Eligible Deferred Compensation Plans Under Section 457

Notice 98–8

I. PURPOSE

This notice provides guidance relating to the requirements applicable to eligible deferred compensation plans described in § 457(b) of the Internal Revenue Code ("§ 457(b) plans"). Section 457 was amended by §§ 1447 and 1448 of the Small Business Job Protection Act of 1996, Pub. L. 104–188 ("SBJPA"), and more recently by § 1071 of the Taxpayer Relief Act of 1997, Pub. L. 105–34 ("TRA '97"). Unless indicated otherwise, references to § 457 in this notice refer to § 457 as amended by the SBJPA and TRA '97.

Specifically, this notice provides guidance on—

- in-service distributions from a § 457(b) plan if the total amount payable to the participant does not exceed $5,000;
- an additional election to defer commencement of distributions from a § 457(b) plan;
- cost of living adjustments to the $7,500 limitation on maximum deferrals under a § 457(b) plan; and
- the trust requirements applicable to state and local government employers maintaining a § 457(b) plan, including the requirements for custodial accounts and annuity contracts.

II. BACKGROUND

Section 457 provides rules for nonqualified deferred compensation plans established by state and local governments or tax-exempt organizations. These employers can establish either § 457(b) plans or ineligible plans under § 457(f) of the Internal Revenue Code ("Code"). Section 457 was amended by §§ 1447 and 1448 of the SBJPA, as well as by § 1071 of TRA '97. These amendments and the guidance provided by this notice relate only to § 457(b) plans.

Section 1447 of the SBJPA amended § 457(e)(9) of the Code to permit, under certain conditions, in-service distributions from a § 457(b) plan if the total amount payable to the participant does not exceed $3,500. Under § 1071 of TRA '97, this $3,500 amount was increased to $5,000. Section 1447 of the SBJPA also permits an additional election by a participant to defer commencement of distributions under a § 457(b) plan. Further, § 1447 of the SBJPA provides for the $7,500 maximum deferral amount, under §§ 457(b)(2) and 457(c)(1), to be adjusted (in $500 increments) to reflect increases in the cost of living.

Section 1448 of the SBJPA added new § 457(g) of the Code, which requires that § 457(b) plans maintained by state or local government employers hold all plan assets and income in trust, or in custodial accounts or annuity contracts (described in § 401(f) of the Code), for the exclusive benefit of their participants and beneficiaries.

III. IN-SERVICE DISTRIBUTIONS OF SMALLER AMOUNTS

Section 457(e)(9)(A), as amended by the SBJPA and TRA '97, permits certain in-service distributions from a § 457(b) plan if the total amount payable to the participant does not exceed a specified dollar amount. This specified dollar amount was changed from $3,500 to $5,000 effective for plan years beginning after August 5, 1997. Each participant can be given only one such in-service distribution from the plan. This in-service distribution is available only if no amount has been deferred under the § 457(b) plan for the participant during the 2-year period ending on the date of the distribution.

Under this provision, for plan years beginning after August 5, 1997, a § 457(b) plan may provide for the total amount payable to a participant with a balance of $5,000 or less to be distributed to the participant if the participant so elects. Alternatively, the plan may provide for the total amount payable to a participant with a balance of $5,000 or less to be distributed automatically to the participant. A § 457(b) plan is permitted to substitute a specified dollar amount that is less than $5,000 under either of these alternatives. In addition, these two alternatives can be combined; for example, a plan could provide for automatic cashout for balances up to $500 and allow participants to elect a cashout for balances above $500 but not above $5,000. A § 457(b) plan is not required to permit in-service distributions under any of these alternatives.

IV. ADDITIONAL DEFERRAL ELECTION

Under § 457(d)(1)(A), benefits under a § 457(b) plan generally may not be made available to a participant before the participant separates from service with the employer. In-service distributions are permitted only if the participant has an unforeseeable emergency or attains age 70½, or if the in-service distribution provision described in section III of this notice applies.

Section 1.457–1(b) of the regulations provides that amounts are not made available if a participant irrevocably elects, prior to the time the amounts become payable, to defer the payment to a fixed and determinable future time. For this purpose, the time at which amounts become payable (the "first permissible payout date") is the earliest date on which a plan permits payments to begin after separation from service (i.e., disregarding payments to a participant who has an unforeseeable emergency or attains age 70½, or under the in-service distribution provision described in section III of this notice). Prior to the changes made by the SBJPA, a participant could not change this deferral election after the first permissible payout date.

Section 457(e)(9)(B), as amended by the SBJPA, provides that the amount payable to a participant under a § 457(b) plan is not treated as made available merely because the plan allows the participant to make an additional election, after the first permissible payout date, to defer the commencement of distributions so long as this additional deferral election is made before distributions begin (a "§ 457(e)(9)(B) additional deferral election"). Only one § 457(e)(9)(B) additional deferral election can be made after the end of the period in which the plan permits a participant to make deferral elections under § 457(d)(1)(A) and § 1.457–1(b) of the regulations.

A participant is not precluded from making a § 457(e)(9)(B) additional deferral election merely because the participant

has previously received a hardship distribution under § 457(d)(1)(A) or has made other deferral elections prior to separation from service.

The § 457(e)(9)(B) additional deferral election is not available if the participant has separated from service and distributions have begun. The § 457(e)(9)(B) additional deferral election permits the participant to elect only to defer, and not to accelerate, commencement of distributions under the plan.

The § 457(e)(9)(B) additional deferral election provision is illustrated by the following examples:

Example (1). (i) Employee *A* is a participant in an eligible § 457(b) plan. The plan provides that the total amount deferred under the plan is payable to a participant who separates from service before age 65. Payment is made in a lump sum 90 days after separation from service, unless, during a 30-day "window period" immediately following the separation, the participant elects to receive the payment at a later date or in 10 annual installments to begin 90 days after separation from service or at a later date. The plan also permits eligible participants to make a § 457(e)(9)(B) additional deferral election. Employee *A* separates from service at age 50. The next day, during the 30-day window period provided in the plan, Employee A elects to receive distribution in the form of 10 annual installment payments beginning at age 55. Two weeks later, within the 30-day window period, Employee A makes a new election permitted under the plan to receive 10 annual installment payments beginning at age 60 (instead of at age 55).

(ii) In this example, the two elections Employee *A* makes during the 30-day window period are not § 457(e)(9)(B) additional deferral elections (because they are made before the first permissible payout date under the plan) and therefore do not preclude the plan from allowing Employee *A* to make a § 457(e)(9)(B) additional deferral election after Employee *A*'s election to receive 10 annual installment payments beginning at age 60.

Example (2). (i) The facts are the same as in Example (1). Employee A has made no other deferral elections after the 30-day window period and before age 59. While age 59, Employee *A* elects to defer commencement of the installment payments until Employee *A* attains age 65.

(ii) In this example, under § 457(e)(9)(B), the total amount payable to Employee *A* will not be treated as made available merely because Employee *A* made this additional election at age 59 (after the first permissible payout date under the plan, but before commencement of distributions). However, after making this election, Employee *A* may make no further elections to change the date on which distributions commence.

V. COST OF LIVING ADJUSTMENTS IN MAXIMUM DEFERRAL AMOUNT

Sections 457(b)(2) and (c)(1) limit the maximum deferrals under an eligible § 457(b) plan during any taxable year to $7,500. Section 457(e)(15) provides for cost of living adjustments (in $500 increments) of this maximum deferral amount at the same time and, generally, in the same manner as adjustments are made to the limitations for tax-qualified plans under § 415(d). This change is effective for taxable years beginning after December 31, 1996. The maximum deferral amount for each year is announced before the beginning of the year at the same time as cost of living adjustments under § 415(d).

For 1997, the maximum deferral amount remains at $7,500. For 1998, the maximum deferral amount is $8,000.

VI. TRUST REQUIREMENTS UNDER § 457(g)

Section 457(g) requires that all assets and income of a § 457(b) plan maintained by a state or local government employer ("governmental § 457(b) plan") be held in trust, or in custodial accounts or annuity contracts described in § 401(f), for the exclusive benefit of participants and beneficiaries. Section 457(g) applies generally to assets and income held by a governmental § 457(b) plan on and after August 20, 1996. However, with respect to a governmental § 457(b) plan in existence on August 20, 1996, a trust (or a custodial account or annuity contract) is not required to be established before January 1, 1999.

Section 457(g) does not apply to a § 457(b) plan established by a tax-exempt organization that is not a governmental entity. Prior to the addition of § 457(g) to the Code, all § 457(b) plans were subject to § 457(b)(6), which mandates that a § 457(b) plan be unfunded and that plan assets not be set aside for participants. Section 457(b)(6) continues to apply to a § 457(b) plan of a tax-exempt employer.

To satisfy the trust requirement applicable to governmental § 457(b) plans under § 457(g)(1), a trust must be established pursuant to a written agreement that constitutes a valid trust under state law. The terms of the trust must make it impossible, prior to the satisfaction of all liabilities with respect to plan participants and their beneficiaries, for any part of the assets and income of the trust to be used for, or diverted to, purposes other than for the exclusive benefit of plan participants and their beneficiaries.

In order to satisfy the requirement that all plan assets and income be held in trust, amounts deferred under a governmental § 457(b) plan after a trust has been established must be transferred to the trust within a period that is not longer than is reasonable for the proper administration of the accounts of participants. For purposes of this requirement, a governmental § 457(b) plan may provide for amounts deferred for a participant under the plan to be transferred to the trust within a specified period after the date the amounts would otherwise have been paid to the participant. For example, a governmental § 457(b) plan could provide for amounts deferred under the plan to be contributed to the trust within 15 business days following the month in which these amounts would otherwise have been paid to the participant.[1]

Unless all assets or income of a plan are held in one or more trusts that satisfy the requirements of this section VI (or in custodial accounts or annuity contracts that are treated as trusts under section VII of this notice), the plan is not a § 457(b) plan because the requirements of § 457(g) are not met.

VII. CUSTODIAL ACCOUNTS AND ANNUITY CONTRACTS UNDER § 457(g)(3) TREATED AS TRUSTS

Section 457(g)(3) provides that, for purposes of the § 457(g)(1) trust requirements, custodial accounts and annuity contracts described in § 401(f) will be treated as trusts under rules similar to the rules under § 401(f). Section 1.401(f)–1(b) of the regulations contains requirements that a custodial account or an annuity contract must satisfy to be treated as a trust. For purposes of applying the § 401(f) rules under § 457(g), the requirements under § 1.401(f)–1(b) of the regulations generally will be used to determine whether a custodial account or annuity contract meets the requirements of § 457(g)(3).

A custodial account will be treated as a trust under § 457(g)(1) if the custodian is

[1] *Cf.* section 2510.3–102(b) of the Department of Labor regulations concerning contributions to an employee pension plan that is subject to the Employee Retirement Income Security Act ("ERISA") (such as a plan qualifying under § 401(k) of the Code). A governmental § 457(b) plan is not subject to ERISA, and, thus, is not subject to the Department of Labor regulations.

a bank, as described in § 408(n), or a person who meets the nonbank trustee requirements of section VIII of this notice, and the account meets the requirements of section VI of this notice, other than the requirement that it be a trust.

An annuity contract will be treated as a trust under § 457(g)(1) if the contract is an annuity contract, as defined in § 401(g), that has been issued by an insurance company qualified to do business in the state, and the contract meets the requirements of section VI of this notice, other than the requirement that it be a trust. An annuity contract does not include a life, health or accident, property, casualty or liability insurance contract.

The use of a custodial account or annuity contract as part of a governmental § 457(b) plan does not preclude the use of a trust or another custodial account or annuity contract as part of the same governmental § 457(b) plan, provided that all such vehicles satisfy the requirements of §§ 457(g)(1) and (3) and all assets and income of the plan are held in such vehicles. Unless all assets and income of a plan are held in one or more trusts, custodial accounts, or annuity contracts that satisfy section VI or VII of this notice, the plan is not a governmental § 457(b) plan because the requirements of § 457(g) are not met.

VIII. NONBANK CUSTODIANS

The custodian of a custodial account may be a person other than a bank only if the person demonstrates to the satisfaction of the Commissioner that the manner in which the person will administer the custodial account will be consistent with the requirements of §§ 457(g)(1) and (g)(3). To do so, the person must demonstrate that the requirements of paragraphs (2)–(6) of § 1.408–2(e) of the regulations relating to nonbank trustees will be met. The written application must be sent to the address prescribed by the Commissioner in revenue rulings, notices and other guidance published in the Internal Revenue Bulletin in the same manner as prescribed under 1.408–2(e) of the regulations.

To the extent that a person has already demonstrated to the satisfaction of the Commissioner that the person satisfies the requirements of § 1.408–2(e) of the regulations in connection with a qualified trust (or custodial account or annuity contract) under § 401(a), that person will be deemed to satisfy the requirements of this section VIII.

IX. PAPERWORK REDUCTION ACT

The collection of information requirement contained in this notice has been reviewed and approved by the Office of Management and Budget (OMB) in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1580.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

The collection of information in this notice is pursuant to section 457(g) of the Internal Revenue Code of 1986. This information is required to ensure compliance with the statutory requirements that certain eligible deferred compensation plans hold their assets in trust for the exclusive benefit of their participants and beneficiaries. The collection of information is mandatory. The likely respondents are state or local governments.

The estimated total reporting burden is 10,600 hours.

The estimated burden per respondent varies from .033 hour to 2 hours per trust established depending upon individual respondents' circumstances, with an estimated average of one hour for each trust established, and from 20 hours to 50 hours per application for approval as a custodian with an estimated average of 35 hours for each application submitted to qualify as a custodian. The estimated number of respondents is 10,260 including 10 applications for approval as a custodian.

The estimated frequency of responses is one-time only.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

DRAFTING INFORMATION

The principal author of this notice is Cheryl Press of the Office of the Associate Chief Counsel (Employee Benefits and Exempt Organizations). However, other personnel from the IRS and Treasury participated in its development. For further information regarding this notice, contact Cheryl Press at (202) 622-6030 (not a toll-free number).