposed regulations state that the rules of Code Section 457(f) apply separately and in addition to any requirements applicable to the plan under Code Section 409A
- The proposed regulations also state that although Code Section 457(f) do not preclude the acceleration of payments, acceleration is generally prohibited under Code Section 409A

Example

- On December 1, 2017, an employer establishes a plan for an employee, under which an initial amount is credited to the account and is increased periodically by earnings based on a reasonable specified rate of return. The entire account balance is subject to a SRF until December 1, 2021. The plan states that amounts will be paid in three installments on each January 15, beginning in 2024 (1/3rd for the first installment, ½ of the remaining balance for the second installment and the remaining balance for the third installment)
- In 2022, the plan is amended to provide for payments to begin in 2023. This acceleration causes the plan to fail to comply with Code Section 409A during 2022

Example

- The account balance is:
  - $100,000 on 12/1/21;
  - $118,000 on 12/31/2022;
  - $120,000 on 1/25/2023 (so that the payment made that day is $40,000—120,000/3);
  - $88,000 on 1/15/2024 (so that payment made that day is $44,000); and
  - $50,000 on 1/15/2025 (so that payment made that day is $50,000)

Example

- Remember that the SRF lapses on 12/1/2021
- The $100,000 amount of the account balance on 12/1/21 is included in income on that date
- Because the plan fails to meet Code Section 409A in 2022, the employee has income under 409A equal to the account balance on 12/31/ 2022, reduced by the amount previously included in income (that is $18,000 since the account balance at that time is $118,000). The amount included in gross income under 409A is subject to an additional 20% tax and premium interest tax
- Additional amounts are included in income in 2024 and 2025, when the remaining payments are made

ERISA

- While not discussed in this presentation, remember that many of these Code Section 457(f) plans are subject to ERISA
- In many cases, that means that the employees covered by the plan must be limited to a top group and a special filing must be made for the plan

Action Items

- Review all severance plans, vacation plans and sick leave plans
- Review all plans that contain non-compete provisions as the SRF
- Review all plans that contain a rolling risk of forfeiture
- Review the tax treatment of plans that pay over a period of time after the SRF lapses
- Review short- and long-term bonus plans for compliance with short-term deferral rules
- Any new plans should be drafted to comply with these proposed regulations
- Add Code Section 409A savings clause

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