Third Quarter 2006

Retirement PLAN WATCH

LINKS and LINES
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800-749-4221 (other than NY)
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Governmental §457 Plans

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) granted public schools with a deferral bonanza by removing any need to coordinate §457 deferrals with deferrals to other employer plans such as §403(b)s and §401(k)s.

This means school district employees may "double dip" (i.e., defer the relevant year's maximum deferral limit ($15,000 in 2006) into a §457 and the same amount into a §403(b)). In addition, the portability provisions of EGTRRA can add impressive flexibility to an employee's retirement and financial planning goals. Your district can provide this attractive option to your employees through Legend and other vendors that provide §403(b) accounts.

Changes made by EGTRRA have greatly enhanced a school district's options in providing attractive benefits for its employees.

Let's review the basics of §457 plans under these rules.

Eligible Employers

A governmental §457 plan is a deferred compensation arrangement that state and local governmental agencies can adopt for their employees and/or independent contractors. For governmental agencies other than public school districts, this is the only vehicle available to many of these employers who want to provide their employees with the opportunity to electively defer to a tax-sheltered account. Employers can include each state, county, city and municipality. Under legislation enacted ten years ago, governmental §457 plans must establish a trust or custodial accounts, or both, to protect these retirement assets.

Only governmental agencies are eligible to adopt a §457 plan in a trust format.

Please note: non-governmental, non-profit organizations can adopt a §457(b) or §457(f) plan, but only for their highly compensated employees in a top-hat group and not in a trust format. Top-hat refers to those individuals within an organization that can affect or influence the adoption and operation of the deferred compensation plan – i.e., not just highly compensated employees. In this type of plan, the deferred compensation remains an asset of the employer and is accessible to creditors if the organization runs into hot water.

Participant Deferrals and Accounts

Insurance companies have approached many school districts about establishing governmental §457(b) slots, and many may try to get exclusive contracts. Exclusive contracts are not necessary unless the district wishes to severely limit the investment choices. If a plan participant is still working for the governmental §457 plan employer, his or her §457 account can be transferred only to vendors approved by the employer. This scenario is similar to that of a §401(k) account, but quite different from that of a §403(b) account which currently can be transferred to any §403(b) vendor, even while the accountholder is still employed.

An individual still employed by the §457 plan employer cannot roll his §457 assets anywhere until he is eligible for a distribution from the plan, i.e., until he is separated from service.

A plan participant still employed by the §457 plan employer cannot roll his §457 assets anywhere (i.e., take distribution of his account and roll it to another employ-

er's plan or an IRA) until he is eligible for a distribution from the plan (i.e., until he is separated from service). A §403(b) participant may roll her §403(b) assets once she has attained age 59½, even if she is still employed.

The non-governmental §457(b) accounts and §457(f) accounts are not eligible for rollover to IRAs and other types of plans.

Eligible Employees

Participation in governmental §457(b) plans can be limited to employees of the employer, to independent contractors performing services for the employer, or the plan can include both. (As mentioned before, only the top-hat group of employees can participate in non-governmental §457(b) plans and §457(f) plans.)

Deferral Limits

In 2006, employees may defer the lesser of $15,000 or 100% of includible compensation to either a governmental §457(b) account or a non-governmental §457(b) top-hat account. Thereafter, this annual limit will be indexed to inflation in $500 increments. Just like §403(b) plan deferrals, §457 plan deferrals are exempt from federal and most states' income taxes, but are subject to FICA taxes at the time of deferral.

Prior to 2002, to determine §457(b) includible compensation you would subtract amounts deferred to other plans, including §403(b) plans and cafeteria plans, from gross compensation to arrive at includible compensation. However, the current definition includes all compensation received in a tax year from any source, and does not exclude deferrals to other plans.

There is no limit to the amount that can be deferred to a §457(f) account. Instead, the employee must be subject to a contractual "substantial risk of forfeiture."

Catch-ups

Retirement Catch-Up

A special catch-up rule applies to the three tax years immediately preceding the tax year that the employee attains normal retirement age under a governmental or non-governmental §457(b) plan. It is unfortunate that this catch-up is defined in the way it is, as most retiring employees are receiving lump sums in the year they retire and this definition usually precludes using the retirement catch-up in that final year!

IRS Regulations allow normal retirement age to be defined as a range of ages, mirroring the ages that qualify for full benefits under the applicable state defined benefit plan. However, if the plan does not define normal retirement age, age 65 must be used.

This catch-up allows the deferral of up to twice the normal deferral limit, meaning an employee in this situation could defer $30,000 this year! However, the actual catch-up rule limits the deferral to the lesser of 1) twice the normal deferral limit or 2) the aggregate amount of contributions that the employee could have made in prior years but did not defer. In other words, you have to go back to each prior plan year, calculate the employee's limit for that year and subtract the amount actually deferred. Then you add all of the prior years' amounts not deferred to arrive at the amount that can be used in the catch-up. As a result, if the plan has just been adopted by a school district, the employees will not have any amounts from prior years to use in this calculation, and therefore they would not be able to use this catch up.

The over age 50 catch up cannot be used in conjunction with the retirement catch up.

Over-50 Catch-Up

Employees of governmental agencies over age 50 can use the over-50 catch-up ($5,000 in 2006), but not in conjunction with the retirement catch-up. An individual using the over-50 catch-up in his deferrals to his §403(b) can also use the catch-up for his deferrals to his §457 account. Employees who are participants in a non-governmental §457(b) plan or a §457(f) plan are not eligible for the over-50 catch-up.

Loans

Governmental §457 plans may now offer loans to participants under rules similar to qualified plan loans. It is up to the employer to determine whether loans will be available to their plan participants. Many school districts do not adopt a loan provision, since most §403(b) accounts provide loans.

Non-governmental §457(b) plans and §457(f) plans may not offer loans.

Distributions

Benefits may not be paid to an employee before the

employee 1) attains age 70½, 2) separates from service, or 3) incurs an unforeseeable emergency. Since §457 plan assets are deferred compensation and not qualified assets, there is no 10% premature penalty for distributions received prior to age 59½. Also, for the same reason, §457 plan assets could not be rolled over into an IRA in the past. However, Congress has now granted complete portability to governmental §457(b) accounts.

A governmental §457(b) plan participant may take distributions from his account after separation from service at any time and in any manner his custodial account or annuity contract provides. Participants who had started a stream of payments under the old §457 rules may change their "irrevocable" payment elections if their contracts have been revised.

However, a non-governmental §457(b) plan must still abide by the old rules and is subject to a "window period" after the employee separates from service. During this window, the employee must make an election regarding when distributions will commence and in what manner the distributions will be paid. After that, the participant has only one more opportunity to change his/her mind on this election. Once a stream of payments has been started, it cannot be altered.

Governmental plan participants have the option of rolling their assets to an IRA or an eligible retirement plan offered by a new employer, if desired. However, doing so may subject those assets to the 10% premature penalty if the participant takes a distribution before attaining age 59½, so consideration must be given to the individual's needs prior to that age. Leaving assets in a §457 account might make sense if the district employee wishes to retire prior to age 55.

It might still benefit a participant to roll his §457 assets to an IRA even though this might subject him to the 10% premature penalty.

§403(b) account distributions can be made without the 10% premature penalty only if the employee retires in the year he attains age 55 or thereafter. Retirement at any earlier age subjects these distributions to the penalty unless the participant arranges for a §72(t) stream of payments based on his life expectancy. With a §457 account, the employee could take whatever distributions he requires without having to deal with all the restrictions placed on a §72(t) stream.

A participant might still benefit by rolling his governmental §457 assets to an IRA using a §72(t) stream of payments until the 5 year rule is satisfied (when he can stop the stream if desired) because the IRA market typically includes a much wider array of investment choices than those offered through many §457 plans.

The required minimum distribution rules apply to governmental and non-governmental §457(b) accounts. Benefits must commence in the year in which the employee attains age 70½, or in which the employee separates from service, whichever occurs later. That means required minimum distributions can be delayed past age 70½ if the employee is still working for the eligible employer. Death distributions now hinge on the required beginning date for minimums just like IRA, §403(b) and qualified plan death distributions do.

An unforeseeable emergency can be a qualifying event for distribution while a participant is still employed with the district. This is the §457 plan's version of a hardship distribution, which must result from a sudden and unexpected illness or accident to the employee or his/her dependent, or loss of property due to a casualty or events beyond the employee's control. Distribution may not be made if relief is available through insurance, reasonable liquidation of other assets or cessation of deferrals to the plan.

Another EGTRRA change dictates that Qualified Domestic Relations Order (QDRO) distributions from governmental §457 plans are to be treated just like those distributions from qualified and §403(b) plans (i.e., taxable to the recipient, not the participant).

§457(b) plan assets are deferred compensation and, as such, distributions to employees have been reported on Form W-2 in the past. But now reporting is done on Form 1099-R (just like for §403(b)s), relieving §457(b) plan employers from an aggravating administrative burden. All §457 vendors should be prepared to report to the IRS directly, just as they do for IRAs and §403(b)s.

The tax liability on a §457(f) account hinges on the removal of the substantial risk of forfeiture. Tax reporting of distributions from this type of plan must still be done on Forms W-2 by the employer. If you are interested in this type of plan, give your Legend Retirement Advisor a call.

Access bills and make changes to participant contributions online!

Employers using ADSERV's Billing Services can now access their bills via the internet and make changes to participants' accounts online. It's convenient, and it improves processing time and accuracy.

When billing changes are submitted by an employer, the information is downloaded and stored in a "workfile" program on our AS/400 system. When the Employee Benefit Account Department receives the money relating to the employer's account, this bill will be pulled from the "workfile" program and processed.

Procedures on submitting checks remain the same.

A unique access code is required in order for each employer to use this system.

1. Call ADSERV at 1-800-749-4221 (other than NY) or 1-800-749-4321 (NY only) to receive your unique employer access code.

2. If you need technical help during the set-up process, or have any questions about using this process, call the appropriate phone number above and ask for Alejandra Salatino at ext. 718.

"Education is when you read the fine print. Experience is what you get if you don't."
– Pete Seeger

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