Nonprofits and Tax-Exempt Organizations

ALERT

JULY 2016

IRS Issues Proposed Section 457(f) Regulations on Deferred Compensation Arrangements for Governmental and Tax-Exempt Entities

The Treasury Department last week issued long-awaited proposed regulations under Section 457(f) of the Internal Revenue Code regarding nonqualified deferred compensation arrangements sponsored by governmental and tax-exempt entities. Section 457(f) essentially requires that nonqualified deferred compensation in excess of amounts permitted to be deferred under an "eligible Section 457(b) plan" be included in income at the later of contribution or vesting. The proposed regulations address important issues concerning the application of Section 457(f), including defining what constitutes bona fide severance pay and death and disability plans excluded from compensation, adding a short-term deferral exclusion and clarifying the meaning of "substantial risk of forfeiture."

1. Definitions of Excluded Compensation Clarified. Section 457 generally excludes "bona fide vacation leave, sick leave, compensatory time, severance pay, disability pay and death benefit plans" from compensation. The proposed regulations clarify the definitions of these various types of excluded compensation.

   a. Severance Pay Plan Defined. The proposed regulations provide that, to qualify as a bona fide "severance pay plan" excluded from compensation, (1) benefits may be payable only upon "involuntary" severance, or pursuant to a "window program" or an "early retirement incentive plan", (2) benefits must not exceed two times the participant's annualized compensation and (3) the plan must require that all benefits be paid no later than the last day of the second calendar year following the year in which severance from employment occurs.

The second and third criteria generally follow the definition of severance under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"); however, the definition of involuntary severance is a significant addition to the ERISA statutory definition, codifying less formal prior guidance. Under these proposed regulations, severance paid pursuant to an employee-initiated "good reason" departure may be treated as involuntary if certain requirements are met. These requirements are similar to those under the Section 409A regulations and include a substantially identical safe-harbor definition of good reason. The definition of window program also generally follows

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the definition under the Section 409A regulations. Early retirement incentive plans are limited to retirement subsidies payable in coordination with a qualified defined benefit pension plan.

b. Other Welfare Benefit Plan Definitions. The proposed regulations define bona fide death benefit and disability pay plans similarly to the definitions under Section 409A regulations, but provide significantly more detail on what constitutes a bona fide sick or vacation leave plan.

c. New Short-Term Deferral Exclusion. Similar to the exclusion under Section 409A, the proposed regulations add a "short-term deferral" exclusion, under which a deferral of compensation does not occur with respect to any amount actually or constructively received on or before the 15th day of the third month following the later of the end of the calendar year or the employer's fiscal year in which the payments vest. This new exclusion is significant in that it will allow payments to be made after the vesting year without becoming subject to Section 457(f), so that the payments do not have to be included in income at the time of vesting.

2. Rules Relating to "Substantial Risk of Forfeiture." The definition of "substantial risk of forfeiture" under the proposed regulations generally is similar to the definition under the Section 409A regulations: An amount is subject to a substantial risk of forfeiture 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 future performance depends on the facts and circumstances, but the proposed regulations specify that the inquiry should examine whether the hours required to be performed during the relevant period are substantial in relation to the amount of the compensation.

a. Noncompete as a Substantial Risk of Forfeiture. Unlike the Section 409A regulations, these proposed regulations provide that a noncompete condition may be considered a substantial risk of forfeiture if (1) the condition is expressly proscribed in an enforceable written agreement; (2) the employer consistently makes reasonable efforts to verify compliance with all of the noncompetition agreements to which it is a party, including the one at issue; and (3) the facts and circumstances and timing indicate that the employer has a substantial and bona fide interest in preventing the employee from performing the prohibited service and that the employee has a bona fide interest in engaging, and has the ability to engage, in the prohibited services. The proposed regulations identify several relevant factors to be taken into account.

b. Conditions for Initial Deferrals and Extensions. The proposed regulations create special rules to determine whether initial deferrals of current compensation may be treated as subject to a substantial risk of forfeiture (so as to allow a voluntary deferral) and whether a substantial risk of forfeiture can be extended (i.e., rolled to a later year).

(1) The present value of the deferral amount payable on lapse of the new substantial risk of forfeiture period must be "materially

greater" than the amount that would have been paid absent the initial election or extension. "Materially greater" here means more than 125 percent of the deferred amount measured as of the date that amount would otherwise have been paid. (Interestingly, the proposed regulations specify these regulations cannot be used to interpret Section 1.409A-1(d)(1) even though the same "materially greater" language is used in that regulation.)

(2) A voluntary deferral or extension must require the performance of substantial services or a limitation on competition (i.e., not merely a performance condition).

(3) The additional period for which substantial services must be performed must be at least two years, absent an intervening event such as death, disability or involuntary severance.

(4) The agreement must be made in writing prior to the beginning of the calendar year in which services are performed (in the case of an initial deferral) or at least 90 days before the lapse of an existing substantial risk of forfeiture. Special rules apply for new employees but not newly eligible employees.

The proposed regulations also add a substitution rule, similar to the Section 409A regulations, which provides that if an amount is forfeited, the new risk of forfeiture will be ignored for purposes of 457(f). This means that the above requirements may not be circumvented by just cancelling an existing right and replacing it with a new one having a later vesting date.

3. Calculation of Section 457(f) Inclusion. The proposed regulations provide that the amount to be included in income under an ineligible plan will be the present value of deferred compensation at the later of (1) the first date that there is a legally binding right to the compensation or (2) the date that the compensation is no longer subject to a substantial risk of forfeiture (i.e., the vesting date). The amount included in income under an ineligible plan will include any earnings as of the inclusion date. Earnings that accrue on deferred amounts after the inclusion date will be included in income when paid. Once amounts are "properly" taken into income, they are considered an investment in the contract and are not taxable again at the time of distribution.

a. Defined Benefit Plans. For a defined benefit plan, the present value of the ultimate benefit payable is calculated by multiplying the amount of a payment (or of each payment in a series of payments) by the probability that any contingencies will be satisfied, and then discounting that amount using an assumed rate of interest. The proposed regulations require that the present value be determined "using actuarial assumption and methods that, based on all the facts and circumstances, are reasonable as of the applicable date," without regard to whether the present value is "reasonably ascertainable" under Treasury Regulation Section 31.3121(v). This calculation ignores the probability that payment will not be made or that payment will be reduced based on adverse financial conditions of the plan or of the employer. If the date of payment is conditioned upon separation from employment, severance is generally deemed to occur on the fifth anniversary of the applicable date, unless circumstances indicate that this assumption is not reasonable.

If unreasonable assumptions are used to calculate present value, the IRS will calculate present value using methods it determines to be reasonable. However, the IRS will apply the midterm AFR, or Applicable Federal Rate, and because the AFR is considerably lower than any reasonable discount rate, this will result in the maximum acceleration of tax. The proposed regulations do not address the result if an unreasonably low discount rate is used (e.g., if an employer uses a rate of zero to avoid present value calculations). The IRS would likely view a zero discount rate as unreasonable and could take the position that amounts included in income in excess of the amount computed using the midterm AFR may not be treated as an investment in the contract because they have not been properly included in income.

b. Account Balance Plans. For an account balance plan that is credited at least annually based on a predetermined actual investment or a reasonable interest rate, the amount included in gross income will be the account balance as of the applicable inclusion date (typically, the vesting date), taking into account both principal and earnings. However, if the amounts credited to the account are not reasonable and are not based on a predetermined actual investment, as defined in Treasury Regulation Section 31.3121(v), the includible amount will be increased by the present value of the excess of the earnings to be credited under the plan over the amount that would be credited using a reasonable rate of interest. Again, if the taxpayer does not make the determination applying reasonable crediting rates, the IRS will apply the midterm AFR in making the determination.

c. Coordination With Other Inclusion Sections. The proposed regulations clarify the application of Section 457(f) to amounts that were includible in income under certain other provisions of the Code, such as Section 83 or Section 401(b). Any amounts that have not yet been included in income by reason of the application of such other Code sections will be included in income at the time that Section 457(f) would otherwise apply.

4. Recurring Part-Year Compensation. The proposed Section 457(f) regulations coordinate with the proposed Section 409A regulations to clarify that a plan or arrangement under which an employee receives recurring part-year compensation will not be considered a deferral of compensation under Section 457(f) if the arrangement does not defer payment 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) (e.g., $265,000 for 2016) for the calendar year in which the service period commences.

5. Applicability Date. With limited exceptions, the proposed regulations will apply, for calendar years beginning after the publication date of the final regulations, to existing deferrals pursuant to a binding legal right that arose during a prior calendar year and that have not previously been included in income. Thus, if the proposed regulations are finalized in their current form, all existing arrangements will need to be amended to the extent necessary to comply with the new rules no later than the end of the calendar year in which the regulations are finalized. Taxpayers may also

rely on the proposed regulations prior to the final publication date.

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