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Executive Compensation for Tax Exempt and Governmental Employers: Unraveling New Proposed Regulations on Non-Qualified Deferred Compensation Under Section 457

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Nearly 40 years ago, Congress concluded that because tax-exempt employers are not subject to taxation, they are more inclined (more so, at least, than taxable employers) to provide non-qualified deferred compensation to their employees. As a result, Congress passed Section 457 of the Internal Revenue Code (Section 457) to limit the amount of deferred compensation a tax-exempt employer may promise to its employees. Now, the IRS has proposed new regulations that will greatly impact non-qualified deferred compensation plans maintained by tax-exempt employers under Section 457. Here are our key takeaways from the proposed regulations.

Background on Section 457 Arrangements

Section 457 generally separates non-qualified deferred compensation arrangements into two types of programs and regulates these two types of plans in different ways.

1. Eligible Plans: if a deferred compensation program is designed to look much like a 401(k) plan and provides limited benefits (capped at $18,000 in 2016), the arrangement is subject to Section 457(b) which allows the deferred amounts to avoid taxation until distributed to the employee.
2. Ineligible Plans: if a deferred compensation arrangement provides larger or different benefits than those permitted under eligible plans, the arrangement is likely subject to Section 457(f) which means that the deferred amounts become taxable when they are no longer subject to a substantial risk of forfeiture (i.e., when they become vested).

The newly proposed IRS regulations will significantly affect ineligible plans.

Substantial Risk of Forfeiture Is the Name of the Game

In an attempt to even the playing field with taxable employers not subject to Section 457(f), tax-exempt employers often pushed the envelope with ineligible plans by using various tactics to delay the vesting date of deferred compensation. These tactics created uncertainty regarding what constitutes a substantial risk of forfeiture. The proposed Section 457 regulations address these important 457(f) design tactics in a mostly favorable way for tax-exempt employers:

A. Current Compensation Deferrals

The IRS currently takes the position that salary deferrals cannot be made to ineligible plans because such amounts are already vested when they go into the plan. In other words, they cannot escape taxation at the time of deferral. Under the proposed Section 457 regulations, employees may defer current compensation if the following requirements are met:

1. The employer must provide a match of more than 25% of the amount the employee contributes.
2. The employee must commit to provide additional substantial services for at least two years in order to receive both the deferral and the match.
3. The deferral election must be made in writing and document the employee's agreement to continue service. To defer current compensation, the deferral election must be made prior to the beginning of the year to which the compensation relates.

B. Rolling Risk of Forfeiture

Historically, some ineligible plans were designed to allow the employer and employee to agree to push out the vesting date of an amount payable under the arrangement (and thereby push out the time of taxation), referred to as rolling the risk of forfeiture. But practitioners worried that by pushing out the vesting date, the arrangement became subject to, but did not comply with, Section 409A, which would make the compensation taxable.

The proposed regulations will legitimize the practice of rolling the risk of forfeiture, provided that the election to push out the vesting date occurs at least 90 days prior to the date the compensation would have otherwise vested. The election to roll the risk of forfeiture also must otherwise comply with the general requirements applicable to deferring current compensation, as summarized in paragraph A above.

C. Non-Competes

Another tactic employers utilize to push out the vesting date of an ineligible plan in order to defer taxation of compensation is to condition the amounts payable under the ineligible plan on the employee adhering to the terms of a non-compete. Like the rolling risk of forfeiture, this practice too was called into question under Section 409A because Section 409A does not recognize non-competes as creating a substantial risk of forfeiture. If implemented, the proposed Section 457 regulations will legitimize this practice as well, subject to the following requirements:

1. The right to the compensation must be clearly tied to adherence to the terms of the non-compete.
2. The employer must make reasonable and regular efforts to verify adherence to the non-compete requirements.
3. The facts and circumstances must support a bona fide interest of the employer in subjecting the employee to a non-compete and a bona fide interest of the employee, and the ability of the employee, to otherwise compete.

Section 409A and Section 457(f) Interaction

The proposed regulations clarify that an arrangement subject to Section 457(f) will also be subject to Section 409A unless the arrangement is separately exempt from Section 409A. Typically, an ineligible plan will be exempt from Section 409A under the short-term deferral rule, which generally provides that amounts paid shortly after becoming vested are exempt from Section 409A.

Importantly, when determining whether an ineligible plan is exempt from Section 409A under the short-term deferral rule, the Section 409A definition of a substantial risk of forfeiture is used. This is significant because the salary deferral rule, rolling risk of forfeiture rule, and non-compete rules discussed above will likely not satisfy the Section 409A short-term deferral rule.

The takeaway is that ineligible plans designed around these types of tactics will need to comply with both Section 457 and Section 409A. Newly issued Section 409A rules suggest that an ineligible plan will comply with Section 409A even if the plan utilizes a non-compete or rolling risk of forfeiture so long as the plan includes the promised amount in income on the date the arrangement vests under Section 457(f).

Bona Fide Severance Pay Plans

Although Section 457 identifies bona fide severance pay plans as exempt from the requirements of Section 457, neither the statute nor previous regulations define what constitutes a bona fide severance pay plan. This has left tax-exempt employers wondering if a particular severance arrangement could be subject to Section 475(f).

The proposed Section 457 regulations clarify how to structure bona fide severance pay plans to be exempt from Section 457 by borrowing heavily from the Section 409A separation pay plan rules. The following are the key requirements of a bona fide severance pay plan that is exempt from Section 457:

1. Severance must be paid only on an involuntary termination of employment (including a good reason resignation by the executive) or pursuant to a reduction in force window program.
2. Severance payments may not exceed two times the executive's

prior year rate of pay.

3. Severance payments must be paid no later than the end of the second calendar year following the year of the involuntary termination.

Applicability Dates

The proposed regulations must be finalized before they will go into effect, but the effective date could be as early as January 1, 2017. Once effective, the regulations will apply to all new arrangements **and** to pre-existing arrangements where the promised benefits have not yet become taxable.

Next Steps

Because of the retroactive application of the proposed regulations, tax-exempt employers should begin now to take an inventory of all deferred compensation programs that are not clearly designed to comply with the qualified plan rules (Sections 401(a), 401(k), 457(b) and 403(b)). Once these plans have been identified, employers should work with counsel to determine whether any of these plans require modification to comply with 457(f) or to comply with the bona fide severance pay plan requirements to ensure these plans are exempt from or comply with Section 457 and Section 409A.

If you have any questions about the proposed regulations, please contact any member of the Holland & Hart Employee Benefits Group, or feel free to contact the Holland & Hart attorney with whom you typically work.

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