Treasury Department Issues Proposed 457 Regulations

On June 22, the IRS published new and long-awaited regulations under Section 457(f) of the Internal Revenue Code. For now, these regulations are "proposed," but it is anticipated they will become final around January 1, 2017. In the meantime, they can be relied upon immediately. Also, importantly, when finalized they are retroactive, meaning that they will apply to any existing deferral arrangements under 457(f) that have not yet become taxable.

In general, these proposed regulations are favorable to employers who provide nonqualified deferred compensation under Section 457(f) of the tax code. They also add flexibility for employees participating in those plans. For example, a non-compete agreement can now be used to delay taxation under a 457(f) plan. This and other key topics are discussed in more detail in the summary below.

For purposes of this summary, certain shorthand phrases will be used. The new proposed regulations will be referred to as the "Regulations." A substantial risk of forfeiture will be referred to as "SRF." Any reference to "457" is a reference to an "ineligible" plan under Section 457(f) of the tax code.

Summary of Key Topics

The following is a description and summary of key topics addressed in the proposed regulations:

- **Substantial risk of forfeiture.**[1] The most important focus of the Regulations is on the definition and use of "substantial risk of forfeiture" or "SRF". Amounts deferred under a 457(f) plan are taxable when the SRF lapses. Generally, this means that when amounts are vested, they are also taxable to the employee. The new Regulations provide that "an amount is generally subject to a[n] [SRF]…only if entitlement to [an] amount is conditioned on the future performance of substantial services." The Regulations describe several new and favorable ways a deferred amount can avoid taxation, as follows:
    - *Covenants not to compete (or "non-competes")* are now considered to be a valid SRF. For example, an employee who is about to become vested may sign a non-compete with the employer. Taxation of any deferred amounts will be delayed until the fulfillment of the non-compete agreement. This works only if: (i) the employee agrees to refrain from performing certain services under a written agreement enforceable under applicable law; (ii) the employer must consistently make reasonable efforts to verify compliance with all non-compete agreements to which it is a party; and (iii) at the time agreement becomes binding, the employer has a substantial and bona fide interest in preventing the employee from competing and that the employee has a bona fide interest in engaging, and the ability to do so, in competing.
    - *Rolling risk of forfeiture.* Under the new Regulations, and prior to vesting, an employer and employee may agree to extend the SRF to a later date. For example, if the employee is scheduled to become vested at age 65, the employer and employee may agree to move that vesting date to age 67. For a new employee, an agreement with a new, valid SRF

[1] Note: A 409A SRF is different than an SRF under 457. Plans under 457 may have to comply with both. An SRF under 457 will likely comply with 409A as long as amounts are includible in income on the date of vesting under 457.

must be in place prior to the end of the year (i.e., Dec. 31). For existing deferrals, an agreement to extend the SRF must be in place at least 90 days before the date on which the existing SRF lapses. The following conditions must also be met:

    - The present value of the amount to be paid upon lapse of the new SRF must be materially greater (more than 125%) than the amount the employee otherwise would be paid absent the new SRF. In other words, the employee must receive something in excess of 125% of the original amount promised in order for the new SRF to apply.
    - The new SRF must be based upon the future performance of substantial services or adherence with a non-compete (see discussion about relating to non-competes).
    - The agreement must be for a minimum of two years (although death, disability or involuntarily termination can be intervening events that would trigger payment).

  - *Anti-abuse rule.* The Treasury Department realizes that sometimes employers abuse the SRF rules, so an "anti-abuse" rule now applies. This rule states that amounts are not subject to SRF "if the facts and circumstances demonstrate that the forfeiture condition is unlikely to be enforced."

- **Voluntary deferrals of current compensation**. Prior to these Regulations, it was highly questionable whether employees in a 457 plan could defer their own compensation (salary, bonus, etc.). Under these Regulations, employees in a 457(f) plan may now voluntarily defer compensation under the following conditions:
  - *Employer match*. The employer must provide match of more than 25% of the employee deferral.
  - *Two year commitment*. The employee must commit to provide additional substantial services for at least two years in order to receive both the deferral and the match.
  - *Agreement in writing*. The deferral election must be made in writing and document the employee's agreement to continue service.

- **Taxation**. These Regulations clarify that taxation under 457 occurs on the later of: (i) the first date on which the employee obtains a legally binding right; or (ii) if the compensation is subject to a substantial risk of forfeiture, the date on which the SRF lapses.

- **Adoption of the 409A "short-Term deferral" rule**. These Regulations make clear that a short-term deferral under 457 is the same as a short-term deferral under 409A. In other words, if payments under a 457 plan are made within 2 ½ months after the end of the calendar year in which vesting occurs, they are not subject to the rules of 457.

- **Present value calculations**. The Regulations go to great length to discuss present value calculations. The importance of this discussion is that amounts includible in income upon vesting are based on present values. As mentioned above, taxation occurs as of the vesting date, not as of the end of the calendar year (which is the case under 409A).

- **Exchange of rights in deferred compensation**. The Regulations state that when a legally binding right to compensation is exchanged or converted for a different right, the new right is still considered subject to the rules under 457. Similarly, if a non-deferred right is converted to a deferral under 457, the new right will be subject to the rules under 457. One example given is where cash is promised in the future, but instead of receiving cash, the employer instead agrees to provide healthcare coverage. The provision of healthcare coverage would still be considered a 457 plan.
- **No deferral of compensation for:**
  - Reimbursements, medical, or in-kind benefits
  - Legal settlements, etc.
  - Taxable educational benefits, etc.
- **Involuntary termination or termination for "Good Reason":** Amounts payable under these circumstances qualify as a valid SRF if the possibility of forfeiture is substantial. The definition of "termination for Good Reason" is basically the same as under 409A.
- **Bona fide benefit plans.** If a plan is a bona fide: death benefit, severance pay, disability, sick or vacation leave plan, it is generally exempt from the rules under 457.
- **Both 457 and 409A will apply to most deferred comp**. The Regulations clarify that both 409A and 457 will apply to most plans of tax-exempt entities. Despite this new guidance, most plans will avoid application of 409A and 457 under the properly-structured "short-term deferral" rule mentioned above.
- **Effective date.** Although these Regulations are only proposed and will not be effective until at least January 1, 2017, they can be relied upon immediately. Once effective, and unless modified, the Regulations will apply to all new arrangements plus pre-existing arrangements where promised benefits have not become taxable.
- **Next steps:** Employers with 457 plans should have their plans reviewed by a qualified attorney to ensure that they are in compliance with these Regulations.