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An Overview of the New Section 457(f) Regulations

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On June 22, 2016, the Internal Revenue Service (IRS) issued proposed regulations under Section 457(f) of the Internal Revenue Code of 1986, as amended (Code).¹ These long-awaited regulations were first previewed in IRS Notice 2007-62. In that Notice, the IRS announced its intention to issue proposed regulations that would harmonize the rules for deferred compensation plans of tax-exempt organizations (and state and local governments) under Section 457(f) with the then-new special rules for all deferred compensation arrangements under Section 409A. After nine years, the proposed regulations now issued address three principal issues, although with some unexpected changes and opportunities.

The harmonization of sections 457(f) and 409A, as previewed in Notice 2007-62, was expected to address three principal issues:

- **What would constitute a “bona fide severance pay plan,” which is exempt from the Section 457 rules.** The

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Notice stated that the guidance likely would provide that a bona fide severance pay plan must provide a benefit payable only upon involuntary severance from employment, the benefit must be limited to not more than two times the employee's annual rate of pay up to the annual limit on pensionable compensation under Section 401(a)(17), and payments must be completed by the end of the second tax year after the year in which the employee separated from service.

- **Whether a covenant not to compete can serve as a “substantial risk of forfeiture” event under Section 457(f).** The Notice stated the guidance likely would provide that the risk of forfeiture would not be substantial merely because the right to the amount is conditioned, directly or indirectly, on refraining from the performance of services. This was viewed as an indication that the guidance likely would prohibit the use of a covenant not to compete as a substantial risk of forfeiture.
- **Whether the vesting date for Section 457(f) deferred compensation can be delayed to a later date.** The Notice stated the intent to adopt the Section 409A position that a substantial risk of forfeiture event cannot be moved to a later date unless the deferred compensation amount subject to that delayed date is “materially greater” than the deferred compensation amount that would have been paid without the delay.

BONA FIDE SEVERANCE PAY PLAN

Section 457(e)(11) provides that certain types of compensation arrangements, including bona fide severance pay plans, are treated as not providing deferred compensation (and therefore are not governed by Section 457). The proposed regulations provide the following guidelines as to what will be considered a bona fide severance pay plan:

- The severance pay benefits must be provided only upon an involuntary severance from employment (or under an early retirement window program or voluntary early retirement incentive plan).
- The severance amount payable must not exceed two times the employee's annualized compensation based on the annual rate of pay for services to the employer for the calendar year preceding the year in which the severance from employment occurs.

- The severance amount must be paid no later than the last day of the second calendar year following the year in which the severance from employment occurs.

It is worth looking at each of these guidelines separately, reviewing the IRS “fine print,” and considering the implications if the approach in the proposed regulations is adopted in the final regulations.

The proposed regulations state that the first requirement for this exception from Section 457(f) is that the severance pay must be provided only upon an involuntary severance from employment (*i.e.*, without “cause,” as defined by the employer). This refers to an independent decision of the employer, and is intended to be distinguished from situations in which the employee voluntarily terminates employment or requests that the employer treat a voluntary or mutual termination decision as an involuntary termination. The IRS will look at the underlying facts to determine whether a severance from employment is in fact involuntary.

An important issue is whether a voluntary termination by the employee for “good reason” (or similar terminology) can ever be treated as an involuntary termination for this purpose. Many employment agreements and severance pay agreements or policies give an employee the right to terminate employment for “good reason,” and then provide the same severance pay benefits as are provided in the case of an involuntary termination. Although the 2007 Notice indicated that only an involuntary termination could trigger severance pay benefits that would be exempt from Section 457(f), the proposed regulations provide significant flexibility (1) to fashion a severance pay trigger for a voluntary termination for good reason, and (2) to exclude the resulting severance pay benefits from the reach of Section 457(f).

The proposed regulations provide that a “good reason” termination can be established under the facts and circumstances, or by coming within a safe harbor. This is the same structure used in the Section 409A regulations. Regardless of the approach used (facts and circumstances or safe harbor), the good reason termination right must be described in writing, in advance, and in a way that indicates that avoiding the Section 457 rules is not the primary purpose. In addition to those factors, the key elements of these two approaches in the proposed regulations are as follows:

- **Facts and circumstances approach:** The good reason termination right must result from unilateral employer action resulting in a material adverse change in the working relationship (such as a material reduction in the employee’s duties, working conditions, or pay). Other favorable factors are that severance payments (for a voluntary termination for good reason) are the same as for an involuntary termination

without cause, or that the employee is required to give notice to the employer of the good reason event and provide the employer the opportunity to correct the good reason event.

- **Safe harbor approach:** A good reason termination right will satisfy this element of the exception from Section 457 if strict triggering event and timing requirements are met. First, the employment termination must occur not more than two years after the initial existence of one of the following conditions: (1) a material diminution in base compensation, (2) a material diminution in the employee's authority, duties or responsibilities, (3) a material diminution in the authority, duties or responsibilities of the supervisor to whom the employee is required to report, (4) a material diminution in the budget over which the employee has authority, (5) a material change in the geographic location at which the employee must perform services, or (6) any other action or inaction constituting a material breach by the employer of the agreement under which the employee performs services. Second, the amount, time, and form of severance payment (for the voluntary termination for good reason) must be the same as the amount, time, and form of severance payment made upon an involuntary termination. Third, the employee must give notice to the employer of the existence of the good reason event within 90 days after the initial existence of the good reason event, and then the employer must have at least 30 days to remedy the condition (such that the severance payments would not be owed).

If the triggering event for the severance payments satisfies the facts-and-circumstances approach or the safe harbor approach, that is still only one element of the exception for a bona fide severance pay plan. One of the other required elements is that the total amount of severance pay cannot exceed two times the employee's annualized compensation based on the annual rate of pay for services to the employer during the calendar year preceding the year in which termination occurs. This amount can be adjusted by the general rate of increase that would have applied if employment had not terminated. It is not clear if this can be the rate of increase in market data for that individual's position, the rate used by the employer for executive employees generally, or some other objective measure of salary increase that arguably could have been used but for the termination.

It is also not clear whether the reference to "annualized compensation" means base salary only (presumably before any pre-tax salary reductions), total cash compensation, total W-2 compensation (which

then could include certain forms of benefits), or total compensation including deferred compensation and benefits that are not taxable or not yet taxable. Absent further guidance from the IRS, it would seem reasonable to use W-2 compensation for this purpose, but organizations should be wary of a more restrictive IRS interpretation that “annualized compensation” means only base salary of the individual. What is noteworthy about this element of the exception, even if the reference is to base salary only, is that the compensation for this purpose is not limited to the annual limit on pensionable compensation under Section 401(a)(17), which in 2016 is \$265,000. Because most severance arrangements for more highly compensated executives do not exceed two times annual compensation, the use of all compensation, without the Section 401(a)(17) limit, provides a much greater possibility that most severance arrangements for more highly compensated executives will fall outside the reach of Section 457(f).

The final required element concerns the timing of the severance payments. To qualify for the bona fide severance pay plan exception from Section 457(f), the severance payments must be completed before the end of the second tax year ending after the year in which the severance from employment occurs.

The limits on the amount and timing of severance pay benefits (to qualify as a bona fide severance pay plan exempt from Section 457) raise an interesting issue about adjusting arrangements to fit within the exception as described in the proposed regulations. Any severance pay arrangement that exceeds two times annual compensation, or exceeds 24 months in payment beyond the year of termination, should be reviewed carefully, with special consideration of any restructuring options that would enable the arrangement to fit more squarely in the exception described in the proposed regulations. In particular, the plan sponsor should carefully consider whether changing payment timing under an existing arrangement (to satisfy the proposed regulations) could be problematic in and of itself under Section 409A.

ROLLING RISK OF FORFEITURE

The proposed regulations provide additional detail on what constitutes a “substantial risk of forfeiture”. Unlike nonqualified deferred compensation arrangements in the for-profit world, where distributions structured under Section 409A are generally taxable when paid even if a “substantial risk of forfeiture” expired many years before payment, amounts deferred under a plan subject to Section 457(f) are taxable when the substantial risk of forfeiture lapses, even if not distributed to the participant at that time. The proposed regulations provide that a substantial risk of forfeiture exists under Section 457(f) only if entitlement

to the amount is conditioned on the future performance of substantial services or upon a condition related to the purpose of the compensation (*i.e.*, only if the condition relates to the participant's performance of services for the employer or its activities or organizational goals).

Elective Deferral Opportunities

The proposed regulations provide significant elective deferral opportunities for Section 457(f) plan participants. Plan participants may want to defer taxation by extending the period during which a substantial risk of forfeiture exists. For example, a 61-year old college professor intending to retire at age 65 who would otherwise vest in a \$100,000 retention payment for 2017 services on December 31, 2017, might want to delay taxation until 2021 (*i.e.*, until the year the professor retires), believing that the professor will be in a lower income tax bracket in that year. In that case, the employer and the professor might agree to an arrangement on November 1, 2017, whereby the professor must provide an additional four years of substantial services to the college to vest in (and therefore be taxed on) the \$100,000.

The proposed regulations are clear that this attempt to extend the period during which a substantial risk of forfeiture exists would not be respected and that the \$100,000 would be taxable in 2017 (assuming the participant remained employed until December 31, 2017). The regulations impose the following requirements on the \$100,000 to defer taxation until 2021:

- **Benefit must be materially greater:** The present value of the deferred benefit must be materially greater than the present value of the amount that the employee could have received had the substantial risk of forfeiture not been extended. The regulations provide that that amount is "materially greater" if its present value is more than 125 percent of the present value of the amount the participant could have received without the extension. In the example described, the benefit was the same whether it vested in 2017 or 2021, so the attempted extension of the substantial risk of forfeiture would fail to meet this requirement.
- **Minimum two years of substantial future services:** The participant must be required to perform additional substantial services for at least two years following the date the substantial risk of forfeiture otherwise would have expired

(or, as discussed later, must refrain from competing under a noncompete agreement that satisfies the requirements of the new regulation) for at least two years. However, an agreement may provide that the substantial services condition will lapse on the participant's death, disability or involuntary severance from employment (without cause) without resulting in expiration of the substantial risk of forfeiture on the date the parties entered into the agreement. The agreement between the professor and the college would satisfy this particular requirement.

- **Timing:** The written agreement to extend the substantial risk of forfeiture must be signed at least 90 days before the original substantial risk of forfeiture would have lapsed.² November 1, 2017 is less than 90 days before December 31, 2017, so the attempted amendment will not have met this particular requirement.

In the example of our college professor, the parties would have to have agreed on or before October 2, 2017, that more than \$125,000 would vest in 2021 subject to the provision of substantial services until the date the substantial risk of forfeiture expired.

Creating a Substantial Risk of Forfeiture

The regulations also permit the employer and employee to *create* a substantial risk of forfeiture when none previously existed to defer taxation of current compensation. This creates significant opportunities for elective compensation deferrals. For example, a hospital president might wish to defer \$200,000 of compensation that would otherwise be paid semimonthly in 2017. The same three requirements apply to this deferral as applied to the college professor's deferral, except that the deferral election must be in effect by December 31, 2016 (*i.e.*, before the start of the year in which the compensation is earned). To satisfy the "materially greater" requirement, the hospital might provide for a "match" of 30 percent of the amount deferred, bringing the total amount subject to a substantial risk of forfeiture to \$260,000. To delay taxation, each semimonthly payment must be subject to a substantial risk of forfeiture for at least two years following the date it otherwise would have been paid (*e.g.*, a payment that otherwise would have been made on January 15, 2017, must be subject to a substantial risk of forfeiture until at least January 15, 2019).

Rather than providing a match, the hospital might consider coordinating the elective deferral with a planned-for (but not agreed-to

or announced) retention bonus payment contingent upon the performance of substantial future services until the time the substantial risk of forfeiture elapses on the deferred compensation. For example, if the hospital was planning on providing the president with a \$75,000 bonus for continuing to provide substantial services until December 31, 2019, it might instead permit the president to defer less than \$300,000 of 2017 compensation ($25\% \times \$300,000 = \$75,000$) until December 31, 2019, and provide the \$75,000 as an employer contribution rather than as a bonus. The hospital president would receive \$275,000 (the \$200,000 elective contribution plus the \$75,000 employer contribution) provided the president provided substantial services until December 31, 2019, and the amount was payable on that date. The hospital would need to ensure that the participant had no legally binding right to receive the \$75,000 merely because the president continued to provide substantial services until that date, as the regulations explicitly provide that compensation a participant would receive for continuing to perform services regardless of whether a deferred amount is subject to an additional substantial risk of forfeiture is not taken into account in determining whether the “materially greater” requirement is met.

NONCOMPETITION AGREEMENTS

Many practitioners likely were surprised that the proposed regulations provide that under certain circumstances, a noncompete agreement (or covenant not to compete) can constitute a substantial risk of forfeiture under the new regulations, as the preamble to the Section 409A regulations expressly provides that such an agreement is not a substantial risk of forfeiture under Section 409A. If the proposed Section 457(f) regulations had instead provided that a substantial risk of forfeiture could not be maintained under noncompete agreements, those agreements would likely only be used if another exception to Section 457(f) coverage were available (such as the severance pay exception, discussed later).

The regulations provide that compensation is not treated as subject to a substantial risk of forfeiture merely because it would be forfeited if the employee accepts a position with another employer. The following conditions must be met for a noncompete agreement between a tax-exempt entity and an employee to constitute a substantial risk of forfeiture:

- The right to payment for not competing is established pursuant to an enforceable written agreement (this likely refers to an independent written agreement having the force of an independent contract and not merely to a noncompete clause in a deferred compensation plan or arrangement);

- The employer makes reasonable ongoing efforts to verify compliance with noncompete agreements (including the agreement applicable to the employee); and
- At the time the agreement becomes binding, the facts and circumstances indicate that the employer has a substantial and bona fide interest in preventing the employee from performing prohibited services and that the employee has a bona fide interest in, and ability to, engage in the prohibited competition. The regulations provide that factors taken into account include the 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.

The proposed regulations also provide that for a risk of forfeiture to be substantial, “the possibility of actual forfeiture in the event that the forfeiture condition occurs must be substantial based on the facts and circumstances.” Among other relevant factors, the extent to which the employer has enforced forfeiture conditions in the past is relevant in determining whether a risk of forfeiture is “substantial.” As applied to noncompete agreements, this means an employer should make sure it is prepared to bring suit if an employee or former employee violates an agreement—otherwise, the risk of forfeiture not only for the agreement in question but for other noncompete agreements may not be “substantial” for purposes of the regulations.

Complying with these requirements may often be easier said than done. The “enforceable written agreement” test would not be fulfilled when, due to state law, the noncompete agreement is *per se* unenforceable, such as California. But a noncompete agreement also would not be enforceable if a court determines it is overly broad (due to length of time, geographic scope, or range of activities), and simply declares the entire noncompete agreement invalid rather than “blue penciling” the unenforceable provisions. The IRS could address this by interpreting the word “enforceable” to mean that there must be a good legal basis for believing that the arrangement is enforceable. However, the IRS instead could assert that all compensation paid under an agreement that a court ultimately determined to be overly broad was never subject to a substantial risk of forfeiture and that amounts paid under the agreement should have been subject to tax as of the date the parties entered into the arrangement, though this would seem to be an overly harsh result in the authors' opinion.

Similarly, the requirement to make reasonable ongoing efforts to verify compliance with noncompete agreements raises facts-and-circumstances questions about what efforts are necessary. For example, if a tax-exempt university has entered into noncompete agreements with a number of its coaches, some of whom the university no longer considers to be a competitive threat, how many does it need to monitor? Does it need to monitor agreements for coaches it no longer considers a competitive threat even if it considers such monitoring a waste of resources? What if it cannot locate one or more of the coaches? In the authors' opinion, using a third-party vendor to make periodic (such as quarterly) checkups on the former employee subject to the noncompete obligation should be sufficient, but there is little guidance on this point.

Finally, the requirement that the employee and employer have respective interests in engaging in the prohibited competition and preventing it means that employers should evaluate the necessity of noncompetes on a case-by-case basis, rather than having a general policy of entering into noncompete agreements with every employee in a particular position. For example, if a university has a policy of entering into noncompete agreements with its coaches, does it face "significant adverse economic consequences" if the track-and-field coach leaves to work at another school? If the coach is independently wealthy and has recently had a stroke, does the coach have a "financial need" or "ability" to continue coaching? The example used in the regulations to illustrate a noncompete agreement with a substantial risk of forfeiture is that of a "well-known college sports coach with a long history of success" in a university's sports program, whose departure would be "substantially detrimental to its sports program and would result in significant financial losses" and who has a "bona fide interest in continuing to work as a college sports coach and is highly marketable." This example illustrates a "picture-perfect" noncompete agreement with a substantial risk of forfeiture, and there is no guidance as to how far an agreement can deviate from the example and still be interpreted as maintaining a substantial risk of forfeiture.

Many practitioners (including the authors) likely welcome the opportunities presented under the proposed regulations. The final regulations may provide additional guidance on some of the unanswered questions raised in this article.

NOTES

1. References to "Sections" throughout this article refer to the applicable Code section.
2. Note that a special rule applies for newly hired employees.

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