Coping with the Interaction of § 409A, § 457 and Form 990 Reporting Obligations

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David W. Powell
Groom Law Group, Chartered
Washington, D.C.

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How we got here

- Section 457 – generally effective 1979 for state and local governments, extended to tax-exempt organizations by TRA ’86.
- Section 409A – enacted in 2004 effective 2005, but with various grandfathers and transition relief, so that final regulations were not fully effective until January 1, 2009
- Form 990 changed substantially for the 2008 year – generally due 15th day of the 5 month after year ends (May 15 for a calendar year filer)

Section 457 – what does it do?

- Unless a deferred compensation plan is exempt, the plan must meet § 457(b), or it will be taxable under § 457(f)
  - 401(a)/401(k),SEP, SIMPLE, 403(b), 415(m) plans are all exempt from 457
    - That essentially leaves “nonqualified” plans
  - 457(b) plans are similar to 401(k) plans in some ways, but are nonqualified – and therefor are structured around constructive receipt concerns
    - That is why the distribution rules are more restrictive than 401(k) plans, and 457(b) plans of tax-exempt employers must be unfunded
    - Plans of tax-exempt employers must be “top hat” (for a select group of management or highly compensated employees) in order to be exempt from ERISA (compliance with which would be problematic)
    - Governmental 457(b) plans were similar to tax-exempt employer 457(b) plans (except for top-hat restriction) until the SBJPA of 1996

Governmental and church 457 plans

- We will not discuss them much because:
  - Church plans do not have to be top hat since a separate exemption from ERISA applies, but churches also usually don't file 990s
  - Most churches are not subject to § 457 – only separate church-related entities which are not churches or qualified church controlled organizations under § 3121(w)(3)(A) and (B) are subject to § 457 (§ 457(e)(13))
    - That generally includes church-controlled hospitals, colleges, universities and nursing homes
    - What is the "general public" and existence of government grants may raise issues for other types of separate church controlled organizations
  - Under SBJPA '96, governmental 457(b) plans were essentially converted from a nonqualified type of arrangement to a qualified type of arrangement. Distribution rules for such plans were generally conformed to the 401(k) rules. This was largely in reaction to the Orange County bankruptcy of 1994
  - Also, governmental entities don't file 990s
  - Intentional governmental 457(f)s are rare

What are the exemptions from § 457?

- In addition to the qualified plans previously referred to, 457 also exempts:
  - *Bona fide* vacation leave, sick leave, compensatory time, severance pay, disability pay and death benefit plans (§ 457(e)(11))
  - Plans paying solely "length of service" awards to bona fide firefighting, fire prevention, EMS and ambulance services, not to exceed $3000
  - Certain voluntary early retirement incentive plans and employment retention plans for schoolteachers and their unions (§ 457(e)(11)(D), (f)(2)(F))
    - In response to TAM 199903032, which had held an early retirement incentive plan for teachers not to be severance pay under § 457(e)(11) since not involuntary, and not subject to a SRF and immediately taxable under § 457(f) at the age the teacher qualified for the payments
  - Nonelective deferred compensation attributable to services not performed as an employee, if all individuals with the same relationship to the payor are covered under the same plan with no individual variations or options under the plan (e.g., members of the PGA Tour) (§ 457(e)(12))
  - Transfers of property subject to § 83 (§ 457(f)(2)(C)

Comparing the § 457 and § 409A exemptions

- Statutory § 409A exemptions generally parallel those of § 457(e)(11) *except for* severance pay
  - Probably due to perception that the § 457 severance pay exception had been abused by tax planners
- But final regulations under § 409A added an exception for certain severance arrangements, subject to fairly strict limits

409A separation pay plan exemption

- Unless short term deferral exemption applies (discussed below), may pay only on involuntary separation or under a window program
  - Facts and circumstances, but characterization in documents sets up a rebuttable presumption
    - Note trap for unwary in separation agreements
  - Separations "for good reason" may be treated as involuntary
    - Regulations provide a safe harbor definition of "good reason"
  - Non-renewal of a contract may be involuntary separation "where the service provider was willing and able to continue performing services"
  - Must meet § 409A reg definition of separation pay plan:
    - Separation pay generally may not exceed 2 times the lesser of annualized compensation based on annual rate of pay for taxable year of employee preceding year of separation, or the § 401(a)(17) limit ($245,000 for 2009)
    - Must be paid no later than last day of second taxable year following year of separation
  - Window program also defined in the § 409A regs
    - Cannot exceed 12 months; must not be part of a "pattern of repeatedly providing for similar separation pay in similar situations for substantially consecutive, limited periods of time"

Taxation under § 457(f) – what is a substantial risk of forfeiture?

- **Section 457(f)(3): SRF exists "if such person's rights to such compensation are conditioned upon the future performance of substantial services by any individual" (see also Reg. § 1.457-11)**
  - Common attempts at workarounds, pre-409A:
    - Noncompete agreements
    - Consulting agreements
    - Rolling risks of forfeiture
    - Severance pay plans with easy triggers
    - Split dollar life insurance as a purported death benefit plan (largely eliminated due to changes in taxation of split dollar – see Reg. § § 1.61-22 and 1.7872-15 in 2003)
    - Mutual fund stock options (if granted before 5/8/02 – see Reg. § 1.457-12) (also will not meet §409A exception for stock options)
  - IRS long skeptical of these
    - See, e.g., past IRS Continuing Professional Education materials for its agents on Exempt Organizations

After-tax 457(f) plans

- Sometimes used to avoid tax issues
- Significant advantage remains in that earnings credited on amounts taxed under § 457(f) are not taxed until paid so long as not funded, under the § 72 rules for recovery of investment in the contract (Reg. § 1.457-11(a)(3))

Why is a substantial risk of forfeiture also important for § 409A?

- Definition of deferred compensation
  - "determined at the time the service provider obtains a legally binding right to the compensation" (Reg. § 1.409A-1(a)(1))
  - A "legally binding right" is not the same as not having a SRF: a LBR may exist even though compensation "may be reduced or eliminated by operation of the objective terms of the plan, such as the application of a nondiscretionary, objective provision creating a substantial risk of forfeiture" (Reg. §1.409A-1(b)(1))
- "Short term deferral" (STD) exception to § 409A:
  - Must be paid on or before 15th day of 3rd month from later of:
    - the end of the 1st taxable year of the employee in which the right to payment is no longer subject to a SRF, or
    - the end of the 1st taxable year of the employer in which the payment is no longer subject to a SRF (Reg. §1.409A-1(b)(4))

Substantial risk of forfeiture under § 409A

- "conditioned on performance of substantial future services by any person or the occurrence of a condition related to a purpose of the compensation, and the possibility of forfeiture is substantial" (Reg. § 1.409A-1(d))
  - Not SRF "merely because .. conditioned upon the *refraining* from the performance of services"
- Elections to defer salary not subject to a substantial risk of forfeiture unless the PV of the amount subject to SRF is "materially greater" than the PV of the amount the employee otherwise could have elected to receive
  - Note that this also effectively precludes traditional "rolling risks of forfeiture"

Issues raised by comparing § 457(f) SRF and § 409A SRF

- Can elective contributions/rolling risks of forfeiture be considered subject to a SRF unless there is an additional "match"?
  - No under § 409A – will § 457(f) have the same rule?
- Will noncompete agreements suffice as a SRF?
  - No under § 409A – § 457(f)?
- IRS Notice 2007-62 – suggests IRS will conform § 457(f) and § 409A SRF rules, but asked for comments

Consulting agreements and 457(f)/409A

- Section 409A does not distinguish between employment and independent contracting/consulting for purposes of determining a "separation from service" for distribution purposes
  - Note: 409A regulations have a detailed definition of "separation from service", which generally requires a substantial drop in amount of services performed, e.g., no more than 20% of prior level (Reg. § 1.409A-1(h))
- Thus, even if the vesting condition is substantial enough to be a SRF, payment cannot be made on account of separation from service under § 409A until consulting ends
  - Prior § 457(f) workaround efforts typically attempted to commence installment payments upon changing from employee to IC, but not tax any installment until paid
- Alternatively, plan can pay upon specified dates, subject to performance of substantial consulting services for each payment as a SRF, then make each payment under the STD rule as the SRF on each payment lapses
  - Again, assuming the consulting services are substantial and bona fide

Section 409A rules on distributions

- When can amounts be paid under § 409A?
  - Specified date
  - Death
  - Disability
  - Separation from service
  - Unforeseeable emergency
  - Change in control of a corporation
    - Note: the preamble to the final 409A regulations provides some guidance how this applies to non-stock tax exempt organizations, but it remains unclear
  - 409A regulations provide certain other limited exceptions
- Elections to defer further
  - Can be made if, generally, made 1 year before the amount would otherwise be paid, is not effective for 1 year, and additional deferral is to a time at least 5 years later than when the amount would otherwise be paid (Reg. §1.409A-2(b))
  - Note that this is not for purpose of the definition of a "substantial risk of forfeiture," but is only a permissible election of a date of payment – thus, does not affect time of taxation

Anticipated IRS guidance on coordinating § 457(f) and § 409A

- IRS Notice 2007-62 – guidance on interaction of § 457(f) and § 409A is on the way
- Suggests that severance pay exceptions may be made parallel
- Any difference in what is a substantial risk of forfeiture?
  - Elective deferrals a particular concern
  - Will other contingent events besides performance of future services be allowed?
  - Will noncompete agreements clearly not qualify?
- Definition of death benefit plan
  - Reg. §1.409A-1(a)(5) cross-references the definition in the § 3121(v) regulations ("Payments … in the event of death are death benefits … only to the extent the total benefits payable under the plan exceed the lifetime benefits payable under the plan.")
- Any transition relief to fix nonconforming plans?

Coordinating 457(f) plans with the § 409A rules

- Pre-§ 409A 457(f) plans subject to a SRF commonly paid out shortly after no longer subject to SRF, since PV taxable at that point
  - This would typically work within the STD exemption under § 409A
- SRFs may, however, need to be conformed to the § 409A definitions, depending upon IRS guidance
  - Most likely to affect rolling risks of forfeiture, elective plans, plans subject to noncompete agreements
- Where 457(f) plan payments are not made within the STD rule, (e.g., after-tax 457(f) plans that pay upon a specified date or upon separation from service, deferring taxation only on earnings), time and form of payment must conform to § 409A
  - Section 409A regs allow acceleration of payment of amount equal to federal, state and local withholding taxes due to 457(f) (see, Reg. § 1.409A-3(j)(4)(iv))

Deferred compensation on the Form 990

- Prior years: Part V of Form 990 (V-A for current officers directors trustees and key employees, V-B for former) and Schedule A (for certain other highly paid employees) had a Column (D) for "Contributions to employee benefit plans & deferred compensation plans". According to the instructions, these are to show "all cash and noncash compensation" and in Column (D), "all forms of deferred compensation and future severance payments (whether or not vested; and whether or not the deferred compensation plan is a qualified plan under section 401(a))" (see 2007 Instructions to the Form 990, pp. 40-41)
- 2008 Form 990 is more specific

The 2008 Form 990

- Overriding concept appears to be providing information on the economic value of the accrual earned in the reporting period
- "If the payment of an amount of deferred compensation requires the employee to perform services for a period of time, the amount is treated as accrued or earned ratably over the course of the service period, *even though the amount is not funded and may be subject to a substantial risk of forfeiture until the service period is completed*."
  - Instructions to Schedule J of the Form 990 (emphasis added)

2008 Form 990, cont'd

- Has a new Part VII, Section A and a Schedule J, Part II, each with multiple "columns"
- All deferred compensation essentially reported in one of two ways:
  - Reported on Part VII.A.(F) ("Estimated amount of other compensation from the organization and related organizations" and Sched. J.II.C ("Deferred Compensation"):
    - 401(a)/403(b) nonelective employer contributions (DC)
    - 401(a) DB accruals
    - NQ plan DB accruals
    - NONVESTED contributions to a NQ plan
    - NONVESTED amounts under 457(b) [Note: vesting in a 457(b) is rare due to effect on annual limit)
  - Reported on Part VII.A.(D) ("Reportable compensation for the organization") or (E) (same but from a related organization) and Sched. J.II.B(iii) ("Other Reportable Compensation"):
    - 401(k)/403(b) elective contributions (DC)
    - Amounts includible in income under 457(f)
    - VESTED contributions to NQ plans [Note: for a 457(f) plan, this should be the same as when included in income]
    - VESTED amounts deferred under 457(b) [Note: normally, this would be all 457(b) deferrals]
    - Split dollar life insurance

2008 Form 990 specific rules, cont'd

- What is the distinction? Appears to depend upon whether it is also reported on a W-2 or 1099-MISC
- Taxable distributions from 401(a)/403(b) plans reported on 1099-R: not reported
- Distributions from 457(b) plans: not reported
- Earnings (qualified plans): not reported
- Earnings (nonqualified plans):
  - NQ DC earnings not reported (pp 22, 25 of instructions)
  - Another entry on p. 26 of instructions states increase in NQ earnings reported in the second manner, but instructions to Sched J suggest that this is referring to reporting an actuarial increase under a DB plan
- $10,000 de minimis reporting rule generally does not apply to (F) and (D) column reporting – see 990 instructions

Some 990 issues

- Distributions from NQ/457(f) plans not addressed, but presumably not reportable as should have been previously reported as contributed/accrued
- Any changes in method of reporting of NQ/457(f) plans from 2007 to 2008 (or anything else that stands out) can be explained in the Supplemental Information section of Schedule J
- Somewhat contradictory chart in 990 instructions as to whether to report NQ earnings, but rule appears to be that they are only reported for DB plans per Schedule J instructions
- Estimating DB accruals for a DB NQ/457(f) plan: ("reasonable estimate of increase in actuarial value" – Instructions to Form 990, p. 25)
- Future instructions may revise how reporting ties into the W-2 and 1099-MISC as reporting of NQ compensation on those evolves