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Using a Non-Compete to Create a Substantial Risk of Forfeiture Under a Section 457(f) Plan: Limited (But Meaningful) Opportunities

by Eric D. Altholz on November 2, 2021

The Treasury Department's proposed regulations regarding the income tax treatment of "ineligible plans" of tax-exempt employers under Code Section 457(f), published in June 2016, were greeted with much fanfare. (You can review our initial commentary on the proposed regulations **here**. Final regulations have not yet been published, but taxpayers may rely on the proposed regulations now.) Section 1.457(f)-12 of the proposed regulations (the "Proposed Regulations") attempts to fill in the gaps, and iron out some of the inconsistencies, between the general rules governing deferred compensation plans under Code Section 409A and the special rules governing "ineligible plans" ("Section 457(f) plans"). Accordingly, the Proposed Regulations confirm the Code Section 409A concepts and rules that apply to Section 457(f) plans and also explain the ways in which the rules differ, so as to preserve the unique status of Section 457(f) plans within the wider world of deferred compensation arrangements. One significant way in which the Proposed Regulations depart from the Code Section 409A rules is that they approve the use of covenants not to compete as a valid way to establish a substantial risk of forfeiture, which can defer the taxation of the deferred compensation benefit.

Section 457(f) "ineligible" plans: a brief refresher

The deferred compensation plans of tax-exempt organizations and state and local governments are governed by Code Section 457. (Plans of state or local governments will not be discussed here.) Code Section 457 divides the deferred compensation plans to which it applies into two categories. Plans that meet the requirements of Code Sections 457(b) through (e) are referred to as "eligible" deferred compensation plans. These plans – commonly referred to as Section 457(b) plans – are frequently used by tax-exempt employers to allow their highly compensated and management employees to make elective deferrals of salary and other compensation in addition to the benefits provided under the employer's Section 403(b) or other retirement plan. Section 457(b) plans allow participants to delay the receipt of compensation until separation from service or beyond. Annual contributions to a Section 457(b) plan are subject to the same dollar limitation that applies to elective deferrals under a Section 403(b) or Section 401(k) plan (i.e., $19,500 for 2021), but nondiscrimination rules do not apply. Section 457(b) plans are required to be "unfunded" – just like all other nonqualified deferred compensation plans – and benefit distributions can be rolled over only into another Section 457(b) plan of another employer. Finally, Section 457(b) are explicitly exempt from the requirements of Code Section 409A, just like tax-qualified retirement plans and Section 403(b) plans.

Any deferred compensation arrangement of a tax-exempt employer that does not meet the requirements of Code Sections 457(b) through (e) is considered an “ineligible” plan and will be subject to income taxation under Code Section 457(f). In this sense, a Section 457(f) plan is more easily described in terms of what it is not, rather than in terms of what it is. In most cases, tax-exempt employers establish Section 457(f) plans because the low dollar limit on annual elective deferrals under a Section 457(b) plan is insufficient to provide a meaningful total benefit to the highest paid key employees. For that reason, supplemental executive retirement plans maintained by tax-exempt employers typically take the form of Section 457(f) plans.

The key concept that drives the income tax treatment of a Section 457(f) plan – and distinguishes it from a Section 457(b) plan – is this: the deferred compensation is subject to income tax when it ceases to be subject to a substantial risk of forfeiture (i.e., when the executive earns a vested right to receive the payment). The Proposed Regulations explain the concept this way: “The present value of compensation deferred under an ineligible plan is includible in the gross income of a participant . . . on the later of the first date on which there is a legally binding right to the compensation or, if the compensation is subject to a substantial risk of forfeiture, the first date on which the substantial risk of forfeiture lapses.” Prop. Reg. Section 1.457-12(a)(2). (Emphasis added.) For this reason, most Section 457(f) plans provide for the payment of the deferred compensation benefit within a very short time after the vesting date. In addition, this approach to vesting and payment allows virtually all well-designed Section 457(f) plans to qualify for the “short-term deferral” exception under Code Section 409A. Thus, most Section 457(f) plans are effectively exempt from the requirements of Code Section 409A even though they are not explicitly exempt from Code Section 409A.

Substantial risk of forfeiture under the Proposed Regulations

The Proposed Regulations state that the rules of Code Section 457(f) apply to a Section 457(f) plan “separately and in addition to any requirements applicable to the plan” under Code Section 409A. Prop. Reg. Section 1.457-12(d)(5)(i). Accordingly, the threshold question of whether and when an employee has a “legally binding right” to deferred compensation is determined under the same basic rules that would apply under Code Section 409A. Similarly, the Proposed Regulations describe the basic concept of “substantial risk of forfeiture” consistent with both the historic definition of the term and the definition of the term under Code Section 409A. In general, an amount of compensation is subject to a substantial risk of forfeiture only if entitlement to the amount is conditioned on the future performance of substantial services, or upon the occurrence of a condition that is related to a purpose of the compensation if the possibility of forfeiture is substantial. Prop. Reg. Section 1.457-12(e)(i). However, where the regulations under Code Section 409A expressly provide that a covenant not to compete will not constitute a substantial risk of forfeiture, the Proposed Regulations take the opposite approach, albeit with significant qualifications.

Under the Proposed Regulations, compensation that is to be paid only upon compliance with a non-compete can be considered subject to a substantial risk of forfeiture only if the following requirements are satisfied:

1. The right to receive payment of the compensation must be expressly conditioned upon the employee refraining from the future performance of services pursuant to an enforceable written agreement;
2. The employer must make reasonable ongoing efforts to verify compliance with noncompetition agreements, including the noncompetition agreement applicable to the employee; and
3. At the time the enforceable written agreement becomes binding, the facts and circumstances must show both that the employer has a substantial interest in preventing the employee from providing competing services and that the employee has the ability to and a substantial interest in engaging in competition by providing the prohibited services.

To this combination of formal and operational requirements, the Proposed Regulations add one additional requirement that can only be met in operation: in order to constitute a substantial risk of forfeiture, "the possibility of actual forfeiture in the event that the forfeiture condition occurs must be substantial based on the relevant facts and circumstances." Prop. Reg. Section 1.457-12(e)(iv). In applying this requirement, the Proposed Regulations provide that factors to be considered include the extent to which the employer has enforced forfeiture conditions in the past, the level of control or influence of the person subject to the non-compete over the organization (including individuals who would be responsible for enforcing the non-compete), and the likelihood that the non-compete would be enforceable under applicable law.

Clearly, the Treasury Department did not wish to make it easy for a tax-exempt employer to use a non-compete as a method of deferring income taxation on Section 457(f) plan benefits. Nevertheless, a tax-exempt employer may still find some utility in the opportunity afforded by the Proposed Regulations if it has other good reasons to include a non-compete in an employment agreement or deferred compensation plan. For example, a university may have a highly prized athletic coach, development executive, investment officer, or professor whose skills and reputation are so valuable that the university would suffer substantial harm if that special person decamped for a competing institution. A hospital or health system may have a CEO or a special surgeon (or group of surgeons) who are considered so critical to the success of the organization that that the loss of that person would damage the organization. (Whether the restrictions imposed under the non-compete are acceptable to the high performing person is another matter.)

If a tax-exempt employer thinks that the use of a non-compete can be justified and wishes to condition the payment of deferred compensation on compliance with a non-compete, we recommend the following:

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1. Consult with employment law counsel to determine whether the contemplated non-compete is likely to be enforceable under state law as written. State laws typically impose reasonableness requirements on the geographic scope and duration of restrictive covenants, and it will be easiest to support compliance with the Proposed Regulations if such requirements are observed. (As explained below, there may a reasonable basis to argue that applicable state laws are preempted by ERISA, but compliance with state law would be preferable.)
2. Make sure that you can articulate the basis for requesting the non-compete, to help document that the organization has a substantial interest in preventing the employee from competing. It may be more effective to memorialize this in the minutes of a meeting of the governing body rather than in a file memo written by the organization's general counsel.
3. Carefully draft the enforceable non-compete provision into the written document containing the deferred compensation arrangement and make it abundantly clear that compliance with the non-compete is a condition to payment. (As explained below, there may be advantages to having the arrangement take the form of a formal plan document as opposed to an employment agreement.)
4. Develop an approach to periodically verify the employee's compliance with the non-compete, follow that approach, and document the actions taken to verify compliance.

As the foregoing recommendations imply, a non-compete crafted purely as a tax deferral device is less likely to survive close scrutiny than a non-compete based on real, demonstrable goals of the organization.

What if the employer is in a state that limits or prohibits the use of non-competes?

Many states impose statutory limitations on the use of non-competes. For example, the Commonwealth of Massachusetts essentially prohibits the imposition of a non-compete that would restrict or impair the ability of a physician to freely practice medicine elsewhere in the state after ending employment with a current employer. And a handful of states – most notably California – essentially prohibit the use of non-competes, rendering most (if not all) non-competes unenforceable in those states. Depending on the circumstances and the desired scope of the restrictions, tax-exempt employers in these states may face an uphill battle demonstrating the enforceability of the non-compete and therefore the efficacy of the non-compete as a substantial risk of forfeiture.

In these cases, and perhaps in all cases, a tax-exempt employer may improve its chances of success by including the non-compete in a written plan document that makes it clear that compliance with the non-compete is required as a condition to the vesting and payment of a benefit to which the employee would not otherwise be entitled. To avoid any doubt, the plan should state clearly that the benefit is being provided in exchange for the employee's agreement to comply with the non-compete. By crafting the plan document in this way, the employer may be able to argue that any state law prohibitions or limitations on the use of non-competes should be preempted by ERISA. Even though the Section 457(f) plan will be designed to qualify as a "top hat" plan, and top hat plans are exempt from most provisions of ERISA, the limited applicability of the administrative and enforcement provisions of ERISA (e.g., the claims procedure) create the possibility of cloaking the plan in the protective shield of ERISA. If nothing else, the possibility of ERISA preemption at least creates a hurdle that a participant would have to clear before heading directly to state court to invalidate the non-compete under state law.

If you have questions about deferred compensation plans of any type, please contact a member of Verrill's Employee Benefits & Executive Compensation Group.

Eric D. Altholz
Partner
T (207) 253 4908
email