McDermott Will & Emery

Proposed 457(f) Regulations: Opportunities and Challenges

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Introduction

- Welcome and surprising opportunities with respect to tax-exempt and governmental entities' "ineligible nonqualified deferred compensation" arrangements in 2016 regulations.
- 2016 regulations significantly expanded 457(f) plan sponsors' ability to do the following without immediate taxation to participants:
  - Permit elective deferrals
  - Use noncompetition agreements
  - Make larger severance payments than otherwise permitted under 409A

Introduction (cont'd)

- Presentation addresses those issues and
  - Rules and limitations of the short-term deferral exception
  - The interaction of the 2016 regulations with existing regulations under Section 409A of the Internal Revenue Code
  - Other types of arrangements potentially affected by the 2016 regulations (e.g., vacation pay, flexible allowance plans)
  - Best practices

Agenda

- Short-Term Deferral Exception
- Elective Deferral Feature
- Rolling Risks of Forfeiture
- Noncompetes and Impact on Taxation
- Interplay between 409A and 457(f)
- Arrangements to Monitor
- Next steps

Short-Term Deferral Exception – New!

- Prior to Proposed Regulations, an amount earned and vested in one year was taxable in that year – no exceptions!
- Now, deferred compensation ***does not exist*** if it meets the "short term" deferral definition provided by Code Section 409A, but substituting the new definition of "substantial risk of forfeiture" under the Proposed Regulations for that of the Code Section 409A risk of forfeiture.
- The service provider must actually or constructively receives such payment on or before the last day of the applicable 2½ month period
- This means that the typical annual bonus can be fully vested in one year, but paid out and taxable early in the next year

Short-Term Deferral Exception – New!

- "An amount of compensation is subject to a substantial risk of forfeiture only if entitlement to the 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."
- Proposed regulations clarify that substantial means ***substantial*** – minor amount of required services will not work!

Elective Deferral Feature

- Elective deferrals very rare prior to 2016 regulations
  - In 2007 guidance, IRS stated: "**a rational participant normally would not agree to subject a right to amounts that may be earned and payable as current compensation, such as salary payments, to a condition that subjects the right to the same payments to a real possibility of forfeiture**."
  - No reason to defer receipt of compensation if taxation occurs when substantial risk of forfeiture expires

Elective Deferral Feature (cont'd)

- 2016 regulations permit elective deferrals if the following conditions are met:
  - The deferral election **must be made in writing before the beginning of the calendar year** in which the services will be performed and the compensation will be earned;
  - The present value of the **amount to be paid** when the substantial risk of forfeiture lapses **must be materially greater** defined as more than twenty-five percent (25%) of the amount the executive otherwise would have received absent the substantial risk of forfeiture; and
  - The executive **must provide substantial services for at least two (2) additional years** or must agree not to compete for at least two (2) additional years.

Elective Deferral Feature (cont'd)

- Example:
  - Hospital's CFO receives compensation of $500,000/yr. She wants to defer $200,000 of her 2018 compensation.
  - She elects to defer $200,000 by December 31, 2017 to be received in a lump sum in 2021.
  - Hospital provides a $60,000 "matching contribution", also received in 2021
- **Downside:** If she terminates employment other than due to an involuntary termination without cause, death or disability, she forfeits her right to receive any portion of the payment

Elective Deferral Feature (cont'd)

- What if employer doesn't want to provide an additional "matching contribution"?
- **One approach:** If employer is open to providing a retention bonus payable in a future year, coordinate the bonus with the deferral opportunity.
  - Bonus opportunity should not be agreed to or announced before the deferral opportunity is provided.
- In example above, if hospital planned to pay CFO a $60,000 retention bonus in 2021 anyway, could offer her the opportunity to defer any amount of 2018 compensation under $240,000.

Elective Deferral Feature (cont'd)

- Subsequent elective deferrals permitted
  - Similar rules apply, but subsequent deferral must occur 90 days before amount would otherwise be paid, rather than before beginning of preceding year
- Example:
  - Our CFO in the above example would otherwise receive her distribution on July 1, 2021.
  - On any date before April 2, 2021, she could elect to further defer compensation later than the July 1, 2021 date. Need to meet other rules regarding future performance of services for at least two years (i.e., earliest subsequent deferral date is July 1, 2023) and benefit more than 25% greater than existing benefit.

Rolling Risk of Forfeiture – It's Back!

- Tips:
- Identify initial elective deferral vs rolling risk of forfeiture
- Keep track of dates required to "Roll"
- 25% match is substantial – excessive compensation?
- "Roll" as long as possible so "re-Roll" not required
- If possible, use covenant not to compete as the risk of forfeiture. For example, at initial deferral, distribution is one year following separation from service contingent on non-compete satisfied through that date. In that case, employee can separate when ever he or she wants.

Use of Noncompetes
As a Substantial Risk of Forfeiture

- Question #10 of IRS Notice 2005-1 then articulated the following:
  - "…Any addition of a substantial risk of forfeiture after the beginning of the service period to which the compensation relates, or any extension of a period during which compensation is subject to a substantial risk of forfeiture, in either case whether elected by the service provider, service recipient or other person (or by agreement of two or more of such persons), is disregarded for purposes of determining whether such compensation is subject to a substantial risk of forfeiture. **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**." (**emphasis added**)

Use of Noncompetes As a Substantial Risk of Forfeiture

- Additionally, IRS Notice 2007-62 then stated:
  - "This notice announces the intent of the Treasury Department (Treasury) and the Internal Revenue Service (Service) to issue guidance under § 457, which applies to nonqualified deferred compensation plans of state and local governments and tax-exempt entities, concerning the definitions of a bona fide severance pay plan under § 457(e)(11) and concerning the definition of substantial risk of forfeiture under § 457(f)(1)(B). This notice also describes the guidance that the Treasury and the Service anticipate issuing, **which in many respects would be similar to the rules in the recent final regulations under § 409A**, and requests comments on the issues intended to be addressed by such guidance." (**emphasis added**)

Use of Noncompetes As a Substantial Risk of Forfeiture

- The Proposed Regulations now clarify that noncompetes can be utilized as a substantial risk of forfeiture in the following situations:
  1. The executive's right to the compensation **must be specifically conditioned in writing** on the refraining from performing future services **and** the **noncompete must be enforceable** under applicable law;
  2. The tax-exempt entity must make reasonable efforts to verify the executive's compliance with the noncompete; and
  3. Regardless of any other factors, the facts and circumstances **must demonstrate that the tax-exempt entity has a "bona fide interest"** in ensuring that the executive is prevented from performing services **and** that the **executive has a "bona fide interest"** in his/her ability to engage in performing services.

Use of Noncompetes
As a Substantial Risk of Forfeiture

- **Challenges**
  - Developing procedures to appropriately monitor and document executive activities post-termination.
  - The “bona fide interest” requirements may pose a new challenge with respect to aging executives (e.g., may be harder to demonstrate that older executives have a legitimate interest in continuing to work or have a true financial need to work). These criteria will be evaluated from both the executive’s viewpoint and the tax-exempt entities’ viewpoint.

Use of Noncompetes
As a Substantial Risk of Forfeiture

- **Solution**: Since many executives receiving severance pay are likely subject to noncompetition restrictions anyway, the tax-exempt entity can piggyback off of these prior procedures, but strengthen them for Code Section 457(f) compliance purposes. Periodic written verification from the executives will be critical, but independent monitoring by the tax-exempt entity beyond this will likely be necessary as proof of reasonable efforts (e.g., monitoring Facebook pages, Google searches, etc.).

Use of Noncompetes
As a Substantial Risk of Forfeiture

- **Opportunity Presented**
  - Ability to continue tax deferral post-termination is viewed as valuable by many executives (notwithstanding that they are an unsecured creditor of the tax-exempt entity).
  - Further, nonpayment of deferred amounts for violation of the noncompete does provide significant leverage for the tax-exempt entity. Because the substantial risk of forfeiture will not lapse until the end of the noncompetition period, it offers a significant reprieve period following an executive's departure.
  - Potentially provide longer deferral periods versus time-based vesting currently being used.

Interplay Between Code Section 457(f) And Code Section 409A

- Primarily concern is where 457(f) and 409A provisions govern similar situations but have different rules
- Two areas of focus:
  - Separation pay arrangements
  - Noncompetition agreements
- Certain payments made on an involuntary separation from service are exempt from Section 457(f)
  - This allows separation payments to be made over a period of time and not be taxed immediately

Interplay Between Code Section 457(f) And Code Section 409A (cont'd)

- To qualify for 457(f) exception, separation from service:
  - Must be "**involuntary**";
  - Be **paid by the end of the second calendar year following the separation from service**; and
  - Generally **not exceed 2X annualized rate of pay** for prior year.
- Similar requirements to meet 409A exception, but maximum amount payable also cannot exceed two times an annual limit under the Code ($540,000 in 2017).

Interplay Between Code Section 457(f) And Code Section 409A (cont'd)

- Back to the CFO we discussed earlier with 2018 compensation of $500,000. Assume her annualized rate of pay is $400,000.
- If she terminates employment involuntarily in 2019 and is entitled to receive continued compensation payments for two years after her employment termination, she'd be entitled to $800,000.
- Amounts in excess of two times annual Code limit exempt from 457(f), but not 409A.

Interplay Between Code Section 457(f) And Code Section 409A (cont'd)

- **Solution #1:** Use 409A short-term deferral exception and provide that amounts in excess of 2x annual limit will be paid during short-term deferral period.
  - Sample language: "If your total severance payment exceeds two times the limit under Section 401(a)(17) of the Code (the "401(a)(17) Limit") for the year in which your separation from service occurs, your severance shall be paid in separate payments. One payment shall be a lump sum payment equal to the payment you are due under the Plan in excess of two times the 401(a)(17) Limit. This amount shall be paid by March 15 of the year following the year in which your employment terminated. The remaining amount shall be paid as a series of periodic payments payable in equal monthly installments during the twenty-four month period beginning in the month next following the 30th day after your separation from service. All payments under this subsection shall be treated as a series of separate payments under Treasury Regulations Section 1.409A-2(b)(2)(iii)".

Interplay Between Code Section 457(f) And Code Section 409A (cont'd)

- **Solution #2:** Structure payments in excess of two times the 401(a)(17) Limit to be 409A compliant fixed-date payments.
- **Solution #3:** Don't pay more than two times 401(a)(17) Limit. Remember not-for-profits want to rely on the rebuttable presumption of reasonableness so ensure that an understanding is obtained for severance within the respective peer group.
- Payments should be designated "separate payments" under 409A regardless of which approach is taken.

Interplay Between Code Section 457(f) And Code Section 409A (cont'd)

- Noncompetition agreements which meet the requirements we've discussed are 457(f)-exempt
- Noncompetition agreements meeting those requirements are not 409A-exempt, meaning they must comply with it
- Be aware of potential interactions
  - Example: If a noncompetition agreement is being used to roll a risk of forfeiture for an amount that has already been deferred, payment timing must comply with 409A subsequent deferral rules

Arrangements to Monitor

- Vacation Pay
  - Determination of whether a sick or vacation leave plan is a “bona fide sick or vacation leave plan” is made based on the relevant facts and circumstances.
  - However, the Proposed Regulations provide that a plan is treated as a “bona fide sick or vacation leave plan” (and not an arrangement to defer compensation), if the **facts and circumstances demonstrate that the primary purpose of the plan is to provide participants with paid time off from work because of sickness, vacation,** or other personal reasons.

Arrangements to Monitor…continued

- Vacation Pay
  - The six (6) factors used in determining whether a plan is a “bona fide sick or vacation leave plan” include:
    1. Whether the **amount of leave provided could reasonably be expected to be used in the normal course** by an employee (before the employee ceases to provide services to the eligible employer) absent unusual circumstances;
    2. **The ability to exchange unused accumulated leave for cash** (i.e., commonly referred to as PTO cashouts) or other benefits (including nontaxable benefits and the use of leave to postpone the date of termination of employment);
    3. **The applicable restraints (if any) on the ability to accumulate unused leave** (such as placing a cap on the amount that can be accrued and not used) and carry it forward to subsequent years in circumstances in which the accumulated leave may be exchanged for cash or other benefits;

Arrangements to Monitor…continued

- Vacation Pay Continued…
    4. The **amount and frequency of any in-service distributions of cash or other benefits offered in exchange for accumulated and unused leave**;
    5. Whether any **payment of unused leave is made promptly upon severance** from employment (or instead is paid over a period after severance from employment); and
    6. Whether the program (or a particular feature of the program) is **available only to a limited number of employees**.

Arrangements to Monitor…continued

- Vacation Pay Continued…
  - If PTO accrual policies permit a significant accrual of PTO hours such that it is extremely unlikely to be used “in the normal course” by the employee and would further guarantee a large payment of cash to the employee to settle or reduce the accumulated PTO hours, then perhaps the arrangement “smells” more like a deferred compensation plan than a “bona fide sick or vacation leave” plan.

Arrangements to Monitor…continued

- Elimination of Potential Flexible Allowance Plans
  - A final provision that is somewhat buried within the Proposed Regulations states the following
    - "(4) *Income inclusion when compensation is paid or made available*. Amounts paid or made available to a participant or beneficiary under an ineligible plan are includible in the gross income of the participant or beneficiary under section 72, relating to annuities….**An amount is also paid or made available for this purpose if there is** a transfer, cancellation, or **reduction of an amount of deferred compensation in exchange for benefits under a welfare benefit plan**, a fringe benefit excludible under section 119 or section 132, or any other benefit that is excludible from gross income." **(emphasis added)**

Arrangements to Monitor…continued

- Elimination of Potential Flexible Allowance Plans
  - Some tax-exempt entities have historically offered a type of arrangement under Code Section 457(f) that is designed to provide a slate of alternative benefits to their executives, sometimes referred to a “flexible benefit allowances.”
  - Executives then have either deferred their own base salary or alternatively use an employer contribution made to the Code Section 457(f) plan to “exchange” the contribution being made in order to acquire additional benefits such as: life insurance, death benefits for surviving spouses, long-term disability coverage, long-term care coverage, conversion to an auto allowance, etc.

Arrangements to Monitor…continued

- Elimination of Potential Flexible Allowance Plans
  - In these situations, the executive achieves a tax deferral on the compensation or contribution, but then equally converting it into a benefit that ultimately might not be taxable or includable in income.
  - The Proposed Regulations appears to be directing that plans which offer these features will no longer be considered “tax deferred” plans but instead will be construed as making the compensation or employer contribution available to the executive to purchase the welfare benefits and hence, making these amounts “available” to the executive and therefore, subject to immediate taxation.

Next Steps for Elective Deferrals

- **STEP #1:** Determine how new benefit will be delivered: (a) whether the employer will piggyback this new benefit by adding it to an existing Code Section 457(f) plan; or (b) whether a new Code Section 457(f) plan will be used for offering this new benefit.
- **STEP #2:** Determine how much of a tandem employer contribution will be provided in order to achieve the "materially greater" standard of more than twenty-five percent (25%).
- **STEP #3:** Determine whether the addition of the tandem employer contribution in STEP #2 requires any adjustment or reduction to any other nondiscretionary executive benefit provided to the executive so that the executive's total compensation package stays within the appropriate reasonable compensation provisions.
- **STEP #4:** Because voluntary deferral elections must be made in writing **before the beginning of the calendar year in which the services will be performed and the compensation will be earned**, this is done in conjunction with the beginning of a new plan year.

Next Steps for Rolling Risks or Noncompetes

- **STEP #1:** Determine whether any substantial risks forfeiture used under a Code Section 457(f) plan can be retroactively replaced with either the rolling risk of forfeiture or noncompete substantial risk of forfeiture or whether the introduction of these new substantial risks of forfeitures must only be prospective . For a substantial risk of forfeiture currently at play and being used under a Code Section 457(f) plan, converting it or changing it to either a rolling risk of forfeiture or noncompete substantial risk of forfeiture requires an evaluation to determine whether the "subsequent change" to the vesting date violates any of the new provisions under the Proposed Regulations but also whether it violates any of the provisions of Code Section 409A (e.g., re-deferrals are required by Code Section 409A to be for a minimum of five (5) years).
- **STEP #2:** Determine the amount of administrative support that the tax-exempt entity can provide to operate and administer the revised substantial risk of forfeiture provisions of the Code Section 457(f) plan.

Next Steps for Rolling Risks or Noncompetes

- **STEP #3:** Determine whether the addition of the new substantial risk of forfeiture under the Code Section 457(f) plan works counter to any provisions or benefits offered under any employment or severance arrangement and if so, what changes are necessary.
- **STEP #4:** Establish written procedures for : (1) securing timely ninety (90) day advance elections for rolling risks of forfeiture extensions, (2) monitoring and verifying noncompete compliance by executives; and (3) coordination of any interplay between Code Section 457(f) and Code Section 409A where application of both provisions requires something above and beyond the Code Section 457(f) basic requirements.

Next Steps on Severance

- Review all severance arrangements which are based on any involuntary termination without cause or voluntary resignation with good reason and ensure those arrangements are in writing and meet the new requirements of the Code Section 457(f) “bona fide severance pay plans” (pertaining to circumstances for the severance from amount as well as the total amount to be paid and when) to maximize the potential exemption from both the application of Code Section 457(f) and Code Section 409A.

Next Steps PTO

- Determine whether design would fall within or outside the above factors for qualifying as a “bona fide sick or vacation leave” plan (and therefore, exempt from the application of Code Section 457(f)).
  - If current design contains several features that would cause it to fall outside of a “bona fide sick or vacation leave” plan (e.g., excessive carryovers with no cap, frequency of the availability of PTO cashout options, etc.), the entity may want to discuss with legal counsel the best way in which to make adjustments to the existing policy to ensure its satisfaction of the new definition under the Proposed Regulations.

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Questions?

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