

Part III – Administrative, Procedural and Miscellaneous

Excluded Bona Fide Severance Pay Plans Under § 457(e)(11) and Amounts Subject to a Substantial Risk of Forfeiture Under § 457(f)

Notice 2007-62

I. PURPOSE

This notice announces the intent of the Treasury Department (Treasury) and the Internal Revenue Service (Service) to issue guidance under § 457, which applies to nonqualified deferred compensation plans of state and local governments and tax-exempt entities, concerning the definitions of a bona fide severance pay plan under § 457(e)(11) and concerning the definition of substantial risk of forfeiture under § 457(f)(1)(B). This notice also describes the guidance that the Treasury and the Service anticipate issuing, which in many respects would be similar to the rules in the recent final regulations under § 409A, and requests comments on the issues intended to be addressed by such guidance.

II BACKGROUND

Section 457 applies to nonqualified deferred compensation plans established by state and local government and tax-exempt employers. Three types of nonqualified deferred compensation plans are subject to § 457: (1) an eligible § 457(b) plan established by a state or local government employer; (2) an eligible § 457(b) plan established by any other tax-exempt entity that is not a governmental entity; and (3) any

other deferred compensation plan established by either type of employer (an ineligible nonqualified deferred compensation plan). An ineligible nonqualified deferred compensation plan is subject to § 457(f). Section 457(f)(3)(A) provides that the term plan includes any agreement or arrangement.

Section 457(e)(11) states that § 457 does not apply to certain types of plans, including a bona fide severance pay plan. Section 457(f)(2) provides that the rules of § 457(f) do not apply to a qualified plan under § 401(a) or § 403(a), a § 403(b) annuity, a nonqualified annuity described in § 403(c), that portion of any plan which consists of a transfer of property described in § 83, that portion of any plan which consists of a trust to which § 402(b) applies, a qualified governmental excess benefit arrangement described in § 415(m), or that portion of any applicable employment retention plan described in § 457(f)(4).

Section 457(f)(1) provides that compensation under a nonqualified deferred compensation plan subject to § 457(f) is included in the gross income of the participant or beneficiary for the first taxable year in which there is no substantial risk of forfeiture of the rights to such compensation. Section 457(f)(3)(B) provides that the rights of a person to compensation are subject to a substantial risk of forfeiture if such person's rights to such compensation are conditioned upon the future performance of substantial services by any individual. Any amount deferred under a § 457(f) plan that is not subject to a substantial risk of forfeiture (i.e., a vested amount) is currently included in gross income (even if not actually or constructively received), and the amount subsequently paid or made available is taxed under § 72. See § 1.457-11(c).

Section 409A applies to ineligible nonqualified deferred compensation plans maintained by tax-exempt and governmental employers, as well as to nonqualified deferred compensation plans maintained by taxable employers. Section 409A generally provides that, unless certain requirements are met, amounts deferred under a nonqualified deferred compensation plan for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income. Section 409A(d)(4) provides that the rights of a person to compensation are subject to a substantial risk of forfeiture if such person's rights to such compensation are conditioned upon the future performance of substantial services by any individual.

Section 409A does not apply to qualified plans (as defined under § 219(g)(5), without regard to subparagraph (A)(iii) thereof), eligible deferred compensation plans under § 457(b), or qualified governmental excess benefit arrangements described in § 415(m). See § 1.409A-1(a)(2). However, § 409A applies to nonqualified (ineligible) deferred compensation plans to which § 457(f) applies, separately and in addition to the requirements applicable to such plans under § 457(f). See § 1.409A-1(a)(4). Section 409A(c) provides that nothing in § 409A prevents the inclusion of amounts in gross income under any other provision of the Code or any other rule of law earlier than the time provided in § 409A. Section 409A(c) further provides that any amount included in gross income under § 409A is not required to be included in gross income under any other Code provision or any other rule of law later than the time provided in § 409A.

Final regulations under § 409A were published on April 10, 2007 (72 FR 19234) and generally become applicable January 1, 2008.¹ Those regulations provide guidance on when a separation pay plan (as defined in § 1.409A-1(m)) is treated as not providing for a deferral of compensation for purposes of § 409A. See § 1.409A-1(b)(9). The regulations also define a substantial risk of forfeiture for purposes of § 409A. See § 1.409A-1(d).

III. BONA FIDE SEVERANCE PAY PLANS UNDER § 457(e)(11)

The Treasury and the Service anticipate issuing guidance providing that an arrangement is a bona fide severance pay plan under § 457(e)(11), and thus is not subject to the requirements of § 457, if: (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 (taking into account only pay that does not exceed the maximum amount that may be taken into account under a qualified plan pursuant to § 401(a)(17) for the year in which the employee has a severance from employment), and (3) the plan provides that the payments must be completed by the end of the employee's second taxable year following the year in which the employee separates from service. With respect to the requirement that benefits be payable only upon involuntary severance from employment, it is anticipated that the guidance would include exceptions for window programs, collectively bargained separation pay plans, and certain reimbursement or in-kind benefit arrangements (similar to the exceptions in § 1.409A-1(b)(9)(ii), (iv), and (v)).

¹ For general and transition guidance regarding the application of § 409A, see Notice 2005-1, 2005-2 CB 274, and Notice 2006-79, 2006-43 IRB 763. See also Notice 2006-100, 2006-51 IRB 1109, which provides guidance to employers and payers on their reporting and wage withholding for calendar years 2005 and 2006 with respect to deferrals of compensation and amounts includible in gross income under § 409A.

IV. SUBSTANTIAL RISK OF FORFEITURE UNDER § 457(f)

The Treasury and the Service further anticipate issuing guidance regarding a substantial risk of forfeiture for purposes of § 457(f)(3)(B) under rules similar to those set forth under § 1.409A-1(d).

Section 1.409A-1(d) provides that a right to an amount of compensation is subject to a substantial risk of forfeiture if entitlement to the amount is conditioned on the performance of substantial future services or the occurrence of a condition that is related to a purpose of the compensation and the possibility of forfeiture is substantial. For this purpose, if a service provider's entitlement to the amount is conditioned on the occurrence of the service provider's involuntary separation from service without cause, the right is subject to a substantial risk of forfeiture if the possibility of forfeiture is substantial. An amount is not subject to a substantial risk of forfeiture merely because the right to the amount is conditioned, directly or indirectly, upon refraining from the performance of services. Further, as described in § 1.409A-1(d)(1), the addition of any risk of forfeiture after the right to the compensation arises, or any extension of a period during which compensation is subject to a risk of forfeiture (sometimes referred to as a "rolling risk of forfeiture"), is generally disregarded for purposes of determining whether such compensation is subject to a substantial risk of forfeiture under § 409A.

Section 1.409A-1(d)(1) provides that an amount is not considered subject to a substantial risk of forfeiture beyond the date or time at which the recipient otherwise could have elected to receive the amount of compensation, unless the present value of the amount made subject to a risk of forfeiture is materially greater than the present value of the amount the recipient otherwise could have elected to receive absent such

risk of forfeiture. This is because, absent tax considerations, a rational participant normally would not agree to subject a right to amounts that may be earned and payable as current compensation, such as salary payments, to a condition that subjects the right to the same payments to a real possibility of forfeiture. Accordingly, in this situation, agreement to subject the amount to a substantial risk of forfeiture indicates that the recipient of the compensation is confident that there is not a real risk of forfeiture and is only subjecting the amount to the purported risk of forfeiture as a means of avoiding taxation. Thus, amounts that an individual could have elected to receive under a salary deferral election generally cannot be made subject to a substantial risk of forfeiture under the rules of § 409A beyond the date or time the salary would otherwise have been received.

The Service and Treasury anticipate that upcoming guidance under § 457(f) will generally adopt the rules relating to substantial risk of forfeiture that are contained in § 1.409A-1(d).

As noted above, § 1.409A-1(d) provides that an amount of compensation is subject to a substantial risk of forfeiture if the entitlement to the amount is conditioned upon the occurrence of a condition related to a purpose of the compensation, and the possibility of forfeiture is substantial. Section 1.409A-1(d) further provides that a condition related to a purpose of the compensation must relate to the service provider's performance for the service recipient or the service recipient's business activities or organizational goals (for example, the attainment of a prescribed level of earnings or equity value of completion of an initial public offering). Comments are requested on whether any special rules should apply for purposes of § 457(f) with respect to this

aspect of the definition of a substantial risk of forfeiture, taking into account that state and local government and tax-exempt entities to which § 457(f) applies generally do not have business activities or organizational goals that are comparable to profit-making entities.

V. INTERACTION OF §§ 409A AND 457(f) UNDER ANTICIPATED STANDARDS

Under the rules at § 1.409A-1(b)(4)(i) relating to short-term deferrals, a deferral of compensation for purposes of § 409A does not occur if the plan under which a payment is made does not provide for a deferred payment and the service provider actually or constructively receives such payment on or before the first day of the applicable 2 ½ month period. Under § 1.409A-1(a)(4), the inclusion in income of an amount under § 457(f) is treated as a payment of the amount for purposes of the short-term deferral rule contained in § 1.409A-1(b)(4).

If the standard for a substantial risk of forfeiture for purposes of § 409A described in Part IV of this notice is adopted, a substantial risk of forfeiture under § 457(f)(1)(B) could not lapse later than the date the substantial risk of forfeiture lapsed under § 409A and § 1.409A-1(d). Accordingly, if a participant under an ineligible plan under § 457(f) included an amount of deferred compensation in gross income when it ceased to be subject to a substantial risk of forfeiture under § 457(f), the amount generally would not be subject to § 409A because the right to the amount and the payment would qualify as a short-term deferral under § 1.409A-1(a)(4). However, the right to earnings on amounts that have previously been included under § 457(f) would be deferred compensation for purposes of § 409A unless the right to the earnings independently satisfied the requirements for an exclusion from coverage under § 409A.

VI. EFFECTIVE DATE AND RELIANCE

The Treasury and the Service anticipate that the guidance described in this notice would be prospective. With respect to periods before such guidance is issued, no inference should be made from the anticipated guidance described in this notice regarding either the definition of a bona severance pay plan for purposes of § 457(e)(11)(A)(i) or the determination of substantial risk of forfeiture for purposes of § 457(f). However, pending the issuance of further guidance, taxpayers may rely on the definition of a bona fide severance pay plan in the anticipated guidance described in section III of this notice for purposes of § 457(e)(11)(A)(i) and the rules regarding a substantial risk of forfeiture in the anticipated guidance described in the first two paragraphs of section IV of this notice for purposes of § 457(f). Comments are specifically requested as to the extent to which transition guidance regarding the application of § 457(f) would be necessary and appropriate, and what such transition guidance would provide.

This notice does not affect the application of § 409A or the guidance thereunder, including the determination of whether a plan is subject to § 409A and the application of the transition guidance issued under § 409A.

VII. REQUEST FOR COMMENTS

Treasury and the Service intend to issue guidance reflecting the definitions of a bona fide severance pay plan for purposes of § 457(e) and substantial risk of forfeiture for purposes of § 457(f), as described in Parts III and IV of this notice. Comments regarding these definitions, and any related issues that should be addressed under § 457, are requested.

Written comments should be submitted by October 15, 2007. Send submissions to CC:PA:LPD:PR, (Notice 2007-62), Room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, D.C. 20044. Comments may also be hand delivered Monday through Friday between the hours of 8:30 a.m. and 4:00 p.m. to: Internal Revenue Service, CC:PA:LPD:PR, (Notice 2007-62), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. Alternatively, comments may be submitted via the Internet at *notice.comments@irs.counsel.treas.gov* (Notice 2007-62). All comments will be available for public inspection.

VIII. DRAFTING INFORMATION

The principal author of this notice is Cheryl Press of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the Treasury and the Service participated in its development. For further information regarding this notice, contact Ms. Press at (202) 622-6060 (not a toll-free call).