

# **The Anticipated 457(f) Regulations and How They Affect Deferred Compensation for Tax Exempts**

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# THE ANTICIPATED 457(f) REGULATIONS AND HOW THEY AFFECT DEFERRED COMPENSATION FOR TAX EXEMPTS

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## I. INTRODUCTION

Many tax-exempt entities rely on nonqualified deferred compensation arrangements to recruit and retain high level executives. For these arrangements, the implementation of §409A<sup>1</sup> imposed a new layer of regulations that required coordination with existing rules. The Internal Revenue Service (IRS) provided guidance on some of the resulting coordination issues in Notices 2007-62 and 2008-62 and promised new proposed regulations under §457. However, as reported in the *Pension and Benefits Daily*, the Treasury Department has indicated that the high priority given to producing health care and pension funding relief regulations has caused a backlog that includes long-awaited guidance on § 457(f).<sup>2</sup> In the meantime, employers are left to follow the guidance under §409A and in Notices 2007-62 and 2008-62 to ensure continued compliance with tax rules and to avoid adverse tax consequences for participants.

Section 409A imposes strict requirements on nonqualified deferred compensation, including restrictions as to the timing of deferral elections, limits on distribution events, and constraints on a participant's ability to accelerate or further delay distribution of deferred amounts. Section 457 governs nonqualified deferred compensation paid by state and local governmental and tax-exempt employers to employees and independent contractors.<sup>3</sup> There are two primary types of plans subject to §457, (1) "eligible" plans established by a state or local government employer or any other tax-exempt entity under §457(b) and (2) "ineligible" nonqualified deferred compensation plans established by state or local government employers or any other tax-exempt entity, which plans are subject to §457(f).<sup>4</sup> Since §409A applies to ineligible §457(f) plans, such plans will be subject to the requirements of both §457(f) and §409A.<sup>5</sup> An issue arises since certain events that constitute a substantial risk of forfeiture under §457(f) are disregarded in determining whether a substantial risk of forfeiture exists under §409A. A separate issue arises in that §457 does not apply to "bona fide severance pay" whereas

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<sup>1</sup> All section references used herein are to the Internal Revenue Code of 1986, as amended, and to the regulations issued thereunder.

<sup>2</sup> Mary Hughes, *Treasury Priority Is Health, Plan Funding, Not Deferred Compensation*, *Bortz Says*, PENSION & BENEFITS DAILY, Sep. 21, 2010.

<sup>3</sup> Specifically, §457 covers a State, political subdivision of a State, any agency or instrumentality of a State or political subdivision of a State, and any other organization (other than a governmental unit) exempt from tax under the Internal Revenue Code. I.R.C. §457(e)(1).

<sup>4</sup> Treas. Reg. §1.457-1; Treas. Reg. §1.457-2(e).

<sup>5</sup> Section 409A specifically excludes from its coverage §457(b) plans but does not exclude §457(f) plans. Treas. Reg. §1.409A-1(a)(4).

§409A does not have such an exception but instead has an exception for compensation payable upon an “involuntary termination.” Failure to comply with §409A will result in serious tax consequences, including immediate taxation of amounts sought to be deferred and a 20% penalty and interest on such amounts.<sup>6</sup> Employers, therefore, must be careful to consider both §457 and §409A when reviewing existing deferred compensation plans and in preparing new plans.

An additional consideration for employers with respect to §457 is Notice 2007-62 and Notice 2008-62. Notice 2007-62 announced the intent of the Treasury Department and the IRS to issue guidance under §457 regarding the definition of “substantial risk of forfeiture” under §457(f) and the definition of a bona fide severance pay plan under §457(e)(11).<sup>7</sup> Although Notice 2007-62 provides that any future guidance will be prospective, such guidance could drastically change the design of §457(f) plans. Notice 2008-62 announced the intent of the Treasury Department and the IRS to issue guidance under §457 that addresses certain types of arrangements involving recurring part-year compensation (*e.g.*, arrangements involving public school employees who provide services during a 10-month school year and elect to be paid ratably over 12 months).<sup>8</sup>

Below we describe the most important of the regulatory requirements governing nonqualified deferred compensation programs paid by tax-exempt and governmental employers introduced under §409A and §457(f), including Notice 2007-62 and Notice 2008-62, and the related compliance issues for tax exempt and governmental employers using nonqualified deferred compensation arrangements.

## II. OVERVIEW OF §409A AND §457

### A. §409A

#### 1. General Overview

The American Jobs Creation Act of 2004 added §409A, a provision governing nonqualified deferred compensation, to the tax code.<sup>9</sup> On April 10, 2007, the IRS and the Treasury Department issued final regulations interpreting §409A and clarifying several exceptions to the application of §409A, including certain severance arrangements and compensation paid within a short-term deferral period, as described in more detail below.<sup>10</sup> Section 409A is generally applicable to amounts deferred after December 31, 2004 and amounts deferred before January 1, 2005 if such amounts vest after December 31, 2004.<sup>11</sup> Section 409A

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<sup>6</sup> I.R.C. §409A(a)(1).

<sup>7</sup> I.R.S. Notice 2007-62, 2007-32 I.R.B. 331.

<sup>8</sup> I.R.S. Notice 2008-62, 2008-29 I.R.B. 130.

<sup>9</sup> Public Law 108-357 (118 Stat. 1418).

<sup>10</sup> Prior to the issuance of the final regulations, the IRS issued Notice 2005-1 on December 20, 2004 setting forth initial guidance with respect to the application of §409A, and supplying transition guidance. The IRS issued proposed regulations regarding the treatment of nonqualified deferred compensation under §409A on September 29, 2005.

<sup>11</sup> Treas. Reg. §1.409A-6.

generally does not apply to arrangements that are deferred and vested on or prior to December 31, 2004 so long as such arrangements are not materially modified after October 3, 2004.<sup>12</sup> Because vesting results in immediate inclusion in income under §457(f), very few deferred compensation arrangements of tax-exempt and governmental employers are subject to this grandfather provision.

Section 409A generally provides that all amounts deferred under a nonqualified deferred compensation plan are currently includible in gross income to the extent they are not subject to a substantial risk of forfeiture unless the plan meets specified restrictions set forth in §409A.<sup>13</sup> Failure to comply with the requirements of §409A results in (a) automatic inclusion of all amounts deferred under the plan to the extent not subject to a substantial risk of forfeiture and not already included in income, (b) a 20% penalty on amounts includible in income, and (c) an interest charge at the underpayment rate plus 1% on amounts previously deferred and not included in income.<sup>14</sup>

A plan or arrangement generally provides “deferred compensation” under §409A if an employee has a legally binding right to compensation in one taxable year that is or may be paid to the employee in a later year.<sup>15</sup> Section 409A does not apply to certain qualified plans, including qualified plans under §401(a), cash or deferral arrangements under §401(k), annuity contracts under §403(b), or annuity plans under §403(a), as well as eligible deferred compensation plans under §457(b).<sup>16</sup> Section 409A, however, does cover a wide range of plans and arrangements, including salary and bonus arrangements, severance arrangements, reimbursement arrangements, relocation policies, etc.<sup>17</sup>

## 2. Substantial Risk of Forfeiture

As described above, under §409A, all amounts deferred under a nonqualified deferred compensation plan are currently includible in income to the extent not subject to a substantial risk of forfeiture unless the plan meets certain restrictions set forth in §409A, including, for example, restrictions relating to the timing of deferral elections and distributions. The lapse of a substantial risk of forfeiture, therefore, does not cause immediate taxation of deferred amounts so long as the requirements set forth in §409A are met. Compensation is subject to a substantial risk of forfeiture if entitlement to the compensation is conditioned on the performance of substantial services or the occurrence of a condition related to the purpose of the compensation, and the possibility of forfeiture is substantial.<sup>18</sup> An amount is not subject to a substantial risk of

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<sup>12</sup> *Id.* Generally, a plan is materially modified if a benefit or right existing as of October 3, 2004 is enhanced or a new material right or benefit is added, and such material enhancement or addition affects amounts earned and vested before January 1, 2005. Treas. Reg. §1.409A-6(a)(4).

<sup>13</sup> I.R.C. §409A(a).

<sup>14</sup> I.R.C. §409A(a)(1).

<sup>15</sup> Treas. Reg. §1.409A-1(b).

<sup>16</sup> Treas. Reg. §1.409A-1(a)(2).

<sup>17</sup> Treas. Reg. §1.409A-1.

<sup>18</sup> Treas. Reg. §1.409A-1(d).

forfeiture under §409A merely because the right to the amount is conditioned, directly or indirectly, upon refraining from the performance of services.<sup>19</sup> Therefore, a noncompetition restriction will not serve as a valid substantial risk of forfeiture under §409A. Additionally, under §409A, an amount is not considered subject to a substantial risk of forfeiture beyond the date the participant could have elected to receive the compensation, unless the present value of such amount (disregarding the risk of forfeiture) is materially greater than the present value of the vested amount the participant otherwise could have elected to receive.<sup>20</sup> In such a case, the entire amount is considered subject to a substantial risk of forfeiture. Finally, the extension of the period in which compensation is subject to a substantial risk of forfeiture is disregarded under §409A in determining whether a substantial risk of forfeiture exists.<sup>21</sup>

### 3. Short-term Deferral Exception

The short-term deferral exception provides that compensation is not subject to §409A if such arrangement specifies a payment date or payment event that will occur no later than the later of (a) 2 ½ months after the end of the participant’s first taxable year in which the benefits are no longer subject to a substantial risk of forfeiture or (b) 2 ½ months after the end of the employer’s first taxable year in which the benefits are no longer subject to a substantial risk of forfeiture.<sup>22</sup> This means, for example, that if a participant has a vested right to compensation on December 31 of year five if the participant remains continuously employed through December 31 of year five and such compensation is paid by March 15 of year six (2 ½ months following the end of the later of the employer’s tax year or the participant’s tax year), the compensation will not be considered “deferred compensation” under §409A and therefore will not be subject to the requirements of §409A.

### 4. Severance Pay Exception

Severance pay is not excluded from §409A, although severance pay programs that provide for severance upon an involuntary termination are not considered deferred compensation subject to §409A if the following conditions are satisfied: (a) payment is made only upon an “involuntary termination” (including certain resignations by the participant for good reason), (b) the payments do not exceed two times the lesser of the participant’s annual compensation or the compensation limit under §401(a)(17) (currently \$245,000 for 2011 which means a total cap of \$490,000 for 2011), and (3) the payments must be completed by the end of the second calendar year following termination.<sup>23</sup> An involuntary termination means a separation from service due to the employer’s exercise of its unilateral authority to terminate the service provider’s services, where the service provider was willing and able to continue performing services.<sup>24</sup> The regulations under §409A further provide that an involuntary termination includes a resignation

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<sup>19</sup> *Id.*

<sup>20</sup> *Id.*

<sup>21</sup> *Id.*

<sup>22</sup> Treas. Reg. §1.409A-1(b)(4)(i).

<sup>23</sup> Treas. Reg. §1.409A-1(b)(9)(iii).

<sup>24</sup> Treas. Reg. §1.409A-1(n)(1).

by a service provider for “good reason” as long as the good reason trigger requires a material negative change to the service provider in the employment relationship.<sup>25</sup>

## 5. Compliance Deadline and Correction Programs

Employers had until December 31, 2008 to amend plan documents to comply with §409A and the final regulations issued under §409A. As described above, the penalties for failure to comply with the requirements of §409A are very substantial, resulting in automatic inclusion in income of all deferred amounts under the arrangement and all arrangements in the same category,<sup>26</sup> an additional 20% tax on all such amounts includible in income, plus a further tax equal to an interest charge on the taxes that would have been paid if the amounts had never been deferred in the first place.<sup>27</sup>

a. *Operational Corrections (Notice 2008-113)*. On December 5, 2008, the Treasury Department and the IRS issued Notice 2008-113, which clarifies and expands upon prior guidance issued under Notice 2007-100.<sup>28</sup> Notice 2008-113 gives taxpayers a limited ability to correct certain operational failures of a nonqualified deferred compensation plan to comply with §409A. Notice 2008-113 is effective for tax years beginning on or after January 1, 2009.<sup>29</sup>

Under Notice 2008-113, unintentional operational failures that are corrected in the same taxable year in which the failures occur generally get broad relief from the income inclusion and additional taxes triggered under §409A.<sup>30</sup> In addition, for limited unintentional operational failures that are corrected in the taxable year immediately following the taxable year in which the failure occurs, Notice 2008-113 limits the income inclusion and additional taxes otherwise applicable.<sup>31</sup> Notice 2008-113 is very clear that its relief is limited to unintentional failures and does not provide relief for plan terms that fail to meet the requirements of §409A or for failures directly or indirectly related to

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<sup>25</sup> Treas. Reg. §1.409A-1(n)(2). Whether good reason exists is primarily a facts-and-circumstances analysis, however, §409A includes a safe harbor definition for good reason. For the safe harbor definition to apply, the plan must define good reason to include actions taken by the employer resulting in a material adverse change in the duties to be performed, the conditions under which such duties are to be performed, or the compensation to be received for performing such services, and the avoidance of the requirements of §409A is not a purpose of the inclusion of these conditions in the plan or a purpose of the actions by the service provider in connection with the satisfaction of these conditions. Additionally, the service provider must provide the employer with notice of the good reason condition within 90 days of the initial existence of the condition and the employer must be provided with at least 30 days to cure such good reason trigger. *Id.*

<sup>26</sup> Arrangements are categorized under Treas. Reg. § 1.409A-1(c)(2).

<sup>27</sup> I.R.C. § 409A(a)(1).

<sup>28</sup> IRS Notice 2008-113, 2008-51 I.R.B. 1305; Notice 2007-100, 2007-52 I.R.B. 1243.

<sup>29</sup> Notice 2007-100 is obsolete for taxable years beginning on or after January 1, 2009.

<sup>30</sup> IRS Notice 2008-113, 2008-51 I.R.B. 1305.

<sup>31</sup> Certain relief available under Notice 2008-113 is limited to service providers that are not “insiders” with respect to the service provider. “Insiders” include officers of the organization. *Id.*

participation in an abusive tax avoidance transaction.<sup>32</sup> Relief provided under Notice 2008-113 is available only if the service recipient takes commercially reasonable steps to avoid reoccurrence of the failure. If the same or a substantially similar operational failure has occurred in the past, relief under Notice 2008-113 is not available for taxable years beginning after December 31, 2009 unless the service recipient or service provider can demonstrate that the service recipient had established procedures and taken reasonable steps to avoid recurrence of the failure and the failure occurred despite the diligent efforts of the service recipient to avoid such failure.<sup>33</sup>

b. *Documentary Corrections (Notices 2010-6 and 2010-80)*. On January 5, 2010, the IRS issued Notice 2010-6 and subsequently modified and expanded this relief under Notice 2010-80. Notice 2010-6 established procedures for taxpayers to voluntarily correct certain failures of nonqualified deferred compensation plans to comply with the document requirements of §409A.<sup>34</sup> Notice 2010-6 includes detailed requirements that must be satisfied in order to be eligible for relief under Notice 2010-6, including general eligibility requirements, requirements for a particular correction method, and notice and reporting requirements. In general, the notice and reporting requirements included in Notice 2010-6 require that the employee and employer attach a statement to their original federal income tax return that contains certain information mandated by Notice 2010-6, including the name and taxpayer identification number of each employee affected by the failure, the identification of the nonqualified deferred compensation plan affected by the failure, and information regarding the amount involved in each failure and whether such amount is taxable. Under Notice 2010-80, this requirement does not apply for corrections completed in 2010 and for certain corrections that may be made only through December 31, 2011.

Notice 2010-6 is clear that relief is available only for document failures that are inadvertent and unintentional. The relief is not available for document failures that are directly or indirectly related to participation in an abusive tax-avoidance transaction. Notice 2010-6 also provides that correction is not available for a document failure unless the employer identifies all other nonqualified deferred compensation plans that have a similar document failure and all such failures are corrected in a manner consistent with Notice 2010-6. Except as provided under the transition rules, Notice 2010-6 did not permit relief for document failures due to nonqualified plans linked to qualified plans or other nonqualified plans. Notice 2010-80 modified Notice 2010-6 to permit document corrections for linked plans as long as the linkage does not affect time or form of payment.

Notice 2010-6 permits correction of various document failures under §409A, including correction of ambiguous or impermissible payment events, correction of faulty

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<sup>32</sup> Additionally, relief is not available with respect to any erroneous payment occurring during any taxable year of the service provider in which the service recipient experiences a substantial financial downturn, or otherwise experiences financial or other issues, if such downturn or other issue indicates a significant risk that the service recipient would not be able to pay the amount deferred when the payment became due. *Id.*

<sup>33</sup> *Id.*

<sup>34</sup> IRS Notice 2010-6, 2010-3 I.R.B.

distribution provisions, and correction of provisions providing for impermissible initial deferral elections, and includes an amendment period following an employer's initial adoption of a plan. Notice 2010-6 generally requires a plan amendment to correct the listed document failures. However, in many instances Notice 2010-6 imposes adverse tax consequences upon the occurrence of certain events. Most commonly, if the previous and incorrect distribution event occurs within one year after the plan correction to fix the event under Notice 2010-6, each affected employee must include a stated percentage (generally 50%) of the amount deferred under the plan that was corrected under Notice 2010-6 in income for purposes of §409A, and the employee must pay federal income taxes, as well as the additional 20% penalty tax under §409A on such amount (but not the additional premium interest tax) for the year in which the event occurred.

Transition relief under Notice 2010-6 permits the correction of document failures on or before December 31, 2010 or December 31, 2011 with respect to certain failures, without subjecting the deferred amount to tax under §409A. If a plan document failure was corrected under Notice 2010-6 on or before December 31, 2010, or December 31, 2011 if applicable, the plan may be treated as having been corrected on January 1, 2009 (the transition relief expiration date), and no income inclusion under §409A will be required as a condition of the relief. However, as part of the correction under Notice 2010-6, any operational failures arising out of the retroactive amendment to the plan (e.g., payments made in 2009 or 2010 that should not have been made under the corrected plan) must have been corrected on or before December 31, 2010 or December 31, 2011, if applicable.

## **B. Section 457 Plans**

### **1. General Overview**

Section 457 governs nonqualified deferred compensation paid by state and local governmental and tax-exempt employers to employees and independent contractors.<sup>35</sup> Churches, church controlled organizations, and the federal government or any agency or instrumentality thereof are, however, excluded from coverage under §457.<sup>36</sup> Since §457(b) limits the amount of compensation that can be deferred under an eligible §457(b) plan, many tax-exempt employers provide additional deferred compensation to their executives through an ineligible §457(f) plan.

Section 457(b) plans are popular retirement programs for tax-exempt employers because the plans allow for the deferral of compensation without requiring such amounts to be subject to a substantial risk of forfeiture.<sup>37</sup> Therefore, if certain requirements are met, participants are taxed on amounts deferred under a §457(b) plan in the taxable year in which such compensation is paid to the participant or other beneficiary (or when paid or otherwise made available to the participant or other beneficiary in the case of a plan sponsored by a tax-exempt entity, even if

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<sup>35</sup> I.R.C. §457(e).

<sup>36</sup> I.R.C. §457(e)(13); Treas. Reg. §1.457-2(e).

<sup>37</sup> See I.R.C. §457(a)(1).

such amounts are not distributed to the participant).<sup>38</sup> Another advantage of §457(b) plans is that they are not subject to the strict requirements imposed under §409A for nonqualified deferred compensation.<sup>39</sup> To qualify as a §457(b) plan, the plan must meet certain requirements set forth primarily in §457(b) and the related regulations, including, for example, that employers must generally limit the amount that can be deferred for a participant each year to the lesser of (a) 100% of the participant's taxable compensation or (b) a specified amount as set forth in §457 (which amount is \$16,500 in 2011).<sup>40</sup>

If a plan sponsored by a tax-exempt employer fails to satisfy one or more of the requirements of §457(b), it is treated as an "ineligible" plan subject to §457(f). The advantage of a §457(f) plan is that there is no limit under the Internal Revenue Code on amounts that can be deferred under such plans and it is not subject to the other requirements of §457(b). The downside, however, is that unlike §457(b) plans, amounts deferred under §457(f) plans are taxable to the participant when such amounts are no longer subject to a substantial risk of forfeiture.<sup>41</sup> Once the substantial risk of forfeiture lapses, deferred amounts are includible in the participant's income, whether or not such amounts are actually received by the participant.

## 2. Substantial Risk of Forfeiture

Since amounts are taxable under §457(f) when no longer subject to a substantial risk of forfeiture, in order to defer taxation, §457(f) plans may make the right to payment conditioned on future service and may also impose a post-employment non-competition restriction or obligation to provide consulting services. Whether such restrictions subject the compensation to a substantial risk of forfeiture generally depends on the facts and circumstances relating to the deferral arrangement. Note, however, that under Notice 2007-62, the IRS and Treasury Department anticipate issuing guidance which will substantially restrict the definition of substantial risk of forfeiture, as discussed in more detail in Section III.

a. *Future Performance.* Under §457(f), compensation is subject to a substantial risk of forfeiture if the participant's right to such compensation is conditioned upon the future performance of substantial services.<sup>42</sup> A valid substantial risk of forfeiture exists if a participant's benefits vest upon the participant's involuntary termination of employment without cause, disability, death, or upon a change in control.<sup>43</sup>

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<sup>38</sup> I.R.C. §457(a)(1); Treas. Reg. §1.457-7(b).

<sup>39</sup> Treas. Reg. §1.409A-1(a)(2)(vii).

<sup>40</sup> I.R.C. §457(b).

<sup>41</sup> I.R.C. §457(f)(1) (providing that "compensation shall be included in the gross income of the participant or beneficiary for the 1st taxable year in which there is no substantial risk of forfeiture of the rights to such compensation" and "the tax treatment of any amount made available under the plan to a participant or beneficiary shall be determined under section 72"); Treas. Reg. §1.457-11.

<sup>42</sup> I.R.C. §457(f)(3)(B); Treas. Reg. §1.83-3(c).

<sup>43</sup> See, e.g., I.R.S. Priv. Ltr. Rul. 200321002 (death, disability); I.R.S. Priv. Ltr. Rul. 9429007 (change in control); I.R.S. Priv. Ltr. Rul. 199943008 (involuntary termination without cause).

b. *Noncompetition Restriction.* A participant's adherence to a non-competition agreement may be considered a substantial risk of forfeiture if the participant can demonstrate that under the facts and circumstances there is a real likelihood that the participant will be required to actually refrain from performing substantial services.<sup>44</sup> Factors considered in determining whether a covenant not to compete constitutes a substantial risk of forfeiture include, but are not limited to, the following: (a) the age of the participant, (b) the availability of alternative employment opportunities, (c) the likelihood of the employee's obtaining such other employment, (d) the degree of skill possessed by the participant, (e) the participant's health, and (f) the practice (if any) of the employer to enforce such covenants.<sup>45</sup>

c. *Post-termination Consulting Agreement.* A substantial risk of forfeiture can include the participant's performance of substantial consulting services after termination of employment.<sup>46</sup> Whether services are substantial depends on the regularity of the performance of the services as well as the time spent in performing such services.<sup>47</sup> The fact that the participant performing services has the right to decline to perform such services without forfeiture may tend to establish that services are insubstantial.<sup>48</sup> Similarly, compensation transferred to a retiring participant subject to the sole requirement that it be returned unless the participant renders consulting services upon the request of his or her former employer will not be considered subject to a substantial risk of forfeiture unless the participant is in fact expected to perform substantial services.<sup>49</sup>

d. *Rolling Risk of Forfeiture.* The IRS has ruled that a substantial risk of forfeiture can be extended beyond when it would otherwise lapse. The intent of the rolling risk of forfeiture is to delay the payment of the deferred compensation as well as the duration of the substantial risk of forfeiture. For example, if a participant has a vested right to payment in year five, the participant and the employer may decide in year four that they want to continue to defer compensation into year seven. In this example, the participant and the employer agree to roll the risk of forfeiture for two additional years.

### 3. Severance Programs

Section 457 does not apply to certain types of plans, including bona fide severance pay, vacation leave, sick leave, compensatory time, disability pay, or death benefit plans.<sup>50</sup> Although

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<sup>44</sup> Treas. Reg. §1.83-3(c)(1).

<sup>45</sup> Treas. Reg. §1.83-3(c).

<sup>46</sup> *Id.*

<sup>47</sup> *Id.*

<sup>48</sup> *Id.*

<sup>49</sup> *Id.*

<sup>50</sup> I.R.C. §457(e)(11).

there is no statutory definition for severance pay, the IRS has taken the position that severance benefits are not excluded from §457 if they are payable upon termination for any reason.<sup>51</sup>

### C. Application of §409A to §457(f) Plans

Since ineligible §457(f) plans are also subject to §409A, employers must consider requirements under both §457(f) and §409A when designing nonqualified deferred compensation plans.

#### 1. Substantial Risk of Forfeiture

As described above, under §457(f), deferred compensation is taxed when it is no longer subject to a substantial risk of forfeiture.<sup>52</sup> In many cases a substantial risk of forfeiture for §457(f) purposes is the same as under §409A. There are, however, certain events that constitute a substantial risk of forfeiture under §457(f) that are disregarded in determining whether a substantial risk of forfeiture exists under §409A.

a. *Rolling Risk of Forfeiture.* Unlike under §457(f), any addition of a risk of forfeiture after the legally binding right to the compensation arises or any extension of a period during which compensation is subject to a risk of forfeiture is invalid under §409A.<sup>53</sup> Additionally, under §409A, an amount is not considered subject to a substantial risk of forfeiture beyond the date the participant could have elected to receive the compensation, unless the present value of such amount (disregarding the risk of forfeiture) is materially greater than the present value of the vested amount the participant otherwise could have elected to receive.<sup>54</sup> The rationale behind this is that a participant would not elect to continue to subject amounts to a substantial risk of forfeiture unless the participant was to receive an additional benefit.

b. *Non-compete Agreements.* Under §409A, an amount is not subject to a substantial risk of forfeiture merely because the right to the amount is conditioned, directly or indirectly, upon refraining from the performance of services.<sup>55</sup>

Since, as a practical matter, compensation under most §457(f) plans is usually paid when the compensation is no longer subject to a substantial risk of forfeiture (under both §457(f) and §409A) and is therefore included in the employee's income, such compensation will be excluded from coverage under §409A if payable within the short-term deferral exception. As explained above, to meet this exception the compensation must be paid within 2 ½ months after the close of the tax year (the later of the employer's or the employee's) in which the employee vests. For example, under a common §457(f) plan, an employee vests in his or her deferred compensation upon the employee's death or disability, or at a fixed time in the future, provided that the

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<sup>51</sup> See, e.g., TAM 199903032.

<sup>52</sup> I.R.C. §457(f)(1)(A).

<sup>53</sup> Treas. Reg. §1.409A-1(d).

<sup>54</sup> *Id.*

<sup>55</sup> *Id.*

employee remains continuously employed by the employer until such time. If the amounts are distributed within 2 ½ months after the close of the year in which the participant became disabled, died, or attained the fixed vesting date, the plan will qualify for the short-term deferral exception under §409A and will therefore be excluded from coverage under §409A. If compensation is not paid within the short-term deferral exception (*e.g.*, the plan conditions payment on compliance with a non competition restriction or the provision of consulting services or allows for a rolling risk of forfeiture), it must meet the requirements of §409A, otherwise the benefits will be currently taxable to the participant, even if distributed at a later time.

## 2. Severance Pay Plan

“Bona fide severance plans” are exempt from coverage under §457, which means that §457 plans may provide for severance payment upon a participant’s involuntary termination of employment. Section 409A, however, does not have an exception for bona fide severance plans. The regulations under §409A, however, do provide the exception described above in Section II.A.4 for severance pay arrangements. Consequently, plans meeting the bona fide severance plan exception under §457 may still be subject to §409A if the plan does not meet the exception under §409A for severance pay arrangements. This will be particularly true where either the distribution of severance extends beyond the two-year grace period found in the §409A exception or the amount involved exceeds \$490,000 (in 2011). The latter is a realistic possibility for some tax-exempts, such as hospitals or large academic institutions, that provide their CEOs with significant pay packages. However, being subject to §409A is not the end of the world. It just means you need to make sure that the severance arrangement complies with the straightforward timing of distribution requirements within §409A.

### III. ANTICIPATED CHANGES REGARDING §457 PLANS

#### A. Notice 2007-62

On July 23, 2007, the IRS issued Notice 2007-62 which announced the intent of the Treasury Department and the IRS to issue guidance under §457 regarding the definition of “substantial risk of forfeiture” and the definition of a bona fide severance pay plan.<sup>56</sup> Notice 2007-62 states that the definitions will generally be similar to the definitions set forth in §409A, as described in more detail below. The Treasury Department and the IRS anticipate that the guidance under Notice 2007-62 will be prospective and that pending the issuance of further guidance, taxpayers may rely on the definitions for substantial risk of forfeiture and bona fide severance pay plan described in Notice 2007-62. If such guidance is issued it could change the design of some §457(f) plans.

#### 1. Definition of “Substantial Risk of Forfeiture”

Notice 2007-62 states that future guidance under §457(f) will generally adopt the rules relating to the definition of a substantial risk of forfeiture under §409A. As described above, under §409A, a right to an amount of compensation is subject to a substantial risk of forfeiture if the amount is conditioned on the performance of substantial future services or the occurrence of

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<sup>56</sup> IRS Notice 2007-62.

a condition that is related to a purpose of the compensation and the possibility of forfeiture is substantial.<sup>57</sup> Unlike under §457(f), compensation is not subject to a substantial risk of forfeiture under §409A merely because the right to the amount is conditioned, directly or indirectly, upon the refraining from the performance of services.<sup>58</sup> Additionally, under §409A, unlike under §457(f), the addition of any risk of forfeiture after the legally binding right to the compensation arises, or any extension of a period during which compensation is subject to a risk of forfeiture (*i.e.*, a rolling risk of forfeiture), is disregarded in determining whether compensation is subject to a substantial risk of forfeiture, unless the present value of such amount (disregarding the risk of forfeiture) is materially greater than the present value of the vested amount the participant otherwise could have elected to receive.<sup>59</sup> This means that if this guidance is issued, the structure of §457(f) plans would have to change since events previously considered substantial risks of forfeiture would no longer be considered as such.

## 2. Prohibition of Salary and Bonus Deferrals

In describing what constitutes a bona fide substantial risk of forfeiture, Notice 2007-62 makes it clear that elective salary deferrals and bonus deferrals can never be made subject to a substantial risk of forfeiture beyond the date or time the salary would otherwise have been received. The stated rationale for this position is that “a rational participant normally would not agree to subject a right to amounts that may be earned and payable as current compensation, such as salary payments, to a condition that subjects the right to the same payments to a real possibility of forfeiture. Accordingly, in this situation, agreement to subject the amount to a substantial risk of forfeiture indicates that the recipient of the compensation is confident that there is not a real risk of forfeiture and is only subjecting the amount to the purported risk of forfeiture as a means of avoiding taxation.”

There are many employers who have §457(f) elective deferral arrangements that would have to be frozen or terminated should this rule go into effect. Some at the IRS would argue that regardless of Notice 2007-62, under current law such elective deferrals do not work for the reason stated above. Nonetheless, their current widespread use in the tax-exempt area makes it difficult for the IRS to address them on audit without a specific regulatory prohibition. At this time, for those employers who have elective deferral arrangements it may be best to sit tight until the regulatory landscape clears. For those employers who do not, it may be best not to establish one at this time.

## 3. Severance Arrangements

Notice 2007-62 states that the guidance under §457(f) will provide that an arrangement will be deemed a bona fide severance pay plan under §457 and therefore not subject to §457, if the following conditions are met:

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<sup>57</sup> Treas. Reg. §1.409A-1(d).

<sup>58</sup> *Id.*

<sup>59</sup> *Id.*

- a. the benefit is payable only upon an involuntary separation from employment,
- b. the amount payable does not exceed two times the participant's annual rate of pay for the year in which the participant has a separation from employment, up to the pay limit under §401(a)(17) (\$245,000 in 2011 for a total amount of \$490,000), and
- c. the arrangement provides that the payments must be completed by the end of the participant's second taxable year following the year in which the participant separates from employment.<sup>60</sup>

If this guidance is issued, severance payments to high-paid employees of one times salary, which are common, will have to be scaled back if the employee makes more than the dollar limit (\$490,000 for 2011). This seems a bit arbitrary since severance of one times salary is common for long-serving executives and the reasonableness of the amount is already evaluated under the intermediate sanctions regime.

Note that Notice 2007-62 states that it is anticipated that guidance will include exceptions for window programs, collectively bargained separation pay plans, and certain reimbursements or in-kind benefit arrangements similar to the exceptions in §409A.<sup>61</sup>

## **B. Notice 2008-62**

On July 1, 2008, the IRS issued Notice 2008-62 which announced the intent of the Treasury Department and the IRS to issue guidance under §457 that addresses certain types of arrangements involving recurring part-year compensation.<sup>62</sup> This guidance would address the common arrangements involving public school employees who provide services during a 9 or 10-month school year and elect to be paid ratably over 12 months. It is expected that the regulations would provide that if certain conditions are satisfied, §457(f) would not apply to such arrangements.<sup>63</sup> It is also expected that a conforming change will be proposed for regulations under §409A so that §409A will not apply to such arrangements if certain conditions are met.<sup>64</sup>

In a typical arrangement involving a school teacher, the teacher earns compensation during a 9 or 10-month school year but the teacher's employer pays the teacher based on a 12-month payment schedule. This means that some of the compensation that the teacher earns in one taxable year (*e.g.*, August through December) is paid in the following taxable year. The proposed rules provide that this compensation would not be considered deferred compensation under §457(f) or §409A if certain conditions described below are met.

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<sup>60</sup> IRS Notice 2007-62.

<sup>61</sup> *Id.*

<sup>62</sup> I.R.S. Notice 2008-62, 2008-29 I.R.B. 130.

<sup>63</sup> *Id.*

<sup>64</sup> *Id.*

Notice 2008-62 provides that the regulations to be proposed under §457(f) will specify that an arrangement in which an employee or independent contractor receives recurring part-year compensation (as defined in §409A) will not provide for deferred compensation for purposes of §457(f) if: (1) the arrangement does not defer payment of any of such compensation beyond the last day of the thirteenth month following the beginning of the service period and (2) the arrangement does not defer from one taxable year to the next taxable year the payment of more than the applicable dollar amount under §402(g)(1)(B) for the calendar year in which the service period begins (\$16,500 for 2010 and 2011).<sup>65</sup> In other words, the amount the teacher earns during the first calendar year that is paid in the second calendar year must not exceed the dollar amount in §402(g)(1)(B).

The latter requirement is problematic for employees who make over \$198,000 for the 2010-2011 school year (for a 10-month school year beginning on August 1).<sup>66</sup> While not typical in public schools, in colleges and universities it may be an issue. Further, the IRS argues that §457(f) applies even if the 12-month pay for 9-month (or 10-month) faculty is not elective but imposed on the faculty member by the institution. Ultimately, affected colleges and universities will either have to have dual payroll periods, which is unlikely, or will have to pay everyone on a 9-month (or 10-month) pay period. The upshot is that the IRS and Treasury are forcing colleges and universities to change their business practice intended to provide faculty members with income during the summer months when they are otherwise not teaching, all to avoid a “deferral” of income that affected faculty members, and most everyone else, view simply as a regular payroll cycle.

Notice 2008-62 provides that until further guidance is issued, taxpayers may rely on the rule set forth above for purposes of both §457(f) and §409A beginning with the first taxable year that includes July 1, 2008.

#### **IV. EMPLOYER ACTION**

##### **A. Section 409A Compliance**

As the deadlines for perfecting documentary compliance and the 2010 transition relief for certain documentary corrections under Notice 2010-6 have passed, employers ideally should have already conducted a comprehensive review of any arrangements that may be considered “deferred compensation” for tax purposes under the broad scope of §409A. Employers who have not thoroughly reviewed plans or arrangements that provide for deferred compensation should do so in order to take advantage of the document correction program under Notices 2010-6 and 2010-80 or the operational correction program under Notice 2008-113. Further, employers, especially large institutions with many dispersed executives authorized to negotiate compensation packages, should promulgate a policy requiring a pre-execution review by counsel of any proposed plans or arrangements that may be deemed to provide deferred compensation. Such plans and arrangements include, but are not limited to:

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<sup>65</sup> *Id.*

<sup>66</sup> Note that in this example the Code section 402(g)(1)(B) limit for 2009 is applied (\$16,500).

- traditional deferred compensation arrangements (*e.g.*, elective deferral arrangements, excess defined benefit plans, supplemental employee retirement plans (SERPS), rabbi trusts, and other financing arrangements);
- bonus and incentive compensation programs (*e.g.*, annual bonus, short-term incentive plans, long-term incentive plans, and performance plans);
- employment agreements (*e.g.*, formal agreements, letter agreements/offer letters, and retention agreements);
- severance agreements (*e.g.*, severance plans, separation agreements, reduction-in-force agreements);
- independent contractor agreements;
- fringe benefit/perquisite arrangements;
- policies or arrangements involving compensation (*e.g.*, vacation policy, reduction-in-force policies, tax gross-up commitments, and taxable reimbursement arrangements);
- split-dollar life insurance arrangements; and
- §457(f) deferred compensation arrangements.

As discussed above, §409A provides certain exceptions to this broad definition of deferred compensation, the most important of which are (i) the “short-term deferral” exception, and (ii) the exemption for certain severance payable on an involuntary termination. Plans qualifying for these exceptions must be carefully drafted to ensure that the exception is not jeopardized and that, in the event it is jeopardized, the arrangement complies with §409A. Thus, it is important to conduct a comprehensive review of all plans and arrangements that could be subject to §409A before they are finalized. Failure to comply with §409A may result in the immediate taxation of all or a substantial portion of a participant’s vested deferred compensation, plus an additional 20% penalty tax and interest payment for that participant.

## **B. Section 457(f) Compliance**

Notice 2007-62 states that guidance will be prospective and that until guidance is issued no inference should be made from the anticipated guidance described in the notice regarding the definition of a bona fide severance pay plan under §457(e)(11) or the determination of substantial risk of forfeiture for purposes of §457(f). Therefore, employers do not need to amend their plans at this time. However, Notice 2007-62 provides that pending issuance of the guidance, taxpayers may rely on the definition of a bona fide severance pay plan and the rules regarding a substantial risk of forfeiture in the anticipated guidance. Therefore, employers designing new plans will want to take Notice 2007-62 into account. To the extent the proposed requirements would not inhibit the design of the new program it may be prudent to follow the guidance of Notice 2007-62.

With respect to recurring part-year compensation, since Notice 2008-62 provides that, beginning with the first taxable year that includes July 1, 2008, until further guidance is issued taxpayers may rely on the rules set forth in the Notice for purposes of both §457(f) and §409A, any such programs should be reviewed to ensure compliance with the requirements of Notice 2008-62 to the extent it does not inhibit the design of the current program. If program changes are required, though, an affected employer should consult with its tax or benefits counsel.