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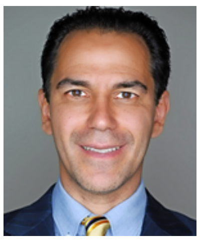
IRS Proposed Rules Affecting Compensation Arrangements of Governmental and Tax Exempt Entities – Here at Last



BY THOMAS M. ASMAR

On June 22, 2016, the IRS issued much-anticipated proposed regulations under Internal Revenue Code Section 457 (the "Proposed Regulations") impacting certain plans maintained by state or local governments or other tax exempt organizations that provide for the deferral of compensation. Practitioners and plan sponsors now have guidance on common features of Section 457 plans, such as deferrals tied to noncompetition covenants, "rolling" risks of forfeiture and initial deferrals of current compensation, all of which will be important as new Section 457 plans are designed and existing ones are reviewed for compliance going forward.

Key highlights of 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 exempt from the deferred compensation rules of Section 457; and
- When amounts deferred under a 457(f) plan are includible in income and how these amounts are to be determined.

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One of the most important takeaways is that 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. The differences in these rules may provide flexibility and significant planning opportunities for Section 457 plans.

Background of Section 457 and Interplay With Section 409A

A deferred compensation plan maintained by a tax-exempt employer is generally subject to the tax rules under Section 457(f), unless the plan either is not subject to Section 457 pursuant to one of the exceptions listed in Code Section 457(e)(11) or the plan is "eligible" under Section 457(a) (commonly referred to as a 457(b) plan). In addition, Section 457(f)(2) provides that certain other plans and arrangements, including tax-qualified plans under Section 401(a) and 403(b), are not subject to the rules under Section 457(f).

In addition, Section 409A provides rules governing nonqualified deferred compensation plans that generally apply to all employers. 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, a Substantial Risk of Forfeiture and the Short-Term Deferral Exception 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. This provides 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 the plans may still be subject to Section 409A. This is a topic of interest as the meaning of a substantial risk of forfeiture for purposes of Section 457(f) had been unclear for quite some time.

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 at the time the participant obtains a legally binding right to the compensation.

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.

Amending a Plan to Add a Right to Deferred Compensation. The Proposed Regulations provide that if 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, then the participant may be treated as having obtained a legally binding right to the compensation under Section 457(f) at the time of the amendment. For example, if a plan which provides retiree health benefits and does not provide for a deferral of compensation is amended to permit participants to receive future cash payments in lieu of health benefits, it may become a plan that provides for the deferral of compensation at the time of the amendment.

Amending a Plan to Exchange a Right to Deferred Compensation. Under the Proposed Regulations, if a plan that provides for a deferral of compensation is amended to exchange an amount deferred under the plan for some other right or benefit that would otherwise be excluded from the participants' income, the plan, as amended, will continue to be treated as a plan that provides for a deferral of compensation. For example, if a plan which provides for a deferral of compensation is amended to provide health benefits in lieu of cash deferrals, the plan will continue to be treated as a plan that provides for a deferral of compensation.

Substantial Risk of Forfeiture

The Proposed Regulations provide that an amount is generally subject to a ''substantial risk of forfeiture'' for purposes of Section 457(f) 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 under Section 457:

- 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.

Note that an amount will not be considered subject to a substantial risk of forfeiture if the facts and circumstances indicate that the forfeiture condition is unlikely to be enforced, taking into account factors such as the past practices of the employer, 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, and the enforceability of the provisions under applicable law.

Noncompetition Covenants. Noncompetition covenants have frequently been used by tax-exempt employers as a substantial forfeiture condition under Section 457 in order to delay taxation on the deferred amount until the date on which the substantial risk of forfeiture lapses (i.e. the end date of the noncompetition covenant) for employees who retire or otherwise voluntarily resign from employment. The Proposed Regulations provide that 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 in making this determination 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 which 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 provide much needed guidance on the extent to which Section 457 plans may be designed to avoid current income taxation by allowing employees to unilaterally elect to defer current salary and agree to make the deferral subject to a substantial risk of forfeiture and by extending an existing substantial risk of forfeiture (commonly referred to as a rolling risk of forfeiture). Specifically, the Proposed Regulations permit initial deferrals of current compensation (i.e. salary, commissions and certain bonuses that is payable on a current basis) to be subjected to a substantial risk of forfeiture and allow an existing risk of forfeiture to be extended 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. The Proposed Regulations provide that there is no implication that this standard under Section 457 would also apply under Section 409A. (Under Section 409A, an amount of compensation is not considered to be subject to a substantial risk of forfeiture beyond the date on which the employee otherwise could have elected to receive the amount, unless the present value of the amount subject to the substantial risk of forfeiture is materially greater than the amount the service provider could have received absent the substantial risk of forfeiture, noting that Section 409A does not specify a threshold for testing whether an amount is ''materially greater'' for this purpose.)

- 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 and entered into within the following applicable timeframes:
  - For an initial deferral of current compensation, before the beginning of the calendar year in which any services giving rise to the compensation are performed;
  - For a rolling risk of forfeiture, at least 90 days before the date on which an existing substantial risk of forfeiture would have lapsed absent the extension; and
  - For newly hired employees, within 30 days after the date of hire but only with respect to amounts attributable to services rendered after the addition or extension is agreed to in writing.

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. 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 (i.e. a resignation for good reason), the right to compensation will be subject to a substantial risk of forfeiture if the possibility of forfeiture is substantial.

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 which is substantially similar to the safe harbor under Section 409A and which 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 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, 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 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 which 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 are paid in coordination with a defined benefit pension plan that is tax-qualified under Section 401(a).

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 which are exempt from Section 457.

Bona Fide Death Plan. Benefits under a bona fide death benefit plan may be provided through insurance and any lifetime benefits payable under the plan that may be includible in income will not be treated as including the value of any term life insurance coverage provided under the plan.

Bona Fide Disability Pay Plan. A bona fide disability pay plan pays benefits only in the event of a participant's disability which generally requires that:

- The participant is unable to engage in substantial gainful activity by reason of a 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;

- The participant 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 income replacement benefits for a continuous period of not less than three months under an accident or health plan covering employees of the employer; or

- The participant is determined to be totally disabled by the Social Security Administration or the Railroad Retirement Board.

Bona Fide Sick Leave and Vacation Leave Plan. A sick leave or vacation leave plan will generally be treated as a bona fide sick leave or vacation leave plan if the relevant facts and circumstances demonstrate that the primary purpose of the plan is to provide employees with paid time off from work because of sickness, vacation or other personal reasons. Factors to consider in making this determination include whether the amount of leave provided could reasonably be expected to be used by the employee in the normal course (and before the cessation of services), any limits on the ability to exchange unused accumulated leave for cash or other benefits and any applicable accrual restrictions (i.e. use it-or-lose it rules), the amount and frequency of any in-service distributions of cash or other benefits offered in exchange for accumulated and unused leave, whether the payment of unused sick or vacation leave is made promptly upon severance from employment (or, instead, is paid over a period of time after severance from employment), and whether the sick leave, vacation leave, or combined sick and vacation leave offered under the plan is broadly applicable or is available only to certain employees.

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 15th 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 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 which are short-term deferrals under Section 409A are also short-term deferrals under Section 457(f), though the reverse is not necessarily the case. For example, a plan that requires compliance with a noncompetition covenant as a condition to payment may be designed as a short-term deferral under Section 457(f) if all of the applicable requirements for a substantial risk of forfeiture under Section 457 are satisfied, but the plan would not qualify as a short-term deferral under Section 409A because a requirement to refrain from performing services as a condition to payment is not a substantial risk of forfeiture for purposes of Section 409A.

Recurring Part-Year Compensation and Other Exceptions Under Section 457(f)

Recurring Part-Year Compensation Exception. Recurring part-year compensation generally refers to compensation paid for services in a position that the employer and employee reasonably anticipate will continue under similar terms and conditions in subsequent years, and under which the employee will be required to provide services during successive service periods each of which comprises less than 12 months (i.e. a teacher provides services during a school year comprised of 10 consecutive months but is paid ratably over a 12-month period) and each of which begins in one taxable year of the employee and ends in the next taxable year. Like Section 409A, under the Proposed Regulations a plan under which an employee receives recurring part-year compensation will not provide for the deferral of compensation under Section 457(f) if each of the following two requirements are met:

- Payment of any of the recurring part-year compensation is not deferred to a date beyond the last day of the 13th month following the first day of the service period for which the recurring part-year compensation is paid; and

- The amount of the recurring part-year compensation (not merely the amount deferred) does not exceed the annual compensation limit under Section 401(a)(17) ($265,000 for 2016) for the calendar year in which the service period begins.

Other Exceptions Under Section 457(f). The Proposed Regulations also provide that a deferral of compensation will not occur under Section 457(f) to the extent that a plan provides for any of the following:

- The payment of expense reimbursements, medical benefits, or in-kind benefits as described in Section 409A;

- Certain indemnification rights, liability insurance or legal settlements, as described in Section 409A; and

- Taxable educational benefits for an employee as described in Section 127(c)(1), but excluding any benefits provided for the education of any other person, including the employee's spouse, child or other family member.

Calculating the Amount Included in Income Under Section 457(f)

The total amount of compensation deferred under a 457(f) plan that is includible in income 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 includible in income 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.

Under the Proposed Regulations, the amount of 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 (referred to as the ''applicable date''). Any earnings credited thereafter on that amount of deferred compensation are includible in income when paid or made available to the participant. As of the applicable date, the present value of compensation deferred under the plan is equal to the present value of the future payments to which the participant has a legally binding right. This present value is calculated by multiplying the amount of a payment (or the amount of each payment in a series of payments) by the probability that any condition or conditions 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 based on reasonable actuarial assumptions. The Proposed Regulations include other special rules that apply in making this calculation which generally follow the rules under Section 409A.

Account Balance Plan. For an account balance plan, if the account balance is determined using a predetermined actual investment or a reasonable rate of interest (i.e. fixed earnings credited annually), the present value of the amount payable under the plan as of the applicable date is generally equal to the amount credited to the participant's account, which includes both the principal and any earnings or losses through the applicable date. If the account balance is not determined using a predetermined actual investment or a reasonable rate of interest, the present value of the amount payable under the plan as of the applicable date is equal to the amount credited to the participant's account as of that date, plus the present value of the excess of any earnings to be credited under the plan during the period beginning after the applicable date and ending on the projected payment date over the earnings that would be credited during this period using a reasonable rate of interest.

Non-Account Balance Plan. For a non-account balance plan, the present value of the amount deferred as of the applicable date is equal to the present value of the participant's right to receive payment of the compensation in the future after taking into account the time value of money and the probability that the payment will be made. The actuarial assumptions used to calculate this present value must be reasonable and determined based on all of the relevant facts and circumstances, subject to certain rules on assumptions regarding the probability of death occurring before payment under the plan and without discounts for the unfunded status of the plan, the risk that the employer may be unwilling or unable to pay, future plan amendments or changes in law and other similar contingencies.

Formula Amounts. If the amount payable under a plan is determined by reference to one or more factors that are indeterminable on the applicable date (i.e. a plan benefit that depends on a participant's final average compensation and total years of service), the assumptions used to calculate the present value of the amount payable under the plan must take into account all of the relevant facts and circumstances on the applicable date and be based on reasonable, good faith assumptions with respect to any contingencies as to the amount of the payment.

Other Rules. The Proposed Regulations include certain other rules for determining the present value of an amount payable under a plan which generally follow the rules under Section 409A regarding the treatment of payment triggers based upon specified events (except for a special rule under Section 457 for when a severance from employment may be deemed to occur if it has not occurred by the applicable date), payment restrictions, alternative times and forms of a future payment, reimbursement and in-kind benefit arrangements and split-dollar life insurance arrangements.

In addition, the Proposed Regulations include certain loss deduction rules that are substantially similar to those in the proposed regulations under Section 409A. If a participant were to include an amount of deferred compensation under a 457(f) plan in income, but the compensation subsequently paid or made available to the participant is less than the amount previously included in income (because the participant forfeits or loses some or all of the compensation due to death or some other reason, such as investment performance), then the participant would be entitled to a deduction for the taxable year in which any remaining right to the amount is permanently forfeited or otherwise lost.

Other Statutory Changes

Since the publication of the final regulations under Section 457 in 2003, there have been a number of changes to Section 457 such as allowing eligible governmental plans maintained by state or local governments to include Roth contribution features and permit in-plan rollovers to qualified Roth accounts and providing for special rules relating to qualified military service and eligible public safety officers. The Proposed Regulations make certain conforming changes to the final regulations to reflect these statutory changes.

Effective Dates

The Section 457 regulations will 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. The Proposed Regulations make clear that no implication is intended regarding application of law before the Proposed Regulations become final. Taxpayers may generally rely on the Proposed Regulations until the final regulations are published.

Action Items

Tax exempt and state and local government employers with plans that include common features such as a salary deferral arrangement, deferrals tied to a noncompetition covenant or a rolling risk of forfeiture should review the terms of these plans in light of the guidance under the Proposed Regulations as certain plans may need to be amended for compliance. In addition, employers should inventory and review any other existing compensation arrangements that may provide for deferred compensation, including employment agreements, severance plans, disability and vacation plans, deferred compensation plans and incentive compensation plans and arrangements. Employers should engage in a thorough review of these existing plans sooner than later considering that it is anticipated that when the Proposed Regulations become final they will apply to existing arrangements that include previously deferred amounts to which the legally binding right arose during prior years.

