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Deferred Compensation: What Non-Profit and Governmental Employers Need to Know About IRS Guidance on Section 457 - Part 1

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There has been a lot of buzz recently about the long-awaited proposed rules issued by the ***Internal Revenue Service*** under ***Internal Revenue Code Section 457***. Section 457 only applies to non-profit and governmental employers and is unusual because Section 457(f) can result in an employee being taxed on compensation or benefits prior to actually receiving them! While Section 457(f) comes into play primarily with respect to deferred compensation, it also applies to benefits such as severance pay, disability pay, death benefits and sick and vacation leave.

What is Section 457(f)?

Section 457(f) applies to all “deferred” compensation except compensation that is deferred under a Section 457(b) “eligible” deferred compensation plan or a Section 457(e) “bona fide” severance, disability, death benefit, and sick leave and vacation leave plan.

Section 457(f) provides that an amount of “deferred” compensation will be taxed *to the employee* at the time it is no longer subject to a substantial risk of forfeiture. This is true even though the employee may not receive the compensation until a later year.

While the rules are well fleshed out with respect to establishing a Section 457(b) plan, much uncertainty existed with respect to when compensation was otherwise subject to (or exempt from) Section 457(f). The new proposed rules provide some much needed guidance.

When is Compensation “Deferred”?

Generally, compensation is “deferred” if the employee has a legally binding right now to receive the compensation but that compensation is or may be payable in a later tax year. For example, if an employee earns a bonus during 2016 that will be paid in June of 2017, the employee has a right to compensation in 2016 that will be paid in 2017, and the bonus is “deferred” compensation. An employee does not have a legally binding right to compensation to the extent it can be unilaterally reduced or eliminated by the employer.

Good news! Under the proposed rules, compensation is not “deferred” if the compensation must be paid and actually is paid within 2 ½ months following the end of the calendar year (or employer's tax year, if later) in which the payment is no longer subject to a substantial risk of forfeiture. This is referred to as a “short-term deferral.” For bonus plans, this means that as long as the bonus plan provides that the bonus must be paid by March 15th of the year following the year in which the employee earns the bonus and the bonus is actually paid on or before that March 15th, the plan will not be subject to Section 457(f).

While this is good news, this can lead to unusual results if the bonus plan is not carefully designed. For example: An employee earns a bonus on November 1, 2016, to be paid in installments on the first day of each month for the next 24 months with each installment treated as a separate payment. Under the proposed rules, the value of the bonus (excluding the January, February and March 2017 installments) is “deferred” compensation and will be taxed to the employee in 2016, even though the employee will receive most of the compensation in future years. The value of the January, February and March 2017 installments will be taxed to the employee in 2017 because these payments fall under the "short-term deferral" rule discussed above and are not “deferred” compensation.

This unusual result highlights the need for careful review of any compensation arrangement that might defer compensation.

Stay tuned! We will continue our coverage of Section 457 and important takeaways from the proposed rules in a series of alerts over the next few weeks. The next alert will address what it means for compensation to be subject to a substantial risk of forfeiture.