Executive Compensation Arrangements for Tax-Exempt Organizations

A Practical Guidance® Practice Note by Carol V. Calhoun, Venable LLP

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This practice note sets out important legal and tax considerations when developing executive compensation arrangements for tax-exempt organizations, including new excise tax rules enacted under 2017 tax reform legislation. It provides guidance on practical steps for attorneys advising their tax-exempt clients on various aspects of executive total compensation packages, including deferred compensation, incentive compensation, severance, vacation, and fringe benefits.

This practice note is divided into the following main topics:

- Executive Compensation Considerations for Tax-Exempt Entities
- Reasonable Compensation
- Excise Tax on Excess Executive Compensation
- Deferred Compensation Rules
- Severance Pay
- Vacation and Sick Leave Plans
- Performance Bonuses and Other Nonfixed Payments
- Fringe Benefits

Governmental organizations, churches, and qualified church-controlled organizations (QCCOs), whether or not also exempt from federal tax under I.R.C. § 501(c), are beyond the scope of this practice note. Governmental organizations are subject to quite different executive compensation rules than nongovernmental tax-exempt organizations. Churches and QCCOs are exempt from both the Employee Retirement Income Security Act (ERISA) (unless they elect otherwise) and the deferred compensation rules under I.R.C. § 457.

For a full listing of key content covering executive employee agreement considerations, see Executive Employment Agreement Resource Kit.

For a full listing of key content covering departing employees, see Departing Employees Resource Kit.

For additional information on private inurement and excess benefit transaction issues for tax-exempt entities, see Planning Tax-Exempt Organizations § 12.04 and Executive Compensation § 13.02, "Executive Compensation for Tax_ Exempt Organizations". For general executive compensation considerations primarily focused on taxable entities (including I.R.C. § 409A compliance issues), see Executive Employment Agreement Negotiation and Drafting (Pro-employer), Executive Employment Agreement Negotiation and Drafting (Pro-executive) and the Executive Employment Agreement Resource Kit.

For a full listing of key content covering the provision of severance or separation pay on various terminations of employment, see Severance Benefits Resource Kit.

Executive Compensation Considerations for Tax-Exempt Entities

Deferred compensation and other executive compensation plans and arrangements for tax-exempt organizations often differ from those established for taxable (for-profit) entities. This is due in part to the tax consequences for nonqualified deferred compensation arrangements commonly provided to executives. Although executives benefit from delayed taxation under such arrangements, a for-profit organization cannot deduct the related compensation expense until the benefits are paid. However, a tax-exempt organization is unconcerned with the tax benefit of compensation deductions. Hence, they have less incentive to avoid deferred compensation arrangements, which can result in undue delay and manipulation from the government's perspective. In addition, high levels of executive compensation in the nonprofit sector are a red flag area for violations of the private inurement prohibition applicable to tax-exempt entities. See Treas. Reg. § 1.501(c)(3)-1(c)(2). Consequently, special rules were developed to stem the potential for abuse.

Executive compensation plans of tax-exempt organizations are subject to three principal sets of rules:

Reasonable compensation rules. This requirement is applicable to the aggregate of all compensation that the executive receives, but creates specific concerns in the case of:

- Deferred compensation
- Performance bonuses
- Fringe benefits

Excise tax on excess executive compensation. A tax-exempt employer is liable for an excise tax on certain "excess compensation." As with the reasonable compensation rules, this rule applies to the aggregate of all compensation that a covered executive receives, but creates specific concerns in the case of:

- Deferred compensation
- Performance bonuses
- Fringe benefits

Deferred compensation rules. These rules apply based on:

- ERISA coverage and exceptions
- I.R.C. § 457 rules (governing deferred compensation for tax-exempt and state and local government entities)
- I.R.C. § 409Arules (governing nonqualified deferred compensation for all entities)

Deferred compensation arrangements are also subject to special rules for Social Security and Medicare (FICA) taxes under I.R.C. § 3121(v)(2). However, because those rules are the same for tax-exempt organizations as for taxable organizations, this practice note does not discuss them.

As discussed later in this practice note, many plans not commonly thought of as providing for deferred compensation can fall within the deferred compensation rules noted above, unless they meet certain exceptions, particularly:

- Severance plans
- Vacation pay
- Performance bonuses
- Fringe benefits

This practice note first reviews the reasonableness requirement and the deferred compensation rules as generally applicable to tax-exempt entities and then their application to specific types of plans.

Reasonable Compensation

The reasonableness of compensation paid to employees applies to for-profit entities and tax-exempt entities alike, and the tests for whether the compensation is reasonable are similar (though not identical) in both cases. Violations of the test of reasonableness are apparent only when looking at an employee's total compensation, including:

- Salary or wages
- Contributions to retirement plans
- Deferred compensation
- Payment of the employee's personal expenses
- Personal use of the entity's property or facilities

Although the reasonableness rule applies to both taxable and tax-exempt entities, it is especially relevant for tax-exempt entities. For a taxable organization, the only penalty for violating it is the limit on the deductibility of compensation to an amount that is reasonable. I.R.C. § 162; Treas. Reg. § 1.162-7(b)(3). The penalties for a tax-exempt organization are far more onerous.

Penalties for Reasonableness Requirement Violations

Loss of Tax-Exempt Status

I.R.C. § 501(c) sets forth the rules for an organization to acquire and maintain tax-exempt status. For most kinds of tax-exempts, one of the requirements is that "no part of the net earnings . . . inures to the benefit of any private shareholder or individual . . .." I.R.C. § 501(c)(3); Treas. Reg. § 1.501(c)(3)-1(c)(2).

Mere payment of compensation to an executive is not necessarily considered inurement to the benefit of any private individual, and individuals operating charitable organizations have no duty to donate their services. They are entitled to reasonable compensation for their efforts. World Family Corp. v. Commissioner, 81 T.C. 958 (T.C. 1983). However, the emphasis is on **reasonable** compensation; an organization that pays unreasonable compensation may, in extreme cases, lose its tax exemption (e.g., Mabee Petroleum Corp. v. United States, 203 F.2d 872 (5th Cir. 1953)).

Excess Benefit Transaction Penalty Tax

Even if the IRS does not impose the extreme penalty of loss of tax-exempt status, it may impose penalty taxes on the organization under I.R.C. § 4958. This penalty tax on so-called excess benefit transactions seeks to avoid conflicts of interest between a tax-exempt organization and disqualified persons. The tax is imposed in two tiers:

- First tier tax: 25% of the amount involved
- Second tier tax: an additional 200% of the amount involved where the excess payment is not corrected before the earlier of the date that an IRS notice of deficiency is mailed and the date on which the tax imposed is assessed

I.R.C. § 4958(a)(1), (b).

A disqualified person who receives an excess benefit from a relevant transaction has liability for the tax. A disqualified person for this purpose includes any person who was in a position to exercise substantial influence over the affairs of the applicable tax-exempt organization. I.R.C. § 4958(f)(1); Treas. Reg. § 53.4958-3. Thus, an executive of a tax-exempt organization receiving an unreasonable level of compensation may be a disqualified person subject to the penalty.

In addition, an organization manager who knowingly and willfully participates in an excess benefit transaction is subject to an excise tax equal to 10% of the amount involved (up to $20,000). I.R.C. § 4958(a)(2); Treas. Reg. § 53.4958-1(d). Thus, a disqualified person who is both a manager who knowingly and willfully participates in the transaction and receives an excess benefit is subject to both excise taxes.

Information on how to correct an excess benefit transaction can be found at the IRS web page Intermediate Sanctions—Excess Benefit Transactions. The long-standing IRS examination guidelines for excess benefit transactions penalties can be found under I.R.M. § 7.27.30.

State Law Penalties

While the following discussion related to federal law, in instances in which compensation is not considered reasonable under applicable state law, the Attorney General may have the power to impose civil and/or criminal penalties, and/or to revoke the registration of charitable entities operating in violation of the law.

Reasonable Compensation Testing

To ensure that compensation is reasonable, an employer must look at two aspects of the compensation, performing a substantive test and a procedural test.

Substantive Test

The substantive test has two prongs:

- **Amount test.** This prong focuses on whether the total amount paid is excessive.
- **Purpose test.** This prong examines whether the services for which the compensation was paid were necessary to carrying out the organization's exempt purposes.

The second of these is mostly self-explanatory. A tax-exempt cannot, for example, pay an executive for services that benefit a private business rather than the tax-exempt itself. However, it comes up in the context of whether a performance bonus has impermissibly established a joint venture between the tax-exempt entity and the executive. (See further discussion below under Performance Bonuses and Other Nonfixed Payments)

The rules for determining whether the amount of compensation paid to an executive of a tax-exempt organization is excessive are identical to the ones used under I.R.C. § 162 to determine whether compensation paid by taxable organization is tax deductible as reasonable compensation. See Instructions to IRS Form 990, available at IRS, Current Form 990 Series—Forms and Instructions (hereafter, Form 990 Instructions). Under those rules, compensation is not excessive if it is "such [an] amount as would ordinarily be paid for like services by like enterprises under like circumstances." Treas. Reg. § 1.162-7(b)(3).

The IRS has no standard formula for determining when compensation is reasonable. Instead, market rate is determined by researching what someone in a similar position would earn at an organization that is of the same size and has a similar mission or field of activity. Because the IRS recognizes that tax-exempt entities are often in competition with taxable organizations for executives, tax-exempt organizations can look at for-profit compensation when determining market rate, as long as the job, organization size, and organization mission/purpose are comparable.

In assessing whether compensation is excessive, courts have applied two types of tests. In the context of profit-making businesses, many courts have applied an independent investor test, which looks to whether an inactive, independent investor would have been willing to pay the amount of disputed compensation on the basis of the facts of the particular case (e.g., Miller and Sons Drywall Inc. v. Commissioner, 2005 Tax Ct. Memo LEXIS 114). However, because this analysis would clearly not apply to a tax-exempt organization, we would look to an alternative multifactor test. In applying this test, 12 factors have been cited by the courts:

- Amount of responsibility
- Qualifications

- Size of business in sales dollars
- Contribution to profits
- Intent
- Ratio of salaries to net income
- Compensation paid in prior years
- Accumulated earnings
- Expert testimony
- Actual salaries paid
- Number of owners
- Number of related parties

See Englebrecht, Ted D., Holcombe, Calee Jo, and Murphy, Kristie, "An Empirical Assist in Determining Reasonable Compensation in Closely Held Corporations," Vol. 30, No. 1, Journal of Applied Business Research, p. 233.

Clearly, some of these factors would be hard to apply in the case of a nonprofit, but in general, they may be of assistance on the substantive tests.

In addition to the federal rules, nonprofits must also pay attention to any state laws that limit the compensation they can provide to executives. The California Nonprofit Integrity Act of 2004 (CNIA), for example, stipulates that all compensation paid to the CEO and CFO of a registered charity must be "just and reasonable." And unlike the IRS, the California Attorney General's Office takes the position that compensation paid in prior years cannot be considered in determining the reasonableness of compensation in later years, unless there was an explicit agreement in the prior years to defer compensation.

Procedural Test

The IRS will not rule on whether compensation to be paid to any particular employee is reasonable, since this involves a factual matter that cannot be determined in advance. Rev. Proc. 2017-3, Section 3.01(28). However, if an organization follows certain procedures, as described below, the IRS can refute a presumption of reasonableness only if it develops sufficient contrary evidence to rebut the probative value of the comparability data relied upon by the authorized body. Thus, you should advise tax-exempt employers to find and use contemporaneous persuasive comparability data when they authorize compensation and benefits that may be seen as excessive. Form 990 Instructions (Appendix G).

In order to rely on the presumption of reasonability, the following conditions must be met:

- **Evidence of compensatory intent.** The organization must provide contemporaneous written substantiation of its intent to provide an economic benefit as compensation. This may be done by:
    - Producing a signed written employment contract
    - Reporting the benefit as compensation on a Form W-2, Form 1099, or Form 990 filed before the start of an IRS examination –or–
    - Reporting by the executive of the benefit as income on a Form 1040 filed before the start of an IRS examination

  See Treas. Reg. § 53.4958-4(c).

- **Approval absent conflict of interest.** The transaction must be approved by an authorized body of the organization (or an entity it controls) that is composed of individuals who do not have a conflict of interest concerning the transaction. Typically, an organization will have a policy that no member of the executive committee, human resources department, or other body that sets compensation will be a staff member, the relative of a staff member, or have any relationship with staff that could present a conflict of interest.
- **Reliance on comparability data.** Before making its determination, the authorized body must obtain and rely upon appropriate data as to comparability. Under a special safe harbor for small organizations having gross receipts of less than $1 million, appropriate comparability data includes data on compensation paid by three comparable organizations in the same or similar communities for similar services.
- **Documentation of determination.** The authorized body must adequately document the basis for its determination concurrently with making that determination. The documentation should include:
    - The terms of the approved transaction and the date approved
    - The members of the authorized body present during deliberation and those who voted on it
    - The comparability data relied upon and how it was obtained –and–
    - Any actions by a member of the authorized body having a conflict of interest

  To be contemporaneous, ensure the documentation requirements are met before the later of the next meeting of the authorized body or 60 days after the final actions of the authorized body are taken, and that approval of records as reasonable, accurate, and complete occurs within a reasonable time thereafter.

Treas. Reg. § 53.4958-6(c); see also Form 990 Instructions (Appendix G, under "What Is Reasonable Compensation" and "Rebuttable Presumption of Reasonableness").

Excise Tax on Excess Executive Compensation

Tax reform legislation signed into law in late 2017 (Pub. L. No. 115-97) and effective as of the 2018 tax year imposes new excise taxes on tax-exempt organizations for certain "excess" executive compensation arrangements under new I.R.C. § 4960. Pub. L. No. 115-97, § 13602. Final rules implementing Section 4960 made only slight modifications to the proposed rules. See 86 Fed. Reg. 6,196 (Jan. 19, 2021) (adding Treas. Reg. §§ 53.4960-1 through 53.4960-5). These final regulations will supersede initial IRS guidance under I.R.S. Notice 2019-9 and the proposed regulations at 85 Fed. Reg. 35,746 (June 11, 2020). For taxable years that begin before January 1, 2022, taxpayers may rely on the Notice, the proposed regulations, or the final rules (provided, in each case, they are applied in their entirety). The final rules apply for all taxable years beginning after December 31, 2021.

Note that the excise tax on excess compensation is separate from the penalty tax on excess benefit transactions discussed in the section above entitled "Excess Benefit Transaction Penalty Tax" under Reasonable Compensation. Compensation can represent excess compensation whether or not it also constitutes an excess benefit transaction and vice versa. Treas. Reg. § 53.4960-4(a)(1).

Under the new law, certain tax-exempt organizations (described below) are liable for a 21% excise tax (the corporate rate) on:

- Any remuneration (other than an excess parachute payment) in excess of $1 million paid to a covered employee for a calendar year –and–
- Any excess parachute payment paid to a covered employee

I.R.C. § 4960(a); I.R.S. Notice 2019-9, Pt. I.A (clarifying that the $1 million limitation measurement period will be the calendar year ending with or within the employer's taxable year); Treas. Reg. § 53.4960-1(c).

Definitions and Rules of Application

Entities Covered

The **applicable tax-exempt organizations** subject to the excise tax include the following types of entities if they are the common-law employer of a covered employee (regardless of whether another entity pays the compensation):

- Entities exempt from tax under I.R.C. § 501(a)
- Farmers' cooperatives described in I.R.C. § 521(b)(1)
- Entities that exclude income from tax under I.R.C. § 115(1) (referring to governmental entities that are separately organized from a state or political subdivision of a state eligible to exclude certain income from gross income) –and–
- Political organizations within the meaning of I.R.C. § 527(e)

I.R.C. § 4960(a); Treas. Reg. § 53.4960-1(b). Footnote 1251 on page 264 of the Joint Committee on Taxation's General Explanation of Public Law 115-97 ("Blue Book") indicates that public colleges and universities were intended to be applicable tax-exempt organizations, but that a technical correction might be necessary to accomplish this result. Accordingly, the IRS's position is that those public colleges and universities having IRS determination letters recognizing their tax-exempt status under I.R.C. § 501(c)(3) and 501(a) or that exclude all or part of their income from gross income under I.R.C. § 115(1) are applicable tax-exempt organizations. Absent both those criteria, an organization would not be an applicable tax-exempt organization (but could become liable for the tax as a related organization, as described further below). See 85 Fed. Reg. 35,747.

Unfortunately, this rule provides little guidance for many public colleges and universities. A governmental unit (sometimes referred to as an integral part of government) generally is not taxable at all in the absence of specific statutory authorization for taxing that income. A governmental entity that is separately organized from a state or political subdivision of a state (an instrumentality of government) is a taxable entity, but can exclude from gross income under I.R.C. § 115(1) any income which is derived from any public utility or the exercise of any essential governmental function and accruing to a state, any political subdivision thereof, or the District of Columbia. There have been private rulings which have characterized public colleges and universities as either integral parts of government or instrumentalities of government, but there is no bright-line test to determine whether a particular college or university is an integral part of government or an instrumentality of government. In most instances, it had not been important to make this distinction (to the extent that all of the entity's income would be excludible under I.R.C. § 115(1)), so most such entities have not bothered to get rulings as to their status. A public college or university that has never obtained a ruling on its status may have to make a difficult judgment call regarding whether to consider itself an integral part of government (and thus not an applicable tax-exempt organization) or an instrumentality of government (and thus an applicable tax-exempt organization).

Pending further consideration, certain federal government instrumentalities that are exempt from current and future federal taxes under the enabling acts (as opposed to under I.R.C. § 115(1)) will not be liable for Section 4960 excise taxes, although remuneration they pay to a covered employee would be taken into account for applicable determinations. 86 Fed. Reg. 6,196–97.

Exceptions for Certain Non-U.S. Entities

The final rules introduced an exception from applicable tax-exempt organization status for non-U.S. entities substantially all of whose support derives from non-U.S. sources (see I.R.C. § 4948(b)) if the entity is either

(1) exempt from tax under I.R.C. § 501(a)

(2) is a taxable private foundation (see I.R.C. § 4940(d)(3)(A).

Treas. Reg. § 53.4960-1(b)(2). Such organizations are also exempt from liability for Section 4960 excise taxes as a related organization, although remuneration they pay to a covered employee would be taken into account for applicable determinations.

In addition, compensation paid to covered employees by so-called **related organizations** (having a control or support relationship with an applicable tax-exempt organization) for services rendered to the related organization is taken into account for purposes of assessing the excise tax, and the related organization bears its share of any excise tax liability. See I.R.C. 4960(c)(4)(B); Treas. Reg. § 53.4960–1(i) (related organization definition); Treas. Reg. § 53.4960-5(a)(3) (allocation of liability). However, the final regulations provide for exceptions from coverage in certain circumstances where services provided by an employee of a related organization would otherwise invoke the excise tax, as noted below.

Covered Employees

A **covered employee** is an employee (or former employee) of an applicable tax-exempt organization if the employee is one of the five highest compensated employees of the organization for a taxable year beginning after December 31, 2016. Individuals who become covered employees remain one for life, even if they are no longer among the five highest compensated employees. I.R.C. § 4960(c)(2). There is no minimum threshold for covered employee status, so applicable tax-exempt organizations must track their five highest-compensated employees for each calendar year (even if they are not highly compensated employees under I.R.C. § 414(q) and even if there is no Section 4960 liability for that year), since those individuals will remain covered employees for all future years. Treas. Reg. § 53.4960-1(d).

Exceptions under the final regulations generally apply for the following individuals:

- An unpaid volunteer of the tax-exempt organization (even if employed by a related organization) if their total annual hours worked for the tax-exempt organization and related organizations are no more than 10% of all services performed for the tax-exempt organization and related applicable tax-exempt organizations (or if their total hours are less than 100)
- An employee who is not compensated by an applicable tax-exempt organization, a related applicable tax-exempt organization, or any taxable related organization controlled by the applicable tax-exempt organization if more than 50% of their total hours providing services (measured over a two-year period pursuant to a modification in the final rules) are on behalf of a related non-applicable tax-exempt organization
- An employee of an applicable tax-exempt organization if the organization paid less than 10% of the employee's total remuneration for services performed for the tax-exempt organization and all related organizations
- An employee of an applicable tax-exempt organization if either (1) a related applicable tax-exempt organization paid at least 10% of the individual's total remuneration paid by the employer organization and any related organization or (2) no related applicable tax-exempt organization paid at least 10% of the total remuneration paid by the employer organization and any related organization and the employer organization paid less remuneration than at least one related applicable tax-exempt organization

Treas. Reg. § 53.4960-1(d)(2)(ii), (iii), (iv).

Remuneration

In general, **remuneration** includes all compensation reported on an individual's Form W-2 for services to an applicable tax-exempt organization. However, amounts that are subject to a substantial risk of forfeiture are included in remuneration when they vest, even if they have not yet been paid, which means that they may be included in remuneration in a different year from the year in which they are reported on the Form W-2. See, for example, the discussion of 457(b) plans and 457(f) plans later in this practice note. Remuneration that is not subject to a substantial risk of forfeiture is treated as paid Remuneration also includes compensatory payments made by a related organization with respect to an applicable tax organization. I.R.C. § 4960(c)(3), (4).

However, three types of compensation are exempt from the rule:

- Roth contributions
- Compensation attributable to medical services of licensed professionals, such as doctors, nurses, or veterinarians
- Amounts that were paid or that vested (even if not paid) before the effective date of I.R.C. § 4960 (e.g., amounts

under a 457(f) plan that vested prior to the taxable year of the employer beginning before January 1, 2018)

I.R.C. § 4960(c)(3); Treas. Reg. § 53.4960-2(a). However, amounts that did not vest before the effective date of I.R.C. § 4960 are included in remuneration when they vest, even if they were deferred before the effective date of I.R.C. § 4960. For example, suppose that an executive had been deferring $20,000 a year for 30 years under a 457(f) plan before January 1, 2018, but the entire amount became vested in 2019. The entire amount deferred (including any earnings) would be included in remuneration in 2019, which might well both cause the executive to become a covered employee for life and push total 2019 remuneration over the $1 million mark. On the other hand, any amount of remuneration that is vested prior to the Section 4980 effective date is not taken into account (even if it is actually or constructively received after that date). 86 Fed. Reg. 6,209.

For additional details on remuneration and the exceptions, see I.R.S. Notice 2019-9, Pt. II.D and II.E; 85 Fed. Reg. 35,750–57; and 86 Fed. Reg. 6,199–209.

Parachute Payment

A **parachute payment** under these rules is a payment to a covered employee (subject to the exclusions noted below) if:

- The payment is contingent on the employee's involuntary separation from employment –and–
- The aggregate present value of all such payments equals or exceeds three times the base amount.

I.R.C. § 4960(c)(5)(B); Treas. Reg. § 53.4960-3. Only amounts that become payable (or that become vested) if the employee experiences an involuntary termination (or certain window programs), generally applying the I.R.C. § 409A definitions, are considered.

If an involuntary separation from employment causes an acceleration of vesting or payment, then the value of the acceleration may also constitute a parachute payment. Treas. Reg. § 53.4960-3(f)

However, parachute payments do not include payments:

- To a qualified retirement plan, simplified employee pension plan, or SIMPLE IRA
- To a tax-deferred annuity or annuity contract exempt under I.R.C. § 403(a) or 403(b)
- To an eligible deferred compensation plan under I.R.C. § 457(b)
- For medical services provided by a licensed professional –or–
- To an individual who is not a highly compensated employee under I.R.C. § 414(q) (i.e., annual compensation for prior year does not exceed the applicable threshold ($155,000 for 2024)

I.R.C. § 4960(c)(5)(B); Treas. Reg. § 53.4960-3(a)(2).

Base Amount

The **base amount** is the average annualized compensation includible in the covered employee's gross income for the five taxable years ending before the date of the employee's separation from employment. I.R.C. § 4960(c)(5)(D); Treas. Reg. § 53.4960-3(k).

Excess Parachute Payment

An **excess parachute payment** is the amount by which any parachute payment exceeds the portion of the base amount allocated to the payment. Excess parachute payments are subject to the excise tax even if they do not exceed the $1 million limit applicable to other remuneration. Similar to the golden parachute rules under I.R.C. § 280G, the excise tax only applies if the total present value of all parachute payments exceeds the threshold of 3x the base amount, but the tax applies to all excess parachute payments (i.e., parachute payment amounts exceeding 1x the base amount). I.R.C. § 4960(c)(5)(A); Treas. Reg. § 53.4960-4(d)).

An excess parachute payment is not counted in determining whether the $1 million limit on remuneration is exceeded. However, a single severance payment can trigger both the excise tax on excess compensation (other than excess parachute payments) and the excise tax on excess parachute payments.

For example, suppose that A is a covered employee and receives regular compensation of $600,000, plus a severance payment of $1.8 million, in 2019. A's average annualized compensation for the five taxable years ending before the separation from service is $500,000 (the base amount). Since the severance payment is more than three times the base amount, the excess parachute payment excise tax is triggered. The excess parachute payment amount is $1.3 million ($1.8 million minus the base amount). The other $500,000 of the severance payment is added to the $600,000 in regular compensation for the year to determine whether the $1 million in annual remuneration (other than excess parachute payment) limit is exceeded. That means that $100,000 ($600,000 + $500,000 – $1 million) is subject to the excise tax as excess compensation (other than excess parachute payments). The total amount subject to the excise tax is the $100,000 in excess compensation (other than excess parachute payments) plus the $1.3 million excess parachute payment, or $1.4 million.

For additional details on the parachute payment provisions of I.R.C. § 4960, see I.R.S. Notice 2019-9, Pt. II.F to II.H; 85 Fed. Reg. 35,759–64; and 86 Fed. Reg. 6,209--12. Several of the rules mirror the similar provisions of the I.R.C. § 280G regulations (e.g., determining the base amount, the present value of parachute payments, and the value attributed to accelerated vesting or payment). For guidance on applying the mechanics of those rules, Section 280G Parachute Payment Determinations and Calculations.

Deferred Compensation Rules

The three main compliance concerns for the executive deferred compensation arrangements of a tax-exempt organizations are to ensure:

- The value of the deferred compensation must, when added to the rest of the executive's compensation package, represent reasonable compensation (as discussed in the previous section)
- The deferred compensation is structured as a top hat plan under ERISA to avoid funding and other requirements –and–
- The deferred compensation arrangement qualifies as a:
  - 457(b) plan –or–
  - 457(f) plan that meets (or is exempt from) the requirements of I.R.C. § 409A

Each of these considerations is described further below.

Valuation Issues for Deferred Compensation Reasonableness Testing

As noted above, you need to take account the value of deferred compensation in determining whether total compensation is reasonable. Thus, you need to have a mechanism to determine the value of the deferred compensation promise. You may want to look by analogy to the valuation principles used in the regulations under I.R.C. § 3121(v)(2). Those rules provide separate valuation methods for account balance plans versus non-account balance plans.

Account Balance Plans

An account balance plan is defined as:

> [A] nonqualified deferred compensation plan under the terms of which a principal amount (or amounts) is credited to an individual account for an employee, the income attributable to each principal amount is credited (or debited) to the individual account, and the benefits payable to the employee are based solely on the balance credited to the individual account.

Treas. Reg. § 31.3121(v)(2)-1(c)(1)(ii)(A). This is the most common type of deferred compensation plan.

If an account balance is determined using a predetermined actual investment (whether as a notional bookkeeping account or an actual investment held in a rabbi trust) or a reasonable rate of interest, the value of deferred compensation payable under an account balance plan is generally the amount credited to the account. For example, suppose that the plan provides that the employer will put $5,000 into a rabbi trust, and the executive will get the value of that rabbi trust (including the earnings thereon) at the end of five years. The value of the deferred compensation today would be $5,000. See Treas. Reg. § 31.3121(v)(2)-1(d). The same would be true in the absence of a rabbi trust, if the executive will get $5,000 plus interest calculated at a reasonable rate compounded quarterly at the end of five years.

The situation becomes more complicated if the deferred amount is credited with interest at an unreasonable rate. For example, if the employer promised a benefit of $5,000, plus interest at a rate of 50% a year, payable in five years, then the value could not be deemed to be only $5,000. In that situation, the value of the deferred compensation is equal to the amount credited to the participant's account, plus the present value of the excess of the earnings to be credited under the plan over the earnings that would be credited during that period using a reasonable rate of interest. See Treas. Reg. § 31.3121(v)(2)-1(d)(2)(iii).

Non-account Balance Plans

In some instances, a deferred compensation plan is not based on an account balance. For example, a plan might simply provide that the executive would receive a benefit of $10,000 in five years. Other examples might include plans providing for an annuity benefit based on a formula. For non-account balance plans, the value of the deferred compensation is the present value of the right to receive payment of the compensation in the future, taking into account the time value of money and the probability that the payment will be made. Prop. Treas. Reg. §§ 1.457-12(a)(2) and (c), 81 Fed. Reg. 40,548 (June 22, 2016) (see Part IV.B of the preamble). This contrasts with the rules of I.R.C. § 3121(v)(2), under which discounts based on the probability that payments will not be made due to the unfunded status of the plan, the risk that the eligible employer or another party may be unwilling or unable to pay, the possibility of future plan amendments or changes in law, and other similar contingencies cannot be taken into account. Treas. Reg. § 31.3121(v)(2)-1(c)(2).

Top Hat Plan ERISA Exemption

Under ERISA, a pension benefit plan (which, as defined under ERISA § 3(2) (29 U.S.C. § 1002(2)), includes many deferred compensation arrangements) must normally be funded. However, a funded plan that covers only one or more executives would give rise to a number of unfavorable tax consequences under I.R.C. § 402(b). To avoid this issue, a deferred compensation plan for an executive must be structured as a so-called top hat plan. These rules are the same that would apply for a taxable organization.

Top hat plans are not only exempt from ERISA's funding rules, but also its participation, vesting, and fiduciary responsibility requirements. ERISA §§ 201(2), 301(a)(3), 401(a)(1) (29 U.S.C. §§ 1051(2), 1081(a)(3), 1101(a)(1)). They are also exempt from Form 5500 reporting and ERISA disclosure requirements, provided that the sponsor files a simple one-time notice with the Department of Labor (DOL). 29 C.F.R. § 2520.104-23. For more information on the DOL notice filing, see Top Hat Plan Statement Filing Rules and Procedures.

Two questions arise with respect to determining whether a plan is a top hat plan:

- Is the plan unfunded?
- Is the plan maintained primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees?

Top Hat Plan Funding – Rabbi Trusts

As discussed above, a top hat plan must be unfunded. However, some form of funding is desirable from the perspective of executives seeking assurance that the amount will ultimately be paid, even if changes in the organization's board cause it to reconsider payment or if the organization's finances make payment a hardship for the organization. In addition, as discussed above, valuing deferred compensation for purposes of the reasonable compensation test is difficult if the amount ultimately to be paid is not based on a fixed set-aside each year, plus earnings at a reasonable rate. Having the rate depend on the performance of a trust is one way to ensure that the rate is reasonable. The primary mechanism for achieving this goal is a rabbi trust.

A rabbi trust is one in which any assets held by the trust will remain subject to the claims of the employer's general creditors in the event of the employer's insolvency. The IRS treats such trusts as being unfunded and, therefore, excluded from the rules of I.R.C. § 402(b), which generally governs the tax treatment of trusts under nonqualified plans. The DOL has stated its intention to look to the IRS rules governing rabbi trusts for purposes of determining funded status for the definition of a top hat plan. ERISA Advisory Opinion 90-14A; DOL Op. 90-14A.

For rabbi trust drafting guidance and a form based on IRS model language in Rev. Proc. 92-64, see Rabbi Trust Drafting and Design and Rabbi Trust. Because the IRS will not issue rulings on a rabbi trust, use of the model form is advisable to assure compliance with IRS requirements.

A rabbi trust does not have all of the benefits of a funded arrangement. In the event of the organization's insolvency, the executive's benefits may not be paid. However, a rabbi trust with an independent third-party trustee protects the executive in situations short of the organization's insolvency, such as if a new board disagrees with the prior board's decision to provide deferred compensation and refuses to make payment, if the organization is suffering cash flow issues short of insolvency, or if the organization has charitable purposes that are a higher priority for it than paying out deferred compensation.

For more information on this topic, see Rabbi Trust Drafting and Design.

Top Hat Plan – Select Group

Top hat plans must be maintained "primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees." See Top Hat Plans. Although I.R.C. § 414(q) and Treas. Reg. § 1.414(q)-1T set forth a definition of highly compensated employee for purposes of plan qualification requirements, case law clarifies that this definition cannot be used for purposes of determining top hat plan status. Instead, a four-part test is used, looking at the:

- Percentage of the total workforce invited to join the plan
- Nature of their employment duties
- Compensation disparity between top hat plan members and non-members –and–
- Actual language of the plan agreement

Bakri v. Venture Mfg., 473 F.3d 677, 678 (6th Cir. 2007); Cramer v. Appalachian Reg'l Healthcare, No. 2012 U.S. Dist. LEXIS 154624 (E.D. Ky. 2012).

The DOL takes the position that the term "primarily," as used in the phrase "primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees," refers to the purpose of the plan and not the participant composition of the plan. Therefore, a plan cannot include any employees who are not part of "a select group of management or highly compensated employees" without losing its status as a top hat plan. DOL Op. 90-14A.

Internal Revenue Code Deferred Compensation Rules

Deferred compensation plans of tax-exempt organizations are subject to two sets of rules:

- **Section 457 rules for tax-exempt organizations.** In general, I.R.C. § 457(f) imposes income taxes on all nonqualified deferred compensation in the first year such amounts are no longer subject to a substantial risk of forfeiture, except to the extent that it is paid under a 457(b) plan as described in the next section. This tax timing rule applies even if the plan otherwise complies with I.R.C. § 409A, which substantially restricts nonqualified deferred compensation arrangements for nonprofits. Moreover, when amounts are included in income under I.R.C. §§ 457(b) or (f), they are counted as remuneration in determining whether the excise tax on excess compensation applies.
- **Section 409A rules for all employers, including tax-exempt organizations.** I.R.C. § 409A sets forth rules allowing for the deferral of income recognition and income taxation of nonqualified deferred compensation until the amounts are paid, even if the amounts are no longer subject to a substantial risk of forfeiture. However, if the strict rules of Section 409A are not met, then two things happen for any amounts deferred under the plan that are no longer subject to a substantial risk of forfeiture:
  - Such amounts are included in the income of the employee (even if they are not yet payable under the terms of the plan).
  - The employee is subject to an additional 20% tax on such amounts, plus an interest penalty based on any underpayment of tax liability for an earlier year when the deferred amount should have been included in income.

Although both Section 457 and Section 409A potentially impose taxes at the point at which nonqualified deferred compensation ceases to be subject to a substantial risk of forfeiture, the meaning of "substantial risk of forfeiture" for purpose of the two sections is slightly different, as described in the discussions below.

On June 22, 2016, the Treasury Department issued proposed regulations under Section 457 (proposed 457 regulations) and Section 409A (proposed 409A regulations). 81 Fed. Reg. 40,548 (June 22, 2016) (Section 457) and 81 Fed. Reg. 40,569 (June 22, 2016) (Section 409A). These proposed regulations modified several long-standing rules and are taken into account for purposes of the discussion below. Although not yet finalized, taxpayers may rely on the proposed regulations until the applicability date.

Section 457

As noted in the previous section, Section 457 provides that deferred compensation paid by tax-exempt organizations is taxable at the time it is no longer subject to a substantial risk of forfeiture (i.e., vests), unless the plan is a 457(b) plan. I.R.C. § 457(f).

Thus, a deferred compensation plan other than a 457(b) plan that does not subject the amount deferred to a substantial risk of forfeiture would cause amounts under the plan to be taxable as soon as they obtained the legally binding right to a plan benefit, even though payment may not occur until years into the future. To avoid this, a deferred compensation plan for an executive of a tax-exempt organization must be structured so as either to be a 457(b) plan or to ensure that the compensation remains subject to a substantial risk of forfeiture during the period of deferral. The latter alternative is referred to as a 457(f) plan. As discussed later in this practice note, a 457(f) plan (but not a 457(b) plan) is subject not only to I.R.C. § 457(f), but also to I.R.C. § 409A.

Income Inclusion under Section 457

The amount recognized as taxable income under Section 457 is the present value of the amount that becomes vested during the tax year. If payment occurs in a later year, the employee may be subject to additional income tax under the annuity tax rules of I.R.C. § 72. The taxable amount in the year of payment would be any excess over the amount recognized as income in the year of vesting, which earlier amount is treated as an investment in the contract under the annuity rules. However, if income is included for a deferred amount that is never paid, because the right to the benefit was forfeited under the terms of the plan, the individual is entitled to a deduction for the tax year in which the forfeiture occurs. Treas. Reg. § 1.457-11(a); see also Prop. Treas. Reg. § 1.457-12(c)(2), 81 Fed. Reg. 40,565.

Section 457(b) Plans

I.R.C. § 457(b) provides an exception to Section 457's general income recognition rule for unfunded plans of a tax-exempt organization that qualify as a so-called eligible deferred compensation plan. I.R.C. § 457(a). The following rules apply for nongovernmental eligible deferred compensation plans. Eligible deferred compensation plans must meet all of the following requirements:

- Only individuals who perform service for the employer may be participants.
- The maximum amount that may be deferred under the plan for a year (other than rollover amounts) cannot exceed the lesser of certain dollar limits, as adjusted for inflation ($23,000 for 2024) or 100% of the participant's compensation, subject to certain catch-up contributions. (For information regarding excess deferrals, see IRS, 457(b) Plans – Correction of Excess Deferrals.)

- Compensation can be deferred for any calendar month only if an agreement providing for such deferral has been entered into before the beginning of such month.
- The plan will not distribute amounts earlier than the earliest of:
  - The calendar year in which the participant attains age 70½
  - The participant's severance from employment with the employer –or–
  - An unforeseeable emergency
- The plan meets certain minimum distribution requirements beginning on the participant's death or attainment of age 72 (age 70½ for individuals who attained that age by December 31, 2019), in accordance with I.R.C. § 401(a)(9).

I.R.C. § 457(b); see also Treas. Reg. §§ 1.457-2 through 1.457-10.

A 457(b) plan provides certain flexibility as compared with other types of deferred compensation plans. For example, it can defer benefits until retirement or other termination of employment, rather than to a fixed date. And it can provide for the payment of benefits over a period of time, rather than in one lump sum. However, as with other deferred compensation plans, amounts deferred will be counted as remuneration in determining whether the excise tax on excess executive compensation applies at the time they cease to be subject to a substantial risk of forfeiture. This means that they will be included in remuneration in the year deferred, rather than the year in which they are included in income for purposes of income taxes.

A disadvantage of a 457(b) plan is that it permits only a relatively low level of deferrals. For example, for 2024, the maximum deferral for most participants is $23,000. Somewhat higher limits apply to those with long service or who are close to retirement (see IRS, Issue Snapshot – Section 457(b) Plan Catch-Up Contributions). Nevertheless, the maximum amount that can be deferred under a 457(b) plan is much less than many organizations wish to provide for their executives. Thus, a tax-exempt organization will typically defer the maximum for an executive under the 457(b) plan, which amounts are fully vested, and then defer additional amounts that are subject to a substantial risk of forfeiture under a 457(f) plan.

Section 457(f) Plans

If a deferred compensation plan of a tax-exempt organization is not a 457(b) plan (or is not otherwise exempt), the general Section 457 income recognition rule applies and any amounts of compensation deferred are included in the executive's gross income for tax purposes for the first taxable year in which there is no substantial risk of forfeiture of the rights to such compensation. The amount is also treated as part of remuneration for purposes of the excise tax on excess compensation in the first taxable year in which there is no substantial risk of forfeiture. Delaying distributions beyond the date that benefits will become taxable would mean that an executive would owe taxes on money not received. To avoid this, 457(f) plans are typically structured so as to ensure that amounts deferred are subject to a substantial risk of forfeiture during the entire period of deferral.

This differs from a nonqualified deferred compensation plan of a taxable organization, which can provide for deferred payment of vested amounts so long as the arrangement complies with Section 409A rules. For example, a taxable entity can offer an executive a retention bonus that will become vested if the executive remains employed for at least five years, but will not be paid (or recognized in income) until the executive reaches a specified retirement age. For a tax-exempt entity, this arrangement would result in the executive becoming taxed on the amount of the bonus in the year that the five-year vesting period is satisfied.

Exceptions to the Application of Section 457

Short-term deferrals. The proposed 457 regulations establish a short-term deferral rule based on the one under Section 409A. If an arrangement provides in writing that the payment must occur, under any circumstances, on or before March 15 of the year following the calendar year in which the right to the amount is no longer subject to a substantial risk of forfeiture (and the amount is paid by that date), the arrangement would not be a plan providing for a deferral of compensation to which I.R.C. § 457(f) applies. Although the March 15 date always works as a rule of thumb, where applicable, the applicable period extends to the 15th day of the third month following the end of the employer's first taxable year in which the right to payment is no longer subject to a substantial risk of forfeiture. Prop. Treas. Reg. § 1.457-12(d)(2), 81 Fed. Reg. 40,562.

The short-term deferral rule does not apply in determining remuneration subject to the excise tax on excess compensation discussed above. Thus, for example, if a payment ceases to be subject to a substantial risk of forfeiture in 2019, but is not paid until January of 2020, it would be included in remuneration in 2019 even though it would not be subject to income taxation until 2020. See footnote 1252 on page 264 of the Blue Book.

Qualified plan exemption. Qualified plans and other tax-favored deferral arrangements described in I.R.C. § 457(f)(2) (e.g., 401(k), 403(b), and 415(m) plans) are exempt from the

Section 457 income inclusion rule. I.R.C. § 457(f)(2); Treas. Reg. § 1.457-11(b).

Other exceptions. The following arrangements are also exempt or not considered to be deferrals of compensation for purposes of Section 457:

- Severance pay plans (discussed further below)
- Bona fide vacation and sick leave (discussed further below)
- Compensatory time, disability pay, death benefit, and volunteer length-of-service award plans, and certain voluntary early retirement incentive plans
- Certain recurring part-year compensation arrangements (e.g., where a teacher who does not work during the summer is nevertheless paid in substantially equal amounts throughout the year)
- Taxable reimbursements of expenses, medical benefits, or in-kind benefits (based on parallel exemptions for such benefits from Section 409A)
- Taxable educational assistance for an employee (but not a family member) under I.R.C. § 127(c)(1)

I.R.C. § 457(e)(11); Prop. Treas. Reg. §§ 1.457-11(c)(1), (2), 81 Fed. Reg. 40,560; and Prop. Treas. Reg. § 1.457-12(d)(3), (4), 81 Fed. Reg. 40,566.

Substantial Risk of Forfeiture under Section 457

Identifying when a substantial risk of forfeiture exists under Section 457 is important for structuring arrangements to comply with the short-term deferral exception to Section 457 and for identifying the year in which deferred amounts become taxable under I.R.C. § 457(f). Rights to deferred compensation are subject to a substantial risk of forfeiture if the executive's rights to such compensation are conditioned upon the future performance of substantial services. I.R.C § 457(f)(3)(B). The proposed 457 regulations bring the Section 457 definition of substantial risk of forfeiture into closer alignment with the definition under the Section 409A final regulations by providing as follows:

- **Performance goals.** An amount conditioned upon the occurrence of a condition that is related to a purpose of the compensation (e.g., a performance goal of the employee or organizational goal of the tax-exempt entity) is considered to be subject to a substantial risk of forfeiture if the possibility of forfeiture is substantial.
- **Involuntary severance.** Amounts whose payment are conditioned on an involuntary severance from employment without cause, or a bona fide voluntary termination for good reason (e.g., severance), are only considered subject to a substantial risk of forfeiture if the possibility of forfeiture is substantial.
- **Noncompetes.** Refraining from the performance of substantial services (e.g., pursuant to a covenant not to compete) may form the basis of a substantial risk of forfeiture, subject to the following conditions:
    - The covenant not to complete must be an enforceable written agreement.
    - The employer must make reasonable ongoing efforts to verify compliance with noncompetition agreements in general and with the specific noncompetition agreement applicable to the employee.
    - The employer must have a substantial and bona fide interest in preventing the employee from performing the prohibited services.
    - The employee must have a bona fide interest in, and ability to, engage in the prohibited competition.
- **Likelihood of enforcement.** In any case, a substantial risk of forfeiture will not be deemed to exist unless the facts and circumstances indicate that forfeiture provision is likely to be enforced.

Prop. Treas. Reg. § 1.457-12(e)(1), 81 Fed. Reg. 40,567.

The proposed 457 regulations also contain special rules relating to elective deferred compensation arrangements, that is, arrangements in which the executive can elect (1) to defer the payment of compensation that is normally payable on a current basis (e.g., salary or commissions) with the addition of a payment condition that subjects the amount to a substantial risk of forfeiture, or (2) to extend the deferral period of an amount already deferred. The concern is that a rational executive who could get cash now would not agree to defer the money until later if there were any meaningful risk of not receiving it. Thus, the proposed 457 regulations allow such initial elective deferrals and elections to extend a deferral period only if the election meets all of the following requirements:

- The present value of the amount to be paid upon the lapse of the substantial risk of forfeiture (as extended, if applicable) must be materially (at least 25%) greater than the amount the employee otherwise would be paid in the absence of the substantial risk of forfeiture (or absence of the extension).
- The initial or extended substantial risk of forfeiture must be based upon the future performance of substantial services or adherence to an agreement not to compete. It may not be based solely on the occurrence of other types of conditions (e.g., a performance goal for the organization). However, if there is a sufficient service condition, the arrangement can also impose other conditions. For example, the risk of forfeiture could continue until the later of two years or when a performance goal was met.
- The period for which substantial future services must be performed may not be less than two years (absent an

intervening event such as death, disability, or involuntary severance from employment).

- The agreement subjecting the amount to a substantial risk of forfeiture must be made in writing before (1) the beginning of the calendar year in which any services giving rise to the compensation are performed in the case of initial deferrals, or (2) at least 90 days before the date on which an existing substantial risk of forfeiture would have lapsed in the absence of an extension. Special rules apply to new employees (but not to employees who are newly eligible to participate in a plan).

Prop. Treas. Reg. § 1.457-12(e)(2), 81 Fed. Reg. 40,567–68.

Based on the above factors, a 457(f) plan must be structured in very different ways than a deferred compensation plan for a taxable organization:

- Because of the need for an ongoing condition to payment to provide a substantial risk of forfeiture, it is difficult to design a 457(f) plan to effectively defer payment until retirement or to a post-retirement period, and many executives will balk at arrangements that require extended vesting periods.
- Since any deferred amounts will become taxable in the year they cease to be subject to a substantial risk of forfeiture, a 457(f) plan cannot efficiently provide for payments over an individual's lifetime, or over a period of years, following the date on which benefits become payable, but rather must be paid immediately to avoid a mismatch in the timing of taxation.
- In most instances, a 457(f) plan must distribute benefits in a year in which the executive is still working (since a service-based requirement usually forms the basis for the substantial risk of forfeiture). Because an executive's compensation tends to rise over time, the tax advantages of deferral may be offset by the executive being in a higher tax bracket at the time benefits are paid. In addition, when amounts deferred over many years become vested in a single year, care must be taken to avoid triggering the excise tax on excess remuneration discussed above.

Section 409A

As noted above, Section 409A imposes a 20% additional tax and potential interest penalties on compensation deferred under a nonqualified deferred compensation plan that does not meet certain requirements, unless an exception applies. Because Section 409A applies separately and independently from Section 457, tax-exempt organizations must ensure their nonqualified deferred compensation arrangements are eligible for an exception from Section 409A (usually as a short-term deferral) or comply with the Section 409A rules. The interaction of the two statutes is discussed further below.

Section 409A Basics

All arrangements subject to Section 409A must:

- Be in writing (and include any applicable provisions required by Section 409A for the specific arrangement, such as the six-month delay rule)
- Provide for a time of payment upon one or more of the following permissible payment events, as specified in the original deferral agreement:
    - Separation from service
    - Disability
    - Death
    - A fixed payment date or schedule
    - A change in control of the business
    - An unforeseeable emergency
- Where deferral elections are permitted, comply with the applicable rules, including requiring:
    - Initial elections to defer compensation to be made before the end of the year preceding the year in which the services are rendered (subject to certain exceptions) –and–
    - Subsequent elections to further defer the payment of compensation to be (1) filed more than 12 months before the first payment of the deferred compensation becomes due, (2) not take effect for 12 months, and (3) defer by at least five years the date for the commencement of the payment
- Not be modified as to form or timing of payment, except as permitted under Section 409A –and–
- Be operated in compliance with Section 409A (e.g., there can be no acceleration of the timing of payment before the permissible payment event)

Certain arrangements are exempt from Section 409A, including:

- Short-term deferrals (described in the following section)
- Qualified and other tax-favored plans (e.g., 401(k), 403(b), and 415(m) plans), including 457(b) plans
- Certain severance benefits (discussed further below)
- Bona fide vacation and sick leave plans (discussed further below)
- Compensatory time, disability pay, and death benefit plans
- Nontaxable welfare benefits

Note that these exceptions do not always line up with the exceptions to Section 457.

The Section 409A rules are extremely complex. For more guidance on Section 409A rules, see Section 409A Fundamentals and the other resources in the Section 409A Resource Kit..

Interaction between Section 409A and Section 457 for Tax-Exempt Entities

As discussed earlier in this practice note, Section 457's general rule requires employees to recognize as taxable income any deferred compensation amounts in the first year that they are vested. Therefore, unlike taxable entities not subject to Section 457, tax-exempt employers effectively cannot take advantage of Section 409A-compliant plans that operate to defer the taxation of vested compensation until payment in a later year. Nevertheless, Section 409A still applies to tax-exempt employers, so it is important to ensure that these entities' deferral arrangements are eligible for an exception to Section 409A (or comply with the Section 409A rules if not exempt) to avoid the significant negative tax consequences of a Section 409A failure. Treas. Reg. § 1.409A-1(a)(4).

Short-term deferrals and substantial risk of forfeiture. Most 457(f) plans are not nonqualified deferred compensation plans for purposes of Section 409A because they automatically fall under Section 409A's short-term deferral exception. Section 409A does not apply if the deferred compensation must in all circumstances be paid no more than the first two and one-half months after the close of the tax year in which it ceases to be subject to a substantial risk of forfeiture. Treas. Reg. § 1.409A-1(b)(4). Further, under Treas. Reg. § 1.409A-1(a)(4), the inclusion in income of an amount in income under I.R.C. § 457(f) is treated as a **payment** for purposes of the short-term deferral rule. So, on first glance, one might think that I.R.C. § 409A would never apply to a 457(f) plan, because income inclusion necessarily occurs in the same year in which the substantial risk of forfeiture lapses.

However, differences between the definitions of substantial risk of forfeiture for purposes of Sections 457 and 409A can make Section 409A a concern for a 457(f) plan in certain circumstances. The two most common are:

- **Extended deferral periods.** As discussed above, an executive covered by a 457(f) plan can elect to extend the substantial risk of forfeiture for purposes of I.R.C. § 457(f) if certain conditions are met. However, for purposes of I.R.C. § 409A, the addition of any risk of forfeiture after the legally binding right to the compensation arises, or any extension of a period during which compensation is subject to a risk of forfeiture, is disregarded for purposes of determining whether such compensation is subject to a substantial risk of forfeiture.

  Moreover, once the present value of deferred compensation is included in income, imputed earnings under the plan are not taxable under I.R.C. § 457(f) until they are actually or constructively received, at which time they are taxable under the rules applicable to annuities. Nevertheless, the imputed earnings are subject to the rules of I.R.C. § 409A.

  Treas. Reg. § 1.409A-1(d)(1). Thus, if an executive extends the period of deferral under the 457(f) plan, the rules of I.R.C. § 409A must be followed in order to avoid Section 409A penalties.

- **Noncompete agreements.** For a 457(f) plan, a covenant not to compete will be deemed to create a substantial risk of forfeiture under certain circumstances, as set forth above. However, for purposes of I.R.C. § 409A, "An amount is not subject to a substantial risk of forfeiture merely because the right to the amount is conditioned, directly or indirectly, upon the refraining from the performance of services." Treas. Reg. § 1.409A-1(d)(1).

To avoid the 20% additional tax and potential interest penalty, a 457(f) plan that is subject to Section 409A because of the mismatch of substantial risk of forfeiture definitions must meet all of the requirements for Section 409A compliance summarized in the section entitled "Section 409A Basics," above, unless another Section 409A exception applies.

See the practice note Substantial Risk of Forfeiture under the IRC for additional discussion on the different definitions of substantial risk of forfeiture under the Internal Revenue Code.

Special accelerated payment rule for 457(f) plans. For 457(f) plans that are subject to Section 409A, there is a limited special exception to the Section 409A prohibition on accelerated payments. This rule allows the plan to provide (or be amended to provide) for a distribution of a portion of the amount deferred under the plan earlier than the stipulated permissible payment event if the deferred compensation is required to be included in income under I.R.C. § 457(f) because it becomes vested. The amount that may be distributed is capped at the maximum tax withholding triggered by the income inclusion for federal, state, and local taxes (note that this may be less than the actual tax liability). Treas. Reg. § 1.409A-3(j)(4)(iv). This exception can ease the burden on an employee who becomes subject to a tax liability on amounts that will not be paid under Section 409A plan until a later time.

457(b) plans. Note that 457(b) plans are exempt from Section 409A, so such "eligible deferred compensation plans" will not raise any Section 409A issues so long as the 457(b) rules are satisfied. I.R.C. § 409A(d)(2)(B). Avoiding potential Section 409A failures is another reason for 457(b) plan sponsors to be vigilant about compliance, since loss of eligible deferred compensation plan status would subject the arrangement to Section 409A and potentially risk a violation of its strict deferred compensation rules.

Severance Pay

ERISA, Section 457, and Section 409A all provide similar, but not identical, coverage exceptions for severance plans. The consequences of a plan that provides for post-termination benefits (in the case of ERISA) or for deferred compensation (in the case of Sections 457 and 409A) failing to qualify for a severance plan coverage exception under each of these statutes is different:

- **ERISA.** Unless it falls within the DOL safe harbor discussed below, a severance plan is likely to be considered an employee pension benefit plan under ERISA that must be structured as a top hat plan to avoid various ERISA requirements as discussed in the section entitled "Top Hat Plan ERISA Exemption" under Deferred Compensation Rules, above.
- **Section 457**. Unless it qualifies as an exempt severance pay plan as discussed below, a severance plan would be subject to Section 457 such that amounts deferred under it will be taxable when they cease to be subject to a substantial risk of forfeiture within the meaning of I.R.C. § 457(f).
- **Section 409A.** To the extent it does not qualify for the separation pay plan exception discussed below (or another exception to Section 409A), severance rights are subject to Section 409A's strict requirements.

Each of the specific regulatory exceptions are described in the following sections. Note as a preliminary matter, however, that some severance plans do not defer compensation at all. Such plans do not present issues under Sections 457 or 409A.

A severance agreement will not defer compensation if either:

- The severance compensation is paid in the same year in which the severance arrangement is entered into or within the first two and one-half months of the following year.
- The severance plan specifies that the employer has the right to amend the agreement at any time before the employee terminates employment (and, if there is a separation of service without any modification, then the severance is paid either within the same year as the termination of employment or within the first two and one-half months of the following year).

A common example of the first type is a situation in which the executive's employment contract did not provide for severance, but the employer offers severance at the time of termination (e.g., as consideration for the executive signing a general release of claims against the employer). One pitfall to beware of in this area is that if the employer develops a pattern or practice of offering similar severance arrangements to a class of executives at the time of their termination, the arrangement may ultimately be held to represent a contract with all such executives from the inception of their employment, which would make this alternative unavailable.

The second type is typical of broad-based severance plans covering a number of executives (and perhaps even rank-and-file employees). Since the employer can unilaterally alter or eliminate the severance benefit, or terminate the plan altogether, the covered employees do not have a legally binding right to receive the severance benefit.

Severance Plan Exceptions

Even if a severance plan is considered to defer compensation, it may nevertheless fall within an exception to the ERISA, Section 457, and/or Section 409A rules. However, as described under Excise Tax on Excess Executive Compensation above, because severance pay is based on separation from service, you will need to be mindful of the risk that substantial plan benefits may trigger the excise tax on excess parachute payments. And because a severance payment is often larger than normal annual compensation, you will also need to ensure that it does not cause the excise tax on excess compensation (other than excess parachute payments) to apply.

ERISA Severance Pay Plan Safe Harbor

A severance plan will not constitute an employee pension benefit plan under ERISA if it meets the following tests:

- Payments are not contingent, directly or indirectly, upon the employee's retiring.
- The total amount of the payments does not exceed the equivalent of twice the executive's annual compensation during the year immediately preceding the termination of service.
- All payments are completed either:
  - In the case of an executive whose service is terminated in connection with a limited program of terminations, within 24 months after the termination

- date (or, if later, after the employee reaches normal retirement age) –or–
  - In the case of all other employees, within 24 months after the termination date

29 C.F.R. § 2510.3-2. For a further discussion of this topic, see ERISA Title I Fundamentals and ERISA Coverage of Benefit Plans.

A plan that does not meet the above rules will need to be structured as a top hat plan, as discussed in the section entitled "Top Hat Plan ERISA Exemption" under Deferred Compensation Rules, above. For more information on this topic, see Severance Benefit ERISA Considerations Checklist.

Section 457 Bona Fide Severance Pay Plan Exception

The exception to Section 457 for severance arrangements applies to bona fide severance pay plans described in I.R.C. § 457(e)(11)(A)(i). Such arrangements are not considered to provide for the deferral of compensation for purposes of Section 457. Until issuance of the proposed 457 regulations, there was little guidance on what constituted a bona fide severance pay plan. Those rules establish the following criteria:

- The plan is permitted to pay the benefit only upon involuntary severance from employment (or pursuant to a window program or voluntary early retirement incentive plan). A voluntary severance from employment for "good reason" may be treated as an involuntary severance from employment under certain conditions (and the regulations include a safe harbor for bona fide good reason provisions).
- The amount of the severance benefit must not exceed two times the executive's annualized compensation, based on the annual rate of pay for the calendar year preceding the year of termination (or the year of termination if the executive had no compensation in the preceding year), adjusted for any pay increases expected to continue indefinitely if the executive had not had a severance from employment.
- The plan must provide in writing for payment of the entire severance benefit no later than the last day of the second calendar year following the year in which the termination occurs.

Prop. Treas. Reg. § 1.457-11(d), 81 Fed. Reg. 40,560–61.

Although these rules have not yet been finalized, tax-exempt entities may rely on them to structure arrangements that will be considered bona fide separation pay plans for purposes of Section 457.

A severance arrangement that does not meet the above requirements and provides for any payment later than the applicable short-term deferral period could result in current taxable income to the executive under Section 457 in the year the legally binding right to the severance is created, unless payment is subject to a substantial risk of forfeiture.

For example, if the severance benefits are contingent on an executive's satisfaction of a covenant not to compete that meets the requirements described in the section entitled "Substantial Risk of Forfeiture under Section 457" above, the noncompete covenant should serve to create a substantial risk of forfeiture, thereby avoiding income inclusion through the end of the noncompete period.

Section 409A Separation Pay Plan Exception

The severance pay plan exclusion under the proposed 457 regulations is based in part on Section 409A's separation pay plan exception under Treas. Reg. § 1.409A-1(b)(9)(iii). For purposes of Section 409A, separation pay does not provide for a deferral of compensation to the extent that the separation pay, or a portion of the separation pay, provided under the plan is:

- Payable only upon involuntary severance from employment (including pursuant to a bona fide "good reason" provision) or pursuant to a window program or voluntary early retirement incentive plan
- Greater than the lesser of two times either (1) the executive's annual rate of pay, based on the calendar year preceding the year of termination (or the year of termination if the executive had no compensation in the preceding year), or (2) the compensation limit under I.R.C. § 401(a)(17) for the year of termination ($345,000 for 2024) –and–
- Paid under the terms of the plan, by the end of the executive's second taxable year following the year in which the executive separates from service

If a plan does not meet the above requirements, or to the extent that the amount paid exceeds the limitation, it will be considered deferred compensation for purposes of Section 409A. The ability to apply the Section 409A separation pay exception to a partial amount under a severance arrangement differs from the Section 457 severance pay plan exception, which is all-or-nothing.

You must be careful when drafting separation agreements that do not qualify for the exception and are subject to Section 409A, particularly if payment is contingent on the executive's execution of a general release of claims against the employer. As noted above, Section 409A has strict rules designed to minimize the ability to manipulate the timing of payments of nonqualified deferred compensation. However, when severance pay is contingent on the executive's waiver of claims against the employer, it is sometimes possible for the executive to effectively choose between receiving payment in the year of termination or the following year. This occurs when the period for the executive to sign the waiver falls at the end of a calendar year such that the executive can execute the release promptly and receive the amount right away, or delay delivery of the release until after December 31 so that payment will occur in the next year. This de facto discretion on the part of the executive is a plan document violation under Section 409A, so the agreement must be drafted so as to avoid it. For details, see I.R.S. Notice 2010-80, modifying I.R.S. Notice 2010-6.

Vacation and Sick Leave Plans

Vacation and sick leave plans can give rise to deferred compensation concerns because many paid time off policies provide employees a cash-out of their accrued but unused paid time off upon termination of employment or at the end of a plan year. However, any bona fide vacation plan is exempt from Sections 457 and 409A (though not from the excise tax on excess compensation). I.R.C. §§ 457(e)(11)(A)(i), 409A(d)(1)(B).

The proposed 457 regulations do not provide any bright-line test as to when a vacation or sick leave plan will be considered bona fide. Instead, they use a facts and circumstances test to determine whether the primary purpose of the plan is to provide participants with paid time off from work due to sickness, vacation, or other personal reasons. The following factors are to be considered:

- Whether the amount of leave provided could reasonably be expected to be used in the normal course by an employee (before the employee ceases to provide services to the eligible employer) absent unusual circumstances
- The ability to exchange unused accumulated leave for cash or other benefits (including nontaxable benefits and the use of leave to postpone the date of termination of employment)
- The applicable restraints (if any) on the ability to accumulate unused leave and carry it forward to subsequent years in circumstances in which the accumulated leave may be exchanged for cash or other benefits
- The amount and frequency of any in-service distributions of cash or other benefits offered in exchange for accumulated and unused leave
- Whether any payment of unused leave is made promptly upon severance from employment (or instead is paid over a period after severance from employment) –and–
- Whether the program (or a particular feature of the program) is available only to a limited number of employees

Prop. Treas. Reg. § 1.457-11(f), 81 Fed. Reg. 40,561–62.

The last factor may be a particular concern in instances in which an executive has a more generous vacation plan than is available to other employees.

The final regulations issued under Section 409A do not provide a definition of bona fide vacation or sick leave plans "because the definitions of these terms may raise issues and require coordination with the provisions of section 451, section 125, and, with respect to certain taxpayers, section 457." 72 Fed. Reg. 19,234 (April 17, 2017). However, the IRS stated that, until further guidance, taxpayers whose participation in a nonqualified deferred compensation plan would be subject to Section 457(f) may rely on the definitions of bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan applicable for purposes of Section 457(f) as also being applicable for purposes of Section 409A. I.R.S. Notice 2005-1, Q&A 6 (reaffirmed in the final regulations).

Performance Bonuses and Other Nonfixed Payments

Performance bonuses and other nonfixed payments present two kinds of issues. First, special rules apply in determining whether they meet the reasonableness test described earlier under Reasonable Compensation. Second, care must be taken in structuring them so that they are not considered deferred compensation for purposes of Sections 409A and 457 (or otherwise comply with the applicable rules), and that they do not trigger the excise tax on excess compensation described above.

Reasonableness Testing Issues

Performance bonuses and other nonfixed payments present special issues under both the substantive and procedural reasonableness tests for reasonable compensation.

Reasonableness Issues – Substantive Test

As discussed under "Reasonable Compensation—Testing" in the Reasonable Compensation section above, in determining whether compensation is excessive, you look to the value of the compensation. But what about situations in which the value of the compensation cannot immediately be determined? For example, suppose the executive initially accepts a low salary (less than their worth) with a start-up nonprofit, but is promised that the organization will make up for it (in effect, paying more compensation than the executive is worth in a future year), with the increase to be based on overall growth in the organization? Or what if an executive is promised a performance bonus the amount of which is based on specific performance targets?

Such situations involve two issues: First, how does one determine whether the bonus is excessive? And, second, does the bonus establish an impermissible joint venture between the executive and the tax-exempt organization?

The mere establishment of profit-sharing incentive compensation plans does not result in prohibited inurement or other private benefit that will cause a tax-exempt entity to lose its exempt status under I.R.C. § 501(c)(3). If the bonus reflects reasonable compensation for services performed to further the organization's exempt purpose, it would be acceptable. However, as a substantive matter, the IRS and the courts consider three factors in determining whether compensation is reasonable in this situation:

- If the compensation paid under an incentive plan, when considered with the other compensation paid to the executive, is determined to be unreasonable on examination, the exempt status under I.R.C. § 501(c)(3) will be jeopardized (e.g., I.R.S. Gen. Couns. Memo. 39674 (Oct. 23, 1987), 1987 GCM Lexis 80).
- If the amount an executive earns under the compensation arrangement depends on net revenues, does the arrangement accomplish the organization's charitable purposes, such as keeping actual expenses within budgeted amounts, where expenses determine the amounts the organization charges for charitable services?
- The presence of a percentage compensation agreement will terminate the organization's exemption under I.R.C. § 501(c)(3) where such arrangement transforms the principal activity of the organization into a joint venture between it and the executive or is merely a device for distributing profits to persons in control. Rev. Rul. 69-383.

The last consideration could be an issue, for example, if a physician is the chief executive of an organization designed to provide medical services to patients needing medical attention, regardless of their ability to pay, but determines the fees for each patient seen. Lorain Avenue Clinic v. Commissioner, 31 T.C. 141 (1958).

Moreover, compensation can be "excess" for purposes of the excise tax even if it is "reasonable." For example, suppose that an organization determines that a covered executive has been underpaid for many years and should therefore be paid $1.5 million in the current year. Even if the IRS agreed with that determination, the amount in excess of $1 million in that year would be subject to the excise tax. Unlike the reasonable compensation determination, the excise tax is determined strictly on a year-by-year basis.

Reasonableness Issues – Procedural Test

As discussed under "Reasonable Compensation Testing" in the Reasonable Compensation section above, if certain procedural steps are followed, the tax-exempt organization will generally have established a rebuttable presumption that the amount of compensation is not excessive. However, in the case of a nonfixed payment, generally no rebuttable presumption arises until the exact amount of the payment is determined, or a fixed formula for calculating the payment is specified, and the requirements creating the presumption have been satisfied. Treas. Reg. § 53.4958-6(d).

Nevertheless, if the authorized body approves an employment contract with an executive that includes a nonfixed payment with a specified cap on the amount, the authorized body can establish a rebuttable presumption as to the nonfixed payment when the employment contract is entered into by, in effect, assuming that the maximum amount payable under the contract will be paid, and satisfying the requirements giving rise to the rebuttable presumption for that maximum amount. Treas. Reg. § 53.4958-6(d)(2); see also Form 990 Instructions. Thus, in the example of the executive paid a below-market salary during the start-up period of a tax-exempt organization, three mechanisms could be employed. First, the amount of the extra compensation could be specified in the initial employment agreement, but subject to a cap. Second, the amount of the additional compensation could be specified in the initial employment agreement, but determined under a fixed formula. Third, the organization could wait until the start-up period had ended, and then determine whether an additional payment to the executive was reasonable compensation, based on the executive's having been undercompensated for past services.

The executive might be reluctant to accept a low initial salary based on an understanding that the authorized body would merely consider past undercompensated services, to the extent reasonable, at some unspecified future date. However, an arrangement to pay a fixed amount or an amount subject to a fixed formula raises deferred compensation issues, as discussed below.

Performance Compensation – Avoiding Deferred Compensation Rules

Often, bonuses are calculated based on results from a particular year, but can only be calculated after the end of that year. Employers commonly use one of two methods to avoid the application of Sections 457 and 409A on bonuses under these circumstances:

- Pay the bonus by March 15 of the year following the year with respect to which the bonus is calculated.
- Provide that the bonus will be paid on a specific date only if the executive is still employed on that date.

Both methods take advantage of the short-term deferral rules for deferred compensation arrangements. In most cases, this structure is necessary to avoid the mismatch of taxation and payment of vested deferred amounts under I.R.C. § 457(f).

However, performance compensation will not avoid the excise tax on excess compensation. For example, suppose that a covered executive is paid $500,000 in salary in year 1. In year 2, the executive receives a $500,000 bonus attributable to year 1, plus $600,000 in regular compensation. Thus, the compensation attributable to year 1 was $1 million and the compensation attributable to year 2 was $600,000. However, because the bonus attributable to year 1 was actually paid in year 2, it will trigger the excise tax on excess compensation in year 2.

Fringe Benefits

Fringe benefits provided to executives of tax-exempt entities raise two issues:

- Taxable fringe benefits such as company cars must be valued and included in determining whether the executive's overall compensation package is reasonable, and whether the excise tax on excess compensation applies.
- Unless an exception applies, certain fringe benefits paid after termination of employment may be treated as deferred compensation.

Fringe Benefits – Special Reasonableness and Excise Tax Requirements

As noted earlier in the discussion of Reasonable Compensation, nontaxable fringe benefits do not have to be taken into account when determining whether an executive's compensation package is reasonable. Moreover, because they are not part of W-2 compensation, they are not counted in determining the excise tax on excess compensation for a covered executive. However, some fringe benefits, although primarily provided in order to enable the executive to perform the job, may be in part taxable and thus are subject to reasonable compensation and excise tax analysis.

The most common example is a company car. An organization may want to provide an executive with a car, both to simplify business travel and to ensure that the executive is driving a car that is of high enough quality to impress potential donors. However, if the executive also uses the car for personal purposes (even if it is just to drive to and from work), a portion of the car's value becomes taxable and thus a part of the compensation package for purposes of determining both reasonable compensation and excess compensation. The portion that is a taxable fringe benefit must be taken into consideration in determining whether the executive's overall compensation package is reasonable, and whether a covered executive's compensation constitutes excess compensation.

Fringe Benefits – Avoiding Deferred Compensation Rules

Fringe benefits that are paid or made available in a year later than the year in which the employee obtains the legally binding right to the benefit can fall under the nonqualified deferred compensation rules. However, Section 409A and the proposed 457 regulations specifically exclude certain fringe benefit reimbursement and in-kind benefit arrangements provided after termination of employment to the extent provided for a limited period of time, including:

- Continuation of health insurance coverage, to the extent non-taxable to the employee (or other non-taxable welfare benefits) (Section 409A only, although such benefits could be exempt from Section 457 under a bona fide severance pay plan)
- Reimbursement of expenses that the service recipient could otherwise deduct as business expenses incurred in connection with the performance of services for expenses incurred up to the end of the second year following termination, so long as payment is provided by the end of the third year following termination
- Reimbursement of reasonable outplacement or moving expenses directly related to the termination of services including the reimbursement of all or part of any loss incurred due to the sale of a primary residence for expenses incurred up to the end of the second year following termination, so long as payment is provided by the end of the third year following termination
- Reimbursement of medical expenses otherwise deductible under I.R.C. § 213 (without regard to the 7.5% of adjusted gross income limitation) provided during the period that COBRA continuation coverage would apply under a group health plan of the employer

- De minimis separation benefits, defined as aggregating less than the I.R.C. § 402(g) limit for contributions to 401(k) plans ($23,000 for 2024) (e.g., estate planning or tax-preparation assistance), provided by the end of the second year following termination (Section 409A only, although such benefits could be exempt from Section 457 under a bona fide severance pay plan)

Treas. Reg. §§ 1.409A-1(a)(5), 1.409A-1(b)(9)(v)(A)–(D); Prop. Treas. Reg. 1.457-12(d)(4)(i), 81 Fed. Reg. 40,566.

Section 457 present valuation determinations for fringe benefits. The proposed 457 regulations provide that the rules in the Section 409A proposed income inclusion regulations (Prop. Treas. Reg. § 1.409A-4(b)(4), 73 Fed. Reg. 74,380 (Dec. 8, 2008)) apply for purposes of determining the present value of reimbursement and in-kind benefit arrangements for fringe benefits that must be included in income under I.R.C. § 457(f) because an exclusion is not available. Prop. Treas. Reg. § 1.457-12(c)(1)(viii), 81 Fed. Reg. 40,565.

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