

New Compensation Restrictions Coming for Colleges and Universities

Regulations would affect severance, retirement incentives and other deferred compensation.

For more information,
please contact
your regular Vorys
attorney or one of the
following:

G. Ross Bridgman
gbridgman@vorys.com
614.464.6338

Anthony C. Ciriaco
acciriaco@vorys.com
614.464.5425

Alan D. Duffy
adduffy@vorys.com
614.464.5425

Jennifer B. Dunsizer
jbdunsizer@vorys.com
614.464.5631

Robert A. Harris
raharris@vorys.com
614.464.8373

Kelly Jennings Yeoman
kjyeoman@vorys.com
614.464.6284

An IRS official recently stated that long-awaited regulations under Section 457 of the Internal Revenue Code, first announced in 2007, are in clearance and may be issued as soon as September 2011.

These regulations will require that all exempt organizations, including colleges and universities, review and potentially revise their employment, severance and deferred compensation agreements to avoid tax penalties.

Deferred Compensation Limitations Applicable to Exempt Organizations

Section 457 limits the ability of colleges and universities to provide deferred compensation to employees, directors and other service providers. For this purpose, “deferred compensation” includes any compensation payable in a later year, such as severance, retirement incentives and similar rights to future payments. Section 457 does not apply to “qualified” retirement plans, such as 403(b) and 401(k) plans.

Except for limited amounts deferred under an “eligible Section 457(b)” plan or payments of “bona fide” severance, Section 457 requires that deferred compensation be taxed immediately (*i.e.*, there is no tax deferral) unless subject to a substantial risk of forfeiture.

The IRS has never defined what constitutes a “substantial risk of forfeiture” or “bona fide” severance. The anticipated Section 457 regulations will define these terms and address what the IRS states is a “lot of confusion” under Section 457.

Substantial Risk of Forfeiture

The IRS is concerned that the risk of forfeiture used in many deferred compensation plans is not “substantial” and, by defining this term, is seeking to limit the following common practices:

- Salary and bonus deferrals, other than to eligible Section 457(b) plans;
- The use of non-competition and similar covenants to create a risk of forfeiture; and
- Additions to or extensions of a risk of forfeiture (referred to as “rolling” vesting).

The Section 457 regulations will define a substantial risk of forfeiture as existing only if the right to payment is conditioned upon either an involuntary termination or the occurrence of a condition related to the purpose of the compensation (such as a change in control or the attainment a specified level of earnings or revenue). Many existing deferred compensation plans will not satisfy this strict definition and will need to be reviewed and restructured.

“Bona Fide” Severance

Many colleges and universities characterize supplemental termination and retirement pay arrangements as exempt from Section 457 under an exception for payments of “bona fide” severance. The IRS is skeptical that these arrangements in fact provide for “bona fide” severance, particularly if payment is made upon retirement or other voluntary terminations.

The Section 457 regulations are expected to limit “bona fide” severance to payments:

- Made solely upon an involuntary termination;
- That do not exceed two times the employee’s salary; and
- Are paid over no more than two years following termination.

We anticipate that the Section 457 regulations will treat certain voluntary terminations for “good reason” or occurring during a limited voluntary termination window as being involuntary. Exempt organizations that use severance pay to provide additional income for voluntary terminations will need to revise or discontinue this practice.

Recommendations

The scope of the Section 457 regulations, including any transition relief, will not be known until regulations actually are issued. Our experience is that balancing legal compliance with protecting employees’ reliance interest makes revising or unwinding deferred compensation programs a delicate and time consuming process.

In order to ensure an orderly process, colleges and universities should begin to:

- Identify potentially affected deferred compensation arrangements;
- Evaluate potentially affected arrangements to determine whether significant structural or operational changes will be needed;
- Consider how best to communicate any required changes; and
- Determine whether and, if so, how replacement programs should be structured.

This client alert is for general information purposes and should not be regarded as legal advice.

IRS CIRCULAR 230 DISCLOSURE: In order to ensure compliance with requirements imposed by the U.S. Internal Revenue Service, we inform you that any federal tax advice contained in this communication (including any attachments) is not intended or written to be used, and it cannot be used, by any taxpayer for the purpose of (i) avoiding penalties that may be imposed under the U.S. Internal Revenue Code or (ii) promoting, marketing, or recommending to another person, any transaction or other matter addressed herein.