

457(f) Plans and Substantial Risk of Forfeiture
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The concept of “substantial risk of forfeiture” (SROF) carries major import with regard to 457(f) Plans. Under a 457(f) plan, benefits are taxed when a SROF no longer exists. §457 states that a SROF exists in situations in which the "rights to compensation are conditioned upon the future performance of substantial services by any individual."

The “literal” interpretation of the above is that if you no longer have to perform substantial future services in order to receive the benefit, then there is no longer a SROF.

While §457 and its regulations fail to define what constitutes a SROF, its regulations along with an number of private letter rulings have referenced IRS §83 and its associated regulations in addressing what constitutes a SROF for 457(f) purposes.

The private letter rulings generally state that a valid risk of forfeiture exists if employees must continue to work until some future time or age, death, or disability. If the employee terminates employment (unless terminated involuntarily other than for cause) prior to that time/age, death, or disability, the employee forfeits 100% of his deferred amounts. *In other words, in order to delay taxation in a 457(f) plan, there should be no vesting prior to the occurrence of the above mentioned events.*

Since the full vested value of the employee’s benefit will be taxed upon vesting, benefits under 457(f) plans are typically paid out in the form of a lump sum.

457(f) Plans and 409A

457(f) plans are subject to the rules of 409A (unless the “short term deferral” or other exemptions apply.)

In an attempt to “postpone or delay” the lapse of a SROF, 457(f) documents have frequently included certain provisions that have been accepted at times by the courts as acceptable definitions.

One example is a “rolling risk of forfeiture”, or pushing the vesting date out further as the original one approaches. Another example is to create a substantial risk of forfeiture by including a non competition clause in a terminating executive's employment agreement. Under this practice, there would be no income inclusion under Sec. 457(f) until the non-compete period ends.

The 409A regulations contain their own definition of SROF and specifically state that “rolling risk of forfeiture” and non competition clauses are disregarded for SROF purposes.

In addition, 409A regulations state (paraphrased) that salary compensation is not subject to a SROF beyond the date the participant could have elected to receive the compensation

unless the present value of the amount made subject to the risk of forfeiture is "materially greater" than the present value of the amount the participant otherwise could have elected to receive absent such a risk of forfeiture. This is interpreted to mean that a salary deferral election in a 457(f) plan (or any other 409A plan) cannot generally be subject to a SROF, unless there is a materially greater amount at pay out time (ignoring earnings), such as a deferred match.

As a result, 457(f) plans with the above mentioned definitions may still create a substantial risk of forfeiture for Sec. 457(f) purposes, but may generate income taxation and penalties under Sec. 409A.

One should note the distinct ramifications of violating SROF with 409A and 457(f):

- ❖ 457(f) - Violation of SROF causes immediate taxation of the value of your account, whether you receive the account or not.
- ❖ 409A- Violation of SROF has no effect, until you violate the provisions of 409A; you then pay tax on your account plus penalties, whether you receive the account or not.

In Notice 2007-62, the IRS went further and has announced plans to publish guidance which would apply the 409A definition of substantial risk of forfeiture to ALL 457(f) plans, whether exempt from 409A or not. This would result in the SROF definition for 457 and 409A being exactly the same. Consequently, all new 457(f) plans (assuming the guidance would apply only prospectively) would be subject to immediate taxation if they contained any of the above three definitions of SROF.