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CAB 16-4

Milliman

CLIENT ACTION Bulletin

Employee Benefits

IRS Proposes Deferred Compensation Rule for Governmental and Tax-Exempt Entities

SUMMARY

The IRS has issued a long-awaited proposed rule on nonqualified deferred compensation plans (NDCPs) maintained by tax-exempt organizations (other than churches and certain church-controlled entities) and state and local governments. The proposed rule provides guidance for plan sponsors in determining when amounts are includible in employees' incomes, the amounts that are includible, and the types of arrangements that are not subject to the requirements of tax code section 457. The proposed rule, which plan sponsors may rely upon immediately, also aligns the requirements for 457(f) plans with section 409A NDCPs. However, this *Client Action Bulletin* focuses on what many plan sponsors and participants may consider the most significant portion of the proposed rule: the expanded definition of a "substantial risk of forfeiture" (SROF) in 457(f) plans.

DISCUSSION

Overview of 457 Plans and the Proposed Rule

In general, NDCPs for tax-exempt organizations are arrangements that, as in the corporate world, must limit participation to only the entities' top-level executives and managers (i.e., "top-hat" restriction). Based on the plan type and the nature of the organization, such NDCPs must comply with tax code section 457. If they meet the requirements of section 457(b), they are considered "eligible plans"; otherwise, they are deemed "ineligible" for 457(b) status and thus are covered by the rules of section 457(f).

Eligible 457(b) plans are similar to traditional tax-qualified defined contribution plans in that there is a maximum annual dollar limit on contributions and participants are taxed on benefits only when amounts are distributed. In contrast, participants in ineligible 457(f) plans are not restricted by any contribution limits but they are taxed when their benefits under the plan are no longer subject to a SROF, regardless of when such benefits are actually payable. 457(f) plans also must comply with tax code section 409A; 457(b) plans are exempt.

In addition to reinforcing the potential application of tax code section 409A to 457(f) plans, the proposed rule incorporates certain statutory changes and required amendments that apply solely to governmental 457(b) plans (e.g., provisions dealing with designated Roth contributions, certain public safety officers, and qualified military service). It also includes instructions (with examples) for calculating the present value of compensation deferred under a 457(f) plan. Furthermore, the proposed rule offers guidance on identifying arrangements (i.e., vacation, sick leave, compensatory time, severance pay, disability pay, death benefits, length-of-service awards to certain volunteers, and voluntary early retirement incentive plans) that qualify for an exception to 457 coverage.

SROF Change Presents Opportunities for 457(f) Plan Sponsors and Participants

Because any amount deferred on a 457(f) plan participant's behalf must be included as taxable income in the year in which the amounts no longer are subject to a SROF, the definition of SROF has a significant impact on both the employer's 457(f) plan design and the participant's tax planning. Over the years many 457(f) plan sponsors have sought to permit participants to defer their compensation (i.e., make elective deferrals) and/or extend the plan's SROF time trigger (and thus postpone the participant's taxation) by including "rolling risk" and/or "non-compete" features. While past IRS policy statements indicated that forthcoming guidance would prohibit such features, the new proposed rule permits their use under specified conditions.

Creation or Extension of SROF – To create a SROF for new elective deferrals or extend a SROF for an existing plan benefit, the proposed rule requires each of the following to be satisfied:

- The present value of the amount payable upon the lapse of the initial SROF (or as extended, if applicable) must be more than 125% of the amount the employee otherwise would be paid in the absence of the SROF (or of the extension). The proposed rule measures the present value as of the date the amount would have otherwise been paid (or the date the SROF would have lapsed without regard to an extension).
- The initial or extended SROF must be based upon a participant's future performance of substantial services or adherence to an agreement not to compete, and must not be based solely on the occurrence of a condition (e.g., meeting a performance goal), although such a condition may be combined with a sufficient service condition.
- The minimum period for which a participant must perform substantial future services is two years (unless there is an intervening event such as the participant's death, disability, or involuntary severance from employment).
- For initial elective deferrals, an agreement subjecting the deferrals to a SROF must be made in writing before the start of the calendar year that services are performed. For SROF extensions, an agreement must be made at least 90 days before the existing SROF expires. A special rule applies to newly hired employees: if they have been providing services for less than 90 days before the initial election or extension, they have up to 30 days from the date of hire to agree in writing to an initial election/extension, but only regarding amounts attributable to services rendered after executing the initial election/extension. However, this special rule is not available for employees newly eligible to participate in a plan.

Non-compete clauses – The proposed rule provides that non-compete clauses will create a SROF that is acceptable only if:

- The employee's right to the compensation is expressly conditioned on his/her refraining from performing future similar services for a competitor under a written agreement that is enforceable under applicable law (e.g., state law).
- The employer must consistently make reasonable efforts to verify compliance with all of its noncompetition agreements, not just selected ones.
- When the noncompetition agreement becomes binding, the employer must have a substantial and bona fide interest in preventing the employee from performing the prohibited services and the employee must have a bona fide interest in engaging, and an ability to engage, in providing the prohibited services. Factors the proposed rule takes into account for this purpose include: the employer's ability to show that significant adverse economic consequences would likely result from an employee performing the prohibited services for a competitor; the employee's marketability based on specialized skills, reputation, or other components; and the employee's interest, financial need, and ability to engage in the prohibited services.

If the parties do not clearly intend to actually enforce the agreement, the IRS could deem the SROF condition not satisfied.

ACTION

Until the IRS issues a rule in final form, the agency will not assert positions that are contrary to those set forth in the proposed rule, thereby allowing taxpayers to rely on the proposed rule. The IRS is soliciting comments on the proposed rule until Sept. 20, 2016. Thus, the rule is not expected to be finalized until sometime in 2017 – with an effective date likely in 2018 – at the earliest.

All governmental and tax-exempt organizations should review the entire proposed rule with their employee benefits consultants and ERISA or tax counsel to ascertain if any existing arrangements are affected and whether existing plan documents, communications materials, and/or administrative procedures should be modified to ensure continued compliance.

For additional information about the IRS's proposed rule on deferred compensation arrangements for governmental and tax-exempt entities under section 457, please contact your Milliman consultant.