

IRS Clarifies Section 457 Exemptions for Bona Fide Severance Pay Plans and Other Benefit Plans

Article By:

Christine M. Kong

Margaret R. Wickett

We will discuss the exemptions from Section 457 for bona fide severance pay plans, death benefit plans, disability pay plans, and sick leave or vacation plans and what employers should know going forward. The newly proposed regulations provide welcome guidance in this area.

Current Law

The term “plan” under Section 457 generally includes any plan or arrangement, including an individual employment agreement, of a tax-exempt or a governmental employer under which compensation is deferred. Section 457(d)(11) and the 2003 final regulations under Section 457 provide that bona fide vacation leave, sick leave, compensatory time, severance pay, disability pay or death benefit plans do not provide for the deferral of compensation (and therefore these plans are not subject to Section 457), but the 2003 final regulations did not provide guidance regarding the meaning of these terms.

Bona Fide Severance Pay Plans

The proposed regulations adopt the “severance pay exemption” concept from Code Section 409A (Section 409A) with certain changes. Under the proposed regulations, a bona fide severance pay plan does not provide for the deferral of compensation (and therefore it is not subject to Section 457) if the following requirements are met:

- Benefits are only payable upon an involuntary severance from employment or pursuant to a window program or a voluntary early retirement incentive plan.
- Pursuant to a written plan document, the entire severance benefit is required to be paid by December 31 of the second calendar year following the calendar year in which severance from employment occurs.
- The severance payable does not exceed two times the employee's annualized compensation based upon the employee's annual pay rate with the employer for the calendar year

preceding the year in which severance from employment occurs (or the current calendar year, if the employee had no compensation for services provided to the employer in the preceding year).

Comment: *The definition of a “bona fide severance pay plan” under the proposed regulations differs from the definition of a “separation pay plan” under Section 409A. A separation pay plan is exempt from Section 409A if, among other requirements, the severance payable cannot exceed two times the lesser of the employee’s annualized compensation for the year preceding the year in which separation occurs or the Code Section 401(a)(17) compensation limit for the year in which separation occurs (\$265,000 for 2016). Severance payable under a bona fide severance pay plan is not limited by the Code Section 401(a)(17) limit. Because benefits offered by tax-exempt employers are subject to Section 409A and Section 457 unless an exemption applies, tax-exempt employers may wish to design their severance programs to meet the requirements of the bona fide severance pay plan exemption, the separation pay plan exemption, and/or the “short-term deferral” exemptions under Section 409A and the proposed regulations.*

Comment: *Severance may also be subject to the Employee Retirement Income Security Act (ERISA). If subject to ERISA, a Form 5500 annual report may need to be filed with the Department of Labor each year and certain information regarding the severance program must be provided to participants.*

Involuntary Severance from Employment

Under the proposed regulations, an involuntary severance means a severance from employment due to the employer’s exercise of its unilateral authority to terminate an employee’s employment. Whether a severance from employment is involuntary is based on the facts and circumstances, without regard to the employer’s or the employee’s characterization of the reasons for paying severance. An involuntary severance from employment may include the failure to renew an employee’s contract at expiration if the employee was willing and able to execute a new contract under terms substantially similar to those in the expiring contract. An employee’s implicit or explicit request to be involuntarily terminated generally will not constitute an involuntary severance from employment if the employee was willing and able to continue performing services

Good Reason Severance from Employment

A voluntary severance from employment may be treated as an involuntary severance from employment if the severance is for “good reason.” Under the proposed regulations, a severance is for good reason if it occurs under conditions pre-specified in writing that result in a material negative change to the employee’s employment. A material negative change would include a material reduction in the employee’s compensation, duties, or working conditions. Other factors to be considered in determining whether a severance is for good reason are whether the employee is required to notify the employer of the existence of the good reason condition, and whether the employer has a reasonable opportunity to cure the condition.

Material Negative Change Safe Harbor

The proposed regulations also provide a safe harbor under which a voluntary severance from employment is considered to result from a material negative change to the employee’s employment,

and thus constitute a severance for good reason under Section 457. The requirements of the safe harbor are met if the following are specified in writing at the time the employee's legally binding right to payment arises:

- The severance from employment occurs during a period of time not to exceed two years following the initial existence of one or more of the following conditions arising without the employee's consent:
 1. A material diminution in the employee's base compensation;
 2. A material diminution in the employee's authority, duties, or responsibilities;
 3. A material diminution in the authority, duties, or responsibilities of the supervisor to whom the employee reports, including a requirement that the employee report to a corporate officer or employee instead of reporting directly to the employer's board of directors or similar governing body;
 4. A material diminution in the budget over which the employee retains authority;
 5. A material change in the geographic location at which the employee must perform services; or
 6. Any other action or inaction that constitutes a material breach by the employer of the agreement under which the employee is employed.
- The amount, time, and form of payment is substantially the same as the amount, time, and form of payment that would have been made upon an actual involuntary severance from employment (to the extent the right to such payment exists).
- The employee is required to notify the employer of the initial existence of the applicable condition(s) within 90 or fewer days, and the employer has at least 30 days to remedy the condition(s).

Bona Fide Death Benefit Plans

Payment under a bona fide death benefit plan is not considered deferred compensation for purposes of Section 457. The proposed regulations clarify that death benefits may be provided through insurance, and that lifetime benefits payable under a death benefit plan are not considered to include the value of any term life insurance coverage provided under the plan that is includible in income.

Bona Fide Disability Pay Plans

A plan (whether insured or a self-insured) that pays benefits only in the event of an employee's disability does not provide for the deferral of compensation for purposes of Section 457. Under the proposed regulations, an employee is considered disabled only if the employee:

- Is unable to engage in any substantial gainful activity by reason of any medically determinable

physical or mental impairment that can be expected to result in death or last for a continuous period of not less than 12 months;

- Is, by reason of any medically determinable physical or mental impairment that can be expected to result in death or last for a continuous period of not less than 12 months, receiving income replacement benefits for at least three months under an accident and health plan covering employees of the employer; or
- Is determined to be totally disabled by the Social Security Administration or Railroad Retirement Board.

Bona Fide Sick Leave or Vacation Plans

The proposed regulations provide that a bona fide sick leave or vacation leave plan does not provide for the deferral of compensation under Section 457 if the plan's primary purpose is providing an employee with paid time off from work because of sickness, vacation, or for other personal reasons.

Whether a plan's primary purpose is to provide for sick leave or vacation leave is based on the facts and circumstances. Factors to consider include (i) whether the leave could reasonably be expected to be used by the employee in the normal course; (ii) the employee's ability to exchange accrued unused leave for cash or other benefits (including nontaxable benefits or the use of leave to postpone termination of employment); (iii) any restraints on the ability to accumulate unused leave and carry it forward to subsequent years where the accrued leave may be exchanged for cash or other benefits; (iv) the amount and frequency of any in-service distributions of cash or other benefits offered in exchange for accrued, unused leave; (v) whether accrued unused leave is paid promptly upon severance from employment or over a period after severance from employment; and (vi) whether the plan or any plan features are available only to a limited number of employees.

Effective Date

In general, the regulations are proposed to apply to compensation deferred under a plan for calendar years beginning after the date the IRS adopts the proposed regulations as final regulations (the "applicability date"), including deferred amounts to which an employee's legally binding right arose during prior calendar years that were not previously included in income. Taxpayers may rely on the proposed regulations until the applicability date.

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National Law Review, Volume VI, Number 213

Source URL: <https://natlawreview.com/article/irs-clarifies-section-457-exemptions-bona-fide-severance-pay-plans-and-other-benefit>