Bloomberg BNA

Pension & Benefits Daily ™

View From McDermott: Section 457(f) Proposed Regulations—Not What We Expected (In a Good Way)

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The very long awaited release of the new proposed regulations for Internal Revenue Code (the ''**Code**'') Section 457(f) plans arrived at the end of June and presents welcome and surprising new opportunities with respect to tax-exempt and governmental entities' ''ineligible nonqualified deferred compensation'' arrangements.

With the issuance of Notice 2007-62 (the ''**Notice**''), the Internal Revenue Service placed a chilling effect on executives of tax-exempt entities to electively defer compensation beyond the first point actual services or performance based goals were required. In very general terms, the Notice indicated that future IRS guidance surrounding Code Section 457(f) would (1) prohibit *voluntary* deferrals of compensation which would be subject to a substantial risk of forfeiture, and (2) conform the rules relating to substantial risk of forfeiture to those rules that are contained in Regulation Section § 1.409A-1(d) (which basically eliminated the ability to use a noncompetition restriction and limited the use of a rolling risk of forfeiture as a viable substantial risk of forfeiture). In response to the statements made in the Notice, the vast majority of tax-exempt entities ceased offering voluntary deferral programs under Code Section 457(f) plans and conservatively revised the underlying vesting provisions (which act as the substantial risk of forfeiture) to either a cliff-vesting schedule or alternatively, a pre-determined future retirement date.

Since that time, tax-exempt entities have relied simply on providing executives with elective deferrals only at the ''paltry'' amounts allowed under Section 401(k)/403(b) plans, e.g. $18,000 per year, and under Section 457(b) plans, e.g. $18,000 per year. The typical ineligible non-qualified deferred compensation plan, prior to the new proposed regulations, have commonly only provided for contributions that were 100% employer-funded. Effective immediately, tax-exempt entities are no longer so restricted and can move forward with confidence in providing tax favored deferred compensation for their executives and thereby placing them a little closer (but not identical) to the for-profit counterparts.

However, although the good news is that tax-exempt entities can now provide legitimate tax deferred compensation in more situations, the compliance aspects have morphed and require greater scrutiny with respect to drafting. Specifically, caution must be exercised with respect to adherence to not only the newly proposed Section 457(f) regulations (the "**Proposed Regulations**"), but also with respect to Code Section 409A which regulates all deferred compensation arrangements, not just those of tax-exempt entities. Failure to comply with the rules of Code Section 409A can result in immediate taxation of vested amounts plus a twenty percent (20%) penalty tax on the service provider or employee. The Proposed Regulations make clear that Code Section 409A applies to Code Section 457(f) arrangements, but unfortunately do not provide an exact match in relevant definitions, making co-ordination between the two sets of rules challenging.

I. Basic Definition of Deferred Compensation for Section 457(f)-Short Term Deferrals and Substantial Services

In the for-profit world, the Department of Treasury and the IRS views deferred compensation as having some preliminary checks and balances. The taxable corporation is not entitled to a tax deduction until the deferred compensation is paid or otherwise made available to the executive. Therefore, for-profit corporations have some interest in limiting deferred compensation because the related delayed tax deduction impacts their bottom line. In the not-for-profit world, the "tax deduction" is not relevant because tax-exempt entities do not pay tax absent application of unrelated business taxable income. It was determined that requiring the taxation of the non-profit executive on a deferral of compensation under Code Section 457(f) when no longer subject to a substantial risk of forfeiture requirement would somewhat balance the scales in the tax-exempt arena.

Code Section 457(f) was designed to require immediate taxation of vested "ineligible non-qualified deferred compensation", which references deferrals other than those made under Code Sections 401(k), 403(b), and 457(b) qualified type deferred compensation arrangements. In general, a plan provides for a deferral of compensation if a participant has a "legally binding right" during a taxable year to compensation that, pursuant to the terms of the plan, is or may be payable in a later taxable year (Section 1.457-12(d)(1)(i)).

Similar to the Code Section 409A rules defining deferred compensation, the Proposed Regulations generally provide that a participant does not have a legally binding right to compensation to the extent that it may be unilaterally reduced or eliminated by the employer after the services creating the right have been performed (Section 1.457-12(d)(1)(ii)). Certain discretionary bonuses would fall in to this category.

For the first time, the Proposed Regulations set up the basic definition of deferred compensation for Code Section 457(f) purposes and provide guidance on several important exemptions. Specifically, deferred compensation does not exist if it meets the "short term" deferral definition provided by Code Section 409A (Section 1.409A-1(b)(4)(i)), but substituting the new definition of "substantial risk of forfeiture" (Section 1.457-12(e)(1)) under the Proposed Regulations for that of the Code Section 409A risk of forfeiture. In this situation, the appropriate definition generally would be:

> "A deferral of compensation does not occur if the plan under which a payment. . .is made does not provide for a deferred payment and the service provider actually or constructively receives such payment on or before the last day of the applicable 2½ month period. . .The applicable 2½ month period is the period ending on the later of the 15th day of the third month following the end of the service provider's first taxable year in which the right to the payment is no longer subject to a substantial risk of forfeiture or the 15th day of third month following the end of the service recipient's first taxable year in which the right to the payment is no longer subject to a substantial risk of forfeiture. . .
>
> An amount of compensation is subject to a substantial risk of forfeiture only if entitlement to the amount is conditioned on the future performance of substantial services, or upon the occurrence of a condition that is related to a purpose of the compensation if the possibility of forfeiture is substantial (Section 1.457-12(e)(1)(i))."

Prior to the Proposed Regulations, employees of tax exempt entities would have been taxable on any fully vested deferred compensation in the calendar year in which the deferred compensation vested, even if such deferred compensation was not paid out, including if it was paid out very shortly after the year in which vested. For example, an executive with a bonus that vested on December 31, 2016 would have been taxable on the bonus in 2016 even if such bonus was not paid until February of 2017. Now, given the synchronization of the definition of deferred compensation under the Proposed Regulations with the definition of what constitutes a "short term deferral," an executive of a tax-exempt entity who becomes fully vested in a bonus on December 31 of a calendar year need not pay tax on such amount during the vesting calendar year if such bonus is actually distributed no later than March 15th of the subsequent calendar year.

Challenge: This small ability to defer from one year to the next is welcome, but at the same time, the Proposed Regulations emphasize that a "substantial risk of forfeiture" based solely on a requirement to provide services, must be based on the provision of *substantial* services (Section 1.457-12(e)(1)(ii)). Note that the language of the Proposed Regulations for "substantial risk of forfeiture" quoted above is identical to the language used for Code Section 409A purposes.

The Proposed Regulations provide an example where a departing employee is required to provide consulting services for a period of time. The example concludes: "The consulting services provided by the former employee do not constitute substantial services because they are insubstantial in relation to the payment." Because the consulting services required were *not substantial* in relation to the size of the payment, the executive is currently taxed under Section 457(f) on the payment (Section 1.457-12(e)(3)).

Solution: The substance of the deferred compensation structure is the key to satisfying all the requirements of the Proposed Regulations. Given the heightened compliance aspect of ensuring "substantial services" in order to achieve the additional one-year deferral, alternative structures may need to be explored which achieve the desired objective but also meet all the legal criteria.

Opportunity Presented: The synchronization of the definition of deferred compensation under the Proposed Regulations with the definition of a "short-term deferral" under Code Section 409A is very good news in that prior to the Proposed Regulations, even this one year deferral was impossible.

II. Increased Ability of Executives to Make Voluntary Deferral of Their Own Pay

In the Notice, the IRS indicated that ''a rational participant normally would not agree to subject a right to amounts that may be earned and payable as current compensation, such as salary payments, to a condition that subjects the right to the same payments to a real possibility of forfeiture.'' The Proposed Regulations reverse this position and provide the following parameters in which executives may defer annual base salary:

- The deferral election must be made in writing before the beginning of the calendar year in which the services will be performed and the compensation will be earned;

- The present value of the amount to be paid when the substantial risk of forfeiture lapses must be materially greater defined as more than twenty-five percent (25%) of the amount the executive otherwise would have received absent the substantial risk of forfeiture; and

- The executive must provide substantial services for at least two (2) additional years or must agree not to compete for at least two (2) additional years.

The Proposed Regulations provide the following example:

> ''*Example 3*. Facts. On December 31, 2017, a participant enters into an agreement to defer $15,000 of the participant's current compensation that would otherwise be paid during 2018, with payment of the deferred amounts to be made on December 31, 2024, but only if the participant continues to provide substantial services until December 31, 2024. Under the terms of the agreement, the participant's periodic payments of current compensation are reduced, and a corresponding amount is credited (with a 30% employer match) to an account earning a reasonable rate of interest. The present value of the amount payable on December 31, 2024 is 130% of the present value of the amount deferred. Conclusion. The amounts deferred are subject to a substantial risk of forfeiture because the plan satisfies the requirements of paragraphs (e)(2)(ii) through (v) of this section.''

As noted above, the arrangement met the requirements for an elective deferral and therefore, the timing of taxation was deferred until distribution (Section 1.457-12(e)(3)).

Challenge: The challenge will be to structure the deferral so that it is ''materially greater.'' The tax-exempt entity is not permitted to easily accomplish this by simply providing an annual investment return which exceeds twenty-five percent (25%) per year. Unreasonable rates of returns are subject to immediate taxation under the Proposed Regulations (Section 1.457-12(c)(iv)(B)).

Solution: It is foreseeable that the manner in which the more than one hundred twenty-five percent (125%) increase is to be achieved is for the employer to provide some type of corollary employer contribution (such as a more than twenty-five percent (25%) matching contribution as provided in the above example), on the amount electively deferred by the executive to ensure the present value of the amount to be paid meets the ''materially greater'' criteria.

Opportunity Presented: Since executives have not been able to defer their own compensation in any significant capacity, all deferred compensation was provided by the tax-exempt entity above and beyond the executive's regular compensation. Here, the Proposed Regulations allow the tax-exempt entity to restructure their executive arrangements to not only provide deferred compensation but to ensure that the executive has some ''skin in the game'' by placing their own money at risk to achieve a greater gain at the end of the employment relationship. In essence, the same overall compensation position can be provided, but requiring executive voluntary deferrals in exchange for certain employer provided amounts will provide the tax-exempt entity more leverage in these situations than currently available.

III. Use of Rolling Risk of Forfeiture as a Substantial Risk of Forfeiture

The Notice also indicated that ''the addition of any risk of forfeiture after the right to the compensation arises, or any extension of a period during which compensation is subject to a risk of forfeiture (sometimes referred to as a ''rolling risk of forfeiture''), is generally disregarded for purposes of determining whether such compensation is subject to a substantial risk of forfeiture.'' The Proposed Regulations now clarify that rolling risks of forfeiture can be utilized as a substantial risk of forfeiture in the following situations:

- The present value of the amount to be paid when the substantial risk of forfeiture lapses must be materially greater defined as more than twenty-five percent (25%) of the amount the executive otherwise would have received without the substantial risk of forfeiture extension;

- The executive must provide substantial services for at least two (2) additional years or must agree not to compete for at least two (2) years; and

- The extension of the substantial risk of forfeiture is made in writing at least ninety (90) days before the existing substantial risk of forfeiture lapses.

Compared to the situation in which a substantial risk of forfeiture is being *added* where none existed previously (e.g., in the case of a deferral of current compensation), the above requirements are identical except for the timing of the election - for rolling risks which are an extension of the current vesting date the election must be made ninety (90) days before the compensation would have vested whereas for an initial deferral the written agreement must be entered into before the beginning of the calendar year in which the services generating the compensation will be performed.

Challenge: Similar to the challenge above under the voluntary deferrals discussion, the challenge will be to not only structure the extension so that the present value of the compensation paid at a later date is ''materially greater'' but to also ensure procedures are in place so that each event date on which a substantial risk of forfeiture will lapse can be tracked by the tax-exempt entity such that sufficient notice is provided to any executive for purposes of making a permissible advance ninety (90) day election, if the tax-exempt entity chooses to permit redeferrals. The internal procedures for presenting each executive with a timely election period in which to extend a deferral period are critical in cases where redeferral opportunities were promised. If the tax-exempt entity inadvertently does not timely notify the executives or does not provide ''windows'' in which to elect such changes, the executives will be claiming ''foul'' and demanding some type of ''fix'' for their subsequent deferral loss. Keep in mind that the Proposed Regulations do not require the tax-exempt entity to ensure the executives are provided an redeferral election window, but if redeferrals will be permitted, executives will inherently expect to be advised of any relevant timing issues such that they can comply with if they choose to.

Solution: Administratively speaking, less is more. The more streamlined the subsequent deferral elections can be made, the less errors will occur with respect to missed subsequent deferral opportunities. For example, assuming the ''materially greater'' requirement is satisfied, the Proposed Regulations do provide flexibility on when (i.e., what date) the subsequent deferral date can be pushed to (subject to the minimum additional two (2) year requirement). As such, if all executives can choose different future dates and the Code Section 457(f) plan has many participants, the Code Section 457(f) plan can quickly become an administrative nightmare in terms of tracking all of the various event dates on which a substantial risk of forfeiture will lapse and then ensuring the advance ninety (90) day notice election is timely provided to each executive based on the varying event dates. However, if, for example, the Code Section 457(f) plan provides that all subsequent deferral dates have to occur on any future January 1st that is at least five (5) years out, then internal controls can be put in place such that subsequent deferral election notifications are first provided to all impacted executives on each July 1st with the submission date for those subsequent deferral elections being due to the plan administrator no later than each October 1st. Streamlining options under a Code Section 457(f) plan to simplify the rolling risk of forfeiture administration will ensure greater likelihood of compliance.

Opportunity Presented: As noted above, the rolling risk of forfeiture does provide executives with an opportunity and some flexibility to set their own future event date on which the substantial risk of forfeiture lapses with respect to their nonqualified deferred compensation. However, the drawback in providing this flexibility likely means the tax-exempt entity will be required to provide additional contributions in order to meet the more than one hundred twenty-five percent (125%) materially greater test. Notwithstanding this, the rolling risk of forfeiture feature may provide some usefulness and planning advantages in the retention bonus area. Retention bonuses to be paid as a result of working to a specified date could have those specified dates extended to a later date, if warranted, by simply increasing the retention amount to be paid to a minimum of one hundred twenty-five percent (125%). The ability to further extend the retention period (which must be a minimum of two years) might provide tax-exempt entities some maneuverability in the area of hiring new executives (and evaluating their effectiveness) and well as in succession planning timelines for long-term exiting executives.

IV. Use of Noncompetes as a Substantial Risk of Forfeiture

Finally, and the trickiest of the new rules, the Notice had also unfavorably indicated that ''an amount is not subject to a substantial risk of forfeiture merely because the right to the amount is conditioned, directly or indirectly, upon refraining from the performance of services.'' This was generally thought to be addressing the use of noncompetes as a substantial risk of forfeiture. Again, in response to this, many tax-exempt entities eliminated noncompetes as their substantial risk of forfeiture and implemented a simple time or performance-based vesting schedule. On a surprise note, the Proposed Regulations now clarify that noncompetes can be utilized as a substantial risk of forfeiture in the following situations:

- The executive's right to the compensation must be specifically conditioned *in writing* on the refraining from performing future services **and** the noncompete must be enforceable under applicable law (e.g., California holds noncompetes unenforceable in this context so a noncompete used in California would not be an appropriate substantial risk of forfeiture);

- The tax-exempt entity must make reasonable efforts to verify the executive's compliance with the noncompete; and

- Regardless of any other factors, the facts and circumstances must demonstrate that the tax-exempt entity has a ''bona fide interest'' in ensuring that the executive is prevented from performing services **and** that the executive has a ''bona fide interest'' in his/her ability to engage in performing services.

The Proposed Regulations provide a great example of the use of a covenant not to compete to delay the timing of taxation to the executive:

> ''*Example 4*: Facts. Employee A is a well-known college sports coach with a long history of success in a sports program at University X. University X reasonably expects that the loss of Employee A would be substantially detrimental to its sports program and would result in significant financial losses. Employee A has bona fide interest in continuing to work as a college sports coach and is highly marketable. On June 1, 2020, Employee A and University X enter into a written agreement under which Employee A agrees to provide substantial services to University X until June 1, 2023. The parties further agree that University X will pay $500,000 to Employee A on June 1, 2025 if Employee A has not performed services as a sports coach before that date for any other college or university with a sports program similar to that of University X. The agreement is enforceable under applicable law and University X would be reasonably expected to enforce it. Conclusion: The $500,000 payable under the agreement is subject to a substantial risk of forfeiture until June 1, 2025, and includible in Employee A's gross income on that date'' (Section 1.457-12(e)(3))

First, the agreement is in writing and enforceable under applicable law. Second, based on the coach being ''well-known,'' University X can easily verify his compliance with the noncompete. Finally, University X has a ''bona fide interest'' in the successful coach not providing similar services to another college or university that has a comparable sports program to University X and therefore, directing attention and support away from University X.

Note that most State's rules governing noncompetes require the noncompete to be of a reasonable duration, limited in geographic area, and not operate to completely prohibit any form of employment by the departing executive.

Challenge: The challenge will be to develop procedures to appropriately monitor and document executive activities post-termination. Additionally, the ‘‘bona fide interest’’ requirements may further pose a new challenge with respect to aging executives, as it may be harder to demonstrate that older executives have a legitimate interest in continuing to work (depending on their age when they terminate employment) or have a true financial need to work.

Solution: Since many executives receiving severance pay are likely subject to noncompetition restrictions anyway, the tax-exempt entity can piggyback off of these prior procedures, but strengthen them for Code Section 457(f) compliance purposes. Periodic written verification from the executives will be critical, but independent monitoring by the tax-exempt entity beyond this will likely be necessary as proof of reasonable efforts (e.g., monitoring Facebook pages, Google searches, etc.).

Opportunity Presented: The ability to continue tax deferral post-termination is viewed as valuable by many executives (notwithstanding that they are an unsecured creditor of the tax-exempt entity) and when coupled with nonpayment of deferred amounts for violation of the noncompete does provide significant leverage for the tax-exempt entity. Because the substantial risk of forfeiture will not lapse until the end of the noncompetition period, it offers a significant reprieve period following an executive’s departure. Further, the ability to utilize a noncompete as a substantial risk of forfeiture. instead of a time-based vesting schedule will potentially provide longer deferral periods with respect to the compensation instead of requiring periodic taxation events which occur with time-based vesting.

V. Section 409A Overlap with Section 457A

The Proposed Regulations set forth the rules for income inclusion under Code Section 457(f) but additionally confirm that such income inclusion is required to be coordinated with income inclusion where there has been a Code Section 409A failure, if any (Section 1.457-12(d)(5)(iii)). Income inclusion under Code Section 457(f) occurs for executives of tax-exempt entities where there is no longer a substantial risk of forfeiture under an ineligible deferred compensation arrangement and if the deferred compensation arrangement is exempt from Code Section 457(f), income inclusion occurs generally only at distribution (Section 1.457-11(a)).

Unlike Code Section 457(f) which controls the timing of taxation, the reasoning behind Code Section 409A is to regulate the manner that deferrals are made. Initial and subsequent deferral elections must be timely made and distributions must be made only upon a prespecified date, death, disability, separation from service, or severe financial hardship. A Code Section 409A violation occurs where elections or distribution are not made properly pursuant to these Code Section 409A rules (Section 1.457-12(d)(5)(ii)) and the income inclusion occurs where there has been a violation of Code Section 409A based on the deferred compensation value at year end (Section 1.457-12(d)(5)(iii)).

Below is a chart which reflects whether a particular arrangement is generally ‘‘subject to’’ or ‘‘exempt from’’ Code Sections 457(f) and 409A, followed by a chart detailing the differences in defined terms between the two Code Sections. If an arrangement is not exempt from Code Section 409A, the arrangement must be carefully designed to comply with the timing rules required for such plans.

One of the most significant differences between Code Section 457(f) and Code Section 409A is that a risk of forfeiture based on a covenant not to compete is respected for Code Section 457(f) purposes, but not Code Section 409A. If a rolling risk of forfeiture based on a covenant not to compete is made for a two year period with a more than twenty-five percent (25%) employer matching contribution, income inclusion will not occur for Code Section 457(f) purposes, but that extension will not be respected for Code Section 409A purposes. Therefore, if *distribution* occurs two years after the originally scheduled date, a Code Section 409A violation will have occurred. The solution would be that the risk of forfeiture extension could be a minimum of two years but then any subsequent distribution would need to wait for an additional three years in order to satisfy the Code Section 409A subsequent deferral rule requiring a minimum five (5) year delay. This structure would be permitted by Code Section 409A without violation, but that would also mean that to avoid income inclusion under Code Section 457(f) the risk of forfeiture is for a prolonged period of time.

Note also as the charts below illustrate, that exempt involuntary severance pay plans for Code Section 457(f) allow two years of compensation to be paid, but for Code Section 409A purposes, the permitted severance pay is limited to a dollar amount referencing tax-qualified retirement plan contribution limits under Code Section 401(a)(17). What this means is that a tax-exempt entity can have an involuntary severance pay plan with an unlimited level of salary paid out as long as it is not more than two years, but to comply with Code Section 409A, the payment schedule would need to be hardwired as the severance pay plan, or at least the part in excess of the Code Section 409A limits for such severance pay plans, would be considered a deferred compensation plan subject to the Code Section 409A distribution rules. This anomaly is similar to restructures that had to occur under the Code Section 409A regulations where the involuntary severance arrangement would pay out an amount that would exceed twice the Code Section 401(a)(17) limit and therefore, public companies (subject to the six month delay on certain deferred compensation payments) had to break the amounts into two pieces – one covered by the Code Section 409A severance exemption and the other piece payable but restructured to comply with the Code Section 409A distribution rules.

Type of Arrangement	Exempt From or Subject to Code Section 457(f)	Exempt From or Subject to Code Section 409A
Qualified Type Plans, including Code Sections 401(a), 403(b), and 457(b)	Exempt	Exempt

Type of Arrangement	Exempt From or Subject to Code Section 457(f)	Exempt From or Subject to Code Section 409A
Bona Fide Vacation, Sick, Compensatory Time, or death benefit	Exempt	Exempt, but no definition yet for 409A
Disability	Exempt	Exempt
Involuntary, including "Good Reason" severance paid over two years	Exempt	Exempt but limited in amount which may be paid
Window program severance	Exempt	Exempt but limited in amount which may be paid
Short Term Deferral, paid within 2.5 months of first year where no risk of forfeiture based on services or performance goals	Exempt	Exempt
Short Term Deferral, paid within 2.5 months of first year where no risk of forfeiture, based on covenant not to compete only	Exempt	Exempt
Short Term Deferral, paid within 2.5 months of first year where no risk of forfeiture, where there is a rolling risk of forfeiture	Exempt	Exempt, but no definition yet for Code Section 409A, and also cannot be a subsequent redeferral based on noncompete
Voluntary early retirement incentive plan may be maintained only by a local educational agency or a tax-exempt education association	Exempt	Not addressed
The portion of any plan that consists of a transfer of property described in Code Section 83	Exempt	Exempt
The portion of a plan that consists of a trust described in Code Section 402(b)	Exempt	Exempt
A qualified governmental excess benefit arrangement described in Code Section 415(m)	Exempt	Exempt
The portion of any applicable employment retention plan described in Code Section 457(f) (4)	Exempt	Not addressed
Recurring part-year compensation	Exempt	Exempt
The payment of expense reimbursements, medical benefits, or in-kind benefits	Exempt	Exempt
Certain indemnification rights, liability insurance, or legal settlement	Exempt	Exempt
Taxable educational benefits for an employee	Exempt	Not addressed

Additionally, because of the interplay and application of both sets of regulations, it is also important to understand where the underlying definitional terms vary between the two sets of regulations. Below is a chart which compares relevant definitions from both Code Section 457(f) and Code Section 409A and highlights the similarities and differences. As demonstrated in the noncompete discussion above, where Code Section 409A provides a more restrictive definition, care must be exercised as to whether differences in the two definitions cause greater restrictions to apply in order to meet both sets of rules.

Defined Terms	Under Code Section 409A	Under Code Section 457(f)	Differences
Definitions As Apply to Substantial Risk of Forfeitures			
General Definition (including substantial service)	Treas. Reg. § 1.409A-1(d)(1): "Compensation is subject to a substantial risk of forfeiture if entitlement to the amount is conditioned on the performance of substantial future services by any person or the occurrence of a condition related to	Prop. Reg. § 1.457-12(e)(1)(i): "An amount of compensation is subject to a substantial risk of forfeiture only if entitlement to the amount is conditioned on the future performance of substantial services, or upon the occurrence of a condition that is related to a	Prop. Reg. § 1.457-12(e)(1)(ii) clarifies the standard for determining whether the service is substantial: "the relevant facts and circumstances, such as whether the hours required to be performed during the relevant period are substantial in

Defined Terms	Under Code Section 409A	Under Code Section 457(f)	Differences
	a purpose of the compensation, and the possibility of forfeiture is substantial.''	purpose of the compensation if the possibility of forfeiture is substantial.''	relation to the amount of compensation.''
Noncompetition Conditions	Treas. Reg. § 1.409A-1(d)(1): ''An amount is not subject to a substantial risk of forfeiture merely because the right to the amount is conditioned, directly or indirectly, upon the refraining from the performance of services.''	Prop. Reg. § 1.457-12(e)(1)(iv) provides that noncompetition conditions could cause substantial risk of forfeiture if three conditions are satisfied: A. The right to payment of the amount is expressly conditioned upon the employee refraining from the future performance of services pursuant to an enforceable written agreement; B. The employer makes reasonable ongoing efforts to verify compliance with noncompetition agreements; and C. At the time that the enforceable written agreement becomes binding, the facts and circumstances demonstrate that the employer has a substantial and bona fide interest in preventing the employee from performing the prohibited services and that the employee has bona fide interest in, and ability to, engage in the prohibited competition.	Noncompetes expressly not a risk of forfeiture for Code Section 409A but is such under Code Section 457(f) if certain conditions met.
Conditions Related to a Purpose of the Compensation	Treas. Reg. § 1.409A-1(d): ''A condition related to a purpose of the compensation must relate to the service provider's performance for the service recipient or the service recipient's business activities or organizational goals.''	Prop. Reg. § 1.457-12(e)(1)(iii): ''A condition related to a purpose of the compensation must relate to the participant's performance of services for the employer or to the employer's governmental or tax-exempt entities (as applicable) or organizational goals.''	Proposed Regulations clarify the application to governmental or tax-exempt entities only.
Enforcement of Forfeiture	Treas. Reg. § 1.409(A)-1(d)(3): ''In determining whether the possibility of forfeiture is substantial in the case of rights to compensation granted by a service recipient to a service provider that owns a significant amount of the total combined voting power or value of all classes of equity of the service recipient (where the service provider's ownership is determined with application of the attribution rules under section 318 if the service recipient is a corporation, or if the service recipient is an entity that is not a corporation, with application by analogy of the attribution rules under section 318), all relevant facts and circumstances will be taken into account in determining whether the probability of the service recipient enforcing such condition is substantial.''	Prop. Reg. § 1.457-12(e)(1)(v): ''To constitute a substantial risk of forfeiture, the possibility of actual forfeiture in the event that the forfeiture condition occurs must be substantial based on the relevant facts and circumstances. Factors to be considered for this purpose include, but are not limited to, the extent to which the employer has enforced forfeiture conditions in the past, 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 condition, and the likelihood that such provisions would be enforceable under applicable law.''	Prop. Reg. § 1.457-12(e)(1)(v) omits the ownership part, ''a service recipient to a service provider that owns a significant amount of the total combined voting power or value of all classes of equity of the service recipient . . . .,'' but keeps the factors listed in Treas. Reg. § 1.409(A)-1(d)(3)(A) to (E) in determining the likelihood of enforcement; the proposed regulation also includes one additional factor, the likelihood that such provisions would be enforceable under applicable law.
Addition or Extension of Risk of Forfeiture	Treas. Reg. § 1.409A-1(d)(1): ''Except as provided with respect to certain transaction-based compensation under § 1.409A-3(i)(5)(iv), the addition of any risk of forfeiture after the legally binding right to the compensation arises, or any extension of a period during which compensation is subject to a risk of for-	Prop. Reg. § 1.457-12(e)(2): ''The initial addition or extension of any risk of forfeiture after a legally binding right to compensation arises, including the application of a risk of forfeiture to a plan providing for deferrals of current compensation (an additional or extended risk of forfeiture), will be disregarded unless the plan meets the re-	Rolling risks of forfeiture expressly disregarded by Code Section 409A unless the amount became ''materially greater'' which is not defined. Rolling risk of forfeitures are permitted under Code Section 457(f) if more than 25% materially greater standard met, the deferral is in writing and timing conditions met.

Defined Terms	Under Code Section 409A	Under Code Section 457(f)	Differences
	feiture, is disregarded for purposes of determining whether such compensation is subject to a substantial risk of forfeiture. An amount will not be considered subject to a substantial risk of forfeiture beyond the date or time at which the recipient otherwise could have elected to receive the amount of compensation, unless the present value of the amount subject to a substantial risk of forfeiture (disregarding, in determining the present value, the risk of forfeiture) is materially greater than the present value of the amount the recipient otherwise could have elected to receive absent such risk of forfeiture.''	quirements of paragraphs (e)(2)(ii) through (v) of this section.'' Paragraphs (e)(2)(ii) generally provide three additional requirements: A. The present value of the benefit must be materially greater (i.e., more than 125 percent);B. Minimum two years of substantial future services; andC. The parties must agree in writing to the timing of any addition or extension of a substantial risk of forfeiture.	
Short-Term Deferral	Treas. Reg. § 1.409A-1(b)(4): ''In general. A deferral of compensation does not occur under a plan with respect to any payment (as defined in Sec. 1.409A-2(b)(2)) that is not a deferred payment, provided that the service provider actually or constructively receives such payment on or before the last day of the applicable 2 ½ month period.''	Prop. Reg. § 1.457-12(d)(2) generally refers to § 1.409A(b)(4) in defining short-term deferral, but also permits noncompete as a risk of forfeiture.	None.
Severance From Employment for Good Reason			
General Definition for Good Reason	Treas. Reg. § 1.409A-1(n)(2)(i): ''Generally such conditions will be pre-specified under an agreement to provide compensation upon a separation from service for good reason. Such a good reason (or a similar condition) must be defined to require actions taken by the service recipient resulting in a material negative change to the service provider in the service relationship.''	Prop. Reg. § 1.457-11(d)(2)(ii)(A): ''. . .a participant's voluntary severance from employment will be treated as an involuntary severance from employment. . .if the severance occurs under certain bona fide conditions that are pre-specified in writing (referred to herein as a severance from employment for good reason), provided that the avoidance of the requirements of section 457 is not the primary purpose of the inclusion of the conditions or of the actions by the employer in connection with the satisfaction of the conditions, and a voluntary severance from employment under such conditions effectively constitutes an involuntary severance from employment.''Prop. Reg. § 1.457-11(d)(2)(ii)(B): ''A severance from employment for good reason will be treated as an involuntary severance from employment only if the relevant facts and circumstances demonstrate that it was the result of unilateral employer action that caused a material negative change to the participant's relationship with the eligible employer.''	Prop. Reg. § 1.457-11(d)(2)(ii) provides similar definition of severance for good reason except that the proposed regulation does not require the good reason to be defined in the writing, although the Proposed Regulations do require certain bona fide conditions to be pre-specified in writing. The Proposed Regulations also list the exact same factors for determining whether material negative change requirement is satisfied.
Safe Harbor	Treas. Reg. § 1.409A-1(n)(2)(ii): ''For purposes of this section and	Prop. Reg. 1.457-11(d)(2)(ii)(C): ''The requirements of paragraph (d)(2)(ii)(B)	Definitions are virtually identical. The Proposed Regulations however

Defined Terms	Under Code Section 409A	Under Code Section 457(f)	Differences
	§ § 1.409A-2 through 1.409A-6, if a plan provides that a voluntary separation from service will be treated as an involuntary separation from service if the separation from service occurs under certain express conditions, a separation from service satisfying the conditions set forth in the plan will be treated as an involuntary separation from the service if the necessary conditions (or set of conditions) require the following:(A) The separation from service must occur during a pre-determined limited period of time not to exceed two years following the initial existence of one or more of the following conditions arising without the consent of the service provider: (*1*) A material diminution in the service provider's base compensation. (*2*) A material diminution in the service provider's authority, duties, or responsibilities. (*3*) A material diminution in the authority, duties, or responsibilities of the supervisor to whom the service provider is required to report, including a requirement that a service provider report to a corporate officer or employee instead of reporting directly to the board of directors of a corporation (or similar governing body with respect to an entity other than a corporation). (*4*) A material diminution in the budget over which the service provider retains authority. (*5*) A material change in the geographic location at which the service provider must perform the services. (*6*) Any other action or inaction that constitutes a material breach by the service recipient of the agreement under which the service provider provides services;(B) The amount, time, and form of payment upon the separation from service must be substantially identical to the amount, time and form of payment payable due to an actual involuntary separation from service, to the extent such a right exists; and (C) The service provider must be required to provide notice to the service recipient of the existence of the condition described in paragraph (n)(2)(ii)(A) of this section within a period not to exceed 90 days of the initial existence of the condition, upon the notice of which the service recipient must be provided a period of at least 30 days during which it may remedy the condition and not be	of this section are deemed to be satisfied if a severance from employment occurs under the conditions described in paragraph (d)(2)(ii)(C)(*1*) of this section, those conditions are specified in writing by the time the legally binding right to the payment arises, and the plan also satisfies the requirements in paragraphs (d)(2)(ii)(C)(*2*) and (*3*) of this section.(*1*) The severance from employment occurs during a limited period of time not to exceed two years following the initial existence of one or more of the following conditions arising without the consent of the participant:(*i*)A material diminution in the participant's base compensation;(*ii*) A material diminution in the participant's authority, duties, or responsibilities;(*iii*) A material diminution in the authority, duties, or responsibilities of the supervisor to whom the participant is required to report, including a requirement that a participant report to a corporate officer or employee instead of reporting directly to the board of directors (or similar governing body) of an organization;(*iv*) A material diminution in the budget over which the participant retains authority;(*v*) A material change in the geographic location at which the participant must perform services; or(*vi*) Any other action or inaction that constitutes a material breach by the eligible employer of the agreement under which the participant provides services; (*2*) The amount, time, and form of payment upon the severance from employment is substantially the same as the amount, time, and form of payment that would have been made upon an actual involuntary severance from employment, to the extent such right to payment exists; and (*3*) The participant is required to provide notice to the eligible employer of the existence of the applicable condition(s) described in paragraph (d)(2)(ii)(C)(*1*) of this section within a period not to exceed 90 days after the initial existence of the condition(s), upon the notice of which, the employer must be provided a period of at least 30 days during which it may remedy the condition(s) and not be required to pay the amount.''	expressly requires that ''those conditions [be] specified in writing by the time the legally binding right to the payment arises.''

Defined Terms	Under Code Section 409A	Under Code Section 457(f)	Differences
	required to pay the amount.''		
Disability	Treas. Reg. § 1.409A-3(i)(4)(i): ''a service provider is considered disabled if the service provider meets one of the following requirements:A. The service provider is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment that can be expected to result in death or can be expected to last for a continuous period of not less than 12 months.B. The service provider is, by reason of any medically determinable physical or mental impairment that can be expected to result in death or can be expected to last for a continuous period of not less than 12 months, receiving income replacement benefits for a period of not less than three months under an accident and health plan covering employees of the service provider's employer.''Further Treas. Reg. § 1.409A-3(i)(4)(iii) provides that ''a plan may provide that a service provider will be deemed disabled if determined to be totally disabled by the Social Security Administration or Railroad Retirement Board. A plan may also provide that a service provider will be deemed disabled if determined to be disabled in accordance with a disability insurance program, provided that the definition of disability applied under such disability insurance program complies with the requirements of this paragraph (i)(4).''	Prop. Reg. § 1.457-11(e)(2): ''a participant is considered disabled only if the participant meets one of the following conditions: (i) The participant is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment that can be expected to result in death or last for a continuous period of not less than 12 months; (ii) The participant is, by reason of any medically determinable physical or mental impairment that can be expected to result in death or last for a continuous period of not less than 12 months, receiving income replacement benefits for a period of not less than three months under an accident and health plan covering employees of the eligible employer; or (iii) The participant is determined to be totally disabled by the Social Security Administration or Railroad Retirement Board.''	Although the two definitions are very similar, the final Code Section 409A Regulations provide the additional option of using the employer's long-term disability as a gauge so long as disability is defined as stringently in that plan as under the final Code Section 409A regulations.
Legally Binding Right	Treas. Reg. § 1.409A-1(b)(1): ''A service provider has a legally binding right during a taxable year to compensation that, pursuant to the terms of the plan, is or may be payable to (or on behalf of) the service provider in a later taxable year. . . .A service provider does not have a legally binding right to compensation to the extent that compensation may be reduced unilaterally or eliminated by the service recipient or other person after the services creating the right to the compensation have been performed. However, if the facts and circumstances indicate that the discretion to reduce or eliminate the compensation is available or exercisable only upon a condition, or the discretion to reduce or eliminate the compensation lacks	Prop. Reg. § 1.457-12(d)(1)(i): ''the participant has a legally binding right during a calendar year to compensation that, pursuant to the terms of the plan, is or may be payable to (or on behalf of) the participant in a later calendar year.''Prop. Reg. § 1.457-12(d)(1)(ii): ''A participant does not have a legally binding right to compensation to the extent that the compensation may be reduced or eliminated unilaterally by the employer or another person after the services creating the right to the compensation have been performed. However, if the facts and circumstances indicate that the discretion to reduce or eliminate the compensation is available or exercisable only upon a condition, or the discretion to reduce or eliminate the compensation lacks substantive significance, a participant	None

Defined Terms	Under Code Section 409A	Under Code Section 457(f)	Differences
	substantive significance, a service provider will be considered to have a legally binding right to the compensation.''	is considered to have a legally binding right to the compensation. Whether the discretion to reduce or eliminate compensation lacks substantive significance depends on all the relevant facts and circumstances.''	

Defined Terms	Under Code Section 409A	Under Code Section 457(f)	Differences
Severance Pay Plan	Treas. Reg. § 1.409A-1(b)(9)(iii): A separation pay plan that is not [a collectively bargained program] and that provides for separation pay only upon an involuntary separation from service or pursuant to a window program does not provide for a deferral of compensation to the extent that the separation pay, or portion of the separation pay, provided under the plan meets the following requirements: (A) The separation pay does not exceed two times ***the lesser of***— (*1*) The sum of the service provider's annualized compensation based upon the annual rate of pay for services provided to the service recipient for the taxable year of the service provider preceding the taxable year of the service provider in which the service provider has a separation from service with such service recipient (adjusted for any increase during that year that was expected to continue indefinitely if the service provider had not separated from service); or (*2*) The maximum amount that may be taken into account under a qualified plan pursuant to section 401(a)(17) for the year in which the service provider has a separation from service; and(B) The plan provides that the separation pay must be paid no later than the last day of the second taxable year of the service provider following the taxable year of the service provider in which occurs the separation from service.	Prop. Reg. § 1.457-11(d)(1): A bona fide severance pay plan is an arrangement that meets the following requirements: (i) Except as provided in [the window program provisions], benefits are payable only upon involuntary severance from employment (as defined for Code Section 457(f)); (ii) The amount payable does not exceed two times the participant's annualized compensation based upon the annual rate of pay for services provided to the eligible employer for the calendar year preceding the calendar year in which the participant has a severance from employment with the eligible employer (or the current calendar year if the participant had no compensation for services provided to the eligible employer in the preceding calendar year), adjusted for any increase during the year used to measure the rate of pay that was expected to continue indefinitely if the participant had not had a severance from employment; and (iii) The entire severance benefit must be paid to the participant no later than the last day of the second calendar year following the calendar year in which the severance from employment occurs, pursuant to a requirement contained in a written plan document.	Although the two definitions are very similar, the final Code Section 409A Regulations provide the additional limitation that the total amount of benefit that can be paid to a participant and still be exempt from the application of Code Section 409A cannot exceed two times the Code Section 401(a)(17) compensation limit ($265,000 for 2016). Therefore, even if the arrangement meets the ''bona fide severance'' exception for Cod Section 457(f), it the amount exceeds two times the Code Section 401(a)(17) limit, the arrangement will still need to meet the Code Section 409A payment timing rules.

VI. Best Practices

At the time of the initial deferral of compensation, a tax exempt entity, which legitimately can apply a noncompete to services by an executive, would apply the noncompete for a period during employment and for a pre-set period following separation from services, for example, two years. This particular design and structure would be compliant with Code Section 457(f) as a short term deferral, and would also comply with Code Section 409A because it is an *initial* deferral election with a distribution made at a date certain, e.g., two (2) years following separation from service. If a noncompete is *extended* from an original deferral, or it is added as a means to further defer, then because the noncompete is not respected as a substantial risk of forfeiture under Code Section 409A and cannot qualify as a short-term deferral under Code Section 409A, the initial deferral and subsequent deferral rules must be followed. Therefore, for the subsequent deferral, the election must be made one year in advance of the originally scheduled distribution date, and must be for an additional five year period.

In those situations where a noncompete cannot be used, a good design would be to allow initial deferral elections for a predetermined period, for example five years, with risk of forfeiture based on substantial services. If a rolling risk of forfeiture was permitted to extend the timing of taxation, a very conservative position would be to extend the risk of forfeiture for an additional five years and require such further deferral election to be one year prior to the original vesting date, in compliance with the Code Section 409A subsequent deferral rules. Less conservative, but still supported by the Code Section 409A regulations, is to simply follow the Code Section 457(f) rule for rolling risks of forfeiture, e.g., a deferral election made ninety (90) days before the rolling risk of forfeiture lapses and an extended vesting date of at least two years further from such date.

Conclusion

The Proposed Regulations present some unexpected and surprising opportunities with respect to the ability to electively defer compensation and to have deferred compensation paid out, contingent on a valid covenant not to compete and upon a rolling risk of forfeiture. In short, these Proposed Regulations provide significantly more flexibility for tax-exempt entities to design their deferred compensation plans. However, in redesigning any deferred compensation plans, tax exempt entities must carefully consider and follow the timing rules of Code Section 409A, which are an overlay to the Proposed Regulations.