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UNITED STATES DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE

PUBLIC HEARING ON PROPOSED REGULATIONS

"DEFERRED COMPENSATION PLANS OF STATE AND LOCAL GOVERNMENTS AND TAX-EXEMPT ENTITIES"

[REG-147196-07]

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PARTICIPANTS:

For IRS:

ILYA E. ENKISHEV
Attorney
Executive Compensation (Employee Benefits)
(Tax Exempt and Government Entities)

STEPHEN B. TACKNEY
Deputy Associate Chief Counsel (Employee Benefits)
(Tax Exempt and Government Entities)

CATHERINE L. FERNANDEZ
Branch Chief
Executive Compensation (Employee Benefits)
(Tax Exempt and Government Entities)

For U.S. Department of Treasury:

CHRISTA BIERMA
Attorney-Advisor
Office of Benefits Tax Counsel

Speakers:

KIRK SHERMAN

JAMES PATTERSON
Sherman & Patterson

NORMA SHARARA

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PROCEEDINGS

(10:00 a.m.)

MR. TACKNEY: All right. Good morning, everyone. We're going to go ahead and start. This morning we are going to have our public hearing on proposed regulations, deferred compensation plans of state and local governments, and tax-exempt entities. It's REG-147196-07.

The proposed regs were published in a Federal Register on Wednesday, June 22, 2016. This will be our public hearing. The way this will work, we have a couple of speakers who have submitted their comments and outlines, so they will be speaking. Following them, we will open it to the floor. If anybody else wishes to speak, they can ask and come up and speak as well. We will give ten minutes, but we also don't count the time that we're speaking, so we try to keep track of that. That being said, with the limited number of speakers, if you want to request extra time, that's fine.

If anybody needs, by the way, to ever use the bathroom, you will need to have an escort, so please exit over there and grab an escort to use the bathroom or otherwise go to the cafeteria or anything like that you will need an escort. We're also, of course, being recorded and there will be a transcript available.

With that note, let's go ahead and get started with our first speaker.

MR. SHERMAN: Thank you for your time today. I'm Kirk Sherman from Sherman & Patterson. I was a second year associate in 1986 when Congress extended Section 457F to tax-exempt organizations. I don't know whether it's bragging or if it's sad, but since then I've focused my practice in executive and position compensation for tax-exempt organizations: credit unions, healthcare organizations and associations. We've drafted thousands of benefits plans and employment agreements and severance agreements.

From the few comments submitted on the 457F proposed regulations and the short line of speakers at today's hearing, the tax-exempt world seems quite pleased with the proposed regulations, and we agree. The softening of the regulations from what was announced in 2007 may have a lot to do with that.

My purpose today is to address a couple of ways that we believe the regulations can be adjusted on the margin to facilitate understanding and compliance. I divide my comments among three topics: the elective deferral rules, the treatment of loan regime split dollar, and the factors for evaluating non-compete restrictions.

The elective deferral plan rules are clear when applied to a vanilla deferral. I elect to defer X percent of my salary. Applying the rules to two other common plan designs is not as clear. The first of this is a plan where the employer provides supplemental dollars and allows the employee, in December, before the beginning of the year, to choose a vesting date for those dollars. Subject to a

minimum, might be two or three years, and often with no stated maximum vesting date. We ask, is this an addition or extension of a risk of forfeiture after legally binding right to the compensation?

MR. TACKNEY: But I guess, if I could say, I did not understand this request in that we have repeatedly said that the reason you would need to be paying for the extension is that there's no economic reason someone would elect to have to work longer to make this same amount of money or the same value of money.

So it seems that that's exactly what you're asking for, is for someone to make the decision, which is not economically reasonable, based solely on tax reasons which we specifically said was not what we wanted to do. So I guess I'm not understanding how that's at all consistent with anything we've done, either in the proposed regs here or in 409A or in any of the other areas.

MR. SHERMAN: We don't object to that result. It's just the wording of the regulation causes us to trip a little bit in getting to that result. I mean, we agree that if somebody could have the dollars in two years but they elect five years, so that's going to be an elective deferral from two years to five years.

The reason that we trip over this is talking about the addition or the extension after the legally binding right to the compensation rises. At the point -- the money's always subject to a risk of forfeiture, so there's no addition to the minimum, but to the additional years there would certainly be an addition for that. We agree with that.

The question can come up as when does the legally binding right to the compensation arise? A lot of plans say make your election, participant, before the beginning of the plan year. But it also has a provision in the plan that says we can amend the plan at any time prospectively. So that up until, let's say, I make my election December 15, on December 31 the employer can still come back and say, by the way, we've changed our mind and we're not going to give you this deferred compensation this year.

So I would say that that participant doesn't have a legally binding right until the point they get to January 1st and start rendering the services. And so what we propose in this to get to the result, what would help us in understanding those regulations, is something like the language you used in the elective deferral section to say that in addition to initial deferral of current compensation, it talks about elective deferrals of compensation beyond the date the employee would receive them in the absence of the election. That would be helpful for us to understand this type of plan.

The second one, I think we'll get the same response, and maybe some additional question or comment, would be the so-called flexible benefit plan that has been out there for, I will say decades, because it has been decades. There was far fewer today than there were originally. But still, there are dozens of those plans out there.

Now, that's a plan where an employer will say to a participant, you can choose from among these benefits, none of which has currently taxable income. So it

might be long-term disability insurance, long-term care insurance, and deferred compensation to simplify the plan.

And so the question becomes now, it's similar to the first example, is this an elective deferral where the participant says, you know, I will take the deferred comp.

MR. TACKNEY: I guess my first question is, what is your 125 analysis?

MR. SHERMAN: The 125 analysis is as soon as the proposed 125 regulations go into effect, we've got problems because the preamble to those regulations did talk about an election no matter when that election is made. We think that would cover this type of election.

MR. TACKNEY: Do you think there's an answer right now, absent the proposed regs under 125? So how would we answer -- if we don't have any answer under 125, I'm wondering -- or we do which may not -- you know, which would come into effect? Why would we answer that now?

MR. SHERMAN: I'm sorry. So your question is why would you answer it now?

MR. TACKNEY: How could we answer the 125 questions either out there or would be answered in a negative way if it is finalized as proposed?

MR. SHERMAN: So you've got the dilemma of if we respond to this question under 457F, it would either allow them under 125 or disallow them under 125. I understand that point.

MR. TACKNEY: Right. We looked at these and they raise issues across so many sections of the Code. In fact, we put out some chief counsel advice pointing that out. That we'd really have to coordinate across. And including a non-eligible employer's it would be 409A. It's going to be --

MR. SHERMAN: Yes.

MR. TACKNEY: It's going to be 125.

MR. SHERMAN: Right.

MR. TACKNEY: Depending on all of the different arrangements and all of the elections.

MR. SHERMAN: Yes.

MR. TACKNEY: That's why it's hard to do piecemeal.

MR. SHERMAN: We appreciate that. Our clients, over the years we've had many who have been audited. Our clients who sponsor these kinds of plans and the auditors occasionally have raised the issue. But unbearably, probably after speaking -- and I'm sure after speaking with national -- have come back and said new rules are coming. When the new rules come out you've got to comply with them.

MR. TACKNEY: I will say this is one of the reasons we did ask for comments which we really do want on the leave plans because, honestly, we've seen it a lot with the use of leave. You can basically elect to use your leave for various types

of benefits or otherwise have it cashed out. That was one of the reasons we asked for comments there.

MR. SHERMAN: Mm-hmm.

MR. TACKNEY: That may be more of a state and local government issue than tax-exempts, but we are trying to wrap our hands around all these abilities to elect the different types of benefit.

MR. SHERMAN: Yes. Very good. We'll look forward to -- but, in fact, what we were going to propose that would answer this question for us is the same answer as under the elective deferral for supplemental dollars. That if you elect a deferral beyond when you could have had the value of the benefits. So if you could have had disability insurance today, then that is current compensation, and elected deferred compensation is then a deferral of that money would be an elective deferral subject to the elective deferral.

MR. TACKNEY: We've also though -- I guess, we were looking in some ways at also how the revenue procedure on constructive receipt and the need to make the election in the year before you earn the compensation rather than when you would receive the compensation. That's been a conservative place we've landed with some of the private letter rulings because it's conservative. I mean, would you be more aggressive than that is what you're saying? In other words, if I got a deferred benefit, I'd be able to make the election later?

MR. SHERMAN: I'm sorry. Are we talking still within the flex plan? The flexible --

MR. TACKNEY: Yes. I mean, if I earned it this year, but I don't get -- you know, I get to choose do I want retiree health or do I want deferred compensation or do I want -- so I'm not actually taking it currently. Are you saying they'd get to make the election later?

MR. SHERMAN: That's not --

MR. TACKNEY: Okay.

MR. SHERMAN: No, no, no. We're not --

MR. TACKNEY: So we're just looking --

MR. SHERMAN: -- suggesting that.

MR. TACKNEY: -- at making it the year before you actually earn it and get it at, kind of, at the same time?

MR. SHERMAN: Yes.

MR. TACKNEY: Okay.

MR. SHERMAN: That's the --

MR. TACKNEY: Because that's been --

MR. SHERMAN: -- focus.

MR. TACKNEY: -- our dilemma is kind of this disconnect sometimes between earning and receiving.

MR. SHERMAN: Mm-hmm. And I think the new regulations now, the proposed regulations, if they go into effect as they are, would actually go a long way to answering that question as it relates to the deferred compensation elements of the plan. Particularly, the additional language that would help us understand how that electing beyond the minimum, including current minimum, if you have choices of some current benefit would apply.

One more comment on elective deferrals. I was surprised, just in the last couple of weeks, a very experienced and I would say well-known deferred compensation attorney was proposing a deferral plan for one of our joint clients, and it was an employer plan that had only supplemental dollars in it from the employer, 5 percent of salary.

The vesting date would be age 65 or two years after the year that the money went into the plan, whichever is later. We said, well, with that kind of a design, then somebody who leaves at 65 will have two years of accruals that they will not be able to take with them because they will not have met the two year minimum vesting date. So we suggested, why don't we just make it all cliff vested at 65, including the money that would come from 63 to 65 because these are employer dollars? This is not an elected deferral plan.

The provisions that he was citing for the minimum two year deferral were under the elective deferral plans. I recall back to an early private letter ruling. I should have looked up the number, but it was where the IRS said that -- it established and said, you need a minimum of two years of service between the time the plan goes in and the vesting or the time the individual comes into the plan and the vesting date to be at a substantial risk of forfeiture.

So they said a plan cliff vested at 65 is fine for anybody that comes into the plan before age 63. So that their service, up until 65, would meet the minimum two years. That would apply even to the money that was deferred at 64 1/2. It was, again, supplemental dollars, not elective.

We get to that conclusion under the proposed regulations. But the fact that this, again, a distinguished attorney raised this as his interpretation that the two year minimum applied to supplemental dollars.

MR. TACKNEY: I can see where the confusion lies and, in fact, I think that's something we may need to address more clearly in the regulations. In the sense that the two year concept that the two years minimum is really a safe harbor and example in the Section 83 regs. The Section 83 regs, if you had something that serially granted you property, such as stock, you would measure the two years from every grant.

Now, we do have some PLRs that talk about periodic, I'm sorry, ratable vesting, but we still measure from every grant. So I think what you're hearing is there's some confusion with deferred compensation is is the same concept that you measure it from every accrual or every contribution or every however you'd

want to express that. That may need to be something we think about, clarifying how that works.

MR. SHERMAN: That would be helpful. We believe that allowing the deferral, up to the cliff vesting date, in those circumstances would be beneficial for a couple of reasons. Tax deferral for two years is not that big of a deal. Does that go on the public record?

But the administration on that kind of a plan, for people, now they have to say, okay, now when you're 63 we're going to stop paying you, putting the money in the plan, and we're just going to pay it to you in cash. It really becomes an administration challenge, and a potential for just administrative errors that could lead people.

MR. TACKNEY: Right. I think we asked for comments also on what (inaudible) for forfeitures as far as being a significant service mean is something we haven't given a lot of flesh to in the past. As far as, also, not only the two years, but do you have to be providing continuing services? Does it have to be -- what level of services?

I think one thing, you know, I understand your concern. One other concern though is, we obviously wouldn't want someone to contribute money on December 30th that vests on January 2nd as a way to, basically, defer a year with no real vesting concept. So there is a need to kind of figure out why would that, as an initial and solo contribution be a problem, but, for instance, as the last contribution in a career long plan not be a problem.

MS. FERNANDEZ: I think, in fact, the two year safe harbor that Stephen is referring to in the 83 regs is nowhere other than an example in the 83 regs. So it's not set out as a rule even. It's simply part of an example.

MR. SHERMAN: One way to address this would be to do a similar example in the 457F side that had employer dollars going in, vesting at 65. Yes, that's a substantial risk of forfeiture if you come into the plan by age 63, similar like to that private letter ruling approach.

MR. TACKNEY: It'd be interesting. We'd have to deal with modifications and all that. I'm trying not to build -- it'll be interesting how we think about it, and if you have further suggestions we're also open to comments after this. I don't want to build too big a cathedral of complications around. On the other hand, I don't want you to be able to come into a plan at 63 and accrue all your money at 64, in 11 months and 29 days.

MR. SHERMAN: Mm-hmm.

MR. TACKNEY: So that, you know, we have to --

MR. SHERMAN: Sure.

MR. TACKNEY: There's a whole -- yes, we'll --

MR. SHERMAN: Bail on some of these.

MR. TACKNEY: We'll have to think about -- we certainly didn't, at least I don't think there was an intention to make a career long plans last two years vest immediately.

MR. SHERMAN: Okay. If I could then move to loan regime split dollar. I think it's a shorter discussion. As you know, under 409A there is notice 2007-34 that specifically or expressly exempts loan regime split dollar from 409A to the extent there is no provision for forgiveness or reduction, non-repayment of the loan.

That's been very helpful as clients have considered loan regime split dollar. If they have that exemption, it has eliminated what otherwise would have been a lot of expense and detailed legal analysis. I mean, it's just not a very practical level. That was very helpful.

We would ask that you consider the similar exemption under the 457F proposed regulations. I do see my time is gone. May I have a little more?

MR. TACKNEY: Absolutely.

MR. ENSKISHEV: Yes. You're okay.

MR. SHERMAN: I'm almost done. Thank you. So finally, my last point on non-compete restrictions. That snapping you heard in June was from all of the necks whipping around when we read the parts that non-competes won't apply unless substantiated by -- unless certain conditions are satisfied. There I go, that was the language. We were fully expected and our clients were prepped to no longer rely on non-compete restrictions as a tax deferral mechanism.

That's not to say they would have gone away under the deferral plans. They just no longer would have been relied upon for tax deferral. The reason is, in deferral plan, a non-compete in the deferral plan, for the employer is a single most efficient way to protect the employer from non-compete from unfair competition.

The reason is, from the employee's perspective, without that forfeiture provision the employee starts to calculate, well, will the employer invest the legal expenses necessary, and potentially the public reputational risk of suing me to keep me from competing or can I, you know, am I going to be safe to go through? It's kind of an interesting calculus that executives and physicians go through all the time.

But if you have a deferral plan with a nice pot of money in it that says, if I go across the street and work I lose X dollars then it's very easy for the executive to understand the cost of competing. From the employer's side, there is nothing easier to enforce the non-compete restriction than simply not writing the check for the benefit, instead of having to invest in the lawyers and the potential negative publicity that comes with that.

So we are all for non-compete restrictions in the plans, even if they were no longer available for tax deferral, and many of them won't be because of the higher bar. But that's fine, but we'll continue to see them in the plans, we believe.

The last reason for including them is in states like California or Oklahoma where the state prohibits non-compete restrictions in a benefit plan. In the broad ERISA preemption employers are able to get that protection because the ERISA law of non-competes would preempt the state law. So it is valuable and it will continue to be there.

Our sole comment about the non-compete testing is provisions, is with respect to the financial need element. Over 30 years of watching executives and physicians, and those who've competed and those who haven't, net worth has little correlation to indicate who's at risk of competing. Integrated Healthcare Strategies from Gallagher recently did a study of their CEOs, 307 of them.

There is an aging population of CEOs. The masters of healthcare administration is not producing enough people to come in and fill the ranks and so there's a problem. With this aging group, of this group, nearly half, 48 percent, are over age 60 and 12 of them are between 70 and 80. Many of these are people who came out of retirement because the employers had a leadership void and needed transition leadership or because the CEOs, frankly, needed to be relevant again. And so they found that retirement wasn't suiting them.

These are very wealthy people, whatever wealthy means, so they're not competing. They're not reentering the workforce for financial reasons. They're entering for personal, strategic, some might even say charitable reasons.

So the other aspect or the problem that we see with financial need is that who's going to be the arbiter of what is financial need? Who's going to decide when an executive no longer needs the money or is not in a position to need the money to compete? Who's going to be the one to sit them down and ask, now, show us your balance sheet? Show us your assets. What are your liabilities? What's your cash flow needs? Those are discussions that just won't happen.

So we would encourage, we'd love a high standard. We love the individuals focusing on the individual's ability to compete. We think that eliminating the financial need criteria would actually be very beneficial and help for an easier administration of the plan.

MR. TACKNEY: I think we were looking at knowledge that the employer would have, for instance, is this an older person with a particularly vested SERP, for instance, in comparison to a slightly younger person with no significant retirement benefits coming out of the employer. Would you say even with restricted to that type of knowledge that it's not a factor to be considered?

MR. SHERMAN: I would just because the turnover amongst CEOs is fairly high. I don't know exactly what it is.

MR. TACKNEY: Well, I guess --

MR. SHERMAN: Where you accumulate a SERP with one employer and then go on to another employer, and so the current employer may not know what has accumulated from all of the other employers.

MR. TACKNEY: I guess it's interesting. Where we've seen a lot of cases is not at the CEO level. It is at lower levels where non-competes were being basically signed off on, not followed, not used, and we were wondering whether the fact that these were mid-level people without significant benefits, retirement type benefits are being eligible for payments under them would be a significant factor in thinking this person may need to go compete --

MR. SHERMAN: Yes.

MR. TACKNEY: -- as opposed to someone who is truly retiring at a higher level. So I think that's where we were coming from in our experience with cases we've seen which had, basically, blanket non-competes with choice of term.

MR. SHERMAN: Yes, that's interesting. As we were reading it and viewing it we really limited it to the top, really few people, as even those who might even be considered as qualifying for it. Because, frankly, you know, vice president of human resources going across -- that may hurt, but not more than turnover if that person left anyway versus if they go across the town. That's not going to hurt the employer. It's not going to be a substantial employer economic interest.

MR. TACKNEY: Right. But I think people were actually saying don't worry about it. Just if you want to defer sign a non-compete and say how long you want to --

MR. SHERMAN: Oh.

MR. TACKNEY: That's why we were trying to come up with something that at least took into account if you really know these people are going to need to continue their career, probably need to continue their career, you know, unless they're otherwise independently wealthy. Should that be a factor in?

MR. SHERMAN: I can see on the margin in that situation, yes.

MR. TACKNEY: I think we're coming at it --

MR. SHERMAN: We're --

MR. TACKNEY: -- from two different experiences. But I do agree we may need, especially that what we intended was limiting it to the types of information that employer would otherwise know. I don't think we intended for people, and we have gotten this question, that really have to sit down and discuss peoples' personal financial information.

MR. SHERMAN: Yes.

MR. TACKNEY: So, yes, I definitely -- but really what this is trying to get at is the type of situations you're actually talking about, so we'd appreciate any comments which is, this is someone who is likely interested in competing and could damage this institution, and we will track and we will know if they're competing. This is not intended as a tax deferral tool that people will understand --

MR. SHERMAN: Mm-hmm.

MR. TACKNEY: -- that they can cancel at any time and otherwise get paid when they choose.

MR. SHERMAN: Right. Yes, okay.

MR. TACKNEY: We're trying to come up with a way to differentiate the two types of situations.

MR. SHERMAN: I think the rule's actually -- the proposed rules go well down that path, from what they've been. And so I think that's a significant improvement, but we'll continue to think about.

MR. TACKNEY: My last thing. If you can just remind people, because the people used to say non-competes work under Section 83. We always remind them the proposed regs have a presumption against them working and you have to rebut that to actually work. So it's been interesting in this field when we come out with these things how we get, a but non-competes work under 83. So a little misnomer.

MR. SHERMAN: Is that a glass half full analysis? I'm not sure.

MR. TACKNEY: Half empty.

MR. SHERMAN: Can I plead the fifth on that?

MR. TACKNEY: And thank you for your -- is that how -- by the way, we've also gotten comments that people are able to use forfeiture provisions despite, in states where they cannot be enforced as true non-competes where they can't compete. Is that the analysis people are using? Is it only when they are agreeing that it's an ERISA plan or is there some other way they're able to enforce the forfeiture provision without, for instance, getting injunctive relief?

MR. SHERMAN: It's only the ERISA preemption that I'm aware of.

MR. TACKNEY: Okay.

MR. SHERMAN: Yes. You may be aware there's case law in California and Oklahoma on that that supported that position.

MR. TACKNEY: Great. Thank you.

MR. SHERMAN: Thank you for your time.

MR. TACKNEY: Our next speaker?

MR. PATTERSON: Hello. I am James Patterson. You just heard from my law partner. I'd like to start by thanking the panel for having this hearing today and for the time spent by the IRS and Treasury in developing the proposed 457F regulations.

This morning I will share thoughts on four topics. First, grandfathering. Second, operational and documentation compliance effective dates. Third, the more than 125 percent standard for elective deferrals. Fourth, bona fide severance plans.

So first, grandfathering. My written comments I recommended the IRS clarify the impact of the final regulations on deferrals that occur before the effective date of the regulations. The proposed regulations provide that the new rules will apply to new deferrals. There's no confusion there. The guidance then provides that those amounts include, "deferred amounts to which the legally binding right arose during prior calendar years that were not previously included in income during one or more prior calendar years."

The provision has created confusion. In preparation for this hearing I reviewed about 20 summaries from industry commentators and found that they were divided almost equally into three camps. Those who believe prior deferrals are subject to the new rules, those who believe the prior deferrals would be subject to the law in effect when the deferrals were made, and those who recognized the confusion or cited the language in the proposed regulation but did not interpret it. Likely, because they weren't sure what it meant.

Our law firm actually showed up on two of the lists. We initially thought prior deferrals would be subject to the new rules, but on closer review changed our view that the law in effect at the time of deferral would govern those amounts.

MR. TACKNEY: Let me go through the way I read it and let me know where I'm missing something.

MR. PATTERSON: Sure.

MR. TACKNEY: This says they apply the date they're final, is the general rule.

MR. PATTERSON: I'm sorry. That they apply when?

MR. TACKNEY: As of the date we adopt final rules.

MR. PATTERSON: Okay.

MR. TACKNEY: So they would apply in the year that you have final rules.

MR. PATTERSON: Mm-hmm.

MR. TACKNEY: So if we made this 2017 it would be 2017.

MR. PATTERSON: Mm-hmm.

MR. TACKNEY: Including deferred amounts to which the legally binding right arose during prior calendar years. So those would be calendar years before 2017 that were not previously included income during one or more prior calendar years. So you haven't already included them on your 1040 we're not going to double tax you.

MR. PATTERSON: Mm-hmm.

MR. TACKNEY: What's unclear?

MR. PATTERSON: It's unclear whether you're referring to prior deferrals.

MR. TACKNEY: Well, wouldn't that be amounts to which a legally binding right arose during prior calendar years that were not previously included in income? How is that not an amount? I'm not understanding how that's not an amount.

MR. PATTERSON: Mm-hmm.

MR. TACKNEY: I understand there's a wish and a comment to get it, for that to be the final effective date rule, but I'm not understanding how this is unclear as to what we were proposing.

So we can just move on, in a way, I mean, we can always adopt what we want. But I've read this and I think there's a wish to try to interpret it to not cover those amounts.

MR. PATTERSON: Mm-hmm.

MR. TACKNEY: But it specifically says, it will apply as the date and it will apply to deferred amounts to which the legally binding right arose during prior calendar years that you haven't already included in income.

MR. PATTERSON: Yes.

MR. TACKNEY: I think, for instance, one of the things we're afraid of is we did not want, after these proposed regs came out, if they said they were effective only as to deferrals after final people would stop. Why not? You would start deferring everything right now and to try to get under what you think was the position prior to the final regs. So we don't want stuffing, so I can't --

MR. PATTERSON: Mm-hmm.

MR. TACKNEY: We have to deal with stuffing.

MR. PATTERSON: Okay.

MR. TACKNEY: Also, given some of the aggressive positions we've seen taken in 457F we weren't entirely comfortable saying that was, you know, a free pass. Unfortunately, I think that's how some people may interpret the idea that the final regs only apply to amounts after the final regs is that somehow we're giving a free pass.

MR. PATTERSON: Mm-hmm.

MR. TACKNEY: There's no, you know, we were not giving a free pass.

MR. PATTERSON: Right.

MR. TACKNEY: I'm just letting you know the concerns that led to that particular provision.

MR. PATTERSON: Okay. But it sounds like when I talked about our two interpretations that our first interpretation is your belief rather than our second interpretation that those deferrals made before the regulations were finalized would be subject to the law in effect at that time.

MR. TACKNEY: Right. We won't pick them up in a year before they're finalized if they're weren't otherwise subject -- I mean, can't say pick them up. They won't be subject to the final regs for years prior to the years the final regs are published. So they won't be retroactive to open years and cause you to have -- you know, on the other hand, as of 2017 the way this would read, if that's when we go final, all your amounts deferred, no matter when deferred that you haven't

otherwise included in income, if they are vested under the final rules would be vested in 2017 and need to be included in income.

MR. PATTERSON: Okay.

MR. TACKNEY: That's what we have proposed.

MR. PATTERSON: Mm-hmm. So we would say -- so we think the law, as I mentioned, we think the law in effect at the time of deferrals should control. Retroactive tax law creates unfairness for tax payers who made decisions based on the law and guidance at the time --

MR. TACKNEY: Well --

MR. PATTERSON: -- especially --

MR. TACKNEY: -- given our notice that we said what we were going to do and this isn't nearly as strict as our notice that was seven years ago --

MR. PATTERSON: Mm-hmm.

MR. TACKNEY: -- what are people doing that we need to be worried about that they would be unfairly treated as vested in 2017? What is it that (inaudible)?

MR. PATTERSON: Well, say for instance, perhaps an elective deferral plan and maybe an election that was made 15 years ago where there were private letter rulings at the time. There was discussion by the IRS that why would somebody defer money? Why would they do that and think it could be subject to risk of forfeiture? Well, there were letter rulings out, and still are, that this was a practice. This was done.

So you may have someone who electively deferred amounts 15 years ago that now would become taxable if they didn't follow the rules now that say that there needs to be a greater than 25 percent match on those amounts. That would be --

MR. TACKNEY: Well, technically if we didn't grandfather all we would be saying is that there are no regulations that apply to that. I can't say we'd necessarily be agreeing that they weren't taxable before.

MR. PATTERSON: Mm-hmm.

MR. TACKNEY: You're leaving just them open to whatever the state of the law is today without reliance on the proposed regs. So I also worry, this is not meaning to say grandfathering doesn't meant that they're not subject to tax. It means they're not subject to the regulations.

MR. PATTERSON: Okay. Sure, sure. If it's not the proposed regulations or the final regulations that they would be subject to it would be the tax law in effect at that time. Perhaps, the service says those would have been taxable anyway.

MR. TACKNEY: Because I think for many years we've been saying --

MR. PATTERSON: Mm-hmm.

MR. TACKNEY: -- elective deferrals with no -- just elective deferrals without anything else would be subject to taxation on deferral. We've been saying that for many, many years.

MR. PATTERSON: Okay. Thank you. Second point, operational and documentation compliance effective dates. Our law firm of Sherman & Patterson works with, among other clients, approximately 600 tax-exempt hospitals and credit unions of varying sizes. Ranging from small $20 million credit unions to large billion dollar credit unions and healthcare systems.

The limited scope of 457F of the code lends itself well to the development of boutique law firms, like ours, that focus on the executive and physician compensation needs of tax-exempt employers. I recognize as I discuss operational and documentation compliance that our views are at least somewhat self-serving, as we will have a lot of work to do when the regulations are finalized.

We also represent various consulting firms who have hundreds of tax-exempt clients who similarly have a strong desire to have time to respond to the new rules. Exempt organizations themselves, however, need sufficient time to analyze and respond to the new rules. The timeline for a typical organization that will modify its plan to comply with the new guidance will be along the lines of: Attorneys review the final rules when they are issued, addressing open issues informally amongst themselves or, perhaps, with the IRS directly.

The attorneys then make contact with their consulting clients, let them know how the new rules work. The consultants review their plans and determine which plan designs will work going forward, which plans for individual clients need to be revised. The consultants reach out to boards of directors, of their tax-exempt clients with this information. The boards meet to revisit their objectives for providing deferred compensation, discuss their options, and then review and ultimately approve a new plan design.

The boards communicate this new plan design to the executives or outside organization that assists the board in administering the plan. The employer develops communication material, such as plan books, to help the plan participants understand changes to the plan. They meet, specifically with executives, and talk about the changes that need to be made.

The administrator, the board, or the consulting firm circles back with the benefit's attorney to request updates to the plans. After reviewing the drafts and making any necessary changes the board executes the new plan documents.

Even in cases where consulting firms are not involved, and where the tax-exempt organizations use local counsel to assist with the design and documentation the process is still time consuming. I believe that an orderly transition, in most cases, would require six to nine months, at a minimum. Therefore, I encourage the IRS not to attempt to issue final rules this year and have them take effect January 1, 2017.

Rather, a much more orderly approach would be for the IRS to issue the final rules in January or February 2017 with an effective date of January 1, 2018. If publication of the final rules is delayed beyond March 2017 then ideally the effective date would be deferred to January 1, 2019. As you know the industry has waited nine years to get this proposed guidance, and the guidance is different than that which the IRS originally anticipated giving, which we're very happy about.

But I believe that both of those factors further support an orderly rather than rushed rollout of the new rules.

MR. TACKNEY: I know we've talked about the non-compete, but what specific changes as to current plan operations that we would possibly agree wouldn't lead to taxation under 457F which isn't really compliance. It's a tax timing rule because you can't really comply out of it. You can either have a non-vested -- it's a vesting timing. But what exactly are the changes that are problematic?

MR. PATTERSON: We need to understand those and understand how plans with prior elective deferrals need to be revised. So that's a big issue. There are a lot of plans with elective deferral components that would need to be revised. We need to understand what the new rules are.

MR. TACKNEY: And these are elected deferrals with no match or no other contribution. And despite the fact that we've said for years that we don't think that works we should do what?

MR. PATTERSON: Give the industry time to respond to the clarifications in the final regulations.

MR. TACKNEY: But if we said they already had to be included, which would be our position in prior years, what would we be doing by grandfathering that?

MR. PATTERSON: No, not grandfathering. Not asking you for that.

MR. TACKNEY: Right, but I'm just saying if your current -- I guess I'm -- okay, I'm not really understanding where this is leading in the sense of are these plans that you are saying currently have elected deferrals with no match and need to instill a match?

MR. PATTERSON: Potentially, yes.

MR. TACKNEY: But then wouldn't they have had -- our position would have been they had income inclusion all along on their no match elective deferrals and then you can just implement your match.

MR. PATTERSON: And you're saying that's been the position of the Service for decades?

MR. TACKNEY: Well, it certainly has been for the last decade.

MR. PATTERSON: Mm-hmm. Yeah, that's an area where perhaps we have a different view on what the Service felt in looking at private letter rulings, in looking at just -- I don't know, client audit experience, where they looked at that specific issue. But specifically letter rulings and practices where elective deferrals were

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allowed. Court cases, court cases that addressed those. I mean those are things that we've relied on in our practice. And so, yes, I would say that a plan like that would still take some time for the attorneys, the advisors, the Boards, everyone involved, to analyze and to revise according to additional guidance that we receive.

MR. ENKISHEV: What's the typical timeline for that? From the -- you mentioned the process, from the beginning to the end, is it nine months, six months?

MR. PATTERSON: It's more than six weeks or four weeks. I don't know. It depends on the size of the organization, the complexity of the benefit plans, the situation. It is different for each organization. But I would say for no organization, would say four weeks would be sufficient. I don't even know that most boards meet within that period of time. So if the Service finalized regs at Thanksgiving for them to take effect, five weeks later would be very difficult.

Yes, thank you. So as to the timing of compliant plan documentation I can't help but think back to the 409A days. Shortly after our firm completed documentation required under the proposed 409A regulations for hundreds of clients the IRS issued final regulations that required more revisions to all of those plans. I appreciate that the IRS is not requiring updated plans until the rules are finalized, but based on the timeline we just discussed I still suggest the IRS give the industry significant time, even 12 months from the operational effective date of the final 457F regulations, before documentation compliance is required. Again, there are processes that need to take place for the actual documentation work to get done and to be designed properly and to be approved and signed.

MR. TACKNEY: So you would have -- I guess I'm not understanding in the sense that you would have vesting rules, but even though they would vest under the plan document they wouldn't vest because six months later you will be amending the document? Because again, this isn't compliance in the sense of 409A about timing of payments and things like that, this is -- all you're really talking about is staying out of 457F by staying deferred and by staying subject to substantial risk of forfeiture. So it seems that you either are or you aren't under the terms of the plan. And are you saying someone would vest under the terms of the plan but you would be amending it later to say they didn't?

MR. PATTERSON: I'm saying that once the rules become operational that -- let's say that there's a six month period, I'm saying that I believe it's a stretch to believe that the documentation can all be updated within that same period of time.

MR. TACKNEY: But we're only talking about vesting. We're only talking about vesting. So if we're talking about vesting how do you say that you're operationally putting a vesting condition into place? It's either legally they're vesting or not. Are you communicating it to them and then they will actually forfeit if the condition happens or are you not? Because I'm kind of not understanding if they're not bound by something in writing.

MR. PATTERSON: Yeah, I understand --

MR. TACKNEY: -- how you would even force the forfeiture condition.

MR. PATTERSON: I understand your point. Perhaps the better request from us would be give more time for operational and documentation compliance (laughter) to make them occur at the same time. I understand the point you're raising. By dividing out operational compliance and documentation compliance I'm just trying to point to the practical realities that companies to do what you're asking them to do.

MR. TACKNEY: It's going to be a big weighing I think because the other issue we've had is some people very much pushing the boundaries in the world of no regulations. So asking us to allow people to continue in that vein, and especially in some type of grandfathered mode, is also problematic. So I can understand where you are not one of the more aggressive players and you just want to bring things -- maybe you need to make some slight modifications. On the other hand, we don't want stuffing and for people to interpret or think we are implying that somehow the more aggressive practices were working because -- and that's why we would delay the effective date. So it's also a problem for us that we don't -- we're not changing from defined rule to another defined rule, which makes life a little easier. It's we're kind of in this gray area where we all don't have a meeting of the minds --

MR. PATTERSON: Mm-hmm, right.

MR. TACKNEY: -- necessarily and how do we cope with that? But I think your points are well taken, especially for those less aggressive and folk just trying to follow the rules.

MR. PATTERSON: Okay. Thank you. Third point is just perhaps a tedious request. The more than 125 percent standard. We appreciate that the IRS has fleshed out the meaning of the materially greater standard as set out in 409A for additional or extended substantial risks of forfeiture to qualify in deferring taxes.

I also understand that when a line is drawn there is always something right below the line that doesn't qualify. However, I recommend changing the more than 125 percent of present value standard to at least 125 percent of the present value. 25 percent is an easy target to understand and I suggest the IRS avoid the need for what I saw in a recent document, said that with elective deferrals there would be a provision required of a match of 25 percent plus $1.00.

MR. TACKNEY: You're not alone in making that comment, so well taken.

MR. PATTERSON: Okay. Thank you. Finally, bona fide severance plan. Competitive severance arrangements will at times exceed the 24 months of annualized compensation that the proposed regulations allow to qualify the plan as bona fide. I believe the 24 months of annualized compensation limit is another helpful line in the sand the IRS and Treasury have drawn. I simply suggest that the IRS follow the 409A separation pay standard and clarify that a bona fide severance pay plan is the severance pay, or as 409A clarifies, the portion of the severance pay that meets the two times annual compensation and timing

requirement. This would mean the first 24 months of severance at the annualized compensation level would be treated as a bona fide severance plan, assuming the other qualifications are met, and any excess would not. I believe an example similar to the one provided in our written comments would be helpful.

Also, employers often provide guaranteed severance followed by additional severance if the executive has not found other employment, or a similar design with full severance stated at the outset, but a portion of which is subject to offset if the terminated executive find subsequent employment during the severance period. In these designs the full extent of the severance benefits is not known at the beginning of the severance period. I recommend the IRS clarify in the regulations that the portion of the severance period that is subject to offset not be taxable until it is actually paid, assuming the bona fide severance plan exemption does not apply.

MR. TACKNEY: But I just find that confusing because it seems it's the individual's decision whether to take the other employment or not. While substantial services may, you know -- also the decision whether to stay or not -- we normally outside of this providing substantial services don't put forfeiture conditions, make them completely in control of the employee. So here I mean the employee has complete control over whether they take another job or not. In some sense it's opposed to the employer doesn't have any influence on that. So it also doesn't fit normally our condition related to the performance of the services, how does -- whether they performed services or not for another organization relate to your business and your business goals. So I'm a little confused on that one. I can understand that they would need to get an offset for any amounts that they aren't actually paid because they've chosen, but why would we treat that differently, for instance, to some type of termination for cause or other non substantial risk of forfeiture forfeiture condition if in fact the employee is in complete control of whether they forfeit or not?

MR. PATTERSON: Mm-hmm, mm-hmm.

MR. TACKNEY: It seems like anybody -- you could put it in -- somebody could leave at 80 and you could say if you get another job within the next five years there will be an offset and they would just, you know, automatically they could choose whether or not and that would be offset -- you know, I just worry that seems particularly subject to abuse in certain situations especially.

MR. PATTERSON: So yeah, I understand the point that you're making there. What we would recommend is that the IRS clarify in the regulations that the portion of the severance that is subject to the offset not be taxable until it's actually paid, assuming the bona fide severance plan exemption does not apply.

MR. TACKNEY: But the only way to do that is to say it's not subject to a substantial risk of forfeiture, but what's the substantial risk of forfeiture?

MR. PATTERSON: So in this case, if the plan has a design where they get 24 months of severance and then they'll get an extra 6 months if they're still unemployed, so that then at 24 months they determine -- they have terminated

employment at that point. That the taxation of that benefit or the impact of it be addressed at that point, rather than tax them on the front end --

MR. TACKNEY: Oh, okay. You just want them taxed at the end of the two years?

MR. PATTERSON: Right, right.

MR. TACKNEY: I see. Okay.

MR. PATTERSON: Rather than at the beginning where --

MR. TACKNEY: For anything past two years I thought you were saying you wanted that -- so you -- you want that ability to pay after two years and still have the two years be out, but you also want what's after two years out until the end of the two years?

MR. PATTERSON: In a plan designed like that we think it would be a favorable position. We think it would be a reasonable position for the IRS to take. Severance is all about -- these severance plans and the way they're designed, we look at it not just from the participant standpoint, as you are, but from the employer standpoint. And the ability to provide competitive severance, to be able to have the right people doing the right things for the organization, we think that there is merit to that. And if a severance plan is designed the way that I described --

MR. TACKNEY: Well, it seems that's just -- I mean it's -- doesn't have anything to do with the services there, you just want to pay less severance if they have other sources of income. Well, I don't understand how that has anything to do with their performance of services at your organization.

MR. PATTERSON: So our position -- I'm not sure if this answers your point, but our position would just be rather than tax them on the front end if they don't actually end up getting the severance because some of it is offset, that they not be taxed on the front end and then have to rely on the miscellaneous itemized deduction limitations where they might not be able to get that money back. It may just never be received. So it seems like a fair approach to address those plans differently if there is -- so maybe it's similar to the present value rules that the IRS addressed in the proposed regulations. That if we look at what the projected value of the severance would be, in a design like that could we use that as a rationale to say we're not sure this is going to be 30 months of severance, it may only be 24.

And so our position would just be with plans like that we think that there's a reason in the market to have them. We see them and it would be a reasonable position to treat those differently than a plan that provided a guaranteed 30-month or whatever period of severance.

MR. TACKNEY: Okay.

MR. PATTERSON: Well, that's it for me. Thank you so much for letting me present these thoughts. Do you have any other questions?

MR. TACKNEY: No. I know I've been a little pointed, so thanks guys.

MR. PATTERSON: Thank you.

MR. TACKNEY: Thank you. Is there anybody here who -- we're opening the floor if anybody wants to speak. You've got to get up to the microphone to get recorded. It's a public hearing, we need to be recorded. And you do need to identify yourself. Thank you.

MS. SHARARA: Hi. I'm Norma Sharara. I'm here today in my personal capacity, not in my official capacity. I had a question with respect to the Dash 11 Regs where there is a definition of disability, and a definition of involuntary separation from service which includes good reason. Those terms are used in the Dash 12 sections of the regs; for example, in the Dash 12 section it says, if you have a rolling risk of forfeiture and you want to push it off, it has to be pushed off at least two years, except if there's a death or disability or involuntary separation from service. And I just wanted a clarification that the definitions in Dash 11 section of the proposed regs would apply in the Dash 12 section of the regs.

MR. TACKNEY: Well, if we haven't made it clear I will take that as a comment that we need to clarify that in the final regs, so.

MS. SHARARA: Thank you. That's all.

MR. TACKNEY: Do we have anyone else who would like to speak. All right, with that, that closes our public hearing on proposed regulations. I'd like to thank our speakers. And thanks everyone for attending.

(Whereupon, at 10:53 a.m., the HEARING was adjourned.)