

MEMO# 14714

May 9, 2002

IRS ISSUES PROPOSED REGULATIONS CONCERNING ELIGIBLE DEFERRED COMPENSATION PLANS UNDER CODE SECTION 457

[14714] May 9, 2002 TO: PENSION COMMITTEE No. 16-02 PENSION OPERATIONS ADVISORY COMMITTEE No. 32-02 RE: IRS ISSUES PROPOSED REGULATIONS CONCERNING ELIGIBLE DEFERRED COMPENSATION PLANS UNDER CODE SECTION 457 The Internal Revenue Service has issued the attached proposed regulations, which would provide guidance on compensation deferred under eligible section 457(b) deferred compensation plans of state and local governmental and tax-exempt entities. The proposed guidance reflects changes made to the Internal Revenue Code since the existing final regulations were issued in 1982, including the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Job Creation and Worker Assistance Act of 2002, and would apply generally for taxable years beginning after December 31, 2001. Annual Deferrals, Deferral Limitations and Excess Deferrals Proposed section 1.457-4 discusses annual deferrals, deferral limitations and excess deferrals under eligible plans, and includes the scheduled increases in, and cost-of-living adjustments to, the maximum deferral limitations, the availability of age 50 catch-up contributions, and the special section 457 catch-up contributions available to certain participants in the last three years ending before the participant attains normal retirement age. In addition, the proposed regulations address the treatment of excess deferrals under the two different types of 457 plans. Under the proposed regulations, an eligible governmental plan would be required to distribute excess deferrals to the participant, with allocable net income, but if an excess deferral arose under a plan of a tax-exempt employer, the plan would not be an eligible plan. An excess deferral that occurred by virtue of the individual limitation for multiple eligible plans under section 457(c), however, could be, but would not be required to be, distributed to the participant. A plan would not lose its status as an eligible plan by failing to distribute the excess deferrals, although those amounts are currently includible in the participant's income. The preamble to the proposed regulations requests comment as to recordkeeping requirements concerning excess distributions that are not distributed, as well as the proper income and payroll tax reporting of distributions of excess deferrals. 2 Loans, Qualified Domestic Relations Orders (QDROs) and Purchases of Past Service Credit The proposed regulations also provide guidance concerning plan loans and QDROs. The provisions concerning loans clarify that a loan from an unfunded eligible plan of a tax-exempt organization would be treated as an impermissible distribution in violation of the requirements of section 457. Loans from an eligible governmental plan would be subject to a facts and circumstances standard in order to determine whether the loan was bona fide and for the exclusive

purpose of benefiting participants and beneficiaries. For example, the loan must bear a reasonable rate of interest in order to satisfy the exclusive benefit requirement of section 457(g). In addition, the proposed regulations would clarify that an administrator or sponsor of an eligible plan may honor the terms of a QDRO described in section 414(p) of the Code without jeopardizing its eligible status. This rule would apply even if the order required distribution of the benefits of a participant to an alternate payee in advance of the general rules for eligible plan distributions. The proposed regulations also would address the transfer of amounts deferred by a participant or beneficiary under an eligible governmental plan of a state to a defined benefit governmental plan of that state. No amount would generally be includible in gross income by reason of the transfer, and it would not be treated as a distribution; therefore, such a transfer could be made before severance from employment. Rollovers Under the portability provisions of EGTRRA, eligible governmental plans may accept rollovers from other types of plans, but only if the receiving eligible governmental plan maintains the rollover amount in a separate account. The proposed regulations would include such rollovers as part of the amount deferred under the receiving plan, but not take such rollovers into account for purposes of the plan ceiling limitation on annual deferrals. The preamble notes that EGTRRA does not require a separate account for each type of rollover contribution (e.g., an account for rollovers from qualified plans that is separate from rollovers from section 403(b) arrangements), but requests comment on whether there are any special characteristics applicable to qualified plans, section 403(b) arrangements or IRAs under section 72(t) that could be lost if multiple types of separate accounts are not maintained. Written comments on the proposed regulations must be submitted by August 6, 2002. If you have any comments that you would like the Institute to include in a comment letter concerning the proposed regulations, please contact me at (202) 371-5432 or at kireland@ici.org. Kathy D. Ireland Associate Counsel Attachment Attachment (in .pdf format) 3