

Employee Benefits

New IRS Proposed 457(f) Regulations Provide Nonqualified Deferred Compensation Opportunities for Executives of Tax Exempt Entities

Mark E. Bokert and Alan Hahn

On June 22, 2016, nine years after promising to do so, the Internal Revenue Service (IRS) issued long-awaited guidance on deferred compensation arrangements for tax-exempt non-profit and governmental employees under Section 457(f) of the Internal Revenue Code of 1986, as amended (the Code) in the form of proposed regulations (the Proposed Regulations).¹ As expected, in many ways the Proposed Regulations mirror requirements under Section 409A of the Code. However, the Proposed Regulations include a new definition of substantial risk of forfeiture, which provides significantly more flexibility than the definition under Section 409A. Additionally, the Proposed Regulations allow for continued extensions of the substantial risk of forfeiture, thereby extending the deferral period, if certain conditions are satisfied. The Proposed Regulations will apply to compensation deferred for calendar years beginning after the publication of the final regulations. However, employers may rely on the Proposed Regulations until the applicability date. Employers will want to work with their legal counsel to understand the nuances of the Proposed Regulations to determine whether any of their nonqualified deferred compensation arrangements may benefit from the greater flexibility offered under the Proposed Regulations and whether there are opportunities to design new programs for their executives.

Background

Employees of tax-exempt entities can generally elect to defer compensation under two types of non-qualified deferred compensation

Mark E. Bokert is a partner and co-chairs the Benefits & Compensation Practice Group of Davis & Gilbert LLP. His practice encompasses nearly all aspects of executive compensation and employee benefits, including matters related to equity plans, deferred compensation plans, phantom equity plans, qualified retirement plans, and welfare plans. Mr. Bokert may be contacted at mbokert@dglaw.com. Alan Hahn is a partner and co-chairs the Benefits & Compensation Practice Group of Davis & Gilbert LLP. His practice is devoted to advising clients of all sizes, including in the design and implementation of a wide variety of creative, unique, and tax-effective employee benefit plans and programs. Mr. Hahn may be contacted at ahahn@dglaw.com.

plans: (i) an eligible plan under Section 457(b) of the Code, and (ii) an ineligible plan under Section 457(f) of the Code.

Section 457(b) plans have limits on the amount of compensation (and any matching contributions from employers) that participants are allowed to defer annually (for 2017, \$18,000 plus \$6,000 for participants age 50 or older). Section 457(b) plan participants can exclude the deferred compensation or contributed amounts from their gross income until these amounts are paid or otherwise made available to the participant in the case of a plan of a tax-exempt entity.²

Deferred compensation plans that fail to satisfy the Section 457(b) plan requirements (*e.g.*, by exceeding the annual deferred compensation limit) are ineligible plans and are subject to Section 457(f) of the Code. Section 457(f) plans differ in two primary respects from Section 457(b) plans. First, there is no limit on the amount that can be deferred annually. Second, the deferred amounts in Section 457(f) plans are included in the participant's gross income when the participant obtains a legally binding right to the compensation and the compensation is no longer subject to a substantial risk of forfeiture.³

Section 457(f) only applies to the extent that a plan provides for the deferral of compensation. A deferral of compensation exists where a participant has a legally binding right to compensation that is or may be payable in a later taxable year. A participant generally does not have a legally binding right to compensation to the extent that it may be unilaterally reduced or eliminated by the employer after the services creating the right have been performed.⁴

Short Term Deferrals

The Proposed Regulations incorporate the short-term deferral exemption language from Section 409A with the exception that the exemption applies the Proposed Regulations' definition of substantial risk of forfeiture.⁵ This means that a payment is not treated as deferred compensation (and therefore the compensation is not subject to Section 457(f)) if the compensation is required to be paid, and the participant actually or constructively receives the payment, on or before the 15th day of the third month following the end of the tax year (of either the employer or the employee, whichever is later) in which the legally binding right to the compensation arose or, if later, the date the employee's right to the payment is no longer subject to a substantial risk of forfeiture.⁶

Substantial Risk of Forfeiture

Although the definition of a substantial risk of forfeiture is critical for Section 457(f) plans, no definition was included in Section 457 of the Code. Without any clear guidance on how to interpret a Section 457(f)

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substantial risk of forfeiture, employers have historically relied on the definitions found in the regulations for Sections 83 and 409A of the Code.

The Proposed Regulations' definition of substantial risk of forfeiture generally follows the definition from Section 409A. Under the Proposed Regulations,

[a]n 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.⁷

The facts and circumstances of each situation will dictate whether or not an amount is considered subject to a substantial risk of forfeiture.

A condition on the future performance of substantial services would constitute a substantial risk of forfeiture if the hours required to be performed are substantial in relation to the amount of compensation.⁸ Additionally, the Proposed Regulations define a "condition related to a purpose of the compensation" as a condition related to the participant's performance of services for the employer or to the employer's governmental or tax-exempt activities or organizational goals.⁹ The Proposed Regulations further require the likelihood of the forfeiture condition occurring to be substantial. In assessing the likelihood of the forfeiture condition occurring and actually being enforced, the Proposed Regulations apply a facts and circumstances analysis based on the past practices of the employer, the level of control or influence of the employee with respect to the organization and the individual who would be responsible for enforcing the forfeiture, the enforceability of the provisions under applicable law, and other relevant factors.¹⁰ After reviewing the individual circumstances, it can be determined whether or not the compensation is truly subject to a substantial risk of forfeiture.

The parties must generally agree to the addition of a substantial risk of forfeiture in writing before the beginning of the calendar year in which the services giving rise to the compensation are to be performed.¹¹ If an employee was not providing services in the prior calendar year, then the agreement must be entered into within 30 days after commencement of employment, but can only apply to amounts attributable to services performed after the agreement is executed.¹²

While the above requirements for a substantial risk of forfeiture are substantially similar to the requirements under Section 409A and should therefore be familiar to employers, the Proposed Regulations provide for some important differences from Section 409A's requirements. In particular, the Proposed Regulations provide that compliance with a non-compete agreement may constitute a substantial risk of forfeiture and also allow for a rolling risk of forfeiture. These provisions are discussed more fully below.

Non-Compete Agreements

In order for compliance with a non-compete agreement to be considered a substantial risk of forfeiture, the non-compete agreement must be in writing, the employer must have a substantial and bona fide interest in preventing the employee from performing the prohibited services, the employee must have a bona fide interest in, and ability to, engage in the prohibited competition, and the employer must make reasonable ongoing efforts to verify the employee's compliance with the agreement.¹³ The Proposed Regulations are consistent in mandating that non-compete agreements can only be considered a substantial risk of forfeiture if a risk of competition truly exists based on the applicable facts and circumstances.

Factors to be taken into account in determining whether the employer has a substantial and bona fide interest in preventing the employee from performing the prohibited services include the employer's ability to show significant adverse economic consequences that would likely result from the prohibited services. In determining whether the employee has a bona fide interest in, and ability to, engage in the prohibited competition, factors to consider include the marketability of the employee based on specialized skills, reputation, or other factors and the employee's interest, financial need, and ability to engage in the prohibited competition.¹⁴ For example, if the employee has no interest in competing with his or her prior employer as demonstrated by his or her desire to retire or go back to school to enter a new field, his or her non-compete agreement would not be treated as a substantial risk of forfeiture. Similarly, if the employee held an easily replaceable position with his or her previous employer, then his or her employer will have difficulty demonstrating a significant economic impact if the employee takes a position with a competitor, which means the non-compete agreement would not be considered a substantial risk of forfeiture.

Some non-compete agreements could fail the substantial risk of forfeiture classification due to employers not having adequate resources or procedures in place to verify compliance, which renders the non-compete agreements ineffective. Employers must also ensure that their non-compete agreements are enforceable under local law, so that they can be actionable in order to create the substantial risk of forfeiture.

Rolling Substantial Risk of Forfeiture

The Proposed Regulations also allow for an existing substantial risk of forfeiture to be extended, which is commonly referred to as a rolling substantial risk of forfeiture, under certain conditions.¹⁵ First, the present value of the amount to be paid upon lapse of the extended substantial risk of forfeiture must be at least 125 percent of the amount that the participant would have received absent the extension of the substantial

risk of forfeiture.¹⁶ The present value is determined as of the date of the extension, not the ultimate date of receipt, meaning that subsequent gains in the amount are not relevant in determining whether the 125 percent threshold is satisfied. This means that if, as of the date the initial risk of forfeiture would have lapsed, the value of the deferred compensation is \$100,000, the present value of the amount subject to the extension must be at least \$125,001.¹⁷ Second, the extended substantial risk of forfeiture must be based upon the future performance of substantial services or compliance with a non-compete agreement.¹⁸ Third, in order to constitute a substantial risk of forfeiture, the employee must be required to perform substantial services for a period of two years after the employee could otherwise have received the compensation in the absence of the existence of the substantial risk of forfeiture, though this requirement can lapse in the event of death, disability, or an involuntary separation from service. Fourth, the agreement subjecting the amount to an extended substantial risk of forfeiture must be made in writing at least 90 days prior to the date on which an existing substantial risk of forfeiture would have lapsed absent the extension.¹⁹

Determination of Present Value

The rules for determining present value for purposes of Section 457(f) are similar to the rules under Section 409A. However, whereas Section 409A determines present value as of the end of the employee's tax year, Section 457(f) determines present value as of the applicable date.²⁰ In general, present value is determined by multiplying the amount of the payment (or the amount of each payment in a series of payments) by the probability that any condition or conditions on which the payment is contingent will occur and discounting the amount using an assumed rate of interest to reflect the time value of money.²¹ However, the rules for determining the present value for purposes of Section 457(f) vary depending on the nature of the deferred compensation. As such, employers will want to confer with their legal counsel and accountants in making any determination with respect to the present value of deferred compensation.

Conclusion

Now that the IRS has issued the Proposed Regulations, employers and plan sponsors should work with their legal counsel to determine how the Proposed Regulations may impact their deferred compensation arrangements. While the IRS is still seeking comments on the Proposed Regulations, employers can nevertheless rely on them in drafting their deferred compensation arrangements. Employers should familiarize themselves with the rules, including the greater flexibility offered under

Section 457(f) as opposed to Section 409A, and will want to work with legal counsel to ensure that maximum flexibility is retained while ensuring compliance.

Notes

1. 81 Fed. Reg. 40,548.
2. Treas. Reg. § 1.457-7.
3. 26 U.S.C. 457(f)(1).
4. Prop. Treas. Reg. § 1.457-12(d)(1).
5. *Id.* at (d)(2).
6. Treas. Reg. § 1.409A-1(b)(4).
7. Prop. Treas. Reg. § 1.457-12(e)(1)(i).
8. *Id.* at (e)(1)(ii).
9. *Id.* at (e)(1)(iii).
10. *Id.* at (e)(1)(v).
11. *Id.* at (e)(2)(iv).
12. *Id.*
13. *Id.* at (e)(1)(ii)(A)-(B).
14. *Id.*
15. *Id.* at (e)(2)(i).
16. *Id.* at (e)(2)(ii).
17. *See, id.* at (e)(3).
18. *Id.* at (e)(2)(i).
19. *Id.* at (e)(2)(iv).
20. *Id.* at (c)(1)(v).
21. *Id.* at (c)(1)(i).