SECTION 457(b)—ONE CODE PROVISION, TWO DISTINCT TYPES OF PLAN

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Sponsors must remain vigilant to avoid confusion caused by the rapid evolution of governmental 457(b) plans into fundamentally different 401(k)-like plans.

Over the past 35 years, Section 457(b) has evolved to provide for two distinct types of retirement benefit plans. For governmental employers, 457(b) plans may serve as broad-based retirement plans with the features of a 401(k) plan. For nongovernmental exempt employers, however, a 457(b) plan functions as a "top-hat" plan available only to a select group of management and highly compensated employees. The nongovernmental 457(b) plan is less flexible than its governmental sibling, and nongovernmental exempt employers instead must use other tax-favored retirement plans like 401(k) plans or 403(b) plans to provide flexible, tax-deferral options to rank-and-file employees.[1]

Although 457(b) plans cannot function as broad-based retirement plans for nongovernmental exempt organizations, a 457(b) plan offers the executives and other highly-compensated employees of these organizations valuable opportunities to defer compensation in addition to what they are able to defer under their organization's 401(k) or 403(b) plan. Nongovernmental exempt organizations should keep in mind, however, that the 457(b) plans they can sponsor for their executives and other highly compensated employees are fundamentally different plans from 401(k)-like governmental 457(b) plans. Moreover, the ability to correct errors in a nongovernmental 457(b) plan without the risk of audit penalties or adverse tax consequences to participants is quite limited.

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History—457(b) plans are nonqualified plans

In their earliest form, Section 457(b) "eligible deferred compensation plans" were not even available to exempt organizations. These plans originated as special nonqualified plans for governmental employers as part of Revenue Act of 1978, which added Section 457, a provision that restricted the ability of governmental employers to defer employee compensation. The Section 457 regime, including 457(b) plans, was not extended to nongovernmental exempt employers until 1986. Subsequent legislation has added 401(k)-like features to 457(b) plans sponsored by governmental employers, which generally cannot sponsor 401(k) plans and can sponsor 403(b) plans only in limited circumstances.[2] These 401(k)-like features have not been extended to 457(b) plans sponsored by nongovernmental exempt employers, which generally can sponsor 401(k) or 403(b) plans in any event.[3] As a result, 457(b) plans have

in many ways become 401(k) substitutes for governmental employers—particularly those governmental employers prohibited from sponsoring 403(b) plans. Meanwhile, 457(b) plans sponsored by nongovernmental exempt employers have remained closer to their origins as nonqualified deferred compensation plans.

Nonqualified deferred compensation plans. "Nonqualified deferred compensation plans" are plans that do not meet the requirements necessary to "qualify" for favorable tax treatment under Section 401(a). For a plan to be a "qualified retirement plan" that meets the Section 401(a) requirements, it must satisfy certain standards, such as the mandate to hold assets in a vehicle (i.e., a trust) for the exclusive benefit of participants, limits on contributions and benefits, and restrictions on design to prevent discrimination in favor of highly compensated employees.[4]

Both qualified and nonqualified plans generally permit an employer to credit an employee with benefits payable at a later date, deferring taxation on the benefits until the amount is paid. The Code expressly provides for the deferral of taxation for qualified plan benefits and even provides that the employer may obtain the tax deduction as early as the time the benefits are funded under the qualified plan.[5] The deferral of taxation on nonqualified plan benefits, however, turns on the avoidance of the application of the principle of "constructive receipt."

Under the Code and regulations, amounts set apart or made available to an employee are generally deemed "constructively received" for the purpose of including those amounts in income subject to taxation.[6] Amounts however are not "constructively received," however, if they are merely credited to the employee on the books of the employer and the right to receive the amount has been deferred to a later date, even if it was the employee who elected to defer payment of the amount.[7] IRS guidance on this point explains that an employer's mere unsecured promise to pay an amount is not regarded as the current receipt of income by the employee.[8] Accordingly, a typical nonqualified deferred compensation plan is not funded by a trust or other instrument maintained for the exclusive benefit of participants; any amounts set aside to fund the benefit remain subject to the claims of the employer's creditors.[9] The unsecured nature of the employer's promise to pay the benefit defers the inclusion of the amount in the employee's income, and defers the employer's tax deduction, until the time the amount is paid.[10] In recent years, Section 409A imposed additional, express restrictions regarding the time and form of payment of nonqualified deferred compensation, but employers and employees

[1] Sections 401(a), 401(k)(4)(B)(i), 403(b)(1)(A).

[2] Sections 401(k)(4)(B)(ii), 403(b)(1)(A). Indian tribal governments and associated entities are permitted to sponsor 401(k) plans. Section 401(k)(4)(B)(iii).

[3] Sections 401(k)(4)(B)(i), 403(b)(1)(A)(i).

[4] Sections 401(a)(2), (4), (16).

[5] Sections 402(a), 404(a).

[6] Section 451(a); Reg. 1.451-2(a).

[7] *Id.*

[8] Rev. Rul. 60-31, 1960-1 CB 174, as modified in Rev. Rul. 64-279, 1964-2 CB 121, and Rev. Rul. 70-435, 1970-2 CB 100.

[9] See Ltr. Rul. 8113107 (acknowledging that setting aside vested amounts irrevocably in a fund held by a third party for an employee's benefit generally results in immediate inclusion of the amount in the employee's income, but ruling that when vested amounts are set aside in a grantor ("rabbi") trust that remains subject to the claims of the employer's creditors, the amounts are not included in the employee's income until paid).

[10] Section 404(a)(11).

[11] See Needles and DuPuy, "How the IRS Is Changing the Regulation of Deferred Compensation," 21 Exempts 5, page 3 (Mar/Apr, 2009).

[12] Staff of the Joint Comm. on Taxation, *General Explanation of the Revenue Act of 1978*, page 68.

[13] Prop. Reg. 1.61-16.

[14] Revenue Act of 1978 ("RA '78"), P.L. 95-600, 11/6/78, section 132.

[15] Treasury Department, *Report to the Congress on the Tax Treatment of Deferred Compensation Under Section 457* (Jan. 1992), page 4 (citing H. Rep't. No. 1445, 95th Cong., 2d Sess. 53 (1978)). The Joint Committee on Taxation report also cited the plan funding requirements of the Employee Retirement Income Security Act (ERISA), which generally do not apply to governmental plans and function to limit participation in less-regulated unfunded, non-qualified deferred compensation plans sponsored by private employers "primarily to highly compensated and managerial employees."

[16] Section 457(e)(1), as in effect after enactment of RA '78.

[17] Section 457(b), as in effect after enactment of RA '78.

[18] Staff of the Joint Comm. on Taxation, *supra*, note 12 at 68.

[19] Sections 457(b)(2), (c)(2), both as in effect after enactment of RA '78.

[20] Section 457(b)(3), as in effect after enactment of RA '78.

[21] Section 457(a), as in effect after enactment of RA '78.

[22] Sections 457(b)(5), (6), both as in effect after enactment of RA '78.

[23] Section 457(b)(6), as in effect after enactment of RA '78.

[24] Section 457(b), as in effect after enactment of RA '78.

[25] Section 457(e)(1), as in effect after enactment of the Tax Reform Act of 1986 ("TRA '86"); Staff of the Joint Comm. on Taxation, *General Explanation of the Tax Reform Act of 1986*, page 654. The rules applied to deferrals after 1/1/87, except those made to certain fixed arrangements in place prior to 8/16/86.

[26] Staff of the Joint Comm. on Taxation, *supra* note 25 at 654.

[27] *Id.* at 657.

[28] Section 457(b), as in effect after enactment of TRA '86.

continue to defer compensation under nonqualified plans.[11]

The Revenue Act of 1978. With the enactment of Section 457 in the Revenue Act of 1978, Congress overrode the application of these principles to the nonqualified deferred compensation plans of governmental employers.[12] Congress made this change in response to a proposed IRS regulation that would have precluded the deferral of vested benefits under nonqualified deferred compensation plans of all employers.[13] In the 1978 Act, Congress moved to prevent the IRS from enacting the new regulations with respect to the plans of taxable employers, but neither applied the new Section 457 rules to nongovernmental exempt organizations nor precluded the IRS from imposing its prior proposed regulations on nongovernmental exempt organizations.[14] Congress treated those employers differently than taxable employers because "[a] taxable employer may prefer to pay current compensation over deferred compensation in order to avoid the deferral of its deduction," and tax-indifferent employers would not be so restrained by "this 'tax tension' between the deferral desired by the employees and the current deduction desired by the employer."[15]

As originally enacted, Section 457 generally provided that compensation deferred under a nonqualified plan or arrangement of a state or local government (or rural electric cooperative) would be included in the employee's income in the first year in which the amount was not subject to a substantial risk of forfeiture.[16] Amounts subject to a substantial risk of forfeiture—unvested benefits—could thus continue to be deferred under arrangements today referred to as 457(f) plans. Congress, however, also permitted the limited deferral of vested compensation through "eligible State deferred compensation plans" in Section 457(b).[17] In creating this "457(b) plan," Congress recognized that state and local government employees should not be completely prohibited from deferring vested compensation, but "concluded that limitations should be imposed on the amounts of compensation that can be deferred under these arrangements and allowed to accumulate on a tax-deferred basis."[18]

The original iteration of the 457(b) plan permitted deferrals up to the lesser of $7,500 or 33.3% of an employee's or other service provider's compensation, with the limit determined by considering the individual's deferrals to other 457(b) plans and 403(b) plans (1986 legislation added a requirement to consider contributions to 401(k) plans).[19] A special "catch-up" provision permitted extra deferrals by participants in their final three years prior to attaining retirement age.[20] The deferred amounts and any income attributable to the deferred amount would not be included in the participant's compensation until paid or otherwise made available.[21] Deferred amounts and related income, however, could not be paid prior to separation from service or the occurrence of an unforeseeable emergency (or, as provided in subsequent legislation, upon the participant's attaining age 70-1/2).[22] Keeping with the traditional application of nonqualified plan principles, amounts deferred under a 457(b) plan could not be held in a trust for the exclusive benefit of participants, but had to remain property of the employer and subject to its creditors.[23] The 1978 Act included a generous ongoing grace period during which governmental employers could correct 457(b) plan document errors without penalty, running from the date on which the IRS notified the sponsor of the error to the start of the first plan year that began no less than 180 days after the date of the notification.[24]

For nongovernmental exempt employers, however, a 457(b) plan functions as a top-hat plan.

The Tax Reform Act of 1986. Congress, believing that it was appropriate to impose limits on the amount of compensation deferred by other tax-indifferent employers, extended the Section 457 regime to nongovernmental exempt organizations in the Tax Reform Act of 1986.[25] Along with making other adjustments to the 457(b) plan rules, Congress additionally imposed accelerated distribution rules on 457(b) plans to prevent such arrangements from "accumulat[ing] on a tax-favored basis for too long a period" and to ensure that these tax-favored plans were "used primarily for retirement purposes."[26] Conveniently, the extension of the Section 457 regime and the other changes were forecast in the aggregate to have a positive revenue effect for the fisc.[27]

Although the extension of Section 457 to nongovernmental employers did not create a fundamentally different plan structure, the law resulted in distinctions between governmental and nongovernmental 457(b) plans that persist and set the course for the evolution of the 457(b) plan into essentially two different types of plans. For one, Congress did not extend the generous grace period for correcting 457(b) plan document errors to nongovernmental sponsors.[28] The 1986 Act also indirectly imposed a more significant distinction between governmental and nongovernmental 457(b)

plans that resulted in a stark variation in the demographics of governmental 457(b) plans (which can, in effect, cover the employer's entire work force) and nongovernmental exempt organization 457(b) plans (which generally only cover executives and highly compensated employees).

This demographic distinction resulted because, as expressly acknowledged by the staff of the Joint Committee of Taxation, Congress extended Section 457 to nongovernmental employers without exempting 457(b) plans from the Employee Retirement Income Security Act of 1974 (ERISA).[29] ERISA generally governs employer-sponsored retirement plans, but exempts plans sponsored by governmental entities. ERISA requires that covered plans be adequately funded by assets held in trust exclusively for participants.[30] As the plans of governmental employers are not subject to ERISA, there was no conflict for governmental employers between ERISA's trust requirement and Section 457's mandate that all 457(b) plan assets remain property of the employer and subject to its creditors.[31] The retirement plans of nongovernmental exempt employers, however, generally are subject to ERISA.[32] Therefore, to satisfy the 457(b) requirements, nongovernmental exempt employers must avoid ERISA's trust requirement using a more limited exception: the "top-hat" plan exception. ERISA exempts "top-hat" plans—plans maintained for the benefit of "a select group of management or highly compensated employees"—from many of its mandates, including the trust requirement.[33] As a result, nongovernmental 457(b) plans generally are "top-hat plans," open only to the executives or highly compensated employees of nongovernmental exempt organizations, while governmental 457(b) plans may have broad coverage.

In the Tax Reform Act of 1986, Congress also prohibited governmental entities and nongovernmental tax-exempt organizations from establishing new 401(k) elective "cash or deferred arrangement" plans, intending "to limit the number of employers that can maintain cash or deferred arrangements" to slow the "shifting of the burden of retirement savings to employees."[34] While 501(c)(3) organizations and public schools could offer elective deferral arrangements through 403(b) plans, other exempt organizations and governmental entities that did not have access to an existing 401(k) plan could only offer employees elective deferral opportunities through unfunded, nonqualified 457(b) plans.[35] These plans therefore became popular with state and local governments seeking to provide their employees with a tax-favored supplement to their pension programs. By 1993, over 90% of all local governments and all 50 states offered their employees the opportunity to participate in Section 457 arrangements.[36] Although intervening legislation modified Section 457(b)'s rules regarding distributions, grandfathering, and special exceptions,[37] the next significant change in the 457(b) plan rules resulted from the large numbers of governmental employers sponsoring broadly available 457(b) retirement programs that lacked the secure funding of qualified plans.

The Small Business Job Protection Act of 1996

In the Small Business Job Protection Act of 1996,

[29] Staff of the Joint Comm. on Taxation, *supra* note 25 at 654.

[30] 29 U.S.C. sections 1081; 1103(a).

[31] 29 U.S.C. section 1003(b)(1); Section 457(b)(6), as in effect after enactment of TRA '86.

[32] 29 U.S.C. sections 1003(a), (b)(2).

[33] *Id.* 29 U.S.C. section 1081(a)(3).

[34] Section 401(k)(4)(b), as in effect after enactment of TRA '86; Staff of the Joint Comm. on Taxation, *supra* note 26 at 634.

[35] Governmental Accountability Office, *Public Pensions: Section 457 Plans Pose Greater Risk Than Other Supplemental Plans*, GAO/HEHS-96-38 (1996), page 2.

[36] *Id.* at 14 (citing study of Access Research Corp.).

[37] Unemployment Compensation Amendments of 1992, P.L. 102-318, 7/3/92, section 521; Omnibus Budget Reconciliation Act of 1989, P.L. 101-239, 12/17/89, section 7811; Technical and Miscellaneous Revenue Act of 1988, P.L. 100-647, 11/10/88, section 1011).

[38] Governmental Accountability Office, *supra* note 35 at 16-17.

[39] Staff of the Joint Comm. on Taxation, *General Explanation of Tax Legislation Enacted in the 104th Congress* (1996), page 162.

[40] H. Rep't. No. 104-586, 104th Cong, 2d Sess. 117 (1996).

[41] Section 457(g), as in effect after the Small Business Jobs Protection Act of 1996 (SBJPA).

[42] Staff of the Joint Comm. on Taxation, *supra* note 39 at 163.

[43] *Id.*

[44] SBJPA, P.L. 104-188, 8/20/96, section 1426.

[45] Section 457(b)(2)), as in effect after the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA); Staff of the Joint Comm. on Taxation, *General Explanation of Tax Legislation Enacted in the 107th Congress* (2003), pages 92-93.

[46] Section 457(e)(15), as in effect after enactment of EGTRRA; Staff of the Joint Comm. on Taxation, *supra* note 45 at 90-91.

[47] Section 457(b)(2), as in effect after enactment of EGTRRA; Staff of the Joint Comm. on Taxation, *supra* note 45 at 116.

[48] EGTRRA, P.L. 107-16, 6/7/01, section 631(a); Staff of the Joint Comm. on Taxation, *supra* note 45 at 112-13.

[49] *Id.*; Section 414(v)(6)(A)(iii), as in effect after enactment of EGTRRA.

[50] Section 457(c), as in effect after enactment of EGTRRA.

Congress further bifurcated the world of 457(b) plans into plans sponsored by governmental employers and plans sponsored by nongovernmental tax-exempts. This development was driven by municipal financial woes that threatened the security of 457(b) plan benefits of local government employees.

In 1994, Orange County, California, which set aside 457(b) plan salary deferrals in an investment pool along with its general tax revenues, filed for bankruptcy after the investment pool experienced significant losses.[38] The insolvency threatened to leave participants with less than 100% of the value of their accounts. The Orange County development came on the heels of negative press coverage surrounding a 1992 Los Angeles County plan to use $250 million of deferrals allocated to meet 457(b) plan obligations as a loan to make payroll. Although the county never went through with the loan, the news raised attention to the risks faced by 457(b) plan participants.

In the wake of these events, Congress recognized that municipal employees' 457(b) plan benefits "were not protected from the employer's general creditors in case of the employer's bankruptcy."[39] Concerned "about the potential for employees of certain State and local governments to lose significant portions of their retirement savings because their employer has chosen to provide benefits through an unfunded deferred compensation plan rather than a qualified pension plan,"[40] Congress required governmental 457(b) plan benefits, like qualified plan benefits, to be funded by assets held in trust, custodial accounts, or insurance contracts for the exclusive benefit of participants.[41] At the same time, Congress provided that these funded amounts could be loaned to plan participants on the same terms as participant loans could be made from qualified plans.[42]

For the 457(b) plans of nongovernmental exempt organizations, however, the legislation made no change to the rule precluding the contributions of funds to a trust or other vehicle for the exclusive benefit of participants.[43] As a result, the 457(b) plans of nongovernmental exempt employers would be required to remain unfunded (and participant loans would remain unavailable). The Small Business Job Protection Act, however, restored the ability of nongovernmental exempt employers to sponsor 401(k) plans, giving exempt organizations another option for providing elective deferred compensation arrangements with secure funding.[44] Thus, the Act had split the 457(b) plan into two fundamentally different retirement savings vehicles.

The Economic Growth and Tax Relief Reconciliation Act of 2001. Five years later, the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) further advanced the evolution of governmental 457(b) plans into 401(k) plan substitutes while enhancing the role of nongovernmental 457(b) plans as supplemental plans for a select "top-hat" group of management and highly compensated employees.

As part of a general overhaul of defined contribution plan limits in EGTRRA, Congress raised the deferral limits for 457(b) plans and harmonized the 457(b) limits with the limits applicable to 401(k) and 403(b) plans.[45] The new dollar limit was set to begin at $11,000 in 2002, incrementally increase to $15,000 in 2006, and thereafter be indexed to inflation in the same manner as the parallel 401(k) and 403(b) dollar limits.[46] EGTRRA also increased the percentage of compensation limit on 457(b) plan deferrals to 100%, bringing it in line with the percentage limits for 401(k) and 403(b) plans.[47] Furthermore, EGTRRA provided for catch-up contributions for participants who attained age 50 by the end of a plan year.[48] Congress extended this new age 50 catch-up feature to 401(k), 403(b), and governmental 457(b) plans, but did not extend it to the 457(b) plans of nongovernmental exempt employers.[49]

Significantly, in overhauling the deferral limits, Congress also eliminated the coordination of the 457(b) deferral limit with the 401(k) and 403(b) contribution limits.[50] Applying the 2006 limit of $15,000 as an example, a participant could now make a full deferral up to $15,000 to a 457(b) plan as well as another $15,000 deferral to either a 401(k) or 403(b) plan—a total of $30,000 in deferrals in a single year. Although this change was of no benefit to employees of governmental employers unable to sponsor 401(k) or 403(b) plans, it was a boon to employees of governmental employers that offered grandfathered 401(k) plans or were eligible to offer 403(b) plans. Further, the change enhanced the appeal of the 457(b) plan as a supplemental plan for a nongovernmental exempt organization's select "top-hat" group of employees, who now could double their deferrals by first deferring up to the limit to a 401(k) or 403(b) plan and

then again up to the same limit to the 457(b) plan.

In addition to revising the deferral limits, EGTRRA also changed the rules governing governmental 457(b) plan distributions to bring those plans more in line with 401(k) and 403(b) plans. The new rules provided that certain eligible distributions from governmental 457(b) plans are eligible for tax-free rollovers to qualified plans, 403(b) plans, and IRAs, and that governmental 457(b) plans are permitted to receive tax-free rollover distributions from those types of plans (provided that the receiving governmental 457(b) plan separately accounted for the amounts).[51]

Congress also conformed the rules regarding when amounts deferred under a governmental 457(b) plan are included in income with the rules governing the timing of income inclusion under the qualified plans.[52] Section 457(a) originally deferred taxation until amounts credited under plan were "paid or otherwise made available."[53] With EGTRRA, Congress bifurcated the rule and removed the "otherwise made available" condition from the income inclusion rule applicable to governmental 457(b) plans, while retaining the original rule for the 457(b) plans of exempt organizations.[54] The result, as articulated in the Service's post-EGTRRA Section 457 regulations, was to give governmental 457(b) plan participants the ability to draw down their 457(b) plan account balances at will once they had a distribution event, without facing the risk that entire amounts that they could have elected to receive would be subject to taxation.[55] For participants in nongovernmental 457(b) plans, however, amounts "otherwise made available" continue to be includible in income, thus precluding their ability to request partial distributions at will.[56] Instead, nongovernmental 457(b) plan participants generally must elect the time and form of payment of their benefits before the amounts become payable and have only a limited ability to subsequently defer amounts that are scheduled to be paid.[57]

Although differences remain between governmental 457(b) plans and 401(k) and 403(b) plans, the EGTRRA modifications continued the convergence of governmental 457(b) plans with 401(k) and 403(b) plans. Subsequent legislation has continued to advance conformity. New defined contribution retirement plan features typically are extended to governmental 457(b) plans as a matter of course. For example, the Pension Protection Act of 2006 introduced "eligible automatic contribution arrangements" that permit participants to take distributions of amounts automatically deferred within 90 days of the first deferral.[58] Congress made this new feature available to governmental 457(b) plans at the same time it was first introduced for 401(k) and 403(b) plans.[59] Meanwhile, other 401(k) and 403(b) features have become available in 457(b) plans. For one, the Small Business Jobs Act of 2010 permitted governmental 457(b) plans to accept after-tax Roth IRA contributions.[60] Despite the ongoing evolution of the governmental 457(b) plan, its nongovernmental sibling has generally retained its nonqualified deferred compensation plan character.

Correcting 457(b) plan errors

Given the potential for confusion over which features are available in nongovernmental plans and the incessant changes in the rules governing retirement plans generally, there is significant risk that a nongovernmental 457(b) plan sponsor will fail to maintain and operate its plan in accordance

[51] Section 402(c), as in effect after enactment of EGTRRA; Staff of the Joint Comm. on Taxation, *supra* note 45 at 132.

[52] Section 457(a), as in effect after enactment of EGTRRA; Staff of the Joint Comm. on Taxation, *supra* note 45 at 137.

[53] Section 457(a), as in effect after enactment of RA '78.

[54] Section 457(a), as in effect after enactment of EGTRRA.

[55] Reg 1.457-7(b)(1).

[56] Reg 1.457-7(c)(1).

[57] Reg 1.457-7(c)(2).

[58] Section 414(w), as in effect after the enactment of the Pension Protection Act of 2006.

[59] *Id.*

[60] Section 402A(e)(2)(B), as in effect after enactment of the Small Business Jobs Act of 2010.

[61] Section 457(f)(1); Reg. 1.457-9(b).

[62] Reg. 1.457-4(e)(3).

[63] *Id.*

[64] Section 457(b)(6); Reg. 1.457-9(a).

[65] Rev. Proc. 2013-12, 2013-4 IRB 313, § 4.09.

[66] *Id.* § § 1.01, 10.

[67] *Id.* § 4.09.

[68] *Id.*

[69] IRS, "Correction Options for 457(b) Plans," Employee Plans News, 2014-3 (3/4/14), available at www.irs.gov/pub/irs-tege/epn_2014_3.pdf.

[70] *Id.*

[71] IRS, "Employee Plans Compliance Unit (EPCU)—Non-Governmental 457(b) Plans Project" (10/8/14) available at www.irs.gov/Retirement-Plans/Employee-Plans-Compliance-Unit-(EPCU)-Non-Governmental-457(b)-Plans-Project.

[72] IRS, "Employee Plans Compliance Unit (EPCU)—Non-Governmental 457(b) Plans Project," Employee Plans News, 2013-2 (6/ 24/13), available at www.irs.gov/pub/irs-tege/epn_2013_2.pdf.

[73] *Id.*

with the Code and regulations. The failure of a plan to comply with any one of the rules of Section 457(b) will immediately subject the amounts deferred to the rules of Section 457(f), which generally require the inclusion of all vested deferrals in participants' incomes.[61] The IRS maintains no formally recognized voluntary correction programs through which a nongovernmental 457(b) plan sponsor can correct failures without the threat of accelerating income inclusion to participants, but there are hopeful signs that the IRS may be taking a softer stance on the correction of nongovernmental 457(b) plans.

The regulations allow nongovernmental 457(b) plan sponsors to self-correct one common failure—excess participant deferrals—in a limited fashion. If a participant makes contributions in excess of the annual deferral limit (including catch-ups) to one or more 457(b) plans of the sponsor, the plan has until April 15 of the following year to distribute the excess deferral and related income without threatening the plan's status.[62] Notably, a governmental 457(b) plan merely needs to distribute excess deferrals with income allocable on the excess "as soon as administratively practicable after the plan determines that the amount is an excess deferral" in order to avoid jeopardizing the plan's status.[63] Aside from the excess deferral correction regulations, governmental 457(b) plan sponsors have no certain method of implementing corrections.

Governmental 457(b) plan sponsors, on the other hand, have generous correction opportunities. They are able to take advantage of the statutory grace period to correct errors. That grace period runs from the time the IRS notifies the sponsor of the error until the start of the first plan year that begins no less than 180 days after the IRS notification.[64] Governmental 457(b) plan sponsors can even provisionally submit proposed corrections of operational errors to the IRS for approval, applying the principles of the Service's Employee Plans Compliance Resolution System (EPCRS).[65] EPCRS is a system of correction programs that allow plan sponsors to correct qualified plan and 403(b) plan errors, including correction through a "Voluntary Compliance Program" that allows sponsors to submit proposed corrections for IRS approval.[66] The IRS has not formally opened the EPCRS program to any 457(b) plan sponsors, but the primary EPCRS guidance provides that sponsors of governmental 457(b) plans can submit proposed corrections "on a provisional basis outside of EPCRS." [67] Although the guidance indicates that this provisional correction process is generally limited to governmental 457(b) plan sponsors, it also concedes that the IRS may consider the submission of a nongovernmental 457(b) plan that erroneously covered a broad range of the sponsor's employees, rather than just a select group.[68]

More recent informal IRS guidance suggests that the agency may be increasingly willing to entertain discussions about correcting nongovernmental 457(b) plan errors. In a 2014 newsletter article, the IRS discussed its limited acceptance of requests for voluntary correction of 457(b) plan errors.[69] Although the article made clear that the IRS retained the right to accept or reject the requests, it did not state that nongovernmental plan sponsors were prohibited from submitting requests. The article in fact encouraged *governmental* 457(b) plan sponsors to consider simply self-correcting using the grace period, rather than submitting a correction request to the IRS.[70] Further, in describing a 457(b) plan compliance check project that is focused on nongovernmental plan sponsors—and discussed below—the IRS reiterated that it will accept 457(b) plan voluntary correction submissions.[71] Although there is no general correction process for nongovernmental 457(b) plan errors, these recent developments suggest that the IRS may be willing to work with nongovernmental 457(b) plan sponsors to remedy failures on a voluntary basis.

The 2013-2014 IRS nongovernmental Section 457(b) compliance check

Given the absence of formal correction opportunities for nongovernmental 457(b) plan sponsors, any guidance to help avoid common pitfalls is valuable. A Section 457(b) compliance check program initiated by the Service's Employee Plans Compliance Unit in June 2013 provides insight on significant issues facing nongovernmental 457(b) plan sponsors from the Service's perspective. The stated goals of the project were to learn more about the operation of these plans, verify compliance with the Code, identify noncompliance issues, and recommend methods to remove any compliance barriers.[72] To this end, the IRS planned to send 200 questionnaires per year to nongovernmental 457(b) plan sponsors in 2013 and 2014.[73] All questionnaires should have been distributed by this time.

The questions suggest that the IRS is focused on identifying nongovernmental 457(b) plans that erroneously offer features available only in governmental 457(b) plans and on reviewing plan provisions pertaining to more difficult-to-administer features.[74] For 457(b) plan sponsors reviewing their plans' compliance with law and employers weighing the benefits and risks of offering 457(b) plans, the compliance-check questionnaire functions as a helpful checklist of issues to consider.

457(b) plan sponsor eligibility. The questionnaire's initial queries—whether the sponsor is an exempt organization or a state or governmental unit—go to the issue of which organizations are eligible sponsors.[75] Generally, states, their political subdivisions, and agencies and instrumentalities of states and their political subdivisions, but not the federal government or its instrumentalities, are eligible to sponsor governmental 457(b) plans.[76] Exempt organizations, with the exception of churches or certain church-controlled organizations, also are eligible 457(b) plan sponsors.[77] Notably, an exempt organization that also is a governmental entity has "dual status" and will be treated as the sponsor of a governmental 457(b) plan.

Participant eligibility/top-hat status. The questionnaire then moves to the issue of which employees are eligible to participate in nongovernmental 457(b) plans, asking sponsors to check whether "highly compensated employees," "management employees," or "all employees" are eligible to participate.[78] Because nongovernmental 457(b) plan sponsors are prohibited from setting aside amounts for the exclusive benefit of participants—yet are typically subject to ERISA and its general requirement that benefits be held in trust—only "a

Services and Information

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select group of management or highly compensated employees" may participate in order for the plan to meet the "top-hat" exception to ERISA's trust requirement.[79]

A subsequent question asks whether the employer has filed a "top-hat" exemption with the U.S. Department of Labor ("DOL").[80] Top-hat plans that are maintained for the purpose of benefiting only a select group of management or highly compensated employees are exempt from many of ERISA's requirements, including the trust requirement, but remain subject to ERISA's reporting obligations.[81] DOL, however, permits top-hat plan sponsors to satisfy these reporting obligations by making a one-time summary filing.[82] The failure to file a top-hat exemption with DOL can result in significant penalties for failure to meet ERISA's reporting requirements. For nongovernmental 457(b) plan sponsors and other top-hat sponsors that have overlooked this filing, DOL offers a Delinquent Filer Voluntary Compliance Program, which allows sponsors to remedy their oversight with a simple filing and the payment of a $750 fee.[83]

Availability of plan loans The questionnaire asks sponsors about the availability of plan loans.[84] Loans are one of the 401(k)-like features that have been introduced to governmental 457(b) plans, but are plainly prohibited in nongovernmental 457(b) plans. In fact, the regulations specifically provide that if a participant receives a loan from a nongovernmental 457(b) plan, the amount will be treated as having been "made available" in violation of the Section 457(b) distribution requirements.[85]

Availability and administration of catch-up contributions. The questionnaire also seeks information about a plan's provision for catch-up contributions.[86] Governmental 457(b) plans can offer two types of catch-up contributions—the special 457(b) catch-up and the age 50 catch-up also found in 401(k) and 403(b) plans.[87] Nongovernmental 457(b) plans, however, may only offer the special 457(b) catch-up, which permits a participant in the last three tax years ending prior to the participant's attainment of normal retirement age to defer an additional amount that is the lesser of (1) twice the annual limit ($35,000 for 2014), or (2) the "underutilized limitation"—the sum of the maximum basic annual deferral limits for prior years in which the participant was eligible to participate in the plan less the participant's actual deferral.[88] The special catch-up can be particularly challenging to administer because it requires accurate records of prior contributions. Moreover, in determining the underutilized limitation when years before 2002 are involved, the calculation for the pre-2002 year generally must account for contributions made to all plans of all employers for the year with which the 457(b) deferral limitation was coordinated, such as 401(k) plans.[89]

Plan funding. The questionnaire directly asks whether plan assets are available to general creditors of the sponsor or if they are held in trust for the exclusive benefit of participants.[90] While governmental 457(b) plans must hold the assets of the plan in a trust, custodial account, or insurance contract for the exclusive benefit of participants,[91] the only acceptable answer to this question for a nongovernmental 457(b) plan sponsor is that any amounts set aside to fund the plan benefits remain subject to the claims of the sponsor's general creditors.[92]

Although nongovernmental 457(b) plan assets cannot be held in trust for the exclusive benefit of plan participants, sponsors may wish to set aside the deferred amounts to meet the plan's benefit obligations (e.g., to be invested in a manner that corresponds to participant investment elections to ensure that there are adequate funds to meet the obligations, regardless of investment experience). For this purpose, nongovernmental 457(b) plan sponsors can set aside funds corresponding to the deferrals in a "rabbi trust" without violating the rules of Section 457(b).[93] Assets in a rabbi trust are held for

[74] IRS, "Compliance Check Cover Letter and Questionnaire," available at www.irs.gov/pub/irs-tege/letter_4663f.pdf.
[75] IRS, "Compliance Check Cover Letter and Questionnaire," questions 1-2.
[76] Section 457(e)(1)(A).
[77] Section 457(e)(1)(B); Reg. 1.457-2(e).
[78] IRS, "Compliance Check Cover Letter and Questionnaire," question 3.
[79] Section 457(b)(6); 29 U.S.C. section 1081(a)(3).
[80] IRS, "Compliance Check Cover Letter and Questionnaire," question 9.
[81] 29 U.S.C. sections 1021, 1051(2), 1081(a)(3), 1101(a)(1).
[82] 29 C.F.R. section 2520.104-23.
[83] 78 Fed. Reg. 6135, 6140 (2013).
[84] IRS, "Compliance Check Cover Letter and Questionnaire," question 5.
[85] Reg. 1.457-6(f)(1).
[86] IRS, "Compliance Check Cover Letter and Questionnaire," questions 6-7.
[87] Reg. 1.457-4(c).
[88] Reg. 1.457-4(c)(3).
[89] Reg. 1.457-4(c)(3)(iv).
[90] IRS, "Compliance Check Cover Letter and Questionnaire," question 8.
[91] Section 457(g).
[92] Section 457(b)(6).
[93] See Ltr. Rul. 201211001; Rev. Proc. 92-64, 1992-2 CB 422.

the purpose of the plan participants, but remain subject to the claims of the sponsor's creditors in the event of the sponsor's insolvency.[94]

Administration of hardship distributions. The questionnaire's final query pertains to hardship distributions made from the 457(b) plan in the last three years.[95] Both governmental and nongovernmental 457(b) plans may make hardship distributions, generally on the same terms,[96] so the risk of error does not stem from differences between governmental and nongovernmental 457(b) plans. The risk instead stems from differences between the standards for 457(b) hardship distributions and 401(k) and 403(b) hardship distributions. A 457(b) plan can provide only for hardship distributions upon an "unforeseeable emergency," which must be defined in the plan as "a severe financial hardship" resulting from injury or accident, loss of property due to casualty, or "other similar extraordinary or unforeseeable circumstances…."[97] For 401(k) and 403(b) plan purposes, hardship distributions may be made available "on account of an immediate and heavy financial need" when "necessary to satisfy the financial need."[98]

The determination of both an "unforeseeable emergency" and an "immediate and heavy financial need" are based on relevant facts and circumstances,[99] but the regulations make clear that the standards are not identical. Specifically, the 401(k) and 403(b) plan rules contemplate a hardship distribution to pay for the purchase of a principal residence or to pay tuition,[100] but the 457(b) plan rules generally provide that "the purchase of a home and the payment of college tuition are not unforeseeable emergencies."[101] Given the discrepancies between the 457(b) hardship distribution standards 401(k) and 403(b) hardship distribution standards, a plan administrator should ensure that the proper standard is applied before commencing a distribution, particularly when an organization may sponsor a 457(b) plan as well as a 401(k) plan or 403(b) plan, which both provide for hardship distributions.

Conclusion

Nongovernmental 457(b) plans offer nongovernmental exempt organization executives and other highly compensated employees a valuable opportunity to defer vested compensation. Sponsors of these plans, however, must remain vigilant to avoid confusion caused by the rapid evolution of governmental 457(b) plans into fundamentally different 401(k)-like plans. Particularly in the absence of clear correction procedures, nongovernmental 457(b) plan sponsors should take care to ensure that concepts from the broad-based governmental 457(b) area do not infiltrate plan documentation and administration. The Service's compliance check questionnaire can serve as one starting point for a nongovernmental 457(b) plan sponsor seeking to get a sense of where compliance problems may arise.

As defined contribution retirement plans, such as 401(k) plans, 403(b) plans, and 457(b) plans, evolve to respond to concerns about retirement security and defined benefit pension costs, governmental 457(b) plans likely will continue to converge with 401(k) and 403(b) plans and grow ever further apart from their more limited, nongovernmental 457(b) plan siblings. ■

94 Rev. Proc. 92-64, 1992-2 CB 422.

95 78 Fed. Reg. 6135, 6140 (2013).

96 Section 457(d)(1)(iii).

97 Reg. 1.457-6(c)(2)(i).

98 Regs. 1.401(k)-1(d)(3), 1.403(b)-6(d)(2) (incorporating Section 401(k) hardship distribution rules).

99 Regs. 1.401(k)-1(d)(3)(iii), 1.457-6(c)(2)(ii).

100 Reg. 1.401(k)-1(d)(3)(iii)(B).

101 Reg. 1.457-6(c)(2)(i).