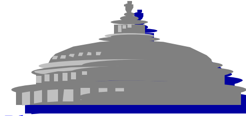
Focus on 457



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IRS Receives Written Comments and Testimony On Section 457 Proposed Regulations

The Internal Revenue Service (IRS) issued proposed regulations under Internal Revenue Code (Code) section 457 on May 8, 2002. These proposed regulations provide guidance on all tax legislation affecting section 457 plans since 1982, including the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). EGTRRA made major changes to governmental section 457(b) plans and the guidance contained in the proposed regulations is very much appreciated.

The IRS solicited written comments and held a public hearing on August 29. Four of the five speakers at the hearing urged the IRS to eliminate a proposed provision for 457(f) plans restricting the ability of tax-exempt employers to compensate employees with stock options. Mary Willett, president of the National Association of Government Defined Contribution Plans focused on governmental plan issues, as did many of the written comments submitted.

This article summarizes ten of the major issues affecting eligible governmental 457(b) plans addressed by those submitting comments to the IRS and the change they would like to see to the final regulations.

1. Allow amounts rolled into a 457(b) plan to be distributed at any time.

Under the proposed regulation, 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 in 457(d).

Public Comment: IRS is urged to revise the final 457 regulations to follow the rule currently applicable to qualified plans and 403(b) plans. Under this rule, amounts rolled into a 457 plan would be available for distribution at any time.

Rationale: Amounts rolled into 457 plans have already met the distribution restrictions of the prior plan. There is no need to impose additional distribution restrictions on the rollover amounts and such restriction would place 457 plans at a disadvantage vis-à-vis 401(k) and 403(b) plans.

2. Eliminate the requirement that agreements for deferral to be entered into prior to the first day of the month.

Under the proposed regulations, an agreement to defer compensation into a 457(b) plan is not valid unless it is entered into before the first day of the month in which compensation is paid or made available to the participant.

Public Comment: IRS is urged to adopt a more flexible rule by eliminating the "first day of the month" requirement and allowing deferral agreements to be treated as valid if entered into any time prior to the date the compensation is paid or made available.

Rationale: The preamble to the proposed regulations specifically states that the rules governing deferral agreements operate on a cash basis.

3. Allow plan-to-plan transfers and trustee-to-trustee transfers for the purchase of service credits among plans of any state.

Under the proposed regulations, plan assets may be transferred from one eligible 457(b) plan to another only if both plans are located within the same state. The "same state rule" also applies to trustee-to-trustee transfers from a governmental 457 plan to a governmental defined benefit plan for the purchase of service credits.

Public Comment: The final regulation should not restrict plan-to-plan or trustee-to-trustee transfers among plans within the same state.

Rationale: Code section 457 does not contain a requirement that governmental plans involved in a transfer of plan assets be located within the same state. A restriction not contained in the Code should not be imposed by the regulations.

4. Define the term "family member" for purposes of making an unforeseeable emergency distribution due to funeral expenses.

Under the proposed regulations, an eligible plan may permit a distribution to a participant or beneficiary faced with an unforeseeable emergency. Although 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 Comment: The IRS was asked to define family member.

Rationale: The term "dependent," which is also used in the unforeseeable emergency regulations, is a defined term. Defining the term family member will encourage more uniform enforcement of this regulation since may employers would like to expand the definition to include extended family members, while others take a very restrictive view.

5. Allow participants to defer sick and vacation pay into an eligible 457 plan so long as the payment is made within a reasonable period of time after severance of employment.

Under the 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." (Emphasis added.)

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

Rationale: Requiring the participant to be employed in the month the accumulated sick and vacation pay or back pay is paid creates a problem for many employers. An employee's accumulated sick and severance pay is typically determined as of the last day at work. Employers need a reasonable period of time after that date to calculate the dollar value of the accumulated sick and vacation days and write the check.

6. Income and payroll tax reporting of excess deferral distributions should follow the rules applicable to excess deferral distributions from section 401(k) and 403(b) plans.

Under the proposed regulations, plan level excess deferrals must be distributed, with allocable earnings, as soon as practicable after discovery. Failure to make the distribution may endanger the eligible status of the plan. In situations where the participant contributes to plans of two or more employers, the plans are not required to distribute the excess amount.

Public Comment: Excess deferrals to an eligible plan should be treated in a manner similar to section 401(k) and section 403(b) excess deferrals. Participants should be required to notify the employer of any excess deferrals because the employers would have no way of knowing about the other plan. Upon receipt of notice of an excess deferral, either employer could distribute the excess plus allocable earnings. The excess deferral distribution would be tax reported on Form 1099-R with the excess deferral amount being taxed in the year contributed and the earnings taxed in the year distributed from the plan. FICA tax on the excess deferral would have been properly withheld when the amount was contributed.

IRS was also urged to follow this same rule whether the excess is the result of a single employer's plan(s), multiple employer plans, or plans maintained by tax-exempt entities.

Rationale: Since many employers offer more than one type of elective deferral arrangement under 401(k), 403(b) and/or 457(b), the rules for correcting excess deferrals should be consistent among the various types of plans.

7. Eliminate the substantial risk of forfeiture requirement on non-vested amounts and the earnings thereon.

Under the proposed regulations, employer contributions subject to a vesting schedule are treated as being subject to a substantial risk of forfeiture. Thus, non-vested amounts are not treated as annual deferrals until the taxable year in which they vest and must be adjusted to reflect gain or loss allocable to the compensation from the date of deferral to the date vested.

Public Comment: Non-vested amounts in a governmental 457 plan should receive the same treatment as non-vested amounts in a 401(k) or 403(b) plan. All references to "substantial risk of forfeiture" in connection with section 457(b) eligible governmental plans should be deleted from the final regulations. Any gain allocable to the compensation from the date of deferral to the date vested, should not be treated as an additional amount deferred into the plan.

Rationale: The concept of "substantial risk of forfeiture" is not contained in Code section 457 except with respect to ineligible plans subject to section 457(f). A restriction not contained in the Code should not be imposed by the regulations.

8. Treat non-vested amounts and the earnings thereon as "annual deferrals" in the year contributed rather than the year vested.

Under the proposed regulations, non-vested amounts, including the earnings thereon, are treated as contributions subject to the contribution limits in the year that the amounts vest.

Public Comment: Non-vested contributions to an eligible section 457 plan should be treated as annual deferrals in the year contributed, not the year in which such amounts become vested. Further, as discussed in number 7 above, the earnings should not be treated as amounts deferred for 457(b) deferral limit purposes.

Rationale: Non-vested amounts to 401(k) and 403(b) plans are not subject to this onerous rule. If deferrals, as adjusted for gain or loss, are to be counted as annual deferrals only when vested, such treatment will cause recordkeeping and FICA tax withholding to become extremely complicated.

9. Clarify that transfers for purchase of service credits are not subject to section 415(n).

Under the proposed regulations, a transfer may be made from an eligible governmental plan of a state to a defined benefit governmental plan only if the transfer is a repayment or is for the purchase of permissive past service credit (as defined in section 415(n)(3)(A) under the receiving defined benefit governmental plan.

Public Comment: IRS was urged to clarify the final regulations to provide that purchases of permissive past service credit are not subject to the provisions of section 415(n).

Rationale: This proposed regulations is too restrictive since there is no supporting statutory language or legislative history subjecting such transfers to the limitations of Code section 415.

10. Special characteristics applicable to other types of plans or IRAs should not be maintained if such assets are rolled into a section 457 plan.

The proposed regulations specifically asked for 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) which could be lost if multiple types of separate accounts are not maintained.

Public Comment: Recordkeeping would become extremely complex and onerous if multiple accounts were required and if the new employer is required to obtain all information necessary about the prior plan to maintain any special characteristics of the prior plan. The only special characteristic that should carryover to the 457 plan is the early withdrawal penalty under section 72(t) as provided in section 457(a)(2). Amounts rolled from an IRA into a 457 plan should receive the same treatment that 401(k) or 403(b) rollover dollars will receive. Special IRA characteristics should be lost. The same rule should apply to dollars rolled from a 401(k), 403(b) or 457 plan into an IRA. The IRA rules under section 72(t) should apply.

Rationale: Currently, amounts rolled from qualified plans and section 403(b) plans to IRAs lose their special characteristics. For example, a participant's December 31, 1986 account balance in a section 403(b) plan is not subject to the required minimum distribution rules of section 401(a)(9). If those monies are rolled into an IRA, however, that special characteristic is lost. Similarly, eligible section 457 plans are not subject to the early withdrawal penalties under section 72(t). Under the new portability rules, however, section 457 assets rolled to a qualified plan, a section 403(b) plan or an IRA become subject to such tax when distributed from the new plan. Here again, the special characteristic is lost. Participants preferring to maintain the special characteristics of a particular plan can maintain their account balance in that plan at severance from employment rather than rolling it into a 457 plan.

What Happens Now?

IRS representatives have indicated that they are in the process of reviewing each of the comments and will be taking them into account in formulating the final regulations. Copies of the comment letters submitted to the IRS may be obtained from the FOIA RR. A copy of the transcript of the public hearing is available by calling 1-800-955-2444.

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