



IRS proposes long-awaited IRC Section 457 regulations

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The U.S. Department of the Treasury recently issued proposed regulations to supplement the existing regulations on the application of IRC Section 457 to eligible and ineligible deferred compensation plans of public and tax-exempt entities. Many of the changes are administrative in nature and clarify gaps in the prior regulations. Some of the more significant changes include:

1. Three provisions relate to statutory changes to sections 457 and 457A since the final regulations were issued.

First, the proposed regulations authorize non-deductible Roth-style contributions to eligible plans within the ceiling amount. Separate accounting for such contributions and their earnings is required, and distributions are excluded from income, under rules similar to those imposed under Treas. Reg. §1.402A-1. Second, certain distributions for accident and health insurance premiums under government plans are excluded from income. Third, in the case of a participant who dies while performing qualified military service, such that the individual is not employed at the time of death, the survivors are generally entitled to the benefits the participant would have received under the plan had the participant returned to service before death.

2. A number of changes relate to plans that are not subject to Section 457 or that are treated as not providing for a deferral of compensation.

In particular, definitions are provided for several plans that do not provide for a deferral of income. These plans include bona fide vacation, sick leave, compensatory time, severance pay, disability pay or death benefit plans. In addition, plans paying solely length of service awards to bona fide volunteers also do not provide for a deferral of income. Definitions are provided for several of these plans, and the definition of "disability" under Section 409A is adopted for purposes of Section 457.

Other provisions relate to plans that are excluded from consideration under Section 457. With respect to severance pay plans, the proposed regulations adopt limitations similar to those imposed by Section 409A and provide that a severance for good reason constitutes an involuntary severance from employment. Window plans and voluntary early retirement incentive plans are also excluded from the scope of Section 457. Definitions and terms throughout the regulations are similar to those used in the regulations under Section 409A and Treas. Reg. 1.409A-1(b)(9). The amount of the separation pay is limited to twice the annual compensation paid in the year preceding the separation; in the case of a person working for less than one year, the cap is twice the annualized compensation paid. Finally, pursuant to the terms of the plan, the compensation must be paid no later than December 31 of the year following the year in which the separation takes place.

A definition of "involuntary separation" similar to that imposed under Section 409A is provided, including a separation for good reason. A safe harbor provision similar to that under Section 409A is also provided, including the requirement that the conditions be specified in the plan, as well as a notice requirement by the employee and an opportunity to remedy by the employer.

3. The remaining provisions relate primarily to ineligible plans under Section 457(f).

The proposed regulations provide that amounts of deferred compensation will be included in income on the date (the “applicable date”) that is the latter of the date the participant obtains a legally binding right to the compensation or the date on which any substantial risk of forfeiture lapses. The amount to be recognized is the present value, on that date, of the amount of the compensation and any earning on it. Earnings on that amount that accrue after that date are included in income when paid or made available for payment. Extensive guidance is provided regarding the calculation of the present value of the compensation to be included in income, and a taxpayer who does not receive a portion of the amount recognized in income may take a deduction for that amount.

The proposed regulations define what constitutes a deferral of compensation using terms similar to those found in IRC Section 409A. They also extend the short-term deferral rule to payments made under Section 457.

The Section 409A rules relating to recurring part-year compensation are made applicable to Section 457.

The regulations provide that both Section 457 and Section 409A may apply to plans under Section 457(f) and explain how the two sections may overlap and interact with each other.

The long-awaited guidance regarding what constitutes a substantial risk of forfeiture is provided. The definitions of what constitute deferred compensation and a substantial risk of forfeiture closely follow those for Section 409A, with one major exception: A covenant not to compete may still constitute a substantial risk of forfeiture, provided three conditions are met: (i) the agreement not to compete is contained in a written agreement; (ii) the employer must consistently make reasonable efforts to verify compliance with the agreement; and (iii) the facts and circumstances must show the employer had a bona fide interest in having the employee not engage, and the employee was able to engage in the prohibited activities. The proposed regulations also permit the extension of a risk of forfeiture beyond a vesting date provided certain requirements are met (a so-called “rolling risk of forfeiture”).

The regulations are proposed to apply to compensation, including amounts not previously included in income, deferred under a plan for calendar years beginning after the date that is 90 days after notice is given that the regulations are final. However, taxpayers may rely upon the regulations prior to the date they become final.

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