

A horizontal banner image with a grid overlay. It contains various legal symbols: a scale of justice, a gavel, a computer keyboard, and open books. The text 'JONES DAY COMMENTARY' is overlaid in white, bold, sans-serif font.

JONES DAY
COMMENTARY

AN IMPENDING COLLISION AT THE INTERSECTION OF CODE SECTION 457 AND CODE SECTION 409A

On July 23, 2007, the Internal Revenue Service issued Notice 2007-62 announcing that new guidance will be issued under Code Section 457, a provision that is applicable to nonqualified deferred compensation plans of state and local governments and tax-exempt entities. The Notice provides that the term “bona fide severance pay plan” contained in Code Section 457 will be defined in a manner that parallels a definition applicable to separation pay plans contained in final regulations recently issued under Code Section 409A. The Notice also provides that the term “substantial risk of forfeiture,” contained in Code Section 457(f), will be defined in a manner that corresponds to and is consistent with the definition of substantial risk of forfeiture contained in the Code Section 409A regulations. Code Section 409A applies to deferred compensation plans of all employers, including entities that are subject to the rules of Code Section 457(f).

If the anticipated guidance described in the Notice is actually issued, it will dramatically affect the design of Code Section 457(f) plans and eliminate or greatly restrict certain practices that are commonly used in many such plans.

BACKGROUND

Code Section 457(f) applies to certain nonqualified deferred compensation plans established by state and local governments and tax-exempt employers. Essentially, Code Section 457(f) applies to the deferred compensation plans of such employers if the deferred compensation plans are not “eligible” plans under the provisions of Code Section 457(b). Because eligible plans under Code Section 457(b) are limited in the amount of deferred compensation that they can provide, many tax-exempt entities and some governmental employers use Code Section 457(f) plans to provide additional deferred compensation for their employees.

Under a Code Section 457(f) plan, compensation deferred under a plan is included in the gross income of a participant at the time the participant's right to the compensation is no longer subject to a substantial risk of forfeiture. Code Section 457(f) provides that a person's right to receive compensation is subject to a substantial risk of forfeiture if the person's rights to the compensation *are conditioned upon the future performance of substantial services by any individual*. Amounts that become taxable under Code Section 457(f) are currently included in income even if the amounts are not actually or constructively received.

Code Section 409A generally provides that, unless certain requirements are met, amounts deferred under a nonqualified deferred compensation plan for all taxable years are currently includible in gross income to the extent the amounts are not subject to a substantial risk of forfeiture and have not previously been included in gross income. Code Section 409A also provides that a person's right to receive compensation is subject to a substantial risk of forfeiture if the person's rights to the compensation *are conditioned upon the future performance of substantial services by any individual*. In addition to inclusion in income, amounts that fail to satisfy Code Section 409A are subject to a 20 percent penalty tax and an interest penalty.

One major difference between Code Section 457 and Code Section 409A is that "bona fide severance plans" are exempt from the requirements of Code Section 457. That exception allows an employer to promise severance benefits to employees if the employees are terminated for any reason. Unlike Code Section 457, Code Section 409A does not include an exception for bona fide severance plans.

Final regulations under Code Section 409A were published on April 10, 2007, and generally become applicable January 1, 2008. Deferred compensation plans must be amended to comply with Code Section 409A on or before December 31, 2007, and all transition rules applicable to Code Section 409A will expire on that date. The final regulations under Code Section 409A include guidance on when a "separation pay plan" is treated as not providing for a deferral of compensation for purposes of Code Section 409A and define "sub-

stantial risk of forfeiture" for purposes of Code Section 409A. Prior to the issuance of Notice 2007-62, there was no indication from the IRS as to whether separation pay plans under Code Section 409A were the same as or similar to bona fide severance plans under Code Section 457, nor was there any formal indication as to whether a substantial risk of forfeiture under Code Section 409A was the same as a substantial risk of forfeiture under Code Section 457(f). In fact, the final regulations under Code Section 409A cast serious doubt on common practices used under Code Section 457(f) to delay taxation of promised benefits, including (1) forfeiture of the benefits if a two-year noncompetition agreement was violated, (2) allowing a two-year rolling risk of forfeiture to delay vesting, and (3) using certain types of salary deferral arrangements to delay compensation payments to future years.

BONA FIDE SEVERANCE PLANS

Notice 2007-62 provides that future guidance will address what constitutes a bona fide severance pay plan that is exempt from the requirements of Code Section 457(f). Under the Notice, an arrangement is a bona fide severance pay plan if: (1) the benefit is payable only upon involuntary severance from employment, (2) the amount payable does not exceed two times the employee's annual rate of pay (taking into account only pay that does not exceed the maximum amount that may be taken into account under a qualified plan pursuant to Code Section 401(a)(17) for the year in which the employee terminates employment (or two times \$225,000 for 2007)), and (3) the plan provides that the payments must be completed by the end of the employee's second taxable year following the year in which the employee separates from service. With respect to the requirement that benefits be payable only upon involuntary severance from employment, the Notice provides that the Code Section 457 guidance will include exceptions for window programs, collectively bargained separation pay plans, and certain reimbursement or in-kind benefit arrangements. These anticipated rules will be almost identical to the rules that exempt certain involuntary separation pay plans from the provisions of Code Section 409A.

SUBSTANTIAL RISK OF FORFEITURE

Notice 2007-62 provides that the expected guidance will generally adopt the same rules for the definition of substantial risk of forfeiture under Code Section 457(f) as are contained in the final regulations defining substantial risk of forfeiture under Code Section 409A. The final regulations under Code Section 409A provide that a right to an amount of compensation is subject to a substantial risk of forfeiture if entitlement to the amount is conditioned on the performance of substantial future services or the occurrence of a condition that is related to a purpose of the compensation and the possibility of forfeiture is substantial.

Under the final regulations, deferred compensation is not subject to a substantial risk of forfeiture merely because the right to the deferred compensation is conditioned, directly or indirectly, upon refraining from the performance of services (a noncompetition agreement). In addition, under the final regulations, the addition of any risk of forfeiture after the right to the compensation arises, or the extension of a period during which compensation is subject to a risk of forfeiture (a “rolling risk of forfeiture”), is generally disregarded for purposes of determining whether the deferred compensation is subject to a substantial risk of forfeiture. If Code Section 457(f) plans are made subject to the same definition of substantial risk of forfeiture that is contained in the Code Section 409A final regulations, these commonly used deferral methods under Code Section 457(f) plans will no longer create a mechanism for deferral.

The final regulations under Code Section 409A also provide that deferred compensation is not subject to a substantial risk of forfeiture beyond the date or time when the recipient otherwise could have elected to receive the compensation, unless the present value of the amount that is subject to a risk of forfeiture is materially greater than the present value of the amount the recipient otherwise could have elected to receive absent the risk of forfeiture. This position is based on the assumption that a rational recipient would not agree to subject a right to current compensation to a real possibility of forfeiture. Accordingly, the Code Section 409A final regulations provide that an agreement to subject currently

payable compensation to a substantial risk of forfeiture indicates that the recipient of the compensation is confident that there is no real risk of forfeiture and that the purported risk of forfeiture is only a means of delaying taxation. Therefore, under the final regulations, compensation that an individual would have received if the individual had not made a salary deferral election generally cannot be made subject to a substantial risk of forfeiture beyond the date or time the salary would otherwise have been received. If this rule is applied to Code Section 457(f) plans, the common practice of using certain salary deferral agreements to defer taxation under Code Section 457(f) plans will no longer be allowed.

INTERACTION OF CODE SECTION 409A AND CODE SECTION 457(F)

Under the Code Section 409A final regulations, a deferral of compensation does not occur if a plan does not provide for a deferred payment and the service provider actually or constructively receives any payments within a relatively short period of time after the date the compensation is no longer subject to a substantial risk of forfeiture (the short-term deferral exception). Also under the Code Section 409A final regulations, the inclusion of an amount in income under Code Section 457(f) is treated as an actual payment of the compensation for purposes of the Code Section 409A short-term deferral rule. Therefore, if the Code Section 409A definition of substantial risk of forfeiture is applied to Code Section 457(f) plans, a substantial risk of forfeiture under Code Section 457(f) will lapse at the same time the substantial risk of forfeiture lapses under Code Section 409A. Because the Code Section 409A final regulations will treat the vesting event as an actual payment, if a participant in a Code Section 457(f) plan includes an amount in income when the amount is no longer subject to a substantial risk of forfeiture under Code Section 457(f), the amount generally will not be subject to Code Section 409A because the payment will qualify for the short-term deferral exception.

The Notice states, however, that the right to earnings on amounts that previously have been included in income under Code Section 457(f) will be deferred compensation for pur-

poses of Code Section 409A unless the right to the earnings independently satisfies the requirements for an exclusion from coverage under Code Section 409A. Because earnings on amounts held in Code Section 457(f) plans after the amounts become vested generally are not taxed until the amounts are actually distributed from the plan, any earnings that remain in a Code Section 457(f) plan after a vesting date will have to comply with the rules under Code Section 409A in order to avoid taxation and penalties. This issue can be avoided, however, if all amounts in the plan are actually paid to the participant within the short-term deferral period.

EFFECTIVE DATE AND RELIANCE

The Internal Revenue Service anticipates that the guidance described in the Notice will be prospective and that until guidance is actually issued, no inference should be made regarding either the definition of a bona fide severance pay plan or the definition of substantial risk of forfeiture for purposes of Code Section 457. The Notice does provide, however, that pending the issuance of actual guidance, taxpayers may rely on the definitions of a bona fide severance pay plan and substantial risk of forfeiture contained in Notice 2007-62. Comments are specifically requested as to the extent that transition guidance regarding the application of Code Section 457(f) would be necessary and appropriate, and what such transition guidance should provide.

The effective date for full compliance with the final Code Section 409A regulations is January 1, 2008. Therefore, employers who have Code Section 457(f) plans probably will be updating their plans to comply with the Code Section 409A final regulations before actual guidance is issued under

Code Section 457. Employers whose Code Section 457(f) plans will not comply with the anticipated guidance will be in the difficult situation of having to decide whether to change their plans to comply with the anticipated guidance by December 31, 2007, or whether to wait for actual guidance. Employers will also have to decide whether to continue to allow salary deferrals into their Code Section 457(f) plans and whether to continue to make employer contributions to their Code Section 457(f) plans. If contributions continue to be made to a Code Section 457(f) plan that does not satisfy the anticipated guidance and the anticipated guidance is actually issued, employers and employees will have to hope that reasonable transition rules will be provided.

LAWYER CONTACTS

For further information, please contact your principal Firm representative or one of the lawyers listed below. General e-mail messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

Michael K. Blais

1.214.969.4564

mkblais@jonesday.com

Marlene P. Frank

1.614.281.3843

mpfrank@jonesday.com

Sarah H. Griffin

1.213.243.2560

sgriffin@jonesday.com

Jones Day publications should not be construed as legal advice on any specific facts or circumstances. The contents are intended for general information purposes only and may not be quoted or referred to in any other publication or proceeding without the prior written consent of the Firm, to be given or withheld at our discretion. To request reprint permission for any of our publications, please use our "Contact Us" form, which can be found on our web site at www.jonesday.com. The mailing of this publication is not intended to create, and receipt of it does not constitute, an attorney-client relationship. The views set forth herein are the personal views of the authors and do not necessarily reflect those of the Firm.