Comments on Compensation Deferred Under Eligible Deferred Compensation Plans

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4245 N. Fairfax Dr., Suite 750
Arlington, VA 22203
Phone 703.516.9300
Fax (703) 516-9308
www.aspa.org

Comments on Compensation Deferred Under Eligible Deferred Compensation Plans

The American Society of Pension Actuaries ("ASPPA") offers the following comments on the proposed regulations under Internal Revenue Code ("Code") Section 457, issued on May 8, 2002 ("Proposed Regulations").

ASPPA is a national organization of approximately 5,000 members who provide actuarial, administrative, consulting, legal and other professional services for qualified and other retirement plans.

ASPPA commends the Service for issuing the much-needed and detailed Code Section 457 guidance. Although in 1982 the Service issued comprehensive Code Section 457 final regulations ("1982 Regulations"), those regulations did not address many of the practical and compliance issues encountered by employers who maintain 457 plans and by practitioners who work with such plans. Also, the significant statutory amendments made to Section 457 since 1982 have made updated and expanded Section 457 guidance essential.

I. Summary of Comments
In summary, ASPPA's comments on the Proposed Regulations are as follows:

- The definition of "annual deferral(s)" should be changed so that compensation deferred under an eligible plan is taken into account as an annual deferral in the year of the deferral.
- Guidance should be provided regarding what agreements or arrangements constitute bona fide death benefit or severance plans.
- Final Regulations should confirm that Code Section 457(f)(1) does not apply to SEPs or SIMPLE IRAs.
- Final regulations should indicate to what extent an eligible plan's written document may incorporate by reference provisions of Code Section 457.
- The statement in the Proposed Regulations' preamble that a participant may not elect the special

Section 457 catch-up more than once should be clarified, and final regulations should expressly state that a participant may be permitted to take advantage of the underutilized limitation during any combination of three years prior to the participant's attainment of normal retirement age.

- The Proposed Regulations' rule that an eligible governmental plan's failure to distribute "excess deferrals" within a reasonable time will cause it to be an ineligible plan should be eliminated or modified because it is inconsistent with the flush language of Code Section 457(b).

- Earnings on excess deferrals should be taxable to the participant in the taxable year in which distributed.

- Excess deferrals under an eligible plan of a tax-exempt employer should not cause the plan to be an ineligible plan. ASPPA proposes that final regulations permit eligible plan status to be maintained if the excess deferrals are either distributed or treated as deferrals under a separate, ineligible plan.

- The unforseeable emergency distribution provisions should include safe harbor rules similar to the 401(k) rules for determining hardship.

- Final regulations should address the consequences to ineligible plan participants if the employer becomes an ineligible employer. ASPPA proposes that, in such an event, the tax consequences to participants be determined in accordance with Code Section 451.

- The requirement that the defined benefit governmental plan to which deferrals under an eligible governmental plan may be transferred be "of that state" should be eliminated because it is neither part of, nor authorized, by any applicable statute.

- Earnings on amounts deferred under an ineligible plan should be includible in gross income when taxed or made available, as under existing regulations.

II. Definition of Annual Deferral(s)

The definition of "annual deferral(s)" states that "[t]he amount of compensation deferred under an eligible plan is taken into account as an annual deferral in the taxable year of the participant in which deferred, or, if later, the year in which the amount of compensation is no longer subject to a substantial risk of forfeiture." Section 1.457-2(b)(2) of the Proposed Regulations provides that if the amount of compensation deferred is subject to a substantial risk of forfeiture, the amount of compensation deferred which is taken into account as an annual deferral in the tax year in which the risk lapses is to be adjusted to reflect gains or losses that occur up until the time the risk lapses. Section 1.457-2(b)(3) of the Proposed Regulations provides that if the eligible plan is a defined benefit plan, the annual deferral for a tax year is the present value (determined using reasonable actuarial assumptions and methods) of the increase in the participant's accrued benefit that is not subject to a substantial risk of forfeiture.

Code Section 457 does not require or permit deferred compensation to be taken into account as an annual deferral when the substantial risk of forfeiture on that compensation lapses. The term "substantial risk of forfeiture" appears in subsection (f), but in no other subsection of 457.

The proposed annual deferral timing rules misconstrue the congressional intent regarding substantial risk of forfeiture. The Joint Committee on Taxation's General Explanation of the Revenue Act of 1978 does not refer to "substantial risk of forfeiture." However, that explanation, in its discussion of the rule under Code Section 457(e)(6) that compensation be taken into account at its present value, states:

> However, in the case of an independent contractor or an employee who performs services during a taxable year in return for some compensation payable currently and additional compensation payable in a later taxable year, it will be necessary, as of the close of the taxable year, to determine (without regard to any restriction other than one having a substantial risk of forfeiture) the present value of the right to receive the future payment or payments and compare that to the includible compensation for the taxable year to determine if the limitations on deferral have been satisfied.

> If future payments are subject to a substantial risk of forfeiture, then they will not be valued until there is no longer a substantial risk of forfeiture. At the close of the first taxable year in which the future payments are no longer subject to a substantial risk of forfeiture, the present value of such payments must be compared to the includible compensation for such year to determine if the deferral limitations have been met.

In other words, the concept of “substantial risk of forfeiture” in applying annual deferral limits relates not to the deferrals, but to the compensation with respect to which the maximum deferral amounts are calculated. For example, if a participant’s compensation is $100,000, of which $70,000 is subject to a substantial risk of forfeiture, only $30,000 is taken into account as compensation when applying the annual deferral limit.

ASPPA Recommendation: The definition of “annual deferral(s)” should be changed so that the compensation deferred under an eligible plan is taken into account as an annual deferral in the tax year of the deferral (or, if the eligible plan is a defined benefit plan, that the annual deferral for the tax year should be the present value of the increase in the participant’s accrued benefit), regardless of whether that amount (or present value of the increase) is subject to a substantial risk of forfeiture.

The Proposed Regulations’ timing rule poses practical concerns as well. Delaying the time when deferred compensation is taken into account can cause a “bunching” of annual deferrals in a tax year and thereby reduce the participant’s deferred compensation amount for the year the substantial risk of forfeiture lapses. In order to avoid this result, employers would have to carefully track deferred compensation amounts that are subject to a substantial risk of forfeiture and earnings on the amounts. If the earnings up until the time the substantial risk of forfeiture are allowed to lapse are greater than were reasonably anticipated, annual deferral amounts could exceed the maximum deferral limitation. If this excess occurred in an eligible plan of a tax-exempt employer, then under Section 1.457-4(e)(3) of the Proposed Regulations, the entire plan would become ineligible.

It should be noted that Section 411(p)(1) of the Job Creation and Worker Assistance Act of 2002 amended Code Section 403(b)(1) to provide that a 403(b) annuity contribution be taken into account when applying the 415(c)(2) contribution limits in the year they are made, rather than, as under prior law, in the year in which they become nonforfeitable. This statutory change reflects a congressional intent that contributions under tax-favored plans be taken into account when they are made. Given that Section 457 does not provide for the timing rules of Section 1.457-2(b) of the Proposed Regulations, a different intent or policy should not apply to the timing of Section 457(b) annual deferrals.

III. Inapplicability of Code Section 457 to Bona Fide Death Benefit and Severance Plans

Code Sections 457(e)(11)(A)(i) and 1.457-2(k) of the Proposed Regulations provide that certain plans, including bona fide death benefit and severance plans, are not treated as agreements or arrangements under which compensation is deferred. However, the Proposed Regulations do not provide specific guidelines on agreements or arrangements that are not subject to Section 457. Such guidance would be helpful, as there is considerable uncertainty regarding the scope of some of these non-457 arrangements. For instance, many employers have adopted programs funded with large amounts of cash-value life insurance, relying on advice that these programs are exempt as death benefit plans. The guidance should clarify the status of such programs

IV. Inapplicability of Code Section 457(f)(1) to SEPs and SIMPLE IRAs

Code Sections 457(e)(11) and 1.457-2(k) of the Proposed Regulations enumerate the types of plans to which none of the provisions of Section 457 or the Proposed Regulations applies. Also, Section 457(f)(2) of the Code and Section 1.457-11(b) of the Proposed Regulations list the types of plans or portions of plans to which Code Section 457(f)(1) and Section 1.457-11(a) of the Proposed Regulations do not apply.

Neither simplified employee pensions described in Section 408(k) (“SEPs”) nor simple retirement accounts described in Section 408(p) (“SIMPLE IRAs”) are listed among the plans, which are expressly excluded from the application of Section 457 or 457(f)(1).

SEPs and SIMPLE IRAs contributions would be immediately includible in the participant’s gross income if Section 457(f)(1) governed the tax treatment of nonforfeitable SEP and SIMPLE IRA contributions. Congress and the Service have acknowledged that SEPs and SIMPLE IRAs may be maintained by governmental and tax-exempt employers (see, e.g., Code Section 408(k)(6)(E) and Notice 98-4, Q.B-4) and, presumably, that

SEP and SIMPLE IRA contributions for employees of such employers should be subject to the same tax-favored treatment as similar contributions are for employees of other types of employers.

ASPPA Recommendation: The Service should expressly state in final regulations that SEPs and SIMPLE IRAs are among the plans to which Code Section 457(f)(1) does not apply.

V. Incorporation of Provisions of Code Section 457(b) by Reference
Section 1.457-3(a) of the Proposed Regulations requires that an eligible plan be a written plan, which contains all the material terms and conditions for the plan's benefits. Plans should not fail to comply with Section 1.457-3(a) if they incorporate certain provisions of Code Section 457, such as the deferral limits of Code Sections 457(b)(2) and (3), by reference. The final 457 regulations should state the extent to which incorporation by reference is permissible.

VI. One-Time Use of Special Section 457 Catch-up
The preamble to the Proposed Regulations states "a participant may not elect to have the special Section 457 catch-up apply more than once, unless the participant is covered by a plan of another employer." The Proposed Regulations do not expressly set out a "one-time" use rule, although the final sentence of Section 1.457-4(c)(3)(v) does state that for a special Section 457 catch-up, an entity sponsoring more than one eligible plan may not permit a participant to have more than one normal retirement age ("NRA") under its eligible plans.

Both Section 457(b)(3) and Section 1.457-4(c)(3)(i) of the Proposed Regulations state that an eligible plan may provide for the special 457 catch-up for one or more of the participant's taxable years ending before the participant attains NRA. Thus, presumably, a plan may permit a participant to take advantage of the participant's underutilized limitation in any one, or combination of, the participant's three pre-NRA years (i.e., the participant's use of the underutilized limitation is not restricted to a single year).

ASPPA Recommendation: In light of the foregoing, the Service should clarify the preamble's reference to the "one-time" use of the special 457 catch-up, and, in particular, expressly state in the final regulations that an eligible plan may permit a participant to take advantage of the underutilized limitation during any combination of the participant's three pre-NRA years.

The Service should also clarify what constitutes "another employer." For example, it would appear that different school districts within the same city are to be treated as separate employers. Express rules on what constitutes "another employer" would help ensure compliance with applicable requirements.

VII. Excess Deferrals Under an Eligible Plan Other Than As A Result of the Individual Limitation

A. Eligible Governmental Plans

> *(1) Consequences of Failure to Distribute Excess Deferrals*
> Section 1.457-4(e)(2) of the Proposed Regulations provides that in order to be an eligible governmental plan, the plan must provide that the amount of a participant's annual deferrals in excess of the permissible maximum with respect to the plan must be distributed to the participant, with allocable net income, as soon as administratively practicable after the plan determines that the amount is an excess deferral, and a failure to so distribute the excess deferral will cause the plan to be an ineligible plan.
>
> The flush language of Code Section 457(b) (as well as Section 1.457-9 of the Proposed Regulations) provides that a plan of a governmental employer which has been administered inconsistent with the requirements for eligible plans will cease to be treated as meeting such requirements if the employer fails to correct the inconsistencies within a specified period following notification by the Secretary of the Treasury. Because Section 1.457-4(e)(2) of the Proposed Regulations can have the effect of causing an eligible governmental plan to lose its eligible status before the time specified in the flush language of 457(b), it is inconsistent with Section 457(b).
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> *ASPPA Recommendation:* The provisions of Section 1.457-4(e)(2) should be eliminated or modified to be consistent with the flush language of Code Section 457(b).

(2) Timing of Inclusion of Earnings in Gross Income
Although Section 1.457-4(e)(1) of the Proposed Regulations states that the amount of the excess deferrals under an eligible plan are taxable to the participant in the year of the excess deferral (or, if later, the first tax year in which there is no substantial risk of forfeiture), the Proposed Regulations do not state in which tax year earnings on excess deferrals are includible in the participant's gross income.
ASPPA Recommendation: All excess deferral earnings should be includible in the tax year in which the earnings are actually distributed; including earnings in prior years would, in many instances, require participants to amend previously-filed income returns and pay interest on past-due taxes attributable to excess deferrals.

B. Eligible Plan of Tax-Exempt Employer
Section 1.457-4(e)(3) of the Proposed Regulations provides that, if a participant's annual deferrals in a tax-exempt employer's plan exceed its annual deferral limits, the plan is ineligible. Section 1.457-4(e)(3) provides for no correction opportunity, as does the proposed Section 1.457-4(e)(2) rule, for excess deferrals under an eligible governmental plan. Section 1.457-4(e)(3) would cause all plan participants to bear the consequences of the plan being an ineligible plan by reason of any participant's excess deferral. The provisions of Section 1.457-4(e)(3) are harsh and unnecessary.

In view of the complexities of calculating the annual deferral limits in catch-up and other situations, an employer or participant who fully intends to comply with the limit may nevertheless inadvertently exceed the maximum on a particular occasion. Furthermore, as discussed in II, above, the provisions of Section 1.457-2 (b)(2) of the Proposed Regulations can cause a greater-than-anticipated amount to be taken into account as annual deferrals in one year if earnings on deferred compensation up until the time the substantial risk of forfeiture lapses are more than are reasonably anticipated. There currently is no Employee Plans Compliance Resolution System (Revenue Procedure 2002-47) program for correction of compliance failures experienced by eligible plans. Retaining Section 1.457-4(e)(3) may cause some employers to establish a separate eligible plan for each employee it seeks to cover under the plan to insure that the consequences of the excess deferrals of one employee will be confined to the plan covering only that employee.

ASPPA Proposal: ASPPA proposes that the final 457 regulations should provide that excess deferrals under eligible plans of tax-exempt employers will not cause the plan to be an ineligible plan if either (1) excess deferrals, plus allocable earnings, are distributed to the participant(s) with excess deferrals, or (2) the plan document includes terms which provide that excess deferrals are (or will be recharacterized as) deferred compensation under a separate plan which is an ineligible plan, and that the excess deferral is treated (or recharacterized) in accordance with these terms. The above proposal is equitable, easy to administer, and consistent with both the provisions of Code Section 457(b) and rules for disposition of excesses under other types of tax-favored plans.

VIII. Distributions For Unforeseeable Emergencies
Code Section 457(1)(A)(iii) and Section 1.457-6(c) of the Proposed Regulations provide that an eligible plan may permit a distribution for an unforeseeable emergency if certain requirements are satisfied.

The proposed Code Section 457 unforeseeable emergency rules are unnecessarily more restrictive, and less well-developed, than the hardship rules for Code Section 401(k) plans. Harmonization of the rules for eligible 457 plans and 401(k) plans would promote simplification. Under the Proposed Regulations, an unforeseeable emergency includes foreclosure on, or eviction from, the participant's principal residence, medical expenses, funeral expenses, and financial hardship of a beneficiary; except in extraordinary circumstances, it does not include a home purchase or tuition payments.

The Proposed Regulations do not include any safe harbor provisions for determining whether an unforeseeable emergency exists. Many governmental and tax-exempt employers expend an inordinate amount of time determining unforeseeable emergencies on a case-by-case basis.

ASPPA Recommendation: The final 457 regulations should include safe harbor rules similar to the 401(k) rules for determining hardship.

IX. Tax Consequences to Participants of an Ineligible Plan if the Employer Ceases to be an Eligible Employer

Section 1.457-10(a)(2)(i) of the Proposed Regulations provides that if a tax-exempt employer which maintains an eligible plan ceases to be an eligible employer and the plan is not terminated in accordance with Section 1.457-10(a)(2)(ii) of the Proposed Regulations, the tax consequences to the plan's participants and beneficiaries will be determined in accordance with Code Section 451. Section 1.457-10(a)(2)(i) further provides that if a state which maintains an eligible plan ceases to be an eligible employer and the plan is neither so terminated nor transferred to another eligible plan of that state as permitted by Section 1.457-10(b) of the Proposed Regulations, the tax consequences to the participants will be determined in accordance with Code Section 402(b), and the trust will no longer be treated as tax-exempt under Section 501(a). However, the Proposed Regulations do not address the tax consequences to participants of an ineligible plan if the employer becomes an ineligible employer.

ASPPA Recommendation: Section 457(f) of the Code (which by its terms applies only to plans of eligible employers) ceases to apply, and the consequences to the plan's participants should thereafter be determined in accordance with Code Section 451, regardless of when benefits under the ineligible plan accrued and regardless of whether the employer had been a tax-exempt employer or a state. The final 457 regulations should expressly state that such are the consequences if an employer ceases to be an eligible employer.

X. Purchase of Permissive Past Service Credit

Section 1.457-10(b)(4)(i) of the Proposed Regulations provides that "[a]n eligible governmental plan of a state may provide for the transfer of amounts deferred by a participant or beneficiary to a defined benefit governmental plan (as defined in Section 414(d)) of that state, and no amount shall be includible in gross income, if the conditions in paragraph (b)(4)(ii) are met." (Emphasis added.)

However, the condition that the transferee defined benefit governmental plan be of the state which maintains the transferring eligible governmental plan is neither required nor authorized by statute and is unduly restrictive. The condition should be eliminated. Code Section 457(e)(17), which is the statutory provision governing non-includibility in the case of such a transfer, requires that the transferee plan be only "a defined benefit governmental plan [as defined in Section 414(d)]."

XI. Timing of Inclusion of Earnings on Amounts Deferred Under An Ineligible Plan

Section 1.457-3(a)(2) of the 1982 Regulations provides that earnings credited on compensation deferred under an ineligible plan are includible in the participant's or beneficiary's gross income only when paid or made available, as long the participant's interests in the employer's assets were not senior to the employer's general creditors. Section 1.457-11(a)(2) of the Proposed Regulations provides that earnings which accrue on deferred amounts under an ineligible plan up to the date there is no substantial risk of forfeiture on the deferred amounts are includible in the first taxable year in which there is no substantial risk of forfeiture; the inclusion timing of Section 1.457-3(a)(2) of the 1982 Regulations applies only to other earnings. Proposed Regulations Section 1.457-11(a)(3).

There have been no changes to Code Section 457 since the issuance of the 1982 regulations that would warrant or support the proposed change in the timing of including earnings on deferred compensation under an ineligible plan. Section 1.457-3(a)(2) of the 1982 Regulations provides for virtually identical tax treatment of such earnings as is explained by the Joint Committee on Taxation:

> While amounts deferred under an ineligible State deferred compensation plan generally would be included in income in the year of deferral, earnings credited on such deferred amounts would not be subject to current taxation as long as the participant has no interest in the assets of the entity sponsoring the plan which is more secure than that of general creditors. Where the participant has no such interest, earnings on amounts deferred under the plan will not be taxable to the participant until paid or otherwise made available and then will be taxed according to the annuity rules (sec. 72).

The provisions of Section 1.457-3(a)(2) of the 1982 Regulations reflect the correct and intended timing rule and should therefore be retained.

Furthermore, the Proposed Regulations do not include any provisions, which would allow earnings, which accrued prior to the effective date of the Proposed Regulations, to be taxed under the provisions of the 1982 Regulations. The absence of any grandfathering for pre-effective date earnings unfairly changes the rules for participants who entered into deferred compensation arrangements in reliance on the 1982 Regulations because taxes on the pre-effective date earnings would, in many cases, be accelerated.

These comments have been prepared by the Tax-Exempt & Governmental Plans Committee of ASPPA's Government Affairs Committee. We appreciate the opportunity to provide these comments, and are available to discuss them with you further.

Sincerely,

Amiram J. Givon, Esq., APM, Co-chair Tax-Exempt & Governmental Plans Committee	Brian H. Graff, Esq. Executive Director
David A. Pratt, Esq., APM, Co-Chair Tax-Exempt & Governmental Plans Committee	Jeffrey C. Chang, Esq., APM, Co-chair Government Affairs Committee
Janice M. Wegesin, CPC, QPA Administration Relations Chair	R. Bradford Huss, Esq., APM, Co-chair Government Affairs Committee

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