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Section 457(f) Plans and Noncompete Clauses: What the IRS Gave, the FTC May Take Away

by Eric D. Altholz on May 20, 2024

When the IRS published proposed regulations harmonizing key provisions of Code Sections 409A and 457(f) in 2016, executive compensation lawyers and consultants rejoiced. It was not just that a long wait was over (roughly nine years from the publication of IRS Notice 2007-62, which promised guidance on these issues). The proposed regulations provided much-needed clarifications and explanations regarding the interplay of two different sets of rules, both of which can apply to the deferred compensation plans of tax-exempt employers. What's more, the proposed regulations included a special opportunity for tax-exempt employers by confirming that an enforceable noncompete may constitute a substantial risk of forfeiture (equivalent to any other vesting event) if certain requirements are met.[1]

In our experience, noncompetes are used sparingly in deferred compensation plans of tax-exempt employers. However, when applied in appropriate situations, a noncompete can provide a way for a tax-exempt employer to extend the vesting period and tax-deferred growth of a benefit that otherwise would have vested before the cessation of an executive's employment. With the publication of the Federal Trade Commission's Final Non-Compete Clause Rule, it appears the FTC may have taken this special opportunity away from tax-exempt employers – at least it thinks it has, at least in some cases.

The FTC's Final Rule has been roundly criticized by businesses of all sizes in many industries, as well as their lobbyists and law firms. The immediate filing of lawsuits by the U.S. Chamber of Commerce and other stakeholders has already cast doubt on the long-term future of the Final Rule. Federal judges may strike down the Final Rule's broad prohibition against noncompetes. In the meantime, however, there is a significant question about the extent to which the FTC's Final Rule applies to tax-exempt employers and their deferred compensation plans and agreements.

The preamble to the FTC final rule acknowledges that: (1) Section 501(c)(3) tax-exempt organizations are "corporations"; (2) an entity is subject to its jurisdiction as a "corporation" under the FTC Act only if it is "organized to carry on business for its own profit or that of its members"; and (3) organizations that claim tax-exempt status generally are ***not*** organized to carry on business for their own profit or that of their members. Nevertheless, the agency

[1] This differs significantly from the 2007 final regulations under Code Section 409A, which explicitly reject the use of a noncompete to establish a substantial risk of forfeiture under a deferred compensation plan subject to Section 409A. We wrote about the use of a noncompete to establish a substantial risk of forfeiture under Section 457(f) a few years ago. While that piece continues to be available on this site, and it may still be useful to some, it should be read in light of the publication of the FTC Final Rule.

believes it can exercise jurisdiction over Section 501(c)(3) organizations under certain circumstances and arguably has done so.[2] For that reason, the FTC devotes several pages of the preamble to the Final Rule to explaining why "[m]erely *claiming* tax-exempt status in tax filings is not dispositive" of its jurisdiction over a tax-exempt organization (emphasis in the original) and discussing the factors it would consider in evaluating a potential enforcement action.

It may be some time before we have answers to the questions raised by litigants challenging the FTC Final Rule. For now, tax-exempt employers need to consider the possibility that the Final Rule, if it takes effect on September 4th, may render unavailable the use of a noncompete to delay the vesting and payment of deferred compensation beyond the cessation of employment. For this reason, tax-exempt employers considering the use of a noncompete as a substantial risk of forfeiture for a senior executive may want to proceed with the desired plan or contract now before the Final Rule takes effect on September 4th.[3]

In the meantime, here are some currently unanswerable questions unique to tax-exempt employers:

- Assuming the FTC Final Rule survives judicial review, will the FTC or the IRS publish more definitive guidance that will allow tax-exempt employers to reliably conclude they are exempt from the Final Rule?[4] Would community hospitals be exempt from the rule while large regional health systems (some of which have for-profit subsidiaries) potentially wouldn't be? Would social clubs and fraternal organizations be exempt from the rule while big city museums would be at risk? And what about large private universities with highly profitable athletic programs?
- Assuming at least some tax-exempt employers will be subject to the FTC Final Rule, will the IRS provide guidance addressing the impact of the rule on the provisions of the proposed regulations under Code Section 457(f) that allow a noncompete to establish a substantial risk of forfeiture?

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[2] The preamble to the Final Rule cites the following cases: *In the Matter of Preferred Health Servs., Inc.*, F.T.C. No. 41-0099, 2005 WL 593181 (Mar. 2, 2005) and *In the Matter of Boulder Valley Individual Prac. Assoc.*, 149 F.T.C. 1147, 2010 WL 9434809 (Apr. 2. 2010).

[3] Existing noncompetes entered into with "senior executives" (as defined) are grandfathered under the Final Rule, but the Final Rule prohibits entering into a noncompete with a senior executive after the September 4th effective date.

[4] To evaluate whether profit-seeking business activities carried on by a tax-exempt organization outweigh its tax-exempt mission, the FTC has stated that it will consider: (1) whether the corporation is organized for and actually engaged in business only for charitable purposes; and (2) whether either the corporation or its members derive a profit. The preamble to the Final Rule cites *In the Matter of Coll. Football Ass'n*, 117 F.T.C. 971, 992-999 (1990) regarding this issue.

- What would happen if a tax-exempt organization enters into a noncompete after September 4th under the mistaken belief that the FTC Final Rule does not apply to it, then is subsequently found to be subject to the rule (perhaps as a result of an FTC enforcement action or litigation commenced by an aggrieved senior executive)? In that case, the vesting condition tied to the expiration of the noncompete period would be null and void. But as of what date would the benefit be deemed to have vested? As of the date of the executive's participation in the plan or entry into the contract? As of the executive's separation from service date?
- If the invalidation of a noncompete causes a tax-exempt employer to be hit with the 21% excise tax under Code Section 4960 (or triggers the excise tax sooner than expected), will the IRS allow the employer to defer or spread out payment of the tax?

We will track developments regarding these issues in the months ahead. In the meantime, if you have questions about how the FTC Final Rule may affect your deferred compensation plans or agreements, contact a member of our Employee Benefits & Executive Compensation Group.

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