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Long Awaited! 457 Deferred Compensation Rules

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From: Kristy Buckley

Brand new **proposed federal regulations** for deferred compensation plans offered under Internal Revenue Code Section 457 will be published today, June 22, 2016, together with a more brief set of **proposed rules** applicable to Code Section 409A. Code Section 457 applies specifically to state and local governments and to tax exempt entities. The 457 proposed rulemaking will enter into a comment period and then hold a public hearing on October 18, 2016. If you have specific comments that you want us to advance on your behalf before this rule is finalized, please contact us as soon as possible.

Before discussing the actual proposed regulations, it is helpful to lay out the two different types of 457 Plans currently available.

One type is a **457(b) Plan**. A 457(b) Plan is called an 'eligible plan' and income deferred under such plan is only includible in the participant's gross income when paid or is otherwise made available to the participant. 457(b) Plans must meet certain specific requirements to qualify.

The other type is a **457(f) Plan**. A 457(f) Plan is called an 'ineligible plan' and income deferred under such plan is only includible in the participant's gross income when the participant's rights to compensation are no longer subject to a substantial risk of forfeiture.

The last time regulations were issued for 457 was in 2003. There have been various law changes since the 2003 Regulations, including:

- The American Jobs Creation Act of 2004, which added Code Section 409A (nonqualified deferred compensation plans).
- The Pension Protection Act of 2006, which broadened non-spouse rollover options and added new subsections to 457 regarding early retirement incentive plans, employment retention plans, and a specific rule for public safety officers.
- The Heroes Earnings Assistance and Relief Tax Act of 2008, which created a new rule for death

benefits payable to qualified active military and treatment of military differential wage payments.

- The Small Business Jobs Act of 2010 and American Taxpayer Relief Act of 2012, which follow a progressively relaxed set of rules regarding Roth conversions.

ROTH WOULD BE CLEARLY AVAILABLE FOR 457(B) GOVERNMENTAL PLANS

The proposed regulations amend the typical 457(b) Plan rules to include an optional design feature that allows for Roth contributions. The rule outlines the following proposed features:

1. The 457(b) eligible plan must be a governmental plan (it appears that tax-exempt entities are excluded from this proposed rule).
2. The designated Roth contribution will be included in the participant's taxable income in the year of deferral.
3. The designed Roth contribution must be an irrevocable election made before the first day of the month in which the compensation would have otherwise been paid or made available.
4. The plan must separately account for designated Roth contributions.
5. Qualified distributions from the Roth portion of a participant's 457(b) eligible governmental plan will be excluded from gross income.

SUBSTANTIAL RISK OF FORFEITURE: NON-COMPETES UNDER SCRUTINY

Certain 457 Plans utilize non-compete language and there has been ambiguity regarding whether non-compete provisions provide a substantial risk of forfeiture that can create a deferral of income inclusion. The proposed regulations set the following conditions:

1. The right to the payment must be expressly conditioned on the employee refraining from performing future services pursuant to an enforceable written agreement.
2. The employer must make reasonable ongoing efforts to verify compliance with all of the non-competition agreements to which it is a party.
3. At the time that the non-compete becomes binding, the facts and circumstances must show: (a) the employer has a substantial and bona fide interest in preventing the employee from performing the prohibited services; and (b) the employee has a bona fide interest in engaging, and ability to engage, in the prohibited services.

Furthermore, additional deferrals or extensions based on substantial risks of forfeiture must satisfy all of the following requirements:

1. The present value of the amount subject to the additional or extended substantial risk of forfeiture must be more than 125% of the present value of the amount that the participant would have received absent the additional/extended risk of forfeiture.
2. The employee must be required to perform substantial services in the future (or refrain according to a non-compete) for a minimum of 2 years after the date that the employee would have received compensation.
3. The parties must agree in writing to any addition or extension of substantial risks of forfeiture. An initial addition must be entered into before the beginning of the calendar year. An extension must (generally) be entered into at least 90 days before an existing risk of forfeiture would have lapsed.

QUALIFIED MILITARY AND UNIFORMED SERVICE CHANGES

457(b) Governmental Plans may require a plan amendment that clarifies, in the case of a participant who dies while performing military services, the survivors are entitled to any additional death benefits. Such participants who die while performing military services must be deemed to have resumed employment and then terminated employment on account of death.

In addition, all 457(b) eligible plans (apparently both governmental and tax-exempt) may require a plan amendment that clarifies: participants who are on leave for performing service in the uniformed services must generally be treated as experiencing a severance from employment for distribution purposes.

GENERAL ALIGNMENT AND SIMILARITIES TO 409A STANDARDS

Many of the new regulations are practically verbatim from similar provisions under Code Section 409A and its regulations. Below are some examples.

A. A bona fide severance pay plan is not considered a deferral of compensation pursuant to 457. The proposed regulations offer a definition of severance pay plans under 457. Although some concepts are similar to the “separation pay plan” framework adopted under the 409A regulations, there are some nuanced differences.

B. The regulations offer definitions for what plans constitute **bona fide death benefit plans** and **bona fide disability pay plans**, which are not treated as providing for deferral of compensation pursuant to 457. With respect to **bona fide sick leave and vacation leave plans**, the regulations offer specific factors to keep in mind:

- Whether the amount of leave is reasonably expected to be used in the normal course;
- Limits on the ability to exchange unused accumulated leave for cash or other benefits, including accrual restrictions;
- The amount and frequency of any in-service of cash or other benefits offered in exchange for accumulated and unused leave;
- Whether the payment of unused sick or vacation leave is made promptly upon severance of employment;
- Whether the leaves offered under the plan are broadly applicable versus only available to certain employees.

C. “Ineligible” 457(f) Plans will have a new set of rules that define income inclusion based on a **present value calculation** that is similar to the rule proposed under Section 409A. Present value for 457(f) Plans will be determined according to the “applicable date” which is defined as the later of

- the first date on which there is a legally binding right to the compensation; or
- the first date on which the substantial risk of forfeiture lapses.

By comparison, the present value calculation under Section 409A is meant to be determined according to the end of the participant’s taxable year. Interestingly, the income inclusion rules for 409A have been in proposed format since 2005 but these new 457 regulations clearly intend that both sets of proposed rules (409A and 457(f)) for income inclusion will be finalized and further intend the 457 regulations to cross-reference the 409A regulations.

D. Short term deferrals paid within the applicable 2 ½ month period will not be considered deferrals of compensation subject to 457. This rule aligns with historic 409A treatment except that it follows the 457 rules regarding substantial risk of forfeiture. Therefore, for purposes of 457, short term deferrals are payments actually or constructively received by a participant on the later of the 15th day of the third month following (a) the end of the first calendar year in which the right to payment is no longer subject to a substantial risk of forfeiture; or (b) the end of the employer’s first

taxable year in which the right to payment is no longer subject to a substantial risk of forfeiture.

E. IRS Notice 2008-62 included certain specific rules for **recurring part-time compensation** under both 409A and 457 plans but commentators found some requirements difficult to reconcile with certain partial-year teaching positions. Both sets of proposed regulations (409A and 457) include a 13-month rule plus an annual compensation limit (aligned to qualified plan limits).

For More Information

Contact Kristy Buckley at 406-522-4522 or kbuckley@crowleyfleck.com, or Sarah Loble at 406-457-2033 or sloble@crowleyfleck.com, if you would like more information.

If you require assistance with a particular employee benefit matter, or have questions or comments regarding this newsletter, please contact one of the attorneys listed below.

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