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# **Substantial Risk of Forfeiture and Bona Fide Severance: Synchronizing the Layers of Sections 457(f) and 409A**

**By Candace L. Quinn, Seyfarth Shaw LLP  
New York, New York**

**By Frances Rivera-Medero, Seyfarth Shaw LLP  
New York, New York**

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## **Introduction**

In Notice 2007-62,<sup>1</sup> the Internal Revenue Service announced its intent to provide guidance under I.R.C. §457<sup>2</sup> regarding the definition of bona fide severance pay plans excluded from the application of §457 under §457(e)(11), and regarding the definition of substantial risk of forfeiture for purposes of excluding amounts from gross income under an ineligible deferred compensation plan under § 457(f).

Section 457 applies to nonqualified deferred compensation plans established by state and local governments and tax-exempt employers and includes “eligible” §457(b) plans and “ineligible” deferred compensation plans established by eligible employers that are subject to §457(f). The term plan under §457(f) is broadly defined and includes any agreement or arrangement providing for nonqualified deferred compensation that does not meet the limitations and requirements of §457(b).

Section 457(e)(11) provides that certain types of plans such as a bona fide severance pay plan will not be subject to §457.

Compensation deferred under a nonqualified deferred compensation plan subject to 457(f) is taxable in the first taxable year in which there is no substantial risk of forfeiture of the right to such compensation. Under §457(f)(3)(B), the right of a employee to compensation is subject to a substantial risk of forfeiture if the right to the compensation is conditioned upon the future performance of substantial services by the employee. Therefore, any amount that is not subject to a substantial risk of forfeiture or is vested is currently included in taxable income whether or not it is actually or constructively received.<sup>3</sup>

Section 409A<sup>4</sup> applies to ineligible nonqualified deferred compensation plans maintained by tax exempt and governmental employers and overlays the requirements of § 457(f). Pursuant to §409A, if the requirements of paragraphs (a)(1) through (a)(4) of the

statute<sup>5</sup> are not met, amounts deferred under a nonqualified deferred compensation plan for all taxable years are includible in gross income to the extent the compensation deferred is not subject to a substantial risk of forfeiture and not previously included income. A substantial risk of forfeiture under §409A exists if the person's right to the compensation is conditioned upon the future performance of substantial services. Section 1.409A-1(a) of the Treasury Regulations defines substantial risk of forfeiture for purposes of 409A.<sup>6</sup> In contrast, the regulations under § 83 include "refraining from performance" as a condition that may create a substantial risk of forfeiture.<sup>7</sup> Accordingly, the definition of substantial risk of forfeiture under §409A is considered narrower than the interpretation of substantial risk of forfeiture under §457(f) which has relied on §83 and the rules and regulations thereunder for guidance.

## Excluding Bona Fide Severance Pay Plans

Section 457(e)(11) exempts from the definition nonqualified deferred compensation bona fide vacation leave, sick leave, compensatory time, severance pay, disability pay, or death benefit plans.

In an attempt to clarify the provisions governing bona fide severance pay plans and align their application with §409A, Notice 2007-62 explains that the Internal Revenue Service and the Department of the Treasury intend to provide in forthcoming formal guidance that an arrangement is a bona fide severance pay plan under § 457(e)(11), and therefore excluded from §457(f) if: (i) the benefit is payable only upon involuntary severance from employment; (ii) the amount does not exceed two times the employee's annual rate of pay (taking into account only pay that does not exceed the maximum amount that may be taken into account under a qualified plan pursuant to § 401(a)(17) for the year in which the employee is severed from employment; and (iii) the plan provides that the payments must be completed by the end of the employee's second taxable year following the year in which the employee separates from service.

The Notice further provides that certain exceptions to these requirements are expected to be included in the formal guidance that would be similar to exceptions provided in the final regulations under §409A.<sup>8</sup> These exceptions would allow exclusion of bona fide severance pay from §457(f) in cases of voluntary severance from employment through participation in window programs, collectively bargained separation pay plans, and certain reimbursements or in-kind benefit arrangements.<sup>9</sup>

## Aligning Substantial Risk of Forfeiture

Under §457(f) and related regulations, a substantial risk of forfeiture exists where rights to transferred property, or to amounts of deferred compensation, are conditioned upon (i) the future performance or refraining from performance of substantial services by any person;<sup>10</sup> or (ii) the occurrence of a condition related to a purpose of the transfer, and the possibility of forfeiture is substantial if such condition is not satisfied.<sup>11</sup> This concept arose out of the combination of § 457(f) with the provisions of § 83 and related regulations, the last of which were, until recently, the primary source of a definition of the term "substantial risk of forfeiture."<sup>12</sup> With reliance on § 83 and related regulations, covenants not to compete have traditionally been used as a tool to defer taxation of amounts subject to §457(f).<sup>13</sup>

Section 409A provides for a significant departure from §457(f)'s interpretation of substantial risk of forfeiture. For purposes of §409A, the right to compensation is subject to a substantial risk of forfeiture if entitlement to the amount is conditioned on the

performance of substantial future services or the occurrence of a condition that is related to a purpose of the compensation and the possibility of forfeiture is substantial.<sup>14</sup> Accordingly, under § 409A, if a service provider's entitlement to the amount is conditioned on the occurrence of the service provider's involuntary separation from service without cause, the right is subject to a substantial risk of forfeiture if the possibility of forfeiture is substantial. However, under §409A, an amount is considered not subject to a substantial risk of forfeiture merely because the right to the amount is conditioned directly or indirectly upon refraining from performance of services. Therefore, noncompete agreements are irrelevant for purposes of §409A, although historically they have been relied on under §457(f) to constitute a substantial risk of forfeiture.

It is anticipated that the IRS and Treasury will provide formal guidance under § 457 adopting the rules under Treasury Regulation §1.409A-1(d) relating to the definition of substantial risk of forfeiture.

### ***Agreements Not to Compete and Extensions of Deferral Periods***

Notice 2007-62 explains that under Treasury Regulation §1.409A-1(d), an amount deferred 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. The Notice evidences the intent to create a uniform definition of substantial risk of forfeiture under §§457(f) and 409A. In this connection, plan sponsors of a tax-exempt or governmental organization should no longer expect to be able to use covenants not to compete in the case of voluntary terminations to create a substantial risk of forfeiture.

Further, as the Notice provides, any addition of a risk of forfeiture after the right to the compensation arises, or an extension of the period during which the compensation is subject to a risk of forfeiture (referred to as "rolling the risk of forfeiture") is disregarded for purposes of determining whether the compensation is subject to a substantial risk of forfeiture under § 409A. The determination of satisfaction of § 409A is prospective in nature. Under current law, the covenant not to compete must be tailored to the individual and be a true covenant not to compete.

With regard to extensions for deferrals under §409A, an amount is not considered subject to a substantial risk of forfeiture beyond the date or time at which the recipient otherwise could have elected to receive the amount of compensation unless the present value of the amount made subject to a risk of forfeiture is materially greater than the present value of the amount the recipient otherwise could have elected to receive absent such risk of forfeiture.<sup>15</sup> Accordingly, the rolling risk of forfeiture under §409A would be ignored and the amount would vest without regard to further elections, unless the requirements of §409A were provided for in the agreement and compiled with at inception. In applying §409A to an ineligible deferred compensation agreement under § 457(f), the practice of rolling the risk of forfeiture to delay taxation will end in plan failure, unless the forfeiture provision is designed to comply with the requirements under § 409A. Under §409A, an amount made subject to such a risk of forfeiture must be of a materially greater benefit.

## **Impact of the Layers of Sections 457(f) and 409A**

Section 409A adds an additional layer of compliance obligations to tax-exempt plan sponsors of ineligible deferred compensation arrangements. It has the effect of further limiting the alternatives that a tax-exempt plan sponsor has to offer its executive employees when negotiating a deferred compensation plan. Under §457(f), income is taxable to the employee only upon lapse of the substantial risk of forfeiture.<sup>16</sup> Section 409A makes those amounts taxable at the time they are deferred if the rules provided therein are violated, and adds an obligation to pay interest and penalties.<sup>17</sup> Accordingly,

taxes, penalties, and interest will be imposed on the employee at any time an agreement subject to §409A fails to meet the requirements of the section. This could create a taxable event at a time when the employee may not have been paid the deferred amounts but is required to pay the taxes and penalties that arise out of the violation. In Notice 2007-62, the Service addresses the timing issues that arise as a result of the different definitions of substantial risk of forfeiture and anticipates guidance to align the provisions.

There are further instances of the problematic application of these sections regarding the interpretations of substantial risk of forfeiture. For instance, in the case of an executive of a tax-exempt organization who intends to terminate her employment and enter into a covenant not to compete with the employer as part of a separation package, as was traditionally done and sanctioned, the amounts deferred subject to the covenant would have been taxable under § 457(f) at the time of lapse of the risk of forfeiture. However, Treasury Regulation §1.409A-1(d) does not recognize covenants not to compete as constituting a substantial risk of forfeiture, so this arrangement would violate the provisions of §409A and would create a tax liability for the amount deferred under the covenant at the time the agreement was entered into, including a 20 percent penalty and the applicable interest under §409A.

The positive aspect of the inclusion in income is that such amounts would have already been included in income for all purposes, including §457(f). The negative aspect is that the earnings credited to the amounts deferred and already included in income would be subject to §409A on a continuing basis until the amounts were paid out. Furthermore, if the executive had not yet satisfied the conditions under the covenant, she may not have received the payments provided for in the separation agreement at the time of the violation of §409A. A likely result is that the taxpayer in this example may not have available the amounts necessary to pay the taxes and penalties imposed pursuant to §409A.

Certain types of arrangements that were held valid under § 457(f), where the only consequence of certain provisions was inclusion in income at the time the substantial risk of forfeiture lapsed, will have to be revised for compliance with §409A, as discussed further below. For example, in PLR 9030025, the Service examined a plan that provided for deferral of compensation, under which amounts deferred were subject to vesting after completion of a "continuous service period," defined in the plan. The plan also provided that certain events would cause the waiver of the service period. The waiver would occur upon retirement, death, disability, or termination due to the reduction of force. The Service ruled that the amounts deferred were subject to a substantial risk of forfeiture, and would be taxable at the time of vesting. Section 409A would cause immediate taxation upon deferral since the §409A regulations do not allow acceleration of payment dates.<sup>18</sup>

The upside of the combination of §§457(f) and 409A is that amounts included in income under § 457(f) will not be subject to §409A since they will meet the short term deferral exemption found in the §409A final regulations. There is short-term deferral if the amounts deferred are paid within two and a half months of the end of the taxable year in which the substantial risk of forfeiture lapses.<sup>19</sup> The inclusion in income of an amount under §457(f) is treated as payment of the amount for purposes of §409A.

Plans that provide for payment of deferred amounts for a period longer than two and a half months, such as the one approved in PLR 9030028, should be revised for compliance with § 409A. Notwithstanding, the only significant problem with §409A in such plans would be the accumulation of earnings since the amounts that ceased to be subject to substantial risk of forfeiture would have already been included in income, and treated as payment for purposes of § 409A.

Under §409A, a plan sponsored by a tax-exempt entity under which deferred amounts are subject to a substantial risk of forfeiture may no longer provide the participant with the discretion to determine the time of payment of deferred amounts after vesting. A provision of this type would allow the election of further deferral, something that the §409A provisions seek to prohibit. Further deferral of amounts already set aside under an ineligible deferred compensation plan must comply with § 409A and the anticipated standards provided in Notice 2007-62.

## Interaction Under Anticipated Guidance

In Notice 2007-62, the Service points out the importance of coordinating these provisions and the interaction of the anticipated standards under § 457(f) aligning the definition of substantial risk of forfeiture with §409A. For instance, under §457(f) earnings accumulated on amounts deferred under an ineligible deferred compensation arrangement would not be taxable until paid or made available.<sup>20</sup> In contrast under § 409A, earnings on deferred amounts are considered deferred compensation. The earnings may be treated differently than the deferred amounts but they must also comply with the provisions of § 409A.

Notice 2007-62 provides that “the rights to earnings on amounts that have previously been included under Section 457(f) would be deferred compensation for purposes of §409A unless the right to the earnings independently satisfied the requirements under §409A.”<sup>21</sup> Plan sponsors that have not yet revised their deferred compensation plans for the earnings on the deferred amounts to comply with § 409A should do so during 2008, while transition relief is still in effect.

## Taxes, Penalties, and Interest

While § 457(f) by itself only determines the timing of taxation of deferred amounts, § 409A not only compels inclusion of income at the time it is earned or deferred, but also compels inclusion of all amounts previously deferred and imposes a penalty equal to 20 percent of the amount includible, plus interest at the underpayment rate plus one percentage point from the time of initial deferral or when the amounts were first includible in income.<sup>22</sup>

## Corrections Program

The IRS has provided limited transitional relief for certain unintentional operational plan failures that occur in a service provider's taxable year beginning before Jan. 1, 2010. However, no relief is provided for plan document failures.<sup>23</sup>

## Effective Dates and Grandfathering

Section 409A applies to all amounts deferred after Dec. 31, 2004. Generally, amounts deferred that are earned and vested before Jan. 1, 2005, are exempt, if the plan under which the deferrals were made was not materially modified after Oct. 3, 2004, unless such modification was made to bring the plan into compliance with §409A. The final regulations take effect Jan. 1, 2009.<sup>24</sup>

Nonqualified deferred compensation plans sponsored by tax-exempt employers must comply with provisions of § 409A and the regulations thereunder in addition to complying with §457(f). Further, nonqualified deferred compensation plans must be amended to include all required provisions under § 409A by Dec. 31, 2008.

There is no grandfathering provision in Notice 2007-62. While the Service expects any future guidance will only have prospective effect, plan sponsors of tax exempt or governmental organizations should begin making arrangements to secure compliance with the expected guidance regarding the definition of bona fide severance pay plan and the rules regarding a substantial risk of forfeiture. Plan sponsors may rely on Notice 2007-62 for such purpose until further guidance is issued.

## Footnotes

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<sup>1</sup> 2007-32 I.R.B. 331.

<sup>2</sup> Unless otherwise noted, any reference to "Section" or "I.R.C. §" refers to a section of the Internal Revenue Code of 1986, as amended.

<sup>3</sup> See Treas. Reg. §1.457-11(a).

<sup>4</sup> Added to the Internal Revenue Code by §885(a) of Pub. L. No. 108-357, the American Jobs Creation Act of 2004.

<sup>5</sup> I.R.C. §§409A(a)(1) through (a)(4) impose distribution restrictions, acceleration restrictions, and election restrictions.

<sup>6</sup> Treas. Reg. §1.409A-1(d)(1). The definition provided by the regulations is a general one, followed by certain exceptions which should not be thought of as exhaustive. For example, the regulations provide 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 the refraining from performance of services." *Id.*

<sup>7</sup> Treas. Reg. §1.83-3(c)(1).

<sup>8</sup> Treas. Reg. §1.409A-1(b)(9)(ii) (collectively bargained separation pay plans), (iii) (involuntary separation through participation in a window program), and (iv) (foreign separation pay plans).

<sup>9</sup> Regarding reimbursement and in-kind benefits, see Treas. Reg. §1.409A-1(b)(9)(v).

<sup>10</sup> Rev. Rul. 67-449.

<sup>11</sup> Treas. Reg. § 1.83-3(c)(1).

<sup>12</sup> Treas. Reg. §1.83-(c)(1) provides that there is substantial risk of forfeiture if "the rights in property that are transferred are conditioned, directly or indirectly, upon the performance (or refraining from performance) of substantial services by any person, or the occurrence of a condition related to a purpose of the transfer, and the possibility of forfeiture is substantial if such condition is not satisfied."

<sup>13</sup> See Rev. Rul. 67-449, 1967-2 C.B. 173.

<sup>14</sup> Treas. Reg. §1.409A-1(d)(1).

<sup>15</sup> Treas. Reg. §1.409A-1(d)(1).

<sup>16</sup> I.R.C. §457(f)(1)(A).

<sup>17</sup> I.R.C. §409A(a)(1)(B).

<sup>18</sup> Treas. Reg. §1.409-3(j).

<sup>19</sup> Treas. Reg. §1.409A-1(a)(4) (defining, in general, short-term deferral as the period ending on the later of the 15th day of the third month following the end of the service provider's first taxable year in which the right to the payment is no longer subject to a substantial risk of forfeiture).

<sup>20</sup> Treas. Reg. §1.457-11(a)(3).

<sup>21</sup> Notice 2007-62, at V.

<sup>22</sup> I.R.C. §409A(a)(1)(B)(ii).

<sup>23</sup> Notice 2007-100, 2007-52 I.R.B. 1243.

<sup>24</sup> See Notice 2007-86, 2007-46 I.R.B. 990, delaying the effective date of the final regulations for one year.