August 2016

PENSION ANALYST

Important information — Plan administration and operation

IRS proposes long-anticipated regulations for Section 457 deferred compensation plans

Who's affected

These proposed rules are applicable to plan sponsors, beneficiaries, participants and record keepers of certain section 457 deferred compensation plans established and maintained by State or local governments or other tax-exempt organizations.

Background and summary

On June 22, 2016, the IRS published proposed regulations intended to clarify and modify existing IRS guidance regarding the application of Internal Revenue Code section 457 ("section 457") to nonqualified deferred compensation arrangements. On the same day, the IRS also issued proposed regulations under Internal Revenue Code section 409A. A separate Pension Analyst publication will address those regulations.

The proposed regulations have been anticipated since the publication of IRS Notice 2007-62 where it was announced that the IRS intended to issue guidance under section 457. The proposed rules include revisions to reflect statutory changes that were enacted subsequent to the publication of the section 457 final regulations in 2003. The proposed rules also provide guidance on certain issues that were not addressed in the final 2003 rules.

The proposed regulations also provide guidance with respect to certain plans offered by State or local governments or other tax-exempt organizations that are exempt from section 457, such as bona fide severance, sick pay and vacation plans. The rules also allow eligible section 457 governmental plans to include a qualified Roth contribution program, under which designated Roth contributions are included in income in the year of deferral and qualified distributions from a designated Roth account are excluded from gross income.

While these rules are not effective until they become finalized, taxpayers may rely on them immediately. The regulations are proposed to apply to compensation under a plan for calendar years beginning after the date of publication of the final regulations, including deferred amounts to which a legally binding right arose during prior calendar years that were not previously included in income.

The IRS will accept comments on the proposals until September 20, 2016. A public hearing is scheduled for October 18, 2016.

Action and next steps

Plan sponsors of section 457 deferred compensation plans should review the information in this publication to understand how it may apply to their plans and participants. In some instances, plan amendments may be necessary. As noted above, the proposed regulations do not indicate that there will be "grandfathering" for existing deferrals that have not already been included in income, so there may be only a limited period in which to make any necessary changes to plan designs and related documentation after final regulations are issued.

In this issue

Overview
Changes applicable to eligible governmental plans

©2016 Prudential Financial, Inc. and its related entities.

Prudential, the Prudential logo, the Rock symbol and Bring Your Challenges are service marks of Prudential Financial, Inc., and its related entities, registered in many jurisdictions worldwide.

RSMH080

- Qualified Roth contributions
- Tax-free distributions to public safety officers
- Rules related to qualified military service
Governmental and tax-exempt plans not subject to section 457
- Bona fide severance pay plans
- Window programs
- Voluntary early retirement incentive plans
Other plans not subject to section 457 deferral of compensation rules
Ineligible plans under section 457(f)
- Present value
- Loss deduction rules
- Definition of deferral of compensation
- Substantial risk of forfeiture
- Recurring part-year compensation
Interaction with 409A rules
Effective dates
- Collective bargaining plans
- Recurring part-year compensation
- Governmental plans
Next steps

Overview

Section 457 plans are nonqualified, unfunded deferred compensation plans established by state and local governments and tax-exempt employers. Section 457 plans can be either "eligible" (under section 457(b) of the Internal Revenue Code (Code)) or "ineligible" (under Code section 457(f)). Under an "eligible" plan, compensation deferred and the income attributable to such deferred compensation, is taxable in the year in which the deferred compensation amounts are paid or made available to a participant or beneficiary, but there is an annual limitation on the amount that may be deferred into the plan. Section 457(f) "ineligible" plans are not subject to annual limitations on the amount to be contributed, but the deferred compensation must be included in the participant's income on the later of the date the participant obtains a legally binding right to the compensation or when the amount is no longer subject to a substantial risk of forfeiture.

Changes applicable to eligible governmental plans

Qualified Roth contributions

As provided under the Small Business Jobs Act of 2010 (SBJA), the proposed regulations reflect changes made by SBJA to allow an eligible governmental plan to include a qualified Roth contribution program, under which designated Roth contributions are included in income in the year of deferral. The proposed rules provide that contributions and withdrawals of a participant's designated Roth contributions must be credited and debited to a designated Roth account maintained for the participant and that the plan must maintain a record of each participant's investment in the contract with respect to that account.

The proposed rules also provide that:

- Forfeitures may not be allocated to a designated Roth account;
- No contributions other than designated Roth contributions and rollover contributions may be made to the account; and
- Qualified distributions from a designated Roth account are excluded from gross income.

©2016 Prudential Financial, Inc. and its related entities.

Prudential, the Prudential logo, the Rock symbol and Bring Your Challenges are service marks of Prudential Financial, Inc., and its related entities, registered in many jurisdictions worldwide.

RSMH080

Tax-free distributions to public safety officers

The Pension Protection Act of 2006 (PPA) permitted eligible retired public safety officers to receive tax-free distributions from qualified retirement plans for the payment of qualified accident and health insurance premiums. The proposed regulations reflect the incorporation of this PPA provision into the section 457 rules. The distributions are excluded from gross income. The maximum annual amount of these tax-free distributions is $3,000. To qualify for the special tax treatment, the premium payments must be made directly from the retirement plan to the insurer. Premiums may be for accident or health insurance or for long-term care insurance for the retired public safety officer, his spouse, or his dependents.

Plans are not required to offer this provision but plan sponsors that want to make this feature available may need to amend their plans to permit such payments.

Rules related to qualified military service

The proposed regulations also amend the section 457 rules to implement the requirements of the Heroes Earnings Assistance and Relief Tax Act of 2008 (HEART Act), so that an eligible section 457 governmental plan must provide that in the case of a participant who dies while performing qualified military service, the survivors of the participant are entitled to any additional benefits that would have been provided under the plan if the participant had resumed and then terminated employment on account of death. This requirement applies to provisions such as:

- Accelerated (i.e., 100%) vesting on account of death while an active participant;
- Eligibility for ancillary life insurance benefits; or
- Other survivor benefits that are available only when a participant dies while an active employee of the plan.

The rules also include a provision that a leave for certain military service is treated as severance of employment for purposes of a plan distribution.

Governmental and tax-exempt plans not subject to section 457

The 2003 final regulations under section 457 defined which categories of plans are subject to section 457. For purposes of section 457, the term “plan” includes any plan, agreement, method, program or any other arrangement, including an individual employment agreement under which an eligible employer defers compensation. The 2003 regulations also identify certain plans that are not subject to section 457 and certain plans that do not provide for a “deferral of compensation” for purposes of section 457.

The proposed rules amend the definition of plan and provide clarification and additional guidance regarding plans that are not subject to section 457 or do not provide for a deferral of compensation.

Bona fide severance pay plans

The proposed regulations provide a plan must meet certain requirements to be a “bona fide severance pay plan” that is treated as not providing for a deferral of compensation and therefore is not subject to section 457. Specifically, a plan must meet the following requirements to be a bona fide severance pay plan:

- Benefits provided under the plan must be payable only upon a participant’s (a) involuntary severance from employment, (b) due to a window program, or (c) pursuant to a voluntary early retirement incentive plan.
- The amount payable to a participant must not exceed two times the participant’s annualized compensation based upon the annual rate of pay for services provided for the calendar year preceding the calendar year in which the severance from employment occurred (or the current calendar year if the participant had no compensation from the employer in the preceding calendar year).
- Under the written terms of the plan, the severance benefits must be paid no later than the last day of the second calendar year following the calendar year in which the severance from employment occurs.

©2016 Prudential Financial, Inc. and its related entities.

Prudential, the Prudential logo, the Rock symbol and Bring Your Challenges are service marks of Prudential Financial, Inc., and its related entities, registered in many jurisdictions worldwide.

RSMH080

The proposed rules define an "involuntary severance from employment" as a severance from employment due to the eligible employer's independent exercise of its authority to terminate the participant's services, other than due to the participant's request, if the participant is willing and able to continue to perform services. Whether an involuntary severance from employment exists is based on the relevant facts and circumstances. To be treated as an involuntary severance from employment, a severance from employment for good reason must result from unilateral action taken by the employer resulting in a material adverse change to the working relationship (e.g. material reduction in the employee's duties, working conditions or pay) under conditions that are pre-specified in writing.

Other factors may be considered to determine whether a termination for good reason is an involuntary severance from employment, such as:

- Whether the payments upon severance from employment for good reason are in the same amount and paid at the same time as payments due to an employer-initiated severance from employment without cause; and
- Whether the employee must give notice to the employer of the material adverse change in conditions and provide the employer with an opportunity to remedy the adverse change.

The proposed regulations include a safe harbor under which a plan providing for payment upon a voluntary severance from employment under certain pre-specified conditions will be treated as providing for payment under a severance from employment for good reason.

Window programs

The proposed regulations clarify that the involuntary severance from employment requirement does not apply to window programs. A window program is a program established by an employer to provide separation pay related to an impending severance from employment.

A window program:

- Must be offered for a limited period of time (typically no longer than 12 months); and
- The employer must make the program available to employees who have a severance from employment during that period under specified conditions.

A program is not offered for a limited period of time, and therefore is not a window program, if there is a pattern of repeatedly providing similar programs, based on all of the relevant facts and circumstances including whether:

- The benefits are on account of a specific reduction in workforce;
- There is a relationship between the separation pay and an event or condition; and
- The event or condition is temporary and discrete or is a permanent aspect of the employer's operations.

Voluntary early retirement incentive plans

The proposed regulations also clarify that the involuntary severance from employment requirement does not apply to an applicable voluntary early retirement incentive plan. These are bona fide severance pay plans for purposes of section 457 with respect to payments made as an early retirement benefit, a retirement-type subsidy, or an early retirement benefit that is greater than a normal retirement benefit, and is paid in coordination with a qualified defined benefit pension plan maintained by a governmental entity or tax-exempt education association. These payments will be treated as a bona fide severance pay plan only to the extent that they otherwise could have been provided under the qualified defined benefit plan with which it is coordinated.

Other plans not subject to section 457 deferral of compensation rules

The proposed rules clarify that the following plans are not treated as providing for the deferral of compensation and therefore are not subject to section 457:

©2016 Prudential Financial, Inc. and its related entities.

Prudential, the Prudential logo, the Rock symbol and Bring Your Challenges are service marks of Prudential Financial, Inc., and its related entities, registered in many jurisdictions worldwide.

RSMH080

- **Bona fide death benefit plans** are plans providing for death benefits as defined under the FICA regulations applicable to nonqualified deferred compensation plans. Benefits under a bona fide death benefit plan may be provided through insurance, and any lifetime benefits payable under the plan are not treated as including the value of any term life insurance coverage provided under the plan that is includible in gross income.
- **Bona fide disability pay plans** must only pay benefits in the event of a participant's disability. The value of any taxable disability insurance coverage that is included in gross income is disregarded. A participant is disabled if the participant meets any of the following three conditions:
  - The participant is unable to engage in substantial gainful activity by reason of a 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;
  - The participant is, by reason of any 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 continuous period of not less than three months under an accident or health plan covering employees of the employer; or
  - The participant is determined to be totally disabled by the Social Security Administration or the Railroad Retirement Board.
- **Bona fide sick leave and vacation leave plans** are not treated as providing for the deferral of compensation if the facts and circumstances demonstrate that the primary purpose of the plan is to provide employees with paid time off from work due to sickness, vacation, or other personal reasons. Factors used in determining whether a plan is a bona fide sick or vacation leave plan include:
  - Whether the amount of leave provided could reasonably be expected to be used by the employee in the normal course (and before cessation of services);
  - Whether there are limits on the ability to exchange unused accumulated leave for cash or other benefits and any applicable accrual restrictions;
  - The amount and frequency of any in-service payments of cash or other benefits offered in exchange for the accumulated and unused leave;
  - Whether the payment of unused sick or vacation leave is made promptly upon severance from employment (or, instead is paid over a period of time after severance from employment); and
  - Whether the sick leave, vacation leave or combined sick and vacation leave is broadly applicable or is available only to certain employees.

Ineligible plans under section 457(f)

Deferred compensation under an ineligible plan is includible in the gross income of the participant or beneficiary on the date that is the later of:

- The date the participant or beneficiary obtains a legally binding right to the compensation; or
- The date the substantial risk of forfeiture lapses, if the compensation is subject to a substantial risk of forfeiture.

Present value

In general, the amount to include in income on the applicable date is the present value of the amount of compensation deferred.

For an account balance plan, the amount to include is generally the account balance (including earnings) on the date the substantial risk of forfeiture lapses. Any earnings credited thereafter are includible in gross income when subsequently paid or made available to the participant. However, if an account balance 457(f) plan has earnings that are not based on a "reasonable rate of interest" or "predetermined actual investment", or are based on the greater of two rates, the proposed rules specify the amount to include in income must include the present value of the expected excess earnings to be credited under the plan after the applicable date and through the projected payment date over the earnings that would be credited during the period using a reasonable rate of interest. If the value including the expected excess earnings is not determined in this manner, the proposed regulations provide that the present value of the compensation deferred will be determined as

©2016 Prudential Financial, Inc. and its related entities.

Prudential, the Prudential logo, the Rock symbol and Bring Your Challenges are service marks of Prudential Financial, Inc., and its related entities, registered in many jurisdictions worldwide.

RSMH080

equal to the amount credited under the plan as of the applicable date, plus the present value of the excess to be credited under the plan through the projected payment date over the earnings that would be credited using the applicable Federal rate.

For nonaccount balance plans (i.e., defined benefit plans), the proposed regulations provide that the present value of the deferred compensation is calculated as the value as of the applicable date (typically, date of lapse of substantial risk of forfeiture) of the right to receive payment of the compensation in the future, taking into account the time value of money and the probability that the payment will be made. Any actuarial assumptions must be reasonable. For this purpose, taking into account the probability that the participant might die before receiving benefits is only reasonable if the plan provides that benefits will be forfeited upon death. If the present value depends on the time when a severance from employment occurs and it has not occurred by the applicable date, for purposes of determining the present value, the severance from employment generally may be treated as occurring on any date before the fifth anniversary of the applicable date unless it would be unreasonable to use that assumption. If amounts payable under the plan are based on factors that are indeterminable as of the applicable date (such as final average compensation or total years of service), the determination of the present value must be based on reasonable, good faith assumptions with respect to any contingencies.

Loss deduction rules

Under the proposed rules, if a participant includes an amount of deferred compensation in income under section 457(f) but the compensation that is subsequently paid is less than the amount included in income because the participant has forfeited or lost some or all of the compensation (e.g., due to investment performance), the participant is entitled to a deduction for the taxable year in which any remaining right to the amount is permanently forfeited under that plan's terms or otherwise permanently lost. For an employee, the deduction would generally be a miscellaneous itemized deduction.

Definition of deferral of compensation

The proposed rules define the term "deferral of compensation" for purposes of determining whether section 457(f) applies to an arrangement. A plan generally provides for a deferral of compensation if a participant has a legally binding right to compensation payable in a later taxable year; however, 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. Whether a plan provided for a deferral of compensation is generally based on the terms of the plan and relevant facts and circumstances.

Under the proposed rules, an amount of compensation deferred under a plan that provides for a deferral of compensation does not cease to be subject to section 457(f) due to any change to the plan that would recharacterize the right as not providing for a deferral of compensation. Further, any change under the plan that results in exchanging an amount deferred under the plan into some other right or benefit that would be excluded from gross income does not affect the characterization of the plan as one providing for a deferral of compensation.

Substantial risk of forfeiture

The proposed regulations also provide guidance regarding the conditions that constitute a "substantial risk of forfeiture" under section 457(f). As noted above, the timing of the lapse of a substantial risk of forfeiture typically dictates the point at which an amount is includible in income under section 457(f); in the absence of a substantial risk of forfeiture, the deferred compensation would be includible in income at the time the legally binding right to the compensation arose.

Under the proposed rules, an amount is generally subject to a substantial risk of forfeiture only if entitlement to that 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.

©2016 Prudential Financial, Inc. and its related entities.

Prudential, the Prudential logo, the Rock symbol and Bring Your Challenges are service marks of Prudential Financial, Inc., and its related entities, registered in many jurisdictions worldwide.

An amount is conditioned on the future performance of substantial services based on all relevant facts and circumstances, such as whether the hours required to be performed are substantial in relation to the amount of compensation. A condition is related to a purpose of compensation only if the condition relates to the employee's performance of services for the employer or to the employer's tax exempt or governmental activities, or organizational goals.

A substantial risk of forfeiture exists based on a condition related to the purpose of the compensation only if the likelihood that the forfeiture event will occur is substantial. An amount is not subject to a substantial risk of forfeiture if the facts and circumstances indicate that the forfeiture condition is unlikely to be enforced. Factors considered for purposes of determining the likelihood that the forfeiture will be enforced include, but are not limited to:

- The past practices of the employer;
- The level of control or influence of the employee with respect to the organization and the individuals who would be responsible for enforcing the forfeiture; and
- The enforceability of the provisions under applicable law.

Noncompetes: Compensation is not considered to be subject to a risk of forfeiture if the employee accepts a position with a competing employer unless the following conditions are satisfied:

- The right to the compensation must be expressly conditioned on the employee refraining from the performance of future services pursuant to a written agreement that is legally enforceable;
- The employer must consistently make reasonable efforts to verify compliance with all of the noncompetition agreements to which it is a party (including the noncompetition agreement at issue); and
- At the time the noncompetition agreement becomes binding, the facts and circumstances must show that the employer has a substantial and bona fide interest in preventing the employee from performing prohibited services and that the employee has an ability to engage in the prohibited services.

Voluntary deferrals and rolling risks of forfeiture: Unexpectedly, the proposed regulations permit initial deferrals of current compensation (e.g. salary, bonus) to be treated as subject to a substantial risk of forfeiture and also permit an existing substantial risk of forfeiture to be extended (often referred to as a rolling risk of forfeiture), subject to certain conditions. In order to comply with this special rule:

- The present value of the amount to be provided after the lapse of the substantial risk of forfeiture (as extended, if applicable) must be materially greater than the amount that would have been provided absent the risk of forfeiture (or absent the extension). For purposes of this rule, an amount is materially greater only if the present value to be paid upon the lapse of the substantial risk of forfeiture is more than 125% of the amount the participant otherwise would have received in the absence of the new or extended substantial risk of forfeiture;
- There must be at least 2 years of substantial future services or adherence to an agreement not to compete (applied on a per deferral basis), absent an intervening death, disability or involuntary severance from employment; and
- The agreement subjecting the amount to the substantial risk of forfeiture must be in writing.

Recurring part-year compensation

Recurring part-year compensation is compensation paid for services performed in a position that the employer and employee reasonably anticipate will continue under similar terms and conditions in subsequent years and under which the employee will be required to provide services during successive service periods each of which is less than 12 months (e.g., a teacher providing services during a school year of 10 consecutive months) and each of which begin in one taxable year and ends in the next taxable year.

The proposed regulations provide that a plan or arrangement under which an employee receives recurring part-year compensation earned over a period of service does not provide for a deferral of compensation if:

- The plan or arrangement does not defer payment of any of the recurring part-year compensation to a date beyond the last day of the 13th month following the first day of the service period for which the recurring part-year compensation is paid; and

©2016 Prudential Financial, Inc. and its related entities.

Prudential, the Prudential logo, the Rock symbol and Bring Your Challenges are service marks of Prudential Financial, Inc., and its related entities, registered in many jurisdictions worldwide.

- The amount of the compensation does not exceed the annual compensation limit under section 401(a)(17) for the calendar year in which the service period begins. The 401(a)(17) limit for 2016 is $265,000.

This reflects greater flexibility than provided under the rule in Notice 2008-62, which limited the amount of recurring part-year compensation that could be deferred from one year to the next to the applicable limit under section 402(g) ($18,000 for 2016).

Interaction with 409A rules

The rules under section 457(f) apply to plans separately and in addition to the requirements under section 409A. A deferred compensation plan of an eligible employer that is subject to section 457(f) may also be subject to section 409A.

Effective dates

The regulations are proposed to apply to compensation deferred for calendar years beginning after the date the final rules are published. This effective date includes deferred amounts to which the legally binding right arose during prior calendar years that were not previously included in income during prior calendar years. As a result, the proposed regulations do not provide for “grandfathering” as to certain amounts deferred under existing arrangements.

Taxpayers may immediately rely on these proposed regulations.

The rules provide special effective dates for certain plans.

Collective bargaining plans

For plans that are maintained pursuant to one or more collective bargaining agreements that have been ratified and are in effect on the date the final rules are published, the final rules would not apply to compensation deferred under the plan before the earlier of the date:

- On which the last of the collective bargaining agreements terminates (without regard to any extension); or
- That is three years after the date the final rules are published.

Recurring part-year compensation

For all plans, with respect to guidance regarding recurring part-year compensation, taxpayers may rely on the proposed rules or guidance provided in IRS Notice 2008-62.

Governmental plans

To the extent legislation is required to amend a governmental plan, the proposed rules apply only to compensation deferred under the plan in calendar years beginning on or after the close of the second regular legislative session of the legislative body with the authority to amend the plan that begins after the date the final rules are published.

Next steps

Plan sponsors should read the guidance discussed in this newsletter and determine the impact of the proposed rules on their plans. There may be instances when plan amendments are necessary. As noted above, the proposed regulations do not indicate that there will be “grandfathering” for existing deferrals that have not been included in income, so there may be only a limited period in which to make any necessary changes to plan documents after final regulations are issued. If there are questions about these rules, plan sponsors should consult with their legal counsel.

Pension Analyst by Prudential Retirement

The Pension Analyst is published by Prudential Retirement, a Prudential Financial business, to provide clients with information on current legislation and regulatory developments affecting qualified retirement plans. This publication is distributed with the understanding that Prudential Retirement is not rendering legal advice. Plan sponsors should consult their attorneys about the application of any law to their retirement plans.

Editor: Julie Koos (563) 585-6811

©2016 Prudential Financial, Inc. and its related entities.

Prudential, the Prudential logo, the Rock symbol and Bring Your Challenges are service marks of Prudential Financial, Inc., and its related entities, registered in many jurisdictions worldwide.

RSMH080