OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

October 7, 2002

Number: **INFO 2002-0222**
Release Date: 12/31/2002
U.I.L.: 457.05-09 457.12-01

GENIN-147228
CC:TEGE:EB:QP2

[redacted]

Dear [redacted]

This responds to the letter you faxed to [redacted] of my staff in late August concerning section 457 plans and their operations. The IRS can only discuss the questions you asked regarding the tax law; that is, provisions of section 457 and other relevant sections of the Internal Revenue Code. Since the IRS generally does not regulate the administration of section 457 plans, it is generally not in a position to answer your questions dealing with administrative operations which are regulated under state law, since state and local governmental plans are exempt from the sort of administrative regulatory oversight that the Department of Labor exercises over the operations of private entities' qualified plans under Title 1 of the Employee Retirement Income Security Act (ERISA). In addition, section 457 does not impose any federal accounting or reporting requirement on governmental section 457 plans; thus, the IRS is unable to answer your questions regarding the accounting or reporting treatment of section 457 plans. What we can provide is general information about the tax law provisions of section 457.[1]

You inquired why Congress created the section 457 plan. According to the legislative history regarding the enactment of section 457 in 1978, the Congress intended to allow state and local governmental employees to defer payment and taxation of a portion of their compensation, but only to a limited extent. The House Ways and Means Committee reported that although these government employees should be able to defer a portion of their compensation from current income taxation, "limitations should be imposed on the amounts of compensation that can be deferred

[1] Section 2.04 of Revenue Procedure 2002-1 defines an "information letter" as a statement issued by the Internal Revenue Service that calls attention to a well-established interpretation or principle of tax law without applying it to a specific set of facts. This section also provides that an information letter is advisory only and has no binding effect on the Service.

under these arrangements and allowed to accumulate on a tax-deferred basis. The committee realizes that the denial of a compensation deduction to a non-taxable entity (such as a state or local government) until an amount is includible in the income of the person providing services does not act as a restraint on the amounts that non-taxable entities are willing to let employees defer as it does when a taxable entity is involved. Accordingly, the committee believes that a percentage-of-compensation limit on amounts that can be deferred, as well as an absolute dollar limitation to prevent excessive deferrals by highly-compensated employees, is necessary." H. Report No. 95-1445 at 53, (1978), 1978-3 C.B. 227

You also inquired about the provision regarding the funding requirement for 457 plans. Before the Congress enacted the trust requirement for governmental section 457 plans in 1996, section 457(b)(6) required eligible deferred compensation plans to provide that all amounts deferred under the plan, all property and rights to property purchased with the amounts, and all income attributable to the amounts, property, or rights to property remain (until paid or made available to the participant or beneficiary under the plan) solely the property and rights of the employer subject to the claims of the general creditors of the employer only. Thus, before 1996, amounts credited to a governmental employee's section 457 account represented contractual obligations of the employer and any funds actually invested were legally considered to be funds belonging to the state (or local) governmental unit until such amounts were paid or made available to the employee. These requirements that a section 457 plan be unfunded still apply to section 457(b) plans established by non-governmental tax-exempt entities.

In 1996, Congress enacted the section 457(g) requirement that governmental section 457(b) plans must, after December 31, 1998, set all amounts deferred aside in a trust, custodial account, or annuity contract for the exclusive benefit of participants and their beneficiaries. Proposed § 1.457-8(a)(2)(ii) of the Income Tax Regulations provides that amounts deferred under an eligible governmental plan must be transferred to a trust within a reasonable period for the proper administration of the participants' accounts, if any. The proposed regulations go on to provide, as an example, that the plan could provide for amounts deferred under the plan to be contributed to the trust within 15 business days following the month in which these amounts would otherwise have been paid to the participant. The only sanction the IRS could impose upon a governmental section 457(b) plan for failing to transfer the deferred amounts into a trust, custodial account or annuity contract within a reasonable time would be to declare the plan to be an ineligible plan, thus ending its tax-deferred status and subjecting all the plan's participants to immediate taxation of all amounts deferred to their accounts. The IRS does not have any information available about governmental section 457(b) plans' compliance with the section 457(g) trust requirement.

Regarding investment options offered under a section 457 plan, although the employer sponsoring the section 457 plan may give the participant a choice of investment methods, the employer is not required to do this. While we are not aware of any benefit an employer may derive by offering certain options and not others, an employer may wish to limit the number of investment options offered under its section 457 plan in order to reduce its administrative expenses related to the plan.

You have asked what tax benefit is provided to the employers offering section 457 plans. Since the only types of employers that can legally sponsor section 457 plans are governmental or other tax-exempt entities that generally do not pay federal income tax on their receipts, they do not need or receive any tax benefit from their section 457 plans. The federal income tax benefits of governmental section 457 plans accrue to the employee-participants who can set aside compensation earned (up to certain limitations) and have them held in trust without being subject to current federal income taxation of the deferred amounts and the earnings thereon until they have been paid their benefits. State and local governments offer section 457 plans to attract employees with this additional low-cost employee benefit.

Finally you've asked about fees of plan administrators. We understand that plan administrators charge fees to compensate themselves for their expenses in administering the section 457 plans. Although we presume that state law and governmental plan sponsors endeavor to ensure that their plans are charged only reasonable fees, section 457 and other federal law provide no rule or limitation regarding fees charged by section 457 plan administrators and trustees. Any regulation and limitation of fees charged to section 457 plans would be entirely at the discretion of state law and governmental plan sponsors.

If you have any question about the federal tax laws under section 457, please call [redacted] at [redacted]

Sincerely,

ROBERT D. PATCHELL
Branch Chief, Qualifed Plans #2
Office of the Associate Chief Counsel
(Tax Exempt and Government Entities)

[redacted]