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IRS Issues Proposed Regulations Under Code Section 457

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On June 21, 2016, the Internal Revenue Service (IRS) issued long-awaited proposed Treasury Regulations prescribing rules under Section 457 of the Internal Revenue Code (the "Code") for the income taxation of deferred compensation arrangements for employees of state and local governments and other tax-exempt organizations (the "Proposed Regulations"). The IRS simultaneously released new proposed Treasury Regulations under Code Section 409A.

Generally, the Proposed Regulations are pleasantly more flexible and practical than the rules previously suggested by the IRS in Notice 2007-62 and also than what was expected by many practitioners. While the Proposed Regulations require clarification on a number of points, these new rules will provide useful guidance in designing compensation for executives of tax-exempt organizations. Among other things, these rules:

- follow Code Section 409A in recognizing a termination by an employee for "good reason" as an involuntary severance from employment;
- unlike under Code Section 409A, recognize required compliance with a noncompetition agreement as a substantial risk of forfeiture;
- contrary to prior IRS policy statements, permit, in certain situations, elective deferral of current compensation and a rollover of existing substantial risk of forfeiture;
- define bona fide severance pay plans that are exempt from Code Section 457, including by imposing a limit on the amount of severance that can be paid under such a plan of two times a participant's prior year's rate of compensation (similar to the Code Section 409A coverage exception), but without the alternative lower limit based on two times the limit for recognizing compensation under qualified plans;

define bona fide sick pay and vacation plans that are exempt from Code Section 457;

- specify with flexibility how to determine present value when calculating the amount to be taxed under Code Section 457(f); and
- emphasize that both Code Section 457(f) and Code Section 409A apply to most deferral arrangements.

The key provisions in the Proposed Regulations that relate to tax-exempt organizations are discussed in more detail below:

Background

Generally, Code Section 457 contemplates (1) "eligible" plans under which deferrals of up to $18,000 per year are permitted and (2) "ineligible" plans, which cover all other deferred compensation arrangements of state and local governments and tax exempt entities. Amounts that are deferred under an eligible plan are generally not taxable until paid or made available to the employee. In contrast, amounts deferred under an ineligible plan are generally includible in gross income when the deferred amounts cease to be subject to a substantial risk of forfeiture.

Plans that Do Not Provide for a Deferral of Compensation and Are Exempt from Tax Code Section 457 Taxation

The Proposed Regulations provide that the following plans and arrangements are treated as not providing for a deferral of compensation for purposes of Code Section 457 and, therefore, accrued amounts under them are not taxed until paid:

Bona Fide Severance Pay Arrangements. The Proposed Regulations provide that, to be considered a bona fide severance pay arrangement, the benefits provided under the plan must be payable only upon a participant's involuntary severance from employment or pursuant to a window program that is offered for a limited amount of time or a voluntary early retirement incentive arrangement. Generally, the Proposed Regulations provide that, while the determination as to whether a severance from employment is involuntary is based on the relevant facts and circumstances, an involuntary severance from employment occurs when an employer independently exercises its authority to terminate a participant's services if the participant is willing and able to continue to perform services.

The Proposed Regulations provide that a participant's resignation for "good reason" will be considered an involuntary severance from employment if it is a result of a unilateral action taken by the employer resulting in an adverse change in the working relationship (such as a material reduction in the employee's duties, working conditions or pay). The Proposed Regulations generally follow the good reason definition rules under Code Section 409A, including use of a "safe harbor" definition.

The amount payable under the plan must not exceed two times the participant's annual compensation based on the annual rate of pay for services provided to the eligible employer for the calendar year prior to the year in which the participant has a severance from employment needs, subject to certain adjustments. In addition, the severance must be paid no later than the end of the second calendar year following the calendar year in which the severance from employment occurs. One point that will require clarification is whether the IRS will permit bifurcation of the payment of severance amounts as it does under the Code Section 409A rules, or whether severance plans will have to be formally separated into a bona fide severance plan with respect to amounts up to two times a participant's annual compensation and a deferred compensation arrangement providing for the payment of additional severance amounts.

Disability Plans. The Proposed Regulations provide that a bona fide disability pay plan is a plan that pays benefits only in the event of a participant's disability. For this purpose, the Proposed Regulations provide that a participant is disabled if the participant meets any of the following three conditions: (1) 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; (2) the participant is receiving income replacement benefits for a continuous period of not less than three consecutive months under an accident or health plan covering employees of the eligible employer that satisfies the criteria in (1); or (3) the participant is determined to be totally disabled by the Social Security Administration or the Railroad Retirement Board. The definition of disability is different than that commonly used in many plans and employment agreements, but largely consistent with that used under Code Section 409A.

- *Sick or Vacation Leave Plans*. The Proposed Regulations provide that a bona fide sick or vacation leave plan is a plan that primarily exists to provide employees with paid time off from work because of sickness, vacation, or other personal reasons. Factors used in determining whether a plan is a bona fide sick or vacation leave plan include: (i) 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); (ii) limits, if any, on the ability to exchange unused accumulated leave for cash or other benefits and any applicable accrual restrictions); (iii) the amount and frequency of any in-service distributions of cash or other benefits offered in exchange for accumulated and unused leave; (iv) 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 (v) 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.

Death Benefit Plans. The Proposed Regulations provide that a bona fide death benefit plan is one that provides death benefits, whether directly or through insurance. The Proposed Regulations further provide that any lifetime benefits payable under a plan that may be includible in gross income will not be treated as including the value of any term life insurance coverage provided under the plan.

Tax Treatment of Deferred Compensation under Code Section 457(f)

Consistent with Code Section 457(f), the Proposed Regulations provide that, if an ineligible plan provides for a deferral of compensation, the compensation deferred under the plan is includible in gross income when it is no longer subject to a substantial risk of forfeiture. Generally, the amount of the compensation deferred under the plan that is includible in gross income is the present value of the deferred compensation on that date. The rules for determining present value under the Proposed Regulations are similar to the rules for determining present value in the proposed income inclusion regulations under Code 409A, except that under the Proposed Regulations, the present value calculation is determined on the date that there ceases to be substantial risk of forfeiture rather than as of the end of the employee's taxable year. The Proposed Regulations, helpfully, permit use of reasonable actuarial assumptions including, where the payout is based on severance from employment, a projected payment commencement date of up to 5 years from the calculation date.

Definition of Deferred Compensation

Generally, 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 generally 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.

Short-Term Deferrals

Similar to the rules under Code Section 409A, the Proposed Regulations provide that certain short-term deferrals of compensation will not be considered to be a "deferral of compensation" for purposes of Code Section 457(f). These are payments that the participant actually or constructively receives on or before the last day of the period ending on the later of the 15th day of the third month following the end of the calendar year in which the right to the payment is no longer subject to a substantial risk of forfeiture or the 15th day of the third month following the end of the employer's taxable year in which the right to the payment is no longer subject to a substantial risk of forfeiture. The Treasury Regulations under Code Section 409A contain a similar concept.

Substantial Risk of Forfeiture

The Proposed Regulations provide that an amount is generally subject to a substantial risk of forfeiture 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. 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. Conditioning an amount upon an involuntary severance from employment (including good reason) will generally qualify as a substantial risk of forfeiture. 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. A substantial risk of forfeiture exists based on a condition related to the purpose of the compensation only if the likelihood that the forfeiture event will occur is substantial. Also, an amount is not subject to a substantial risk of forfeiture if the facts and circumstances indicate that the forfeiture condition is unlikely to be enforced. Factors considered for purposes of determining the likelihood that the forfeiture will be enforced include, the past practices of the employer, the level of control or influence of the employee with respect to the organization and the individual who would be responsible for enforcing the forfeiture, and the enforceability of the provisions under applicable law.

The Proposed Regulations provide that a forfeiture condition tied to a noncompetition agreement may constitute a substantial risk of forfeiture. However, for compliance with a noncompetition agreement that contains a forfeiture condition to be a substantial risk of forfeiture, each of the following conditions must be met: (i) the right to the compensation is expressly conditioned on the employee refraining from the performance of future services pursuant to a written agreement that is enforceable under applicable law; (ii) 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 at issue); and (iii) 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 that the employee has a bona fide interest in engaging, and an ability to engage, in the prohibited services. This is different than the treatment of a substantial risk of forfeiture under Code Section 409A, which specifically provides that a restrictive covenant will not be a substantial risk of forfeiture. The ability and flexibility in utilizing this provision will be very sensitive to the length and scope of the noncompetition agreement and whether the applicable state law governing the noncompetition agreement will permit it to be enforced.

Initial Deferrals of Current Compensation and Extensions of a Substantial Risk of Forfeiture

The Proposed Regulations include special rules to determine whether initial deferrals of current compensation may be treated as subject to a substantial risk of forfeiture and whether a substantial risk of forfeiture can be extended (*i.e.*, "rolled"). The preamble to the Proposed Regulations states that, for this purpose, current compensation refers to compensation that is payable on a current basis such as salary, commissions, and certain bonuses, and does not include compensation that is deferred compensation. This is a welcome change from the IRS's prior stated position, although it will probably be usable only in limited circumstances because of the conditions discussed below.

The Proposed Regulations permit initial deferrals of current compensation to be subject to a substantial risk of forfeiture and also permit an existing risk of forfeiture to be extended only if certain 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 considered materially greater for this purpose only if the present value of the amount to be paid upon the lapse of the substantial risk of forfeiture, measured as of the date the amount would have otherwise been paid (or in the case of an extension of the risk of forfeiture, the date that the substantial risk of forfeiture would have lapsed without regard to the extension), is more than 125% of the amount the employee otherwise would have received on that date in the absence of the new or extended substantial risk of forfeiture. In addition, the initial or extended substantial risk of forfeiture must be based upon the future performance of substantial services or adherence to a noncompetition agreement. The period for which substantial future services must be performed may not be less than two years (but the plan may provide that the substantial risk of forfeiture will lapse earlier upon the participant's death, disability, or involuntary severance from employment). Finally, 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. Special timing rules apply to new employees. It should be noted that if a substantial risk of forfeiture is extended under Code Section 457(f), such extension will still be subject to Code Section 409A requirements with respect to the time of payment and delay of payment.

Reoccurring Part-Year Compensation

Like the newly proposed Treasury Regulations under Code Section 409A, the Proposed Regulations provide that certain reoccurring part-year compensation is not considered a "deferral of compensation." This provision is primarily intended to accommodate teachers who work 10 months of the year, but whose compensation is spread over a full year.

The Proposed Regulations provide that a plan or arrangement under which an employee receives recurring part-year compensation that is earned over a period of service does not provide for the deferral of compensation if the plan or arrangement does not defer payment of any of the recurring part-year compensation 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 Code Section 401(a)(17) ($265,000 for 2016) for the calendar year in which the service period commences.

Interaction of Code Sections 457 and Section 409A

The Proposed Regulations address the interaction of Code Sections 457(f) and 409A on deferred compensation arrangements. The Proposed Regulations provide that the rules under Code Section 457(f) apply to plans separately and in addition to the requirements under Section 409A. As a result, a deferred compensation plan that is subject to Code Section 457(f) may also be a nonqualified deferred compensation plan that is subject to Section 409A. This is a particular concern where a noncompetition provision is involved. It will also require attention in a situation where deferred compensation is paid out over time after the deferred compensation has been included in taxable income under Code Section 457(f) (particularly, as to timing of payment of the taxable earnings on the previously taxed amounts).

Proposed Applicability Dates

Generally, the Proposed Regulations apply to compensation deferred under a plan for calendar years beginning after the date of publication of the rules as final regulations, including deferred amounts to which the legally binding right arose during the prior calendar years that were not previously included in income during one or more prior calendar years. The Proposed Regulations, however, may be relied on immediately.

In the case of a plan that is maintained pursuant to one or more collective bargaining agreements that have been ratified and are in effect on the date of publication of the Treasury decision adopting the rules as final regulations, the regulations would not apply to compensation deferred under the plan before the earlier of (1) the date on which the last of the collective bargaining agreements terminates (determined without regard to any extension thereof after the date of publication of the Treasury decision adopting the rules as final regulations in the Federal Register) or (2) the date that is three years after the date of publication of the Treasury decision adopting the rules.

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