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TAX EXEMPT EMPLOYERS MUST TAKE A LOOK AT THEIR DEFERRED COMPENSATION ARRANGEMENTS IN 2018

By Alan Hahn and Gabrielle White

Many employers sponsor nonqualified deferred compensation arrangements ("NQDCs") for their key employees. The last time many employers reviewed their NQDCs was following the publication of final regulations under Section 409A of the Internal Revenue Code (the "Code"). However, two recent legal changes affecting NQDCs of tax exempt entities mean that a review would be timely. Specifically, in 2016 the IRS released proposed regulations under Section 457(f) of the Code, which address NQDCs of tax exempt entities. Additionally, under the Tax Cuts and Jobs Act, compensation in excess of $1 million to certain employees of tax exempt entities is subject to a 21 percent excise tax. In determining whether the $1 million threshold has been met, only compensation that is no longer subject to a substantial risk of forfeiture under Section 457(f) is counted. Below is an overview of these requirements.

NQDCs of all companies, whether tax exempt or for-profit, are subject to the requirements under Section 409A. However, tax exempt entities are also subject to Section 457(f), which sets out the requirements for deferred compensation for employees of tax exempt entities. Unlike for-profit companies, where amounts deferred under NQDCs are subject to taxation when paid, amounts deferred under NQDCs sponsored by tax exempt entities are subject to taxation when they are no longer subject to a substantial risk of forfeiture. For this reason, most NQDCs of tax exempt entities are structured to pay out amounts immediately upon vesting (so-called "vest and pay" arrangements). Thus, the definition of substantial risk of forfeiture under Section 457(f) is crucial for tax exempt entities.

Even though this definition is essential, the IRS guidance on what constituted a substantial risk of forfeiture for purposes of Section 457(f) was limited prior to the passage of the proposed regulations. Instead, practitioners often relied on guidance issued under Section 409A. However, the proposed regulations provide a broader definition of substantial risk of forfeiture than Section 409A, providing an opportunity for many tax exempt entities to draft plans with greater flexibility and creativity. In particular, tax exempt employers should be aware that (i) compliance with a covenant not to compete **is** a substantial risk of forfeiture; and (ii) "rolling vesting" is permitted, as described below.

the employer would suffer if the employee competed. If the above factors are satisfied, then the covenant not to compete can act as a substantial risk of forfeiture under Section 457(f), such that deferred amounts would not be subject to taxation until the end of the noncompetition period.

The proposed regulations under Section 457(f) also allow a substantial risk of forfeiture to be extended (commonly referred to as "rolling vesting") if the following conditions are satisfied:

"The definition of substantial risk of forfeiture under Section 457(f) is crucial for tax exempt entities."

In regard to using a covenant not to compete as a vesting event, such agreement can be used under Section 457(f) if the following conditions are satisfied:

- The agreement must be in writing and enforceable under applicable law (This means, for example, that use of a covenant not to compete will not be available in California.);
- The employer must have a substantial and bona fide interest in preventing the employee from performing the prohibited services;
- The employee must have a bona fide interest in, and ability to, engage in the prohibited competition; and
- The employer must make reasonable ongoing efforts to verify the employee's compliance with a covenant not to compete (This includes the employer's practice of enforcing covenants generally.).

Whether a covenant not to compete constitutes a substantial risk of forfeiture will depend on the specific facts and circumstances. Factors to be considered include the employee's age (If the employee is approaching retirement, it is less likely that he or she has a bona fide interest in competing.), the marketability of the employee, and the degree of harm

- The present value of the amount to be paid at the end of the extension is at least 125 percent of the amount the participant would have received without the extension;
- The extension must be based on the future performance of substantial services or compliance with a noncompete agreement that meets the above requirements;
- The requirement to perform substantial services must be for at least two years, except in the event of death, disability, or an involuntary termination; and
- The agreement extending the substantial risk of forfeiture must be made in writing at least 90 days before the date when the deferred amount would have vested absent the extension.

Additionally, the passage of the Tax Cuts and Jobs Act is a good reminder for all companies to review their current compensation strategies. Tax exempt entities should take another look at their NQDCs, in light of the proposed regulations under Section 457(f) and the recent tax legislation, and determine whether changes to their plans would be beneficial to them and their executives.