Proposed Modifications to the 457 Regulations

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On June 21, 2016, the IRS proposed regulations prescribing rules for 457 plans. Section 457 of the Internal Revenue Code governs the income taxation of deferred compensation arrangements for employees and independent contractors of tax exempt organizations and state and local governments.

There are two basic categories of 457 plans: "Eligible Plans" or 457(b) plans, and "Ineligible Plans" or 457(f) plans. 457(b) eligible plans generally have the look and feel of 401(k) plans: (i) there are maximum deferral limits, (ii) they are subject to minimum required distribution rules, and (iii) distributions are subject to income tax when paid. 457(f) ineligible plans generally have no limit on the amount that may be deferred, and distributions are subject to income tax when the compensation is no longer subject to a substantial risk of forfeiture (i.e., vested), even if the amounts are to be paid at a later date.

Both 457(b) plans and 457(f) plans permit employee and employer contributions. However, until the publication of these proposed regulations, most 457(f) plans were structured to be only employer contributory due to the uncertainty of the substantial risk of forfeiture on employee elective deferrals.

The proposed regulations cover and clarify a number of areas including what plans are subject and not subject to Section 457, and various rules regarding substantial risk of forfeiture and the calculation of includible income for tax[1] purposes.

The following are some examples of the categories of plans, subject to specific rules, that are not subject to Section 457, and therefore not subject to income tax upon vesting:

- Involuntary Severance Pay Plans or Window Program Plans
- Disability and Death Benefit Plans
- Sick Pay or Vacation Leave Plans
- Expense Reimbursement Plans
- Medical Benefits or In-Kind Benefits
- Recurring part-year compensation (e.g., teachers pay)
- Short-Term Deferrals (discussed below)

The remainder of this article focuses on the proposed regulation clarifications that affect 457(f) plans with respect to (i) what constitutes a substantial risk of forfeiture, and (ii) the calculation of includible income for tax purposes.

Note that Substantial Risk of Forfeiture (SRF) and vesting are used interchangeably in this article.

Substantial Risk of Forfeiture (SRF)

As previously mentioned, 457(f) benefit payments are taxed when a payment is no longer subject to a SRF (i.e., becomes vested). Consequently, a delay in the vesting date will result in a delay of taxation.

The proposed regulations clarify and expand on the definition of a SRF. Prior to the proposed regulations, the definition of a SRF for 457(f) plans was based upon the Section 83 definition and associated regulations.

The proposed regulation adopts essentially the same basic definition of SRF as under Section 409A (i.e., conditioned upon the future performance of substantial services, or the occurrence of a condition that is related to a purpose of the compensation and the possibility of forfeiture is substantial, where death, involuntary separation from service, voluntary separation from service with "good reason" are valid SRFs), but adds two significant conditions that permit the delay of taxation:

1. Covenant Not to Compete is a Valid SRF. Compensation contingent upon compliance with a covenant not to compete will be considered a valid SRF if certain conditions are satisfied:

   - The right to the compensation must be expressly conditioned on the employee refraining from the performance of future services pursuant to a written agreement that is enforceable under applicable law (i.e., must not be prohibited by state law).

   - The employer must consistently make reasonable efforts to verify compliance with all of the noncompetition agreements to which it is a party (including the noncompetition agreement at issue).

   - The facts and circumstances must show that the employer has a substantial and bona fide interest in preventing the employee from performing the prohibited services and that the employee has a bona fide interest in engaging, and an ability to engage, in the prohibited services.

   A valid non-compete covenant will enable a plan to delay the vesting date, and consequently defer taxation. As a result, a valid non-compete may effectively be used to create a SRF upon a voluntary separation from service.

   Example: An employee participates in a 457(f) plan that promises to pay a retirement benefit at age 65 of $10,000 each year for 5 years, as long has he remains continuously employed to age 65, and as long as he continues to comply with a valid non-compete when retired. Violation in any year during retirement causes a forfeiture of the payment due. Each year's payment is subject to a valid SRF. Consequently, in lieu of being taxed on the present value of all 5 payments at age 65 (on the date the benefits vest), the employee will be taxed when each year's benefit is paid, as long as there is no violation of the non-compete from age 65 to age 70, and the employer and employee continue to maintain bona fide interest in preventing or engaging in the prohibited services, as the case may be.

2. Rolling Risk of Forfeiture or Extension is a Valid SRF. Under Section 409A, an addition of, or an extension of a SRF (i.e., rolling the SRF) after the legally binding right arises is not permitted, unless the present value of the amount to be received in the future is "materially greater" than the amount that was to be received prior to the extension. This rule generally results in salary or bonus deferrals not being subject to a current SRF unless the current salary or bonus is exchanged for a much larger promise of payment in the future (e.g., adding a match, etc.). In addition, without the exchange for a larger payment in the future, extending (rolling) the vesting date will not be recognized for 409A short-term deferral purposes. (See "Planning Point" under Short-Term Deferrals below.)

   The proposed 457 regulations permit the addition or extension of a SRF under 457(f) if the "plan" meets the following requirements:

   - The present value of the amount that the employee will receive, based upon reasonable assumptions at the time of the original SRF lapse is at least 125 percent of the amount the employee would have received absent the addition or extension of the SRF (notice the "125%" here as opposed to "materially greater" for 409A).

   - At least 2 years of substantial additional service *or* a 2 year valid non-compete is required (i.e., minimum 2 year roll), measured from the date of the original SRF. Notwithstanding the 2 year minimum, a plan may provide that the substantial future service condition will lapse upon death, disability, or involuntary severance from employment without cause.

   - For an initial SRF, a written agreement must be made before the calendar year in which services are performed. For extensions, a written agreement must be executed at least 90 days before the date a SRF would have lapsed absent an extension. If an employee was not providing services for at least 90 days before the addition or extension, the addition or extension must be agreed to within 30 days after commencement of employment, but is valid only with respect to amounts attributable to services performed after such addition or extension.

   - A condition related to the performance of compensation must relate to the actual performance of services for the employer (not a condition relating to the performance of such services).

   Example: On 1/1/2016, an employer agrees to pay an employee $100,000 on 12/31/2020, if he continues to provide substantial services to the employer through that date (i.e., the vesting date - valid SRF). On 7/1/2020, the employer agrees to modify the agreement and roll the vesting date to 12/31/2022, with the employee agreeing to perform substantial services through that date. In addition, the employer agrees to increase the benefit payable on 12/31/2022 to an amount that has a present value (based upon reasonable assumptions as of 12/31/2020) of $130,000.

   The extension of the vesting (SRF) date to 12/31/2022 will be considered valid, since (i) the modification was exercised at least 90 days before the original vesting date, and (ii) the present value of the revised benefit is at least 125% of the original benefit.

Points to note regarding non-compete covenants and SRF extensions:

- The use of non-compete covenants, rolling SRFs and employee elective deferrals provide significant planning opportunities and benefits for tax-exempt employers and employees, by postponing income and FICA taxation.

- In order to extend the SRF for elective deferrals, 457(f) arrangements must have a significant matching employer contribution, or equivalent, in order to satisfy the above 125% test.

- A 457(f) plan is also subject to the rules under Section 409A, unless there is an exemption from the Section 409A rules[2]**.** If the 409A rules are not met, the employee is subject to penalties and interest payments.

- Section 409A only recognizes extensions of a SRF in limited circumstances. One of the most utilized 409A exemptions is the short-term deferral exemption. If a SRF is extended under Section 457(f), care must be taken to (i) avoid violating 409A, or (ii) subjecting a plan to the requirements of 409A that was exempt prior to the extension under the 409A short-term deferral exemption (See "Planning Point" under Short-Term Deferrals below).

- Section 409A does not recognize a non-compete covenant as a valid SRF. As a consequence, a non-compete covenant that is designed to satisfy the conditions under the proposed regulations will be effective in delaying the date on which the SRF lapses under Section 457, but not under Section 409A. This may result in a loss of a 409A exemption under its short-term deferral rule, thus possibly causing a 409A violation, unless the plan contains required 409A provisions.

Short-Term Deferrals

The proposed regulations provide that a deferral of compensation does not occur (and therefore Section 457 does not apply) with respect to any amount that would be a short-term deferral under the Section 409A regulations (including permitted delays), except that the 457 definition of a SRF above applies, instead of the SRF definition in 409A.

Accordingly, Section 457 does not apply to any payment that is not a deferred payment, provided that the payment is actually or constructively (i.e., taxed) received on or before the last day of the applicable 2 1/2 month period. For this purpose, the applicable 2 1/2 month period is the period ending on the later of the 15th day of the third month following the end of the first calendar year in which the right to the payment is no longer subject to a SRF, or the 15th day of the third month following the end of the eligible employer's first taxable year in which the right to the payment is no longer subject to a SRF.

Stated differently, the short-term deferral exemption will be satisfied if the payment must be paid in full (or taxed in full) within the 2 ½ month span following the end of the taxable year in which the payment becomes vested.

A 457(f) plan that satisfies the short-term deferral exemption avoids amounts being taxed at the time the SRF lapses (i.e., upon vesting), but instead, results in amounts being taxed when paid. As stated above, 457(f) plan amounts that do not satisfy the short-term deferral exemption are taxed upon vesting, even if not paid until a later date.

PLANNING POINT: The definition of a SRF under the 457 proposed regulations is broader (less restrictive) than the SRF definition under 409A. Consequently, amounts that are valid short-term deferrals under 409A will also be valid short-term deferrals under 457(f). However, the reverse is not necessarily true.

Example: In 2016, a 457(f) plan provides a participant with a bonus of $50,000 to be paid on 12/31/2020 if he remains in service to that date (the vesting date). A plan with these terms will satisfy the short-term deferral exemption for both 409A and 457(f).

However, on 7/1/2019, the employer agrees to delay (roll) the vesting and payment date to 12/31/2022, and intends to satisfy all the requirements for a valid roll under the proposed 457 regulations, including increasing the bonus to $70,000. Such a change will preserve the short-term deferral exemption under 457 (present value of $70,000 on 12/31/2020 at a reasonable rate of interest is at least 125% of $50,000), but not necessarily under 409A. Unless the IRS considers the present value of $70,000 to be "materially greater" than the original $50,000, the extension of the vesting date will result in the short-term deferral exemption not be recognized for 409A purposes (since 409A does not generally recognize a rolling SRF). Consequently, the plan is no longer covered by the short-term deferral exemption for 409A purposes, and will violate 409A, and be subject to penalties, due to an impermissible 409A delay in payment (under 409A, the payment date must be delayed at least 5 years from the original payment date).

The takeaway is that the rules of 457(f) apply separately and in addition to any requirements applicable to the plan under 409A.

Amount Includable in Income

Consistent with the current 457(f) regulations, amounts are includable in income on the date (called the "applicable date" in the regulation) that the SRF lapses, or vesting date. The amount to be included in income for tax purposes is referred to as the "Present Value of Compensation." Amounts are includible in income on the vesting date irrespective of the fact that the associated benefits may be paid at a later date. The actuarial assumptions used (e.g., interest, mortality, projected payment date, and others) must be based upon reasonable assumptions based upon the facts and circumstances known at the vesting date, even if not definitive (i.e., not "reasonably ascertainable").

Two points should be noted regarding taxation:

1. Once an amount is taxed, it will not be taxed again. In other words, the participant is considered to have an "investment in the contract" (basis) equal to an amount on which tax was previously paid.

2. In the event the projected benefit is not paid or a lesser amount is paid, the participant is entitled to a deduction in the year the amount is permanently forfeited, based on the difference between the amount that was included in income over the amount actually received.

Example: An employee participating in a 457(f) plan vests in an account balance of $100,000 on 12/31/2016. The employee is taxed on $100,000 on that date. The account will continue to earn interest

until a payment date of 12/31/2020. If the account balance is $125,000 on 12/31/2020, the employee will owe tax on an additional $25,000 ($100,000 was previously taxed and is not taxed again).

On the other hand, if the account balance is $75,000 on 12/31/2020. The employee would be entitled to a tax deduction (miscellaneous itemized deduction) of $25,000 (i.e., $100,000 previously taxed less the $75,000 actually received.)

The proposed regulations lay out specific rules with respect to the methodology for calculating amounts includable in income.

Account Balance (Defined Contribution) Plans – If the account balance is determined using a predetermined actual investment or a reasonable rate of interest, the includable amount is the account balance. If the rate is not reasonable, the includable amount will equal the account balance, plus the present value of the excess (if any) of the earnings to be credited under the plan through the projected payment date, over the earnings that would be credited using a reasonable rate, or the Applicable Federal Rate (special rule when earnings are based on the greater of the earnings on two or more investments or interest rates). Earnings paid after income inclusion are taxed when paid.

Example 1: Assume a participant's account balance on the vesting date is $100,000 including interest at a rate of 5%, which is assumed reasonable. The includible amount would be the $100,000 account balance. Any future earnings on the account will be taxed when paid. The $100,000 will not be taxed again.

Example 2: On 1/1/2016, an employee in a 457(f) plan receives an employer contribution of $100,000. The plan credits interest for the life of the plan at an annual rate of 15%, which in this example is assumed to be unreasonable. The account balance vests on 12/31/2019 with an account balance of $174,900. In order to calculate the includible income as of the vesting date, one must project an anticipated payment date, and calculate the present value of the "excess earnings" (i.e., the present value of future earnings at 15%, over a rate that is considered to be a "reasonable rate"- assumed to be 5% at the time of vesting) payable through the projected payment date, and add that amount to the $174,900 account balance to arrive at the total includible amount.

Assume as of the projected payment date of 12/31/2022, the account balance of $266,000. The present value of the excess earnings on the 12/31/2019 vesting date is $54,882 at 5%. The employee would have includible income of $174,900 (vested account balance) plus $54,882 (present value of excess future earnings), totaling $229,782. On the payment date of 12/31/2022, the employee will have an additional amount of includible income of $36,218 (account balance of $266,000 less an amount previously included of $229,782).

PLANNING POINT: When designing an account balance plan, one should incorporate a realistic interest credit or pre determined investment measure (e.g., Moody's, S&P return) in order to avoid the complexities involved in calculating the includible amount for tax purposes.

Non-Account Balance (Defined Benefit) Plans – As stated above, the actuarial assumptions used in calculating the includible amount (e.g., interest, mortality, projected payment date, and others) must be based upon reasonable assumptions based upon the facts and circumstances known at the vesting date, even if not definitive. With Non-Account Balance plans, it will very likely require the estimate of more assumptions than required under Account Balance Plans. This is of particular relevance when the payment of benefits will occur years after the vesting date. Below are some scenarios:

- If a benefit payment trigger is based upon an event that occurs after the vesting date; one must assume that the trigger occurs upon the earliest possible date the trigger could reasonably be anticipated to occur unless the payment trigger itself is subject to a SRF. For example, if vesting occurs after 5 years, but the benefit is to be paid upon the earlier of a change in control or age 65, the payment date must be estimated (using reasonable assumptions as to the date of the occurrence) in order to calculate the present value. Consequently, if it is reasonable to assume that the change in control is likely to occur prior to age 65, then an estimate of the change in control date must be made. The proposed regulations contain a similar rule for a separation from service event, except the payment date may be any date on or before the 5th anniversary of the vesting date (if that would be a reasonable assumption).

- If a benefit is based on a formula where the amount cannot be readily determined (not reasonably ascertainable) as of the vesting date, one must use reasonable good faith assumptions as of that date to calculate the includible amount (present value). For example, if a vesting date occurs before age 65, but the formula pays 50% of final salary for 10 years at 65, one must calculate the includible amount based upon reasonable assumptions for final salary as of the vesting date.

- If a plan permits alternative times or alternative forms of payment, and the plan permits the time/form to be changed by the employee or employer, then the includible amount is treated as payable in the time/form for which the present value is highest. So, if the benefit, by plan terms, is to be paid at age 65, but may be paid in a lump sum, or a life annuity, the includible amount must be based on the higher present value as of the vesting date.

PLANNING POINT: When designing a Non-Account Balance Plan, consider making the "vesting date" and "payment date" the same, in order to minimize includible income calculation complexities.

Effective Date

The proposed rules are not in effect until formally adopted. However the IRS states the proposed rules may be relied upon immediately. Absent from the proposed rules are any "grandfathering" conditions, which will result in the new rules applying to all current 457 plans where participants have a legally binding right, as well as new plans going forward.

Please feel free to contact The Pangburn Group with questions or concerns regarding the above provisions.

(1) *"Tax" or "taxed" when used in this article generally refers to income tax. Amounts may also be subject to FICA tax under the FICA tax regulations.*

(**2**) *Without a valid exemption, 409A requires (i) distributions only upon a set of permissible payment events, (ii) specific time and form of payments, (iii) limited ability to accelerate or delay payments, (iv) required definitions for certain payment events, (v) severe financial penalties for the employee upon a violation.*