LEGAL UPDATE

IRS Proposal to Modify Rules for Deferred Compensation Plans of Governmental and Tax-Exempt Plans

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Overview. Governmental employers and tax-exempt institutions operate under significant restrictions when offering nonqualified tax-deferred compensation to management and other key employees. After signaling to these employers that further restrictions were in the offing, the Internal Revenue Service recently issued a package of proposed regulations revamping the rules governing so-called "ineligible plans" or "Section 457(f)" plans, that are, in fact, more liberal than anticipated and will make it easier to design and operate these plans.

Tax Treatment. Section 457(f) plans, named after the Internal Revenue Code provision that controls the tax treatment of their participants, are to be distinguished from 457(b) plans (known as "eligible plans"), the other type of nonqualified deferred compensation plan that may be maintained by government and tax-exempt employers. Unlike 457(b) plans and tax-qualified plans, such as 401(k) plans, there is no limit on the amount that may be deferred under a 457(f) plan. However, 457(f) plans suffer an important disadvantage when compared to these other types of plans, specifically, that amounts deferred are taxable to the employee when they become vested, rather than when they are paid to the employee. As a result, 457(f) plans can only be offered to highly compensated employees, because their benefits are neither secured nor vested.

Vesting. In order to prevent contributions and earnings to a 457(f) plan from being taxed when credited, plans generally subject them to a "substantial risk of forfeiture" which delays taxation until the year the forfeiture provisions lapse. The proposed regulations continue the special treatment afforded by current rules that earnings accruing after a contribution has initially vested become taxable only when paid or made available to the participant.

A substantial risk of forfeiture under a 457(f) plan typically conditions the right to payment of plan benefits on the performance of future services measured by time served. Benefits can also be conditioned on the achievement of organizational goals, but only if they are combined with time-based requirements. An amount is not subject to a substantial risk of forfeiture if the surrounding facts and circumstances indicate that the condition is unlikely to be enforced. Death, disability, and involuntary employment termination other

than for cause are events that enable vesting to be accelerated without meeting the original conditions.

In addition, under the proposal, compliance with a covenant not to compete may be a substantial risk of forfeiture if it is in writing, the employer makes reasonable ongoing efforts to verify compliance with noncompetition agreements generally, and has a substantial and bona-fide interest in enforcing noncompete agreements and the employee has such an interest in engaging in prohibited competition. Thus, special circumstances would need to be shown in order to support a risk of forfeiture if an employee has attained retirement age and is, for that reason, unlikely to engage in competition with the employer. The position taken by the proposed regulations on covenants not to compete is a reversal of prior IRS announcements that forthcoming rules would not honor them.

Rolling Vesting. In the past, some 457(f) plans have allowed employees to extend the date when a risk of forfeiture will lapse shortly before it occurred in order to delay taxation. Under this technique, referred to as a "rolling risk of forfeiture," a five-year vesting period could be extended for another five years, provided the extension was elected before the end of the employee's fifth year of service under the plan. An employee who wished to defer taxation would extend the period during which plan benefits would be subject to a risk of forfeiture if he or she felt comfortable that employment would continue until the extended vesting date. The IRS had stated that a rolling risk of forfeiture would be disregarded for purposes of determining whether deferred compensation is subject to a substantial risk of forfeiture.

The proposed regulations also relax the IRS's restrictive stance on rolling vesting. Under the proposed rule, a risk of forfeiture may be extended if it is made pursuant to a writing executed at least 90 days before the existing forfeiture would have lapsed. In addition, the employee must be required to perform substantial services in the future or refrain from competing for a minimum period of two years after the original vesting date, subject to lapsing of the condition in the event of death, disability, or termination of employment without cause. Finally, the present value of the amount subject to the extension must be more than 125 percent of the present value of the amount the employee would have received if the extension had not occurred.

Salary Deferrals. As noted, a corollary to the rule that taxation occurs on vesting is that there must be a realistic possibility of forfeiture of the deferred amount if the employee terminates employment before the vesting date. For this reason, the IRS had indicated that its new rules would not respect salary deferral elections, since no rational employee would subject to a risk of forfeiture an amount the employee could have elected to receive currently. The proposed regulations also backtrack on this threat which would have limited 457(f) plans to contributions made by employers.

Under the proposed regulation, initial deferrals of current salary must meet conditions similar to those required with respect to nonqualified deferred compensation under Section 409A of the Code. Thus, the deferral must be reflected in a written agreement entered into by employer and employee before the beginning of the calendar year in which the services that give rise to the compensation are to be performed. In the case of new employees, the salary deferral agreement must be entered into within 30 days after the commencement of employment. As in the case of extensions of the vesting period, the period of substantial future services or adherence to an agreement not to compete must be at least two years and the amount to be paid upon lapse of these conditions must be more than 125 percent of the amount deferred.

Code Section 409A. Code Section 409A, which became effective in 2005, reformed the rules for deferred compensation by restricting the ability of employees to accelerate or otherwise modify the time for receiving deferred compensation once the time for payment has been established. Amounts are not considered to be deferred compensation for this purpose if they must be paid no later than 2½ months after the employee's or employer's taxable year in which the right to the payment is no longer subject to a substantial risk of forfeiture. The new proposed 457(f) regulations adopt a similar rule for 457(f) plans, so that the new 457 requirements will not apply in the event of such a short-term deferral. The proposed 457 regulations provide that the rules under Section 457 apply to 457(f) plans separately and in addition to the requirements of Section 409A. Accordingly, a 457(f) plan may also be a nonqualified deferred compensation plan subject to Section 409A. The interplay between these provisions can be extremely complicated.

Payments and Payment Substitutes. As noted, plan benefits will be included in a participant's gross income for income tax purposes when the risk of forfeiting the particular benefit lapses. The amount to be included will generally be the present value of the benefit as of such date, discounted pursuant to a reasonable interest rate and multiplied by a factor that reflects the possibility of nonpayment, except that the funded status of the plan or the unwillingness or inability of the employer to pay are disregarded for this purpose. Under an account balance plan, however, the present value is generally the amount credited to the participant's account (including the principal amount and any credited earnings or losses), provided earnings and losses are credited at least annually.

If the amount included for tax purposes exceeds the eventual payout (for example, because of investment performance), the participant will be entitled to a deduction in

the tax year in which the amount is permanently lost. The amount of the deduction, which would be subject to the limitations applicable to miscellaneous itemized deductions, would be equal to the amount previously included in income less the total amount of compensation actually paid or made available.

For purposes of the income tax deduction, an amount is not treated as permanently lost if another amount or an obligation to make a payment in a future year is substituted for the original amount. If an amount is lost and subsequently replaced with a right to another amount or benefit that is subject to a risk of forfeiture, the risk of forfeiture will be disregarded unless the 125 percent and two-year deferral requirements are satisfied. If a plan that provides for deferred compensation is amended to substitute a different benefit that does not come within the definition of deferred compensation (for example, by substituting health benefits for cash), the plan will, nevertheless, retain its status as a plan that provides for deferred compensation. However, health benefits converted to cash would transform the plan into one of deferred compensation.

Effective Date. The new 457(f) regulations will not be effective until the calendar year that begins after publication of the final rule. Special extensions may be applicable for collectively bargained and government plans. However, once the rules are finalized, unpaid deferrals at that time will need to comply even if they arose before the effective date. Taxpayers will be able to rely on the proposed rules until the applicability date.

Conclusion. The new proposed 457 regulations are a favorable development for governmental and tax-exempt employers, since they will allow them to continue using tax deferred plans to attract and retain executive-level employees.

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