NON-QUALIFIED DEFERRED COMPENSATION PLANS OF TAX-EXEMPT AND GOVERNMENTAL ENTITIES

Background

Non-qualified deferred compensation plans maintained by tax-exempt or state or local governmental entities, other than certain "eligible" deferred compensation plans, are subject to special, and often surprising, federal income tax rules under Internal Revenue Code ("Code") section 457(f). These plans, commonly known as "ineligible 457(f) plans," or just "457(f) plans," offer tax-exempt and governmental employers the ability to compensate their senior officers and high level management employees on a basis that is generally unrestricted in terms of who is covered by such plans and the amount of compensation provided.

Compensation deferred under a 457(f) plan is includible in the plan participant's taxable income on the later of the date when the participant obtains a legally binding right to the compensation or the date the right to receive the compensation is no longer subject to a "substantial risk of forfeiture." Thus, depending on the terms of the 457(f) plan or arrangement, amounts may be taxable to the participant in a taxable year prior to the taxable year in which the amount is paid.

New IRS Proposed Rules Under Code Sec. 457(f)

In June 2016, the IRS issued proposed regulations that clarify a number of rules that impact the design and operation of 457(f) plans (the "457(f) proposed rules"). This article will describe a few of the key features of the 457(f) proposed rules.

Substantial Risk of Forfeiture

As noted, the existence and lapse of a substantial risk of forfeiture ("SROF") will determine when deferred compensation under a 457(f) plan becomes taxable. Under the 457(f) proposed rules, an amount is subject to a SROF only if entitlement to the amount is conditioned on (i) the future performance of substantial services, or (ii) the occurrence of a condition related to a purpose of the compensation if the possibility of a forfeiture of the right to the compensation is substantial. The determination as to whether an amount is conditioned on performing substantial services is based on the relevant facts and circumstances, including the amount of time to be spent performing services in relation to the amount of compensation involved. In addition, in determining whether a "condition is related to a purpose of the compensation," such condition must relate to the employee's performance of services for the employer or the employer's tax-exempt or governmental activities or organizational goals, including whether the likelihood of the forfeiture event occurring is substantial.

The 457(f) proposed rules clarify, in a helpful manner, that a SROF includes an involuntary severance from employment without cause and, if certain conditions are met, a voluntary termination of employment for "good reason." Further, a SROF may include a condition restricting an employee's ability to work for a competitor of the employer (i.e., a noncompete restriction). The opportunity to use a noncompete condition as a SROF under a 457(f) plan results in a broader SROF definition than is applicable under Code section 409A (i.e., the federal tax rules governing non-qualified deferred compensation plans maintained by "for-profit" employers).

Another favorable feature of the 457(f) proposed rules is the ability to add a SROF to an initial deferral of current compensation (such as a deferral of base salary) or extend the SROF period for an existing deferral of compensation. The right to initially add with respect to current compensation or extend a SROF under a 457(f) plan is subject to a number of requirements, most notably the present value of the deferred compensation payable upon the lapse of the SROF (as initially added or extended) must be more than 125% of the amount otherwise payable in the absence of such new or extended SROF.

Severance Pay Plan Exception

The 457(f) proposed rules clarify that the exemption from Code section 457 for a bona fide severance pay plan applies if the severance amount (i) is payable only upon an involuntary severance from employment (including a “good reason” quit), a “window” benefit program, or a voluntary early retirement incentive plan; (ii) does not exceed two times the participant’s annual rate of pay for the calendar year preceding the calendar year in which the severance from employment occurs (or the annual rate of pay for the current calendar year if the participant had no compensation in the preceding year), adjusted for any pay increases expected to continue indefinitely if the participant had not terminated employment; and (iii) in accordance with the written terms of the severance plan or agreement, is payable no later than the end of the second calendar year following the calendar year of the severance from employment. This severance pay plan exemption under Code section 457 is similar, but not identical, to the severance pay exception under Code section 409A.

Short-Term Deferral Exception

Compensation that, by its terms, must be, and is, paid within a “short-term deferral period” is treated as not constituting deferred compensation under Code section 457(f). The short-term deferral period ends on the 15th day of the third month following the end of the employee’s or employer’s taxable year (whichever ends later) in which the employee’s right to the compensation is first no longer subject to a SROF (i.e., amount first becomes vested). This short-term deferral exception is applied in a manner similar to the short-term deferral exception applicable under Code section 409A, except the definition of a SROF under the 457(f) proposed rules applies instead of the SROF definition under 409A. Thus, in many cases, but not all, an amount that is short-term deferral exempt under Code section 457(f) will also be short-term deferral exempt under Code section 409A.

Effective Date

The 457(f) proposed rules, which address other areas of Code section 457(f) plan compliance in addition to those described above, will become effective generally for compensation deferred for calendar years beginning after the date the rules are published as final regulations, including deferred compensation to which the legally binding right arose during a prior calendar year. In the interim, taxpayers may rely on the 457(f) proposed rules until the final rules become effective.