Non-competition agreements in IRC Section 457(f) plans used to delay substantial risk of forfeiture

Background

Since 2007, plan sponsors, advisors, and recordkeepers have expected the IRS to provide additional guidance on 457 regulations. In July of 2016, the IRS released long-awaited proposed 457(f) regulations regarding deferred compensation plans of state and local governments and tax-exempt entities.[1]

Use of non-compete agreements

The proposed 457(f) regulations state that a non-compete agreement can be used to extend a participant's substantial risk of forfeiture beyond separation from service, so long as three conditions are satisfied:

- The agreement must be enforceable under applicable state law. In some states, the enforcement of non-compete agreements may be very difficult or impossible.
- The employer must have a substantial interest in preventing the participant from competing, and the participant must have a valid interest in and ability to compete.
    - If the participant went to work for another firm in a different line of business as the former employer, the non-compete may not be valid.
    - If a participant is nearly at retirement age and is likely exiting the work force, the non-compete may not be valid.
- Finally, the plan sponsor must actively monitor the participant post-separation from service and take steps to ensure that they do not violate the agreement.[2]

Example

- An employer establishes an IRC Section 457(f) account for a participant with a vesting date of June 30, 2025.
- The participant and employer agree to establish a non-compete agreement, which extends the substantial risk of forfeiture to June 30, 2026.
- The participant has an interest in and ability to engage in the prohibited competition but refrains from doing so. The employer monitors the participant's compliance with the non-compete agreement.
- Assuming the participant separates from service on or after July 1, 2025 and does not violate the terms of the non-compete agreement until on or after June 30, 2026, the participant's substantial risk of forfeiture expires on June 30, 2026.
- The employer issues a distribution to the participant within 2½ months following June 30, 2026, and the participant includes this distribution when filing their 2026 tax return.

These provisions are based on “facts and circumstances”, so it’s imperative the employer engage legal counsel to negotiate the agreement and make sure it complies with the proposed regulations and local state laws.

[1] See Prop. Treas. Reg. Sec. 1.457.

[2] See Prop. Treas. Reg. Sec. 1.457-12(e)(iv).

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