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A checklist for drafting Section 457(f) plans for tax-exempt employers

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Section 457(f) of the Internal Revenue Code (“Code”) governs “ineligible” deferred compensation plans or arrangements maintained by tax-exempt employers.¹ Section 457(f) does not apply to retirement plans that are qualified under Section 401(a), Section 403(b) plans, or deferred compensation plans that qualify for special tax treatment under Code Section 457(b) (i.e., “eligible” deferred compensation plans). Other plans, such as bona fide severance pay, vacation leave, sick leave, disability pay or death benefit plans are also exempt from Section 457(f).

Benefits provided under a plan subject to Section 457(f) are taxed upon the earlier of (i) the date a legally binding right to the benefits arises, or (ii) the date the benefits are no longer subject to “substantial risk of forfeiture” (SROF), i.e., when the benefits become vested. If benefits are not paid on the vesting date, an employee is nevertheless immediately taxed on the present value of the vested benefits. Detailed rules with respect to Section 457(f) and the exemptions thereunder are included in proposed regulations published on June 22, 2016.²

Drafting a Section 457(f) plan for a tax-exempt employer can be difficult because of the various statutory and regulatory rules that apply. The following is a checklist for drafting this type of plan.

Draft the Section 457(f) plan to be exempt from certain ERISA provisions

In most cases, a Section 457(f) plan of a tax-exempt entity is drafted to qualify as a “top hat plan.” A top hat plan is a nonqualified deferred compensation plan that is designed to defer taxation and avoid key provisions of the Employee Retirement Income Security Act of 1974, as amended (ERISA). Top hat plans are maintained “primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees” and are exempt from the eligibility, vesting, funding, and fiduciary rules under ERISA.³ Often, top hat plans are designed for executives whose annual compensation exceeds the limit for compensation that can be taken into account under a qualified retirement plan.⁴

Consider both Section 457(f) and 409A requirements

Code Section 409A sets forth rules applicable to nonqualified deferred compensation. Both the Section 409A final regulations and the Section 457(f) proposed regulations confirm that tax-exempt employers must consider both Section 409A and Section 457(f) when drafting nonqualified deferred compensation plans.⁵ Therefore, unless a Section 409A exemption applies, benefits provided under a Section 457(f) plan must comply with the Section 409A requirements relating to the time of payment of nonqualified deferred compensation and other plan document requirements.⁶ Complying with Section 409A is important because noncompliance will result in an employee being subject to income tax in the year nonqualified deferred compensation is no longer subject to a SROF, i.e., vested, regardless of when the nonqualified deferred compensation is scheduled to be paid. In addition, an employee must pay a 20% excise tax on noncompliant nonqualified deferred compensation, as well as interest on any late payment of income taxes. Employers may be subject to penalties and interest for failure to timely report and withhold income taxes with respect to nonqualified deferred compensation that does not comply with Section 409A.

Understand that the short term deferral exemptions under Section 457(f) and Section 409A are similar but not identical

Section 409A includes an important exemption for plans providing short-term deferrals. A short-term deferral is defined as compensation that is paid no later than 2½ months after the later of the end of the year in which the compensation is earned or the end of the year in which the compensation is no longer subject to a SROF.⁷ The Section 457(f) proposed regulations also include an exemption for short-term deferrals. This term is defined in the

same manner as Section 409A except that the definition of SROF under the Section 457(f) proposed regulations applies. ⁸

Both the Section 457(f) proposed regulations and the Section 409A final regulations provide that compensation is subject to a SROF if it is conditioned on (i) the future performance of “substantial” services, or (ii) the occurrence of a condition that is related to a purpose of the compensation and the possibility of forfeiture is “substantial. In many cases, a plan that qualifies as a short-term deferral will be exempt from both Section 457(f) and Section 409A. However, there are two key differences in the definitions of SROF under these two Code sections.

Noncompete provisions

The Section 457(f) proposed regulations provide that compensation that is conditioned upon compliance with a noncompete provision is considered subject to a SROF if certain requirements are satisfied. ⁹ In contrast, the Section 409A final regulations clearly state that a noncompete provision will not constitute a SROF. ¹⁰ To qualify as a SROF, the Section 457(f) proposed regulations first require that a noncompete be set forth in an enforceable written agreement that expressly conditions the payment of compensation on the employee refraining from future performance of services. Second, the employer must make reasonable on-going efforts to verify compliance with the noncompete provision. Third, at the time the enforceable written agreement becomes binding, the employer must have a substantial and bona fide interest in preventing performance of the services, and the employee must have a bona fide interest in, and ability to, engage in the prohibited competition.

Rolling risk of forfeiture

The Section 457(f) proposed regulations also permit the extension of a SROF, also referred to as a “rolling SROF,” if certain requirements are met. ¹¹ The Section 409A final regulations do not permit rolling SROFs. To qualify as a rolling SROF the Section 457(f) proposed regulations require that the present value of amount paid when extended SROF lapses must be “materially greater” than the amount the co-worker would have received without the SROF extension. Compensation is considered materially greater if the present value when the extended SROF lapses is more than 125% of the present value of the compensation the employee would receive without the extension. In addition, the employee must provide a minimum of two years of substantial future services. Finally, the extension must be made in writing at least 90 days before the existing SROF lapses.

As a result of the differences in the definition of SROF, it is possible that a plan that is exempt from Section 457(f) as a short-term deferral may not qualify as a short-term deferral that is exempt from Section 409A. This is confirmed in the Section 409A final regulations. ¹² Such a plan, although exempt from Section 457(f), must comply with the requirements of Section 409A to avoid penalties and taxation in the year of vesting (unless another Section 409A exemption applied).

Understand that the Section 457(f) bona fide severance plan exemption is similar but not identical to the Section 409A separation pay plan exemption

Another key exemption from Section 457(f) is a bona fide severance pay plan. A bona fide severance pay plan is an arrangement that meets the following requirements:

- Benefits are paid solely on account of involuntary severance, including a voluntary severance for “good reason,” as defined in the proposed regulations;
- Benefits do not exceed two times the employee’s annualized compensation; and
- All benefits are paid no later than end of second calendar year following the calendar year of severance pursuant to a written agreement. ¹³

An involuntary severance is defined in the Section 457(f) proposed regulations as a severance due to the independent exercise of the employer’s unilateral authority to terminate the employee’s services if the participant was willing and able to continue performing services. An involuntary severance does not include a severance at the employee’s implicit or explicit request. However, it may include the employer’s failure to renew a contract upon its expiration if the employee was willing and able to continue performing services. ¹⁴

Section 409A includes a similar exemption for separation pay plans, including a similar definition of “involuntary.” However, the Section 457(f) exemption for bona fide severance plans differs from the Section 409A exemption in one key respect. The Section 409A exemption requires that the benefits not exceed twice the compensation limit set forth in Code Section 401(a)(17) (for 2019, \$560,000 (2 X \$280,000)).

Both sets of regulations provide that a “good reason” termination can qualify as an involuntary termination and include a similar safe harbor definition of “good reason.”

Include a provision permitting accelerated payment of benefits as necessary to satisfy tax withholdings

As noted above, benefits provided under a plan that is subject to Section 457(f) will be taxed in the year of vesting, notwithstanding when the benefits are actually paid. If such a plan generally provides for the payment of benefits in a future year, the plan should be drafted to permit the accelerated payment of an amount necessary to pay income and employment tax withholding on the present value of benefits taxed in the year of vesting. This will provide a participant with some or all of the cash necessary to pay taxes on the benefits in the vesting year. Such a provision is an exception to the Section 409A prohibition on the accelerated payment of benefits. ¹⁵

Do not guarantee tax consequences of plan

Given the extensive requirements under Section 457(f) and Section 409A and the possibility that courts and governmental entities could interpret the regulatory regimes in conflicting ways, tax-exempt employers should expressly state in the Section 457(f) plan that the employer does not guarantee the tax consequences of the plan.

Consider a savings clause

A savings clause is a means by which a tax-exempt employer can expressly state (i) the intent of a plan, e.g., to be exempt from both Section 457(f) and Section 409A under the short-term deferral rule and (ii) the desire that the plan be interpreted and administered to accomplish this intent. Although it is not clear whether such a provision will convince a court to “blue-line” a plan as necessary to accomplish the stated intent, it is advisable to include such a provision.

File a top hat plan statement with the DOL

A Section 457(f) plan that qualifies as a top hat plan will be subject to limited reporting and disclosure requirements under ERISA, including the filing of an annual Form 5500. However, a tax-exempt employer will be deemed to satisfy the reporting and disclosure requirements by filing a top hat plan statement with the Department of Labor.

¹⁶ Effective August 16, 2019, a top hat plan statement must be filed via the Department of Labor website. ¹⁷

Conclusion

Given the broader application of Section 409A to both taxable and tax-exempt employers, it is possible that regulatory language under the Section 409A and Section 457(f) may be interpreted differently by courts or governmental agencies. For example, if a Section 457(f) plan includes a definition of “good reason” that is broader than the safe harbor definition of “good reason” in the regulations, an employer may not be sure whether the bona fide severance pay exemption under Section 457(f) and the Section 409A separation pay exemption applies to the plan. Similarly, in the event of an audit, plan terms defining a SROF may qualify as a short-term deferral under Section 457(f) but not under Section 409A. Depending on the level of risk tolerance, an employer may opt to draft a Section 457(f) plan to comply with the Section 409A requirements.

Drafting deferred compensation plans for employees of tax-exempt employers is a complex task requiring employers to navigate a myriad of requirements under Section 457(f), Section 409A and ERISA. Employers may want to seek legal counsel to assist them with this difficult process.

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1. Although Code Section 457(f) also applies to governmental employers, that topic is beyond the scope of this article. [↪](#)
2. The proposed regulations are effective for calendar years beginning after the date of publication of final regulations and no implication is intended regarding application of the law before the proposed regulations become applicable. Prop. Treas. Reg. §1.457-13. Nevertheless, it is prudent to consider the proposed regulations in drafting new plans and agreements. [↪](#)
3. ERISA Sections 201(2), 301(a)(3) and 401(a)(1). [↪](#)
4. Retirement plans that are qualified under Section 401(a) of the Internal Revenue Code of 1986, as amended cannot take into account compensation in excess of \$275,000 (for 2018). [↪](#)
5. Treas. Reg. §1.409A-1(a)(4); Prop. Treas. Reg. §1.457012(d)(5). [↪](#)
6. A discuss of the Section 409A requirements is beyond the scope of this article. Only certain aspects of Section 409A particularly relevant to Section 457(f) plans are discussed above. [↪](#)
7. Treas. Reg. §1.409A-1(b)(4). [↪](#)
8. Prop. Treas. Reg. §1.457-12(d)(2). [↪](#)
9. Prop. Treas. Reg. §1.457-12(e)(1)(iv). [↪](#)
10. Treas. Reg. §1.409A-1(d)(1). [↪](#)
11. Prop. Treas. Reg. §1.457-12(e)(2). [↪](#)
12. 72 F.R. 19235 (April 17, 2007) [↪](#)
13. Prop. Treas. Reg. §1.457-11(d)(1). [↪](#)
14. Prop. Treas. Reg. §1.457-11(d)(2). [↪](#)
15. Treas. Reg. §1.409A-3(j)(4)(iv). [↪](#)

16. 29 C.F.R. §2520.104-23(b)(1). [↔](#)
17. <https://www.dol.gov/agencies/ebsa/employers-and-advisers/plan-administration-and-compliance/reporting-and-filing/e-file/tophat-plan-filing-instructions> [↔](#)

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