EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION

Employee Benefits Newsletter
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To Non-Compete (or Not to Non-Compete)

On April 23, 2024, the Federal Trade Commission ("FTC") adopted a rule prohibiting employers from entering into non-competes with their employees. The FTC rule, originally set to take effect on September 4, 2024, was intended to allow employees to change jobs more easily without fear of prior employers limiting their future job prospects. However, on August 20, 2024, a federal court struck down the FTC rule and issued a nationwide injunction prohibiting its enforcement.[1]

Although the case is currently on appeal, the FTC rule is currently not enforceable. Nevertheless, employers should be aware that this decision could cause state or federal lawmakers to enact statutory limitations on non-competes. As a result, employers whose plans or compensation arrangements utilize non-competes may want to consider assessing the potential impact if their non-competes are rendered invalid. Below are some examples of employee benefit arrangements that commonly utilize non-competes.

Code Section 457(f) Plans

A tax-exempt entity may sponsor a nonqualified deferred compensation plan under Section 457(f) of the Internal Revenue Code of 1986, as amended (the "Code"), which allows a select group of highly compensated or key management employees to receive deferred compensation in excess of the contribution limits imposed on plans under Code Sections 401(k), 403(b), and 457(b). Under Code Section 457(f), the deferred amount is included in the employee's gross income once there is no substantial risk of forfeiture of the compensation, in other words, once the compensation vests. Tax-exempt entities may currently treat non-competes as creating a substantial risk of forfeiture. If a non-compete were deemed invalid, however, amounts deferred that are contingent on compliance with such non-compete may become taxable earlier than intended.

Restricted Stock

Under Code Section 83, transfers of property in connection with the performance of services, including restricted stock, are generally included in the employee's gross income once the property is not subject to a substantial risk of forfeiture (i.e., when it vests). Currently, compliance with a non-compete can create a substantial risk of forfeiture under Code Section 83. If a substantial risk of forfeiture lapses based on an unenforceable non-compete, however, the restricted stock would become immediately taxable under Code Section 83.

Golden Parachutes

Code Section 280G imposes a 20% excise tax on certain recipients of excess compensation (often referred to as “golden parachute payments”) in connection with a change in control. The corporation paying the golden parachute also loses a tax deduction. Corporations may minimize the impact of Section 280G on golden parachute payments by attributing a value to non-competes as reasonable compensation. If non-competes become unenforceable, however, this commonly used mitigation strategy might become unavailable.

The future of non-competes is far from settled. If you would like assistance navigating this developing area and determining how it applies to your business, please reach out to a member of our Employee Benefits and Executive Compensation group.

1. *Ryan LLC v. FTC*, No. 3:2024-cv-00986, N.D. Tx.

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