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Steps Tax-Exempt and Governmental Employers Should Take Regarding the New Proposed Regulations for Ineligible Deferred Compensation Plans

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After more than nine years of waiting, eligible tax-exempt, state government, and local government employers (collectively, Tax-Exempt and Governmental Employers)² finally have received the guidance long promised by the IRS regarding the requirements for

“ineligible” deferred compensation plans under §457(f) (Ineligible Plan Requirements). This guidance appeared in proposed Treasury Department and IRS regulations that were published in the Federal Register on June 22, 2016 (Proposed §457 Regulations).³ The Proposed §457 Regulations provide important information for Tax-Exempt and Governmental Employers that either currently have, or are thinking of establishing, nonqualified arrangements that provide taxable compensation or benefits in a future calendar year, including, but not limited to, employment agreements, certain bonus agreements and plans, certain incentive compensation agreements and plans, separation agreements, certain elective and nonelective deferred compensation agreements and plans, severance plans, and certain other types of nonqualified and non-exempt compensation-related agreements, plans, and programs. Among the more important new requirements described in the Proposed §457 Regulations are the following:

- new requirements that will allow Tax-Exempt and Governmental Employers to take full advantage of a commonly-used exemption from certain deferred compensation requirements known as the short-term deferral exemption (described in Part

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² §457(e)(1) defines an eligible employer as, “(A) a State, political subdivision of a State, and any agency or instrumentality of a State or political subdivision of a State, and (B) any other organization (other than a governmental unit) exempt from tax under this subtitle.” The District of Columbia is treated as a State for purposes of this definition. See Reg. §1.457-2(l). Certain churches (as defined in §3121(w)(3)(A)) and qualified church-controlled organizations (as defined in §3121(w)(3)(B)) are not covered by the deferred compensation requirements in §457. See §457(e)(13). The exemption for qualified church-controlled organizations is

narrow in scope, and there are many church-related organizations that will still need to comply with the Ineligible Plan Requirements. Each individual Tax-Exempt and Governmental Employer is referred to in this article as a “Tax-Exempt or Governmental Employer.” Unless otherwise identified, all statutory references in this article are to the I.R.C., and all regulatory references in this article are to the regulations or proposed regulations of the I.R.C.

³ Deferred Compensation Plans of State and Local Governments and Tax-Exempt Entities, 81 Fed. Reg. 40,548 (June 22, 2016).

V.C., below), which will provide additional flexibility when determining when certain types of deferred compensation have to be taxed;

- new information about how to establish a substantial risk of forfeiture that will allow certain types of compensation to be deferred, including the possible use of: (1) certain non-compete conditions; and (2) certain conditions that are related to a purpose of the compensation (described in Part VIII., below);
- new requirements regarding conditioning the receipt of deferred compensation on an involuntary severance from employment without cause, including allowing, for the first time, an employee's election to terminate for a permissible good reason to be treated as an involuntary severance from employment without cause under the Ineligible Plan Requirements (described in Parts V.E., VI., and VIII.C., below);
- new requirements regarding the right of employees to voluntarily elect to defer current compensation (described in Part IX., below);
- new requirements regarding how to extend a substantial risk of forfeiture period after a legally binding right to deferred compensation has arisen, which will allow, among other things, a scheduled deferred compensation payment date to be delayed if certain requirements are satisfied (described in Part X., below); and
- new information about the other types of arrangements that are exempt from the deferred compensation requirements in §457 (§457 Deferred Compensation Requirements), including certain recurring part-year compensation arrangements, bona fide severance pay plans, bona fide death benefit plans, bona fide disability pay plans, and bona fide sick and vacation leave plans (described in Parts V.D.–V.H., below).

I. WHAT ARE THE CURRENT NONQUALIFIED DEFERRED COMPENSATION REQUIREMENTS THAT APPLY ONLY TO TAX-EXEMPT AND GOVERNMENTAL EMPLOYERS?

The current nonqualified deferred compensation requirements for Tax-Exempt and Governmental Employers under §457 establish separate requirements for:

- eligible nonqualified deferred compensation plans under §457(b) (such plans are referred to as Eligible Plans, and such requirements are referred to as the Eligible Plan Requirements); and

- nonqualified deferred compensation plans that do not satisfy the Eligible Plan Requirements, under §457(f) (such plans are referred to as Ineligible Plans).

Under an Eligible Plan, an annual deferral of compensation can be made for eligible employees in an amount equal to the lesser of: (1) the applicable dollar amount, as adjusted periodically for cost-of-living increases (that dollar amount is \$18,000 in 2016);⁴ or (2) 100% of an employee's includible compensation,⁵ subject to certain exceptions⁶ and requirements.⁷ If Tax-Exempt and Governmental Employers would like to provide nonqualified deferred compensation benefits in excess of the permitted amount under an Eligible Plan, they will have to structure that deferred compensation to satisfy the Ineligible Plan Requirements under §457(f) or else qualify under one of the permitted exemptions to the Ineligible Plan Requirements (the main exemptions are described in Part V., below).

The Ineligible Plan Requirements generally apply to nonqualified agreements, plans, or programs of Tax-Exempt and Governmental Employers that provide for taxable compensation or benefits to be provided in a future calendar year, subject to certain exemptions. If an agreement, plan, or program is subject to the Ineligible Plan Requirements, §457(f) generally provides that the applicable taxable compensation or benefits for an employee will be taxed in the first calendar year in which the employee's right to receive such compensation or benefits is no longer contingent on the future performance of substantial services by that employee.⁸ For example, if a tax-exempt employer establishes in 2016 a bonus or incentive compensation arrangement for an employee that provides for a payment in a future calendar year and does not require the employee to continue to perform substantial services through a specified date in that future calendar year, §457(f) generally requires that the present value of that payment be taxed to the employee in

⁴ Notice 2015-75, 2015-46 I.R.B. 668.

⁵ §457(b)(2).

⁶ The deferral limit in this sentence does not include rollover amounts (§457(b)(2)), and is subject to possible catch-up contribution requirements in an employee's last three taxable years before he or she attains normal retirement age that are described in §457(b)(3).

⁷ An Eligible Plan must also satisfy several other requirements, including, among other things, additional statutory requirements in §457, regulatory requirements in Reg. §1.457-1 to §1.457-10 and Reg. §1.457-12, and provisions in the Proposed §457 Regulations that change some or all of Reg. §1.457-1, §1.457-2, §1.457-4, §1.457-6, §1.457-7, §1.457-9, §1.457-10, and §1.457-11 and add a new Reg. §1.457-13.

⁸ See §457(f)(1)(A), §457(f)(3)(B).

2016.⁹ There are several statutory exemptions to some or all of the deferred compensation tax requirements under §457.¹⁰

The deferred compensation requirements under §457 generally also apply to independent contractors,¹¹ subject to the applicable exemptions.¹²

⁹ *Id.* The new requirements regarding the short-term deferral exemption in the Proposed §457 Regulations that are described in Part V.E., below, will provide significant new flexibility when determining the applicable calendar year when certain deferred compensation has to be taxed.

¹⁰ Among the more important of these exemptions are exemptions for: (a) bona fide severance pay, disability pay, death benefit, vacation leave, sick leave, and compensatory time plans under §457(e)(11)(A)(i); (b) certain length of service award plans for volunteers and their beneficiaries under §457(e)(11)(A)(ii); (c) certain voluntary early retirement incentive plans under §457(e)(11)(D); (d) certain nonelective deferred compensation arrangements for nonemployees under §457(e)(12); (e) certain churches (defined in §3121(w)(3)(A)) and qualified church-controlled organizations (defined in §3121(w)(3)(B)) under §457(e)(13); (f) qualified retirement plans described in §401(a) and tax-exempt trusts described in §501(a), under §457(f)(2)(A); (g) annuity plans or contracts described in §403 (e.g., a tax-sheltered annuity plan), under §457(f)(2)(B); (h) the portion of a plan that consists of a transfer of property to which §83 applies, under §457(f)(2)(C); (i) the portion of a plan that consists of a non-exempt trust described in §402(b), under §457(f)(2)(D); (j) a qualified governmental excess benefit arrangement that satisfies the requirements in §415(m), under §457(f)(2)(E); (k) the portion of a plan that consists of an employment retention plan of an educational entity that satisfies the requirements of §457(f)(4), under §457(f)(2)(F); (l) qualified state judicial plans, under Pub. L. No. 95-600, §131(c)(3) as amended by Pub. L. No. 97-248, §252, and Pub. L. No. 99-514, §1107(c)(4); (m) certain “grandfathered” plans or arrangements of tax-exempt entities in existence prior to January 1, 1987, under Reg. §1.457-2(k)(4)(i) and Reg. §1.457-2(b)(4); Notice 87-13, 1987-1 C.B. 432, Q&A-28; and Pub. L. No. 99-514, §1107(c)(3)(B), as amended by Pub. L. No. 100-647, §1011(e)(6)(B); (n) certain “grandfathered” collectively bargained nonelective deferred compensation plans in existence on December 31, 1987, under Reg. §1.457-2(k)(4)(ii) and Pub. L. No. 100-647, §6064(d)(2); (o) amounts deferred under certain “grandfathered” pre-1989 nonelective deferred compensation arrangements, under Reg. §1.457-2(k)(4)(iii) and Pub. L. No. 100-647, §6064(d)(3); and (p) certain “grandfathered” plans for certain individuals covered by pre-1977 Internal Revenue Service guidance, under Reg. §1.457-2(k)(4)(iv) and Pub. L. No. 99-514, §1107(c)(4) or §1107(c)(5).

¹¹ §457(e)(2) provides that “[t]he performance of service includes performance of service as an independent contractor and the person (or governmental unit) for whom such services are performed shall be treated as the employer.”

¹² See the footnotes above for a list of the main statutory exemptions. Included in this list is an exemption for nonelective deferred compensation attributable to services not performed as an employee. Section 457(e)(12)(B) provides that “deferred compensation shall be treated as nonelective only if all individuals (other than those who have not satisfied any applicable initial service requirement) with the same relationship to the payor are covered under the same plan with no individual variations or options under the plan.” See also Reg. §1.457-2(k)(1).

For purposes of this article, the term “Participant” will refer to any employee or independent contractor who has a right to receive taxable compensation or benefits in a future calendar year that is subject to the Ineligible Plan Requirements.

II. IF THE NEW GUIDANCE IS IN THE FORM OF PROPOSED §457 REGULATIONS, WHY SHOULD A TAX-EXEMPT OR GOVERNMENTAL EMPLOYER BE REVIEWING THE NEW GUIDANCE NOW?

Although the Proposed §457 Regulations have been issued in proposed form and generally will not be effective until the calendar year that begins after the date the Proposed §457 Regulations are finalized and published in the Federal Register¹³ (special effective dates apply to certain collectively bargained plans¹⁴ and certain governmental plans that require legislation to be amended¹⁵), Tax-Exempt and Governmental Employers are allowed to rely on the Proposed §457 Regulations now if they would like to do so.¹⁶ Reasons why Tax-Exempt and Governmental Employers should review the Proposed §457 Regulations now include the following:

- when the Proposed §457 Regulations are finalized, they currently are expected to apply to applicable deferred compensation to which a legally

¹³ Prop. Reg. §1.457-13(a).

¹⁴ Prop. Reg. §1.457-13(b)(1) provides that if a plan is maintained pursuant to one or more collective bargaining agreements, and if each such agreement has been ratified and is in effect on the date the Proposed §457 Regulations are published in the Federal Register in final form, those finalized regulations will not apply to compensation deferred under the plan before the earlier of: (a) the date when the last of the applicable collective bargaining agreements terminates (disregarding any collective bargaining agreement extension that occurs after the date the Proposed §457 Regulations are published in the Federal Register in final form); or (b) the first day of the third calendar year that starts after the date the Proposed §457 Regulations are published in the Federal Register in final form.

¹⁵ Prop. Reg. §1.457-13(b)(2) provides that if legislation is needed to make an applicable amendment to a governmental plan, the Proposed §457 Regulations “will not apply to compensation deferred under that plan in taxable years ending before the day following the end of the second legislative session of the legislative body with the authority to amend the plan that begins after the date of publication of the Treasury decision adopting these rules as final regulations in the Federal Register.”

¹⁶ The option to rely now on the Proposed §457 Regulations appears in the preamble to the Proposed §457 Regulations. See 81 Fed. Reg. at 40,557. The preamble to the Proposed §457 Regulations also provides that no implication is intended regarding application of the law before the Proposed §457 Regulations are finalized. *Id.*

binding right arose in prior calendar years and which was not included in gross income in a prior calendar year (thus there would be no “grandfathering” of deferred compensation arrangements entered into prior to the date the Proposed §457 Regulations are finalized);¹⁷

- the lack of guidance that existed prior to the issuance of the Proposed §457 Regulations may have resulted in certain assumptions being made when deciding how to structure an agreement, plan, or program subject to the Ineligible Plan Requirements, and it may be appropriate to revise those assumptions in light of the new guidance issued in the Proposed §457 Regulations;
- as further described below, the Proposed §457 Regulations provide new planning opportunities when structuring an agreement, plan, or program to comply with the Ineligible Plan Requirements that were not clearly available before the issuance of the Proposed §457 Regulations;¹⁸ and
- the Proposed §457 Regulations provide valuable information on how best to structure any new agreement, plan, or program that will be subject to the Ineligible Plan Requirements.¹⁹

¹⁷ Prop. Reg. §1.457-13(a) provides, in part, that when the Proposed §457 Regulations are finalized and take effect, they will also apply to “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.” The Treasury Department and the Internal Revenue Service have requested comments on several issues regarding the Proposed §457 Regulations, including whether there is a need for special transition rules for certain plans established before the proposed effective date of the Proposed §457 Regulations, such as certain severance plans, sick leave plans, and vacation leave plans. 81 Fed. Reg. at 40,557-40,558.

¹⁸ Examples of new planning opportunities that might be available are described in Part III, below.

¹⁹ It is not clear when the Proposed §457 Regulations will be finalized. A public hearing regarding the Proposed §457 Regulations has been scheduled for October 18, 2016. The length of time it will take to finalize the Proposed §457 Regulations after the public hearing has been held will depend, in part, upon the number and types of comments received regarding the Proposed §457 Regulations. If a new agreement, plan, or program is going to be subject to the Proposed §457 Regulations when those Proposed §457 Regulations are finalized, it may be easier for an employer to draft that agreement, plan, or program to comply with the Proposed §457 Regulations now in order to reduce the number of changes that might have to be made when the Proposed §457 Regulations are finalized.

III. WHAT STEPS SHOULD TAX-EXEMPT AND GOVERNMENTAL EMPLOYERS TAKE REGARDING THE NEW INELIGIBLE PLAN REQUIREMENTS IN THE PROPOSED §457 REGULATIONS?

Steps that Tax-Exempt and Governmental Employers should take regarding the new Ineligible Plan Requirements in the Proposed §457 Regulations include the following:

- *Review the Ineligible Plan Requirements in the Proposed §457 Regulations* — The Ineligible Plan Requirements in the Proposed §457 Regulations have a broad scope, and should be considered whenever a Tax-Exempt or Governmental Employer enters into an employment agreement, a separation agreement, or other nonqualified agreement, plan, or program that provides for taxable compensation or benefits in a future calendar year. If any such compensation or benefit is present, an analysis should be made as to whether it qualifies for an exemption from the Ineligible Requirements²⁰ or whether it must be structured to comply with the Ineligible Plan Requirements. When doing that analysis, the requirements in the Proposed §457 Regulations should be taken into account. If not already done, Tax-Exempt and Governmental Employers should identify which person(s) will be responsible for making sure all nonqualified deferred compensation agreements, plans, or programs are structured to either comply with the Ineligible Plan Requirements or be exempt from the Ineligible Plan Requirements. As part of that responsibility, the applicable person(s) should review and understand the requirements in the Proposed §457 Regulations.
- *Identify All Existing Nonqualified Deferred Compensation Arrangements, and Determine Whether They Are Subject to the Ineligible Plan Requirements* — If not already done, Tax-Exempt and Governmental Employers should identify all existing nonqualified agreements, plans, or programs that provide for taxable compensation or benefits in a future calendar year, and should determine which are subject to the Ineligible Plan Requirements and which are exempt from the Ineligible Plan Requirements.
- *Review the Existing Nonqualified Deferred Compensation Arrangements, and Determine If Any Compliance Changes Will Be Needed* — The existing nonqualified deferred compensation agree-

²⁰ The main exemptions are described in Part V., below.

ments, plans, and programs of Tax-Exempt and Governmental Employers that are subject to, or exempt from, the Ineligible Plan Requirements should be reviewed to see if any changes will be needed to help ensure compliance when the Proposed §457 Regulations are finalized. Although there may be some revisions to the Proposed §457 Regulations when they are finalized, most of the current requirements in the Proposed §457 Regulations likely will remain unaltered. Doing such a review sooner rather than later will provide additional time to perform any required amendments for an applicable agreement, plan, or program.

- *Review the Existing Nonqualified Deferred Compensation Arrangements to See If Any New Planning Opportunities Are Available* — The Proposed §457 Regulations provide guidance on how to implement several types of deferred compensation features in an Ineligible Plan that were not allowed or were uncertain prior to the issuance of the Proposed §457 Regulations. These include, but are not limited to: (1) structuring agreements, plans, and programs to take advantage of the new short-term deferral exemption requirements for Ineligible Plans;²¹ (2) using a properly structured noncompete provision to create a substantial risk of forfeiture;²² (3) allowing an eligible Participant's election to terminate employment for a permissible good reason to be a permitted distribution event if certain requirements are satisfied;²³ (4) allowing an eligible employee to voluntarily elect to defer current compensation if certain procedures are followed;²⁴ and (5) postponing a scheduled date of payment of deferred compensation if certain requirements are satisfied.²⁵ Tax-Exempt and Governmental Employers should consider reviewing their existing agreements, plans, and programs that are subject to the Ineligible Plan Requirements to see if any of them should be revised to take advantage of these new planning opportunities.

- *Before Entering Into Any New Nonqualified Deferred Compensation Arrangement, Review Whether It Will Comply with Any Applicable Requirement Under the Proposed §457 Regulations* — Any new nonqualified deferred compensation agreement, plan, or program generally should be structured by a Tax-Exempt or Governmental Employer to either comply with, or be exempt from,

the requirements in the Proposed §457 Regulations. Such structuring could help avoid tax exposure with respect to the Ineligible Plan Requirements, and could also reduce the number of changes that might be needed when the Proposed §457 Regulations are finalized.

- *Verify That All Nonqualified Deferred Compensation Arrangements Also Comply With Any Applicable Requirement Under §409A* — §409A has an additional set of deferred compensation requirements (§409A Requirements) that generally apply to all types of nonqualified deferred compensation plans, programs, or agreements that do not qualify for an applicable exemption.²⁶ When a Tax-Exempt or Governmental Employer structures its nonqualified deferred compensation agreements, plans, or programs to either comply with, or be exempt from, the Ineligible Plan Requirements, it should verify that such agreements, plans, or program will also comply with any applicable §409A Requirements. Caution will need to be exercised when doing such verification, because the requirements in the Proposed §457 Regulations and the §409A Requirements do not always coordinate well.²⁷ If a nonqualified deferred compensation agreement, plan, or program of a Tax-Exempt or Governmental Employer qualifies for an exemption from the Ineligible Plan Requirements but does not qualify for an exemption from the §409A Requirements, it will need to be structured to satisfy the §409A Requirements (which will require, among other things, complying with the applicable time and form of payment requirements).

²⁶ The §409A Requirements apply separately, and in addition to, any requirements under the Proposed §457 Regulations. Prop. Reg. §1.457-12(d)(5)(i). Numerous exemptions exist to the §409A Requirements, including, but not limited to, the following which are comparable to similar exemptions that apply under §457: (a) nontaxable compensation and benefits (Reg. §1.409A-1(b)(1)); (b) compensation and benefits that are not subject to a legally binding right (*Id.*); (c) short-term deferrals (Reg. §1.409A-1(b)(4); Prop. Reg. §1.409A-1(b)(4)(i)(B), §1.409A-1(b)(4)(ii)); (d) recurring part-year compensation (Reg. §1.409A-2(a)(14); Notice 2008-62, 2008-29 I.R.B. 130; Prop. Reg. §1.409A-1(b)(13)); (e) separation pay due to certain involuntary separations from service or participation in certain window programs (Reg. §1.409A-1(b)(9)(iii); Prop. Reg. §1.409A-1(b)(9)(iii)(A)); (f) bona fide death benefit plan (§409A(d)(1)(B); Reg. §1.409A-1(a)(5)); (g) bona fide disability pay plan (*Id.*); (h) bona fide vacation leave plan and bona fide sick leave plan (*Id.*); (i) qualified retirement plans under §401(a) (§409A(d)(2)(A); Reg. §1.409A-1(a)(2)(i)); (j) an annuity plan or contract under §403 (§409A(d)(2)(A); Reg. §1.409A-1(a)(2)(ii), §1.409A-1(a)(2)(iii)); and (k) a qualified governmental excess benefit arrangement under §415(m) (§409A(d)(2)(C); Reg. §1.409A-1(a)(2)(viii)).

²⁷ The chart at the end of this article describes some of the more important differences between the Proposed §457 Regulations and the §409A Requirements.

²¹ See Part V.C., below.

²² See Part VIII.D., below.

²³ See Part VI., below.

²⁴ See Part IX., below.

²⁵ See Part X., below.

- *Correct Any Errors Discovered Regarding the Ineligible Plan Requirements* — If a Tax-Exempt or Governmental Employer discovers any error with respect to the Ineligible Plan Requirements, it should correct that error as soon as reasonably possible. IRS audits regarding the Ineligible Plan Requirements are likely to increase after the Proposed §457 Regulations are finalized.

IV. WHAT CONSTITUTES A DEFERRAL OF COMPENSATION?

An agreement, plan, or program of a Tax-Exempt or Governmental Employer provides for a deferral of compensation for purposes of the Ineligible Plan Requirements if a Participant has a legally binding right during a calendar year to taxable compensation or benefits that is, or may be, paid or provided in a later calendar year, unless one of the exemptions to the Ineligible Plan Requirements applies.²⁸ A deferral of compensation that is subject to the Ineligible Plan Requirements does not cease to be a deferral of compensation if a subsequent change is made that changes a taxable compensation or benefit arrangement in a future calendar year to a nontaxable benefit arrangement.²⁹

There are several statutory and regulatory exemptions to the definition of a deferral of compensation, and some of the more important of those exemptions are described further in Part V., below.

V. WHAT ARE SOME OF THE MORE IMPORTANT EXEMPTIONS TO THE DEFERRAL OF COMPENSATION DEFINITION AND TO THE INELIGIBLE PLAN REQUIREMENTS?

Section 457 and the Proposed §457 Regulations have several exemptions to the deferral of compensation definition that relieve Tax-Exempt and Governmental Employers of the obligation to comply with the Ineligible Plan Requirements. Some of the more important of these exemptions are described below.

A. Nontaxable Compensation and Benefits

If compensation or a benefit provided pursuant to an agreement, plan, or program is nontaxable from the date it first becomes a legally binding right and is still nontaxable, it will not be subject to the Ineligible Plan

Requirements.³⁰ A nontaxable compensation or benefit arrangement that is later amended to include taxable compensation that will be paid by a Tax-Exempt or Governmental Employer in a future calendar year could become subject to the Ineligible Plan Requirements on the date such amendment becomes a legally binding right (e.g., a nontaxable retiree health arrangement that is later amended to allow cash to be paid in a future calendar year in lieu of retiree health coverage), if no other exemption to the Ineligible Plan Requirements apply.³¹

B. Compensation and Benefits That Are Not Subject to a Legally Binding Right

Under the Proposed §457 Regulations, a Participant generally will not have a legally binding right to any taxable compensation or benefits that can be unilaterally reduced or eliminated by his or her employer or another person after the date the Participant has performed the services creating the right.³² However, a Participant could still be considered to have a legally binding right if, based on all of the facts and circumstances, either of the following applies:

- *The Discretion to Reduce or Eliminate the Future Taxable Compensation or Benefits Is Exercisable Only Upon the Occurrence of a Condition* — A Participant will be considered to have a legally binding right to taxable compensation or benefits

³⁰ *Id.*

³¹ *Id.* If a Tax-Exempt or Governmental Employer is considering making a potential cash option available with respect to retiree health coverage, it could try to avoid this new regulatory requirement by, among other things, including language that makes it clear that the individual with the retiree health coverage will not have a legally binding right to the potential cash option unless certain specified events first occur (e.g., a future determination is made by the Tax-Exempt or Governmental Employer that the retiree health coverage will violate a nondiscrimination requirement under the Code, and the Tax-Exempt or Governmental Employer then decides whether or not to offer a cash option). Although the individual with the retiree health coverage may not like the fact that he or she will not have a current legally binding right to any alternative cash option that might be provided, he or she may be willing to accept that arrangement if that is what is required in order to receive the retiree health coverage.

³² Prop. Reg. §1.457-12(d)(1)(ii). Some Tax-Exempt and Governmental Employers have provided that an employee will not have a legally binding right to a deferred compensation benefit until it is actually paid to the employee. Although such a design provides flexibility for a Tax-Exempt or Governmental Employer when deciding whether to pay the deferred compensation benefit, it generally will not be as appealing to employees (employees generally would prefer to have a legally binding right to a deferred compensation benefit, as opposed to a deferred compensation benefit that can be unilaterally terminated by their employers at any time prior to payment).

²⁸ Prop. Reg. §1.457-12(d)(1).

²⁹ Prop. Reg. §1.457-12(d)(1)(i).

payable in a future calendar year if the discretion to reduce or eliminate that compensation or benefits is exercisable only upon the occurrence of a condition (e.g., if the taxable compensation or benefits may be reduced or eliminated by the occurrence of an objective and nondiscretionary condition, or by applying a formula that offsets the applicable deferred compensation by benefits received under another plan).³³

- *The Discretion to Reduce or Eliminate Future Taxable Compensation or Benefits Lacks Substantive Significance* — If the discretion to reduce or eliminate a Participant's future taxable compensation or benefits lacks substantive significance, such discretion will not be enough for the Participant to avoid having a legally binding right to such compensation or benefits. Examples where discretion may lack substantive significance include: (1) when a Participant has effective control over the person who has the discretion (including control over that person's compensation); or (2) when the Participant is a member of the family of the person who has the discretion.³⁴

C. Short-Term Deferrals

The Proposed §457 Regulations have new requirements regarding short-term deferrals, and such deferrals will be exempt from the Ineligible Plan Requirements. A short-term deferral generally is a payment that an eligible Participant actually or constructively receives on or before the later of:

- the 15th day of the third month that immediately follows the end of the Participant's taxable year in which his or her right to receive the payment is no longer subject to a permissible substantial risk of forfeiture; or
- the 15th day of the third month after the end of the employer's tax year in which the Participant's right to receive the payment is no longer subject to a permissible substantial risk of forfeiture.³⁵

This short-term deferral exemption is often referred to as the 2½ month requirement, and has long been part of the §409A Requirements.³⁶ The Proposed §457 Regulations generally incorporate the short-term

deferral exemption requirements from the §409A Requirements, except that it uses the definition of substantial risk of forfeiture that appears in the Proposed §457 Regulations rather than the definition of substantial risk of forfeiture used in the §409A Requirements.³⁷ The definition of substantial risk of forfeiture in the Proposed §457 Regulations is described in Part VIII., below, and allows (among other things) certain non-competition provisions to qualify as a substantial risk of forfeiture.³⁸ Tax-Exempt and Governmental Employers should note, however, that the §409A Requirements do not allow a non-competition provision to qualify, by itself, as a substantial risk of forfeiture.³⁹ Tax-Exempt and Governmental Employers should also note that the definition of substantial risk of forfeiture in the Proposed §457 Regulations has requirements for adding a substantial risk of forfeiture (e.g., when an employee voluntarily elects to defer current compensation) or extending a substantial risk of forfeiture (e.g., when delaying a scheduled deferred compensation payment date) that are significantly different than the applicable requirements in the §409A Requirements.⁴⁰ If a Tax-Exempt or Governmental Employer would like to use a permissible non-competition provision to qualify as a substantial risk of forfeiture under the Proposed §457 Regulations, or if it would like to add or extend a substantial risk of forfeiture under the Proposed §457 Regulations, it should first verify that any such provision has been structured in a way that will not violate the §409A Requirements.

The new short-term deferral requirements for Tax-Exempt and Governmental Employers are a welcome development, because it gives Tax-Exempt and Governmental Employers significantly greater flexibility to structure payments to avoid the adverse tax conse-

³⁷ Prop. Reg. §1.457-12(d)(2). The definition of substantial risk of forfeiture appears in Prop. Reg. §1.457-12(e) and Reg. §1.409A-1(d).

³⁸ The requirements regarding noncompetition provisions are described in Prop. Reg. §1.457-12(e)(1)(iv), and are summarized in Part VIII.D., below.

³⁹ Reg. §1.409A-1(d)(1) provides, in part, as follows: "An amount is not subject to a substantial risk of forfeiture merely because the right to the amount is conditioned, directly or indirectly, upon the refraining from the performance of services."

⁴⁰ The requirements for adding a substantial risk of forfeiture appear in Prop. Reg. §1.457-12(e)(2), and are summarized in Part IX., below. The requirements for extending a substantial risk of forfeiture appear in Prop. Reg. §1.457-12(e)(2), and are summarized in Part X., below. See also Item 4 in the chart attached to this article for a summary of the main differences between the Proposed §457 Regulations and the §409A Requirements with respect to the right of employees to voluntarily elect to defer compensation, and Item 5 in that chart for a summary of the main differences between the Proposed §457 Regulations summary and the §409A Requirements with respect to the extension of a substantial risk of forfeiture period.

³³ *Id.*

³⁴ *Id.*

³⁵ Prop. Reg. §1.457-12(d)(2). As an exception to this general rule, payments delayed for certain reasons beyond the applicable 2½ month period still can qualify for the short-term deferral exemption. Reg. §1.409A-1(b)(4)(ii); Prop. Reg. §1.409A-1(b)(4)(ii).

³⁶ Reg. §1.409A-1(b)(4).

quences that otherwise would arise for certain Ineligible Plan payments made in the calendar year that follows the calendar year in which the Participant stopped performing substantial services for the Tax-Exempt or Governmental Employer. If, for example, a Tax-Exempt or Governmental Employer enters into an agreement with an employee in 2016 for the employee to voluntarily retire on November 30, 2016 in return for a lump sum retirement incentive payment to be made on January 31, 2017, the Ineligible Plan Requirements prior to the issuance of the Proposed §457(f) Regulations generally required that the present value of that lump sum payment be taxed in 2016 because the employee was not required to perform any substantial services in 2017 (this example assumes that the bona fide severance pay plan exemption, the window program exemption, the permissible voluntary early retirement incentive plan exemption, or any other exemption from the Ineligible Plan Requirements does not apply). The new short-term deferral exemption requirements in the Proposed §457 Regulations will allow that lump sum payment to be taxed in 2017 (such payment could be as late as March 15, 2017 if the Tax-Exempt or Governmental Employer has a calendar year tax year, and as late as the end of the applicable 2½ month period if the Tax-Exempt or Governmental Employer has a tax year that is other than a calendar year).

D. Recurring Part-Year Compensation

The Proposed §457 Regulations provide that recurring part-year compensation (e.g., compensation paid over a 12-month period to employees of educational organizations who regularly work an academic year that is less than 12 months) will be exempt from the Ineligible Plan Requirements if:

- the services being paid for are provided in a position that the employer and Participant reasonably anticipate will continue in a similar manner in the following years, and will be provided during successive periods of less than 12 months that begin in one calendar year and end in the subsequent calendar year;⁴¹
- payment of any part of a Participant's recurring part-year compensation is not deferred beyond the end of the 13th month following the Participant's first day of service during the applicable recurring part-year compensation period;⁴² and
- the total amount of the recurring part-year compensation is not greater than the annual compen-

⁴¹ Prop. Reg. §1.457-12(d)(3). This proposed regulation incorporates by reference the definition of recurring part-year compensation that is in Reg. §1.409A-2(a)(14).

⁴² Prop. Reg. §1.457-12(d)(3).

sation limit under §401(a)(17) (that compensation limit is \$270,000 in 2017, and is periodically adjusted by the IRS for cost-of-living increases) for the calendar year in which the applicable recurring part-year compensation period first commenced.⁴³

The recurring part-year compensation requirements in the Proposed §457 Regulations simplify and broaden the recurring part-year compensation requirements issued by the IRS in Notice 2008-62.⁴⁴ The biggest change to the requirements in Notice 2008-62 is that Notice 2008-62 limits the amount of the deferral in the recurring part-year compensation arrangement from one taxable year to the next taxable year to the applicable elective deferral limit in §402(g)(1)(B), as adjusted for cost-of-living increases (\$18,000 in 2017), and the Proposed §457 Regulation would replace this annual deferral limit with the requirement that the total amount of the recurring part-year compensation may not exceed the annual compensation limit in §401(a)(17), as adjusted for cost-of-living increases (\$270,000 in 2017).⁴⁵ On the same day the Proposed §457 Regulations were issued, new proposed regulations under §409A were issued (Proposed §409A Regulations) that include recurring part-year compensation requirements similar to those described in the Proposed §457 Regulations.⁴⁶ Taxpayers have the option, for the calendar year in which the Proposed §457 Regulations and the Proposed 409 Regulations are published in final form and all prior calendar years, to rely on the recurring part-year compensation requirements in either: (1) the Proposed §457 Regulations and the Proposed §409A Regulations; or (2) Notice 2008-62.⁴⁷ Schools and other employers with existing part-year compensation arrangements should review these new requirements to see if any improvements can be made in their existing arrangements.

E. Bona Fide Severance Pay Plan

A bona fide severance pay plan is exempt from the §457 Deferred Compensation Requirements under

⁴³ *Id.*; Notice 2015-75.

⁴⁴ 2008-29 I.R.B. 130. The preamble to the Proposed §457 Regulations said that the changes made to Notice 2008-62 were made as a result of comments received that Notice 2008-62 did not adequately address certain teaching positions (the dollar limit in Notice 2008-62 resulted in adverse tax consequences for certain teachers with academic year compensation as low as \$80,000), and that some employees were not given an option to elect out of a recurring part-year compensation arrangement. 81 Fed. Reg. at 40,556.

⁴⁵ Notice 2008-62, §II; Prop. Reg. §1.457-12(d)(3).

⁴⁶ Prop. Reg. §1.409A-1(b)(13).

⁴⁷ 81 Fed. Reg. at 40,557 and 40,577.

§457(e)(11)(A)(i). The Proposed §457 Regulations define a bona fide severance pay plan as a plan that:

- provides severance benefits only if a Participant's employment ends as a result of either an involuntary severance from employment, participation in a permissible window program, or participation in a permissible voluntary early retirement incentive plan;
- does not pay more than two times the Participant's annualized compensation (based on the Participant's annual rate of pay for the calendar year immediately prior to the calendar year in which the Participant's severance from employment occurred, or for the calendar year in which the Participant's severance from employment occurred if there was no compensation during that preceding calendar year), and revised to reflect any increase during the applicable calendar year that was expected to continue indefinitely if the Participant's severance from employment had not occurred; and
- provides, as part of its written terms, that all of the severance benefits must be paid no later than the end of the second calendar year that follows the calendar year in which the Participant's severance from employment occurred.⁴⁸

An involuntary severance from employment is defined in the Proposed §457 Regulations as “a severance from employment due to the independent exercise of the eligible employer's unilateral authority to terminate the participant's services, other than due to the participant's implicit or explicit request, if the participant was willing and able to continue performing services.”⁴⁹ An employer's decision to not renew a Participant's employment agreement when it expires can qualify as an involuntary severance from employment if the facts indicate that the Participant would have been willing to both extend the employment agreement upon substantially the same terms and render the applicable services.⁵⁰ Whether a severance from employment is involuntary will be based upon the applicable facts and circumstances, and not by how it may have been labeled by an employer or a Participant.⁵¹

The Proposed §457 Regulations define an involuntary severance from employment, and have new requirements that allow an employee's voluntary decision to terminate employment for a good reason to

qualify as an involuntary severance from employment if certain requirements are satisfied.⁵² Those requirements are similar to the good reason requirements under the §409A Requirements, and are described in Part VI., below.

The Proposed §457 Regulations also define what constitutes a permissible window program for purposes of this bona fide severance pay plan exemption. A window program is defined as “a program established by an employer to provide separation pay in connection with an impending severance from employment, if the program is made available by the employer for a limited period of time (typically no longer than 12 months) to participants who have a severance from employment during that period or to participants who have a severance from employment during that period under specified circumstances.”⁵³ A program will not qualify as a window program if, based on all of the applicable facts and circumstances, it is one of a pattern of multiple similar programs offered by an employer that, when combined, would not satisfy the definition of a window program.⁵⁴ The window program definition in the Proposed §457 Regulations is very similar to the window program definition in the §409A Requirements.⁵⁵

A permissible voluntary early retirement incentive plan is defined in the Proposed §457 Regulations as a voluntary early retirement incentive plan maintained by an eligible education agency or education association that has certain payments and supplements made in coordination with a qualified defined benefit plan, and meets certain other requirements.⁵⁶

Although the bona fide severance pay plan exemption in the Proposed §457 Regulations was defined in a similar manner to the exemption in the §409A Requirements for separation pay plans that provide separation pay due to an involuntary separation from service,⁵⁷ the formula for determining the permissible amount payable is different. For a bona fide severance pay plan under the Proposed §457 Regulations, the formula for determining the permissible amount payable is two times a Participant's annualized compensation (based on the Participant's annual rate of pay for the calendar year immediately prior to the calendar year in which the Participant's severance from employment occurred, or for the calendar year in which the Participant's severance from employment occurred if there was no compensation during that

⁴⁸ Prop. Reg. §1.457-11(d).

⁴⁹ Prop. Reg. §1.457-11(d)(2)(i).

⁵⁰ *Id.*

⁵¹ *Id.*

⁵² Prop. Reg. §1.457-11(d)(2)(ii).

⁵³ Prop. Reg. §1.457-11(d)(3).

⁵⁴ *Id.*

⁵⁵ Reg. §1.409A-1(b)(9)(vi).

⁵⁶ Prop. Reg. §1.457-11(d)(4).

⁵⁷ Reg. §1.409A-1(b)(9)(iii).

preceding calendar year), and revised to reflect any increase during the applicable calendar year that was expected to continue indefinitely if the Participant's severance from employment had not occurred.⁵⁸ For a separation pay plan that provides separation pay due to an involuntary separation from service under the §409A Requirements, the permissible amount payable generally may not exceed two times the lesser of: (1) a service provider's annualized compensation based on the annual rate of pay for the taxable year that preceded the taxable year in which the separation from service occurred (or the taxable year in which the separation from service occurred, if the service provider had no compensation in the preceding taxable year and if the service recipient decides to rely on Prop. Reg. §1.409A-1(b)(9)(iii)(A) prior to its effective date), and revised for any increase for that year that was expected to continue indefinitely; and (2) the compensation limit for qualified retirement plans under §401(a)(17), as periodically adjusted for cost-of-living increases (\$270,000 in 2017), for the year in which the service provider has a separation from service.⁵⁹ In light of that difference as well as other differences,⁶⁰ it is important that any use of the bona fide severance pay plan exemption in the Proposed §457 Regulations be accompanied by a review of the applicable §409A Requirements for compliance.

In Announcement 2000-1, the IRS announced transitional reporting relief for broad-based nonelective deferred compensation plans maintained by a State or local government that met certain requirements and that had been treated as an exempt bona fide severance pay plan under §457(e)(11)(A)(i) prior to January 1, 1999.⁶¹ Under this relief, and until the IRS requires otherwise, State and local governments do not have to report deferred compensation amounts under such plans as income prior to the year such amounts are actually or constructively received by a participant or beneficiary. In the preamble to the Proposed §457 Regulations, the IRS announced that when the bona fide severance pay plan requirements in the Proposed §457 Regulations are finalized and take effect, they

⁵⁸ Prop. Reg. §1.457-11(d)(1)(ii).

⁵⁹ Reg. §1.409A-1(b)(9)(iii)(A); Prop. Reg. §1.409A-1(b)(9)(iii)(A).

⁶⁰ Among the other differences is the fact that the bona fide severance pay plan exemption in the Proposed §457 Regulations uses the term "severance from employment" (which is defined in Prop. Reg. §1.457-6(b)(1)) and the exemption in the §409A Requirements for separation pay plans that provide separation pay due to an involuntary separation from service uses the term "separation from service" (which is defined in Reg. §1.409A-1(h)).

⁶¹ 2000-1 C.B. 294.

will supersede the transitional reporting relief in Announcement 2000-1.⁶²

F. Bona Fide Death Benefit Plan

A bona fide death benefit plan is exempt from the §457 Deferred Compensation Requirements under §457(e)(11)(A)(i). The Proposed §457 Regulations have new requirements defining what constitutes a bona fide death benefit plan under the §457 Deferred Compensation Requirements. Under that definition, the present value of the total benefits payable under a bona fide death benefit plan in the event of death must exceed the present value of any lifetime benefits payable under the plan.⁶³ The Proposed §457 Regulations also provide that the death benefits under a bona fide death benefit plan may be provided through insurance, and that the value of any term life insurance coverage provided under that plan that is required to be included in an employee's gross income will not be considered to be lifetime benefits payable under that plan.⁶⁴

G. Bona Fide Disability Pay Plan

A bona fide disability pay plan is exempt from the §457 Deferred Compensation Requirements under §457(e)(11)(A)(i), and the Proposed §457 Regulations have new requirements defining such a plan. A bona fide disability pay plan is defined in the Proposed §457 Regulations as an insured or uninsured plan that: (1) pays benefits only if an employee is disabled (if the plan is insured, the value of any disability insurance coverage that might be included in an employee's gross income will be disregarded); and (2) meets certain other requirements.⁶⁵ An employee in such a plan will only be considered disabled if one of the following three requirements is satisfied:

- the employee has a medically determinable physical or mental impairment that likely will either result in death or last at least 12 continuous months, and as a result is not able to engage in any substantial gainful activity;
- the employee has a medically determinable physical or mental impairment that likely will either result in death or last at least 12 continuous months,

⁶² 81 Fed. Reg. at 40,552. The special effective date requirements for governmental plans described above will apply to such State or local government broad-based nonelective deferred compensation plans.

⁶³ Prop. Reg. §1.457-11(e)(1); Reg. §31.3121(v)(2)-1(b)(4)(iv)(C).

⁶⁴ Prop. Reg. §1.457-11(e)(1).

⁶⁵ Prop. Reg. §1.457-11(e)(2).

and as a result is receiving at least three months of income replacement benefits under an employer accident and health plan for employees; or

- the Social Security Administration or the Railroad Retirement Board has made a determination that the employee is totally disabled.⁶⁶

H. Bona Fide Sick and Vacation Leave Plans

A bona fide sick leave plan and a bona fide vacation leave plan are exempt from the §457 Deferred Compensation Requirements under §457(e)(11)(A)(i), and the Proposed §457 Regulations have new requirements defining such plans. The Proposed §457 Regulations provide that a plan will qualify as a bona fide sick or vacation leave plan if a review of the applicable facts and circumstances indicates that the primary purpose of the plan is to provide employees with paid time off from employment as a result of sickness, vacation, or other personal reasons.⁶⁷ Among the factors that should be considered as part of this facts and circumstances review are the following:

- whether an employee is likely to use during employment the amount of leave granted;
- whether an employee can exchange any unused accumulated leave for cash or other benefits;
- whether there are any restraints on an employee's ability to carry forward to future years any unused accumulated leave that potentially could be exchanged for cash or other benefits;
- whether unused accumulated leave can be exchanged for in-service cash payments or benefits, and, if so, in what amounts and how often;
- whether any payment of unused accumulated leave is made shortly after an employee's employment ends, or over a period of time; and
- whether the plan only covers a limited number of employees.⁶⁸

⁶⁶ Prop. Reg. §1.457-11(e)(2)(i)–§1.457-11(e)(2)(iii).

⁶⁷ Prop. Reg. §1.457-11(f)(1).

⁶⁸ *Id.* In light of the wide variety of sick and vacation leave plans used by employers, the Treasury Department and the IRS acknowledged that additional guidance regarding such plans might be helpful. 81 Fed. Reg. at 40,553. The Proposed §457 Regulations, therefore, authorize the IRS to issue such guidance. Prop. Reg. §1.457-11(f)(2).

I. PAYMENT OF EXPENSE REIMBURSEMENTS, MEDICAL BENEFITS, AND/OR IN-KIND BENEFITS THAT ARE EXEMPT FROM THE §409A REQUIREMENTS WILL ALSO BE EXEMPT FROM THE §457(f) INELIGIBLE PLAN REQUIREMENTS

The Proposed §457 Regulations provide that the following payments and benefits that are not considered a deferral of compensation and that are exempt under the §409A Requirements will also be exempt from the Ineligible Plan Requirements under §457(f):

- payment of certain nonexcludable business expenses, reasonable outplacement expenses, and reasonable moving expenses that are described in Reg. §1.409A-1(b)(9)(v)(A);
- reimbursements of certain medical expenses that are described in Reg. §1.409A-1(b)(9)(v)(B); and
- certain in-kind benefits that are described in Reg. §1.409A-1(b)(9)(v)(C).⁶⁹

J. CERTAIN INDEMNIFICATION RIGHTS, LIABILITY INSURANCE, AND LEGAL SETTLEMENTS THAT ARE EXEMPT FROM THE §409A REQUIREMENTS WILL ALSO BE EXEMPT FROM THE §457(f) INELIGIBLE PLAN REQUIREMENTS

The following indemnification rights, liability insurance, and legal settlements that are not considered a deferral of compensation and that are exempt under the §409A Requirements will, under the Proposed §457 Regulations, also be exempt from the Ineligible Plan Requirements under §457(f):

- certain indemnification and liability insurance plans that are described in Reg. §1.409A-1(b)(10); and
- certain legal settlements that are described in Reg. §1.409A-1(b)(11).⁷⁰

K. Certain Taxable Educational Benefits

The Proposed §457 Regulations exempt from the Ineligible Plan Requirements taxable educational benefits for an employee that were used to educate the employee (educational benefits for the employee's

⁶⁹ Prop. Reg. §1.457-12(d)(4)(i).

⁷⁰ Prop. Reg. §1.457-12(d)(4)(ii), Prop. Reg. §1.409A-1(b)(11).

spouse, children or any other family member are not covered by this exclusion).⁷¹ An educational benefit, for purposes of this exclusion, means educational assistance as defined in §127(c)(1) and the regulations thereunder.⁷²

L. Other Exclusions from the §457 Deferred Compensation Requirements

The Proposed §457 Regulations also describe certain other exclusions from the §457 Deferred Compensation Requirements, including the following:

- certain plans for State judges;⁷³
- certain “grandfathered” plans;⁷⁴
- nonelective deferred compensation plans for individuals not performing services as an employee (e.g., a nonelective deferred compensation plan for independent contractors), but only if all individuals who have the same general relationship with the payor of the deferred compensation are covered by the same nonelective deferred compensation plan with no individual variations (a limited exception could apply for persons who have yet to satisfy a service eligibility requirement);⁷⁵ and
- certain length of service award plans for bona fide volunteers and their beneficiaries, based on qualified services performed by the volunteers that have accrued after December 31, 1996.⁷⁶

⁷¹ Prop. Reg. §1.457-12(d)(4)(iii). This exclusion is very similar to the exclusion for taxable educational benefits under Reg. §1.409A-1(b)(12).

⁷² §127(c)(1) defines educational assistance, in part, as: (a) an employer’s payment of expenses incurred for the education of an employee (which includes, among other things, tuition expenses, certain educational fees and payments, and certain books, supplies and equipment); and (b) courses of instruction that an employer provides for an employee, as well as certain books, supplies and equipment related to such courses. Excluded from the definition of educational assistance under §127(c)(1) are: (a) tools or supplies that may be retained by an employee after finishing a course; (b) meals, lodging, or transportation; and (c) certain payments or benefits for education related to sports, games, or hobbies. Reg. §1.127-2(c) provides additional guidance on the definition of educational assistance.

⁷³ Prop. Reg. §1.457-11(b)(1).

⁷⁴ Prop. Reg. §1.457-11(b)(2).

⁷⁵ Prop. Reg. §1.457-11(b)(3); §457(e)(12).

⁷⁶ Prop. Reg. §1.457-11(c)(2); §457(e)(11)(A)(ii).

M. Other Exclusions from the Ineligible Plan Requirements

Other exclusions from the Ineligible Plan Requirements are included in the Proposed §457 Regulations, including the following:

- qualified retirement plans under §401(a);⁷⁷
- annuity plans and contracts described in §403, including certain nonqualified annuities under §403(c);⁷⁸
- the portion of a plan that consists of a non-exempt trust described in §402(b);⁷⁹
- a qualified governmental excess benefit arrangement described in §415(m);⁸⁰
- the portion of a plan that consists of a transfer of property to which §83 applies;⁸¹ and
- the portion of a plan that consists of an employment retention plan of an educational entity that satisfies the requirements of §457(f)(4).⁸²

VI. WHAT ARE THE NEW GOOD REASON TERMINATION REQUIREMENTS?

The Proposed §457 Regulations have new requirements that will allow an employee’s voluntary severance from employment for a permissible good reason to be treated as an involuntary severance from employment for purposes of the Ineligible Plan Requirements (a voluntary severance from employment for a permissible good reason could, if applicable, be helpful in qualifying for either the bona fide severance pay plan exception described in Part V.E., above, or as a qualifying substantial risk of forfeiture event that can be used for the short-term deferral exemption described in Part V.C., above).⁸³ The Proposed §457 Regulations provide general requirements and factors that will be considered by the IRS when determining whether a permissible severance from employment for a good reason has occurred, and “safe harbor” requirements that can be followed by Tax-Exempt and Governmental Employers who want more certainty that a permissible severance from employment for a good reason has occurred. The good reason requirements in the Proposed §457 Regulations are similar to

⁷⁷ Prop. Reg. §1.457-12(b)(2); §457(f)(2)(A).

⁷⁸ §457(f)(2)(B); Prop. Reg. §1.457-12(b)(2), §1.457-12(b)(5).

⁷⁹ §457(f)(2)(D); Prop. Reg. §1.457-12(b)(3).

⁸⁰ §457(f)(2)(E); Prop. Reg. §1.457-12(b)(4).

⁸¹ §457(f)(2)(C); Prop. Reg. §1.457-12(b)(6).

⁸² §457(f)(2)(F); Prop. Reg. §1.457-12(b)(7).

⁸³ Prop. Reg. §1.457-11(d)(2)(ii).

the good reason requirements under the §409A Requirements.⁸⁴

A. General Requirements and Factors that Will Be Considered When Determining Whether a Permissible Good Reason Termination Has Occurred

The events constituting a permissible severance from employment for a good reason must be specified in advance in writing, and must be the result of a unilateral action by an employee's employer that resulted in a material negative change in the relationship between the employer and the employee.⁸⁵ If an employer unilaterally and materially reduces an employee's employment duties, makes a material negative change in the conditions in which the employee performs his or her duties, or makes a material reduction in the employee's compensation, that will be evidence that a material negative change has occurred.⁸⁶ Among the factors that should be considered when determining whether an employee has had a permissible severance from employment for a good reason are the following:

- *Whether the Good Reason Payments Will be the Same As Would Have Occurred Had There Been an Involuntary Severance from Employment* — whether the payments that will be made to the employee as a result of a permissible severance from employment for a good reason are the same as would have occurred had the employee had an involuntary severance from employment (taking into consideration the amount that would have been paid, when it would have been paid, and the form in which it would have been paid);
- *Whether the Employee Was Required to Give Notice of the Good Reason* — whether the employee was required to give his or her employer notice that a good reason event has occurred; and
- *Whether the Employer Has Had a Reasonable Opportunity to Cure the Good Reason Event* — whether the employer has had a reasonable opportunity to remedy the good reason event identified by the employee.⁸⁷

When structuring a permissible severance from employment for a good reason, the principal purpose of

such a structure must not be to avoid the Ineligible Plan Requirements.⁸⁸ Any permissible severance from employment for a good reason should effectively be the same as if the employee was involuntarily severed from employment by his or her employer.⁸⁹

If, after the permissible good reasons have been specified in writing, there is a subsequent deletion of one or more of those good reasons, such a deletion may be treated as an extension of a substantial risk of forfeiture that would have to satisfy the requirements in the Proposed §457 Regulations for such an extension (those requirements are described in Part X., below).⁹⁰

B. Safe Harbor Good Reason Requirements

If a Tax-Exempt or Governmental Employer follows the safe harbor requirements listed below, the general good reason requirements and factors listed in Part VI.A., above, will be deemed to be satisfied:

- *Good Reason Events Must be Specified in Advance in Writing* — The good reason events must be specified in writing before the date an employee has a legally binding right to receive a deferred compensation payment due to the occurrence of a permissible severance from employment for a good reason.
- *Employee's Severance from Employment Must Occur Within Two Years After the Initial Safe Harbor Good Reason Event Occurs* — An employee must elect to have a severance from employment no later than two years after the date the initial safe harbor reason event occurs.
- *One or More of the Safe Harbor Good Reason Events Must Have Occurred* — In order for an employee to have a permissible severance from employment under the safe harbor requirements, one or more of the following safe harbor events must have occurred without the employee's consent:
 1. *Material Diminution in Base Compensation* — The employer materially diminished the employee's base compensation.
 2. *Material Diminution in the Employee's Authority, Duties, or Responsibilities* — The employer materially diminished the employee's job authority, duties, or responsibilities.
 3. *Material Diminution in a Supervisor's Author-*

⁸⁴ Reg. §1.409A-1(n)(2).

⁸⁵ Prop. Reg. §1.457-11(d)(2)(ii)(A), §1.457-11(d)(2)(ii)(B).

⁸⁶ Prop. Reg. §1.457-11(d)(2)(ii)(B).

⁸⁷ *Id.*

⁸⁸ Prop. Reg. §1.457-11(d)(2)(ii)(A).

⁸⁹ *Id.*

⁹⁰ *Id.* This requirement does not appear in the good reason regulations under §409A (Reg. §1.409A-1(n)(2)(i)).

ity, Duties, or Responsibilities — The employer materially diminished the authority, duties, or responsibilities of a supervisor to whom the employee reports. If an employer requires an employee who used to report directly to the governing body of an employer (e.g., a board of trustees or a board of directors) to now report to an officer or other employee of the employer, that change would qualify as a material diminution under this good reason factor.

4. *Material Diminution in Budget Authority* — The employer materially diminishes any authority an employee may have over the budget.

5. *Material Change in Geographic Location* — The employer materially changes the geographic location where an employee works.

6. *Material Breach of Agreement* — The employer materially breaches the applicable agreement that requires the employee to render services to the employer (e.g., an employment agreement).

- *Good Reason Payments That Will be Made Must be Substantially the Same as Any Applicable Payments That Would Have Been Made Had There Been an Involuntary Severance from Employment* — The payments that will be made when there is a severance from employment due to a safe harbor good reason must be substantially the same (in terms of amounts, timing, and form) as the payments that would have been made had there been an involuntary severance from employment (if applicable).
- *Employee Must Notify Employer Within 90 Days After the Initial Good Reason Event Occurs* — Within 90 days after the date an initial safe harbor good reason event occurs, an employee must notify his or her employer that such an event has occurred.
- *Employer Must be Given at Least 30 Days to Cure the Good Reason Event* — After receiving timely notice from an employee that an initial safe harbor good reason event has occurred, his or her employer must be given at least 30 days to remedy the safe harbor good reason event in order to avoid having to make the deferred compensation payment.⁹¹

VII. WHEN IS DEFERRED COMPENSATION UNDER AN INELIGIBLE PLAN TAXED?

Compensation deferred under an Ineligible Plan will, if one of the statutory or regulatory exemptions

⁹¹ Prop. Reg. §1.457-11(d)(2)(ii)(C).

does not apply, be included in a Participant's gross income for tax purposes on the later of the following two dates (Applicable Inclusion Date):

- the first date the Participant has a legally binding right to the deferred compensation; or
- the first date the deferred compensation ceases to be subject to an applicable substantial risk of forfeiture, to the extent such compensation was subject to a substantial risk of forfeiture from the date it was first deferred (the definition of substantial risk of forfeiture is described in Part VIII., below).⁹²

When deferred compensation is required to be included in a Participant's gross income pursuant to the preceding paragraph, such inclusion will include the present value of any of that deferred compensation that is scheduled to be paid after the Applicable Inclusion Date (including any of that deferred compensation scheduled to be paid in a future calendar year) as well as any earnings on the amounts deferred under the deferred compensation plan through the Applicable Inclusion Date.⁹³ The Proposed §457 Regulations provide detailed rules on how to make that present value computation.⁹⁴ Subsequent earnings on that deferred compensation generally will be includable in a Participant's gross income when paid or made available to the Participant.⁹⁵

The Proposed §457 Regulations also have loss deduction requirements that provide, in part, that if a Participant has been required to include deferred compensation in income and all or a portion of that deferred compensation is never paid, the Participant will be allowed to take a deduction for the taxable year in

⁹² Prop. Reg. §1.457-12(a)(2).

⁹³ *Id.*

⁹⁴ Prop. Reg. §1.457-12(c). The present value computation will be determined by, among other things, "multiplying the amount of a payment (or the amount of each payment in a series of payments) by the probability that any condition or conditions on which the payment is contingent will be satisfied and discounting the amount using an assumed rate of interest to reflect the time value of money." Prop. Reg. §1.457-12(c)(1)(i). The present value requirements in the Proposed §457 Regulations generally are similar to the present value requirements in the §409A Requirements, with one difference being that the present value computation in the Proposed §457 Regulations is determined as of the Applicable Inclusion Date and the present value computation in the §409A Requirements is determined as of the end of the service provider's taxable year. Prop. Reg. §1.457-12(a)(2), Prop. Reg. §1.409A-4; 81 Fed. Reg. at 40,553.

⁹⁵ Prop. Reg. §1.457-12(a)(3). Such earnings will be taxed in accordance with the requirements in §72, and when applying those requirements the Participant will be treated as having an investment equal to the earnings included in gross income on the Applicable Inclusion Date. 81 Fed. Reg. at 40,553. Such taxable earnings will also need to comply with the §409A Requirements.

which the unpaid portion is permanently forfeited or lost.⁹⁶

VIII. HOW IS A SUBSTANTIAL RISK OF FORFEITURE DEFINED?

The Proposed §457 Regulations provide that a deferral of compensation under an Ineligible Plan generally will be subject to a substantial risk of forfeiture if a Participant's right to receive the applicable deferred compensation is contingent on:

- the future performance of substantial services by the Participant; or
- a condition occurring that is related to a purpose of that deferred compensation, as long as there is a substantial possibility that such condition will not occur and a forfeiture of that deferred compensation will result.⁹⁷

The Proposed §457 Regulations also describe how an involuntary severance from employment without cause and certain types of noncompetition provisions can qualify as a substantial risk of forfeiture, and the factors that should be considered when determining whether a substantial risk of forfeiture has occurred.⁹⁸

A. Future Performance of Substantial Services Condition

The Proposed §457 Regulations provide that whether the receipt of deferred compensation is conditioned on the future performance of substantial services will be based on all of the applicable 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."⁹⁹ The Proposed §457 Regulations do not describe what other facts and circumstances should be considered when making this determination. With respect to determining whether the hours required to be performed are "substantial" in relation to the amount of compensation, the Proposed §457 Regulations do not define

⁹⁶ Prop. Reg. §1.457-12(c)(2).

⁹⁷ Prop. Reg. §1.457-12(e)(1)(i).

⁹⁸ The involuntary severance from employment without cause factor is described in Prop. Reg. §1.457-12(e)(1)(i), and is summarized in Part VIII.C., below. The permissible noncompetition conditions are described in Prop. Reg. §1.457-12(e)(1)(iv), and are summarized in Part VIII.D., below. Other factors that should be considered when determining whether a substantial risk of forfeiture has occurred are described in Prop. Reg. §1.457-12(e)(1)(v), and are summarized in Part VIII.E., below.

⁹⁹ Prop. Reg. §1.457-12(e)(1)(ii).

"substantial" or provide other guidance on how to make this determination.¹⁰⁰ d

Before the Proposed §457 Regulations are finalized, it would be helpful to have additional guidance on these issues. The lack of clarity on the definition of "substantial" often will make it difficult for a Tax-Exempt or Governmental Employer to know with any degree of certainty whether the amount of substantial services being required will be considered by the IRS to be sufficient to create a substantial risk of forfeiture. If a Tax-Exempt or Governmental Employer has significant doubts about whether the substantial services that will be required will be considered by the IRS to be "substantial" enough to create a substantial risk of forfeiture, it may want to review the other new options that are available under the Proposed §457 Regulations for creating a substantial risk of forfeiture (i.e., a permissible condition related to a purpose of the compensation or a permissible noncompete requirement) and see if they can be used in conjunction with, or in lieu of, the future substantial services being required.

B. Condition Related to a Purpose of the Compensation

The Proposed §457 Regulations provide that:

- a condition related to a purpose of the compensation must relate to either: (1) a Participant's performance of services for the applicable employer; or (2) the employer's tax-exempt activities or organizational goals (in the case of an eligible tax-exempt organization), or the employer's governmental activities or organizational goals (in the case of an eligible governmental employer);¹⁰¹ and
- the possibility that the condition will not occur and will result in forfeiture must be substantial.¹⁰²

C. Involuntary Severance from Employment Without Cause Condition

If deferred compensation under an Ineligible Plan is conditioned on an employee's involuntary severance

¹⁰⁰ The Proposed §457 Regulations include an example where an employee will be paid \$250,000 for one year of consulting services to be performed, but that example does not describe the consulting services to be performed and merely states as part of the facts that: "The consulting services required are insubstantial in relation to the payment." Prop. Reg. §1.457-12(e)(3), Ex. 1.

¹⁰¹ Prop. Reg. §1.457-12(e)(1)(iii). The preamble to the Proposed §457 Regulations said that this could be, for example, the occurrence of a performance goal for the organization. 81 Fed. Reg. at 40,557.

¹⁰² Prop. Reg. §1.457-12(e)(1)(i).

from employment without cause, such a condition will constitute a substantial risk of forfeiture under the Proposed §457 Regulations as long as the possibility of forfeiture is substantial.¹⁰³ If an employee elects to sever employment for a permissible good reason in accordance with the requirements of the Proposed §457 Regulations, it will be treated in the same manner as an involuntary severance from employment without cause under the Proposed §457 Regulations.¹⁰⁴ The good reason requirements in the Proposed §457(f) Regulations are summarized in Part VI., above.

D. Noncompetition Conditions

Prior to the issuance of the Proposed §457 Regulations, the law was unclear about the extent to which noncompetition conditions could be used to establish a substantial risk of forfeiture for purposes of the Ineligible Plan Requirements and the applicable exemptions. The Proposed §457 Regulations allow noncompetition conditions to be used to establish a substantial risk of forfeiture only if certain requirements are satisfied.¹⁰⁵ An employee's agreement to refrain from the future performance of certain services (e.g., agreeing not to work for certain competitors for a specified period) can constitute a qualifying substantial risk of forfeiture that will defer the taxation of deferred compensation in an Ineligible Plan if all of the following conditions are satisfied:

- the noncompetition requirement must be in an enforceable written agreement;
- reasonable ongoing efforts must be made by the employer to ensure that the requirements in its noncompetition agreements (including the one for the applicable employee) are being followed;
- the employer must have a substantial and bona fide interest in keeping the employee from competing (among the factors that will be considered is whether the employer can demonstrate that if the employee performs the prohibited services, it is likely that such performance would result in significant adverse economic consequences for the employer); and
- the employee has a bona fide interest in, and the ability, to perform the prohibited services (among the factors that will be considered is how marketable the employee is based on his or her skills, reputation, and other credentials, and whether the

employee has an interest, a financial need, and an ability to compete).¹⁰⁶

This noncompetition condition does not appear in the substantial risk of forfeiture definition in the §409A Requirements,¹⁰⁷ and thus any reliance on the noncompetition condition for purposes of the Ineligible Plan Requirements will require a separate analysis to ensure the §409A Requirements are also satisfied.

E. Other Factors That Should be Considered When Determining Whether a Substantial Risk of Forfeiture Has Occurred

The Proposed §457 Regulations provide that a deferral of compensation will only be subject to a substantial risk of forfeiture if:

- the chances of a forfeiture occurring are substantial; and
- it is likely that if a forfeiture occurred, it would be enforced.¹⁰⁸

Among the factors that will be considered regarding the likelihood of enforcement is the employer's past practice on such enforcement, and whether the employee whose compensation is being deferred has any control or influence that could interfere with such enforcement.¹⁰⁹

IX. WHAT DO THE PROPOSED §457 REGULATIONS SAY ABOUT THE RIGHT OF EMPLOYEES TO VOLUNTARILY ELECT TO DEFER CURRENT COMPENSATION?

For years the IRS has raised questions about the extent to which employees of Tax-Exempt and Governmental Employers can voluntarily elect to defer current compensation as part of an Ineligible Plan.¹¹⁰ The IRS has been skeptical about why employees would

¹⁰⁶ Prop. Reg. §1.457-12(e)(1)(iv)(A)–§1.457-12(e)(1)(iv)(C).

¹⁰⁷ Reg. §1.409A-1(d).

¹⁰⁸ Prop. Reg. §1.457-12(e)(1)(i), §1.457-12(e)(1)(v).

¹⁰⁹ Prop. Reg. §1.457-12(e)(1)(v).

¹¹⁰ In 2007, for example, the IRS stated:

Section 1.409A-1(d)(1) provides that an amount is not considered subject to a substantial risk of forfeiture beyond the date or time at which the recipient otherwise could have elected to receive the amount of compensation, unless the present value of the amount made subject to a risk of forfeiture is materially greater than

¹⁰³ *Id.*

¹⁰⁴ *Id.*

¹⁰⁵ Prop. Reg. §1.457-12(e)(1)(iv).

voluntarily put money at risk they otherwise were going to receive, and about whether such deferrals would really be subject to a substantial risk of forfeiture. Such skepticism is reflected in the new rules for voluntary deferrals that are included in the Proposed §457 Regulations.

The Proposed §457 Regulations will only allow eligible employees of Tax-Exempt and Governmental Employers to voluntarily defer current compensation as part of an Ineligible Plan if certain requirements are satisfied.¹¹¹ Current compensation, for purposes of these requirements, is defined as compensation that is payable to an employee on a current basis (e.g., salary and bonuses), and excludes deferred compensation.¹¹² The four main requirements that have to be satisfied in order for initial deferrals of current compensation to be subject to a substantial risk of forfeiture are:

- **125% Payment Requirement** — The present value of the deferred compensation benefit that will be paid when the substantial risk of forfeiture period ends must be greater than 125% of the amount the employee would have received had there been no deferral subject to a substantial risk of forfeiture. When making this computation, any compensation an employee would have received for continuing to perform services even if no voluntary deferral occurred will be disregarded.¹¹³
- **Substantial Services or Noncompete Requirement** — The substantial risk of forfeiture that will ap-

the present value of the amount the recipient otherwise could have elected to receive absent such risk of forfeiture. This is because, absent tax considerations, 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. Thus, amounts that an individual could have elected to receive under a salary deferral election generally cannot be made subject to a substantial risk of forfeiture under the rules of §409A beyond the date or time the salary would otherwise have been received. The Service and Treasury anticipate that upcoming guidance under §457(f) will generally adopt the rules relating to substantial risk of forfeiture that are contained in §1.409A-1(d).

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¹¹¹ Prop. Reg. §1.457-12(e)(2).

¹¹² 81 Fed. Reg. at 40,556.

¹¹³ Prop. Reg. §1.457-12(e)(2)(ii). For purposes of this requirement, present value is determined pursuant to the requirements in Prop. Reg. §1.457-12(c) as of the Applicable Inclusion Date for the amount of compensation that would have been received had there been no new substantial risk of forfeiture. The preamble to

ply to an employee's deferral of compensation must be based on either the employee's future performance of substantial services or compliance with a permissible noncompetition condition, and is not allowed to be based solely upon compliance with a condition related to the purpose of the compensation.¹¹⁴

- **Two-Year Deferral Requirement** — The period during which compensation is being deferred generally must be at least two years. An employer has the option, for a deferral that is contingent upon the performance of future substantial services, to allow a shorter deferral period in the event of an eligible employee's death, disability, and/or involuntary severance from employment.¹¹⁵
- **Advance Written Agreement Requirement** — An employee's voluntary election to defer current compensation generally must be evidenced by a written agreement prior to the start of the calendar year in which the employee will perform the services that will make him or her eligible to receive the compensation that will be deferred.¹¹⁶ If an employee who wishes to defer current compensation was not providing services for the employer for at least 90 days prior to the initial deferral, the written agreement to defer may be made within 30 days after the employee's employment commencement date with respect to compensation for services not yet performed.¹¹⁷
- **Substitution Requirement** — If a new amount that is subject to a substantial risk of forfeiture is substituted, at least in part, for a prior amount that was relinquished or forfeited, the substantial risk of forfeiture for that new amount will be disre-

the Proposed §457 Regulations provides that no implication is intended that this 125% payment requirement would also apply for purposes of the substantial risk of forfeiture requirements in Reg. §1.409A-1(d)(1). 81 Fed. Reg. at 40,557.

¹¹⁴ Prop. Reg. §1.457-12(e)(2)(iii); 81 Fed. Reg. at 40,557. Compliance with a condition related to the purpose of the compensation could be combined with a requirement to perform future substantial services. 81 Fed. Reg. at 40,557.

¹¹⁵ Prop. Reg. §1.457-12(e)(2)(iii). If, for example, an amount is being deferred each semi-monthly payroll period, each such amount deferred will be subject to the two-year deferral requirement. *Id.*

¹¹⁶ Prop. Reg. §1.457-12(e)(2)(iv).

¹¹⁷ *Id.* The preamble to the Proposed §457 Regulations notes that this 30-day requirement applies to new employees, and asks for comments on whether additional requirements should be developed for employees who are newly eligible to participate in a plan. 81 Fed. Reg. at 40,557.

garded unless the four preceding requirements described in this paragraph have been satisfied.¹¹⁸

The rules under the Proposed §457 Regulations regarding an employee's right to voluntarily elect to defer current compensation are different than the applicable rules for such deferrals under the §409A Requirements, and will need to be properly coordinated with the §409A Requirements.¹¹⁹ If, for example, an employee's voluntary election to defer compensation is based on the employee's compliance with a permissible noncompete requirement, such a requirement can be used to establish a substantial risk of forfeiture under the Ineligible Plan Requirements but not the §409A Requirements (although the noncompete requirement, by itself, would not be enough to create a substantial risk of forfeiture under the §409A Requirements, it could be combined with a permissible substantial services requirement).

X. WHAT DO THE PROPOSED §457 REGULATIONS SAY ABOUT HOW TO EXTEND AN EXISTING SUBSTANTIAL RISK OF FORFEITURE PERIOD, AND ABOUT HOW TO DELAY A SCHEDULED DEFERRED COMPENSATION PAYMENT DATE IN AN INELIGIBLE PLAN?

The Proposed §457 Regulations provide important new guidance on how to extend a substantial risk of forfeiture period after an employee has obtained a legally binding right to deferred compensation in an Ineligible Plan.¹²⁰ This guidance will allow, among other things, a delay of a scheduled payment date of deferred compensation in an Ineligible Plan if certain requirements are satisfied (such a delay often is referred to as a "rolling risk of forfeiture"). In order for such an extension or delay to occur, the Proposed §457 Regulations provide that requirements very similar to the five requirements described in Part IX., above, must be satisfied:

- **125% Payment Requirement** — The present value of the deferred compensation benefit that will be paid when the extended substantial risk of forfeiture period ends must be greater than 125% of the amount the employee would have received had the original substantial risk of forfeiture period ended without an extension. When making this computation, any compensation an employee

would have received for continuing to perform services even if no extension of a substantial risk of forfeiture period occurred will be disregarded.

- **Substantial Services or Noncompete Requirement** — The substantial risk of forfeiture that will apply during the extension period must be based on either the employee's future performance of substantial services or compliance with a permissible noncompetition condition, and is not allowed to be based solely upon compliance with a condition related to the purpose of the compensation.
- **Two-Year Deferral Requirement** — The proposed extension of the substantial risk of forfeiture period generally must be at least two years. An employer has the option, for an extension of a substantial risk of forfeiture period that is contingent upon the performance of future substantial services, to allow a shorter extension period in the event of an eligible employee's death, disability, and/or involuntary severance from employment.¹²¹
- **Advance Written Agreement Requirement** — An eligible employee's agreement to extend the substantial risk of forfeiture period generally must be made at least 90 days prior to the date the original substantial risk of forfeiture would have ended had such an extension not been made.¹²² If an employee who wishes to extend a substantial risk of forfeiture period was not providing services for the employer for at least 90 days prior to the proposed extension date, the written agreement to extend the original substantial risk of forfeiture period may be made within 30 days after the employee's employment commencement date with respect to compensation for services not yet performed.
- **Substitution Requirement** — If a new amount that is subject to a substantial risk of forfeiture is substituted, at least in part, for a prior amount that was relinquished or forfeited, the substantial risk of forfeiture for that new amount will be disregarded unless the four preceding requirements described in this paragraph have been satisfied.¹²³

The rules under the Proposed §457 Regulations regarding the right to extend a substantial risk of forfeiture period are different than the applicable rules for such extensions under the §409A Requirements, and

¹¹⁸ Prop. Reg. §1.457-12(e)(2)(v).

¹¹⁹ These differences are described in Item 4 in the chart that appears at the end of this article.

¹²⁰ Prop. Reg. §1.457-12(e)(2).

¹²¹ Prop. Reg. §1.457-12(e)(2)(iii).

¹²² Prop. Reg. §1.457-12(e)(2)(iv).

¹²³ Prop. Reg. §1.457-12(e)(2)(v).

will need to be properly coordinated with the §409A Requirements.¹²⁴

XI. CONCLUSION

The Proposed §457 Regulations provide new requirements, and new planning opportunities, for Tax-Exempt and Governmental Employers, and should currently be considered by Tax-Exempt and Governmental Employers whenever they decide to provide nonqualified taxable compensation or benefits in a future calendar year.

Although the Proposed §457 Regulations provide welcome new flexibility when designing an Ineligible Plan (e.g., the new short-term deferral, noncompete,

¹²⁴ These differences are described in Item 5 of the chart that appears at the end of this article.

good reason, voluntary elective deferral, and delay of a scheduled payment date requirements described above), taking advantage of that flexibility will require careful planning. The differences between the requirements in the Proposed §457 Regulations and the §409A Requirements could create traps for the unwary, as there could be situations where Tax-Exempt and Governmental Employers design a nonqualified deferred compensation arrangement to comply with the Proposed §457 Regulations and fail to confirm that the design chosen also complies with the §409A Requirements. It has always been important to verify that nonqualified deferred compensation arrangements for Tax-Exempt and Governmental Employers comply with the requirements in both §457 and §409A, and that importance is even greater now in light of the significant differences between the Proposed §457 Regulations and the §409A Requirements.

SOME OF THE MORE IMPORTANT DIFFERENCES BETWEEN THE DEFERRED COMPENSATION REQUIREMENTS IN THE PROPOSED §457 REGULATIONS AND THE §409A REGULATIONS

<i>More Important Differences</i>	<i>Applicable Proposed §457 Regulations Cite</i>	<i>Applicable §409A Regulations Cite</i>
<p>1. <i>Difference in the Short-Term Deferral Exemption</i> — The short-term deferral exemption generally is the same under the proposed regulations under §457 (Proposed §457 Regulations) and the regulations in §409A (§409A Regulations), except that the Proposed §457 Regulations use the definition of “substantial risk of forfeiture” in Prop. Reg. §1.457-12(e) when applying the short-term deferral exemption rather than the “substantial risk of forfeiture” definition in Reg. §1.409A-1(d). As noted in number 2 of this chart, there are several differences between these definitions of “substantial risk of forfeiture.” If a short-term deferral under the Proposed §457 Regulations is based on one of these different “substantial risk of forfeiture” definitions (e.g., a permissible non-compete condition can be a “substantial risk of forfeiture” and can be used to structure a short-term deferral under the Proposed §457 Regulations, but not under the §409A Regulations), it will qualify for the short-term deferral exemption under the Proposed §457 Regulations but might not qualify for the short-term deferral exemption under the §409A Regulations.</p>	<p>Prop. Reg. §1.457-12(d)(2) (short-term deferral exemption). Prop. Reg. §1.457-12(e) (definition of substantial risk of forfeiture).</p>	<p>Reg. §1.409A-1(b)(4); Prop. Reg. §1.409A-1(b)(4)(i)(B) and §1.409A-1(b)(4)(ii) (short-term deferral exemption). Reg. §1.409A-1(d) (definition of substantial risk of forfeiture).</p>

<i>More Important Differences</i>	<i>Applicable Proposed §457 Regulations Cite</i>	<i>Applicable §409A Regulations Cite</i>
<p>2. <i>Differences in the “Substantial Risk of Forfeiture” Definitions</i> — There are several differences in the “substantial risk of forfeiture” definition that is in the Proposed §457 Regulations and that is in the §409A Regulations. Among the more important of these differences are the following:</p> <ul style="list-style-type: none"> ● the Proposed §457 Regulations allow the use of a noncompete condition to establish a substantial risk of forfeiture if certain requirements are satisfied, but the §409A Regulations do not allow a noncompete condition to be used to establish a substantial risk of forfeiture; and ● as described in numbers 4 and 5 in this chart, the requirements in the Proposed §457 Regulations for adding a substantial risk of forfeiture (e.g., when an employee voluntarily elects to defer current compensation) or extending a substantial risk of forfeiture (e.g., when delaying a scheduled deferred compensation payment date) are significantly different than the applicable requirements in the §409A Requirements. 	Prop. Reg. §1.457-12(e).	Reg. §1.409A-1(d).

<i>More Important Differences</i>	<i>Applicable Proposed §457 Regulations Cite</i>	<i>Applicable §409A Regulations Cite</i>
<p>3. <i>Different Limits on the Permissible Amount Payable in the Bona Fide Severance Pay Plan Exemption in the Proposed §457 Regulations, and in the Exemption in the §409A Regulations for Separation Pay Plans That Provide Separation Pay Due to an Involuntary Separation from Service</i> — The bona fide severance pay plan exemption in the Proposed §457 Regulations (§457 Severance Plan Exemption) and the exemption in the §409A Regulations for separation pay plans that provide separation pay due to an involuntary separation from service (§409A Involuntary Separation Exemption), have different limits on the permissible amount payable:</p> <ul style="list-style-type: none"> ● the §457 Severance Plan Exemption generally limits severance to two times a participant’s annualized compensation (based on the participant’s annual pay rate for the calendar year preceding the one in which the participant’s severance from employment occurred, or for the calendar year in which the participant’s severance from employment occurred if there was no compensation during the prior year), and revised to reflect any increase during the applicable calendar year that was expected to continue indefinitely; and ● the §409A Involuntary Separation Exemption generally provides that separation pay may not exceed two times the lesser of: (a) a service provider’s annualized compensation based on pay for the taxable year prior to the taxable year in which the separation from service occurred (or the taxable year in which a separation occurred, if the service provider had no compensation in the preceding taxable year and relies on Prop. Reg. §1.409A-1(b)(9)(iii)(A) prior to its effective date), and revised for any increase for that year that was expected to continue indefinitely; and (b) the compensation limit for qualified retirement plans under §401(a)(17) for the year in which the service provider has a separation from service (that limit in 2017 is \$270,000). 	<p>Prop. Reg. §1.457-11(d)(1)(ii).</p>	<p>Reg. §1.409A-1(b)(9)(iii)(A); Prop. Reg. §1.409A-1(b)(9)(iii)(A).</p>

<i>More Important Differences</i>	<i>Applicable Proposed §457 Regulations Cite</i>	<i>Applicable §409A Regulations Cite</i>
<p>4. <i>Right of Employees to Voluntarily Elect to Defer Compensation</i> — The Proposed §457(f) Regulations allow employees to make voluntary salary deferrals if the following requirements are satisfied (as more fully described in the article):</p> <ul style="list-style-type: none"> ● a 125% requirement; ● a substantial services or noncompete requirement; ● a 2-year deferral requirement; ● an advance written agreement requirement; and ● a substitution requirement. <p>The §409A Regulations provide that voluntary salary deferrals by employees generally may not be made subject to a substantial risk of forfeiture. An exception to this general rule exists if the present value of the amount that will be deferred and that will be subject to a substantial risk of forfeiture is “materially greater” than the present value of the amount if no such deferral occurs.</p> <p>Among the more important differences between the voluntary compensation deferral requirements in the Proposed §457 Regulations and the §409A Regulations are:</p> <ol style="list-style-type: none"> (a) the Proposed §457 Regulations provide that the amount being deferred generally must be 125 percent greater, and the §409A Regulations provide that such amount must be materially greater; (b) the Proposed §457 Regulations allow a voluntary compensation deferral to be contingent solely upon complying with a permissible noncompete requirement, and the §409A Regulations do not allow a voluntary compensation deferral to be contingent solely upon a noncompete requirement; and (c) the Proposed §457 Regulations generally require a 2-year voluntary compensation deferral period (subject to certain exceptions), and the §409A Regulations do not specify a minimum voluntary compensation deferral period. <p>A permissible voluntary compensation deferral under the Proposed §457 Regulations may not necessarily be a permissible voluntary compensation deferral under the §409A Regulations, and it will be important before entering into the voluntary compensation deferral to make sure it is structured in a way that does not violate the requirements in the §409A Regulations.</p>	<p>Prop. Reg. §1.457-12(e)(2).</p>	<p>Reg. §1.409A-1(d)(1).</p>

<i>More Important Differences</i>	<i>Applicable Proposed §457 Regulations Cite</i>	<i>Applicable §409A Regulations Cite</i>
<p><i>5. Extension of a Substantial Risk of Forfeiture Period —</i> The Proposed §457(f) Regulations impose the following requirements that must be satisfied in order to extend a substantial risk of forfeiture period (as more fully described in the article):</p> <ul style="list-style-type: none"> ● a 125% payment requirement; ● a 2-year deferral requirement; ● a substantial services or noncompete requirement; ● an advance written agreement requirement; and ● a substitution requirement. <p>The §409A Regulations do not have the specific extension requirements that are listed above for the Proposed §457 Regulations, but rather generally only allow a substantial risk of forfeiture period to be extended if the following requirements are satisfied:</p> <p>Except as provided with respect to certain transaction-based compensation under §1.409A-(3)(i)(5)(iv), 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, is disregarded for purposes of determining whether such compensation is subject to a substantial risk of forfeiture. An amount will not be considered subject to a substantial risk of forfeiture beyond the date or time at which the recipient otherwise could have elected to receive the amount of compensation, unless the present value of the amount subject to a substantial risk of forfeiture (disregarding, in determining the present value, the risk of forfeiture) is materially greater than the present value of the amount the recipient otherwise could have elected to receive absent such risk of forfeiture.</p>	<p>Prop. Reg. §1.457-12(e)(2).</p>	<p>Reg. §1.409A-1(d)(1).</p>