

A New Landscape

Compliance clarifications and planning opportunities for governmental and tax-exempt employers sponsoring deferred compensation arrangements

By Howard L. Clemons, Marcus Wu and Jessica Lutrin

On June 22, 2016, the Internal Revenue Service (IRS) published its long-awaited proposed regulations (the Proposed Regulations) under Section 457(f) of the Internal Revenue Code (the Code). Section 457(f) governs the taxation of ineligible deferred compensation arrangements for employees and other service providers of state and local governments and tax-exempt organizations. The Proposed Regulations clarify nagging uncertainties concerning the Section 457(f) rules, including the requirements for severance, death, disability, and leave plans to be exempt from Section 457(f). Further, the Proposed Regulations provide employers with new planning opportunities for providing deferred compensation. This advisory highlights significant parts of the Proposed Regulations. Governmental and tax-exempt employers should (i) confirm that their existing 457(f) Plans conform to the Proposed Regulations, (ii) confirm that their severance, death, disability, and leave plans qualify for exemption from Section 457(f) under the Proposed Regulations, and (iii) consider the new deferred-compensation planning opportunities offered by the Proposed Regulations.

Background

Section 457(f) governs ineligible deferred compensation plans, or “457(f) Plans.” In short, a 457(f) Plan means an arrangement that is maintained by a government or tax-exempt employer to provide—outside a tax-favored retirement plan—its employees with deferred compensation. “Tax-favored retirement plan” generally means any of the following: 457(b) plan; 401(a) plan, including 401(k) plan; or 403(b) plan.

Under Section 457(f), deferred compensation is taxable to the employee when the compensation is no longer subject to a substantial risk of forfeiture (SROF). In other words, amounts payable under a 457(f) Plan are taxable when they become vested, even if not actually paid until a later date. This substantially differs from the tax treatment of for-profit entities' deferred compensation arrangements, which if properly designed are taxable not when vested, but when paid. Further, under Section 457(f), amounts under a 457(f) Plan become vested when the employee is no longer required to complete "substantial services" in order to receive the amounts.

The following examples illustrate Section 457(f)'s tax-on-vesting rule:

Arrangements that Constitute 457(f) Plans	When Taxed Under Section 457(f)
After completing 10 years of employment, employee is entitled to five annual \$5,000 employer payments beginning in year his or her employment ends	Present value of all five \$5,000 payments taxable in calendar year that employee completes 10 years of employment regardless of whether employee's employment then ends
Under employment contract, employer agrees to provide an executive with a \$100,000 bonus, payable in annual installments over three years, if the executive remains employed through December 31 of the current calendar year	Present value of \$100,000 taxable in current calendar year if executive satisfies December 31 employment requirement
Employer promises to pay executive \$25,000 retention bonus in lump sum on five-year anniversary of date executive completes three years of continuous employment with the employer	Present value of \$25,000 taxable in calendar year that executive completes three-year employment requirement

Before the Proposed Regulations, the IRS had issued little guidance on Section 457(f), leaving many open questions that employers and advisers have struggled to navigate. Making matters worse, the IRS has promised several times over the past decade to issue guidance, but had not followed through, until now. The Proposed Regulations herald a new era under Section 457(f), clarifying several longstanding ambiguities and presenting governmental and tax-exempt employers with significant planning opportunities and flexibility for designing 457(f) Plans.

Highlights and Effective Date

The highlights of the Proposed Regulations can be categorized as either "compliance clarifications" or "planning opportunities":

Compliance Clarifications	<ul style="list-style-type: none"> • Section 409A requirements • Conditions for existence of SROF • Conditions to qualify for Section 457(f) exemption as severance, disability, leave, or death plan
Planning Opportunities	<ul style="list-style-type: none"> • Expanded definition of SROF <ul style="list-style-type: none"> ○ Non-compete covenants ○ Rolling risk of forfeiture ○ Section 457(f) exemptions ○ Short-term deferrals • Voluntary window programs

These items are further discussed below. The Proposed Regulations apply to compensation deferred under a plan for calendar years beginning after the date the IRS adopts the Proposed Regulations as final. Until then, employers may rely on the Proposed Regulations.

Compliance Clarifications

Section 409A Requirements

Reiterating the widely accepted view, the Proposed Regulations provide that unless an exemption applies, a 457(f) Plan is subject to Section 409A of the Code (Section 409A), which imposes rigorous rules relating to permitted distribution events, timing of distributions, and others. As a practical matter, most 457(f) Plans are designed to pay deferred compensation in the same calendar year in which it vests, rendering the 457(f) Plan exempt from Section 409A under Section 409A's "short-term deferral" rule. The IRS also published proposed regulations under Section 409A, which are discussed in a separate client alert published [here](#).

Substantial Risk of Forfeiture

Section 457(f) provides that payments conditioned on "the future performance of substantial services" are subject to a SROF. Beyond this, the guidance on what SROF means for Section 457(f) purposes was sparse. The Proposed Regulations elucidate the rule, providing that deferred compensation is subject to a SROF if either:

- the amount is conditioned on the future performance of substantial services (which is based on all the relevant facts and circumstances); or
- the amount is conditioned on the occurrence of a condition that is related to a purpose of the compensation if the possibility of forfeiture is substantial. A condition is related to a purpose of the compensation only if the condition relates to the employee's performance of service for the employer, or to the "employer's governmental or tax-exempt activities (as applicable) or organization goals." The quoted language clarifies that performance-based conditions are sufficient to establish a SROF. Notably, this provision would enable employers to design 457(f) Plans that condition vesting on a variety of organizational benchmarks, such as target revenues, completion of projects, or other performance criteria.

In addition, the Proposed Regulations note that an amount is not subject to a SROF if the facts and circumstances demonstrate that the forfeiture condition is unlikely to be enforced.

(Also, as before, a 457(f) Plan may accelerate vesting and payment of deferred compensation if any of the following occur before the employee satisfies the applicable SROF condition: death, disability, termination without cause, and certain other events.)

Bona Fide Severance Pay, Disability Pay, Sick Leave and Vacation Leave and Death Benefit Plans

Section 457(f) states that the following types of arrangements are exempt from Section 457(f): (1) a bona fide severance pay plan, (2) a bona fide disability pay plan, (3) a bona fide sick leave or vacation leave plan and (4) a bona fide death benefit plan. Because these plans are exempt from Section 457(f), amounts payable under these plans are taxable only when actually paid (rather than when vested). The Proposed Regulations provide much-needed guidance on the requirements to qualify for each of these exemptions. Accordingly, governmental and tax-exempt employers should review their existing severance, disability, leave, and death benefit plans to ensure that the plan complies with the requirements specified in the Proposed Regulations for the relevant exemption. If a particular plan does not qualify for an exemption, amounts payable under the plan are at risk of being taxed when vested, regardless of when the amounts are actually paid.

1. *Bona Fide Severance Pay Plan*

A bona fide severance pay plan is a plan that satisfies the following requirements:

- a. Benefits under the plan are payable only on an employee's involuntary termination of employment based on the relevant facts and circumstances (unless the program constitutes a voluntary window program). "Involuntary" termination encompasses a resignation for good reason. The Proposed Regulations provide a safe harbor definition of good reason, which is substantially similar to the safe harbor definition under Section 409A.
- b. The benefits payable may not exceed two times the employee's annualized compensation based on the annual rate of pay for services provided to the employer for the calendar year preceding the calendar year in which the employee's employment is terminated.
- c. Under the plan's written terms, the severance benefits must be paid no later than the last day of the second calendar year following the calendar year in which the termination of employment occurs.

As noted, the involuntary requirement does not apply to voluntary window programs. Nevertheless, these programs, which are further discussed below, must still satisfy requirements (b) and (c) above in order to be exempt from Section 457(f) as a bona fide severance pay plan.

2. *Bona Fide Disability Pay Plan*

A bona fide disability pay plan is a plan that pays benefits only upon an employee's disability. The Proposed Regulations provide that an employee is disabled if one of the following conditions is met: (a) the employee is unable to engage in any substantial gainful activity due to 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; (b) the employee is receiving income replacement benefits for a continuous period of at least three months under an accident and health plan for a condition described in (a); or (c) the employee is determined to be totally disabled by the Social Security Administration or the Railroad Retirement Board. This definition of disability is generally consistent with the disability definition used under Section 409A.

3. *Bona Fide Sick Leave and Vacation Leave Plans*

Whether a plan is a bona fide sick leave or vacation leave plan is based on a determination of all the relevant facts and circumstances. If the facts and circumstances demonstrate that the primary purpose of the plan is to provide employees with paid time-off from work because of sickness, vacation or other personal reasons, then the plan is generally treated as a bona fide sick leave or vacation leave plan. Factors that may be taken into account in determining whether a plan is a bona fide sick leave or vacation leave plan include, among others: (a) whether the amount of leave provided could reasonably be expected to be used by the employee in the normal course; (b) limits (if any) on the ability to exchange unused accumulated leave for cash or other benefits and applicable accrual restrictions; and (c) 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. In light of this guidance, governmental and tax-exempt employers that permit employees to voluntarily cash out leave accruals should scrutinize whether these programs are exempt from Section 457(f) as bona fide leave plans.

4. *Bona Fide Death Benefit Plan*

A bona fide death benefit plan is a plan that provides death benefits, whether directly or through insurance.

Planning Opportunities

Because Section 457(f) imposes tax on deferred compensation upon vesting, the rule severely restricts governmental and tax-exempt employers' ability to structure employee incentives tied to deferred compensation. While the Proposed Regulations do not change the tax-on-vesting rule, they do liberalize Section 457(f) by expanding the circumstances under which deferred compensation remains unvested (and therefore nontaxable) and by providing two exemptions. In doing so, the Proposed Regulations offer significant new compensation planning opportunities to governmental and tax-exempt employers.

Expanded definition of SROF

Non-compete Covenants

The Proposed Regulations provide that a covenant not to compete will constitute a SROF, but only if certain requirements are satisfied, one of which is that the employer must make reasonable ongoing efforts to verify the employee's compliance with the non-compete covenant. This would enable governmental and tax-exempt employers to, among other things, provide employees with a post-employment benefit (other than severance) conditioned on the employee's compliance with a non-compete covenant that satisfies the Proposed Regulations' requirements. Compliance notes: A non-compete covenant is not treated as a SROF under Section 409A; employers should be mindful of this difference when designing 457(f) Plans with non-compete covenants. In addition, non-compete covenants may not be enforceable under certain state laws (for example, California).

Rolling Risk of Forfeiture

Under the Proposed Regulations, a 457(f) Plan may permit the vesting (and therefore the taxation) of deferred compensation to be extended beyond the original vesting date. In other words, the Proposed Regulations permit a rolling SROF.

To roll the SROF, the Proposed Regulations require the following: (1) the benefit to be received after the extension of the SROF must be materially greater (by at least 125 percent) than the benefit before the extension; (2) the election must be made at least 90 days before the date the existing SROF would have lapsed; and (3) the SROF must be extended for at least two years.

Although the Proposed Regulations create a path to extending a SROF for purposes of Section 457(f), they do not provide relief from the payment timing rules of Section 409A. For example, under Section 409A, to extend a payment date for deferred compensation, the election to defer payment must be made at least one year before the existing payment date, and the corresponding payment must be deferred for a period of not less than five years from the originally scheduled payment date. Thus, any extension of a SROF that has the effect of changing the 457(f) Plan's distribution schedule will need to comply with these Section 409A requirements. Employers should exercise great care to ensure that a rolling SROF feature under a 457(f) Plan complies with Section 409A.

Section 457(f) Exemptions

Short-term Deferrals

The Proposed Regulations provide that a deferral of compensation is exempt from Section 457(f) if it constitutes a short-term deferral. A short-term deferral means a payment received by an employee on or before the last day of the 2 ½ month period ending on the 15th day of the third month following the later of (1) December 31 the first calendar year in which the right to the payment is vested (i.e., no longer subject to a SROF) or (2) the end of the employer's first taxable year in which the right to the payment is vested. This exemption is noteworthy because it enables employers to design deferred compensation arrangements under which compensation vests in one calendar year, but is not taxed until the next calendar year (as long as the compensation is paid in the next calendar year within the applicable 2 ½ month period). For example, assume that an employer with a 1/1 – 12/31 taxable year agrees to pay a \$5,000 bonus to an employee if he or she satisfies performance targets as of October 1, 2016. The employee achieves those targets, thereby becoming vested. The employer could pay the employee all or any portion of the \$5,000 at any time on or between October 1, 2016 and March 15, 2017. Each payment would be taxed only in the year paid.

Voluntary Window Programs

The Proposed Regulations provide governmental and tax-exempt employers with a new, but limited, opportunity to offer voluntary early retirement incentive benefits. The incentive, or window program, must satisfy three requirements: (1) the program must satisfy requirements (b) and (c) above (which govern the timing and amount of benefits payable) for bona fide severance pay plans; (2) the program must be offered for a limited period of time typically not exceeding 12 months; and (3) the employer cannot have a pattern of repeatedly providing similar programs. If these requirements are satisfied, the program would be exempt from Section 457(f) under the Proposed Regulations as a bona fide severance plan.

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or one of the following members of the Executive Compensation & Benefits practice section:

New York

Susan P. Serota [\(bio\)](#)
+1.212.858.1125
susan.serota@pillsburylaw.com

Peter J. Hunt [\(bio\)](#)
+1.212.858.1139
peter.hunt@pillsburylaw.com

James P. Klein [\(bio\)](#)
+1.212.858.1447
james.klein@pillsburylaw.com

Jessica Lutrin [\(bio\)](#)
+1.212.858.1090
jessica.lutrin@pillsburylaw.com

Benjamin Asch [\(bio\)](#)
+1.212.858.1230
benjamin.asch@pillsburylaw.com

Washington, DC / Northern Virginia

Howard L. Clemons [\(bio\)](#)
+1.703.770.7997
howard.clemons@pillsburylaw.com

Justin Krawitz [\(bio\)](#)
+1.703.770.7517
justin.krawitz@pillsburylaw.com

Los Angeles

Mark C. Jones [\(bio\)](#)
+1.213.488.7337
mark.jones@pillsburylaw.com

San Francisco

Christine L. Richardson [\(bio\)](#)
+1.415.983.1826
crichardson@pillsburylaw.com

Amber A. Ward [\(bio\)](#)
+1.415.983.1048
amber.ward@pillsburylaw.com

San Diego—North County

Marcus Wu [\(bio\)](#)
+1.858.509.4030
marcus.wu@pillsburylaw.com

Lori Partrick [\(bio\)](#)
+1.858.509.4087
lori.partrick@pillsburylaw.com

Silicon Valley

Daniel S. Stellenberg [\(bio\)](#)
+1.650.233.4070
daniel.stellenberg@pillsburylaw.com

Matthew C. Ryan [\(bio\)](#)
+1.650.233.4627
matthew.ryan@pillsburylaw.com

Pillsbury Winthrop Shaw Pittman LLP is a leading international law firm with offices around the world and a particular focus on the energy & natural resources, financial services, real estate & construction, and technology sectors. Recognized by *Financial Times* as one of the most innovative law firms, Pillsbury and its lawyers are highly regarded for their forward-thinking approach, their enthusiasm for collaborating across disciplines and their unsurpassed commercial awareness.

This publication is issued periodically to keep Pillsbury Winthrop Shaw Pittman LLP clients and other interested parties informed of current legal developments that may affect or otherwise be of interest to them. The comments contained herein do not constitute legal opinion and should not be regarded as a substitute for legal advice.

© 2016 Pillsbury Winthrop Shaw Pittman LLP. All Rights Reserved.