July 11, 2016

New Proposed Rules for Deferred Compensation Plans of Tax-Exempt and Governmental Employers

The tax treatment of nonqualified deferred compensation plans established by tax-exempt and governmental employers is governed by Internal Revenue Code section 457, which applies in addition to section 409A of the Code (covering nonqualified deferred compensation plans more generally). Absent an exception, deferred compensation payable by such employers is includible in income under 457(f) unless it is subject to a substantial risk of forfeiture.

On June 22, the IRS issued proposed regulations that align the 457 rules with the 409A rules in many respects. At the same time, the IRS proposed regulations under 409A to provide further coordination between the two regulatory regimes.

The 457 regulations generally will take effect in the calendar year beginning after the final regulations are issued, but also will affect compensation deferred in prior years that has not been included in income during a prior year. Unless the final regulations are issued in 2016, the earliest effective date of the final regulations would be January 1, 2018. Taxpayers may rely on the proposed regulations until the effective date of the final regulations.

A Special Note About Existing Arrangements: The proposed regulations do not "grandfather" existing arrangements or offer a transition period to conform to the proposed or final regulations. Thus, while new arrangements generally should be designed with an eye to compliance with the proposed rules, decisions about existing arrangements will be more complex.

This summary examines selected key topics covered by the proposed regulations, with a focus on the income inclusion rules under 457(f).

Included in this Alert:

The Initial Question—457(f) or Not?

In analyzing a compensation arrangement, the threshold question is whether 457(f) applies to the arrangement.

What is a "plan" for purposes of 457?

Under the proposed rules, a "plan" includes any written or unwritten arrangement under which the payment of compensation for services is deferred by salary reduction, nonelective employer contribution or otherwise. Section 457 applies to arrangements covering an individual (including an arrangement in an individual employment agreement) or a group of employees.*

* Section 457 applies to deferred compensation paid to independent contractors (with a limited exception for broad-based, nonelective plans) as well as employees. For ease of presentation, this summary uses the term "employee," but the rules that are described generally extend to payments to independent contractors as well.

When does a plan provide for a "deferral of compensation"?

Generally, a "deferral of compensation" exists if the employee has a legally binding right in one calendar year to compensation payable in a subsequent calendar year. A right need not be vested to be legally binding.

An employee does not have a legally binding right if the employer has retained an unconditional, unilateral right to reduce or eliminate the compensation, unless the employer's discretion to exercise the right lacks substantive significance.

> **Compliance Tip:** Employers should consider whether it is feasible to reserve a substantive unilateral right to reduce or eliminate compensation without sacrificing or otherwise undermining the goal of the arrangement (*e.g.*, recruitment, retention, etc.).

Amending a plan to convert other promises (*e.g.*, benefits under a retiree health care plan) into a deferral of compensation (such as the right to receive future cash benefits in lieu of health benefits) may cause a plan to become subject to 457(f) at the time of amendment.

> **Compliance Tip:** In anticipation of rules implementing the Affordable Care Act's anti-discrimination rules for fully insured health plans, many executive arrangements give the employer flexibility to pay cash in lieu of a health benefit if providing such benefit fails to comply with the ACA's non-discrimination rules. This practice will need to be evaluated in light of the proposed regulations.

What types of plans are not subject to 457(f)?

A number of plans either do not provide for a deferral of compensation or are otherwise excluded from 457(f)'s application, including:

- "bona fide" vacation leave, sick leave, compensatory time, severance pay, disability pay, and death benefit plans,
- 401(a) and 403(b) tax-favored retirement plans,
- eligible 457(b) deferred compensation plans,
- "short-term deferral" plans,
- eligible recurring part-year compensation plans,
- qualifying reimbursements, medical benefits and in-kind benefits (*e.g.*, subsidized COBRA pursuant to a separation pay plan under 409A),
- plans that provide certain taxable employee tuition benefits, and
- plans established by "steeple" churches and qualified church-controlled organizations.

Is there new guidance on the exclusions for some of these commonly offered benefits, such as leave programs and severance plans?

Yes. Of particular interest to many employers are the provisions on vacation leave, sick leave, severance pay, disability pay, and death benefit plans. Some of these rules were anticipated under earlier guidance (in particular, IRS Notice 2007-62), and others chart new territory. In each case, the facts and circumstances play an important role in the determination of whether a plan satisfies one of these exceptions. Key provisions include:

- A plan is treated as a *bona fide sick or vacation leave plan* (rather than a deferred compensation plan) if its primary purpose is to provide paid time off from work because of sickness, vacation or other personal reasons. The "primary purpose" determination considers factors such as whether an employee can be reasonably expected to use the amount of leave provided and whether the employee has the ability to cash out unused leave or exchange it for other benefits (including using leave to postpone the date of termination of employment).

- The *bona fide severance pay plan* rules are similar to the rules announced in IRS Notice 2007-62 and include the following features:

  - The severance from employment must be involuntary, unless it's a voluntary severance under a "window program" or on account of certain "good reason" conditions.

> **Something to Note:** The IRS uses different terms with different definitions ("severance from employment" for 457 and "separation from service" for 409A), and ancillary rules applicable to the 409A definition do not necessarily apply to the 457 definition.

  - The total amount of severance pay must not exceed a specified cap (generally 2x annualized compensation).

> **Something to Note:** A key and helpful difference between the proposed 457 rules and the 409A regulations is that the 457 cap is 2x the employee's annualized compensation, while the 409A cap is the lesser of 2x annualized compensation or 2x the limit on annual compensation under Section 401(a)(17) ($530,000 for 2016).

  - The severance pay must be paid no later than the last day of the second calendar year following the calendar year in which the severance from employment occurs.

> **Compliance Tip:** While the first 2x of annualized compensation may qualify as exempt from 457(f) under the severance pay plan exception, any amount in excess of the 409A cap (that is, any amount over 2x the 401(a)(17) limit) must be structured to comply with 409A (*e.g.*, paid on specified payment dates following a 409A separation from service) or fit within a separate exemption from 409A (*e.g.*, short-term deferral).

- A *bona fide disability plan* pays benefits (whether or not insured) only upon disability and must use one of three specified definitions of disability.

- For a *bona fide death benefit plan*, the proposed regulations borrow from the definition of death benefits under the FICA regulations, except that the death benefits can be provided through insurance.

How does the short-term deferral rule work?

A payment under a plan is treated as a "short-term deferral," and therefore not deferred compensation subject to 457(f), if it is paid by March 15 of the calendar year following the calendar year in which the amount vests (*i.e.*, ceases to be subject to a substantial risk of forfeiture). For employers with non-calendar fiscal years, short-term deferrals must be paid by the later of the 15th day of the third month following the end of the fiscal year in which the deferred compensation vests and March 15 of the calendar year following the year in which the deferred compensation vests. If a payment satisfies this short-term deferral exception, the amount is taxable only when paid.

Something to Note: This is a particularly welcome exception. Historically, most arrangements have been drafted to provide for full payment in the year of vesting because the deferred compensation was included in income in that year. The short-term deferral rule will allow payment/taxation in the following year as long as full payment occurs by the applicable deadline.

Are there new rules for recurring part-year compensation?

Yes. Recurring part-year compensation (*e.g.*, salary for a 9-month service period that can be spread over 12 months at the election of the employee) is not subject to 457(f) if it is paid in full by the last day of the 13th month following the first day of the first month of the service period, as long as the recurring part-year compensation does not exceed the 401(a)(17) annual compensation limit in effect on the first day of the service period ($265,000 for 2016).

Something to Note: This exception may simplify faculty compensation practices put into place by universities, colleges and other educational organizations after IRS Notice 2008-62 was issued. Additionally, for mandatory arrangements where an employee is required to spread part-year compensation over 12 months, the short-term deferral exception may be available as an alternative path to compliance.

Establishing a Plan Subject to 457(f)

If a compensation arrangement is subject to the 457(f) income inclusion rules, the vesting rules applicable to the compensation will dictate its tax treatment under 457(f).

When does an amount become includible in income under 457(f)?

An amount is includible in gross income on the first date on which the employee has a legally binding right to the amount, unless the amount is subject to a substantial risk of forfeiture. If so, the amount is includible in income on the first date on which the substantial risk of forfeiture lapses.

What constitutes a substantial risk of forfeiture?

The deferred compensation is subject to a substantial risk of forfeiture only if the employee's entitlement is conditioned on:

- the future performance of substantial services; or
- the occurrence of a condition that is related to a purpose of the compensation (if the possibility of forfeiture is substantial).

> **Something to Note:** The inclusion of the second type of condition expands the definition of substantial risk of forfeiture to cover "performance-based" vesting conditions.

The proposed rules do not appear to establish a safe harbor with respect to either the duration or the extent of the substantial future services. Instead, the determination is based on facts and circumstances, including whether the hours required of the employee are substantial in relation to the amount of deferred compensation.

> **Compliance Tip:** The proposed rules do not change the ability to include a plan provision which accelerates vesting upon the employee's death, disability or involuntary severance from employment. A substantial risk of forfeiture will not lapse as a result of such a provision unless and until the specified event occurs.

Can a noncompetition provision be treated as imposing a substantial risk of forfeiture?

Yes, if certain requirements are satisfied. The proposed rules require that:

- the noncompetition requirement must be an express condition of payment in an enforceable written agreement,
- the employer must make a regular and reasonable practice of verifying compliance with its various noncompetition agreements (not just the agreement applicable to a particular employee), and
- the employer must have a substantial and bona fide interest in preventing the employee from providing competing services to another employer and the employee must have the ability to compete (absent the agreement), in each case as supported by the facts and circumstances in effect at the time the written agreement becomes binding on the parties.

> **Compliance Tip:** Noncompetition provisions do not impose a substantial risk of forfeiture under 409A. This difference will require careful attention to the application of 409A when a plan includes a noncompetition provision.

Calculation of Amounts Includible in Income

At its core, 457(f) is an income inclusion provision. Thus, the proposed rules provide guidance regarding how much compensation is included in an employee's income upon vesting and then upon payment.

What is taxed under 457(f) when there is a vesting event?

The present value of compensation deferred is includible in the gross income of an employee on the first date the compensation vests (*i.e.*, when the substantial risk of forfeiture lapses), even if the employee does not receive payment at that time.

In general, how is "present value" determined?

The amount that becomes taxable is the present value of the future payments to which the employee has a legally binding right.

The present value is based on actuarial assumptions and methods that must be reasonable at the time the taxable amount is calculated. The proposed regulations provide specific rules governing assumptions made for this purpose as well as rules governing present value calculations for both account balance and formula benefit plans.

If deferred compensation is paid after the year of vesting, what happens in the year of payment under an account balance plan?

Typically, the present value that is included in income at vesting is the employee's account balance on the vesting date and any subsequent earnings are not taxed until payment.

> **Something to Note:** The proposed rules do not change the long-standing rule that reasonable earnings that accrue after the vesting date are not subject to FICA and Medicare tax.

If an unreasonable earnings rate is used, the present value of the stream of future excess earnings must be included and taxed on the vesting date. This rule treats the excess earnings as additional deferred compensation credits, rather than earnings.

If the earnings rate is determined based on the greater of two rates of return, the present value is equal to the account balance plus the present value of the right to all future earnings.

> **Something to Note:** This rule is punitive because it requires all future earnings to be included in the present value calculation with no exceptions or deductions for reasonable earnings.

If the payments are made in installments, each installment will have a taxable and non-taxable component, assuming there are positive earnings.

What happens in the year of payment under a formula benefit plan?

Under a defined benefit type of plan, a second calculation is performed at the time of payment and the net amount (*i.e.*, the difference between the present value previously included at vesting and the value at the time of payment) is taxable when paid. If the payments are made in installments, each installment will have a taxable and non-taxable component.

Making Changes to a 457(f) Arrangement

It is not unusual for an employer or employee to want to make changes to a deferred compensation plan after it is established, whether to defer vesting and/or payment or to substitute a new arrangement for the existing arrangement.

Is it possible to delay income inclusion under 457(f)?

Unless the rules described below for adding or extending a risk of forfeiture are satisfied, the addition or extension is generally disregarded in determining when the deferred compensation is taxable. As a result, the deferred compensation would remain taxable at the first time the deferred compensation would have vested (and not the later date when the new or extended forfeiture condition lapses).

The rules under 409A must be satisfied independent of the 457(f) analysis. For example, if a plan is structured to be a short-term deferral under 409A, the extension rules under 409A would also need to be satisfied when adding or extending a risk of forfeiture.

> **Compliance Tip:** If an arrangement has a 457(f) risk of forfeiture that is not recognized under 409A (*e.g.*, a noncompetition provision), the arrangement may be a short-term deferral for 457(f) purposes, but it would not be a short-term deferral for 409A purposes.

If deferred compensation is forfeited or relinquished and replaced, in whole or in part, with a right to another amount (or benefit) that is a substitute for the forfeited/relinquished deferred compensation, any new risk of forfeiture is disregarded unless the extension rules described above are satisfied.

Do the proposed rules permit an election to defer current compensation or allow for a "rolling risk of forfeiture"?

Yes, the employer and the employee can agree to add a vesting condition to current compensation or extend an existing vesting schedule if certain requirements are met.

- The agreement is made and documented:

  - in the case of an addition of a substantial risk of forfeiture where none previously existed (*e.g.*, a deferral of salary or other current compensation), before the beginning of the calendar year in which any services that give rise to the compensation are performed, or

  - in the case of an extension of an existing substantial risk of forfeiture, at least 90 days prior to the vesting date.

- The amounts are deferred for at least an additional two years of substantial future services (although an intervening acceleration as a result of death, disability, or involuntary severance from employment without cause is permitted).

- The present value of the new deferred compensation promise is materially greater than the present value of the original amount. If the new promise is more than 125% of the original promise, it will be treated as materially greater for this purpose.

> **Something to Note:** The preamble to the proposed regulations explicitly states that no implication is intended that this 125% safe harbor would also apply for purposes of 409A's extension rules.

May an employer satisfy an existing cash deferred compensation promise with a nontaxable benefit and avoid taxation altogether?

No. While there is an opportunity to add or extend the risk of forfeiture for unvested deferred compensation (as described above), it is not possible to exchange deferred compensation for a nontaxable benefit and avoid taxation under 457(f) altogether.

Next Steps

Written comments on the proposed regulations will be accepted through September 20, 2016, and a public hearing is scheduled for October 18, 2016. Treasury and IRS have requested comments on all aspects of the rules, but specifically ask whether special transition rules are needed for plans established before the effective date, whether additional exceptions to the rules determining amounts includible in income are appropriate, and whether special provisions for newly eligible employees are needed.

Until the 457 regulations are finalized, new arrangements should be structured to comply with the proposed rules. It remains to be seen whether the IRS will issue any transition relief for existing arrangements, but the IRS's request for comments on this topic leaves open the possibility that relief could be forthcoming. In the meantime, we would suggest that employers begin gathering and reviewing any outstanding arrangements they may have, in order to be better positioned to react to the new rules and to take advantage of whatever transition relief (if any) the IRS may issue.

Questions on 457 or this summary should be directed to a member of our 457 team (Abigail Baird, Ellen Benson, William Jewett, William Littell, Kendi Ozmon, Sharon Remmer, Peter Rosenberg, Lorry Spitzer and Jonathan Zorn) or your Ropes & Gray Tax & Benefits advisor.