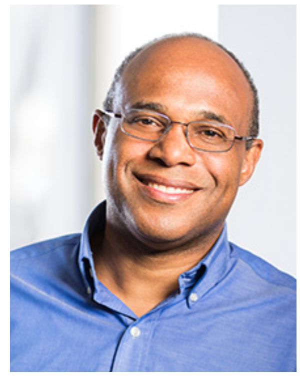
Tax-Exempt Entities and State/ Local Governments Have New Flexibility in Designing Annual and Long-Term Bonus Incentive Plans



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This client alert discusses how tax-exempt entities and state/local governments ("eligible employers") can take advantage of the new rules in the Internal Revenue Service ("IRS") proposed regulations (issued on June 22, 2016) regarding Internal Revenue Code ("Code") Section 457(f) (the "Proposed Regulations") to design more flexible and easier-to-administer annual and long-term bonus incentive plans. Because the Proposed Regulations state that eligible employers can immediately rely on the new rules, eligible employers do not need to wait for the Proposed Regulations to be finalized in order to take advantage of the new flexibility discussed in this client alert. (For a more comprehensive review of the Proposed Regulations, see our July client alert or scroll down the Events page to view our July 27 webinar.)

Background

Unless an exemption applies, Code Section 457(f) requires that when an eligible employer sponsors an "ineligible plan" that provides for a "deferral of compensation," then the compensation payable under the ineligible plan must be included in the participant's or beneficiary's gross income on the later of

(i) the date the participant or beneficiary obtains the legally binding right to the compensation or

(ii) the date that the compensation is no longer subject to a substantial risk of forfeiture.

While Code Section 457(f) is generally considered to be a means of providing supplemental retirement benefits, it also affects the way eligible employers design annual and long-term incentive plans.

Before issuance of the Proposed Regulations, Code Section 457(f) did not provide any grace period or other flexibility with respect to the time of income inclusion for annual or long-term incentive plans. For example, assume an eligible employer that has a calendar taxable year promises to pay an employee a bonus of 10% of base salary in the payroll period ending January 15, 2017, for services the employee performs during the 2016 calendar year. The example above is merely a simple annual bonus arrangement, but prior to the issuance of the Proposed Regulations it could be argued that the present value of the bonus payment was taxable in 2016 as deferred compensation under Code Section 457(f). For that reason, eligible employers would generally require that the employee be continuously employed through the date of payment in order to receive the bonus payment. In the example above, this required employment period would create a substantial risk of forfeiture (where the employee could lose the right to receive the bonus) until January 15, 2017, and permit income inclusion as taxable pay in 2017, instead of in 2016.

However, in an effort to be fair and equitable, employers would frequently still permit a full or prorated payment upon events such as retirement. However, the right to a mid-year retirement payment would destroy the substantial risk of forfeiture and cause early tax inclusion of the bonus payment (*i.e.*, result in the bonus being taxable pay to the employee in 2016 and not 2017). As explained below, through the short-term deferral exemption, the Proposed Regulations provide rules that can help employers avoid these pitfalls and draft more flexible and fair, annual and long-term incentive plans.

Short-Term Deferral Exemption

The Proposed Regulations adopt the short-term deferral exemption from the Code Section 409A regulations, except that the Proposed Regulations use the substantial risk of forfeiture definition from the Proposed Regulations (and not from the Code Section 409A regulations). 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 substantial risk of forfeiture. If the employer has a non-calendar fiscal year, short-term deferrals must be paid by the later of (1) the 15th day of the third month following the end of the fiscal year in which the compensation ceases to be subject to a substantial risk of forfeiture and (2) March 15th of the calendar year in which the compensation ceases to be subject to a substantial risk of forfeiture.

Incorporation of the short-term deferral exemption into the the Proposed Regulations provides employers with an important grace period for making payments under annual or long-term incentive plans. Under the Proposed Regulations, for the above example, where the employer promised to make a payment of 10% of 2016 base salary by January 15, 2017, the employer would no longer have to require performance of services through the scheduled payment date (*i.e.*, January 15, 2017). Therefore, it is now clear that the January 15, 2017 payment (made before the March 15, 2017 deadline to comply with the short-term deferral exemption) would be taxable in 2017 and not in 2016. Moreover, relying on the short-term deferral exemption an annual bonus plan could permit an employer to pay a prorated bonus for 2016 performance even if the employee did not work for the full 2016 year (*e.g.*, employee retired on June 30, 2016), provided the employer makes the payment by March 15, 2017.

Furthermore, if the employer required performance of services through January 15, 2017, the employer could delay payment (if permitted by the terms of plan) until March 15, 2018 — the 15th day of the third month following the end of the employer's first taxable year in which the right to the payment is no longer subject to a substantial risk of forfeiture. Here, since the substantial risk of forfeiture lapsed in 2017 (*i.e.*, on January 15, 2017), under the short-term deferral exemption, the employer has until March 15, 2018 to pay the bonus to the employee. This design is particularly helpful if the annual bonus amounts will be based on employer financials that may not be ready until after the March 15th deadline under the short-term deferral exemption.

The discussion above deals with an annual bonus plan, but the short-term deferral exemption also applies to long-term incentive plans. For example, assume an eligible employer, that has a calendar taxable year, sponsors a long-term incentive plan for its executive director. On November 1, 2016, the employer awards the executive director a bonus under the plan, in which the bonus will be determined based on services performed during the period from January 1, 2017 through December 31, 2019 (a three-year period). Under the plan, the executive director will forfeit the bonus unless she continues performing services through January 15, 2020. Provided at all times before January 15, 2020, the executive director is required to perform services to retain the right to the bonus, and the bonus is paid on or before March 15, 2021, the bonus plan will not be considered to have provided for a deferral of compensation. (Remember that March 15, 2021 is applicable here because the substantial risk of forfeiture lapsed in 2020, even though the performance period was from 2016 through 2019. If the plan were amended to require continued employment through any date in 2019, then the substantial risk of forfeiture would lapse in 2019 and the bonus would need to be paid by March 15, 2020 in order to avoid deferral of compensation under Code Section 457(f).)

In summary, if the plan (whether annual bonus or long-term incentive) comes within the short-term deferral exemption, the amounts are taxed when paid and not when the substantial risk of forfeiture lapses. This is very different from amounts subject to Code Section 457(f) where the amount is taxed once the substantial risk of forfeiture lapses, even if not paid until a later date. However, the employer must still consider other tax rules, such as Code Section 451. If the employee could receive the amounts when the substantial risk of forfeiture lapses but elects to receive the amounts in the following year (*i.e.*, turns back on income in year one and elects to receive it in year two), under Code Section 451 he or she will be taxed on the amounts at the earlier date (year one), when considered in constructive receipt of the amount (not when actually paid in year two).

Definition of Deferral of Compensation

The Proposed Regulations also provide much-needed clarity regarding the definition of deferral of compensation. In particular, the Proposed Regulations define the term *deferral of compensation* for purposes of determining whether Code Section 457(f) applies to a plan (or an agreement/arrangement) as follows:

> A plan provides for the deferral of compensation with respect to a participant for purposes of Section 457(f) … if, under the terms of the plan and the relevant facts and circumstances, the participant has a legally binding right during a calendar year to compensation that, pursuant to the terms of the plan, is or may be payable to (or on behalf of) the participant in a later calendar year.

The Proposed Regulations make clear that whether a deferral of compensation exists is determined based on the terms of the plan and the relevant facts and circumstances at the time that the participant obtains a legally binding right to the compensation or, if later, when a plan is amended to convert a right that does not provide for a deferral of compensation into a right that does provide for a deferral of compensation. This highlights the key roles of proper plan drafting and plan administration, especially with regard to who has authority to influence compensation amounts in the context of a "legally binding right" (as described further below).

Legally Binding Right to Compensation

The Proposed Regulations also adopted the concept of legally binding right from the Code Section 409A regulations to determine when Code Section 457(f) becomes applicable. If a participant does not have a legally binding right to compensation, then under the Proposed Regulations such compensation is not deemed to be deferred and is, therefore, not subject to the requirements of Code Section 457(f). As explained below, an employer can defer taxation on bonus compensation by designing a discretionary plan under which the employee has no legally binding right until a specific later date. In determining whether an employee has a legally binding right to compensation, an eligible employer must carefully consider who or what decides the compensation amount based on the relevant facts and circumstances.

No Legally Binding Right When Employer Has Full Discretion

The Proposed Regulations provide that a participant does not have a legally binding right to compensation to the extent that the compensation may be reduced or eliminated unilaterally by the employer or another person after the services creating the right to the compensation have been performed. Thus, if under the terms of a plan, a participant is promised a special bonus for services performed and the employer has full discretionary authority to determine the bonus amount, including the payment of no bonus at all, then the participant has no legally binding right to the bonus compensation. In that case, the bonus is not taxable in the year performance is completed, but instead when the employer exercises discretion to set the amount of the bonus.

In General, Legally Binding Right Exists When Objective Criteria Decide Compensation Amounts

The Proposed Regulations provide that compensation is not considered subject to unilateral reduction or elimination merely because it may be reduced or eliminated under the objective terms of the plan, such as the application of a nondiscretionary, objective provision creating a substantial risk of forfeiture. The Proposed Regulations also provide that if the facts and circumstances indicate that the discretion to reduce or eliminate the compensation is available or exercisable only upon a condition, a participant is considered to have a legally binding right to the compensation. For example, if under the terms of a plan, an employer may reduce or eliminate compensation only because of a participant's failure to satisfy a certain condition (*e.g.*, continued employment through a specified date), then the participant has a legally binding right at the time of agreement, and taxation will not be deferred unless the compensation is subject to a substantial risk of forfeiture (*e.g.*, no payment will be made unless employment continues through the agreed-upon specified date). Therefore, eligible employers should review bonus plans to get clarity on the reason for deferring taxation. Taxation may be deferred because the bonus amount is fully discretionary under the Proposed Regulations or because a certain, objective condition must be satisfied before the bonus can be paid (resulting in the bonus being subject to a substantial risk of forfeiture).

Legally Binding Right if Person with Full Discretion Is Under Participant's Control or Is Member of Participant's Family

The Proposed Regulations provide that if the facts and circumstances indicate that the discretion to reduce or eliminate the compensation lacks substantive significance, a participant is considered to have a legally binding right to the compensation. In that case, the bonus is taxed when the employee gains the right to the compensation. An important (and sometimes overlooked) example that the Proposed Regulations provide regarding discretion lacking substantive significance is where the participant to whom the compensation may be paid (1) has effective control over the person retaining the discretion to reduce or eliminate the compensation, (2) has effective control over any portion of the compensation of the person retaining the discretion to reduce or eliminate the compensation, or (3) is a member of the family (as defined in Code Section 267(c)(4) but also including the spouse of any member of the family) of the person retaining the discretion to reduce or eliminate the compensation. In this case, even if the amount is generally discretionary, under the Proposed Regulations, the employee could be deemed to have an immediately taxable, legally binding right to the bonus.

Next Steps

The Proposed Regulations provide tax-exempt entities and state/local governments with greater flexibility in designing annual and long-term bonus incentive plans. By taking advantage of the short-term deferral exemption or a fully discretionary bonus plan, taxation of a participant's bonus may be deferred beyond the year in which performance is completed. Non-profit and governmental entities can now use more favorable bonus and long-term incentive plan designs that have been available solely to for-profit employers. Eligible employers should review their bonus plan documents and discuss with their counsel how best to benefit from the flexibility offered under the Proposed Regulations.

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