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Proposed Treasury Regulations Provide Additional Flexibility, Clarity and Planning Opportunities to Sponsors of Deferred Compensation Arrangements

The IRS recently issued proposed regulations under Internal Revenue Code Section 457 that address, among other things, the interplay between Code Section 457(f) and Code Section 409A. Additionally, the IRS issued clarifying guidance on the final Code Section 409A regulations and the proposed Code Section 409A income inclusion regulations.

The Code Section 457(f) proposed regulations have been highly anticipated in the tax-exempt and state and local government communities as they directly impact certain compensation arrangements for such entities. Some of the guidance in these proposed regulations was expected, based on the guidance issued in IRS Notice 2007-62 (the "2007 Notice"). However, the proposed regulations surprisingly diverge in certain areas from the 2007 Notice and provide unexpected flexibility in certain areas. The proposed Code Section 409A regulations provide helpful clarifications under the final regulations and the proposed income inclusion regulations.

Below are some areas of new opportunities and developments under these proposed regulations, as well as some areas where the regulations provide additional flexibility and clarifications that are particularly important to employers and executives.

Highlights from the proposed Code Section 457(f) regulations include:

- *clarifications surrounding "bona fide severance pay plans;"*
- *certain noncompetition agreements can be used as a substantial risk of forfeiture;*
- *"rolling risks of forfeiture" and deferrals of current compensation are permitted if certain conditions are satisfied; and*
- *short-term deferrals also apply to Code Section 457(f).*

Highlights from the proposed Code Section 409A regulations include:

- *Important clarifications regarding changing the time and form of payment for unvested amounts, and*
- *Clarification regarding the subsequent deferral rules and plan terminations.*

Proposed Code Section 457(f) Regulations

Code Section 457 applies to nonqualified deferred compensation plans established by tax-exempt and state and local government employers. Tax exempt and state and local government entities can establish "eligible" Code Section 457(b) plans (subject to deferral limitations but delaying taxation until compensation is paid or made available to

If you have questions or would like additional information about these proposed regulations, please contact the following attorneys in the **Employee Benefits and Executive Compensation** practice:

Gabriel S. Marinaro
+1.312.902.5409
gabriel.marinaro@kattenlaw.com

Austin S. Lilling
+1.212.940.8510
austin.lilling@kattenlaw.com

Andrew R. Skowronski
+1.312.902.5230
andrew.skowronski@kattenlaw.com

the participant) and “ineligible” Code Section 457(f) plans (not subject to the deferral limitations of Code Section 457(b) plans but requiring taxation when the amounts are no longer subject to a substantial risk of forfeiture).

The proposed Code Section 457(f) regulations provide that an amount will be treated as “deferred compensation” where a participant has a legally binding right during a taxable year to compensation that, pursuant to the terms of the plan, is or may be payable in a later taxable year and that is not subject to a substantial risk of forfeiture.

A. Bona Fide Severance Pay Plans

The proposed Code Section 457(f) regulations provide that a bona fide severance pay plan will not be treated as deferred compensation subject to Code Section 457(f) provided that it meets certain requirements, which generally track the “separation pay plan” exception under Code Section 409A. Similar to Code Section 409A’s separation pay plan exception, the proposed Code Section 457(f) bona fide severance pay plan exception provides that a voluntary termination for “good reason” will be treated as an involuntary termination (including a “good reason” safe harbor), provided certain conditions are met. One area where the proposed Code Section 457(f) bona fide severance pay plan exception and the separation pay plan exception under Code Section 409A diverge is that the “two times pay” requirement under the bona fide severance pay plan exception does not contemplate a lower Code Section 401(a)(17) limit.

B. Short-Term Deferrals

Adopting the short-term deferral requirements under Code Section 409A, the proposed Code Section 457(f) regulations provide that a deferral of compensation under Code Section 457(f) does not occur with respect to any payment that the participant actually or constructively receives on or before the later of the 15th day of the third month following the end of the first calendar year in which the right to payment is no longer subject to a substantial risk of forfeiture, or the 15th day of the third month following the end of the eligible employer’s first tax year in which the right the payment is no longer subject to a substantial risk of forfeiture.

Katten Practice Note. *It is unclear whether, like Code Section 409A, the IRS will permit “stacking” of exemptions (i.e., combining the short-term deferral concept and the bona fide severance pay plan concept) under the Code Section 457(f) regulations to exempt maximum amounts from Code Section 457(f) (similar to the flexibility under Code Section 409A).*

C. Noncompetition Restrictions as a Substantial Risk of Forfeiture

The proposed Code Section 457(f) regulations adopt similar, yet not identical, provisions to Code Section 409A and provide that an amount is generally subject to a substantial risk of forfeiture only if entitlement to that 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 and if the possibility of forfeiture is substantial. Whether an amount is conditioned on the future performance of substantial services is based on all of the relevant facts and circumstances, such as whether the hours required to be performed during the relevant period are substantial in relation to the amount of compensation.

A condition is related to a purpose of the compensation only if the condition relates to the employee’s performance of services for the employer or to the employer’s tax exempt or governmental activities, as applicable, or organizational goals. An amount is not subject to a substantial risk of forfeiture if the facts and circumstances indicate the forfeiture condition is unlikely to be enforced. Factors considered for purposes of determining the likelihood that the forfeiture will be enforced include, but are not limited to: (1) the past practices of the employer; (2) the level of control or influence of the employee with respect to the organization and the individual(s) who would be responsible for enforcing the forfeiture; (3) and the enforceability of the provisions under applicable law.

In a surprising change from the 2007 Notice and in breaking with the guidance under Section 409A, the proposed Code Section 457(f) regulations recognize certain noncompetition agreements as providing a substantial risk of forfeiture. The 2007 Notice, referencing Section 409A, noted that noncompetition restrictions would be disregarded for purposes of determining whether an amount was subject to a substantial risk of forfeiture. Under these proposed regulations, compensation subject to a noncompetition requirement will only be subject to a substantial risk of forfeiture if the following conditions are satisfied:

- the right to the compensation must be expressly conditioned on the employee refraining from the performance of future services pursuant to a written agreement that is enforceable under applicable law;
- the employer must consistently make reasonable efforts to verify compliance with all of the noncompetition agreements to which it is a party (including the noncompetition agreement at issue);
- at the time the noncompetition 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 that the employee has a bona fide interest in engaging, and an ability to engage in the prohibited services.

  Katten Practice Note. *Several factors are relevant for this purpose: 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 employees' interest, financial need, and ability to engage in the prohibited services.*

D. Rolling Risks of Forfeiture and Deferrals of Current Compensation

Another area where the proposed regulations and the 2007 notice diverge is on the topic of "rolling risks of forfeiture" and the deferral of current compensation. The proposed regulations provide that current compensation (i.e., salary, commissions, etc.) or an attempt to extend the substantial risk of forfeiture period, (i.e., a rolling risk of forfeiture) is generally disregarded under the proposed regulations unless the following conditions are satisfied:

- the present value of the amount to be paid upon the lapse of the substantial risk of forfeiture must be materially greater than the amount the employee otherwise would be paid in the absence of the substantial risk of forfeiture (or absence of an extension);

  Katten Practice Note. *An amount is "materially greater" for this purpose only if the present value of the amount to be paid on the lapse of the substantial risk of forfeiture, measured as of the date the amount would have otherwise been paid (or in the case of an extension of the risk of forfeiture, the date that the substantial risk of forfeiture would have lapsed without regard to the extension), is more than 125 percent of the amount the participant otherwise would have received on that date in the absence of the new or extended substantial risk of forfeiture.*
- the initial or extended substantial risk of forfeiture must be based upon the future performance of substantial services (or adherence to an agreement not to compete). It may not be based solely on the occurrence of a condition related to the purpose of the transfer (for example, a performance goal for the organization), though that type of condition may be combined with a sufficient service condition;
- the period for which substantial future services must be performed may not be less than two years (absent an intervening event such as death, disability, or involuntary severance from employment); and

  For example, if an employee elects to defer a fixed percentage from each semi-monthly payroll, the two-year minimum applies to each semi-monthly payroll amount that would have otherwise been paid.
- the agreement subjecting the amount to a substantial risk of forfeiture must be made in writing before the beginning of the calendar year in which any services giving rise to the compensation are performed in the case of initial deferrals of current compensation or at least 90 days before the date on which an existing substantial risk of forfeiture would have lapsed in the absence of an extension.

  If an employee with respect to whom compensation is made subject to an initial or extended substantial risk of forfeiture was not providing services to the employer at least 90 days before the addition or extension, the addition or extension may be agreed to in writing within 30 days after commencement of employment but only with respect to amounts attributable to services rendered after the addition or extension is agreed to in writing.

Proposed Code Section 409A Regulations

Code Section 409A provides certain rules and requirements regarding nonqualified deferred compensation, including the time and form of payment of such compensation. In 2007, the IRS issued final regulations covering the bulk of the time and form of payment concepts covered by Section 409A (the "2007 regulations"). In 2008, the IRS issued proposed regulations regarding the calculation of nonqualified deferred compensation amounts includible in income under Section 409A (the "2008 proposed regulations"). The recently proposed 2016 Section 409A regulations (the "2016 regulations") provide certain clarifications regarding the 2007 regulations and the 2008 proposed regulations. The following highlights a few important items from these regulations that should be considered.

A. Changing the Time or Form of Payment for Unvested Amounts

The 2008 proposed regulations permit the correction of certain plan provisions that fail to comply with Code Section 409A while the amounts remain subject to a substantial risk of forfeiture without including the amounts in income or incurring an additional tax under Code Section 409A. However, the 2008 proposed regulations include an anti-abuse provision, which provides that amounts that would otherwise be treated as subject to a substantial risk of forfeiture will not be treated as such if the facts and circumstances indicate that the service recipient has a pattern or practice of permitting impermissible changes in the time or form of payment. The 2016 proposed regulations provide examples of the types of facts and circumstances that indicate whether there is a pattern or practice of permitting impermissible changes in the time and form of payment including: (1) whether a service recipient has taken commercially reasonable measures to identify and correct substantially similar failures promptly upon discovery; (2) whether substantially similar failures have occurred with respect to nonvested deferred amounts to a greater extent than with respect to vested deferred amounts; (3) whether substantially similar failures occur more frequently with respect to newly adopted plans; and (4) whether substantially similar failures appear intentional, are numerous or repeat common past failures that have since been corrected.

The preambles to the 2016 proposed regulations provide that, although correction of certain plan provisions that fail to comply with Section 409A while the amounts are subject to a substantial risk of forfeiture are permissible, this was not intended to allow employers to change the time or form of payment that otherwise meet the requirements under Code Section 409A. Additionally, the 2016 proposed regulations clarify that, to the extent the Code Section 409A correction guidance (See IRS Notice 2008-113 (for operational errors) and IRS Notice 2010-6 (for documentary errors)) prescribe a particular correction method (or methods) for a type of plan failure, that correction method (or one of the permissible correction methods) must be used to correct an unvested amount. This does not, however, require that an employer also observe the general eligibility requirements, income inclusion, additional taxes, premium interest or information reporting requirements prescribed under the Code Section 409A correction guidance.

B. Clarifications Regarding Subsequent Deferrals and Plan Terminations

Much of the 2016 proposed regulations relating to the 2007 regulations focuses on clarifying certain areas where commenters have highlighted a variety of differing interpretations on a particular provision. Two of these clarifications surround the subsequent deferral rules and plan terminations. The 2016 proposed regulations clarify that, unless a Code Section 83(b) election is made, replacement of amounts payable under a plan with restricted stock that defers the income inclusion beyond the payment date of the original payment will be treated as an impermissible subsequent deferral and will not be recognized as the payment under the initial deferral. Additionally, the 2016 regulations clarify that the acceleration of a payment pursuant to a plan termination is permitted only if the service recipient terminates all plans of the same category, and not merely all plans of the same type in which a particular service provider actually participates.

Applicability Dates

Generally, the proposed Code Section 457(f) regulations apply to compensation deferred under a plan for calendar years beginning after the date of publication of final regulations, including deferred amounts to which the legally binding right arose during prior calendar years that were not previously included in income during one or more prior calendar years. However, an employer may choose to rely on these proposed regulations immediately. There are also special effective dates for collectively bargained arrangements and governmental plans.

The provisions of the proposed 2016 Section 409A regulations that are amending the 2007 regulations will apply on or after the date final regulations are published. Prior to finalizing, the existing 2007 regulations can be relied upon (without regard to the 2016 proposed regulations); provided that taxpayers may rely on the guidance in the proposed regulations prior to being finalized.

The IRS clarified that certain positions may not be taken under the existing 2007 regulations, including (1) that a transfer of restricted stock for which no Section 83(b) election is made as replacement for compensation subject to Section 409A will not be treated as a paid on the date provided for under the plan (and will instead be treated as a subsequent deferral), and (2) acceleration of payments upon a plan termination of only those plans in the same plan category and in which the service provider participates.

With respect to the proposed 2016 regulations applicable to the 2008 proposed regulations, taxpayers may rely on the 2008 proposed regulations, as modified by the 2016 regulations, until the final regulations are published.

Planning Opportunities

The proposed Code Section 457(f) regulations provide considerable flexibility and planning opportunities such as altering vesting requirements to include noncompete compliance conditions and considerations surrounding deferrals of current compensation and rolling the risk of forfeiture. Tax-exempt and state and local governmental employers should work with benefits counsel to review existing employment contracts and deferred compensation arrangements to determine what impact this new guidance might have on their compensation practices and whether modifications to current arrangements should be made. Likewise, the proposed Code Section 409A regulations provide important clarifications that need to be considered when administering and drafting nonqualified deferred compensation programs, and employers should take this opportunity to work with their benefits counsel to determine whether any technical changes should be incorporated into currently effective arrangements.

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