

To: Clients and Friends  
From: Smith & Downey  
Date: July 24, 2007  
Re: URGENT - Tax-Exempt and Governmental Employers - Section 457 Guidance

The IRS announced late yesterday that it will issue, on August 6, 2007, Notice 2007-62 describing its "intent to issue guidance" on Code Section 457 issues affecting deferred compensation and severance plans of tax-exempt and governmental employers.

Although tax-exempt and governmental employers have been awaiting guidance on Section 457 issues since August 1986 when Section 457 in its present form was enacted, only in the last several months has the IRS begun to suggest that guidance was forthcoming.

An advance copy of the Notice reveals the IRS's "intent to issue guidance" reflecting the following positions.

1. Defining the Section 457(e)(11) Exemption. Section 457(e)(11) provides that bona fide severance plans are exempt from the Section 457(f) taxation-on-vesting rules. Notice 2007-62 states that the IRS "anticipates issuing guidance" providing that plans will not qualify as bona fide severance plans under Section 457(e)(11) -- and therefore will not be exempt from the taxation-on-vesting rules of Section 457(f) -- unless they:

(a) pay only on involuntary termination of employment (with exceptions for window programs, union plans and certain reimbursement and in-kind programs);

(b) pay amounts that do not exceed two times "annual pay" (taking into account annual pay only up to the Code Section 401(a)(17) qualified plan compensation limit - \$225,000 for 2007); and

(c) complete all payments by the end of the second calendar year after the year of the participant's separation from service.

In our experience, many executive severance plans do not satisfy these requirements, and therefore vested amounts in these plans will become taxable under Section 457(f) under these new rules (absent any transitional relief that might be issued).

2. Defining Substantial Risk of Forfeiture Under Section 457(f). Amounts credited to a Section 457(f) plan are taxed when they vest (i.e., when they are no longer subject to a "substantial risk of forfeiture"). Notice 2007-62 provides that the IRS "anticipates issuing guidance" providing that the following will not qualify as "substantial risks of forfeiture" under Section 457(f) that are sufficient to postpone taxation of Plan accounts:

(a) non-compete agreements; and/or

(b) extensions of initial vesting dates.

Participants with Section 457(f) plan accounts subject only to a non-compete risk, and/or subject only to an extension of an initial forfeiture risk period, will become taxable under these new rules (absent any transitional relief that might be issued).

3. Prohibition of Voluntary Compensation Deferrals. Notice 2007-62 provides that voluntary compensation deferrals to Section 457(f) plans cannot be made subject to a substantial risk of forfeiture, and therefore are taxable when made.

Many Section 457(f) plans permit voluntary deferrals, which will become taxable when made under these new rules (absent any transitional relief that might be issued).

4. Effective Date. The Notice provides that the IRS "anticipates that the guidance described in the Notice would be prospective," but that "no inference should be made from the [guidance]" with respect to the IRS's positions on these issues for periods before the Notice is issued. The IRS requests comments "as to the extent to which transition guidance ... would be necessary and appropriate, and what such transition guidance would provide."

Although this effective date provision is certainly preferable to a statement that the guidance is retroactive, it fails to provide definitive guidance concerning what real-world employers with typical Section 457(e)(11) and Section 457(f) plans should do, if anything: (a) before August 6; or (b) after August 6 but before the Notice is supplemented with more formal guidance containing, or not containing, "necessary and appropriate transition guidance".

We urge all of our clients with Section 457(e)(11) and/or Section 457(f) plans to call us immediately to discuss the range of reasonable responses and the steps they should consider taking now. (On two related points, this would be a good time for tax-exempt employers to ensure that their various deferred compensation plans (as broadly defined) have been amended to comply with the Section 409A Final Regulations issued in April, and to consider whether any steps need to be taken to anticipate the impact of the broadened Form 990 executive compensation disclosures that will be required beginning in 2008.)