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Deferred Compensation for Tax-exempt Organizations: New Proposed Regulations under Code Section 457

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On June 21, 2016, the Internal Revenue Service (IRS) issued anticipated proposed Treasury Regulations prescribing rules under Section 457 of the Internal Revenue Code for the income taxation of deferred compensation arrangements for employees of tax-exempt organizations and state and local governments. The IRS also released new proposed Treasury Regulations under Code Section 409A.

Generally, the proposed regulations are more flexible and practical than the rules previously suggested by the IRS in Notice 2007-62 and also than what was expected by many practitioners. While the proposed regulations require clarification on a number of points, these new rules will provide useful guidance in designing compensation for executives of tax-exempt organizations. Among other things, these rules:

- follow Code Section 409A in recognizing a termination by an employee for "good reason" as an involuntary severance from employment;
- unlike under Code Section 409A, recognize required compliance with a noncompetition agreement as a substantial risk of forfeiture;
- contrary to prior IRS policy statements, permit, in certain situations, elective deferral of current compensation and a rollover of existing substantial risk of forfeiture;
- define bona fide severance pay plans that are exempt from Code Section 457, including by imposing a limit on the amount of severance that can be paid under such a plan of two times a participant's prior year's rate of compensation (similar to the Code Section 409A coverage exception), but without the alternative lower limit based on two times the limit for recognizing compensation under qualified plans;
- define bona fide sick pay and vacation plans that are exempt from Code Section 457;
- specify with flexibility how to determine present value when calculating the amount to be taxed under Code Section 457(f); and
- emphasize that both Code Section 457(f) and Code Section 409A apply to most deferral arrangements.

The key provisions in the proposed regulations that relate to tax-exempt organizations are discussed in more detail in our recent client alert, which is available here.