Financial Wellness

# Section 457(b) Plan

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## What is a Section 457(b) plan?

A Section 457(b) plan is a type of nonqualified deferred compensation plan that certain governmental and tax-exempt organizations can establish for their employees. Like other deferred compensation plans, the purpose of a Section 457(b) plan is to encourage employees to set aside funds for their retirement. Although it is a nonqualified plan, a Section 457(b) plan somewhat mimics a qualified plan in that it offers similar tax benefits for employees. These tax benefits generally include pre-tax salary-reduction contributions and tax-deferred growth of investment earnings.

By establishing and maintaining a Section 457(b) plan, an employer can often attract and retain quality employees and reap other benefits.

***Tip:*** *Internal Revenue Code Section 457(f) provides the general rule for the taxability of income resulting from compensation deferred under a plan maintained by a governmental or nonchurch tax-exempt organization. In general, under Section 457(f), deferred compensation is taxable in the first year in which there is no substantial risk of forfeiture of the deferred compensation. However, an exception applies to "eligible 457 plans" meeting the qualifications of Section 457(b). This discussion applies primarily to eligible 457(b) plans.*

## What types of employers can use a Section 457(b) plan?

Only certain governmental and tax-exempt organizations can establish and maintain a Section 457(b) plan. Governmental organizations that qualify include: (1) a state (including the District of Columbia), (2) a political subdivision of a state (e.g., a city or township), and (3) any agency or instrumentality of a state or of a political subdivision of a state (e.g., a school district or sewage authority). Tax-exempt organizations that qualify generally include any organization that is exempt from federal income tax, except for: (1) a church or synagogue, or (2) any organization controlled by a church or synagogue.

***Tip:*** *Certain organizations may be related to a church but not qualify as church-controlled organizations (e.g., a church hospital). Such organizations may establish 457(b) plans.*

## Section 457(b) plans and ERISA

The Employee Retirement Income Security Act (ERISA) is a 1974 federal law that governs many aspects of retirement plans. Title I of ERISA imposes requirements that include reporting and disclosure, participation and vesting, funding, fiduciary responsibilities, and administration and enforcement. Title I of ERISA applies to all "employee benefit plans," which generally include all retirement plans unless specifically excluded.

Plans established or maintained by a state, a political subdivision, or a state agency or instrumentality are specifically exempted from ERISA Title I. Therefore, 457 plans established by such employers ("governmental 457 plans") are not subject to ERISA.

Plans established by nonchurch tax-exempt organizations generally are subject to the requirements of ERISA Title I. ERISA requires that most retirement plans be funded, and plan assets held in trust. However, these funding requirements are not compatible with the provisions of IRC Section 457(b), which require that 457(b) plans maintained by tax-exempt organizations be unfunded, and that all assets remain part of the general assets of the employer. As a result, nongovernmental plans are generally structured as unfunded nonqualified deferred compensation plans covering only a select group of management or highly compensated employees (a "top-hat" group) to avoid most ERISA requirements. Because the assets of a nongovernmental 457(b) plan are not held in an ERISA trust, participants have less protection than participants in qualified employer plans in the event of the plan sponsor's bankruptcy. Consult a retirement plan expert for further guidance on this issue.

***Tip:*** *Organizations that are closely related to a church but that do not qualify as qualified church-controlled organizations may be able to establish 457 plans that are exempt from ERISA Title I.*

## How much can employees contribute to a Section 457(b) plan?

An employee may defer the lesser of $18,500 in 2018 (up from $18,000 in 2017) or 100% of his or her gross compensation to a Section 457(b) plan. The dollar limit is indexed for inflation each year. An employer may also make nonelective contributions to a

457(b) plan on an employee's behalf. The total employer nonelective contributions and employee deferrals cannot exceed the limits described above.

***Tip:*** *Note that Section 457(b) plan deferrals do not reduce the amount an employee can contribute to a 401(k) or 403(b) plan maintained by you or another employer. For example, if you also maintain a 403(b) plan, your employees can defer $18,500 to each plan in 2018 (plus any applicable catch-up contributions).*

An eligible 457(b) plan (both governmental and nongovernmental) can allow increased contributions during one or more of a participant's last three taxable years preceding attainment of normal retirement age (the "special" Section 457 catch-up rule). The amount of increased contributions the plan can allow may be based on previously underutilized contribution limits (in other words, participants can "make up" for the fact that they did not fully contribute in years past), but a participant's maximum deferral may not exceed twice the allowed contribution amount for the year ($37,000 in 2018).

***Tip:*** *For purposes of this special catch-up during the three taxable years preceding normal retirement age, normal retirement age can be any age between when the participant is entitled to receive full benefits under a separate (1) defined benefit plan, or (2) money purchase pension plan if the employee is not eligible for a defined benefit plan, (or age 65 if there are no such plans) and age 70½. A special rule allows the normal retirement age to be as early as age 40 for certain police and firefighters.*

Eligible governmental 457(b) plans can also include a separate catch-up provision that allows employees age 50 and older to contribute an additional $6,000 in 2018 (unchanged from 2017). Employees who are also eligible for the special catch-up rule described above can use either the special rule or the "age 50" catch-up rule, whichever provides the higher catch-up amount in any year. The "age 50" catch-up rule is not available for nongovernmental 457(b) plans.

***Tip:*** *An employee is eligible for only one catch-up limit under Section 457(b) per year, regardless of whether he or she participates in multiple 457(b) plans of one employer or in separate 457(b) plans of more than one employer. However, an employee may be able to double up on catch-up contributions if he or she participates in a 457(b) plan and also a non-457(b) employer-sponsored plan.*

***Tip:*** *An eligible 457(b) plan can allow participants to defer accumulated sick, vacation, and back pay if two conditions are met: (1) the deferral election must be made during employment, and (2) by deferring such amounts, the participant must not exceed the maximum annual deferral limit. A third requirement applies if the accumulated sick, vacation, and back pay is payable to the participant only after severance from employment. In that case, the participant must make his or her deferral election before the first month in which those amounts could be paid to the participant in cash.*

***Example(s):*** *Eligible 457(b) plan Participant G will retire on January 17, 2019. G's accumulated sick and vacation pay (which totals $10,000) will be payable to G on January 15, 2019. G may elect at any time before January 15, 2019 to defer the accumulated sick and vacation pay to the Section 457(b) plan (assuming G does not exceed the 2019 deferral limit). If, instead, the accumulated sick and vacation pay were payable to G on January 25, 2019, after retirement, G's deferral election would have to be made before January 1, 2019.*

***Caution:*** *If a participant's salary deferrals to an eligible 457(b) plan exceed the plan's maximum annual deferral limits, a governmental plan can retain its eligible status by distributing the excess deferrals (and any net allocable income) to the participant as soon as administratively possible. Similarly, an eligible 457(b) plan of a tax-exempt organization can retain its eligible status by distributing the excess deferrals (and any net allocable income) to the participant no later than April 15 following the close of the taxable year of the excess deferral. If a 457(b) plan does not correct excess deferrals the plan will lose its "eligible" status, and benefits will be taxed under the Section 457(f) ineligible plan rules. However, if a participant exceeds the deferral limits by participating in more than one employer's 457(b) plan, a plan will not lose its eligible status, and the excess deferrals will be included in the participant's gross income. In this case the plan may, but is not required to, distribute the excess (and any earnings) to the participant.*

# Tax benefits of eligible Section 457(b) plans

## *Tax benefits for employees*

As with many other types of retirement plans, employees who participate in a Section 457(b) plan can enjoy significant tax benefits, including:

- Pre-tax contributions: Employees' salary deferrals to a Section 457(b) plan are made on a pre-tax basis. The contribution is taken directly from the employee's salary and invested in the plan before any taxes are withheld. This means that the amount each employee defers to the plan is not included in his or her gross income in the year of deferral. The employee

pays less income tax because his or her taxable income is lower than it would otherwise be. Deferrals (and any net allocable income) are included in the employee's gross income in the year paid (for governmental plans) and in the year paid or made available to the employee (for nongovernmental plans). Special rules apply for determining when amounts are "made available" to a participant in a nongovernmental plan.

- 457(b) plans can also allow participants to make after-tax Roth contributions. There's no up-front tax benefit, but qualified distributions are totally free from federal income taxes.
- Tax-deferred growth: Funds held in a Section 457(b) plan grow tax deferred. Any earnings on plan investments are not taxable as long as they remain in the plan. Only when an employee begins to receive distributions from the plan will he or she pay income tax on the earnings.
- Possible tax credit: Some employees who participate in a governmental 457(b) plan may qualify for a partial income tax credit ("Saver's Credit") for amounts deferred to the plan. The amount of the tax credit (if any) is based on the employee's annual gross income and federal income tax filing status.

### *No employer tax deduction*

With many types of employer-sponsored retirement plans, the employer's contributions to the plan are tax deductible for federal income tax purposes. Contributing to the plan can therefore reduce the employer's taxable income, saving money in taxes. However, any employer that is eligible to have a Section 457(b) plan does not pay any federal income tax in the first place. This means that deductibility of contributions is not an issue for such employers. In addition, payments to exempt governmental deferred compensation plans may be exempt from both the Federal Insurance Contributions Act (FICA) and the Federal Unemployment Tax Act (FUTA). Consult a tax advisor for details.

## How to set up a Section 457(b) plan

### *Adopt a written plan*

Any employer wishing to establish an eligible Section 457(b) plan must adopt a written plan that describes the provisions of the plan. In most cases, this requires the assistance of a retirement plan specialist.

### *Provide forms to participants for salary reduction elections*

Generally, an agreement providing for salary deferrals must be entered into before the beginning of any calendar month for which amounts to be deferred would otherwise be paid or made available to the employee. A new employee, however, can defer compensation during the first month of his or her employment as long as the employee enters into an agreement to defer compensation on or before his or her first day of employment, even if that is after the first day of the month.

## Questions & Answers

### *Which employees must be allowed to participate in the Section 457(b) plan?*

There are no specific coverage requirements for Section 457(b) plans. For a governmental employer, the plan can be offered to all employees or to any group of employees — even a single employee. Individuals who perform services for the employer are eligible to participate. This includes employees as well as independent contractors.

Section 457(b) plans of tax-exempt employers must be unfunded. However, most tax-exempt employers are subject to ERISA, which generally requires that plan assets be held in a trust. Because of this conflict, a tax-exempt organization must limit its Section 457 plan coverage to a select group of management or highly compensated employees (a "top-hat" plan).

### *Can employees contribute to other retirement plans in addition to the Section 457(b) plan?*

Yes, and their Section 457(b) plan salary deferral limit (including catch-up contributions) will not be reduced by contributions made to other types of pension plans.

***Tip:*** *For example, a teacher who participates in both a 457(b) plan and a Section 403(b) plan in 2018 would be able to defer up to $37,000 ($18,500 for each plan), or even more if the teacher is eligible for catch-up contributions under either or both of those plans.*

## When can employees take distributions from the Section 457(b) plan?

In general, Section 457(b) plan distributions may not be taken before:

- The calendar year in which the participant attains age 70½
- The date the participant has a severance from employment (special rules apply to independent contractors), or
- The date the participant is faced with an "unforeseeable emergency" (see below for definition)

An unforeseeable emergency is defined as:

- Severe financial hardship to the participant resulting from an illness or accident suffered by the participant, a spouse, a dependent, or a designated beneficiary
- A loss of the participant's property due to casualty, or
- Other similar extraordinary and unforeseeable circumstances caused by events beyond the participant's control

**Caution:** *Distributions because of an unforeseeable emergency must be limited to the amount reasonably necessary to satisfy the emergency need (which may include amounts necessary to pay income taxes or penalties relating to the withdrawal). Distributions may not be made to the extent the emergency may be relieved through reimbursement from insurance or otherwise, by liquidation of the participant's assets (to the extent liquidation would not itself cause severe financial hardship), or by cessation of deferrals to the plan.*

IRS regulations provide the following examples of an "unforeseeable emergency:"

- The need to pay medical expenses, including non-refundable deductibles and the cost of prescription drugs, for the participant, a spouse, a dependent, or a designated beneficiary
- The cost of rebuilding a home following damage not covered by homeowner's insurance (for example, following a natural disaster)
- The imminent foreclosure or eviction from the participant's principal residence
- The need to pay funeral expenses of a spouse, dependent, or plan beneficiary

The purchase of a home and the payment of college tuition are generally not unforeseeable emergencies.

**Tip:** *The IRS, in Rev. Rul. 2010-27, has provided additional guidance on unforeseeable emergency distributions from Section 457(b) plans. In that Ruling the IRS determined (based on the specific facts given) that a distribution would be permissible to pay the cost of repairing significant water damage to a participant's residence following a water leak in the basement; that a distribution would be permissible to pay the funeral expenses for a participant's adult son who was not a dependent; but that a distribution would not be permissible to pay accumulated credit card debt, absent a showing that the debt itself was caused by extraordinary and unforeseeable circumstances beyond the participant's control.*

Distributions may also be made from a 457(b) plan

- Upon the participant's death
- Upon plan termination
- If the plan contains a "small benefit" rule allowing distribution of account balances less than $5,000 (excluding rollover amounts) where the employee has not contributed to the plan for at least two years. The plan may provide for automatic cash out of these amounts, or may allow the distribution at the request of the participant.
- If the plan accepts rollover contributions from an employer-sponsored qualified retirement plan, 403(b) plan, or IRA, separately accounts for those rollover contributions, and contains a provision allowing the distribution of those rollover dollars at the participant's request. See Revenue Ruling 2004-12.

**Caution:** *457(b) plans can generally have distribution provisions that are more restrictive than the law allows.*

## Can Section 457(b) plan funds be rolled over to other types of plans, or vice versa?

Rollovers of eligible rollover distributions are permitted between employer-sponsored qualified retirement plans, Section 403(b) annuities, governmental Section 457(b) plans, and IRAs. However, these rollover rules do not apply to Section 457(b) plans maintained by nongovernmental tax-exempt organizations.

**Caution:** *Except as discussed below, distributions from 457(b) plans are not subject to the 10% early distribution penalty that applies to employer-sponsored qualified retirement plans, 403(b) plans, and IRAs. But if an employee rolls his or her*

*governmental 457(b) deferrals into one of those other plans, a subsequent distribution from that other plan will be subject to the 10% penalty if the employee is under age 59½, unless an exception applies.*

***Caution:*** *If a governmental 457(b) plan accepts rollovers from an IRA, 403(b) plan, or employer-sponsored qualified retirement plan subject to the 10% early distribution tax (for example, a 401(k) plan) the 457(b) plan must separately account for those rollover dollars, and they remain subject to the 10% early distribution penalty if withdrawn prior to age 59½.*

***Technical Note:*** *If a governmental Section 457(b) plan accepts a rollover from another 457(b) plan, and co-mingles that rollover in the same separate account that includes a rollover from an IRA, 403(b), or employer-sponsored retirement plan subject to the 10% early distribution tax, then distribution of those 457(b) plan dollars may also become subject to the 10% early distribution tax. So 457(b) sponsors should maintain separate accounts for the different types of rollovers.*

***Caution:*** *457(b) plans are not required to allow incoming rollovers.*

***Caution:*** *Nontaxable (after-tax) dollars cannot be rolled over from an employer-sponsored retirement plan or IRA into a Section 457(b) plan.*

***Caution:*** *Roth contributions and earnings can only be rolled into a Roth IRA, or into a designated Roth account in another employer's 401(k), 403(b), or 457(b) plan that accepts rollovers.*

***Tip:*** *457(b) plans can also allow participants to convert non-Roth dollars to Roth dollars (sometimes called an "in-plan conversion" or "in plan rollover.") Only eligible rollover distributions can be converted. The amount converted is included in the participant's federal gross income in the year of the conversion (except for any non-taxable basis).*

## Can plan-to-plan transfers be made between Section 457(b) plans?

Yes. Section 457(b) plans may (but are not required to) permit plan-to-plan transfers as follows:

A participant who severs employment can transfer his or her governmental 457(b) plan account balance to the new governmental employer's 457(b) plan. Similarly, a participant in a tax-exempt employer's 457(b) plan can transfer his or her account balance to the new tax-exempt employer's 457(b) plan. (A participant cannot transfer funds from a tax-exempt employer's 457(b) plan to a governmental employer's 457(b) plan, and vice versa.)

A governmental 457(b) plan can transfer all of its assets to another 457(b) plan in the same state. A governmental employer that maintains more than one Section 457(b) plan can also transfer assets for one or more participants between those plans.

## Can participants take loans from a 457(b) plan?

Eligible 457(b) plans of governmental employers can make loans to participants. Loans generally must follow the rules for loans from qualified plans, including fixed repayment schedules, reasonable interest rates, and lender repayment safeguards. In addition, a loan must be "bona fide" and for the exclusive purpose of benefitting plan participants and beneficiaries. A loan from an unfunded eligible plan of a tax-exempt organization would be treated as an impermissible distribution that violates the requirements of Section 457.

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