

## Publications

# Long-Awaited Update of 457 Plan Regulations

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## SERVICES

At long last, the Service has updated the regulations under Code section 457, published in 1982 when Code section 457 applied only to governmental entities. 67 Fed. Reg. 30826 (May 8, 2002). Many issues have been raised and many changes in the law have occurred over the last 20 years. These new proposed regulations comprehensively restate the current regulations through EGTRRA (including recent technical corrections), and make numerous changes and additions to the current rules.

The bulk of the guidance covers the rules for eligible 457(b) plans of governmental and tax-exempt employers. There is limited guidance on certain “ineligible plans” (sec. 457(f)). The proposed rules generally do not address the exceptions for plans described in Code section 457(e)(11).

The regulations generally are proposed to be effective for taxable years beginning after December 31, 2001. Special effective date provisions apply to the coordination of Code sections 457(f) and 83. Plan amendments to reflect EGTRRA and the proposed regulations are not required to be adopted until the later of further guidance on plan amendments or issuance of final regulations. However, employers may rely on the proposed regulations for taxable years beginning after August 20, 1996 (the SBJPA general effective date). Comments are requested by August 6. A public hearing is scheduled for August 28.

The following summary emphasizes significant differences from the current regulations.

## A. Documentation/Operational Compliance Rules

IRS has never said exactly what provisions must or may be contained in a 457 plan. The proposed regulations take a “qualified-plan” type approach to this issue. In other words, they require the plan to contain “all the material terms and conditions for benefits” including the applicable statutory requirements, and also require “operational compliance.” The same standards — form and operational compliance — apply to optional provisions.

The preamble to the proposed regulations solicits comments on how the IRS' correction programs for qualified plans and 403(b) plans (EPCRS) may be expanded to cover 457(b) plans. In the interim, the preamble indicates that submissions of 457(b) plan failures will be accepted by the IRS on a "provisional" basis outside of EPCRS. We understand that the IRS is preparing a pilot project on 457(b) corrections.

## B. Provisions Affecting Contributions

**Deferrals from Certain Sick Pay, Vacation Pay and Back Pay** — Elective 457(b) contributions can be made from accumulated sick, vacation and back pay, provided the deferral election is made prior to the beginning of the month in which the amounts would otherwise be paid or made available to the participant. Contributions made from accumulated sick, vacation, and back pay are subject to the deferral limit and 100% of includible compensation limitation in the year they are actually made.

**Deferral Limit** — The proposed regulations clarify that the deferral limit (\$11,000 in 2002) applies to the value of the participant's account when vested (including earnings on deferrals prior their becoming vested). Prior regulations suggested this; of course most 457(b) plans provide for immediate vesting.

**Last Three Years Catch-Up Contributions Rule** — For purposes of the "last three-years" catch-up contributions rule — available in the last three years prior to the year in which the participant attains normal retirement age — a 457(b) plan will be required to designate a normal retirement age. This normal retirement age may be any age that is on or after the earlier of (i) age 65, or (ii) the age at which participants have a right to retire and receive, under the basic defined benefit pension plan of the governmental tax-exempt entity, a benefit without actuarial or similar reduction because of retirement before a later specified age; in no event may the normal retirement age be later than 70\_. Alternatively, the plan may provide that a participant can designate a normal retirement age within those ages. However, a 457(b) sponsor may not permit a participant to have more than one normal retirement age under the 457(b) plans it sponsors.

A special rule for determining normal retirement age applies in the case of "qualified police and firefighters," who are permitted to use an earlier normal retirement age, but no earlier than age 40. Plan amendments to reflect this rule need not be adopted until further guidance is issued.

In determining the "underutilized amount" for purposes of calculating the last 3 years catch-up, the proposed regulations clarify that amounts contributed by salary reduction to 401(k), 403(b), SARSEP and SIMPLE IRA plans must be counted for years before 2002. This is a potential recordkeeping problem.

## C. Loans From Governmental 457(b) Plans

The proposed regulations permit loans from governmental 457(b) plans. The SBJPA legislative history contemplated this, but it was not added to the statute. In addition to requiring that the loans comply with Code section 72(p), loans must also comply with the pre-ERISA requirements for qualified plan loans that the loan must be bona fide and for the exclusive purpose of benefiting participants and beneficiaries. Among the facts and circumstances to be considered in making this determination are whether the loan has a fixed repayment schedule, a reasonable interest rate, and safeguards to ensure repayment such as a prudent lender would impose. The preamble to the proposed regulations indicates that the Service will not issue rulings on 457(b) plans with loan provisions until the regulations are finalized.

## D. Provisions Affecting Distributions

**Distribution Elections** — The proposed regulations clarify that a governmental plan may (but is not required to) permit changes in previously irrevocable elections for amounts paid after 2001. This reflects the elimination of "constructive receipt" for governmental plans under EGTRRA.

**Plan-to-Plan Transfers** — Under the proposed regulations, Code section 457(e)(10) plan-to-plan transfers will not be permitted between governmental and tax-exempt 457(b) plans. This is apparently due to the potential exclusive benefit violation in the case of a transfer from a governmental plan to an unfunded tax-exempt employer plan, and a violation of the unfunded requirement in the reverse situation.

Transfers between like 457(b) plans would be permitted in two circumstances. The first is when a participant in the transferor plan terminates employment with the transferor and is employed by the transferee employer. The second is where a governmental 457(b)

plan sponsor is “privatized.” In that case, the governmental employer losing that status may transfer its 457(b) plan to another governmental employer within the same state.

The proposed regulations state that only governmental 457(b) plans may transfer assets to governmental 401(a) plans to purchase past service credit and even limits such transfers to plans within the same state. We note, however, that the statute is not so limited. Any other direct plan-to-plan transfers between qualified plans and 457(b) plans are expressly prohibited.

The proposed regulations continue to limit plan-to-plan transfers between governmental 457(b) plans to plans within the same state. This seems curious, and is not within the statute (though it was in the prior regulations); after 2001, the participant often will be able to take an eligible rollover distribution in any event.

**Accounting for Different Types of Rollovers** — The preamble to the regulations notes that EGTRRA does not require a separate account for each type of rollover (IRA, 401(a), 403(b)) to a governmental 457(b) plan, but specifically requests comments on whether there are any special characteristics of different types of plan under Code section 72(t) (e.g., distributions after age 55 and separation from service) that might be lost if multiple types of accounts are not maintained.

**Severance From Employment for Independent Contractors** — Generally, an independent contractor will be considered to have severed employment upon expiration of the contract (or if more than one, all contracts) if the expiration constitutes a good faith and complete termination of the contractual relationship for providing services. A termination of the contractual relationship does not occur if the eligible employer “anticipates” a renewal of the contract or the independent contractor becoming an employee. The eligible employer is considered to anticipate the renewal of the contract if (1) it intends to again contract for the services provided under the contract, and (2) neither the eligible employer or the independent contractor has eliminated the independent contractor as a possible provider of services under any new contract. Presumably, execution of a new contract with a different contractor is considered to eliminate that possibility. In addition, an eligible employer is considered to “intend” to again contract for services provided under an expired contract if the eligible employer’s doing so is conditioned only upon incurring a need for the services, the availability of funds, or both.

**Safe Harbor for Distributions to Independent Contractors** — Notwithstanding the preceding general rule, a distribution to a participant who is an independent contractor will not be considered to occur prior to a severance of employment if the plan provides that:

no amount will be paid to the participant before a date at least 12 months after the date the contract expires (or, if there is more than one contract, the date all contracts expire), and  
no amount payable to the participant on that date will be paid if, after the expiration of the contract(s) and before that date, the participant performs services for the eligible employer as an independent contractor or an employee.

**Expansion of Definition of Unforeseeable Emergency** — The proposed regulations expand the definition of unforeseeable emergency to include the following:

Imminent foreclosure of, or eviction from, a participant’s or beneficiary’s primary residence;  
the need to pay for medical expenses (including non-refundable deductibles and prescription medicine); and  
the need to pay funeral expenses for a family member.

In addition, unforeseeable emergencies may now occur on account of the financial hardship of a participant or beneficiary, rather than just a participant. (This is consistent with the 401(k) hardship rules.)

We note, however, that the proposed regulations provide that the purchase of a home and the payment of tuition are not unforeseeable emergencies except in extraordinary circumstances.

**Qualified Domestic Relations Orders** — 457(b) plans may comply with the terms of QDROs without jeopardizing their exempt status. (This provision was also added to Code section 414(p) by EGTRRA although the ramifications under Code section 457 for following a QDRO were not explicitly stated.) Amounts paid from governmental 457(b) plans pursuant to a QDRO are taxable to the alternate payee who is the spouse or former spouse of the participant when such amounts are paid. Amounts paid from tax-exempt 457(b) plans pursuant to a QDRO are taxable to the alternate payee who is the spouse or former spouse when they are paid or “made available” to the alternate payee (i.e., the date on which the alternate payee is first able to receive a distribution).

**Corrective Distributions** — The proposed regulations allow eligible governmental plans, but not plans of tax-exempt employers, to make corrective distributions of annual deferrals in excess of the \$11,000, age 50 and last three years catch-up limits.

The corrective distribution must be made, with allocable net income, as soon as administratively practicable after the plan determines that the amount would be an excess deferral. If the plan does not distribute the excess, the plan becomes an ineligible plan taxed under Code section 457(f).

The rule for tax-exempt employers is more restrictive. Any excess deferral causes the plan to be an ineligible plan. It remains to be seen, however, whether this can be mitigated under the new “provisional” EPCRS correction process to be opened for all 457(b) plans.

If any excess deferral results from aggregating multiple governmental 457(b) plans, the excess may, but is not required to be, distributed to the participant. However, in either event, such amounts are includible in the participant’s income. The preamble to the regulations asks for comments on the recordkeeping and income and payroll tax reporting for such previously taxed amounts.

## E. Multiple Versus Single Plans

The proposed regulations indicate that an arrangement does not fail to constitute a single eligible governmental employer plan merely because the arrangement is funded through more than one trustee, custodian or insurance carrier. In addition, the Secretary reserves the right to treat multiple plans as a single plan if necessary to avoid circumvention of the 457(b) rules. (We note that governmental 457(b) plan sponsors have sometimes taken the position that each separate contract is a different “plan,” thus permitting distribution elections for separate investments which might not otherwise satisfy the restrictive 457(d) distribution election requirements before 2002. The changes in the distribution rules beginning in 2002 would appear to moot this issue.)

## F. Change in Status of Employer

If a 457(b) plan of a governmental employer ceases to be an eligible governmental plan, amounts deferred before that date and any earnings thereon will be treated as though the plan continues to be an eligible governmental plan if it is terminated or transferred to another governmental employer.

If a tax-exempt employer becomes a for-profit employer and the plan is not terminated, the tax consequences of the plan will be determined under Code section 451 (i.e., constructive receipt principles). We note that it also may give rise to issues under the Code section 457(d) distribution election rules. If the tax-exempt employer becomes a governmental employer, the plan will become a 457(f) plan (presumably because it will not be funded).

If a governmental employer ceases to be a governmental employer and does not transfer the 457(b) plan to another governmental plan sponsor in the same state, the assets will be taxed to participants under Code section 402(b) or 403(c) (in other words, as a nonqualified trust or annuity).

## G. Plan Termination

A 457(b) plan may be terminated. To be treated as terminated, amounts must be distributed to all participants and beneficiaries as soon as administratively practical after the termination of the plan. The mere provision for such distributions upon termination will not cause the plan to fail to satisfy 457(b).

## H. Limited Guidance on Code Section 457(f)

**Mutual Fund “Option” Plans** — The proposed regulations reiterate the Code requirement that Code section 457(f) does not apply where Code section 83 applies, but also provides that Code section 457(f) applies if the date on which there is no substantial risk of forfeiture precedes the date on which there is a transfer of property to which Code section 83 applies. This appears to mean, for example, that an option which does not have a readily ascertainable fair market value will be taxed under Code section 457(f) on the date it is vested, not on the date exercised under section 83. Presumably, the amount of taxable income under Code section 457(f) would be the fair market value of the option on that date, which would seem to be at least the amount that the option is “in the money” on the date of vesting, though the proposed regulations are not explicit on how to value the option. This rule only applies to options without a readily ascertainable fair market value that were granted on or before May 8, 2002. It is not clear whether a material modification to the terms of such an option would be considered a new option, but presumably so. The preamble to the proposed regulations requests comments on the coordination of Code sections 457(f) and 83.

**Exempt Plans** — The preamble also requests guidance on incorporating the prior interim guidance exempting certain pre-1999, broad-based nonelective governmental plans. This refers to IRS Announcement 2000-1, issued in response to the controversy of over the IRS finding that certain Minnesota teacher severance pay plans resulted in immediate income to the teachers under Code section 457(f). The proposed regulations do not provide any further guidance on how to determine which severance, vacation and death benefit plans

are “bona fide” and not subject to Code section 457, nor do they address the application of Code section 457 to equity and other forms of split-dollar life insurance.

**Taxation of Earnings** — Earnings credited on compensation deferred under an ineligible plan after the date on which there is no substantial risk of forfeiture are includible in the gross income of the participant or beneficiary only when paid or made available, provided that the interest of the participant or beneficiary in any assets of the entity sponsoring the agreement or arrangement is not senior to the entity’s general creditors. Presumably, therefore, subsequent earnings on amounts previously taxed under Code section 457(f) that are held in a rabbi trust will normally not be taxable to the participant or beneficiary until paid.