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## IRS Provides Long-Awaited Guidance Regarding Code Section 457 Plans

The IRS recently issued proposed regulations regarding governmental and tax-exempt deferred compensation plans under Section 457 of the Internal Revenue Code of 1986, as amended (Code). The guidance provides long-anticipated updates and clarifications regarding, among other things, (1) the definitions of a “deferred compensation plan,” “deferred compensation,” and a “substantial risk of forfeiture” under Section 457(f) of the Code; (2) the income tax implications of compensation deferred under an “eligible” versus “ineligible” deferred compensation plan under Section 457 of the Code; and (3) the determination of “present value” when determining income tax for 457(f) plans.

As background, eligible deferred compensation plans under Section 457(b) of the Code must generally meet certain requirements and limit the amount of compensation that can be deferred by plan participants (\$18,000 in 2016) (referred to herein as an “eligible plan”). Ineligible deferred compensation plans under Section 457(f) of the Code are not limited by the requirements of eligible plans and are generally used to provide a benefit in an amount greater than the dollar limit imposed by eligible plans (referred to herein as an “ineligible plan”). The amount deferred (plus earnings) under an eligible plan is generally taxable as of the date of payment. By contrast, the amount deferred (plus earnings) under an ineligible plan is taxable on the date the deferred compensation is no longer subject to a substantial risk of forfeiture.

With the publication of the proposed regulations, the IRS clarified the following issues:

- The term “deferred compensation” means compensation in which, under the plan’s terms, a participant has a legally binding right that is or may be payable in a later taxable year.
- Certain “bona fide” disability, death benefit, sick leave, vacation, and severance pay (for example, window pay) plans do not qualify as deferred compensation plans, subject to the rules and regulations under Section 457 of the Code regarding income inclusion, provided certain conditions are met.
- What determines the present value of an amount deferred under an ineligible deferred compensation plan has been established.
- Short-term deferrals (when the deferral is paid on or before the 15th day of the third month following the tax year in which the participant’s benefit vests) and “recurring part-year compensation” (when the deferral is paid not later than the last day of the 13th month following the first day of the employee’s period of service) are excluded from the definition of deferred compensation.
- A covenant not to compete continues to be a substantial risk of forfeiture under Section 457(f) of the Code if (1) the right to compensation is expressly conditioned on the employee complying with an enforceable noncompete agreement; (2) the plan sponsor takes

reasonable steps to ensure the employee's compliance with the noncompete provision; and (3) the employer has a bona fide interest in the employee refraining from competing, and the employee has a bona fide interest in, and the ability to, engage in the prohibited competition.

- Rules that would allow an existing risk of forfeiture will be extended under certain circumstances (referred to as "rolling risk of forfeiture").

The proposed regulations make clear throughout the extent to which the rules under Code Section 409A relating to nonqualified deferred compensation plans mirror or work in concert with the proposed rules under Code Section 457(f). Consequently, an ineligible deferred compensation plan under Section 457(f) could also be considered a nonqualified deferred compensation plan, subject to the rules and regulations of Code Section 409A.

Because taxpayers and plan sponsors can rely on the proposed regulations until their final adoption, affected plan sponsors may wish to review all applicable plan documents and noncompete agreements in light of the proposed regulations. The general effective date, however, will begin for calendar years beginning after the date the final regulations are published in the Federal Register, provided that special effective dates apply to collectively bargained and governmental plans.

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For more information or if you have any questions concerning the proposed regulations affecting Section 457 plans, or Section 457 plans in general, please contact one of the following members of our [Employee Benefits and Compensation Group](#):

[Bruce B. Barth](#) | [Virginia E. McGarrity](#) | [Devin M. Karas](#) | [Jean E. Tomasco](#)

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