



update

Public Sector Benefits Compliance News

August 19, 2016

IRS Proposed Rules for Deferred Compensation Plans Present an Opportunity to Review Design

The Internal Revenue Service (IRS) has published proposed rules under Section 457 of the Internal Revenue Code (IRC) addressing the income taxation of deferred compensation plans of state and local governments.¹ As summarized in this *Update*, the proposed rules revise the final §457 rules that were issued in 2003:² to incorporate statutory changes and certain other changes for “eligible plans” under IRC §457(b); to provide additional guidance on plans treated as not subject to §457; and to revise and expand the rules for “ineligible plans” under IRC §457(f) to parallel the rules under IRC §409A, with certain notable exceptions.

Because plan sponsors may rely on the proposed rules (*i.e.*, may adopt them immediately) sponsors may want to revisit the design of benefit plans that are affected by the rules, and, for example:

- Consider implementing Roth contribution programs in §457(b) plans;
- Review leave pay programs to ensure they are not subject to deferred compensation rules; and
- Take advantage of new designs allowed for §457(f) plans, including non-compete agreements, “rolling risks of forfeiture” and increased compensation levels for recurring part-year compensation.

Comments are due by September 20, 2016. The IRS will hold a public hearing on October 16, 2016.

Applicability

Generally, the new §457 rules will apply to compensation deferred for calendar years beginning after the rules are finalized, but plans are permitted to implement the proposed rules immediately if they wish to do so. Governmental plans have an extended effective date: the new rules apply to deferrals in calendar years that begin after the close of the second regular legislative session of the body with authority to amend the plan (if applicable) that begins after publication of final rules. A different extended effective date applies to collectively bargained plans.

¹ As noted in Segal Consulting’s [June 23, 2016 hot topic web posting](#), the proposed rules were published in the [June 22, 2016 Federal Register](#).

² For a summary of those rules, see Segal’s November 2003 *Bulletin*, “[Final Rules on Public Sector 457 Plans](#).”



Retirement Compliance News Highlights:

- IRS has proposed regulations governing §457 deferred compensation plans.
- Until final rules are published, plan sponsors may rely on the proposed rules.
- Plan sponsors may want to review their deferred compensation plans, severance pay and paid time-off arrangements in light of the changes made by the proposed rules.

Background

Section 457 governs tax consequences for governmental deferred compensation plans. Participants in “eligible” governmental plans under §457(b) are taxed on their benefits only when the benefits are paid — a favorable tax rule, similar to the rule applicable to benefits under §401(a) and §403(b) plans. Participants in “ineligible” governmental plans under §457(f) are taxed when their right to payment is no longer subject to “a substantial risk of forfeiture” — a much less favorable rule because the participant is taxed at that time whether or not the benefit can then be paid. Compensation deferred under ineligible plans may also be subject to IRC §409A, which imposes additional requirements that generally constrain the timing of deferral elections and the acceleration or further delay of payments and limit distribution events.³

Eligible Plans Under §457(b)

The proposed rules for eligible plans incorporate recent federal law changes affecting eligible plans, including:

- The Small Business Jobs Act of 2010, which allows eligible governmental plans to offer a qualified Roth contribution program;
- The Heroes Earnings Assistance and Relief Tax Act of 2008,⁴ which requires plans to provide death benefits to survivors of participants who die while performing military service as if the participant resumed and then terminated employment on account of death, and also to treat certain active service as a severance from employment for plan distribution rules; and
- The Pension Protection Act of 2006, which excludes from the income of retired public safety officers amounts distributed from an eligible governmental plan to pay qualified health insurance premiums (up to a maximum of \$3,000 per year).

In addition, with regard to deferral elections, the proposed rules clarify that any modification or revocation of a deferral agreement may not take effect before the first day of the following month. Thus, if a participant chooses to stop making deferrals or increase deferral amounts to an eligible plan, deferrals cannot be stopped or increased before the first of the month following the month of the formal election.

Plans Not Subject to §457

Certain types of plans are not subject to any part of §457 because they are treated as not providing a deferral of compensation. These plans include bona fide vacation, sick leave, and compensatory time plans, bona fide death and disability plans, and bona fide severance pay plans. The proposed rules provide new guidance on the specific conditions that each type of plan must satisfy in order to be “bona fide” and excluded from coverage under §457.

For example, bona fide severance pay plans may only pay benefits upon a participant’s involuntary severance from employment, a voluntary termination for good reason, or pursuant to a window program or early retirement incentive program. Bona fide sick and vacation pay plans do not provide for deferral of compensation if the primary purpose of the plan is to provide employees with paid time off, which is determined under a facts and circumstances test that takes into account factors such as whether the amount of leave provided could reasonably be expected to be used in the normal course of an individual’s employment or whether employees can exchange accumulated leave for cash or other benefits and the amount and frequency of such exchanges.

³ IRC §409A was added to the law by the American Jobs Creation Act of 2004, and final regulations were issued in 2007. Proposed revisions to the 2007 final §409A regulations were issued on the same day as the §457 proposed rules discussed in this *Update*.

⁴ For information about the HEART Act, see Segal’s September 2008 *Bulletin*, “[Heroes Earnings Assistance and Relief Tax Act of 2008](#).”

Ineligible Plans Under §457(f)

As noted above, ineligible plans are subject to the less favorable deferred compensation rules of §457(f) and also to the rules of §409A, unless otherwise exempted. The proposed rules revise and supplement the 2003 rules to provide definitions and features under 457(f) that closely follow the §409A rules. For example, the proposed rules provide a short-term deferral rule that parallels the rule under §409A. Under the proposed rule, certain short-term deferrals (amounts paid within a 2½-month period after the year in which the payment is no longer subject to a substantial risk of forfeiture) are not considered a deferral of compensation for purposes of §457(f). In addition, noting that a similar change will be made to the §409A rules, the proposed rules revise prior guidance on recurring part-year compensation for teachers and university faculty to increase the compensation amount that can be paid during the service period without resulting in the compensation being treated as deferred compensation under §457(f).⁵

Two key areas in which the proposed rules differ from the rules of §409A are in the treatment of “non-compete” agreements and “rolling risks of forfeiture” for purposes of the definition of a “substantial risk of forfeiture.”⁶ The §409A rules do not recognize either non-compete agreements or rolling risks of forfeiture for purposes of determining whether there is a substantial risk of forfeiture that defers taxation, but the proposed rules for §457(f) recognize both features for that purpose, if certain requirements are satisfied in each case.

How Segal Can Help

Although the proposed rules are not yet in effect, plans are permitted to implement them now. Segal’s consultants can help sponsors review their §457(b) eligible plans to help ensure that the new requirements detailed in the proposed regulations are reflected in their plans, as applicable. In addition, Segal consultants can assist in evaluating whether revisions are needed to bring severance pay or paid time-off arrangements into compliance. Finally, if plan sponsors are interested in taking advantage of the new opportunities and flexibility offered to ineligible plans under §457(f) with non-compete agreements, where permitted under state law, and rolling risks of forfeiture, Segal’s consultants are available to assist sponsors in reviewing those plans.

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Update is for informational purposes only and should not be construed as legal advice. It is not intended to provide guidance on current laws or pending legislation as they apply to specific situations. On all issues involving the interpretation or application of laws and regulations, plan sponsors should rely on their attorneys for legal advice.

Questions?

For more information about how these new rules may affect your plan, please contact your Segal consultant or the [Segal office nearest you](#).

⁵ See [Notice 2008-62](#) on the IRS website.

⁶ Generally, a rolling risk of forfeiture is an amendment to a deferred compensation plan that extends the original period of deferral for a specified period of years by extending the risk of forfeiture for that same period.



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“The proposed rules revise prior guidance on recurring part-year compensation for teachers and university faculty.”

“[Evaluate] whether revisions are needed to bring severance pay or paid time-off arrangements into compliance.”