

Upcoming IRS Guidance Regarding the Nonqualified Deferred Compensation Plans of Tax-Exempt Organizations

By Mark Simons and David Wolfe

Apart from one brief regulation issued several years ago, the Internal Revenue Service (IRS) has never issued comprehensive guidance for 457(f) plan sponsors. Comprehensive guidance has been discussed and was expected to be issued in 2011, but did not occur ([click here](#) to see Client Alert *Restrictive IRS Guidance for 457(f) Plans Likely to be Issued in 2011*). However, new guidance is anticipated within the next few months in the form of proposed regulations. Upon issuance of the regulations, the IRS will grant a “comment period” during which the public will be able to review, and suggest changes to, the regulations. The guidance will likely cover the following key areas, according to informal IRS comments:

- > **Vesting** — Vesting triggers taxation under 457(f) plans. The IRS intends on describing exactly which triggers are valid vesting events, and which are not. IRS officials have emphasized that they want to use the same definition of vesting under both Sections 457(f) and 409A of the Code to the fullest extent possible. This means, for example, that the concept of a “rolling risk of forfeiture” will no longer work. Similarly, non-competes won’t delay vesting, and pure salary deferral plans (without a substantial match) won’t delay taxation. On the other hand, 457(f) plan sponsors will (for the first time) have official approval for using the concept of a “constructive termination.”
- > **Bona Fide Severance and Bona Fide Vacation Plans** — These two sorts of arrangements have always been exempt from Section 457(f), but the IRS has never provided a clear definition. The upcoming guidance is expected to change that. Among other things, the guidance will describe the extent to which vacation and sick-leave conversion plans are subject to Section 457(f). IRS officials have informally stated that the key to the “bona fide vacation plan” exemption will be whether the amount eligible for conversion is “reasonable” and available to a broad cross-section of the employer’s workforce. They have also noted that bona fide vacation plans will still be subject to the rules of “constructive receipt.”
- > **Present Value** — Upon vesting, the present value of a 457(f) benefit is taxed, but the IRS has never described exactly how present value is calculated for this purpose. For example, it has never described what sort of mortality assumptions and interest rates

should be used, or how contingent events such as death should be factored into the calculation. Upcoming guidance is expected to fill this gap.

- > **“Menus”** — It has become increasingly common for tax-exempt employers to offer terminating executives a choice between things such as nontaxable retiree health coverage and a taxable lump sum cash payment (*e.g.*, for employees who already have retiree health coverage through their spouses). IRS officials have expressed concern that this choice could trigger application of Section 457(f). The guidance is expected to address this risk.
- > **What is “Deferred Compensation?”** — Tax-exempt employers administering deferred compensation plans are obligated to address the interplay of 457(f) and 409A, as 457(f) plans are already subject to the requirements of 409A. The regulations under Code Section 409A provide an extremely broad definition of “deferred compensation,” and include such things as employer payment of taxable medical premiums, in-kind benefits and legal fees. In contrast, practitioners have always taken the view that 457(f) only covers the deferral of elective or non-elective cash compensation. The upcoming guidance may broaden the reach of Section 457(f), as part of an IRS attempt to create a uniform set of rules among non-profit and for-profit sponsors.
- > **Grandfathering** — The IRS will likely offer some sort of transition relief for existing 457(f) plans, but IRS officials have informally stated that any grandfathering provision will be based on the facts and circumstances. Stated differently, it is highly unlikely that all plans in existence before the date of the guidance will be given a blanket exemption — particularly if they contain a provision that was arguable even under prior law (*e.g.*, a vesting provision based on a very weak non-compete requirement). IRS officials have stated that this sort of blanket grandfather would essentially shut down their audits of pre-existing plans, and thus could not be allowed.

Employee Benefits & Executive Compensation Practice Group

If you have any questions about, or would like assistance with, any of the matters discussed in this alert, please contact any member of our Employee Benefits and Executive Compensation Practice Group listed below.

Heather B. Abrigo
(310) 203-4054
Heather.Abrigo@dbr.com

Kathleen O'Connor Adams
(312) 569-1306
Kathleen.Adams@dbr.com

Gary D. Ammon
(215) 988-2981
Gary.Ammon@dbr.com

Bruce L. Ashton
(310) 203-4048
Bruce.Ashton@dbr.com

Pascal Benyamini
(310) 203-4050
Pascal.Benyamini@dbr.com

Mark M. Brown
(215) 988-2768
Mark.Brown@dbr.com

Bradford P. Campbell
(202) 230-5159
Bradford.Campbell@dbr.com

Summer Conley
(310) 203-4055
Summer.Conley@dbr.com

Barbara A. Cronin
(312) 569-1297
Barbara.Cronin@dbr.com

Joseph C. Faucher
(310) 203-4052
Joe.Faucher@dbr.com

Mona Ghude
(215) 988-1165
Mona.Ghude@dbr.com

Lindsay M. Goodman
(312) 569-1314
Lindsay.Goodman@dbr.com

Megan Glunz Horton
(312) 569-1322
Megan.Horton@dbr.com

Robert L. Jensen
(215) 988-2644
Robert.Jensen@dbr.com

Melissa R. Junge
(312) 569-1309
Melissa.Junge@dbr.com

Sharon L. Klingelsmith
(215) 988-2661
Sharon.Klingelsmith@dbr.com

Christine M. Kong
(212) 248-3152
Christine.Kong@dbr.com

David Levin
(202) 230-5181
David.Levin@dbr.com

Howard J. Levine
(312) 569-1304
Howard.Levine@dbr.com

Sarah Bassler Millar
(512) 569-1295
Sarah.Millar@dbr.com

Joan M. Neri
(973) 549-7393
Joan.Neri@dbr.com

Monica A. Novak
(312) 569-1298
Monica.Novak@dbr.com

Cristin M. Obsitnik
(312) 569-1303
Cristin.Obsitnik@dbr.com

Fred Reish
(310) 203-4047
Fred.Reish@dbr.com

Michael D. Rosenbaum
(312) 569-1308
Michael.Rosenbaum@dbr.com

Dawn E. Sellstrom
(312) 569-1324
Dawn.Sellstrom@dbr.com

Lori L. Shannon
(312) 569-1311
Lori.Shannon@dbr.com

Mark J. Simons
(215) 988-2995
Mark.Simons@dbr.com

Ryan C. Tzeng
(310) 203-4056
Ryan.Tzeng@dbr.com

Michael A. Vanic
(310) 203-4049
Mike.Vanic@dbr.com

Joshua J. Waldbeser
(312) 569-1317
Joshua.Waldbeser@dbr.com

Stephen P. Wilkes
(415) 591-7554
Stephen.Wilkes@dbr.com

David L. Wolfe
(312) 569-1313
David.Wolfe@dbr.com

Other Publications



www.drinkerbiddle.com/publications

Sign Up



www.drinkerbiddle.com/publications/signup

Disclaimer Required by IRS Rules of Practice:

Any discussion of tax matters contained herein is not intended or written to be used, and cannot be used, for the purpose of avoiding any penalties that may be imposed under Federal tax laws.

Drinker Biddle

Employee Benefits & Executive Compensation Practice Group

CALIFORNIA | DELAWARE | ILLINOIS | NEW JERSEY
NEW YORK | PENNSYLVANIA | WASHINGTON DC | WISCONSIN

© 2012 Drinker Biddle & Reath LLP.
All rights reserved.
A Delaware limited liability partnership

Jonathan I. Epstein and Edward A. Gramigna, Jr.,
Partners in Charge of the Princeton and Florham Park,
N.J., offices, respectively.

This Drinker Biddle & Reath LLP communication
is intended to inform our clients and friends of
developments in the law and to provide information
of general interest. It is not intended to constitute
advice regarding any client's legal problems and
should not be relied upon as such.