Executive Compensation and Benefits Alert

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New Rules Impact Compensation Arrangements of Governmental and Tax-Exempt Entities

On June 22, 2016, the IRS published much-anticipated proposed regulations under Internal Revenue Code Section 457 impacting certain plans maintained by state or local governments or other tax-exempt organizations that provide for the deferral of compensation. As described in more detail below, the proposed regulations include new rules for determining:

- What constitutes a deferral of compensation and a substantial risk of forfeiture under Section 457;
- Plans that are not subject to the deferred compensation rules of Section 457; and
- When amounts deferred are includible in income and how such amounts are to be determined.

Most notably, the proposed regulations provide for a definition of "substantial risk of forfeiture" that generally follows the definition under Internal Revenue Code Section 409A but contains different rules relating to noncompetition covenants and "rolling" risks of forfeiture.

Background of Section 457 and Interplay With Section 409A

Generally, deferred compensation plans maintained by a tax-exempt employer are subject to the rules under Section 457(f). In addition, Section 409A provides rules governing nonqualified deferred compensation plans generally. The proposed regulations confirm that the rules under Section 457(f) apply to plans separately and in addition to the requirements under Section 409A. Thus, a 457(f) plan may also be a nonqualified deferred compensation plan that is subject to Section 409A, requiring compliance with two separate tax regimes in order to effectively defer compensation. The proposed regulations seek to harmonize the tax regimes of Section 457(f) and Section 409A in certain respects.

The Deferral of Compensation and a Substantial Risk of Forfeiture Under Section 457

Compensation deferred under a 457(f) plan is includible in income on the later of the date on which the participant obtains a legally binding right to the compensation or the date the substantial risk of forfeiture lapses.

In determining whether a plan is subject to Section 457(f), the proposed regulations harmonize certain terms, such as "deferral of compensation" and "legally binding right" to compensation, with those that apply under Section 409A.

The definition of "substantial risk of forfeiture" under the proposed regulations generally follows the definition under Section 409A, but contains different rules relating to noncompetition covenants and rolling risks of forfeiture, which provide an opportunity to design plans that are not subject to the deferred compensation rules of Section 457(f) (by relying on the Section 457(f) short-term deferral exception), but may still be subject to Section 409A.

Deferral of Compensation

Like Section 409A, under the proposed regulations, a plan provides for a "deferral of compensation" if a participant has a legally binding right during a taxable year to compensation that, pursuant to the terms of the plan, is or may be payable in a later taxable year. Whether a plan provides for a deferral of compensation is determined based on the terms of the plan and the relevant facts and circumstances.

Generally, a participant does not have a legally binding right to compensation to the extent that the compensation may be unilaterally reduced or eliminated by the employer after the services creating the right have been performed by the participant.

Substantial Risk of Forfeiture

The proposed regulations provide that an amount is generally subject to a "substantial risk of forfeiture" for this purpose only if entitlement to that 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*. An understanding of the following concepts (which are similar to those used in Section 409A) is necessary to determine whether compensation is subject to a substantial risk of forfeiture:

- Whether an amount is "conditioned on the future performance of substantial services" is based on all of the relevant facts and circumstances, such as whether the hours required to be performed during the relevant period are substantial in relation to the amount of compensation.
- A condition is "related to a purpose of the compensation" only if the condition relates to the employee's performance of services for the employer or to the employer's tax-exempt or governmental activities, as applicable, or organizational goals and only if the likelihood that the forfeiture event will occur is substantial.

The proposed regulations provide guidance in determining whether compensation is subject to a substantial risk of forfeiture in the context of an involuntary severance from employment, noncompetition covenants, initial deferrals of current compensation and rolling risks of forfeiture.

Involuntary Severance From Employment. If a plan provides that entitlement to certain compensation is conditioned on an involuntary severance from employment without cause, which includes a voluntary severance from employment that is treated as an involuntary severance from employment under a bona fide severance pay plan, the right to compensation is subject to a substantial risk of forfeiture if the possibility of forfeiture is substantial.

Noncompetition Covenants. Compensation will not be treated as subject to a substantial risk of forfeiture merely because it would be forfeited if the employee accepts a position with a competing employer unless each of the following three conditions are satisfied:

- The right to the compensation must be expressly conditioned on the employee refraining from the performance of future services pursuant to a written agreement that is enforceable under applicable law;
- The employer must consistently make reasonable efforts to verify compliance with all of the noncompetition agreements to which it is a party (including the noncompetition agreement with the relevant employee); and
- At the time the noncompetition agreement becomes binding, the facts and circumstances must show 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 engaging, and an ability to engage, in the prohibited services. Factors taken into account for this purpose include the employer's ability to show significant adverse economic consequences that would likely result from the prohibited services; the marketability of the employee based on specialized skills, reputation or other factors; and the employee's interest, financial need and ability to engage in the prohibited services.

This differs from the standard under Section 409A that provides that an amount is not subject to a substantial risk of forfeiture merely because the right to the amount is conditioned, directly or indirectly, upon refraining from the performance of services. As a consequence, a noncompetition covenant that is designed to satisfy the conditions under the proposed regulations may be effective to postpone the date on which the substantial risk of forfeiture lapses under Section 457, but not under Section 409A.

Initial Deferrals of Current Compensation and Rolling Risk of Forfeiture. The proposed regulations permit initial deferrals of current compensation (*i.e.*, salary, commissions and certain bonuses that are payable on a current basis) to be subjected to a substantial risk of forfeiture and also allow an existing risk of forfeiture to be extended (commonly referred to as a rolling risk of forfeiture) only if each of the following four requirements are met:

- The present value of the amount to be paid upon the lapse of the substantial risk of forfeiture (as extended, if applicable) must be materially greater than the amount the employee otherwise would be paid in the absence of the substantial risk of forfeiture (or absence of the extension). An amount is "materially greater" for this purpose only if its present value is more than 125 percent of the amount the participant otherwise would have received. Note that the proposed regulations provide that there is no implication that this standard under Section 457 would also apply under Section 409A.
- The initial or extended substantial risk of forfeiture must be based upon the future performance of substantial services or adherence to an agreement not to compete. 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), though that type of condition may be combined with a sufficient service condition.
- The period during 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).
- The agreement subjecting the amount to a substantial risk of forfeiture must be made in writing before the beginning of the calendar year in which any services giving rise to the compensation are performed in the case of initial deferrals of current compensation, or at least 90 days before the date on which an existing substantial risk of forfeiture would have lapsed in the absence of an extension. A special rule applies to new employees.

Unlike the proposed regulations, the addition or extension of a period during which compensation is subject to a risk of forfeiture is generally disregarded for purposes of determining whether the compensation is subject to a substantial risk of forfeiture under Section 409A. This could mean that an extended substantial risk of forfeiture may be respected under Section 457, but not under Section 409A.

Certain Plans That Are Not Subject to Section 457

The proposed regulations provide further guidance on certain plans that are not subject to Section 457.

Bona Fide Severance Pay Plans

A plan or arrangement that satisfies all of the following requirements will be exempt from Section 457 as a bona fide severance pay plan (which is substantially similar to the separation pay plan exception under Section 409A):

- Benefits provided under the plan or arrangement must be payable only upon a participant's involuntary severance from employment or pursuant to a window program or voluntary early retirement incentive plan;
- The amount payable to a participant under the plan or arrangement must not exceed two times the participant's annualized compensation (based on the participant's annual rate of pay for the year preceding the year in which the participant's severance from employment occurs, or the current calendar year if the participant had no compensation in the preceding year, as adjusted for any increase in pay that was expected to continue indefinitely if the participant had not incurred a severance from employment). Note that the corresponding separation pay plan exception under Section 409A further limits the amount payable to two times the maximum amount that may be taken into account under a tax-qualified plan under Section 401(a)(17) for the year of separation (a maximum of $530,000 in 2016); and
- Pursuant to the written terms of the plan or arrangement, the severance benefits must be paid to the participant no later than the last day of the second calendar year following the calendar year in which the severance from employment occurs.

Involuntary Severance From Employment. The proposed regulations define "involuntary severance from employment" 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, if the participant is willing and able to continue to perform services. Whether a severance from employment is involuntary is determined based on the relevant facts and circumstances.

Good Reason. The proposed regulations provide that a severance from employment for "good reason" will be treated as an involuntary severance from employment, provided that the bona fide conditions giving rise to good reason are pre-specified in writing and their primary purpose is not to avoid the application of the deferred compensation rules under Section 457. Generally, "severance from employment for good reason" must result from unilateral action taken by the employer resulting in a material adverse change to the working relationship, such as a material reduction in the employee's duties, working conditions or pay.

The proposed regulations provide a safe harbor "good reason" definition that is substantially similar to the safe harbor under

Section 409A and that includes:

- A material diminution in the participant's base compensation;
- A material diminution in the participant's authority, duties or responsibilities;
- A material diminution in the authority, duties or responsibilities of the supervisor to whom the participant is required to report, including a requirement that a participant report to a corporate officer or employee instead of directly to the board of directors (or similar governing body) of an organization;
- A material diminution in the budget over which the participant retains authority;
- A material change in the geographic location at which the participant must perform the services; or
- Any other action or inaction that constitutes a material breach by the employer of the terms of the agreement under which the participant provides services.

In addition, the safe harbor requires that (i) the severance from employment occur within a limited period of time not to exceed two years following the initial existence of the good reason condition, (ii) the amount, time and form of payment payable upon such severance from employment be substantially the same as the amount, time and form of payment payable upon an involuntary severance from employment, and (iii) the participant provide notice to the employer of the condition giving rise to good reason within 90 days of the initial existence of such condition and the employer be given at least 30 days to remedy the condition.

Window Program. A "window program" generally provides for separation pay in connection with severance from employment that is offered for a limited period of time (typically no longer than 12 months). Whether a window program exists is determined based on the relevant facts and circumstances.

Voluntary Early Retirement Incentive Plan. A "voluntary early retirement incentive plan" is generally treated as a bona fide severance pay plan solely with respect to payments or supplements that are made as an early retirement benefit, a retirement-type subsidy, or an early retirement benefit that is greater than a normal retirement benefit and that is paid in coordination with a defined benefit pension plan that is tax-qualified under Section 401(a).

Transition Rule. When the rules in the proposed regulations regarding bona fide severance pay plans are finalized, they will supersede the transitional guidance in IRS Announcement 2000-1 that applies to certain broad-based nonelective plans of state or local governments that were in existence before December 22, 1999.

Bona Fide Death Plans, Disability Pay Plans, and Sick Leave and Vacation Leave Plans

The proposed regulations also include rules for determining whether a plan constitutes a bona fide death plan, a bona fide disability pay plan, or a bona fide sick leave and vacation leave plan that is exempt from Section 457.

Short-Term Deferral Exception Under Section 457(f)

One of the most commonly used exceptions to the deferred compensation rules under Section 409A is the short-term deferral rule, which provides that compensation is not considered deferred for purposes of Section 409A if the plan or agreement under which the payment is made does not provide for a deferral, and the employee actually or constructively receives the payment on or before the last day of the applicable two-and-a-half-month period ending on the later of the following:

- The 15th day of the third month following the end of the employee's first taxable year in which the right to payment is no longer subject to a substantial risk of forfeiture (usually March 15 of the next calendar year); or
- The 15th day of the third month following the end of the employer's first taxable year in which the right to payment is no longer subject to a substantial risk of forfeiture.

The proposed regulations provide that Section 457(f) does not apply to any amount that would be a short-term deferral under Section 409A, except that the definition of "substantial risk of forfeiture" under the proposed regulations applies instead of the definition of "substantial risk of forfeiture" under Section 409A. Because the substantial risk of forfeiture definition under the proposed regulations is broader than under Section 409A, any amounts that are short-term deferrals under Section 409A are also short-term deferrals under Section 457(f), though the reverse is not necessarily the case.

Calculating the Amount Included in Income

The total amount of compensation deferred under a 457(f) plan that is subject to tax is equal to the present value of the amount of compensation deferred plus any earnings. The proposed regulations include specific rules for determining the present value of compensation deferred under a 457(f) plan. These rules are generally similar to the rules in determining the present value of compensation deferred under the proposed regulations of Section 409A, but one notable difference is that income inclusion under 457(f) plans is determined as of the date on which the amount becomes subject to tax, whereas income inclusion under Section 409A is determined as of the end of the service provider's taxable year. The IRS expects that when finalized, the income inclusion regulations under Section 457 and Section 409A will be consistent for ease of administration.

Effective Dates

The Section 457 regulations generally apply to compensation deferred under a plan for calendar years beginning after the date on which the final regulations are published, including previously deferred amounts to which the legally binding right arose during prior years. Taxpayers may generally rely on the proposed regulations until the final regulations are published.

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If you would like more information, please contact your Skadden attorney or any member of the Executive Compensation and Benefits Group.

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