Insight

IN-DEPTH DISCUSSION

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IRS Issues Proposed Regulations Under Code Section 457 Affecting Deferred Compensation Plans of Tax-Exempt Organizations

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The Internal Revenue Service recently issued proposed regulations under Section 457 of the Internal Revenue Code (the "Code") that prescribe rules regarding deferred compensation plans sponsored by state and local governments and tax-exempt organizations. These regulations relate primarily to the taxes imposed (under Code Section 457(f)) on the organization at the time the individual's right to compensation vests, without regard to actual time of payment.

The proposed regulations provide greater clarity in areas that were previously unclear, including what arrangements will be treated as a deferral of compensation, what constitutes a substantial risk of forfeiture (relating to when a participant's rights are considered vested), and the requirements for certain plans to fall outside the scope of Section 457.

Deferral of Compensation

The proposed regulations define a "deferral of compensation" in much the same way as do the Code Section 409A regulations. Specifically, there must be a legally binding right during one taxable year to compensation that is or may be payable in a later taxable year.

The proposed regulations also provide that a deferral of compensation will not occur if the arrangement would be exempt from Code Section 409A under the short-term deferral rules, but applying the Code Section 457 regulatory definition of "substantial risk of forfeiture" rather than the definition in the Code Section 409A regulations.

Substantial Risk of Forfeiture

The proposed regulations generally provide that, for purposes of Code Section 457, an amount is subject to a substantial risk of forfeiture only if entitlement to the payment is conditioned on either (1) the future

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performance of substantial services; or (2) the occurrence of a condition that is related to the purpose of the compensation. As to the second of these, the possibility of forfeiture must be substantial. The proposed regulations provide more specific guidance on whether compliance with a non-compete provision can be treated as a substantial risk of forfeiture and whether an existing substantial risk of forfeiture can be extended.

Non-Compete Provision

A non-compete provision will not be treated as giving rise to a substantial risk of forfeiture unless the following conditions are satisfied:

- There must be a written agreement that is enforceable under applicable law;
- The employer must make reasonable efforts to verify compliance with all of its non-compete agreements; and
- Under the facts and circumstances (1) the employer has a bona fide interest in preventing the employee from competing, and (2) the employee must have a bona fide interest in and ability to engage in the competitive activities.

Extension of Existing Substantial Risk of Forfeiture

The proposed regulations allow for an extension of substantial risk of forfeiture subject to the following requirements:

- The present value of the compensation in question must be more than 125% of the present value of the compensation that would have been paid following the original vesting date;
- The employee must be required to perform substantial future services, or refrain from competitive activities for at least two years from the original vesting date; and
- There must be a written agreement in place at least 90 days before the original vesting date.

Bona Fide Plans Treated as Not Providing for Deferral of Compensation

Section 457(e)(11) provides that certain bona fide plans, including severance pay, death benefit, disability pay, vacation and sick leave plans, are treated as not providing for the deferral of compensation for purposes of Section 457. The proposed regulations provide greater clarity on the relevant requirements.

Bona Fide Severance Pay Plans

The proposed definition of bona fide severance pay plan closely follows the definition found in the Code Section 409A regulations. In particular, a severance pay plan must:

- Only pay benefits due to an involuntary severance (or voluntary severance for good reason), or under a window program or voluntary early retirement incentive plan;
- The amount payable under the plan may not exceed two times the individual's annual compensation; and
- The severance benefits must be paid no later than the last day of the second calendar year following the individual's severance from employment.

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The proposed regulations provide a safe harbor definition of good reason, which is satisfied if the following requirements are met:

- The severance occurs within two years of the time that one of the following events occur without the consent of the participant:
  - A material diminution in the participant's base compensation;
  - A material diminution in the participant's authority, duties or responsibilities;
  - A material diminution in the authority, duties or responsibilities of the supervisor to whom the participant is required to report;
  - A material diminution in the budget over which the participant retains authority;
  - A material change in the geographic location at which the participant is to perform services; or
  - Any other action or inaction that constitutes a material breach of the individual's employment agreement;
- The above conditions are specified in writing by the time the right to payment is triggered;
- The amount, time and form of payment is substantially the same as would apply to an actual involuntary severance from employment; and
- The participant is required to provide notice of the good reason condition to the employer within 90 days after the occurrence of the condition, and the employer must be provided at least 30 days to cure the condition.

Bona Fide Death Benefit Plan

A plan will be treated as a bona fide death benefit plan if it is providing death benefits as defined in the regulations under Code Section 3121(v)(2).

Bona Fide Disability Pay Plan

A bona fide disability pay plan is a plan that pays benefits only if a participant is disabled. Under this rule, the participant is considered disabled if:

- The participant is unable to engage in any substantial gainful activity due to a medically determinable physical or mental impairment that is expected to last at least 12 months or to result in the participant's death;
- The participant has received income replacement benefits for at least three months under the employer's accident or health plan for a condition described in the preceding bullet; or
- The participant is determined to be totally disabled by the Social Security Administration or the Railroad Retirement Board.

Bona Fide Vacation and Sick Leave Plans

The proposed regulations provide that a plan will be treated as a bona fide vacation or sick leave plan if the facts and circumstances show that the primary purpose of the plan is to provide employees with paid time off. Some of the factors taken into account when making this determination include whether the amount of leave granted can reasonably be expected to be used during employment, whether there are reasonable limits on accruals under the plan, and whether the plan is provided only to a limited number of employees.

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Recommendations

The proposed regulations become effective for calendar years beginning after the regulations are finalized, which could take years. Plan sponsors, however, may rely on the proposed regulations until that time. Tax-exempt employers should have their executive compensation counsel review their existing plans and arrangements, including employment contracts, deferred compensation agreements, incentive compensation plans, severance plans and agreements, and leave programs, to ensure they comply with the proposed regulations.

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