In today's competitive market for top executives, many colleges and universities use Section 457 deferred compensation plans as part of financial packages to attract and retain these executives. New guidance issued by the Internal Revenue Service requires that certain aspects of these plans be revised. Like other tax-exempt organizations that the new guidance covers, this memo will enable colleges and universities to prepare for the guidance and begin the process of making the appropriate design changes to conform with the evolving legal standards.

NEW IRS NOTICE 2007-62
In Notice 2007-62, the Internal Revenue Service (IRS) announced its intent to issue new guidance under Internal Revenue Code (IRC) Section 457(f) plans. These plans constitute nonqualified deferred compensation plans maintained by tax-exempt organizations and by state and local governments. Notice 2007-62 reports that the upcoming guidance will focus on two principal components of IRC Section 457(f): (i) the exemption from IRC Section 457(f) for bona fide severance pay plans (under IRC Section 457(e)(11)), and (ii) the definition of “substantial risk of forfeiture” (under IRC Section 457(f)(3)(B)). These issues are central to the design of many executive compensation programs in the tax-exempt employer realm. Notice 2007-62 reports that the new guidance on these issues will be patterned after similar guidance in the final IRC Section 409A regulations that were issued in April 2007.

NEW SEVERANCE PAY PLAN GUIDANCE
The upcoming guidance will provide that an arrangement will be exempt from IRC Section 457(f) as a bona fide severance pay plan only if all three of the following requirements are satisfied:

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, up to the IRC Section 401(a)(17) pay limit (the 2007 pay cap is two times $225,000, or $450,000); and,
3. The arrangement provides that all payments must be made by the end of the employee's second tax year following the year in which the employee separates from service.

DBGC Comments:
- Tax-exempt employers that use severance pay plans to provide supplemental pay for voluntary employment terminations (including retirement) will need to revise that strategy.
- For those tax-exempt employers that pay severance pay benefits only for involuntary employment terminations, amounts paid in excess of the “two times annual pay” limit (or in excess of two times the IRC Section 401(a)(17) limit, if less) will not be exempt from IRC Section 457(f) under the upcoming guidance and thus will be immediately taxable upon the termination event qualifying the employee for payment (since no substantial risk of forfeiture exists at that time for future payments). Amounts that do not exceed the pay limit will presumably remain exempt (per the IRC final Section 409A regulations) and thus will be not immediately taxable.
- To avoid both accelerated tax liability on higher payment levels and the administrative complexity of a program with two different tax results for different payment levels, tax-exempt employers will likely redesign their severance pay programs (even for involuntary terminations).
- Tax-exempt employers will also need to review the payment period for their involuntary termination severance programs to ensure that the program mandates that all payments be made by the two-year deadline in Requirement 3, above. Continuing health and welfare benefits are sometimes an issue in these cases, and the benefit payment period may need to be capped (or at least clarified in the document governing the program).
- Notice 2007-62 advises employers to expect the guidance to include window programs, collectively bargained separation pay plans, and certain reimbursement or in-kind benefit arrangements as involuntary termination programs for this purpose.
NEW SUBSTANTIAL RISK OF FORFEITURE GUIDANCE

IRC Section 457(f) benefits are taxable when they are no longer subject to a substantial risk of forfeiture. Notice 2007-62 advises tax-exempt employers that a number of rather popular IRC Section 457(f) features will not be considered to be subject to a substantial risk of forfeiture under the upcoming guidance. These include the following features:

1. Use of covenants not to compete to permit payment of the IRC Section 457(f) benefit (and thus avoid forfeiture of the benefit) in the event of voluntary terminations of employment (including retirement);

2. Use of a “rolling vesting” feature by which the employer and employee mutually agree to delay the vesting date by written election of the employee one year or more before vesting otherwise would have occurred; and,

3. Use of an employee deferral election to defer receipt of salary on a tax-deferred and forfeitable basis subject to a substantial risk of forfeiture.

DBGC Comment:
The features described here are included in the design of many IRC Section 457(f) plans. Tax-exempt employers should identify all plans with such features and consider design alternatives. One alternative is an employer incentive pay arrangement with cliff vesting and forfeiture of all amounts for voluntary employment termination (including retirement). Available alternatives to IRC Section 457(f) arrangements should also be considered, including after-tax arrangements (in light of likely future federal income tax rate increases), split dollar life insurance and leveraged after-tax bonus programs.

INTERPLAY OF SECTIONS 409A AND 457(f) UNDER UPCOMING GUIDANCE

Taxation of IRC Section 457(f) benefits when they cease to be subject to a substantial risk of forfeiture generally exempts such amounts from IRC Section 409A under the short-term deferred exception of the final 409A regulations. However, the right to future earnings on amounts previously taxed under IRC Section 457(f) would constitute deferred compensation under IRC Section 409A, unless the right to the earnings independently satisfies the requirements for an exclusion from coverage under IRC Section 409A. Such a separate exclusion is not likely to be available under most plans.

EFFECTIVE DATE OF FUTURE SECTION 457(f) GUIDANCE

Notice 2007-62 reports that the upcoming guidance is expected to apply on a prospective basis. Pending the issuance of the guidance, taxpayers are permitted to rely on the rules previewed in this notice. Comments concerning the definitions of bona fide severance pay plan and substantial risk of forfeiture are requested through October 15, 2007. Comments are also expressly requested on the issue of what transitional rules should be included in the upcoming IRC Section 457(f) guidance.

DBGC Comments:
The coming guidance will not be issued until after the comment period expires and likely not until very late in 2007 at the earliest. The deadline for amendments required to conform IRC Section 457(f) plans to IRC Section 409A is December 31, 2007. Tax-exempt employers will generally prefer to make both their IRC Section 457(f) and IRC Section 409A design changes simultaneously by the year-end 2007 409A deadline. With the attendant approval process required to achieve the rebuttable presumption of reasonableness under the intermediate sanctions rules of IRC Section 4958, the IRC Section 409A redesign process will need to begin soon (if not already) to complete the process by year-end.

Many tax-exempt employers will want to defer their IRC Section 457(f) redesigns until the eventual issuance of the upcoming IRC Section 457(f) guidance to determine how the guidance is affected by the taxpayer comment process noted previously. These employers may be faced with two successive IRC Section 457(f) redesigns: one starting soon (or already begun) under IRC Section 409A to meet the December 31, 2007 deadline under IRC Section 409A, and a second reflecting the new IRC Section 457(f) guidance in very late 2007 or in 2008. The inefficiencies inherent in this two-step redesign process are likely more than offset by the lingering uncertainty as to possible further changes in the upcoming IRC Section 457(f) guidance.
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