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The Impact of Recently Proposed Regulations on Ineligible Nonqualified Plans Under Internal Revenue Code § 457(f)

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The Treasury Department and the Internal Revenue Service recently issued comprehensive proposed regulations governing nonqualified plans subject to tax under Internal Revenue Code § 457. Code § 457 prescribes the tax rules that apply to "eligible" and "ineligible" nonqualified deferred compensation plans. Code § 457(b) defines the requirements to be an "eligible" nonqualified plan; a deferred compensation plan that does not satisfy the requirements of Code § 457(b) is an "ineligible" plan under Code § 457(f). Eligible and ineligible plans may be maintained only by state or local governments or organizations exempt from tax under Code § 501(c). The proposed regulations make the following changes:

- *Eligible plans (Code § 457(b))*

The proposed regulations would amend the final regulations issued in 2003 to reflect subsequent statutory changes made to Code § 457.

- *Ineligible plans (Code § 457(f))*

The proposed regulations make good on the Service's promise, made in Notice 2007-62, to issue "guidance regarding a substantial risk of forfeiture for purposes of § 457(f)(3)(B) under rules similar to those set forth under § 1.409A-1(d)." This promise prompted much concern amount ineligible plan sponsors and their advisors. Notice 2007-62 was aimed squarely at the interaction between Code § 457(f) and the then recently issued final regulations under Code § 409A. It was clear to many that the latter would have *some* consequences for the former. To what extent would Code § 409A force unwelcome changes to the rules governing ineligible plans of deferred compensation? When maintained by private sector tax-exempt entities, these plans are restricted to covering only senior management (or, in the parlance of ERISA, the "top-hat group"), which in many institutions, meant the chief executive officer. In particular, sponsors and their advisors worried about three, broad issues:

- Will the narrower definition of 'substantial risk of forfeiture" set forth in Code § 409A be applied to arrangements governed by Code § 457(f)?
- Will elective deferrals continue to be allowed?
- Will a non-compete agreement continue to operate to defer vesting (and hence the imposition of tax)?

Though not addressed in Notice 2007-62, sponsors of ineligible plans had the following additional worries relating to the interaction between Code § 457 and Code § 409A:

- Code § 457 includes a carve-out for bona fide severance plans; Code § 409A similarly includes a carve-out for severance plans, but only for terminations based on an involuntary termination. It was only a matter of time they surmised, before the regulators intervened to "harmonize" the two provisions of the Code.
- The final Code § 409A regulations contained detailed rules governing what constitutes an "involuntary termination of employment." Whether a termination of employment is also (critically) important for purposes of Code §457, since only an involuntary termination can defer vesting. Will the same definition apply in each case?
- How "constructive termination" actions (often referenced as "good reason" provisions) would operate as a basis for vesting of benefits for ineligible plans?

In this post, we examine the impact of the proposed regulations on ineligible plans under Code § 457(f) with a particular emphasis on the issues raised above. As a result—or at least it so appears—of comments received in response to Notice 2007-62, the worst fears of sponsors and advisors alike have not materialized. Once these rules are made final, however, there will be a "new" far more constrained "normal." These regulations will introduce a new level of rigor into the design, maintenance and operation of ineligible deferred compensation plans.

Background

A "plan" for purposes of Code § 457 includes "any plan, agreement, method, program, or other arrangement, including an individual employment agreement, of an eligible employer under which the payment of compensation is deferred. There are, however, certain plans that are not subject to Code § 457. These include bona fide vacation leave, sick leave, compensatory time, severance pay, disability pay, and death benefit plans, plans paying solely length of service awards to bona fide volunteers (or their beneficiaries), and bona fide severance pay plans. While these exceptions apply to eligible and ineligible plans alike, the exception for bona fide severance pay plans is of particular interest to sponsors of ineligible plans.

Compensation deferred under an ineligible 457(f) plan is includible in the gross income of the participant or beneficiary on the date that is the later of the date the participant or beneficiary obtains a legally binding right to the compensation or, if the compensation is subject to a substantial risk of forfeiture at that time, the date the substantial risk of forfeiture lapses. (This date is referred to in the proposed regulations as the "applicable date.") Generally, the amount of the compensation deferred under the plan that is includible in gross income on the applicable date is the "present value," as of that date, of the amount of compensation deferred. For this purpose, the amount of compensation deferred under a plan as of an applicable date includes any earnings as of that date on amounts deferred under the plan. Any earnings credited thereafter on compensation that was previously included in gross income are includible in the gross income of a participant or beneficiary when paid or made available to the participant or beneficiary.

Before the issuance of the proposed regulations, there was little guidance on the meaning of "present value" for purposes of determining the amount to be included in gross income. Where the benefit to which the participant or beneficiary was entitled was paid in a form other than a lump sum, it is clear that the amount that must be included in gross income is the discounted present value.

Substantial Risks of Forfeiture

Existing regulations provide that a substantial risk of forfeiture exists “if [a] person’s rights to such compensation are conditioned upon the future performance of substantial services by any individual.” Before Code § 409A, designers of non-qualified plans would often rely on non-compete agreements, consulting agreements, rolling risks of forfeiture, and severance arrangements with “softball” triggers to postpone vesting. Code § 409A made all of these more challenging if not impossible to apply, Before 2003, split-dollar life insurance arrangements were also marketed as an alternative to 457(f) plans. Final regulations governing split-dollar life insurance have all but eliminated this approach, however.

Elective deferrals

Code § 409A is generally inhospitable to elective deferrals under non-qualified deferred compensation plans, i.e., arrangements that permit elective deferrals of current compensation. Elective deferrals must satisfy election and payment timing requirements. Once made, the elective deferral can be further postponed only within strict limits. Any extension period during which the compensation is subject to a risk of forfeiture is generally disregarded unless the amount of the benefit to be paid on the lapse of the extended substantial risk of forfeiture is materially greater than the amount the participant otherwise would be paid in the absence of the extended substantial risk of forfeiture.

Non-compete agreements

The final regulations under Code § 409A make clear that a non-competition provision does not create a substantial risk of forfeiture. Non-competition provisions are, however, common among ineligible plans.

Bona fide severance plans

As we note above, Code § 457 includes a carve-out for bona fide severance plans. Code § 409A also includes a carve-out for severance plans, but only for plans based on an involuntary termination of employment.

Involuntary termination of employment

The final Code § 409A regulations provide that a determination of whether a separation from service is “involuntary” is based on all the facts and circumstances. Terminations for “good reason” may qualify as involuntary, provided the good reasons condition (i) is not intended to avoid the application of Code § 409A; and (ii) consists of action(s) taken by the employer that result in a material negative change in the employee's employment (e.g., material negative change in the duties that are required to be performed or compensation paid). The final Code § 409A regulations included additional factors that may be relevant in determining whether a bona fide good reason condition exists and provide "good reason" safe harbor sample language.

The Proposed Regulations

According to the proposed regulations, the rules of Code § 457(f) apply to an ineligible plan *separately and in addition to* the requirements of Code § 409A, if any. Thus, for example, an ineligible plan that pays on vesting (the attainment of a date certain, provided that there has not been a termination of employment) may qualify as a short-term deferral not subject to Code § 409A. If the time for payment is accelerated, however, Code § 409A may apply in addition to Code § 457(f). The proposed regulations include an example of an ineligible plan under which an initial amount is credited to an account and periodically credited with earnings based on a reasonable specified rate of interest. The entire account balance is subject to a substantial risk of forfeiture until dates certain. The balance is paid in three annual installments. After the date of the first installment, the plan is amended to accelerate the subsequent payments. The first installment is taxed under Code § 457(f) on vesting as one would expect. As a consequence of the accelerated payments, however, the subsequent payments fail to meet the requirements of Code § 409A, thereby resulting in acceleration of tax and the imposition of penalties.

NOTE: The **example**, which is on page 40,566 of the rule as published in the Federal Register provides a clear tutorial on the workings of both Code § 457(f) and Code § 409A and one of the ways that the two provisions can interact. It is well worth the read.

Substantial Risks of Forfeiture

What constitutes a "substantial risk of forfeiture" is to the application of the rules governing ineligible plans. According to the proposed regulations:

"An 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." (Emphasis added.)

The "performance of substantial services" prong is neither new nor unexpected. In cases in which a plan provides that entitlement to an amount is conditioned on involuntary severance from employment without cause, or a voluntary severance from employment for good reason, the right to the promised benefit is subject to a substantial risk of forfeiture only if the possibility of forfeiture is substantial. Consistent with Code § 409A, the proposed regulations emphasize that an amount is not subject to a substantial risk of forfeiture if the facts and circumstances demonstrate that the forfeiture condition is unlikely to be enforced.

In general, whether an amount of compensation is conditioned on the future performance of substantial services is based on the relevant facts and circumstances. Payment in connection with an involuntary termination has long been recognized as consistent with a benefit being subject to a substantial risk of forfeiture, and, in a welcome development, the proposed regulations treat a voluntary severance from employment for good reason as a substantial risk of forfeiture in a manner consistent with the Code § 409A rules on the subject.

In contrast, "the occurrence of a condition that is related to a purpose of the compensation" is new in the context of Code § 457(f). It is imported directly from Code § 409A. Specifically, a condition related to a purpose of the compensation must relate to the participant's performance of services for the employer's tax-exempt activities or organizational goals.

To constitute a substantial risk of forfeiture, the possibility of actual forfeiture in the event that the forfeiture condition occurs must be substantial based on the relevant facts and circumstances. Factors to be considered for this purpose include, but are not limited to, the extent to which the employer has enforced forfeiture conditions in the past, the level of control or influence of the employee with respect to the organization and the individual(s) who would be responsible for enforcing the forfeiture condition, and the likelihood that such provisions would be enforceable under applicable law.

Lastly, and to no one's surprise, the proposed regulation includes an anti-abuse rule under which an amount is not subject to a substantial risk of forfeiture "if the facts and circumstances demonstrate that the forfeiture condition is unlikely to be enforced." This feature of the rule is tantamount to a warning shot across the proverbial bow of a good many ineligible plans, particularly those covering CEO's whose relationship with the organization's governing body is "cozy" or controlling.

Additions or extension of risk of forfeiture/Elective deferrals of current compensation

Under a "general rule" the initial addition or extension of any risk of forfeiture after a legally binding right to compensation arises is disregarded. This includes the application of a risk of forfeiture to a plan providing for elective deferrals of current compensation. To this general rule, the proposed regulations provide an exception under which a substantial risk of forfeiture may be added or extended, and under which elective deferrals of current compensation may operate to defer tax, if the following conditions are satisfied:

- The present value of the amount made subject to the additional or extended substantial risk of forfeiture is materially greater than the present value of the amount the employee otherwise would have received absent the initial or extended risk of forfeiture. An amount is "materially greater" only if the present value of the amount subject to the additional or extended substantial risk of forfeiture is more than 125 percent of the present value of the amount that the employee would have received absent the additional or extended risk of forfeiture. (The preamble to the proposed regulations make clear that this requirement is not to be read into Code § 409A.)

NOTE: In the case of elective deferrals, this requirement means that arrangements that permit the elective deferral of current compensation must have a matching employer contribution.

- The employee must be required to perform substantial services in the future, or refrain from competing pursuant to a written agreement for a minimum of two years after the date that the employee could have received the compensation in the absence of the additional or extended substantial risk of forfeiture.
- In the case of an initial addition of a substantial risk of forfeiture if none previously existed (e.g., elective deferrals of current compensation), the written agreement must be entered into before the beginning of the calendar year in which any services that give rise to the compensation are performed. In the case of an extension of a substantial risk of forfeiture, the written agreement must be entered into at least 90 days before an existing substantial risk of forfeiture would have lapsed. If the employee has not been employed for at least 90 days, the addition or extension may be agreed to in writing within 30 days after commencement of employment.

If an amount is forfeited or relinquished and replaced, in whole or part, with a right to another amount (or benefit) that is a substitute for the amount that was forfeited or relinquished and that is subject to a risk of forfeiture, the risk of forfeiture will generally be disregarded.

Non-compete agreements

Conditioning the payment of a benefit under an ineligible plan on the employee refraining from competing post termination has long been used to defer vesting. This approach has a long regulatory history under Code § 83, which deals with compensatory transfers of property, e.g., employer stock or property other than cash. Notably, non-compete clause never constitute a substantial risk of forfeiture for Code § 409A. In the wake of Notice 2007-62, some wondered whether the regulators would adopt a similar rule for Code § 457(f) purposes. They did not.

According to the proposed regulations, an amount of compensation will not be treated as failing to constitute a substantial risk of forfeiture "merely because the right to payment of the amount is conditioned, directly or indirectly, upon the employee refraining from the future performance of certain services," provided the following conditions are satisfied:

- The right to payment of the amount is expressly conditioned upon the employee refraining from the future performance of services pursuant to an enforceable written agreement.
- The employer makes reasonable ongoing efforts to verify compliance with noncompetition agreements (including the noncompetition agreement applicable to the employee).
- The noncompetition provision must be enforceable under the law of the applicable jurisdiction.
- At the time that the enforceable written agreement becomes binding, the facts and circumstances demonstrate that the employer has a substantial and bona fide interest in preventing the employee from performing the prohibited services and that the employee has bona fide interest in, and ability to, engage in the prohibited competition.

The proposed regulations go on to cite the factors taken into account for this purpose, which include:

"[T]he employer's ability to show significant adverse economic consequences that would likely result from the prohibited services; 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 services."

This requirement invites the question: what happens if the conditions of the employee's employment change during the period before vesting? For example, if the employer exits a line of charitable activity that the executive oversees such that, from and after that point, there is no longer the "ability to show significant adverse economic consequences."

Bona fide severance plans

The proposed regulations establish the following standards that must be adhered to in order for a plan to qualify as a "bona fide severance pay plan" that does not provide for the deferral of compensation, and is therefore not subject to Code § 457.

- The benefits provided under the plan must be payable only upon a participant's involuntary severance from employment or pursuant to a window program or voluntary early retirement incentive plan.
- The amount payable under the plan with respect to a participant must not exceed two times the participant's annualized compensation based upon the annual rate of pay for services provided to the eligible employer for the calendar year preceding the calendar year in which the participant's employment terminates.
- Pursuant to the written terms of the plan, the severance benefits must be paid no later than the last day of the second calendar year following the calendar year in which the severance from employment occurs.

The preamble acknowledges that the rule is "similar to the rules for separation pay plans in § 1.409A–1(b)(9) of the final section 409A regulations."

Involuntary termination of employment

An involuntary severance from employment is a severance from employment due to the eligible employer's independent exercise of its authority to terminate the participant's services, other than due to the participant's implicit or explicit request, if the participant is willing and able to continue to perform services. As is the case with Code § 409A, the determination of whether a severance from employment is involuntary is based on the relevant facts and circumstances. Thus, if a severance from employment is designated as an involuntary severance from employment, but the facts and circumstances indicate otherwise, the severance from employment will not be treated as involuntary for purposes of section 457.

In addition, an employee's voluntary severance from employment may be treated as an involuntary severance from employment for purposes of Code § 457 if the severance from employment is for good reason. A severance from employment is for good reason if it occurs under certain bona fide conditions that are pre-specified in writing under circumstances in which the avoidance of section 457 is not the primary purpose. To be treated as an involuntary separation from employment, a termination for good reason must result from unilateral action taken by the employer resulting in a material adverse change to the working relationship (such as a material reduction in the employee's duties, working conditions, or pay). Other factors that may be taken into account in determining whether a termination for good reason effectively constitutes an involuntary severance from employment include the following:

- Whether the payments upon severance from employment for good reason are in the same amount and paid at the same time as payments conditioned upon an employer-initiated severance from employment without cause; and
- Whether the employee is required to give notice to the employer of the material adverse change in conditions and provide the employer with an opportunity to remedy the adverse change.

The proposed regulations also provide a safe harbor, similar to the Code § 409A safe harbor on the subject, under which a plan providing for the payment of amounts upon a voluntary severance will be treated as providing for a payment upon a severance from employment for good reason.

Present value determinations

When determining the amount that must be included in gross income upon the vesting of a benefit under an ineligible plan, one must know the then then current value of the benefit. Both prior law and the proposed regulations refer to this amount in each case as the "present value of the benefit." Prior law under Code § 457 provides little help with establishing present value. There is other precedent, however. Regulations interpreting Code § 3121(v)(2) govern when amounts deferred are "taken into account" for FICA tax purposes and the value of the benefit to be taken into account. Similar rules also appear in proposed regulations governing penalties under Code § 409A. Both sets of rules recognize two types of deferred compensation plans: account balance and non-account balance plans. An account balance plan is any nonqualified deferred compensation plan where the employee's benefit consists solely of a principal amount credited to the employee's account balance, plus income credited to the principal. A non-account balance plan is any nonqualified plan that is not an account balance plan, e.g., a plan that calculates benefits on some other basis than deferred principal plus accumulated income such as a defined benefit SERP.

The proposed regulations draw heavily on the proposed Code § 409A regulations. There is however, one major difference between the two sets of proposed rules. The proposed regulations for Code § 409A provide that the present value calculation is determined as of the end of the service provider's taxable year. In contrast, under the proposed regulations for Code § 457, the present value calculation under these proposed regulations, is determined as of the date in which the substantial risk of forfeiture lapses, i.e., the applicable date. Once both regulations are finalized, the regulators anticipate that the Code § 457 regulations will simply cross reference the Code § 409A final rule.

The proposed regulations provide rules for determining the present value of compensation deferred under an ineligible plan, which include specific rules for determining the present value of compensation deferred under account balance plans. Generally, the present value of an amount deferred under such an ineligible plan as of an applicable date is the value, as of that date, of the right to receive payment of the compensation in the future, taking into account the time value of money <u>and</u> the probability that the payment will be made.

- Non-account balance plans

In the case of a non-account balance plan, the present value of an amount deferred under the general rule described above, i.e., the value, as of that date, of the right to receive payment of the compensation in the future, taking into account the time value of money and the probability that the payment will be made. Actuarial assumptions used to calculate the present value of the compensation deferred must be reasonable based on all of the relevant facts and circumstances. Taking into account the probability that a participant might die before receiving certain benefits is a reasonable actuarial assumption only if the plan provides that the benefits will be forfeited upon death. Moreover, discounts based on the probability that payments will not be made due to the unfunded status of the plan, the risk that the eligible employer or another party may be unwilling or unable to pay, the possibility of future plan amendments or changes in law, and other similar contingencies are not permitted for purposes of determining present value.

If the present value of an amount depends on the time when a severance from employment occurs and the severance from employment has not occurred by the applicable date, then, for purposes of determining the present value of the amount, the severance from employment generally may be treated as occurring on any date on or before the fifth anniversary of the applicable date, unless, as of the applicable date, it would be unreasonable to use such an assumption.

- Account balance plans

In the case of an account balance plan, the present value is generally the amount credited to the account (including principal and any earnings or losses through the applicable date) determined using a predetermined actual investment or a reasonable rate of interest. Thus, under an example set out in the proposed regulation, the present value of a fixed amount to be paid at some designated future date future provided that the employee is then living is the discounted value of the benefit as further modified for mortality. This is the case however only if the account balance is determined using a predetermined actual investment or a reasonable rate of interest.

If the account balance is not determined using a predetermined actual investment or a reasonable rate of interest, the present value of compensation deferred under the plan as of an applicable date is equal to the amount credited to the participant's account as of that date, plus the present value of the excess (if any) of the earnings to be credited under the plan after the applicable date and through the projected payment date over the earnings that would be credited during that period using a reasonable rate of interest. The proposed regulations include a series of examples that illustrate how the rule would apply. In one example, an account balance plan credits interest at a rate that is 5% higher than reasonable. In essence the discounted value of the premium interest increases the present value of the benefit.

The proposed regulations also provide that if the amount of earnings or losses credited under an account balance plan is based on the greater of the earnings on two or more investments or interest rates, then the amount included in income on the applicable date is the sum of the amount credited to the participant's account as of the applicable date and the present value of the right to future earnings.

Going Forward

The rules described above are merely proposals, but they are based on previous, parallel regulatory positions (principally, though not exclusively, under Code § 409A). They also have the benefit of comments in response to previous guidance (i.e., Notice 2007-62). Therefore, it would not be unreasonable to expect that the final rules will bear a strong resemblance to the proposed regulations.

Conspicuously absent from the proposal is any transitional relief. Rather, the preamble simply says that "[n]o implication is intended regarding application of the law before these proposed regulations become applicable." Additionally, "[t]axpayers may rely on these proposed regulations until the applicability date." The problem, of course, is that Code § 409A might as a practical matter impose some constraints on the ability of sponsors to amend many existing plans. For new plans, plan sponsors the safest approach would be to rely on the proposed regulations.

A final note: while there is no "new sheriff in town," the proposed regulations signal clearly that the old sheriff has a new, more restrictive agenda. For sponsors of ineligible plans, and particularly for the members of the various executive and compensation committees that negotiate the payment of benefits under ineligible arrangements, things are about to change for the worse. At a minimum, these individuals will benefit by consulting with their advisors *before* agreeing to the adoption or the amendment of arrangement that could result in the impositions of additional and unexpected taxes on their key executives.

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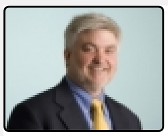

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