

INSIGHTS

The Proposed Code Section 457 Regulations Have Arrived

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On June 22, 2016, the IRS finally issued the long-awaited proposed regulations under Internal Revenue Code (“Code”) Section 457. Code Section 457 applies to deferred compensation plans or arrangements of tax-exempt entities and state and local governments. While the proposed regulations primarily address “ineligible plans” that are subject to Code Section 457(f), the proposed regulations also provide some guidance with respect to “eligible plans” that are subject to Code Section 457(b).

Deferred Compensation Plans

The proposed regulations provide that the following types of plans are not subject to Code Section 457(b) or (f) because they are treated as not providing for a deferral of compensation:

- **Bona Fide Severance Pay Programs:** With a few differences, these programs are similar to the same types of programs that are exempt from Code Section 409A as severance pay plans, including programs that provide benefits upon a “good reason” termination, provided that the termination must result from unilateral action taken by the tax-exempt entity or governmental entity. Factors considered with respect to whether there is a good reason termination include whether the payments upon a good reason termination are in the same amount and paid at the same time as payments to be made upon an involuntary termination without cause, and whether the employee is required to give notice of the material adverse change in conditions initiating the good reason termination and the employer is given the opportunity to cure such adverse change.
- **Bona Fide Death and Disability Programs.**
- **Bona Fide Sick Leave and Vacation Leave Plans.**
- **Window Programs and Voluntary Early Retirement Incentive Plans.**

With respect to eligible plans, the proposed regulations revise or add to certain provisions of the 2003 final Code Section 457 regulations to reflect statutory changes made to Code Section 457 since those final regulations were issued. The most significant addition is that the proposed regulations allow eligible governmental plans to include a qualified Roth contribution program.

With respect to ineligible plans sponsored or maintained by tax-exempt entities or state and local governments, the proposed regulations include guidance on what types of programs

provide for deferred compensation for purposes of Code Section 457(f):

- Consistent with the Code Section 409A regulations, a plan or arrangement provides for deferred compensation for purposes of Code Section 457(f) if an employee has a legally binding right during a taxable year to compensation that, pursuant to the terms of the plan or arrangement, is or may be payable in a later taxable year. An individual 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.
- A deferral of compensation will not occur for purposes of Code Section 457(f) with respect to any amount that qualifies as a short-term deferral under the Code Section 409A regulations. Thus, a deferral of compensation will not occur if the employee actually or constructively receives payment on or before the last day of the period ending on the later of the 15th day of the third month following the calendar year in which the right to payment is no longer subject to a substantial risk of forfeiture or the 15th day of the third month following the end of the tax-exempt entity or governmental entity's first taxable year in which the right to payment is no longer subject to a substantial risk of forfeiture. For this purpose, the definition of a substantial risk of forfeiture provided under the proposed regulations (as discussed below) is used, rather than the definition of a substantial risk of forfeiture under the Code Section 409A regulations.

Substantial Risk of Forfeiture

An amount to which an employee has a legally binding right under an ineligible plan is generally included in the employee's gross income when the right to the amount is not subject to a "substantial risk of forfeiture." Like the Code Section 409A regulations, the proposed Code Section 457(f) regulations provide that a payment is subject to a substantial risk of forfeiture only if the entitlement to the payment is conditioned on 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. Additionally, and unlike the Code Section 409A regulations, a covenant not to compete may be considered to be a substantial risk of forfeiture under the proposed Code Section 457(f) regulations if all of the following are satisfied:

- The right to the compensation must be expressly conditioned on the employee refraining from the performance of future services pursuant to a written agreement that is enforceable under applicable law;
- The employer must consistently make reasonable efforts to verify compliance with all of the non-competition agreements to which it is a party; and
- At the time the non-competition agreement becomes binding, the facts and circumstances must show that the employer has a substantial and bona fide interest in preventing the employee from performing the prohibited services and the employee has a bona fide interest in engaging, and the ability to engage, in the prohibited services.

Under the Code Section 409A regulations, attempts to extend the period covered by a risk of forfeiture, referred to as a "rolling risk of forfeiture," were invalidated; however, under the proposed Code Section 457(f) regulations, a rolling risk of forfeiture may be upheld, but only if all of the following conditions are met:

- The present value of the amount which is further deferred must be materially greater (considered to be more than 125%) than the amount the employee would otherwise be paid if not for the rolling risk of forfeiture;
- Both the initial and extended substantial risk of forfeiture must be based upon the future performance of substantial services or compliance with an agreement not to compete, and may not be based solely on the occurrence of a condition related to the purpose of the compensation;
- The period for which the substantial future services must be performed may not be less than two years, absent an intervening event such as death, disability or involuntary severance from employment; and
- The agreement extending the substantial risk of forfeiture must be in place (in writing) before the beginning of the calendar year in which any services are performed in the case of the initial deferrals or at least 90 days before the date on which an existing substantial risk of forfeiture would have lapsed in the absence of an extension.

Effective Dates

The proposed Code Section 457 regulations generally apply to compensation deferred under both eligible and ineligible deferred compensation plans for calendar years beginning after final regulations are published in the Federal Register, including deferred amounts that were not previously included in income during one or more prior calendar years. Taxpayers may rely on the proposed Code Section 457 regulations until such final regulations are published.