WHITE PAPER

IRS Proposed Changes
Deferred Compensation Rules 2016
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An In-Depth Report from Fulcrum Partners LLC
August 2016

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IRS Clarification and Proposed Regulations Re: Section 409A
Nonqualified Deferred Compensation Plans

IRS Clarification and Proposed Regulations Re: Section 457
Deferred Compensation Plans of State and Local Governments and Tax Exempt Entities

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The US Treasury Department and the Internal Revenue Service have issued proposed guidance and new regulations on deferred compensation arrangements under Sections 409A and 457 of the Internal Revenue Code. These actions were published June 22, 2016, in the Federal Register. Follow these links to read, in full, the proposed regulation clarifications and changes that apply to Section 409A and to Section 457.

On August 4, 2016, Application of Section 409A to Nonqualified Deferred Compensation Plans; Correction was published in an attempt by the IRS to bring further clarity regarding the proposed changes.

Who is affected by the proposed regulations? The Section 409A modifications affect almost every company that defers a portion of executive pay to a future year. The Section 457 regulations apply to the deferred compensation plans of state and local governments and tax-exempt organizations.

Those who could be impacted by the changes include sponsors, administrators, participants, and beneficiaries of nonqualified deferred compensation plans at for-profit organizations and at state and local governments and tax-exempt entities. The new regulations do not apply to compensation in the form of elective deferrals to qualified plans (i.e., a 401(k), 403(b), or 457(b) plan).
What do the regulations address? In summary, the proposed regulations revise and clarify certain specific provisions in existing rules under Sections 1.409A-1; -2; -3; -4; and -6. Generally helpful, the new guidelines formalize some of the informal guidance provided over the years by IRS personnel regarding these topics.

In revising a number of points, the regulations may in some cases increase flexibility for organizations or corporations as employers. Specifically addressed is a provision of the notice of proposed rulemaking regarding the calculation of amounts includible as income under Section 409A(a), as well as clarification of the interaction of Section 457 with Section 409A.

When do the new regulations take effect? A hearing is set for October 18, 2016, at the headquarters of the Internal Revenue Service.

The proposed guidelines are scheduled to be effective after the scheduled hearing. Until that time, taxpayers may rely immediately on the regulations and the income inclusion regulations, as modified by the new proposed regulations.

Any written or electronic comments on the proposed regulations must be submitted to the IRS by September 20, 2016.

The IRS and the US Treasury have specifically requested comments on the following points identified on page 6 of this report.
• Whether it is appropriate to provide any additional exceptions from the application of the rules currently described in the proposed Section 409A regulations to amounts includible in income under Section 457(f), to account for the different manners in which the two provisions apply to an amount deferred.

• If special provisions for newly eligible employees are needed in the context of arrangements subject to Section 457(f), and how an aggregated single plan (versus multiple plans) should be defined for this purpose to ensure that the rules are not subject to manipulation.

• If transition rules are needed for Section 457(f) plans established before the applicability dates of the proposed regulations.

When the comment period closes, the agencies involved, per usual, will review all comments received, conduct an analysis, and decide whether to proceed or issue a new or modified proposal. The published Final Rule will include, in its preamble, response to issues raised in comments.

Although the proposed modifications are not intended to be a general revision, or to bring broad changes, by addressing certain specific provisions, the new regulations will likely increase the flexibility of employers regarding some payment rules under the current regulations.

Since the June 22, 2016, Internal Revenue System announcement of the proposed rules and modifications, numerous articles have been published by reputable sources, offering opinions and interpretations regarding the changes
RECOMMENDATIONS

and application of the changes. It is important to note that sources have not been in wholly consistent agreement in interpreting the new guidelines.

*Fulcrum Partners strongly advises employers and employees including for-profit, non-profit, and state and local governments, to review current employment contracts, incentive compensation plans, and deferred compensation agreements in light of the new regulations and to be diligent in relying on professional guidance. Recognizing that the previous guidelines historically have resulted in misinterpretations, and that the proposed modifications are still within the comment period, further clarifications may be anticipated.*

**CLARIFICATION AND MODIFICATION OF SPECIFIC SECTION 409A ISSUES**

Acknowledging that questions existed regarding Section 409A regulations issued in 2007 and 2008 (see *Internal Revenue Bulletin 2007-19* and *Internal Revenue Notice 2008-62*), the IRS concluded that clarifying and modifying certain requisites of Section 409A tax code will help taxpayers remain in compliance with requirements.

The proposed regulations help define what is, and what is not, to be treated as payment of compensation for purposes of Section 409A. Other specific areas in which the new regulations provide helpful insight include, but are not limited to the following (list follows on page 8).
The separation of service for employees that move to contractor status, with the specification that when an individual transitions from status as an employee to status as an independent contractor, the determination of “separation from service” is based on employee rules, and if separation does not occur, contractor rules apply in determining whether a separation of service occurs subsequently.

Timing of post-death payments, with the option for a plan to permit that a payment triggered by the death of a participant or a beneficiary will be made (or will commence) at any time ranging from the date of death to the last day of the year following the year of death.

Treatment of beneficiaries, including the disability, death, or unforeseeable emergency of the beneficiary, which can serve as a payment event.

A restriction on the ability to correct Section 409A violations related to non-vested amounts, or to otherwise change terms of payment for non-vested amounts. The new rules will further limit the opportunity to make corrections regarding unvested amounts and adds specific rules defining anti-abuse guidelines.

The decision to terminate and liquidate rules for one plan necessitates the termination of all plans of the same type maintained within the controlled group.

Some severance arrangements limited to “two times pay” can be applied to employees who are hired and terminated within the same year.
CLARIFICATION AND MODIFICATION OF SPECIFIC SECTION 409A ISSUES (CONT.)

A COMPREHENSIVE LIST OF THE NINETEEN POINTS OF CLARIFICATION OF SECTION 409A AND THE PROPOSED MODIFICATIONS OR NEW ITEMS RELATED TO SECTION 409A

1) Clarify that the rules under Section 409A apply to nonqualified deferred compensation plans separately and in addition to the rules under Section 457A.

2) Clarify that a stock right that does not otherwise provide for a deferral of compensation will not be treated as if it provides for such deferral solely because the amount payable under the stock right (upon an involuntary separation from service for cause, or the occurrence of a condition within the service provider’s control) is based on a measure that is less than fair market value.

3) Clarify that certain separation pay plans that do not provide for a deferral of compensation may apply to a service provider who had no compensation from the service recipient during the year preceding the year in which a separation from service occurs.

4) Clarify that a stock purchase treated as a deemed asset sale under Section 338 is not a sale or other disposition of assets for purposes of determining whether a service provider has a separation from service.

5) Clarify that a service provider who ceases providing services as an employee and begins providing services as an independent contractor is
A COMPREHENSIVE LIST OF THE NINETEEN POINTS OF CLARIFICATION OF SECTION 409A AND THE PROPOSED MODIFICATIONS OR NEW ITEMS RELATED TO 409A (CONT.)

treated as having a separation from service if, at the time of the change in employment status, the level of services reasonably anticipated to be provided after the change would result in a separation from service under the rules applicable to employees.

6) Clarify that rules for transaction-based compensation apply to stock rights that do not provide for a deferral of compensation and statutory stock options.

7) Clarify the provision permitting payments upon the termination and liquidation of a plan in connection with bankruptcy.

8) Clarify other rules permitting payments in connection with the termination and liquidation of a plan.

9) Clarify and modify §1.409A–4(a)(1)(ii)(B) of the proposed income inclusion regulations regarding the treatment of deferred amounts subject to a substantial risk of forfeiture for purposes of calculating the amount includible in income under Section 409A(a)(1).

10) Clarify various provisions of the final regulations to recognize that a service provider can be an entity as well as an individual.

11) Provide that a plan under which a service provider has a right to payment or reimbursement of reasonable attorneys’ fees and other expenses incurred to pursue a bona fide legal claim against the service recipient with respect to the service relationship does not provide for a deferral of compensation.
A COMPREHENSIVE LIST OF THE NINETEEN POINTS OF CLARIFICATION OF SECTION 409A AND THE PROPOSED MODIFICATIONS OR NEW ITEMS RELATED TO 409A (CONT.)

12) Provide a rule that is generally applicable to determine when a “payment” has been made for purposes of Section 409A.

13) Provide that the addition of the death, disability, or unforeseeable emergency of a beneficiary who has become entitled to a payment due to a service provider’s death as a potentially earlier or intervening payment event will not violate the prohibition on the acceleration of payments.

14) Provide that a plan may accelerate the time of payment to comply with Federal debt collection laws.

15) Modify the short-term deferral rule to permit a delay in payments to avoid violating federal securities laws or other applicable law.

16) Modify the definition of the term “eligible issuer of service recipient stock” to provide that it includes a corporation (or other entity) for which a person is reasonably expected to begin, and actually begins, providing services within 12 months after the grant date of a stock right.

17) Modify the rules regarding recurring part-year compensation.

18) Modify the rules applicable to amounts payable following death.

19) Modify the conflict of interest exception to the prohibition on the acceleration of payments to permit the payment of all types of deferred compensation (and not only certain types of foreign earned income) to comply with bona fide foreign ethics or conflicts of interest laws.
DEFERRED COMPENSATION PLANS OF TAX-EXEMPT ENTITIES RELATED TO CODE

For employees of state and local governments and tax-exempt organizations, any deferred compensation that is not part of a qualified deferred compensation plan is subject to taxation under Section 457(f).

Differences exist in the deferred compensation rules for state and local government employees and non-profit entities as compared to the regulations that apply in these areas to for-profit organizations. However, with respect to severance and substantial risk of forfeiture, the proposed Section 457 modifications will make regulations applicable to government entities and non-profit organizations more comparable to the 409A rules applied to for-profit organizations.

In general, Section 457 separates non-qualified deferred compensation arrangements into two types of programs: eligible plans and ineligible plans. Each type is regulated differently.

If a deferred compensation plan is designed similarly to a 401(k) plan, offering benefits that are limited and capped, it is considered to be an eligible plan arrangement. An eligible plan is subject to Section 457(b) that permits the deferred amount to be taxable only at the point it is distributed to the employee. Eligible plans for tax-exempt entities, satisfy the rules of Code Sections 457 (b) - (c) - (d) and (g).

When deferred compensation plans provide larger benefit amounts or different benefits from the benefits permitted in eligible plans, they will likely be subject to Section 457(f) regulations. The deferred compensation will be taxable when
it is no longer subject to a substantial risk of forfeiture (typically when it becomes vested). The new IRS clarifications and modifications define changes that are especially significant to ineligible plans. The proposed regulations include rules for determining when amounts deferred under these plans are includible in income, the amounts that are includible in income, and the types of plans that are not subject to these rules, (what is, and what is not) to be treated as payment of compensation for purposes of Section 409A.

FROM THE FEDERAL REGISTER REGARDING PART-YEAR COMPENSATION (EXAMPLE: SCHOOL SYSTEM EMPLOYEES)

“To simplify the rule set forth in Notice 2008-62, and recognizing that educational employers frequently structure their pay plans to include recurring part-year compensation and that the main purpose of this design is to achieve an even cash flow for employees who do not work for a portion of the year, these proposed regulations modify the recurring part-year compensation rule for purposes of section 457(f). The proposed regulations provide that a plan or arrangement under which an employee receives recurring part-year compensation that is earned over a period of service does not provide for the deferral of compensation if the plan or arrangement does not defer payment of any of the recurring part-year compensation to a date beyond the last day of the 13th month following the first day of the service period for which the recurring part-year compensation is paid, and the amount of the recurring part-year compensation (not merely the amount deferred) does not exceed the annual compensation limit under section 401(a)(17) ($265,000 for 2016) for the calendar year in which the service period commences. A conforming change is included in proposed regulations under section 409A that are also published in the Proposed Rules section of this issue of the Federal Register.”
The IRS has defined the requirements that must be satisfied in order to prevent severance, vacation, and sick pay from being treated as deferred compensation that is taxable upon vesting.

1) To qualify for the Section 457(f) exemption, proposed changes specify that a **bona fide severance plan** must meet the following conditions:

   - Payment may be made only upon the involuntary termination of an employee who is willing and able to work,
   - Or, the constructive discharge of an employee in accordance with safe harbor or other standards.
   - Additionally, payments must not extend beyond the last day of the second calendar year following the year of the employee’s termination, and the total payments must not exceed 200 percent of the employee’s annualized compensation.

2) **Bona fide vacation or sick leave benefit plans** that qualify for Section 457(f) **must be distinguishable** from “disguised deferred compensation” by the following:

   - Could the amount of leave reasonably be expected to be used in the normal course of employment.
The extent to which there are limits on the ability to exchange unused leave for cash.

Whether the plan is widely available to many employees or is made available only to certain employees.

The amount and frequency of in-service distributions of cash.

Whether payment for unused leave is made promptly upon termination or is paid over time.

3) **Death benefits** will be exempt to the extent they exceed the lifetime benefits payable under the plan.

4) **Disability pay plans** are deemed bona fide if a plan pays benefits only in the event of a long-term disability based on any of three definitions specified in the regulations (Code 409A).

**Substantial Risk of Forfeiture:** The existence of a substantial risk of forfeiture is significant under 457(f), because deferred amounts are subject to taxation as of the date the substantial risk of forfeiture lapses. The proposed regulations define possible situations of a substantial risk of forfeiture as follows:

- A requirement for the employee to perform substantial future services.
- Involuntary termination of the employee without cause or constructive discharge.
SUBSTANTIAL RISK OF FORFEITURE (CONT.)

- When a condition occurs related to the purpose of the compensation (if the possibility of forfeiture is substantial).

The proposed regulations will permit noncompetition agreements to serve as the basis for a substantial risk of forfeiture if: 1) the employer attempts to verify compliance with all of its noncompetition agreements, 2) vesting is expressly conditioned on a written noncompetition agreement enforceable by law, 3) (after it is established,) the employer has a bona fide interest in preventing competition, and 4) the employee is able to, and has, a bona fide interest in competing.

**Note:** The proposed regulations require that the relevant condition (such as defined in this list) is _likely to be_ enforced and is legally enforceable.

**Elective Deferrals and Vesting Date Extensions (Rolling Vesting):** In order for the IRS to honor voluntary elections to defer compensation under a 457(f) plan, and to extend an existing vesting date, the following conditions must be satisfied:

- The current value of the amount payable in the future must be greater than 125 percent of the current value of the amount deferred.

- Any risk of forfeiture must be based on a requirement for the employee to perform services at a future day, or to comply with a noncompetition agreement, however, it cannot be based solely on the occurrence of a specified condition.
OTHER NOTEWORTHY 457 ISSUES

- The vesting date postponement must be for at least two years, unless a condition occurs, such as death or disability, in which case vesting may be accelerated.

- The extension of a substantial risk of forfeiture must be made in writing before the calendar year in which services are performed (for initial deferrals), or ninety days before the date a substantial risk of forfeiture would have otherwise lapsed.

You can read full details of other significant, specific proposed modifications, including the four items identified below, at: www.federalregister.gov/articles/2016/06/22/2016-14329/deferred-compensation-plans-of-state-and-local-governments-and-tax-exempt-entities.

1) Qualified Roth contribution program

2) Certain distributions for qualified accident and health insurance premiums

3) Rules related to qualified military service

4) Other pertinent issues, not specified in this list
Although this document is extensive, it does not represent the full scope or detail of the proposed IRS modifications and clarifications. Fulcrum Partners earnestly encourages sponsors, administrators, participants, and beneficiaries of nonqualified deferred compensation plans to use the announcement of these proposed changes as motivation to review your existing plans and agreements, potentially taking advantage of the new flexibilities in regulations while ensuring that all programs are in full compliance.

For additional information, contact Fulcrum Partners LLC at any of our nationwide locations. www.fulcrumpartnersllc.com/team

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ABOUT FULCRUM PARTNERS LLC

Fulcrum Partners, LLC. was founded in Ponte Vedra Beach, Florida, in 2007, by three former senior consultants of the Executive Benefits Division of Clark Consulting (a division of European-based AEGON, a large international insurer). Prior to the formation of Fulcrum, the founding members, Bruce H. Brownell, CFP®; Scott Cahill; and Joseph Arthur Thompson CFP® collectively had accrued more than 60 years of experience in executive compensation and benefits consulting. Today Fulcrum Partners has grown to a team of 17, including 10 additional partners who were former senior Clark Consultants. Together, Fulcrum Partners serves its clients with more than 200 years of combined professional experience.

Over the years, Fulcrum Partners has continued to grow, offering its clients a unique combination of industry specialists with diverse skill sets, targeted experience, and in-depth expertise in executive compensation and benefits consulting. Fulcrum Partners is a wholly independent, member-owned firm, dedicated to helping clients enhance their Total Rewards Strategy by leveraging the firm’s intellectual capital, experience, and broad multidisciplinary industry relationships.

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