The Tax Adviser

Deferred compensation: The proposed Sec. 457(f) regulations and Sec. 409A

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EXECUTIVE SUMMARY

- Deferred compensation paid by a state or local government or a tax-exempt entity under a Sec. 457(f) plan is not includible in income until the employee has a legally binding right to the compensation or, if later, when it is no longer subject to a substantial risk of forfeiture.
- A substantial risk of forfeiture under Sec. 457(f) includes risks of forfeiture conditioned on the future performance of substantial services, triggered by a condition related to the purposes of the compensation, and in certain cases conditioned on covenants not to compete.
- A valid Sec. 457(f) plan must also conform with Sec. 409A and operate in conformity with that section, or the employee will lose the deferral of the compensation under the plan and be subject to a 20% penalty and retroactive interest.
- Under Sec. 409A, a plan may pay deferred compensation only on or after specified dates or events. In certain circumstances, a plan may allow an employee, beneficiary, or employer to elect to further delay or change the form of a deferred compensation payment.
- An acceleration of payment is allowed under Sec. 457(f) but generally not allowed under Sec. 409A. Most, but not all, deferrals that qualify as short-term deferrals under Sec. 457(f) also qualify as short-term deferrals under Sec. 409A.

Special rules apply under Sec. 457(f) to unfunded deferred compensation plans of state governments, local governments, and their agencies as well as nongovernmental tax-exempt organizations.[1]The IRS has issued comprehensive proposed regulations to replace the existing regulations applicable to Sec. 457(f).[2]

This article discusses the treatment of Sec. 457(f) plans under the new regulations and their interaction with the Sec. 409A regulations that usually apply to unfunded deferred compensation plans.

When deferred compensation is included in income under Sec. 457(f)

The present value of compensation deferred under a Sec. 457(f) plan is included in the gross income of an employee or beneficiary (1) when he or she has a legally binding right to the compensation or, if later, (2) when the compensation is no longer subject to a substantial risk of forfeiture.[3]

The present value of the deferred compensation is generally determined by first multiplying each future payment by the probability that all conditions on the payment will be satisfied. The amount so computed is then discounted using a reasonable assumed rate of interest.[4] However, for a plan with a hypothetical account balance that is earning a reasonable imputed rate of return, the present value is the account balance, including the earnings previously credited to the account.[5]

The valuation of a future payment cannot take into account the possibility that payments will not be made or will be reduced (1) because the plan is unfunded; (2) because of investment risk or the risk that the obligor will not make payment; (3) because of future plan amendments or a change in the law; or (4) because of similar circumstances.[6]

After the present value of deferred compensation is included in income, future imputed earnings under the plan are not immediately taxable. Instead, plan amounts actually or constructively received by a participant or beneficiary are taxable under the rules applicable to annuities. That is, they are taxable under the annuity rules as annuity payments or as non—annuity payments, with amounts previously included in income treated as investment in the plan.[7]

Actual or constructive receipt of payments includes receipt of any taxable or nontaxable benefit from the plan. It includes a transfer of cash, a transfer of property, inclusion in income under the economic benefit doctrine, a taxable contribution to (or taxable receipt of an interest in) a Sec. 402(b) nonexempt trust, or receipt of welfare or fringe benefits.[8]

Exclusions from treatment as Sec. 457(f) deferred compensation

Sec. 457(f) plans are defined largely by exclusion. For example, they do not include qualified plans, Sec. 403 (b) tax-sheltered annuities, Sec. 402(b) nonexempt trusts, Sec. 403(c) nonqualified annuities, Sec. 83 property transfers, qualified governmental excess benefit arrangements (QGEBAs), certain employee retention plans, and Sec. 457(b) eligible plans.[9]

Discretion to reduce or eliminate compensation

Compensation is not deferred under a Sec. 457(f) plan if an employee does not have a legally binding right to the compensation. For example, no such right exists if any other person has complete discretion to reduce or eliminate the compensation. However, the regulations ignore that discretion if its exercise depends on the occurrence of some objective event or if the discretion lacks substance. Discretion may lack substance, for example, because of a family or economic relationship between the employee and the person with the discretionary power.[10]

Exclusion of short-term deferrals

Deferred compensation under a Sec. 457(f) plan does not include short-term deferrals.[11] A deferral is short term if (1) the governing plan does not expressly provide for a deferred payment and (2) absent exceptional circumstances,[12] the compensation is paid before the end of a 2½-month period. For this purpose, a plan does

not expressly provide for a deferred payment if no payment date is specified, or all specified payment dates occur before expiration of the 2½-month period.[13] The 2½-month period ends on the 15th day of the third month after the later of the employee's or the employer's tax year in which the employee first possesses a legally binding right to the payment unhampered by a substantial risk of forfeiture.[14]

Nevertheless, a payment after expiration of the 2½-month period may not jeopardize short-term treatment if (1) timely payment is administratively impractical due to unforeseeable events or (2) an earlier payment would jeopardize the going concern status of the employer. Nor will a late payment jeopardize short-term treatment if the employer reasonably believes that payment would violate a provision of law other than federal tax law. However, the employer must make the payment as soon after as reasonably practicable.[15]

Exclusion of recurring part-year compensation

Delayed payment of an employee's recurring part-year compensation (e.g., a teacher's part-year compensation) is not deferred compensation under Sec. 457(f) if the following conditions are satisfied. First, the employee's service period must be a period of less than 12 months (e.g., 10 months for a teacher), and the employee must reasonably expect the deferral arrangement to continue substantially unchanged in succeeding years.

Second, the employee must receive the compensation on or before the last day of the 13th month following the beginning of the employee's service period. Third, the employee's total compensation for the service period must be *less* than a specified inflation-adjusted amount ($265,000 for service periods beginning in 2016; $270,000 for service periods beginning in 2017).[16]

Exclusion of bona fide severance pay plans

Sec. 457(f) plans do not include bona fide severance pay plans[17] that satisfy all the following requirements:

- Severance benefits must be payable only upon involuntary severance from employment.[18] For this purpose, involuntary severances may include a separation for "good reason" effectively caused by negative changes imposed by the employer, e.g., negative changes in employee pay, authority, duties, or working conditions.[19]
- The amount payable must not exceed twice the employee's ongoing annual rate of pay for the tax year preceding separation (or if none, for the tax year of separation).[20]
- The benefit must be paid by the end of the second calendar year following the calendar year of separation, as required by a written plan document.[21]

Exclusion of window retirement programs

A "window" retirement program (a retirement program that gives employees a specified period or window in which to accept early retirement benefits) is not subject to Sec. 457(f) even though the severance of an employee is voluntary. To qualify, the window program must be available to employees for only a limited time (typically 12 months or less), and the program cannot be part of a recurring pattern of providing similar programs.[22]

In addition, a window program must satisfy the other requirements for a bona fide severance pay plan. That is, the amount payable cannot exceed twice the employee's ongoing annual rate of pay for the tax year preceding separation, and the amount must be paid by the end of the second calendar year following the calendar year of separation.[23]

Exclusion of other plans and payments

Sec. 457(f) plans do not include bona fide sick leave,[24] vacation,[25] disability pay,[26] and death benefit plans.[27] Also excluded are certain specified (1) payments of employee expenses,[28] medical benefits, and in-kind benefits; (2) indemnification rights, liability insurance, and legal settlements;[29] (3) taxable education benefits,[30] bona fide compensatory time programs,[31] and length-of-service awards to bona fide volunteers;[32] (4) employment retention plans for educators;[33] (5) voluntary early retirement incentive plans for educators;[34] (6) types of independent contractor deferrals;[35] and (7) grandfathered plans.[36]

Substantial risk of forfeiture

As noted above, compensation is generally deferred under Sec. 457(f) as long as it is subject to a substantial risk of forfeiture. Substantial risks of forfeiture include risks of forfeiture conditioned on the future performance of substantial services.[37]

Example 1: On Jan. 15, 2017, a state governmental unit enters into a Sec. 457(f) agreement providing for a bonus payment of $250,000 to an employee on Jan. 15, 2019, if the employee provides substantial services until that date. The employee subsequently satisfies his obligation and receives payment on Jan. 15, 2019. The employee includes the $250,000 payment in his gross income for the year 2019, the year of receipt (and includes none in 2017, the year he entered into the agreement).

Example 2: On Jan. 15, 2017, an employee severs her employment with a tax-exempt entity and enters into a Sec. 457(f) agreement providing for payment of $250,000 to the employee on Jan. 15, 2019. However, the employee must provide consulting services to the employer until that date. Unfortunately, the consulting services required are not substantial in relation to the payment. Accordingly, the present value of the future $250,000 payment is includible in the employee's gross income on Jan. 15, 2017. When the employee actually receives the $250,000 payment, she must include in gross income the amount of the payment less the amount included in gross income on the date of her severance from employment.[38]

Condition related to the purpose of the compensation

Compensation is also subject to a substantial risk of forfeiture if forfeiture may be triggered by a condition related to the purpose of the compensation, provided the possibility of forfeiture is substantial. A condition related to a purpose of the compensation must relate to (1) the employee's performance of services for the employer or (2) the employer's governmental or tax-exempt activities or organizational goals. Enforcement of the forfeiture condition must be likely.[39]

Example 3: Under a Sec. 457(f) plan, a tax-exempt charity agreed on June 10, 2019, to pay its president $250,000 when and if the charity received charitable donations aggregating $10 million during the president's term of office. The payment is due two years after reaching the $10 million goal. Assume the risk of not achieving the $10 million goal was substantial, but that the charity nevertheless reached the goal on May 30, 2021, during the president's term of office.

The deferred compensation was subject to a substantial risk of forfeiture since the requirement to reach aggregate charitable donations of $10 million was a condition related to the employer's tax-exempt activities or organizational goals, and the risk of forfeiture was substantial. Thus, the present value of the future $250,000 payment is includible in the president's gross income as of May 30, 2021, when the goal was reached. Upon actual receipt of the $250,000 payment, the president must include in gross income the amount of the payment less the amount previously included in income.

Involuntary severance from employment without cause

Compensation is subject to a substantial risk of forfeiture if it is conditioned on involuntary severance from employment without cause, and the possibility of forfeiture is substantial. Note that a voluntary severance from employment will be treated as involuntary if the severance occurs for "good reason" under conditions previously specified in writing. Severance for good reason may occur as a result of unfavorable changes imposed by the employer, e.g., unfavorable changes in an employee's pay, authority, duties, or working conditions. However, tax avoidance cannot be the primary purpose for the arrangement.[40] (Note that, as discussed above, some severance payments are not treated as deferred compensation subject to Sec. 457(f) if certain conditions are satisfied.)

> ***Example 4:*** A charitable organization agreed to pay an employee $200,000 under a Sec. 457(f) plan three years after the date of severance in the event of his involuntary severance from employment without cause. The employee was fired without cause on Feb. 15, 2020, and received payment three years later on Feb. 15, 2023. The employee will include the present value of the compensation in gross income as of Feb. 15, 2020 (the date the substantial risk of forfeiture lapsed). Upon receipt of payment, the employee will include in gross income the amount of the payment less the amount previously included in income.

Covenant not to compete

A required forfeiture upon violation of a covenant not to compete will constitute a substantial risk of forfeiture if all of the following conditions are satisfied:

- The right to payment of the compensation is expressly conditioned upon the employee refraining from the future performance of services under an enforceable written agreement.
- The employer makes reasonable ongoing efforts to verify compliance with its noncompetition agreements (including the employee's agreement).
- When the written agreement becomes binding and enforceable, the employer has a substantial interest in preventing the employee from performing the prohibited services, and the employee has the interest and ability to perform the prohibited services.[41]

  Example 5: An employee is a well-known and successful college football coach at University *X*. Loss of the coach would be substantially detrimental to the sports program of University *X* and would result in significant financial losses. The coach has a bona fide interest in continuing to work as a college football coach and is highly marketable. On June 1, 2020, the coach and University *X* enter into a written agreement under which the coach agrees to provide substantial services to University *X* until June 1, 2023. University *X* will then pay $500,000 to the coach on June 1, 2025, if, in addition, he has not performed services as a football coach before that date for any other college or university with a football program similar to that of University *X*. The agreement is enforceable, and University *X* would be reasonably expected to enforce it.

The $500,000 payable under the agreement is subject to a substantial risk of forfeiture until June 1, 2025, and is includible in the coach's gross income on that date.[42]

Deferrals of regular compensation and extensions of deferrals

Any of the types of substantial risk of forfeiture described above will defer the taxation of compensation that an employee would not have received without the deferral agreement. On the other hand, to defer regular current compensation, or to extend a previous deferral of compensation, a substantial risk of forfeiture must instead satisfy the following requirements:

- *Materially greater benefit:* 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 employee would have received absent the additional or extended risk of forfeiture, taking into account only that portion of regular current compensation that is deferred.[43]
- *At least two more years of substantial future services:* The employee must perform substantial services for a minimum of two additional years after he or she could have received the compensation in the absence of the additional or extended substantial risk of forfeiture. (Or the employee must refrain from providing services for two or more additional years under a qualified covenant not to compete.) For example, if an employee elects to defer a fixed percentage from each semi-monthly payroll, the two-year minimum applies separately to each semi-monthly payroll amount. However, a plan may provide for immediate payment upon death, disability, or involuntary severance without cause.[44]
- *Timing of written agreement:* The parties must agree in writing to the initial addition or extension of the substantial risk of forfeiture. For an initial addition (e.g., a deferral of current compensation), the parties must enter into the written agreement before the calendar year in which the services are performed. For an extension, the parties must enter into the written agreement at least 90 days before the lapse of the existing substantial risk of forfeiture. New employees have 30 days to sign the written agreement, but the agreement will apply only to the deferral of compensation earned after the agreement is signed.[45]
- *Substitutions for deferred compensation:* If deferred compensation is forfeited or relinquished and replaced with a substitute amount or benefit that is subject to a risk of forfeiture, the risk of forfeiture will be disregarded unless the above three requirements are satisfied.[46]

As noted, the four requirements listed above specifically apply to the deferral of current compensation that the employee would have received absent the deferral agreement. On the other hand, the following example illustrates that the four requirements do not apply to the initial deferral of compensation that the employee would *not* have received if he or she had not entered into the deferral agreement. The example also demonstrates that the four requirements do apply to an extension of such a deferral.[47]

> ***Example 6:*** On Jan. 27, 2020, a state agency agrees to pay an employee $120,000 on Jan. 1, 2023, if the employee provides substantial services until that date. In 2021, the parties enter into a written agreement to extend the payment and the performance of substantial services until Jan. 1, 2028. However, on that later date, the employer will pay an amount that has a present value of $145,000 on Jan. 1, 2023.

Thus, on Jan. 1, 2023, when the original substantial risk of forfeiture would have lapsed, the then present value of the new payment promised for Jan. 1, 2028 is $145,000. Unfortunately, $145,000 is less than 125% of the $120,000 present value of the payment originally promised for Jan. 1, 2023. Accordingly, on that date, the employee will recognize income of $120,000 (the amount no longer subject to a substantial risk of forfeiture).

When the total payment is actually made on Jan. 1, 2028, the employee will have an investment in the contract (basis) of $120,000 for purposes of computing the employee's income under the annuity rules.[48]

> ***Example 7:*** On Dec. 31, 2017, an employee agrees to defer $15,000 of the current compensation he would have otherwise earned in 2018. The deferred compensation is increased by a 30% employer match, and the total amount bears a reasonable rate of interest. The deferred compensation will be paid on Dec. 31, 2024, if the employee continues to provide substantial services until that date. Thus, the present value of the amount payable on Dec. 31, 2024, is 130% of the amount deferred.

The amount deferred is subject to a substantial risk of forfeiture because (1) the present value of the amount deferred is more than 125% of the amount the employee could have otherwise received; (2) the employee must perform more than two years of substantial services; and (3) the employee agreed to the deferral in the year prior to the year the compensation was earned.[49]

Application of Sec. 409A to Sec. 457(f) plans

If the terms of a Sec. 457(f) plan fail to conform to Sec. 409A or the plan fails to operate in conformity with that section, an employee may suffer harsh consequences. The employee must include in gross income all of his or her deferred compensation under the plan that is not subject to a substantial risk of forfeiture and not previously taxed.[50] The employee must also pay a 20% penalty tax on the taxable amounts and must pay cumulative interest on the taxes the employee would have incurred in prior years without the deferral.[51]

Sec. 409A payment events and deferral elections

Under Sec. 409A, a plan may provide for the payment of an employee's deferred compensation only on or after specified dates or events. Those dates and events include (1) a specifically designated time or fixed schedule; (2) death; (3) disability; (4) an unforeseeable emergency; and (5) separation from service (including retirement).[52] Bear in mind that more than one of these permissible payment dates and events may apply to the same deferred compensation (e.g., payment at the earlier of age 70, death, or disability).[53]

Under Sec. 409A, a plan may allow an employee, beneficiary, or employer to elect to further delay a deferred compensation payment or change the form of the payment (a "subsequent deferral election"). In no event, though, may a plan allow a subsequent deferral election to affect payments that become due within 12 months after the election becomes irrevocable. In addition, the electing employee or beneficiary must defer the affected payments for at least five additional years if the payments were (1) due at a specific time; (2) on a fixed schedule; (3) at a change in the ownership or effective control of the corporation or in the ownership of a substantial portion of the assets of the corporation; or (4) at separation from service (including retirement). The additional five-year deferral does not apply to payments triggered by death, disability, or unforeseeable emergencies.[54]

> ***Example 8:*** On Jan. 15, 2017, an employee enters into a Sec. 457(f) agreement with his governmental employer who agrees to pay the employee $250,000 on Jan. 15, 2022, provided the employee continues to provide substantial services for two years until Jan. 15, 2019. However, on Jan. 15, 2020, the employee

irrevocably elects an additional five-year deferral of the $250,000 payment until Jan. 15, 2027, with interest accruing at a reasonable rate after Jan. 15, 2022. Assume the payment's present value is $200,000 on Jan. 15, 2019 (the date the substantial risk of forfeiture lapses), and the amount actually paid on Jan. 15, 2027 (including interest) is $350,000.

Under Sec. 457(f), the $200,000 present value of the future payment is includible in the employee's gross income on Jan. 15, 2019, when the substantial risk of forfeiture lapses. Subsequently, upon payment of the $350,000 deferred compensation on Jan. 15, 2027, the employee includes $150,000 in gross income under the annuity rules (the $350,000 payment less $200,000 investment attributable to the inclusion in income on Jan. 15, 2019).

The employee's subsequent deferral election, deferring payment until Jan. 15, 2027, does not violate Sec. 409A. The election was made more than 12 months before the Jan. 15, 2022, scheduled payment, and the payment was deferred an additional five years until Jan. 15, 2027.

The extension of a substantial risk of forfeiture under Sec. 457(f) may also constitute a subsequent deferral election under Sec. 409A that must satisfy the 12-month rule and the five-year rule.

Example 9: On Jan. 15, 2017, an employee enters into a Sec. 457(f) agreement with her governmental employer who agrees to pay the employee $250,000 on Jan. 15, 2020, provided the employee continues to provide substantial services until that date. The employee in fact provides substantial services for the prescribed period and then retires. However, before retirement, on Oct. 1, 2018, the employer agreed in writing to pay $435,000 of deferred compensation on Jan. 15, 2025, in lieu of the $250,000 payment otherwise due on Jan. 15, 2020. The employee will forfeit the payment if she violates a written covenant not to compete at any time before Jan. 15, 2022. Assume the terms of the covenant not to compete will qualify it as a substantial risk of forfeiture under Sec. 457(f) and that the employee does in fact comply with the terms of the covenant. Assume also that the present value of the $435,000 payment is $325,000 on Jan. 15, 2020, and is $390,000 on Jan. 15, 2022.

Under Sec. 457(f), the $390,000 present value on Jan. 15, 2022, of the future payment is includible in the employee's gross income on that date (when the extended substantial risk of forfeiture lapses). Subsequently, upon payment of the $435,000 deferred compensation on Jan. 15, 2025, the employee includes $45,000 in gross income under the annuity rules (the $435,000 payment less $390,000 investment attributable to the inclusion in income on Jan. 15, 2022).

The employee's agreement to abide by the covenant not to compete before Jan. 15, 2022, and to extend the payment date to Jan. 15, 2025, does not violate either Sec. 457(f) or Sec. 409A. For purposes of Sec. 409A, the parties agreed to the extension on Oct. 1, 2018, more than 12 months before the Jan. 15, 2020, scheduled payment, and the payment was deferred an additional five years until Jan. 15, 2025.[55] (It is irrelevant that the covenant not to compete does not qualify as a substantial risk of forfeiture for purposes of Sec. 409A.)

Under Sec. 457(f), the restrictions on the extension of a substantial risk of forfeiture are satisfied. First, the parties entered into a written extension agreement on Oct. 1, 2018, more than 90 days before the lapse of the existing substantial risk of forfeiture on Jan. 15, 2020. Second, the employee must honor a qualifying covenant not to compete for a minimum of two additional years after Jan. 15, 2020, when she could have otherwise

received the compensation. Third, the $325,000 present value on Jan. 15, 2020, of the $435,000 amount that is subject to the extended substantial risk of forfeiture is more than $312,500 (i.e., more than 125% of the $250,000 payment the employee would have otherwise received on that date).[56]

Acceleration of payments under Sec. 457(f) and Sec. 409A

Under Sec. 409A, a plan generally cannot allow the acceleration of a payment of deferred compensation to an employee or beneficiary, although there are a number of exceptions.[57] The most significant exceptions include death, disability, and unforeseeable emergencies as earlier alternative payment events.[58] Under another exception, the plan may reimburse an employee for any income tax withholding required because of the vesting of amounts under Sec. 457(f) that cannot yet be paid under Sec. 409A.[59] Note that Sec. 457(f) does not itself prohibit the acceleration of payments.

> ***Example 10:*** On Jan. 15, 2017, an employee enters into a Sec. 457(f) agreement with her tax-exempt employer who agrees to pay the employee $250,000 on Jan. 15, 2022, provided the employee continues to provide substantial services for two years until Jan. 15, 2019. Assume the present value of the payment is $200,000 on Jan. 15, 2019. On Jan. 15, 2020, the employee elects to receive payment upon her death, disability, or unforeseeable emergency, if one of those events should occur before payment is due on Jan. 15, 2022. The employee dies on June 30, 2021, and her employer pays $250,000 to her beneficiary.

Under Sec. 457(f), the $200,000 present value of the future payment is includible in the employee's gross income on Jan. 15, 2019, when the substantial risk of forfeiture lapses. Upon the employee's subsequent death, her beneficiary includes $50,000 in gross income under the annuity rules (the $250,000 payment less $200,000 investment attributable to the inclusion in income on Jan. 15, 2019).[60]

The employee's election to accelerate payment violates neither Sec. 457(f) nor Sec. 409A. Sec. 457(f) does not prohibit the acceleration of payments; and death, disability, and unforeseeable emergencies are allowable acceleration events under Sec. 409A.

Note that, if the employee in the above example had instead simply elected to receive payment one year earlier than originally designated, the acceleration would violate Sec. 409A (absent another exception).

Short-term deferrals under Sec. 457(f) and Sec. 409A

An employee may avoid the application of Sec. 457(f) and Sec. 409A by qualifying payments as short-term deferrals. As explained above, a deferral will be short term if the governing plan does not state a payment date or provides payment dates occurring only before the end of a 2½-month period, and the employer makes payment before the end of the period.[61] This 2½-month period ends on the 15th day of the third month after the later of the employee's or the employer's tax year in which the employee first possesses a legally binding right to the payment unhampered by a substantial risk of forfeiture.[62]

Most short-term deferrals under Sec. 457(f) will also qualify under Sec. 409A. For this purpose, the definition of a *substantial risk of forfeiture* is generally the same (though not identical) under the two sections. For example, a payment of compensation conditioned on a requirement to perform substantial future services is a payment subject to a substantial risk of forfeiture under both sections.[63]

Example 11: Assume a state agency granted an employee a $100,000 bonus on Oct. 1, 2017, contingent on her continued performance of substantial services until Oct. 31, 2019. The grant did not state a specific payment date. Thereafter, the employee provided substantial services until Oct. 31, 2019, when the substantial risk of forfeiture lapsed. Assume the employer's tax year ended on Oct. 31, 2019, the employee's tax year ended on Dec. 31, 2019, and the employer paid the bonus on March 15, 2020. Thus, the payment date was the 15th day of the third month (or 2½ months) after the later of the employee's or the employer's tax year in which the substantial risk of forfeiture lapsed.

Consequently, the payment qualifies for the short-term deferral exclusion under both Sec. 457(f) and Sec. 409A. The employee will include the payment in gross income in 2020 (the year of payment) and not in 2019 (the year of vesting).

Similarly, a substantial risk of forfeiture conditioned on involuntary severance from employment without cause appears to be substantially the same under both Code sections.

Example 12: A charitable organization agreed to pay an employee $400,000 under a Sec. 457(f) plan in the event of his involuntary severance from employment without cause. Payment is due on March 15 of the tax year following the year of severance. Thereafter, the employee was fired without cause on Feb. 15, 2020. Assume Sec. 457(f) is applicable to the severance payment because the payment exceeds twice the employee's annual rate of pay for the preceding year.

Assume the employer's tax year ended on July 31, 2020, and the employee's tax year ended on Dec. 31, 2020. Further assume the employer paid the bonus on March 15, 2021 (the designated payment date). Thus, both the payment date and the actual payment were within the period ending on the 15th day of the third month (or 2½ months) after the later of the employee's or the employer's tax year in which the substantial risk of forfeiture lapsed.

Consequently, the payment qualifies for the short-term deferral exclusion from deferred compensation under both Sec. 457(f) and Sec. 409A. The employee will include the payment in gross income in 2021 (the year of payment) and not in 2020 (the year of vesting).

More problematic short-term deferrals

Because certain aspects of the definitions of substantial risk of forfeiture are different under Sec. 457(f) and Sec. 409A, in some situations short-term deferrals qualifying under Sec. 457(f) will not qualify under Sec. 409A. Perhaps most significantly, a covenant not to compete qualifying as a substantial risk of forfeiture under Sec. 457(f)[64] can never qualify as a substantial risk of forfeiture under Sec. 409A,[65] as the following example illustrates.

Example 13: A state agency granted a retiring employee a $100,000 bonus on Feb. 15, 2017, which did not state a specific payment date or event. However, the employee will forfeit the bonus if she violates a written covenant not to compete at any time before Aug. 31, 2019. Assume the covenant not to compete will qualify as a substantial risk of forfeiture under Sec. 457(f) and that the employee does in fact comply with the terms of the covenant.

The employer's tax year ended on Oct. 31, 2019, the employee's tax year ended on Dec. 31, 2019, and the employer paid the bonus on March 15, 2020. Thus, the payment date was the 15th day of the third month after the later of the employee's or the employer's tax year in which the substantial risk of forfeiture lapsed. Consequently, the payment qualifies for the short-term deferral exclusion from deferred compensation under Sec. 457(f).

However, a covenant not to compete cannot qualify as a substantial risk of forfeiture under Sec. 409A. Thus, the bonus payment is deferred compensation that violates Sec. 409A because (1) the payment does not qualify as a short-term deferral and (2) the grant of the bonus did not provide a payment date or event that otherwise qualifies under Sec. 409A. The employee must include the present value of the bonus in gross income as of Dec. 31, 2017, the last day of the year of grant,[66] together with a 20% penalty tax. Interest is not payable because there were no prior years of deferral.

The actual payment on March 15, 2020, is included in gross income on that date as a short-term deferral under Sec. 457(f), but only to the extent the payment exceeds the amount included in income on Dec. 31, 2017, under Sec. 409A.[67]

Similarly, a substantial risk of forfeiture attributable to a "condition related to the purpose of the compensation" that qualifies under Sec. 457(f) might not qualify under Sec. 409A. The Sec. 457(f) proposed regulations refer in part to a forfeiture condition related to the employer's "governmental or tax-exempt activities" or organizational goals.[68] On the other hand, the Sec. 409A regulations refer to a condition related to the employer's "business activities" or organizational goals.[69] Thus, it is possible that a substantial risk of forfeiture under Sec. 457(f) that is conditioned on advancement of the employer's governmental or tax-exempt activities might not be deemed to advance the employer's business activities under Sec. 409A. Perhaps though, the additional reference in both regulations to "organizational goals" provides a solution in most situations.

> ***Example 14:*** Under a Sec. 457(f) plan, a tax-exempt charity agreed on June 10, 2019, to pay its president $250,000 when and if the charity received charitable donations aggregating $10 million during the president's term of office. The agreement does not state a date of payment. The charity reached the $10 million goal on May 30, 2021, during the president's term of office. The charity's tax year ended on Aug. 31, 2021, the president's tax year ended on Dec. 31, 2021, and the charity made the payment on March 15, 2022. Thus, the payment date was the 15th day of the third month (or 2½ months) after the later of the employee's or the employer's tax year in which the substantial risk of forfeiture lapsed.

Consequently, the payment should qualify for the short-term deferral exclusion from deferred compensation under both Sec. 457(f) and Sec. 409A. Under Sec. 457(f), the requirement that the charity reach $10 million of aggregate donations clearly was a condition related to the charity's tax-exempt activities or organizational goals. And even if the requirement was not related to the charity's "business" goals under Sec. 409A, the requirement appears to be related to the charity's "organizational goals" for Sec. 409A purposes.

Thus, the president should be able to include the payment in gross income in 2022 (the year of payment) and not in 2021 (the year of vesting).

Mere payment of deferred compensation before expiration of the 2½-month period will not satisfy short-term deferral requirements if the payment was scheduled to be paid later.

Example 15: Assume that, under a Sec. 457(f) plan, a tax-exempt charity granted an employee a bonus of $100,000 on Nov. 1, 2017, contingent on her continued performance of substantial services until Dec. 31, 2018. Assume both the employer and employee are calendar-year taxpayers, and that the bonus was required to be paid as a lump sum on July 1, 2019. Also assume the present value of the payment is $97,000 on Dec. 31, 2018, when the substantial risk of forfeiture lapses.

By specifying a payment date after the applicable 2½-month period, the bonus plan has a deferred payment that will not qualify as a short-term deferral under either Sec. 457(f) or Sec. 409A. It will not qualify as a short-term deferral even if it is actually paid on or before March 15, 2019 (within the 2½-month period). Note, though, that the arrangement does not violate Sec. 409A since the compensation is payable at a specified time.

However, under Sec. 457(f), the employee must include the $97,000 present value of the compensation in gross income on Dec. 31, 2018, when the substantial risk of forfeiture lapses. Subsequently, upon payment of the $100,000 deferred compensation on July 1, 2019, the employee must include $3,000 in gross income under the annuity rules (the $100,000 payment less $97,000 investment attributable to the inclusion in income on Dec. 31, 2018).

Payment of deferred compensation upon a payment event occurring within the 2½-month period will not satisfy short-term deferral requirements if the payment event could possibly have occurred after the period expired.

Example 16: A state agency granted an employee a bonus on Jan. 1, 2017, that is not subject to a substantial risk of forfeiture. Both the employer and employee are calendar-year taxpayers, and the bonus is payable in a lump sum upon the employee's separation from service. The bonus is not a short-term deferral under either Sec. 457(f) or Sec. 409A because separation from service and payment of the bonus may occur after March 15, 2018 (i.e., after the applicable 2½-month period). The payment will not qualify as a short-term deferral even if the employee separates from service in 2017 and the bonus is actually paid on or before March 15, 2018 (within the 2½-month period).

Note that the arrangement does not violate Sec. 409A since the compensation is payable upon the occurrence of a permissible event (separation from service). However, under Sec. 457(f), the employee must include the present value of the compensation in gross income on Jan. 1, 2017, the date of grant.[70] Subsequently, upon separation from service and timely payment of the bonus, the employee must include in gross income the amount of the bonus less the amount included in gross income on the date of grant (under the annuity rules).

Extending a risk of forfeiture for a short-term deferral

As discussed above, an employee and employer can extend a substantial risk of forfeiture under Sec. 457(f) if certain conditions are satisfied. Although the Sec. 409A regulations are less clear, it appears such an extension is also available under Sec. 409A.[71] However, the Sec. 409A regulations do not state when the parties must agree to the extension. Nor do they state whether a minimum time period is required for the extension. Furthermore, the regulations do not contain a safe harbor for any required increase in compensation. The regulations simply state that:

> [T]he present value of the amount subject to a substantial risk of forfeiture (disregarding, in determining the present value, the risk of forfeiture) [must be] *materially greater* than the present value of the amount the recipient otherwise could have elected to receive absent such risk of forfeiture. [emphasis added][72]

Accordingly, the following example illustrates the possibility of extending a short-term deferral by extending the underlying substantial risk of forfeiture.

Example 17: On July 15, 2017, an employee enters into a Sec. 457(f) agreement with her governmental employer. The employer agrees to pay the employee $250,000 on March 15, 2021, provided the employee continues to provide substantial services for three years until July 15, 2020. Subsequently, on April 1, 2020, the employer agrees in writing to pay $475,000 of deferred compensation on March 15, 2025, in lieu of the $250,000 payment otherwise due on March 15, 2021. However, the employee will forfeit the payment if she fails to provide substantial services for four additional years until July 15, 2024. Assume that the present value of the $250,000 payment is $240,000 on July 15, 2020, when the original substantial risk of forfeiture would have lapsed. Assume that the present value of the new $475,000 payment is $360,000 on that date.

For purposes of Sec. 457(f), the restrictions on the extension of a substantial risk of forfeiture are satisfied. First, the parties entered into a written extension agreement on April 1, 2020, more than 90 days before the lapse of the existing substantial risk of forfeiture on July 15, 2020. Second, the employee must provide substantial services for more than two additional years (four additional years) until July 15, 2024. Third, the $360,000 present value on July 15, 2020, of the $475,000 amount that is subject to the extended substantial risk of forfeiture is more than 125% of the $240,000 present value on that date of the amount subject to the original risk of forfeiture.[73]

It appears that the extension of the substantial risk of forfeiture should also be recognized for purposes of Sec. 409A. The $360,000 present value on July 15, 2020, of the $475,000 amount that is subject to the extended substantial risk of forfeiture appears to be "materially greater" than the $240,000 present value on that date of the amount subject to the original risk of forfeiture. It is in fact 150% of the present value of the original amount.[74]

Thus, under both Sec. 457(f) and Sec. 409A, it appears the compensation of $475,000 should qualify as a short-term deferral taxable to the employee when received on March 15, 2025 (not in 2024 when it vested). Note that if a covenant not to compete had been used to extend the period of the substantial risk of forfeiture under Sec. 457(f), the extension would have failed for purposes of Sec. 409A. Nor would the additional deferral have satisfied either the 12-month rule or the five-year rule under Sec. 409A, and taxes, penalties, and interest would have been due for the year 2020.

The consequences of violating Sec. 409A can be both onerous and complex

Violations of Sec. 409A by a Sec. 457(f) plan can give rise to onerous and complex consequences:[75]

Example 18: On Dec. 1, 2017, a state agency establishes a Sec. 457(f) plan for an employee and credits an initial amount to the plan. The initial balance is thereafter increased by applying a reasonable rate of interest. The entire account balance is subject to a substantial risk of forfeiture until Dec. 1, 2021. The employer must pay the account balance in three annual installments beginning on Jan. 15, 2024. However, in 2022, the parties amend the plan to provide for payments to begin one year earlier on Jan. 15, 2023. The amendment violates the Sec. 409A rule prohibiting acceleration of payments because no exception to the rule applies. The account balance is: $100,000 on Dec. 1, 2021; $118,000 on Dec. 31, 2022; $120,000 on Jan. 15, 2023 (so that the payment made that day is $40,000 ($120,000 ÷ 3)); $88,000 on Jan. 15, 2024 (so that the payment made that day is $44,000 ($88,000 ÷ 2)); and $50,000 on Jan. 15, 2025 (so that the payment made that day is $50,000).

Tax year 2021: On Dec. 1, 2021, when the substantial risk of forfeiture ends, the then $100,000 account balance is included in the employee's gross income under Sec. 457(f).

Tax year 2022: Because the amendment in 2022 accelerates payment and violates Sec. 409A, the employee has gross income under Sec. 409A of $18,000 on Dec. 31, 2022[76] (the then $118,000 account balance less the $100,000 amount previously included in income). The gross income is subject to an additional 20% penalty and interest under Sec. 409A.

Tax year 2023: The first $18,000 of the $40,000 payment in 2023 is excluded from gross income due to the earlier inclusion of that amount caused by the Sec. 409A violation.[77] Because the three annual payments are treated as variable annuity payments, the amount of the investment in the contract allocated to the remaining $22,000 of the 2023 payment is $33,333 (i.e., the $100,000 included in income in 2021 divided by the three expected payments).[78] Thus, no amount is included in gross income for 2023.

Tax year 2024: The employee has unused investment in the contract from 2023 of $11,333 (the excess of the $33,333 portion of the investment allocated to the 2023 payment less the $22,000 amount of the payment that was offset by the investment). Assuming the employee elects under the variable annuity rules to redetermine the amount of investment recognized for payments after 2023,[79] the amount included in gross income for 2024 is $5,000 (i.e., the payment of $44,000, reduced by the $39,000 portion of the remaining investment in the contract that is allocable to the payment). The $39,000 investment allocable to the payment is equal to the $100,000 originally included in income in 2021 less the $22,000 investment recovered in 2023 (or $78,000), divided by two remaining payments.

Tax year 2025: The amount included in gross income in 2025 is $11,000 (the payment of $50,000, reduced by the remaining investment in the contract of $39,000).

In the above example (closely based on an example in the proposed regulations),[80] the election in 2022 to accelerate payment was not treated as a continuing Sec. 409A violation in subsequent tax years, even though the payment continued to be due earlier than the originally established payment date. Thus, it appears that the proposed regulations generally limit a violation of Sec. 409A to the tax year in which it first occurs. Nevertheless, it seems probable that a violation due to plan terms that fail to comply with Sec. 409A for a number of consecutive years should constitute a new violation in each of those years, at least until the plan terms are brought into compliance.[81]

Footnotes

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[1]Sec. 457(f) and its regulations.

[2]Although the old regulations (Regs. Sec. 1.457-11) apply until the new regulations (Prop. Regs. Sec. 1.457-12) are finalized, taxpayers may rely on the proposed regulations immediately (preamble to REG-147196-07 (June 22, 2016)). Special effective dates may apply for (1) plans under collective bargaining agreements and (2) governmental plans requiring state legislation (Prop. Regs. Sec. 1.457-13(b)).

[3]Sec. 457(f)(1)(A); Prop. Regs. Sec. 1.457-12(a)(2).

[4]Prop. Regs. Sec. 1.457-12(c)(1)(i).

[5]Prop. Regs. Sec. 1.457-12(c)(1)(iv).

[6]Prop. Regs. Sec. 1.457-12(c)(1)(ii)(A)(3).

[7]Sec. 457(f)(1)(B); Prop. Regs. Secs. 1.457-12(a)(3)-(5), (d)(1).

[8]Prop. Regs. Sec. 1.457-12(a)(4).

[9]Sec. 457(f)(2); Prop. Regs. Sec. 1.457-12(b). See Prop. Regs. Sec. 1.457-11 for an additional list of plans or arrangements that are excluded.

[10]Prop. Regs. Sec. 1.457-12(d)(1)(ii).

[11]Prop. Regs. Sec. 1.457-12(d)(2) provides that the short-term deferral rules under Sec. 409A apply, except that the relevant substantial risk of forfeiture is as defined in Prop. Regs. Sec. 1.457-12(e).

[12]See Regs. Sec. 1.409A-1(b)(4)(ii) (for an explanation of these exceptional circumstances).

[13]Regs. Sec. 1.409A-1(b)(4)(i)(D); Prop. Regs. Sec. 1.457-12(d)(2).

[14]Regs. Sec. 1.409A-1(b)(4); Prop. Regs. Sec. 1.457-12(d)(2).

[15]Regs. Sec. 1.409A-1(b)(4)(ii); Prop. Regs. Sec. 1.409A-1(b)(4)(ii) (on which the preamble to the proposed regulations state a taxpayer may rely until the regulations become final).

[16]Prop. Regs. Sec. 1.457-12(d)(3); Regs. Sec. 1.409A-2(a)(14); Notice 2015-75; Notice 2016-62.

[17]Sec. 457(e)(11)(A)(i).

[18]Prop. Regs. Sec. 1.457-11(d)(1)(i).

[19]Prop. Regs. Sec. 1.457-11(d)(2)(ii).

[20]Prop. Regs. Sec. 1.457-11(d)(1)(ii).

[21]Prop. Regs. Sec. 1.457-11(d)(1)(iii).

[22]Prop. Regs. Sec. 1.457-11(d)(3).

[23]Prop. Regs. Secs. 1.457-11(d)(3), (d)(1)(ii), (d)(1)(iii).

[24]Sec. 457(e)(11)(A)(i); Prop. Regs. Sec. 1.457-11(f).

[25]Id.

[26]Sec. 457(e)(11)(A)(i); Prop. Regs. Sec. 1.457-11(e)(2).

[27]Sec. 457(e)(11)(A)(i); Prop. Regs. Sec. 1.457-11(e)(1).

[28]Prop. Regs. Sec. 1.457-12(d)(4)(i).

[29]Prop. Regs. Sec. 1.457-12(d)(4)(ii).

[30]Prop. Regs. Sec. 1.457-12(d)(4)(iii).

[31]Sec. 457(e)(11)(A)(i); Prop. Regs. Sec. 1.457-11(c)(1).

[32]Secs. 457(e)(11)(A)(ii), (B), (C); Prop. Regs. Sec. 1.457-11(c)(2).

[33]Sec. 457(f)(4).

[34]Sec. 457(e)(11)(D); Prop. Regs. Sec. 1.457-11(d)(4).

[35]Sec. 457(e)(12); Prop. Regs. Sec. 1.457-11(b)(3).

[36]Prop. Regs. Secs. 1.457-11(b)(1), (2).

[37]Sec. 457(f)(3)(B); Prop. Regs. Sec. 1.457-12(e)(1)(i).

[38]Based on Prop. Regs. Sec. 1.457-12(e)(3), Example 1.

[39]Prop. Regs. Secs. 1.457-12(e)(1)(i), (iii).

[40]Prop. Regs. Secs. 1.457-12(e)(1), 1.457-11(d)(2)(ii).

[41]Prop. Regs. Sec. 1.457-12(e)(1)(iv).

[42]Based on Prop. Regs. Sec. 1.457-12(e)(3), Example 4.

[43]Prop. Regs. Sec. 1.457-12(e)(2)(ii).

[44]Prop. Regs. Sec. 1.457-12(e)(2)(iii).

[45]Prop. Regs. Sec. 1.457-12(e)(2)(iv).

[46]Prop. Regs. Sec. 1.457-12(e)(2)(v).

[47]See the initial deferral allowed in Prop. Regs. Sec. 1.457-12(e)(3), Example 2, that cannot satisfy item 1 above and that does not satisfy item 3 above.

[48]Based on Prop. Regs. Sec. 1.457-12(e)(3), Example 2.

[49]Based on Prop. Regs. Sec. 1.457-12(e)(3), Example 3.

[50]Secs. 409A(a)(1)(A), (d)(5).

[51]Sec. 409A(a)(1)(B).

[52]Sec. 409A(a)(2)(A); Regs. Sec. 1.409A-3(a).

[53]Regs. Secs. 1.409A-2(b)(6), (b)(9), Examples 15 and 24; Regs. Sec. 1.409A-3(j)(2); H.R. Rep't No. 108-755, 108th Cong., 2d Sess. (2004); Staff of the Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 108th Congress* (JCS-5-05) ("Treatment of nonqualified deferred compensation plans").

[54]Sec. 409A(a)(4)(C); Regs. Sec. 1.409A-2(b)(1).

[55]The original arrangement here was a short-term deferral. Although the regulations generally do not treat short-term deferrals as deferred compensation, an employee can treat them as such for purposes of electing additional deferrals under Sec. 409A. For this purpose, the regulations define the payment date for a short-term deferral as the date a substantial risk of forfeiture lapses, which in this example is the same as the original payment date (Regs. Sec. 1.409A-2(a)(4)).

[56]Prop. Regs. Sec. 1.457-12(e)(2).

[57]Sec. 409A(a)(3); Regs. Sec. 1.409A-3(j)(1).

[58]Regs. Sec. 1.409A-3(j)(2).

[59]Regs. Sec. 1.409A-3(j)(4)(iv).

[60]The payment to the beneficiary is taxable under Sec. 691(a) as income in respect of a decedent.

[61]Regs. Sec. 1.409A-1(b)(4)(i)(D); Prop. Regs. Sec. 1.457-12(d)(2).

[62]Regs. Sec. 1.409A-1(b)(4); Prop. Regs. Sec. 1.457-12(d)(2). Some of the following examples in the text are based on the examples at Regs. Sec. 1.409A-1(b)(4)(iii).

[63]Prop. Regs. Sec. 1.457-12(e)(1)(i); Regs. Sec. 1.409A-1(d)(1).

[64]Prop. Regs. Sec. 1.457-12(e)(1)(iv).

[65]Regs. Sec. 1.409A-1(d)(1).

[66]Prop. Regs. Sec. 1.409A-4(b)(2)(i).

[67]Sec. 409A(a)(1)(A)(i). Note that the violation of Sec. 409A in 2017 was not treated as a Sec. 409A violation in subsequent tax years. For an explanation, see the discussion following Example 18 below.

[68]Prop. Regs. Sec. 1.457-12(e)(1)(iii).

[69]Regs. Sec. 1.409A-1(d)(1).

[70]The proposed regulations provide rules and assumptions for determining the present value of an amount due on a future severance of employment (Prop. Regs. Sec. 1.457-12(c)(1)(ii)(C)(2)).

[71]Regs. Sec. 1.409A-1(d)(1).

[72]Id.

[73]Prop. Regs. Sec. 1.457-12(e)(2).

[74]The preamble to the proposed Sec. 457(f) regulations unhelpfully states that there is no implication intended that the 125% standard also applies for purposes of satisfying the "materially greater" requirement under Sec. 409A (REG-147196-07 (June 22, 2016)). However, in Chief Counsel Advice (CCA) 201645012, the IRS Office of Chief Counsel held that the materially greater requirement had been satisfied for purposes of Sec. 409A where, at the time of deferral of salary, the employer credited matching amounts equal to 25% of the amount of salary deferral (so that the total amount deferred was 125% of the deferred salary). The facts stated in the CCA also indicated that the employee (1) made the deferral election in the year prior to deferral and (2) agreed to a substantial risk of forfeiture that lasted for a period of at least two years.

[75]Based on Prop. Regs. Sec. 1.457-12(d)(5)(iii), Example.

[76]Prop. Regs. Sec. 1.409A-4(b)(2)(i).

[77]Regs. Sec. 1.409A-4(f).

[78]Regs. Sec. 1.72-2(b)(3).

[79]Regs. Sec. 1.72-4(d)(3).

[80]Prop. Regs. Sec. 1.457-12(d)(5)(iii), Example.

[81]See Prop. Regs. Sec. 1.409A-4(a)(1)(ii)(A).

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