Higher Ed Institutions Operate in a Complex Deferred Compensation Landscape

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If a higher education institution that is exempt from federal income taxation wishes to provide deferred compensation to an executive or an executive-only group (generally referred to in the tax law as "nonqualified deferred compensation"), there are two separate Internal Revenue Code provisions that must be satisfied: (i) Code Section 409A, which generally governs the tax treatment of nonqualified deferred compensation no matter whether the employer is taxable or tax exempt, and (ii) Code Section 457, which imposes additional constraints on deferred compensation paid by tax exempt and governmental employers. The concept of nonqualified deferred compensation encompasses not only plans or agreements that deliver supplemental retirement benefits to an institution's executives, but to essentially any arrangement under which the institution obligates itself currently to pay compensation in a future year. For example, these two Code Sections also have potential application to long term incentive pay plans and to severance pay commitments of higher education institutions.

The Code Section 409A restrictions on nonqualified deferred compensation fall into three general categories: (i) deferral election restrictions, which essentially require that any choices the employee is given with respect to the time and form of a future payment of deferred compensation must be exercised at the time of entering into the deferral arrangement, (ii) distribution event restrictions, which essentially require that from the outset the future distribution of the deferred compensation has to be linked to the occurrence of one of several permitted distribution events (upon separation from service, at a specified time, upon death, upon disability, upon a change in control of the employer, or upon an unforeseeable emergency), and (iii) distribution acceleration restrictions, which generally provide that distributions cannot be accelerated to an earlier date than that laid down at the time the deferred compensation arrangement is initially put in place. Deferred compensation arrangements of taxable employers that have to comply with Code Section 409A, but that are not also subject to Code Section 457, can be, and frequently are, designed to have a compensation payment date that differs from the date the compensation is no longer subject to a substantial risk of forfeiture, i.e., the "vesting" date. For example, these plans of taxable employers are typically written to say that the employee is "vested" once the employee has completed X years of service, but the deferred compensation will then get paid when the employee quits working for the employer. This sort of design, separating the distribution event from the vesting event, is possible because in the case of taxable employers the taxability to the employee and the tax deductibility by the employer are based on the distribution timing, not on the vesting timing. As a result, an employee of a taxable employer covered by a nonqualified deferred compensation plan can earn or be awarded a vested right to a payment that will occur further out in the future, and the vesting event itself does not trigger any current income tax consequences for the employee.

The additional applicability of Code Section 457 to tax-exempt employers presents them, proverbially, with both a blessing and a curse. The blessing is that Code Section 457(b) authorizes the adoption by tax-exempt employers of what is called an "eligible 457(b) plan." In brief, an eligible 457(b) plan is a retirement accumulation program that the tax-exempt employer can establish solely for the benefit of its "top hat" executive group of employees, that can be established and operated in addition to (not in place of) any Code Section 401(a) or Section 403(b) plan that may cover these same employees, and that, in effect, enables the executive group to "double up" the amount of their annual tax deferred retirement savings if they fully take advantage of the eligible 457(b) plan and also the institution's 401(a) or 403(b) plan. If the tax-exempt employer is also a governmental entity (e.g., a state owned college), the limitation on the class of eligible employees for an eligible 457(b) plan to just a top hat executive group does not apply, so in those cases all employees could be eligible for the plan. Amounts paid to an executive under an eligible 457(b) plan are taxable to the executive when paid, just like amounts paid from a 401(a) and 403(b) retirement plan.

The accompanying curse of Code Section 457, however, is that any deferred compensation commitment that a tax-exempt employer makes that does not qualify as an eligible 457(b) plan becomes subject to the tax treatment rules of Code Section 457(f). Under Code Section 457(f), nonqualified deferred compensation commitments made by tax exempt employers are taxable to the employee when the amount to be paid is no longer subject to a substantial risk of forfeiture, i.e., when it "vests," even if the promised amount is not then payable to the employee. As a result of this Section 457(f) taxability timing rule, it is most commonly the case when a tax exempt employer makes a nonqualified deferred compensation commitment to an executive that the distribution event and the vesting event occur at the same time. Since the deferred amount is includable in the employee's federal taxable income when it vests, to not have it also then be distributable would create the hardship of the employee having to pay the income taxes on money that he cannot then draw on to cover the taxes.

As a further consequence of this 457(f) taxability timing rule, tax exempt employers have historically designed their nonqualified deferred compensation arrangements in creative and, some might say, aggressive ways in an effort to delay as long as possible the date when the deferred compensation becomes vested. One common such approach has been to make vesting subject to the employee's satisfaction of a multi-year non-competition agreement. Another has been the use of what is called a "rolling risk of forfeiture," where the vesting date is initially established as a given time, but then as that time draws near, and the executive is not ready to retire, the vesting date is automatically extended out for another fixed period. It is clear under Treasury regulations the IRS promulgated in 2007 under Code Section 409A that, for Section 409A purposes, these two sorts of purported vesting deferral mechanisms are ineffective and will be disregarded by the IRS. Further, the IRS in 2007 issued Notice 2007-62, in which it states that it intends to issue formal guidance to apply specifically to Code Section 457(f) deferred compensation arrangements defining what will constitute a substantial risk of forfeiture for 457(f) purposes. In that notice the IRS specifically cautions that the 457(f) guidance will follow the 409A regulations. As a result, tax-exempt employers are essentially on notice that many of the existing mechanisms that have been used to defer the vesting date under 457(f) arrangements will be disallowed prospectively, as soon as the promised 457(f) guidance is published.

Now is a prudent time for tax exempt higher education institutions to inventory the nonqualified deferred compensation plans, arrangements, agreements and other commitments of all sorts they may have in existence, and to assess whether any of them are in need of re-thinking or re-design, given the IRS's announced intention to extend the substantial risk of forfeiture rules in the Code Section 409A regulations and apply them to Code Section 457(f) arrangements.

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Mark A. Smith

Partner

Tel: (717) 399-1526

Email: msmith@barley.com