NOT-FOR-PROFIT ORGANIZATIONS

PRACTICE LEADER
Joseph G. Casion
jcasion@hselaw.com

PARTNERS
Ross P. Lanzafame
rlanzafame@hselaw.com
Anthony D. Mancinelli
amancinelli@hselaw.com
Richard T. Yarmel
ryarmel@hselaw.com

ASSOCIATES
Joshua E. Gewolb
jgewolb@hselaw.com
Rayza R. Santiago
rsantiago@hselaw.com

IRS Issues New Proposed Regulations on Deferred Compensation Arrangements of Tax-Exempt Organizations

On June 21, 2016, the IRS issued new Proposed Regulations under Section 457 of the Internal Revenue Code (the "Proposed Regulations"), which address the nonqualified deferred compensation arrangements of tax-exempt organizations. The new rules under the Proposed Regulations will not apply unless and until adopted in final regulations issued by the IRS, but organizations may rely on the Proposed Regulations in the meantime.

The Proposed Regulations address areas of uncertainty relating to such nonqualified deferred compensation arrangements, including when compensation deferred under an arrangement is includible in income and the actual amount to be included in income. The Proposed Regulations also address the interaction between Section 457(f) and Section 409A. As described in greater detail below, the Proposed Regulations:

- confirm that a substantial risk of forfeiture (a "SROF") can include a non-compete agreement under certain conditions;
- permit the extension of a risk of forfeiture (a "rolling risk of forfeiture") if certain requirements are met;
- clarify that, similar to Section 409A, a "short-term deferral" exemption exists for Section 457(f) plans; and
- provide for the exemption of bona fide severance pay arrangements and bona fide death benefit, disability pay, sick leave and vacation plans in a manner that is similar to the corresponding exemptions under Section 409A.

Background

Deferred compensation is an arrangement that provides an employee with a legally binding right in a tax year to compensation that is or may be paid to the employee in a later tax year.

Section 403(b) addresses the requirements for a "qualified" deferred compensation arrangement sponsored by a tax-exempt organization for its employees. Qualified 403(b) arrangements are similar to the qualified 401(k) plans that private employers may sponsor for their employees.

Section 457 addresses the tax treatment of "nonqualified" deferred compensation arrangements, which generally include any deferred compensation arrangement of a tax-exempt organization other than a qualified 403(b) deferred compensation arrangement. There are two types of nonqualified deferred compensation arrangements under Section 457:

- "Eligible" nonqualified deferred compensation arrangements under Section 457(b), which are similar to qualified 403(b) plans in that they allow employees of a tax-exempt organization to defer up to a specified annual maximum amount ($18,000 for 2016) of compensation on a pre-tax basis, but participation in an eligible 457(b) arrangement must be limited to the organization's highly compensated employees. The compensation deferred may be compensation reductions elected by the employee or additional compensation contributions made by the employing tax-exempt organization.

EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION

PRACTICE LEADER
Paul W. Holloway
pholloway@hselaw.com

PARTNERS
Thomas J. Hurley
thurley@hselaw.com
Samuel J. Palisano
spalisano@hselaw.com
Christopher M. Potash
cpotash@hselaw.com
Mark R. Wilson
mwilson@hselaw.com

COUNSEL
Cody R. Braithwaite
cbraithwaite@hselaw.com
Leslie E. DesMarteau
ldesmarteau@hselaw.com
Lisa G. Pelta
lpelta@hselaw.com
Joseph E. Simpson
jsimpson@hselaw.com
Lori J. Stone
lstone@hselaw.com

ASSOCIATES
Emily C. Ayers
eayers@hselaw.com
John W. Brill
jbrill@hselaw.com
Diana R. Clarkson
dclarkson@hselaw.com
Joshua E. Gewolb
jgewolb@hselaw.com
Alexandra E. Lugo
alugo@hselaw.com
Michael J. Roche
mroche@hselaw.com
Jesse A. St.Cyr
jstcyr@hselaw.com

BENEFITS LITIGATION COUNSEL
Erika N. D. Stanat
estanat@hselaw.com
Megan K. Dorritie
mdorritie@hselaw.com
John P. Bringewatt
jbringewatt@hselaw.com

Under Section 457(b), an employee is not subject to tax on nonqualified deferred compensation until the compensation is actually paid to the employee.

- "Ineligible" nonqualified deferred compensation arrangements under Section 457(f), which are any nonqualified deferred compensation arrangement of a tax-exempt organization which is not a Section 457(b) arrangement or which does not qualify for an exemption from Section 457. Participation in 457(f) arrangements must also be limited to the organization's highly compensated employees. Under Section 457(f), an employee is subject to tax on nonqualified deferred compensation when the compensation is no longer subject to a SROF, which typically is when the employee's right to the compensation has vested.

Effective January 1, 2005, Congress adopted a new Section 409A to the Internal Revenue Code, which made sweeping changes to the tax treatment of nonqualified deferred compensation of both private employers and tax-exempt organizations. Under Section 409A, nonqualified deferred compensation became subject to stringent requirements regarding the timing of the deferral and permissible payment events.

While the rules applicable to nonqualified deferred compensation arrangements of tax-exempt organizations under Section 457(f) generally are more restrictive than those under Section 409A, the rules of Section 409A do impact some nonqualified deferred compensation arrangements of tax-exempt organizations.

In Notice 2005-1, the IRS provided interim guidance on the application of Section 409A, and stated that pending additional IRS guidance, tax-exempt organizations are allowed to rely on the definitions of bona fide vacation leave, sick leave, compensatory time, disability pay, and death benefit plans for purposes of Section 457(f), as applicable, for purposes of applying Section 409A to ineligible nonqualified deferred compensation plans under Section 457(f).

At the same time that the IRS issued the Proposed Regulations, it also issued new additional proposed regulations under Section 409A, which provide for clarifications under that section.

Key Provisions of the Proposed Regulations

Substantial Risk of Forfeiture

Compensation is generally subject to a SROF for purposes of Section 457(f) only if entitlement to the compensation is conditioned on one of the following:

- the future performance of substantial services;
- the occurrence of a condition related to a purpose of the compensation, if the possibility of forfeiture is substantial; and

  Note, the facts and circumstances must indicate that the forfeiture condition is likely to be enforced; factors considered for this purpose include (i) past practices of the employer, (ii) the level of control or influence of the employee with respect to the organization and the individual(s) who would be responsible for enforcing the forfeiture, and (iii) the enforceability of the provisions under applicable law.

- compliance with a non-compete provision, but only if certain conditions regarding its enforcement are satisfied.

  Note, this is an area where the Proposed Regulations depart from Section 409A, since non-compete provisions are generally not treated as a SROF under Section 409A.

It has generally been understood that a SROF for a Section 457(f) arrangement may be extended if the resulting payment amount would be materially greater. The Proposed Regulations now provide detailed guidance on the nature of a materially greater benefit that is necessary to extend a SROF. Under the Proposed Regulations, an existing SROF may be extended only if all of the following requirements are met:

- the present value of the amount to be paid upon the lapse of the SROF must be an amount that is more than 125% of the amount the participant otherwise would have been paid in the absence of the extension of the SROF;

  Note, the Proposed Regulations provide specific rules for determining the present value of compensation, which are similar (but not identical) to the rules for determining present value under Section 409A.

- the extended SROF must be based on the future performance of substantial services or adherence to a non-compete;
- the SROF must be extended for at least an additional two years; and
- the agreement extending the SROF must be made in writing at least 90 days before the date the existing SROF would have lapsed.

Short-Term Deferrals

Section 409A provides an exemption for short-term deferrals of compensation, which are defined as compensation that is paid on or before March 15th of the calendar year following the calendar year in which the employee's right to the compensation is no longer subject to a SROF, or if later, on or before 2½ months following the end of the employer's fiscal year in which the employee's right to the payment is no longer subject to a SROF.

The Proposed Regulations specify that a short-term deferral for purposes of Section 457(f) generally is determined in the same way as under Section 409A. Therefore, compensation payable to an employee of a tax-exempt organization will be exempt from Section 457(f) so long as the compensation is paid within the applicable short-term deferral period.

Bona Fide Severance Pay Arrangements

A severance pay plan is a "bona fide severance pay plan" that is exempt from Section 457(f) if it meets certain requirements, including:

- the benefits must be payable only upon an employee's involuntary severance from employment (which may include severance from employment for good reason or pursuant to a window program or voluntary early retirement incentive plan as defined in the Proposed Regulations);

  Note, in general, a severance from employment for good reason must be on account of unilateral action taken by the employer that results in a material adverse change to the working relationship, such as a material reduction in the employee's duties, working conditions or pay.

- the total amount of severance pay must not exceed two times the employee's annualized compensation based on the employee's annual rate of pay; and
- the severance benefits must be paid within two calendar years following severance from employment.

If severance payments do not meet these requirements, then they are includible in the employee's taxable income at the time of severance from employment, even if they are paid in a following year.

Bona Fide Death Benefit, Disability Pay, Sick Leave and Vacation Leave Plans

The Proposed Regulations include guidance for determining whether a plan meets the criteria to be a bona fide death benefit plan, disability pay plan, sick leave plan or vacation leave plan, which are exempt from Section 457(f). There are fairly detailed requirements for each type of plan to qualify for exemption.

Note, a bona fide sick leave plan or vacation leave plan that provides for accrued but unused leave to be paid out to an employee following severance from employment is problematic if the amount of leave provided is beyond the amount that could reasonably be expected to be used by the employee.

Suggested Action

We recommend that tax-exempt organizations take the following actions:

- Review existing deferred compensation plans, employment agreements, severance plans, incentive plans, and any other arrangements that provide deferred compensation to ensure they comply with the Proposed Regulations. Early planning may be able to facilitate the transition to the new requirements for Section 457 arrangements.
- Evaluate whether existing severance pay, death benefit, disability pay, sick leave and vacation plans qualify for the exemption from Section 457(f), and if not, consider amending them in order to do so.
- Consider modifying non-compete provisions to ensure that they will qualify as a SROF, or adding non-compete provisions that comply with the Proposed Regulations if desired. (Consult with counsel prior to revising any conditions that may provide grounds for a good reason termination since eliminating any such condition could result in a determination that a SROF has been extended.)
- Consider modifying provisions that allow an existing SROF to be extended to ensure that they meet the requirements in the Proposed Regulations, or adding such provisions that comply with the Proposed Regulations if desired.

Additional Information

If you would like more information regarding the Proposed Regulations and how they may apply to your arrangements, please contact a member of Harter Secrest & Emery LLP's Not-for-Profit Organizations Group or Employee Benefits and Executive Compensation Group at (585) 232-6500. ■