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Non-Profit Organizations and Government Entities Prepare for New Regulations for “Golden Handcuff” Plans Under Section 457(f) of the Internal Revenue Code

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The IRS has announced that it expects to publish new regulations for ineligible deferred compensation plans under Section 457(f) of the Internal Revenue Code in the near future. Since the adoption of regulations under Section 409A of the Code, employers and contractors have been on alert that new guidance was in process. The public notices of the IRS and the method in which the Section 409A regulations were implemented provide critical insight as to what can be expected from the new regulations.

Section 457(f) of the Code governs certain deferred compensation arrangements for employees of tax-exempt organizations or government entities. These plans typically require for an employee to provide services for some defined period of time with a promise by the employer to make a payment upon the completion of the stated period. Certain types of these plans are often called “retention incentives” or “stay bonuses” as they encourage the employee to provide services for an extended period of time.

A primary benefit of 457(f) plans is that funds credited over a period of time are not subject to taxation as long as the employee is required to perform substantial future services to accrue a right to payment. Usually such an arrangement will provide that the employee perform services for a specified period of time, such as five years or until reaching his or her 65th birthday. Upon completion of the required period of service, the employee “vests” or acquires a legal right to the funds. The funds become fully taxable to the employee on the date of vesting, irrespective of when actual payment occurs. If the employee fails to complete the service period, he/she will have no right to the funds as they will remain assets of the employer under the risk of forfeiture provision.

Across hospitals, universities, independent schools, and many state agencies, there are varying interpretations as to what conditions satisfy the substantial risk of forfeiture requirement. For years, the IRS has interpreted the substantial risk of forfeiture requirement for 457(f) plans consistent with those for property transfers under Section 83. Under this interpretation, funds were subject to a substantial risk of forfeiture provided that the right to the benefit was conditioned on the performance of substantial services. The regulations (and subsequent interpretations of the regulations) recognized a number of circumstances to satisfy the risk of forfeiture requirement. These included employment to a certain date, death, disability, termination without cause, completion of a defined employment term, and in certain circumstances, compliance with a non-compete agreement and performance of consulting services.

With the publication of Notice 2007-62, the IRS informed the government entity and tax-exempt world that this would no longer be the case.

The IRS’s change of heart is based on its perceived need to reconcile the prior interpretation of substantial risk of forfeiture with that of Section 409A of the Code. Section 409A, which became effective on January 1, 2005, also applies to ineligible nonqualified deferred compensation plans of tax-exempt and governmental employers. Most such plans are, however, structured to avoid the application of Code Section 409A as a short-term deferral. While the Section 409A final regulations recognize the substantial risk of forfeiture concept, it provides material restrictions as to which facts meet this requirement.

Under Section 409A, the condition providing the basis for risk of forfeiture must relate to the employee’s services or the employer’s business activity or organizational goals. In very clear terms, the 409A regulations provide that an amount is ***not*** subject to risk of forfeiture merely because of a promise to refrain from performance of services. This would call to question any plan for which the payment is conditioned on a non-compete agreement. The IRS has stated that the new Section 457(f) regulations anticipate issuing guidance for substantial risk of forfeiture in line with those published under Section 409A.

In addition, it is expected that the new regulations for Section 457 will do the following:

- Clarify that a bona fide severance pay plan under Section 457(e)(11) will not be subject to the requirements of Section 457 if it meets three requirements, specifically, (i) it is payable only upon involuntary termination; (ii) the amount paid does not exceed the lesser of twice the employee’s annual salary or the Section 401(a)(17) limit; and (iii) the plan provides for payment to be completed by the end of the employee’s second taxable year after the year of termination.
- Provide that if certain conditions are met, Section 457(f) would not apply to part-year compensation for those employees who work over a part-year period, such as teachers who are employed from September through May, but are paid over a 12- month payment schedule.
- Reconcile the treatment of future earnings on amounts previously vested under Sections 409A and 457(f).

The good news for entities that sponsor such plans is the likelihood that there will be a correction period to address issues with current 457(f) plans. There is precedent from the IRS’s implementation of the 409A regulations, in which employers were provided a safe harbor period for corrections to bring their plans into compliance. However, the safe harbor period may not be very long, and may end as soon as December 31, 2011.

Therefore, every non-profit organization and government entity should identify its deferred compensation plans subject to Section 457(f) to take advantage of the safe harbor. Plans subject to Section 457(f) are likely to include not only formal supplemental executive retirement plans, but also employment agreements, bonus schemes and other incentive compensation programs. For each plan or agreement subject to Section 457(f), the sponsoring employer should determine what the basis for the risk of forfeiture is. Generally, the risk of forfeiture conditions are likely to be; termination of employment without cause or for “good reason,” death, disability, the achievement of performance metrics or milestones; and/or agreements to refrain from providing services for a period post-termination. The sponsoring employer will then be in a position to identify quickly where current plan terms no longer comply with the newly issued regulations and to amend plans where necessary.

Sponsoring employers would also be well-served to discuss with employees participating in plans or agreements subject to Section 457(f) the coming regulations and the likelihood that the employer will be required to amend a participating employee’s agreement. This is particularly true when the plan or agreement’s substantial risk of forfeiture relies solely on a covenant not to perform services for a competitor or when the circumstance of forfeiture would not constitute a substantial risk under the Section 409A regulations. By doing so, sponsoring employers will have laid the foundation with affected participating employees to facilitate amending plan terms that will no longer satisfy the new regulatory requirements of Section 457(f).

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