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Executive Compensation

View From Groom: Long-Awaited Proposed Rules Provide Greater Clarity for Executive Compensation Plans of Exempt Organizations

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The IRS recently issued long-awaited proposed regulations under section 457 of the Internal Revenue Code ("Code") that provide rules for determining when amounts deferred by employees of tax-exempt organizations, including governments, are includible in income, the amounts that are includible in income, and the types of plans or arrangements that are not subject to these rules. As anticipated, these rules mirror many of the rules under Code section 409A with respect to severance and substantial risk of forfeiture. In addition, the proposed regulations update the 2003 final regulations under Code section 457 for other statutory changes in the law affecting plans subject to Code section 457.

We provide below a background summary of Code section 457 and briefly outline the key provisions of the proposed rules regarding: (i) what plans are exempt from Code section 457, (ii) when amounts subject to Code section 457(f) are includible in income, and (iii) how to determine the present value of the amounts includible. Taxpayers may rely on these proposed rules immediately, and once adopted, the final rules, subject to a few limited exceptions, are intended to apply to all deferred compensation arrangements that have not been previously included in income (i.e., there is no grandfathering for prior arrangements). Comments are due on these proposed regulations by September 20, 2016, and a public hearing is scheduled for October 18, 2016.

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Background

Code section 457 generally applies to nonqualified deferred compensation plans maintained by state or local governments and tax-exempt organizations other than a church. The narrow definition of church applies for this purpose, and as a result, Code section 457 does apply to nonqualified deferred compensation plans of church-controlled organizations such as church-related hospitals, colleges, universities and nursing homes. Entities subject to Code section 457 are generally known as "eligible employers". If a nonqualified deferred compensation plan does not meet certain requirements under Code section 457(b), that plan is treated as an "ineligible plan" subject to Code section 457(f). The present value of an amount deferred under an ineligible plan is taxable to the individual employee in the year the amount is no longer subject to a substantial risk of forfeiture (i.e., it is taxed at vesting). Further, Code section 457 specifically exempts from coverage certain types of arrangements, including "bona fide" severance pay and sick and vacation leave plans under Code section 457(e)(11).

Clarified Definitions of Exempt Plans

The proposed rules provide definitions for the following plan types that are exempt from Code section 457:

■ *Severance Pay Plan*—Prior to the proposed rules, there was no authoritative guidance defining the term "bona fide severance pay plan" which is exempt from

Code section 457 under Code section 457(e)(11). Generally, the proposed rules track the definition under Code section 409A for exempt severance pay, including:

- Benefits are payable only upon involuntary severance from employment (this requirement does not apply to window programs or certain voluntary early retirement incentive plans);
- The amount payable does not exceed two times the participant's annualized compensation for the prior calendar year; and
- A written plan document requires that the entire severance amount must be paid no later than the last day of the second calendar year following the calendar year containing the date of participant's severance from employment.

Observation: The exemption under Code section 457 for severance pay plans does not apply the Code section 401(a)(17) compensation limit to the amount of annualized compensation for the two-times limit, unlike the definition under Code section 409A.

Similar to Code section 409A, involuntary severance from employment means an employer's unilateral decision to terminate the participant's services, including severance from employment for good reason (i.e., resulting in a material negative change in the employment relationship). This determination is based on all the facts and circumstances without regard to any characterization of the reason for the payment by the employer or participant.

■ *Sick and Vacation Leave Plans* – The proposed rules provide that a ''bona fide sick or vacation leave plan'' must demonstrate based on the facts and circumstances that the primary purpose of the plan is to provide for paid time off from work because of sickness, vacation, or other personal reasons. Several factors in the proposed rules to be used in this determination include:

- Whether the amount provided could reasonably be expected to be used by the employee in the normal course and before cessation of services.
- Whether the plan limits the ability to exchange unused accumulated leave for cash or other benefits, including non-taxable benefits, and any applicable accrual restrictions (e.g, use-or-lose rules).
- The amount and frequency of any in-service distributions of cash or other benefits in exchange for accumulated and unused leave.
- Whether payment of unused leave is made promptly upon severance from employment (as opposed to paid over a period of time).
- Whether the leave offered is broadly applicable or available only to a limited number of employees.

Observation: The proposed rules call into question the exempt nature of leave programs which allow a participant to accumulate significant amounts of leave to be exchanged for cash or paid at retirement.

■ *Death Benefit and Disability Plans* – The proposed rules clarify the requirements for exemption from Code section 457 with respect to death benefit and disability plans, as set forth below.

- A ''bona fide death benefit plan'' is defined in accordance with the FICA rules under Treasury Regulation § 31.3121(v)(2)-1(b)(4)(iv)(C), i.e., a benefit is a death benefit only to the extent it is in excess of lifetime benefits.
- A ''bona fide disability pay plan'' pays benefits only in the event that a participant is disabled, and the definition of disabled tracks the more restrictive definition provided under Code section 409A (i.e., unable to engage in any substantial gainful activity . . . expected to result in death or last for a continuous period of not less than 12 months).

Substantial Risk of Forfeiture

As noted above, amounts deferred under a plan subject to Code section 457(f) are taxable in the year the amount is no longer subject to a substantial risk of forfeiture. Generally, Code section 457(f)(3)(B) provides that a substantial risk of forfeiture exists if an employee's rights to compensation are conditioned on the future performance of substantial future services. In prior years, practitioners relied on non-authoritative guidance, including several private letter rulings, to further define what is a substantial risk of forfeiture for purposes of Code section 457.

The proposed rules provide that a substantial risk of forfeiture exists 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.''

Except for the limited use of non-compete agreements, as described below, the proposed rules clarify and align this definition with Code section 409A.

■ *Non-Competes*. Generally, non-competes do not create a substantial risk of forfeiture unless all of the following conditions are satisfied:

- The right to payment is expressly conditioned upon the non-compete in a written agreement that is enforceable under applicable law;
- The employer must make reasonable efforts to verify compliance with non-competition agreements, including the one applicable to the employee; and
- At the time the 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, and ability to, engage in the prohibited services.

■ *Rolling Risks of Forfeiture*. Rolling risks of forfeiture are disregarded, subject to a similar, but not identical, exception in Code section 409A. The addition or extension of a risk of forfeiture after the legally binding right to compensation arises must satisfy all of the following:

- The present value of the deferred amount must be ''materially greater'' than the amount the employee otherwise would have received. For this purpose, the amount is materially greater *only if* it is more than 125% of the present value of the prior amount. (**Observation**: The preamble to the proposed rules provides that no implication is intended for this standard to apply to Code section 409A.)
- The employee must be required to perform substantial future services or refrain from competing (i.e., a performance goal does not satisfy this requirement) for an additional period of at least two years,

subject to permitted vesting on death, disability or involuntary termination.

■ The addition or extension of a substantial risk of forfeiture must be made in writing before the calendar year in which services are performed in the case of initial deferrals, or ninety (90) days before the date a substantial risk of forfeiture would have lapsed absent an extension.

■ *Performance Condition*. A condition related to a purpose of the compensation must relate to the participant's performance of services for the employer.

Determination of Present Value

Generally, the rules for determining present value in the proposed rules are similar to the rules for determining present value under Code section 409A. However, present value under the proposed rules is determined as of the applicable date, as compared to the end of the employee's taxable year under Code section 409A. We highlight below a few notable requirements discussed in the proposed rules:

■ *Reasonable Actuarial Assumptions*. The present value must be determined using actuarial assumptions and methods that are reasonable based on all of the facts and circumstances as of the applicable date, including other assumptions, if necessary, regardless of whether such amount is reasonably ascertainable under the FICA rules.

■ *Treatment of Severance from Employment*. If payment depends on severance and the employee has not terminated from employment as of the applicable date, the employer may use any date on or before the fifth anniversary of the applicable date unless unreasonable (e.g., if the employer knows the employee will terminate in 2018, employer cannot use a later date).

■ *Account Balance Plans*. For account balance plans with a reasonable interest rate or based on a predetermined actual investment, the present value is equal to the account balance as of that date. For determining those, the FICA rules of Treasury Regulation sections 31.3121(v)(2)-1(d)(2)(i)(B) and (C) apply. If an account balance plan is credited with the greater of two or more rates of return (e.g., a combination of investment and interest rate), the plan will be treated as a non-account balance plan for purposes of determining present value.

■ *Formula Amounts*. For formula amounts, an employer must use reasonable good faith assumptions with respect to any contingencies. Any increase or decrease due to change in facts and circumstances is treated as earnings or losses, respectively. To the extent applicable, an amount of deferred compensation may be broken into formula and non-formula amounts.

■ *Forfeiture or Other Permanent Loss*. In the event forfeiture occurs after the applicable date, an employee is entitled to a deduction for the amount permanently forfeited. It would generally be treated as a miscellaneous itemized deduction and would not be subject to Code section 1341 (i.e., no unrestricted right).

Other Clarifying Provisions

The proposed rules provide other notable clarifications, as follows:

■ *Short-Term Deferrals*. A deferral of compensation under Code section 457(f) does not occur with respect to any payment exempt from Code section 409A under the short-term deferral exemption. Thus, a deferral from one year only to a payment date on or before March 15 of the following year is not a deferral for either Code section 457(f) or 409A.

■ *Recurring Part-Year Compensation*. A deferral of compensation does not occur with respect to an amount that is recurring part-year compensation, as defined under Code section 409A, if the plan does not defer payment beyond the last day of the 13th month following the first day of the service period, and the amount does not exceed the annual compensation limit under Code section 401(a)(17). This is helpful for professors and teachers who are paid on an annualized basis, though not working the entire year (e.g., not during summer).

■ *Interaction of Code Sections 409A and 457(f)*. The proposed rules make clear that Code section 457(f) applies separately and in addition to any requirements under Code section 409A. Thus, while Code section 409A permits the full recovery of all previously taxed amounts first, distributions from an ineligible plan after the lapse of a substantial risk of forfeiture are subject to the basis allocation or ''investment in the contract'' rules under Code section 72. The proposed rules provide a helpful example that demonstrates the consequences of a Code section 409A failure after the applicable date under Code section 457(f).

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As anticipated, the proposed rules align many of the concepts in Code section 457(f) with Code section 409A, which provides greater certainty when designing and administering plans subject to these rules.