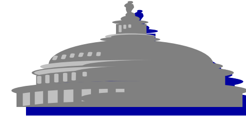
Focus on 457



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IRS Publishes Final 457 Regulations July 11, 2003

The Internal Revenue Service (IRS) issued proposed regulations under Internal Revenue Code (Code) section 457 on May 8, 2002 and held a public hearing regarding the proposed regulations on August 29, 2002. On July 11, 2003, the IRS published final regulations providing guidance on deferred compensation plans of state and local governments and tax-exempt entities. The final regulations include guidance on all tax legislation affecting section 457 plans since 1982, including the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). This article summarizes the changes made to the proposed regulations based upon the comments IRS received from the public.

1. **Allow amounts rolled into a 457(b) plan to be distributed prior to severance of employment**.

Proposed Regulations: Amounts rolled into an eligible 457 plan are included in the definition of “amounts deferred” and cannot be distributed from the 457 plan until the participant has satisfied the distribution rules provided under section 457(d).

Public Comments: The IRS was urged to revise the final 457 regulations to allow amounts rolled into a 457 plan to be available for distribution at any time even if the participant was not yet eligible for a distribution of elective deferrals made to the plan.

Final Regulations: The final regulations prohibit an eligible governmental plan from distributing rolled-in assets to a participant who is not yet eligible for a distribution, but only for distributions made after January 1, 2004. The effective date is delayed because the IRS intends to issue guidance in the near future resolving this issue. The new guidance would be coordinated with the rules applicable to qualified plans and section 403(b) contracts. The IRS expects this new guidance to be issued before the end of the year.

2. Plan-to-plan transfers.

Proposed Regulations: The proposed regulations provided for plan-to-plan transfers between eligible governmental plans under certain circumstances, including the purchase of permissive service credits by transfer from an eligible governmental plan to a governmental defined benefit plan, but only if all such transfers were made by plans within the same state.

Public Comments: Commentators objected to the requirement that transfers be limited to plans within the same state. The IRS was also asked to clarify that section 415(n) does not apply to the purchase of service credit.

Final Regulations: The final regulations eliminate the same state requirement with respect to individual transfers and allow plan-to-plan transfers among eligible governmental plans in three situations. In each case, the transferor plan must provide for transfers, the receiving plan must provide for the receipt of transfers, and the value of the amount transferred into the new plan must be equal to the amount transferred out of the prior plan.

(1) A person-by-person transfer is permitted for any beneficiary or any participant who has had a severance from employment with the transferring employer and is performing services for the entity maintaining the receiving plan. The plans do not have to be within the same State.

(2) No severance from employment is required if the entire plan's assets for all participants and beneficiaries are transferred to another eligible governmental plan within the same State.

(3) No severance from employment is required for a transfer from one eligible governmental plan of an employer to another eligible governmental plan of the same employer.

The final regulations also allow a plan-to-plan transfer from an eligible governmental plan to a governmental defined benefit plan for the purchase of permissive service credit, even if the entities sponsoring the plans are not in the same State. In addition, Treasury and IRS concluded that section 415(n) does not apply to a such a transfer in any case in which the actuarial value of the benefit increase that results from the transfer does not exceed the amount transferred.

3. Unforeseeable emergency distribution due to funeral expenses.

Proposed Regulations: An eligible plan may permit a distribution to a participant or beneficiary faced with an unforeseeable emergency. Although an example provides that the need to pay for the funeral expenses of a "family member" may constitute an unforeseeable emergency, the term "family member" is not defined.

Public Comments: The IRS was asked to define family member.

Final Regulations: The final regulations were modified to define a family member as a spouse or dependent as defined in Code section 152(a).

4. Sick, vacation and back pay.

Proposed Regulations: Participants are allowed to defer accumulated sick and vacation pay or back pay only if an agreement for the deferral is entered into before "the beginning of the month in which the amounts would otherwise be paid or made available and the participant is an employee in that month."

Public Comments: IRS was urged to allow employers a reasonable period of time after the participant's severance from employment to make the payment and deferral.

Final Regulations: The final regulations retain the rule that the deferral election must be made during employment and before the beginning of the month when the compensation would have been payable. Although a special rule was added with respect to the timing of the deferral election for employees terminating during a month, there does not appear to be any relief from the rule that the employee must be employed during the month that the amounts are paid. Under the special rule, if the employee is severing service in the middle of a month, the deferral election need only be made before the date on which the vacation pay would otherwise have been payable.

5. Excess deferrals.

Proposed Regulations: Eligible government plans were allowed to self-correct and remain eligible plans by distributing excess deferrals. Plans of tax-exempt employers, on the other hand, lost their eligible status immediately upon receipt of an excess contribution.

Public Comments: Commentators objected to the less favorable treatment for eligible plans of tax-exempt employers and requested a self-correction mechanism for such plans.

Final Regulations: The final regulations extend self-correction for excess deferrals to eligible plans of tax-exempt employers. Tax-exempt plans remain eligible plans if any excess deferrals, and any income allocable to such amount, are distributed to the participant not later than the first April 15 following the close of the taxable year during which the excess deferral was made. This rule is comparable to the rules for qualified plans under section 402(g). Any excess deferral must be included in the gross income of the participant for the taxable year that the deferral was made. If an excess deferral is not corrected by distribution, the plan is an ineligible plan under which benefits are taxable in accordance with the rules under 457(f). Excess deferrals distributed from tax-exempt plans are reported on Form W-2 with the deferral taxed in the year it was contributed and the earnings taxed in the year distributed.

The rule for governmental plans remains the same -- excess deferrals must be distributed to the participant, with allocable net income, as soon as administratively practicable after the plan determines that the amount is an excess deferral. The excess deferral amount is always taxed in the year it was contributed to the plan, and the earnings are taxed in the year distributed. Governmental plans report excess deferrals on Form 1099-R.

6. Treatment of amounts rolled into an eligible 457 plan.

Proposed Regulations: The IRS specifically requested comment on whether there are any special characteristics applicable to qualified plans, section 403(b) contracts or IRAs under section 72(t) (imposing an additional income tax on early distributions from such plans, contracts, or arrangements) that could be lost if multiple types of separate accounts are not maintained.

Public Comments: Commentators asked for the regulations to permit maintenance of a single rollover account for all amounts that are rolled into the eligible governmental plan.

Final Regulations: Separate accounting is required only to the extent mandated by section 402(c)(10), i.e., only for rollovers from IRAs, qualified plans and section 403(b) contracts. Section 72(t) provides that the early withdrawal income tax applies to distributions from rollovers attributable to IRAs, qualified plans, and section 403(b) contracts.

The final regulations suggest that eligible governmental plans may choose to establish three separate accounts for tax reporting purposes: first, an account for all amounts deferred under that plan; second, an account for any rollover from another eligible governmental plan consisting entirely of 457 deferrals; and third, an account for any rollover amount from an IRA, qualified plan or section 403(b) contract, including any amounts rolled over from another eligible governmental plan that originated from an IRA, qualified plan or section 403(b) contract.

7. Aggregation rules

Proposed Regulations: Several rules aggregate multiple plans for purposes of meeting the eligibility requirements of section 457(b).

Public Comments: Few comments were received with respect to the aggregation rules.

Final Regulations: All of the aggregation rules are retained. For example, in any case in which multiple plans are used to avoid or evade the eligibility requirements, the Commissioner may apply the eligibility requirements as if the plans were a single plan. Also, an eligible employer is required to have no more than one normal retirement age for each participant under all of the eligible plans it sponsors. In addition, all deferrals made to all eligible plans under which an individual participates by virtue or his or her relationship with a single employer are treated as though deferred under a single plan for purposes of determining excess deferrals. Finally, annual deferrals under all eligible plans are combined for purposes of determining the maximum deferral limits.

8. Ineligible plans

Proposed Regulations: Section 457(f) does not apply to an eligible plan, a qualified plan, a section 403(b) contract, a section 403(c) contract, a transfer or property described in section 83, a trust to which section 402(b) applies, or a qualified governmental excess benefit arrangement described in section 415(m). Section 457(f) does apply if the date on which there is no substantial risk of forfeiture with respect to the compensation deferred precedes the date on which there is a transfer of property to which section 83 applies.

Public Comments: A number of commentators objected to the proposed coordination of sections 457(f) and 83 arguing that the proposed regulation would place tax-exempt organizations at a competitive disadvantage when it comes to attracting and retaining executive talent because it would effectively eliminate the use of discounted mutual fund options as a tax effective component of total compensation.

Final Regulations: The interpretation of the coordination of sections 457(f) and 83 is retained. The final regulations also clarify the application of the rule by adding an example involving an option grant. The regulations also include a clarification that, when benefits are paid or made available under an ineligible plan, the amount included in gross income is equal to the amount paid or made available, but only to the extent that the amount exceeds the amount the participant included in gross income when he or she obtained a vested right to the benefit.

9. Severance pay.

The Treasury and IRS continue to seek comments on severance pay arrangements.

10. Effective date of final regulations.

The final regulations generally apply to taxable years beginning after December 31, 2001, subject to certain specific transition rules.

Transition Rule. For taxable years beginning after December 31, 2001 and before January 1, 2004, a plan will not fail to be an eligible plan if it is operated in accordance with a reasonable, good faith interpretation of section 457(b).

Special Delayed Effective Date. The rule under which an eligible governmental plan cannot distribute rollover account benefits to a participant who is not yet eligible for a distribution is not applicable until years beginning after December 31, 2003, since this issue is expected to be resolved before that date.

No changes were made to the final regulations with respect to the following:

1. **Deferral agreements must be entered into prior to the first day of the month that the deferral will be made**.

2. **Employer contributions subject to a vesting schedule are treated as being subject to a substantial risk of forfeiture. All employer contributions and the earnings thereon are treated as amounts deferred in the year that they vest.**

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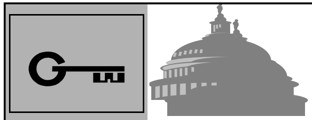

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