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CAUTIONARY OBSERVATIONS FROM THE PROPOSED 457 REGULATIONS

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After more than nine years of deliberations, the IRS has finally released proposed regulations governing all types of deferred compensation plans maintained by non-profit organizations and governmental entities.

In issuing these regulations, the IRS reiterates its long-standing theme that these regulations are intended to work in harmony with, and be supplemental to, the 409A regulations. However, the IRS provides little guidance on how these regulations interact with each other. The following discussion focuses on 3 key aspects of the new guidance: the severance exemption, the substantial risk of forfeiture requirement, and leave programs.

As with the 409A regulations, the 457 regulations exempt severance pay plans from the rules and taxes applicable to deferred compensation. The 457 regulations apply similar criteria with one notable exception: they do not apply the 401(a)(17) compensation limit in determining the "two times" dollar cap on amounts that can be paid pursuant to an exempt severance pay plan. Practitioners in the for-profit arena currently believe they enjoy wide latitude in restructuring severance arrangements that are exempt from 409A. It would not appear that practitioners will have that same latitude for severance arrangements that are exempt from 457, unless the arrangements also satisfy the severance pay exemption under 409A, particularly with regard to the dollar cap limit.

Historically, the proposed 457 rules afforded greater flexibility with respect to what is considered a substantial risk of forfeiture, particularly in the context of non-competes and rolling risks of forfeiture. The regulations restrict, but do not eliminate this flexibility by establishing requirements that must be satisfied for non-competes and rolling risks of forfeitures to create a substantial risk of forfeiture. Despite the fact that there is wide latitude in restructuring short-term deferral arrangements in the for-profit arena, these restrictions will limit the ability to restructure short-term deferral arrangements when using non-competes or rolling risks of forfeiture without taking into consideration whether any restructuring would constitute a separate transgression of the 409A rules.

Finally, the proposed 457 regulations raise the possibility that many leave programs, especially those maintained by governmental entities, could be suspect as deferred compensation arrangements. A paid leave program may be considered suspect if it allows large amounts of leave to be accumulated over the course of many years. In our experience, this is not an uncommon design for many governmental and educational leave programs. If the IRS does not retreat from this position, many such employers may need to reassess the structure of their leave programs. The position taken in the proposed 457 rules might also give for-profit employers some pause as to whether the IRS might take a view that overly liberal leave programs may be subject to 409A requirements as deferred compensation.

Notwithstanding the long-awaited guidance afforded by these regulations, practitioners and plan sponsors would have welcomed greater guidance with respect to the interaction of the 409A and 457 rules. For instance, the rules could have better addressed where and how the 409A rules claw back some of the greater flexibility historically provided by the proposed 457 rules. In the absence of guidance, some of that greater flexibility may turn out to be illusory – and the IRS will have failed to adequately highlight the pitfalls that await those that rely upon the greater flexibility afforded 457 arrangements. Such failure to adequately address the interaction of the regulations raises some troubling questions and possible traps for the unwary.
