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GOVERNMENT 457(B) PRIMER

By: NAGDCA Publications Committee and Executive Board

The following provides a brief overview of the features and rules applicable to governmental 457(b) plans. It is meant to serve as an introductory foundation to the inner workings of these plans and it may serve as a useful tool for those being exposed to these types of plans for the first time. The document is not meant to be used as a comprehensive resource or to provide tax advice, and other sources should be sought for additional information on these plans.

IRC Section 457 includes other types of plans not included in this discussion. These plans include 457(b) plans sponsored by not-for-profit organizations and ineligible plans under section 457(f).

This document will focus on eligible 457(b) deferred compensation plans sponsored by state and local governmental entities and will be limited to this type of plan anytime the term 457(b) is used.

Background

History — Although a form of a deferred compensation plan existed for municipal employers in the previous decade, section 457(b) of the Internal Revenue Code ("IRC") was created with the passage of the Revenue Act on November 6, 1978. 401(k) plans came into existence during the same period, and though the 401(k) was intended for taxable employers, they were also used by some municipal employers. The Tax Reform Act of 1986 prohibited the establishment of new 401(k)'s for municipal employers after May 6, 1986, reinforcing the 457(b) as the primary defined contribution savings vehicle for the majority of municipal employers. However, those municipal employers with established 401(k) plans were allowed to continue (grandfather) them until they choose to terminate at a later date. Subsequent tax acts, especially the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), have brought 457(b) plans into closer alignment with other common defined contribution plans.

ERISA applicability — The Employee Retirement Income Security Act (ERISA) of 1974 applies to most taxable employers who maintain "qualified" employee retirement plans including defined benefit plans and defined contribution plans under IRC Section 401(a). Since 457(b) plans are sponsored by governmental entities, they are exempt from ERISA rules. However, ERISA rules are often considered when establishing policy, procedure and best practice in the administration of a 457(b) deferred compensation plan.

Who is Eligible to Participate

Eligible employee — Generally, any employee of a local or state government may participate, including seasonal and part-time employees, fire fighters, police personnel and public school employees. Many plans allow all employees to participate. However, plan provisions or employer policy may prohibit participation for certain employees. For example, the plan may exclude employees based on length of service, hours worked, minimum age, job class or title and other factors such as labor agreements. Non-discrimination testing (such as ADP/ACP tests) that apply to 401(k) plans do not apply to 457(b) plans. Independent contractors – Individual independent contractors may participate in a plan as long as they provide services under contract to the municipal employer. Plans may choose to exclude independent contractors from participation. Corporations and partnerships may not be participants.

Compensation

What's counted — Generally, compensation is earnings as reported on Form W-2 and is defined by IRC Section 415(c)(3).

Post severance compensation is simply a final paycheck of earned income or lump sum payment of unused vacation or sick pay. Lump sum payments may be considered for deferral but only if the plan permits. Post severance payments must be received by the plan no later than 2½ months after severance of employment or the end of the calendar year, whichever occurs first.

Compensation that is considered to be a severance payment and certain disability payments are not considered eligible compensation. Severance payments are usually part of a "severance package" and are made solely due to separation from service and would not be paid otherwise.

Contributions

Timing issues — A deferral agreement must be in place in the calendar month prior to the calendar month of the deferral. An exception exists for newly hired employees who make a deferral agreement prior to their first day of service.

Post age 70½ — Contributions can continue to be made by participants who are age 70½ and over.

Annual limit — The limit for regular contributions in 2012 is 100% of compensation up to an annual contribution limit of $17,000. The limit may be adjusted for cost of living adjustments annually in $500 increments (IRC 457(e)(15)). This information is updated annually and can be found on the Internal Revenue Service website located at *http://www.irs.gov/retirement*.

Excess deferrals must be returned, with allocable net income (earnings), as soon as administratively practicable.

Additional "Catch-up" for participants age 50 or over — Starting in the year a participant reaches age 50, the participant may contribute an additional amount above the normal limit. For 2012 the additional catch-up amount is $5,500. As with the normal deferral limits, the catch-up may be adjusted for cost of living adjustments annually in $500 increments (IRC Section 414(v)).

Special Three Year Catch-Up — Unlike 401(k) plans, 457(b) arrangements are allowed under 457(b)3 to permit special retirement

catch-up contributions, which in 2012 for example, allow for a contribution of two times the normal contribution limit, or $34,000. This special catch-up is only available to participants who were eligible to contribute up to the annual limit to the 457(b) plan in past years but did not do so. For example, the normal deferral limit for 2011 tax year was $16,500. Let's assume the participant contributes $1,000 for the tax year. In this example the participant may be eligible to defer the underutilized amount of $15,500 ($16,500-$1,000 = $15,500) towards the special three year catch-up.

The special three year catch-up is a one-time election and is only available in the three consecutive years prior to the year of the participants' selected Normal Retirement Age (no later than age 70½) and may be used only once by the participant under the same employer. The Normal Retirement Age is a year in which the participant could receive an unreduced benefit under their primary pension plan (or age 65 if no primary plan exists). For qualified police and firefighters, plans may allow a Normal Retirement Year as early as age 40. Calculation of eligibility and amounts to be used under the retirement catch-up can be complicated and should only be done after a full review of the law and plan rules. The total catch-up amount used under this provision cannot exceed the underutilized amount from previous years. The special three year catch-up may be adjusted for cost of living adjustments annually and effectively increased in $1,000 increments. Special Retirement Catch-Up contributions and the age 50 or over catch-up contributions cannot be used in the same year.

Employer contributions — Employers may also make contributions to a 457(b) plan, such as a matching contribution. Such contributions are subject to FICA taxes. As employer contributions vest, they are treated as employee contributions for purposes of the annual contribution limits. Therefore, employer contributions would limit the amounts employees may contribute, and if subject to a vesting schedule, would increase administrative complexity.

Payroll Tax withholding — Pre-tax deferrals are not subject to federal tax withholding but are subject to FICA and FUTA taxes. Like 401(k) plans, 457(b) deferred compensation arrangements can allow for Roth contributions that do not reduce federal taxable income. The plan must adopt a Roth provision within the Plan Document in order to allow for Roth contributions. These contributions are subject to income taxes and are therefore also subject to withholding. State tax treatment varies from state to state.

Aggregation — Employer and employee contributions to all 457(b) plans must be aggregated for purposes of the annual limits. However, contributions to 403(b), 401(k) or 401(a) plans, even if maintained by the same employer, are not considered for the purposes of aggregation. It's common for a sponsor of 457(b) plan to also offer a 401(a) plan. The most likely objective of offering a separate 401(a) plan is to allow participants to fully defer on a tax qualified basis an amount up to the annual limit within the 457(b) plan. Employer contributions are made to the 401(a) plan and are not aggregated with 457(b) contributions.

Special provisions for military — Under the Heroes Earnings Assistance and Relief Tax (HEART) Act of 2008, military differential pay is considered compensation and may be used for deferral purposes. Under the Uniformed Services Employment and Reemployment Rights Act (USERRA), makeup contributions can be made for the period of qualifying military service based on the rate of pay the participant would have received while in service. The make-up period begins on the date of re-employment and for a period that is the lesser of three times the period of qualifying military service or five years.

Eligible rollovers in — 457(b) plans can accept rollovers from other types of plans but are not required to do so. The rollover portion must be separately accounted for since different tax rules may apply, particularly with regard to premature distribution penalty taxes. Unlike 401(k) plans, amounts held in the rollover account are usually accessible by the participant at any time without requiring separation of service. Some plans may also denote rollover accounts that were from other eligible 457(b) accounts in order to preserve the exemption from premature distribution penalty taxes. Amounts rolled over from other eligible retirement plans do not count towards the above referenced deferral limits. Rollovers should generally be processed as a "trustee to trustee" direct rollover to avoid withholding taxes and other complications. With the exception of Roth designated accounts, rollovers in of after-tax amounts are not permitted.

Roth contributions — Since January 2011, 457(b) plans may accept Roth contributions to a Roth designated account. Roth contributions are made on an after-tax basis but have the potential to be received free of income taxes when distributed. To be income tax-free, distributions must be made after age 59½ and after five tax years from the first Roth contribution. It is important to realize that the rules governing the taxation of Roth distributions do not override the plan's distribution rules. Roth contributions must be separately accounted for and participants may not transfer moneys between the Roth account and the regular pre-tax deferral account. Plans may allow for rollovers from Roth designated accounts of other employer plans but the rules and recordkeeping vary depending on how long the previous Roth account was in existence. Rollovers from Roth IRAs are not allowed.

Distributions

General — With the passage of EGTRAA, regular distributions are allowed upon separation of service or attainment of age 70½ and, subject to the plan's rules, can change the methodology at any time. Typically, plans offer payments in the form of full or partial lump sums, periodic payments and annuity payments.

Unforeseeable emergency withdrawal (UE) – Plans may allow for UEs, but are not required to. The rules differ from hardship withdrawals from 401(k) and other similar plans. A UE must be a severe financial hardship due to an unforeseeable and immediate need. The reasons include primary home foreclosure, funeral expenses, necessary medical expenses and casualty expenses. The purchase of a home and educational expenses are expressly prohibited reasons for a UE. The plan sponsor must use the relevant facts and circumstances of each situation and can refer to limited guidance from the IRS on these issues. Expenses reimbursed by insurance, could be satisfied by cessation of

deferrals, or asset liquidation are not eligible. The expenses can be on behalf of the participant, named beneficiary or dependent. A UE is taxed as income and the distribution can be grossed up for estimated income taxes. UEs cannot be rolled over to defer income taxes.

Loans — Like 401(k)s, 457(b) plans may allow a loan program. The rules follow section 72(p) including limits such as: loans limited to 50% of account value, $50,000 aggregate employer limit. Level amortization over five years (longer if for primary residence) and a reasonable interest rate is required. If the participant defaults on the loan (typically past due by one quarter), the outstanding balance of the defaulted loan is considered a distribution for income tax purposes. Plans may offer multiple loans but the loans must still be aggregated for purposes of the aforementioned limits and adds to administrative complexity. Small Account Distributions – Participants may take in-service distribution of their accounts if three conditions are met: their account value (exclusive of rollovers) is less than $5,000, they have not contributed to the plan in at least two years, and they have not used this provision in the plan before. These rules are more liberal than account distribution rules for 401(k)s.

Service Credits — Plans may allow for direct distributions to a pension plan maintained by the employer to purchase "permissive service credits." This asset transfer does not trigger federal income taxes.

Retired Public Safety Officers — This is an optional plan provision under the HELPS Retiree act. A plan may distribute up to $3,000 annually tax-free to pay directly qualifying health and long term care insurance premiums for Public Safety Officers as defined under the Public Safety Officers Benefit Act.

Special rule for military — Under the HEART Act, participants who are absent for a period of 30 days or more due to qualifying military service may take distributions without requiring a separation of service. The participant may not contribute to the plan for a period of six months following such a distribution.

Required Minimum Distributions (RMDs) — 457(b) plans follow the same RMD rules under section 401(a)(9) as other retirement plans. This includes the important 50% excise tax on missed or inadequate RMDs. Participants must start taking distributions by April 1 of the year following the year they turn age 70½. This date is called the Required Beginning Date (RBD). An optional exception applies to participants who are still working for the employer maintaining the plan allowing them to defer distributions until they actually retire. Participants may not aggregate their RMD from a 457(b) with any other retirement plans including other 457(b) plans. Unlike Roth IRA accounts, Roth account balances in the 457(b) plan are subject to the same plan RMD rules as pre-tax balances.

Rollover accounts — Participants may access funds in their rollover accounts at any time and are not subject to the normal restrictions on timing of plan distributions. Unless specifically identified as coming from another 457(b) account, these amounts may be subject to the federal 10% premature distribution tax penalty for withdrawal prior to attaining age 59½. State penalties may also apply to the premature distribution and, state penalties may vary from state to state.

Rolling assets out — When a participant or beneficiary is eligible to receive a distribution that qualifies as an "eligible rollover distribution", the amount can be rolled to other accepting plans or IRAs. Distributions that are RMDs, return of excess contributions, unforeseeable emergency withdrawals, defaulted loans and payments over a specified period of 10 years or more are not eligible rollover distributions. The term "transfer" applies to trustee-to-trustee transactions that are always between like plans. A rollover may be between like plans but may be between differing types of plans. Pre-tax amounts may be rolled to regular IRA accounts to defer income taxes. A rollover to a Roth IRA is also possible, incurring current income taxes, but may offer tax benefits on later distributions since qualifying distributions from Roth accounts are tax free. Amounts held in a Roth designated account may also be rolled to a Roth IRA account or to another plan that offers a Roth designated account (special rules apply).

In Plan Roth Rollover Accounts (IPRAs) — Starting in 2012, plans may offer IPRAs. In essence, this is a conversion of part or all of a participant's balance from a pre-tax to a Roth designated account. Income taxes are paid upon the transfer to an IPRA in anticipation of receiving qualifying tax-free distributions later on. As with Roth contributions, distributions will be income tax free when the participant is over age 59½ and five tax years have elapsed since the IPRA was established. The rollover is an internal transaction that does not involve an actual distribution of funds. It is only available to participants who are currently eligible to receive a regular distribution. Once the IPRA is processed it cannot be reversed.

Domestic Relations Orders (DROs) — A DRO is a court order that is generally related to the dissolution of a marriage (divorce) but may involve other family members such as children. 457(b) plans are subject to the same rules and regulations as other qualified retirement plans.

Investment options

Common approaches — As with most retirement plans, there is great diversity of types of investment vehicles permissible. Plans do not have to allow for participant self-direction of investments, but most do and offer a menu of investment options. Mutual funds, collective trusts, separate accounts and insurance company products are the most commonly available options. Plan sponsors work to provide investment choices that meet participant's varying tolerances for risk and desire for return.

Core funds — Many plans will offer an array of core investment options, such as large cap domestic equity, small-cap equity, international equity, and fixed income funds, in order to allow participants to create a diversified portfolio of investments.

Target date funds — Such funds are often offered to provide a "one-stop shop" for those participants who don't have time or are unable to design their own asset allocation. Target date funds are generally a well-diversified mix of underlying stock and bond investments. The investment mix becomes more conservative (fewer stocks and more bonds) as the target date is approached. They have an identified retirement date and some form of "glide path" that re-allocates the participant's assets over time.

Self-Directed Brokerage Accounts — Some plans offer a "brokerage window" that allows participants to access investment options that are more specialized than the plan's core options.

Fixed income options — Many plans offer some form of stable value investment option. Stable value funds are designed to offer a book value guarantee and a modest interest return. Plans may offer other types of fixed income options including bond funds, certificates of deposit insured by the FDIC, or money market funds.

ERISA Section 404(c) — This ERISA section does not apply to 457(b) plans but does offer helpful guidance in choosing investment alternative line-ups, providing participant education and administrative procedures.

State/locality rules — Plan sponsors must be aware of any state/local restrictions that may apply to the investment options offered under their plan.

Beneficiary Issues

General — Upon the death of a plan participant, a named beneficiary will receive the deceased participant's plan assets. Since 457(b) plans are not subject to ERISA, spousal waivers are not required to name a non-spousal beneficiary. However, plan sponsors should make participants aware of any state laws that may affect their designations, including the effect of divorce. Spousal beneficiaries may continue to defer distributions until the participant would have attained age 70½ or roll the account into their own name. Non-spousal beneficiaries must, at least, withdraw the account balance by the end of the fifth calendar anniversary of the participant's death (if death was before RBD) or at least annually over their life expectancy.

Rolling assets out as beneficiary — Spousal beneficiaries may roll assets to another retirement plan or IRA. Non-spousal beneficiaries may also roll out but would roll to an inherited IRA account in order to continue taking the appropriate RMDs. Either has the option to rolling and converting to a Roth IRA.

Default provisions — Some plans choose to offer default provisions in the event a beneficiary form is not available or there are other problems.

Missing persons — 457(b) plans often hold accounts where the participant has died and beneficiaries cannot be located. Although there are services that can help find people, they may be costly, and are only useful when complete and accurate information is available.

Fiduciary Issues

Trust requirement — Under the Small Business Job Protection Act of 1996, all assets of a 457(b) must be held in a separate trust. This mechanism protects and insulates participants in the event that the sponsoring employer has financial difficulties, including bankruptcy. From a participant's own account perspective, it should be noted that 457(b) plans do not have the "anti-alienation" protection of ERISA (which, for example, protect individual benefits from state attachment and garnishment laws but is afforded protections under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 and many state laws.)

Determination letters — Plan sponsors often prefer to receive approval from the IRS indicating that their plan meets the requirements of section 457(b) and other applicable laws. There is no prototype submission program but a Private Letter Ruling (PLR) can be requested from the National Office of the IRS.

Form 5500 — The filing of this form is not required for non-ERISA plans.

Administrative Issues and IRS Reporting

Income tax withholding — The same income tax withholding rules apply to distributions from 457(b) plans as other similar retirement plans. Distributions are reported on IRS Form 1099-R. Eligible rollover distributions are subject to a mandatory withholding rate of 20%. Other types of taxable distributions use a default 10% rate or the participant may waive or select a higher rate. Appropriate codes must be used to identify the type of distribution as well as its tax status for premature penalty taxes. 457(b) plan distributions are not subject to the 10% premature distribution excise tax (see Rollover Accounts section.)

402(f) Notice — This notice provides important tax information about distributions and rollovers. The rules requiring its distribution are similar to those for other employer plans.

Fee disclosures — ERISA disclosures under Sections 408(b)(2) and 404(a)(5) are not required of section 457b plans. However, plan sponsors and participants may benefit by requesting fee information from service providers and disclosing to participants the costs associated with their plan.

Correcting errors — 457(b) plans do not have access to the IRS Voluntary Correction Program service under EPCRS. However, they are allowed to correct administrative errors within of 180 days of discovering the error or receiving an IRS notification.

IRA deductibility — Unlike qualified plans, participation in a 457(b) will not, in itself, cause a participant to be considered an "active participant" for IRA deduction purposes. Therefore, the ability to take income tax deductions on IRA contributions would not be subject to the income phase-out rules. However, many public employees participate in a primary retirement plan that would cause them to be considered an active participant.

Savers Tax Credit — This credit is designed to assist lower income taxpayers by proving a tax credit based on contributions to employer retirement plans and IRAs of up to $2,000 annually. Contributions to 457(b) plans qualify for this credit.

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