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Management Alert

IRS Proposes Regulations on 457(f) Plans for Tax-Exempt Employers

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It took only 9 years since first announcing its intention to issue regulations, but the IRS has finally issued proposed regulations for deferred compensation arrangements sponsored by tax-exempt and governmental employers. These special deferred compensation rules, which apply in addition to the deferred compensation rules in Internal Revenue Code ("Code") Section 409A, are embodied in Code Section 457. This alert focuses on how the proposed regulations would affect tax-exempt (rather than governmental) employers under "ineligible" 457(f) deferred compensation plans. Employers typically use 457(f) plans to provide deferred compensation to executives above IRS limits that apply to tax-qualified plans and Section 457(b) "eligible" deferred compensation plans. Using a 457(f) arrangement has the benefit of having no limit on the amount of deferred compensation provided (subject to other concerns such as the intermediate sanction rules). However, Section 457(f) taxes the deferred compensation when it is no longer subject to a substantial risk of forfeiture - *i.e.*, when the compensation becomes vested.

The good news for sponsors of these plans is that there are no major surprises in the proposed regulations. As expected, the new 457(f) regulations borrow concepts and definitions heavily from the final regulations under Code Section 409A, which will, in most cases, allow 457(f) plans that also are subject to Section 409A to comply without the need for a set of different provisions for each Code Section. This alert will discuss some of the highlights of the proposed regulations.

What plans are subject to Section 457(f)?

The proposed regulations define what is "deferred compensation" subject to 457(f). Consistent with the Section 409A regulations, a plan provides for Section 457 "deferred compensation" if a participant has a legally binding right to compensation that, under the terms of the plan, is or may be payable in a later taxable year, subject to the following exceptions:

- <u>Short-term deferrals</u>: Similar to Section 409A, an arrangement that requires payments to be made within 2½ months after the end of the year in which vesting occurs is exempt from Section 457(f) as a short-term deferral. One important distinction from Section 409A is that, for 457(f) purposes, broader rules regarding substantial risk of forfeiture (described below) apply instead of the narrow Section 409A definition.
- <u>Bona fide severance pay plans</u>: Bona fide severance pay plans also are exempt from Section 457(f), and the proposed 457 regulations adopt terms similar to the Section 409A exemption for severance pay plans, including allowing Section 409A "good reason" terminations to be treated as involuntary terminations. However, unlike the 409A regulations, the proposed 457 regulations do not limit the amount of severance to twice the annual limit under Code Section 401(a)(17) - currently $265,000.

- Bona fide sick leave and vacation leave plans: A sick or vacation leave plan is treated as "bona fide" if the primary purpose of the plan is to provide employees with paid time off for sickness, vacation, or other personal reasons. For better or worse, the proposed regulations do not clarify when a carryover or cash-out feature for unused vacation or leave time may impact the plan's "bona fide" status, an issue that has been of significant concern to tax-exempt employers.
- Death and Disability Plans: For disability plans, the proposed 457 regulations adopt the definition of "disability" from the Section 409A regulations.
- Recurring part-year compensation: The most common example of this compensation applies to teachers who are paid over the course of the entire year but only work during the 10-month school year. The 457 exemption applies if the arrangement does not defer payment of any amount 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 does not exceed the annual compensation limit under Code Section 401(a)(17).

Substantial Risk of Forfeiture under Section 457(f)

Similar to Section 409A, a substantial risk of forfeiture exists under Section 457(f) if entitlement to the compensation is conditioned on the future performance of substantial services or on the occurrence of a condition that is substantially related to a purpose of the compensation, provided that the possibility of forfeiture is substantial. However, unlike Section 409A, a covenant not to compete is a substantial risk of forfeiture for Section 457 purposes if the following three conditions are met:

- The right to payment is expressly conditioned on the employee refraining from providing future services pursuant to an enforceable written agreement;
- The employer makes reasonable ongoing efforts to verify compliance with the noncompetition agreement; and
- The employer has a bona fide interest in the employee refraining from competing, and the employee has a bona fide interest in, and the ability to, engage in the prohibited competition.

Rolling Risks of Forfeiture: In general, the IRS has viewed "rolling risk of forfeitures" (*i.e.*, the postponement of the vesting event) with disfavor, by requiring that the "new" forfeiture risk be disregarded in applying tax rules. However, the proposed 457 regulations allow a further risk of forfeiture if certain conditions are met:

- The "new" deferred amount (*i.e.*, the amount subject to the new forfeiture risk) must be materially greater than the amount that would have vested without regard to the new forfeiture risk. The proposed regulations provide that the present value of the new deferral must be more than 125% greater;
- The period for the additional risk of forfeiture must be at least two years after the date the original risk of forfeiture was scheduled to lapse; and
- The agreement for the initial risk of forfeiture must be in place prior to the beginning of the year in which services are rendered, and the agreement to extend the existing risk of forfeiture must be made at least 90 days before the existing risk of forfeiture was scheduled to lapse.

Determining the Amount Subject to Tax

The proposed regulations provide rules for how the amount that is subject to tax under Section 457(f) is to be determined. If the deferred amount may be paid or available at different times or in different forms under the plan, the amount is treated as payable at the time and form where the present value is highest. However, if payment has commenced, or a time and form of payment have been elected and cannot be changed without both party's consent, the time and form of payment as commenced or elected is utilized. More specific guidance is provided for determining the amount subject to tax for account-based and non-account-based plans, formula-based plans, reimbursement arrangements and split dollar life insurance arrangements.

Losses of Amounts Previously Taxed: The proposed regulations adopt the Section 409A tax treatment should an individual include an amount in income under Section 457(f) before it is distributable, but the amount ultimately distributed is less. In this case, the participant may take a miscellaneous itemized deduction for the loss (the difference between the amount previously taken into income and the amount actually received in the taxable year in which the remaining right to the amount is permanently forfeited or lost).

Effective Dates

The 457 proposed regulations are scheduled to apply for calendar years beginning after the date the *final* regulations are published in the Federal Register, including with respect to amounts deferred or accrued in prior years that were not previously included in income, with several exceptions:

- A delayed effective date applies to compensation deferred under a collectively bargained plan.
- For recurring part-year compensation for periods before the effective date of the regulations, taxpayers may rely on either the rules set forth in the proposed regulations or the rules set forth in IRS Notice 2008-62.

Nevertheless, taxpayers may rely on the proposed regulations until the effective date.

Conclusion

There is no telling how long the IRS will take to issue final 457 regulations. Treasury has requested comments, and a public hearing is scheduled for October. Even so, sponsors of plans subject or potentially subject to Section 457(f) should review their plans to determine how the proposed rules will affect them, and consider modifications to plan design to reflect the proposed regulations.

If you have any questions, please contact your Seyfarth attorney, Fredric Singerman at *fsingerman@seyfarth.com*, Richard Schwartz at *rschwartz@seyfarth.com*, Richard Loebl at *rloebl@seyfarth.com*, John Burgess at *jburgess@seyfarth.com*, or Kelly Pointer at *kpointer@seyfarth.com*.