



Compensation Insight

Staying Ahead of the Game with Your 457(f) Plan

With the passing of Section 409A of the Internal Revenue Code last fall, the spotlight has turned to 457(f) plans and the definitions of “substantial risk of forfeiture” used for deferral purposes. As a result, the viability and usefulness of 457(f) plans as effective deferral and retention devices has become an open question.

While the IRS has not issued new guidance specific to 457(f) plans, it has become clear that:

- As part of the exempt organization audit initiative, the IRS has been scrutinizing substantial risks of forfeiture—particularly noncompetes and rolling vesting—used in 457(f) plans
- Section 409A excludes rolling vesting and noncompete concepts from its definition of substantial risks of forfeiture
- Informal discussions with certain IRS officials have indicated that the definition of a substantial risk

of forfeiture in §409A and §457(f) should be the same

This suggests that any 457(f) plan that uses rolling vesting or a noncompete concept may not fulfill the substantial risk of forfeiture requirement. Plan sponsors bear the burden of proving that the risk of forfeiture is substantial for tax deferral.

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The Continued Use of Noncompetes

The IRS position on audit over the past several months has been to:

- Disallow the noncompete as a substantial risk of forfeiture
- Provide tax-exempt employers two options:
 - Terminate the 457(f) plan and distribute deferred compensation plus earnings as taxable income
 - Continue the plan with a cliff vesting schedule: Current participants are given a one-time election to defer compensation for a period they select
- Assess a sanction equal to the amount deferred over the three years audited, less the amount elected for deferral (for a minimum of two years), multiplied by the highest individual tax rate

Switching to a cliff vesting schedule will ease plan administration but dramatically reduce the plan's attractiveness to participants. In the past, there was always an opportunity to save deferrals from forfeiture by satisfying the noncompete.

At SullivanCotter and GCD, we recommend that tax-exempt employers fully understand the risk of continuing to use noncompete concepts in their 457(f) plans. Some noncompetes will suffice as acceptable substantial risks of forfeiture so long as they meet the §83 defini-

tion, i.e., represent truly meaningful restrictions on employees' business activities (are very facts-and-circumstances specific). It is likely the IRS will attempt to disallow the same noncompete for groups of employees, unless the employer can prove such an arrangement is sufficient.

The Continued Use of Rolling Vesting

There are two schools of IRS thought on rolling vesting. One believes rolling vesting never represented a substantial risk of forfeiture and should be eliminated. The other feels that it can be utilized with changes to the way the concept is structured.

Either way, rolling vesting is under scrutiny and the IRS has informally indicated that it will begin disallowing its use. Unfortunately, the IRS was unwilling to discuss the ramifications with us. Based on our experience with noncompetes, the IRS is likely to offer a cliff vesting schedule as the alternative and apply similar sanctions as for noncompetes.

At SullivanCotter and GCD, we hesitate to advise our tax-exempt clients to close these plans when they might obtain tax deferral for a number of years. Right now, we suggest that tax-exempt employers look closely at the risks of employing a rolling vesting concept in their 457(f) plans. If the employer can

determine another substantial risk of forfeiture definition to use for future 457(f) deferrals, we suggest the change be made.

457(f) Plan Trends

If and when the IRS issues guidance on substantial risks of forfeiture for 457(f) plans, it may grandfather current 457(f) plans or apply the new rules retroactively. With this uncertainty, it is difficult to develop strategic plans at this time.

This creates a real dilemma. An employer does not want to terminate and distribute the assets of a 457(f) plan, triggering taxation for all participants, if the IRS grandfathers existing plans. At the same time,

while waiting for IRS guidance, an employer could be selected for audit and have large sanctions assessed.

Over the past few months, some large tax-exempt organizations have frozen their 457(f) plans, awaiting IRS guidance or substituted after-tax defined contribution plans. This eliminates the need for substantial risk of forfeiture, as amounts are taxable in the year in which they are contributed.

For more information on substantial risks of forfeiture and addressing them within your 457(f) plans, contact a SullivanCotter consultant or your GCD attorney today.

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About SullivanCotter

SullivanCotter specializes in developing and implementing total compensation and reward programs for a variety of organizations, and helping with specific compensation needs. A leader in benchmarking, SullivanCotter has developed some of the top compensation surveys in the United States. SullivanCotter has offices in Atlanta, Chicago, Detroit, New York, Parsippany, and Westport

SullivanCotter's compensation consulting services include:

- Compensation philosophy and strategy development
- Compensation program design and benchmarking
- Total compensation and best practice audits and board advisory services
- Base pay programs for executives, managers, and staff
- Physician compensation
- Employee recognition and reward systems
- Executive benefits and perquisites
- Total compensation reasonableness opinions
- And much more

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About Gardner Carton & Douglas

Because of their distinct treatment under the Internal Revenue Code and ERISA, tax-exempt organizations face different benefit design challenges than for-profit organizations. GCD has one of the largest tax-exempt practices in the country, and our experience in dealing with the special concerns of the tax-exempt entity is far-reaching.

GCD legal services include:

- Executive employment agreements, severance pay agreements and retention agreements
- Counseling on the "rebuttable presumption of reasonableness" and intermediate sanctions rules
- Analyzing and designing deferred compensation arrangements (including 457(b) "eligible" plans, 457(f) ineligible plans and split-dollar life insurance arrangements)
- Legal compliance review of compensation arrangements
- Designing effective "substantial risk of forfeiture" provisions for 457(f) arrangements
- Advising clients as to how to report properly on the Form 990 all forms of compensation and benefits for officers, directors and key employees

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