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Report to Congressional Requesters

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PUBLIC PENSIONS

Section 457 Plans Pose Greater Risk Than Other Supplemental Plans

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The Honorable Nancy L. Johnson
Chairman, Subcommittee on Oversight
Committee on Ways and Means
House of Representatives

The Honorable Sam M. Gibbons
Ranking Minority Member
Committee on Ways and Means
House of Representatives

This report is one of three we are issuing in response to your request that we review the status of public pension plan funding.[1] This report specifically addresses your concerns about the financial security of amounts deferred by participants into state and local government supplemental pension plans.

In this report we discuss how plans established under Internal Revenue Code (IRC) section 457 differ from plans created under IRC sections 401(k) and 403(b) in terms of protection against financial loss and other issues.

As agreed with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 15 days from its issue date. At that time, we will send copies to the Commissioner of the Internal Revenue Service, the Chairman of the Securities and Exchange Commission, and interested congressional committees. Copies will be made available to others upon request.

This report was prepared under the direction of Donald C. Snyder, Assistant Director. Mr. Snyder can be reached on 202-512-7204, if you or your staff have any questions.

Jane L. Ross
Director, Income Security Issues

[1]See Public Pensions: Summary of Federal Pension Plan Data (GAO/AIMD-96-6, Feb. 16, 1996) and Public Pensions: State and Local Government Contributions to Underfunded Plans (GAO/HEHS-96-56, Mar. 14, 1996).

Executive Summary

Purpose

Millions of state and local government employees are taking steps to increase their future retirement benefits by deferring some of their wages to supplemental pension plans, known as salary reduction arrangements or plans. The amounts deferred or contributed to some of these plans, however, may be at risk. Recent media reports have highlighted instances of imprudent investment, improper use of plan funds by sponsors, and possible seizure of plan funds by sponsoring governments' creditors.

Such reports have raised concerns among members of the Ways and Means Committee of the House of Representatives. Accordingly, the Committee asked GAO to determine the risks of financial losses inherent in such plans. GAO was also asked to determine whether the provisions of such plans treat participants comparably.

Background

Salary reduction plans enable participants to defer part of their salary and the taxes normally due to a future date. Among the arrangements utilized by state and local governments to augment regular employee pension plans are three plans authorized under the Internal Revenue Code (IRC) at sections 401(k), 403(b), and 457(b). Employees contribute to these plans through salary deferrals, and some governments make matching contributions. Amounts deferred under these plans and any earnings that accrue on them generally are not subject to federal income tax until they are received, usually upon retirement. The benefits received depend on the amount deferred and any earnings or losses thereon.

The Tax Reform Act of 1986 prohibits state and local governments from establishing any new 401(k) plans after May 6, 1986, although existing plans may continue. Federal law generally limits participation in 403(b) plans to employees of public school systems, including kindergarten through 12th grade; colleges; and universities. In addition, some tax-exempt charitable and other not-for-profit organizations, such as hospitals, may sponsor a 403(b) plan. As a result, most state and local government employees today have only 457 plans available to augment their regular government pension.

These plans have different requirements for deferring taxes because they are derived from separate and distinct tax law theories. Section 401(k) and section 403(b) plans are qualified or qualified-type plans whose purpose is to encourage employers to provide plans for rank-and-file workers to protect their savings for retirement. To be qualified and maintain their tax-favored status, such plans must, in part, satisfy certain federal rules.

These rules limit an employer's ability to exclude rank-and-file employees from a plan and limit the extent to which contributions and plan benefits can vary between highly and nonhighly compensated employees. These rules are known as minimum coverage, minimum participation, and nondiscrimination rules. In qualified and qualified-type plans, the amounts deferred from employees' wages and earnings on these amounts are funded; that is, they are held in a tax-exempt trust or annuity contract or a custodial account (such as mutual funds) for the exclusive benefit of participants and are unreachable by creditors of the sponsor. Any earnings are also tax-exempt until the amounts are paid out.

Section 457 plans, on the other hand, are nonqualified, unfunded deferred compensation plans. These plans are driven by the tax law principles of constructive receipt and economic benefit that require taxation on income, even if some salary is not actually paid to the taxpayer but is deferred. One of the keys to avoiding salary deferrals from being taxed under these principles is that the amounts deferred must remain the property of the sponsoring employer and be available to the general creditors of the employer. Although 457 plans are considered unfunded because salary deferrals are not held specifically for employees, most sponsors invest their employees' deferrals to ensure that funds are available when needed to pay benefits.

Results in Brief

Participants in 457 plans are exposed to greater risk than are participants in section 401(k) and 403(b) plans, because of inherent differences between qualified, funded and nonqualified, unfunded plans. Amounts deferred and any earnings under 457 plans are credited to participants' bookkeeping account balances but are not plan assets maintained solely for the participants' benefit as are deferrals under 401(k) and 403(b) plans. While 401(k) and 403(b) plan deferrals are owned solely by the plan participants, 457 plan deferrals are owned by the sponsoring employer until distribution is made to the participant, generally after retiring or leaving employment. Consequently, amounts deferred under 457 plans may be used by a sponsoring government for nonplan purposes and are subject to the claims of its creditors in the event of bankruptcy.

Participants in 457 plans not only have no ownership interest in amounts deferred under these plans, but they cannot avail themselves of additional benefits provided through qualified, funded plans. Because deferred amounts must remain within reach of the employer's creditors to maintain tax-deferred status, a 457 plan participant who leaves state or local

government employment before retirement may not roll over deferred amounts and earnings to an individual retirement account (IRA) and avoid paying taxes on the distribution. Participants in qualified plans, such as 401(k), and qualified-type plans, such as 403(b) plans, however, can defer taxes by rolling over account balances to IRAs.

In addition, in order to maintain tax-deferred status, participants in 457 plans cannot have continuing control over the date of distribution of deferred amounts. Within a short time after leaving government service, participants must choose a date to begin receiving benefits. Often, this is a date selected for retirement many years in the future. That date, once selected, can seldom be changed. Participants in 401(k) and 403(b) plans are not limited in this way.

Finally, 457 plan participants and their employers are not allowed to contribute as much to their retirement savings plans as are participants in the other two plan types. Moreover, this disparity will continue to grow because the 457 plan contribution limit is not indexed for inflation as are the other two plans' limits. Increasing the maximum amount of contribution along with indexing for inflation would have no impact on the tax-deferred status of 457 plans.

Principal Findings

Sponsoring Government Actions Pose Risk to 457 Plan Deferrals

Because 457 plans maintain their tax-deferred status by requiring that the sponsoring government own the deferred amounts, plan participants may risk the loss of some or all their deferrals if their sponsoring government goes bankrupt or funds are in some way mismanaged or lost. For example, if Orange County, California, is unable to emerge from its current bankruptcy proceeding without providing its general creditors with a settlement under which those creditors receive 100 cents on the dollar, the county's 457 plan participants will be forced to share proportionately in the losses of those general creditors.

Further, because any amounts set aside by the employing governments to pay section 457 plan obligations are owned by the sponsoring governments, some governments may view them as funds available for their own use. IRC section 457 does not prescribe that any 457 plan monies must be maintained to pay future benefits. In late 1992, the Securities and

Exchange Commission (SEC) staff learned that Los Angeles County intended to borrow $250 million from the amount set aside to pay its 457 plan obligations to cover payroll expenses. When SEC questioned this course of action as potentially impairing the status of the funds under the federal securities laws, the county abandoned its proposal.

457 Plan Provisions Disadvantage Participants

Amounts payable from a 457 plan are only portable to other 457 plans. They cannot be rolled over to an IRA as can 401(k) and 403(b) plan funds when an employee leaves state or local government employment. According to IRS officials, changing this feature of 457 plans for state and local government plan participants would create a taxable event under the principles of constructive receipt and economic benefit. Also, 457 plan participants must declare, within a short time after retiring or leaving their employment, the date on which they will begin receiving their benefits. The date is final and can only be changed if an emergency occurs. IRS officials state that this feature of nonqualified, unfunded deferred compensation plans, such as 457 plans, arises because allowing participants the option of changing the distribution date would constitute control over the assets, which is inconsistent with the tax principle that these assets be owned or under the control of the plan sponsor.

Finally, the maximum annual employee deferral and employer contribution to 457 plans is $7,500, about $2,000 less than for participants in 401(k) and 403(b) plans. And because the 457 plan's maximum employee contribution is not indexed to inflation as are the employee deferral maximums of 401(k) and 403(b) plans, the disparity between plans can be expected to grow with inflation. This limit on 457 plan deferrals could be increased by legislative changes and indexed to grow in step with 401(k) and 403(b) plans.

Agency Comments

SEC commended our report and agreed with our conclusions (see app. I). SEC added that if the Congress proceeds with legislation relating to public plans, it should consider the status of 457 plans under federal securities laws. SEC also noted some technical changes that we incorporated where appropriate. IRS also commended our report and provided technical comments and an overview of 457 plans (see app. II). We incorporated IRS' technical comments where appropriate.

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Abbreviations

ERISA	Employee Retirement Income Security Act of 1974
IRA	individual retirement account
IRC	Internal Revenue Code
IRS	Internal Revenue Service
SEC	Securities and Exchange Commission

Introduction

Millions of state and local government employees are supplementing their future retirement benefits by contributing to salary reduction plans called salary reduction or defined contribution arrangements. Such plans enable participants to defer part of their current salary for future use. The goal of these plans is to postpone federal income tax until the amounts deferred from an employee's salary and any earnings or losses thereon are received by the participant at separation or retirement.

All salary reduction plans pose some risk of financial loss from poor investment performance. However, amounts in plans organized under Internal Revenue Code (IRC) section 457(b) (hereinafter referred to as 457 plans) bear additional risk because salary deferrals to 457 plans are assets of the sponsoring employer that may be used for nonplan purposes and which are subject in the event of bankruptcy to the claims of general creditors.[2] For example, one municipality's recent bankruptcy could cause financial losses to employees who participated in its 457 plans. In addition, amounts earmarked to pay another county's 457 plan obligations could have been at risk when the county intended to use those amounts to meet payroll expenses. In that case, the county might not have had the funds available when the time came to pay out the amounts due the 457 plan participants. In both cases, county officials were entitled to use the money saved to pay 457 plan obligations for nonplan purposes. As a result, concerns have been raised about the security of deferrals that participants make from their salary under 457 plans.

Three Types of Salary Reduction Plans

A state or local government may elect to offer its employees, among other retirement plans, a deferred compensation arrangement under IRC sections 403(b), 401(k), and 457(b). In all three types of plans, employees may voluntarily defer compensation through payroll deductions. Federal income tax is postponed until employees begin to receive their account balances, usually at retirement or when they are no longer employed by the plan's sponsor. These three salary reduction plans typically are

[2]Section 457 creates two types of plans, an eligible section 457 plan, as defined in section 457(b), and an ineligible section 457 plan, as explained in section 457(f). All section 457 plans are nonqualified, unfunded deferred compensation plans. Amounts set aside to pay plan obligations must remain the property of the employer and subject to the employer's general creditors. Under an eligible plan, amounts deferred will be includable in gross income only for the taxable year in which the compensation or other income is paid or otherwise made available to the participant or other beneficiary. Plan participants involved in a plan subject to section 457(f), which is not an eligible deferred compensation plan, are subject to immediate tax treatment, which renders all such deferrals on compensation subject to tax for the first year in which there is no substantial risk of forfeiture.

intended to supplement an employer-sponsored qualified pension plan under IRC section 401(a).[3]

In general, 401(k) plans, sometimes referred to as cash or deferred arrangements, are qualified plans that allow employees to choose between receiving current compensation or having part of their compensation contributed to a qualified profit-sharing or stock bonus plan. A 403(b) plan, a qualified-type plan sometimes referred to as a tax-sheltered annuity, is a deferred compensation arrangement that may be sponsored only on behalf of employees of public educational systems and other specific tax-exempt organizations.

Section 457(b) plans are nonqualified, unfunded deferred compensation plans that may cover all employees of a state or local government and certain highly compensated employees of a tax-exempt organization. Such plans permit these employees to defer limited amounts of compensation so that, under the principles of constructive receipt and economic benefit, tax will also be deferred on the amounts plus their earnings until some future event.

Eligibility and the security of deferred amounts vary among the three plan types. Employees of public schools, colleges and universities, and some private institutions exempt from tax under IRC section 501(c)(3), such as hospitals, typically participate in 403(b) plans. Contributions to these plans are generally maintained as an annuity contract[4] or custodial account,[5] both of which are reserved for the sole benefit of the participant and his or her beneficiaries.

Employee deferrals under section 401(k) plans are held in trust for the sole benefit of the participants and their beneficiaries. These participants are primarily employed in the private sector. However, some state and local governments established these plans in the late 1970s and early 1980s

[3]A qualified plan is one that receives special tax advantages by meeting requirements of section 401(a), including certain minimum participation, coverage, vesting, and nondiscrimination rules. Among the tax advantages of a qualified plan is permitting employees to contribute to a tax-exempt trust for their exclusive benefit. Additionally, benefits from a qualified plan are not includable in the gross income of a participant until actually paid.

[4]An annuity contract is a contract between the sponsoring entity and a life insurance company. Contributions and their earnings are paid back to the participant at specified intervals over a period of time after retirement or separation.

[5]A custodial account is an arrangement made by the sponsoring government with a third-party agent who invests the assets.

for their employees.[6] With the enactment of the Tax Reform Act of 1986,[7] state and local government employers who had not previously established 401(k) plans were prohibited from establishing new 401(k) plans, but existing plans could continue. Despite concerns raised by representatives of state and local governments, among others,[8] the rationale for this exclusion was that allowing public employees to have access to both 401(k) plans and 457 plans would be "inappropriately duplicative."[9]

Only employees of and independent contractors providing service to state and local government and tax-exempt organizations may participate in 457 plans. Unlike 401(k) and 403(b) plans that are funded and must comply with the nondiscrimination and minimum participation rules, section 457 plans are unsecured promises of the employer to pay amounts in the future. A section 457 eligible, salary reduction plan requires that all deferred compensation and income shall remain solely the property of the employer and be subject to the claims of the employer's general creditors.[10]

Compliance With Employee Participation Rules

In 1999, 401(k) and certain 403(b) plans must begin testing for nondiscrimination and minimum participation rules. Generally, the nondiscrimination rule requires that benefits or contributions provided under the plan do not discriminate in favor of highly compensated employees. The minimum participation rule requires that the plan benefit at least the lesser of 50 employees or 40 percent of all employees. The minimum coverage rule requires that the percentage of nonhighly compensated employees who benefit under the plan must be at least

[6]IRC section 401(k) did not expressly authorize participation by public employees. However, the Internal Revenue Service (IRS) determined in its General Counsel Memorandum 38283 that public employers could maintain such arrangements and accordingly issued several determination letters approving section 401(k) arrangements established by public employers.

[7]P.L. 95-514.

[8]"The particularly appealing feature of the Section 401(k) plan is that it provides security; not just in the sense that amounts set aside for retirement provide a measure of security, but in the safeguards which the Code provides. Amounts in a Section 401(k) plan are placed in trust and are inviolate. Thus they are not subject to claims of creditors, whether of the employee or the employer. This insures that the employee will get his money when he needs it. In these days of budget deficits and financial uncertainty for some public sector employers, such protection is not to be taken lightly." Statement of Richard B. Dixon, Treasurer and Tax Collector of Los Angeles County, before the Finance Committee, U.S. Senate, July 11, 1985.

[9]Chapter 14.06 of The President's Tax Proposal to the Congress for Fairness, Growth, and Simplicity (Washington, D.C.: Office of the President, May 1985), pp. 363-369.

[10]Participants covered by a plan subject to section 457(f) are subject to immediate tax treatment, which renders deferrals of compensation subject to tax for the first year in which there is no substantial risk of forfeiture.

70 percent of the highly compensated employees who benefit under the plan, or the nonhighly compensated employees in the workforce must receive benefits that on average are at least 70 percent of the benefits received by highly compensated employees. State and local government sponsors of these plans have expressed concern that required compliance with these rules will be burdensome and costly.

Principles of Constructive Receipt and Economic Benefit

Two tax principles, constructive receipt and economic benefit, are often intertwined in matters regarding nonqualified, unfunded deferred compensation. Under the principle of constructive receipt, income is taxable even when an employee has not actually received current compensation, if the compensation is credited to the employee's account, set apart for the employee, or otherwise made available to the employee. The principle of economic benefit, on the other hand, taxes assets that have been unconditionally and irrevocably transferred into a fund for the employee's sole benefit because he or she has received a benefit (that is, some deferred salary) that, although not readily convertible to cash, has an immediate value (that is, a fund for his or her benefit) that is secured from the employer's creditors.

Section 401(k) and 403(b) plans are funded, qualified or qualified-type arrangements where the deferred amounts are placed in trust;[11] that is, set aside for the exclusive benefit of the employees who participate in the plans, secured from an employer's creditors. So that such arrangements would not cause the participants to be taxed under the basic principles of constructive receipt and economic benefit, the Congress overrode these two principles by providing for income to be taxed only when it is distributed.

Section 457 plans, on the other hand, are nonqualified, unfunded deferred compensation plans that follow the basic principles of constructive receipt and economic benefit. Participants are not in constructive receipt of their deferrals because the amounts are not set apart for or otherwise available to them at any time. Participants do not derive the economic benefit of their deferred compensation because the deferred amounts are the property of their employers and subject to the employers' general creditors. Instead, participants have bookkeeping accounts with balances that represent the amount that the employers promise to pay at some

[11]A trust is a fiduciary relation with respect to property, subjecting the person by whom the property is held to equitable duties to deal with the property for the benefit of another person which arises as the result of a manifestation of an intention to create it. See Black's Law Dictionary 1681 (4th ed. rev. 1964).

future time. These account balances are comprised of amounts deferred under the plan and any earnings or losses that would have accrued to those amounts if the account balances had been invested as stated under the plan. Although most employers sponsoring 457 plans invest amounts as necessary so that they will be able to provide the promised benefit when due, there is no requirement for them to do so.

Origins of 457 Plans

In 1972, IRS issued the first of a number of private letter rulings holding that tax may be deferred on employee contributions from salary to a nonqualified, unfunded deferred compensation plan where a state or local government was the employer. Nonqualified, unfunded deferred compensation plans of state and local governments and tax-exempt organizations were not subject at that time to certain restrictions placed on qualified plans: (1) they did not need to comply with nondiscrimination rules applicable to qualified plans; (2) there was no limit on the amount participants could contribute; and (3) participants in nonqualified, unfunded plans, unlike participants in qualified plans, could make tax-deductible contributions to individual retirement accounts (IRA).[12] In 1977, however, IRS stopped issuing private letter rulings on the income tax treatment of amounts deferred under nonqualified, unfunded deferred compensation plans, pending formal review of its position.[13] In 1978, IRS changed its position and published proposed regulations that would have subjected participants in nonqualified, unfunded deferred compensation arrangements to immediate taxation on deferred amounts.[14]

Shortly thereafter, the Congress enacted IRC section 457. The House Ways and Means Committee, which drafted the provision, expressed concern that the proposed IRS regulations would impact seriously on the ability of employees of many states and localities to participate in salary reduction arrangements as a means of providing themselves with tax-deferred retirement income.[15] The Committee stressed that for a plan to be eligible for tax deferral, all amounts deferred and income earned thereon must remain assets of the plan sponsor subject to the claims of its general creditors. Thus, participants

[12]House Comm. on Ways and Means, 95th Cong., 2nd Sess. Rep. No. 95-1445, Aug. 4, 1978, at 52.

[13]IR-1881, September 7, 1977.

[14]43 Fed.Reg. 4638, February 3, 1978.

[15]House Comm. on Ways and Means, 95th Cong., 2nd Sess. Rep. No. 95-1445, Aug. 4, 1978, at 52-53.

"cannot have any secured interest in the assets purchased with their deferred compensation and the assets may not be segregated for their benefit in any manner which would put them beyond the reach of the general creditors of the sponsoring entity."[16]

Requirements for Tax-Deferred Plans

Section 401(k) plans must meet three federal requirements for employee participation to be considered qualified. First, the value of the benefits that highly compensated employees as a group may receive is limited by the value of the benefits the less well paid employees collectively receive; this is the nondiscrimination rule. Second, at least the lesser of 50 employees or 40 percent of all eligible employees[17] must participate in the plan; this is the minimum participation rule. Third, the plan must benefit a percentage of nonhighly compensated employees that is at least 70 percent of the percentage of highly compensated employees benefiting under the plan or the nonhighly compensated employees in the workforce must receive benefits that, on average, are at least 70 percent of the benefits received by highly compensated employees; this is the minimum coverage requirement. Additionally, among many other requirements, sponsoring employers must meet certain nondiscrimination tests and report their annual levels of participation, current assets, and current liabilities.[18]

Tax-sheltered annuities under section 403(b) must meet nondiscrimination rules. Salary reduction deferrals to 403(b) plans must also meet special nondiscrimination rules that are deemed satisfied if all employees defer in excess of $200. Starting in 1997, section 403(b) plans that provide employer matching contributions will have to meet special nondiscrimination rules provided by section 401(m). Starting in 1999, section 403(b) plans that provide nonelective contributions (employer contributions that do not reduce a participant's salary) will be required to meet the nondiscrimination, minimum coverage, and minimum participation rules.

For a 457(b) plan to be eligible for tax deferral treatment, the Congress limited the amount of compensation that may be deferred, but permitted participants to wait until after separation from employment to elect the time and method of payout. However, minimum participation, minimum

[16]House Comm. on Ways and Means, 95th Cong., 2nd Sess.,Rep. No. 95-1445, Aug. 4, 1978, at 55.

[17]Eligible employees are those who have at least 1 year of service, are at least 21 years old, and are working full-time.

[18]State and local governments sponsoring 401(k) plans and those 403(b) plans that provide matching contributions are not required to begin nondiscrimination testing until 1999. Special nondiscrimination rules applicable to these plans under section 401(k) and 401(m) will have to be met starting in 1997.

coverage, and nondiscrimination rules that are a cornerstone for the tax-favored status of qualified, funded plans were not imposed.

Prevalence of State and Local Supplemental Plans

Little information is available on the number of 401(k) and 403(b) plans sponsored by state and local governments or the number of people participating in them.[19] However, a 1993 study of over 400 state and local government general pension plans showed that about 8.4 percent of responding governments sponsored a 401(k) plan and 7.1 percent sponsored a 403(b) plan.[20] In that study, 457 plans were the most frequently used salary reduction plans. About 90 percent of local governments and all 50 states provided their employees access to 457 plans. In 1994, an estimated 1,750,000 people participated in about 10,000 plans sponsored by government entities nationwide.[21]

Recent Legislative Proposals

Several bills have been introduced in the 104th Congress to redesign section 457 plans. For example, H.R. 2491, the omnibus budget reconciliation bill, contained provisions that would require all assets and income of a 457 plan to be held in trust for the exclusive benefit of participants and their beneficiaries.[22] However, IRS officials told us that imposition of such a trust requirement would result in immediate taxation for deferrals to a 457 plan because of the requirements of IRC section 457(b)(6). With respect to section 401(k) plans, another provision of the reconciliation bill would have provided a simplified and less costly alternative method of testing for nondiscrimination requirements under IRC.[23] In separate legislation, under section 14212 of H.R. 2517, which was incorporated into the reconciliation bill and then dropped, state and local

[19]State and local plans are not required to file annual reports with the federal government as are most private plans.

[20]The 1993 PENDAT database contains the results of a nationwide survey of state and local government pension plan administrators. It is sponsored by the Public Pension Coordinating Council. We determined that this study may have underrepresented the percentage of state and local governments that provide their employees access to 401(k) plans. These plans are usually administered and managed separately from the general pension plan and, therefore, respondents to the survey may not have been aware that their government had a 401(k) plan. We also determined that this study may not have identified all of the IRC section 403(b) plans in operation because such plans generally are not administered by the state and local government units that responded to the survey. Instead, 403(b) plans tend to be administered by the individual institutions, such as public school systems, colleges, universities, and tax-exempt IRC section 501(c)(3) organizations.

[21]Access Research Corporation, Windsor, Connecticut.

[22]Section 11458 of H.R. 2491, vetoed by the President on Dec. 6, 1995.

[23]Section 11019 of H.R. 2491.

governments and tax-exempt organizations would have been extended the eligibility to provide 401(k) plans to their employees.

Objectives, Scope, and Methodology

In response to concerns about financial losses to state and local government supplemental pension plans, the House Ways and Means Committee asked us to examine the nature and security of such plans. After discussions with Committee staff, we agreed to determine (1) whether amounts held in state and local government salary reduction plans or otherwise promised to participants inherently are at risk of financial loss to the participants and (2) how statutory provisions comparatively treat participants in these plans.

To determine how the plan provisions affect financial risk, we interviewed representatives from IRS and Securities and Exchange Commission (SEC) staff. In addition, we discussed the risk of financial loss relative to plan provisions and whether the provisions treat participants comparably with representatives of the Government Finance Officers Association; the International City/County Managers Association-Retirement Corporation; the National Association of Counties; the National Council on Teacher Retirement; the National Association of Government Deferred Compensation Administrators; and the Nationwide Insurance Company and its subsidiary, the Public Employees Benefit Service Corporation.

To determine how state and local government plans are generally administered, we contacted plan administrators in Alabama, California, Connecticut, Florida, Georgia, Michigan, Minnesota, Mississippi, Nebraska, New Jersey, Ohio, Oklahoma, Tennessee, Texas, and Wisconsin. We selected these states on the basis of information they reported on their 457 plans in the 1993 PENDAT database. We focused our review on 15 states and on eight counties in California. We selected these counties because of the Committee's concerns about the impact of the Orange County, California, bankruptcy on 457 plans sponsored by other California counties.

We conducted our work from January 1995 through January 1996 in accordance with generally accepted government auditing standards.

Sponsoring Government Actions May Pose Risks for 457 Plans

The statutory requirements that provide for tax deferral for 457 plans also place the assets held to pay participants' benefits at risk of loss from creditors of the government sponsor in the event of a bankruptcy and, unless the sponsor provides for a rabbi trust, from the government's using them for other than plan purposes. Two 457 plans in California illustrate these risks. In one case, a county filed for bankruptcy protection, which put amounts set aside to pay the county's obligations under its 457 plan at risk of being used to satisfy the county's creditors. Because participants in 457 plans have no greater rights of their employer than general, unsecured creditors, such actions could reduce the amount participants otherwise would receive from the plan. In the other case, a county government intended to use amounts it set aside for its 457 plan obligations to meet payroll expenses. However, if the amounts held for 457 plan purposes had been placed in a rabbi trust—as permitted for all nonqualified, unfunded deferred compensation plans—they may have been protected from use for nonplan purposes by the sponsor but not from a sponsor's creditors.

Bankruptcy Threat to Orange County 457 Plan

Orange County kept its tax revenues in an investment pool managed by its treasurer and that permitted investments from cities, municipalities, and political instrumentalities outside Orange County. The county regularly contributed deferrals to the pool to assist it in meeting its obligations under this plan. The 457 plan provides that the experience of the investment pool will be used to determine the final amount due participants when they separate from service or retire. Thus, participants' bookkeeping accounts are credited at specified intervals with the interest, gains, and losses realized by the investment pool.

From July to December 1994, the investment pool sustained heavy losses. This resulted in both the pool and Orange County filing for Chapter 9 bankruptcy on December 6, 1994. On May 2, 1995, the state Bankruptcy Court approved a comprehensive settlement of the pool's bankruptcy case. Under this court order, Orange County received amounts from the pool at a rate that was lower than 100 percent of its claims.

No participant funds were used to pay pool creditors and the participants had no standing as claimants in the pool bankruptcy. The participants are general, unsecured creditors of Orange County only—not of the investment pool. However, Orange County's claim against the pool included a claim for amounts it invested there so that funds would be available as needed to pay its yet unmatured obligations under the 457 plan.

Technically, because performance of the pool serves as a measure used to calculate returns for the 457 plan, the investment loss that occurred in the pool would normally affect the account balances of plan participants. As of March 1996, the bankruptcy in Orange County is still ongoing. It is possible that all creditors may eventually be paid 100 percent of their claims and that participants in the 457 plan that invested in the pool may have their account balances fully restored. Administrators of the 457 plan told us that the bookkeeping accounts for each participant would be credited with interest, but all accounts have been reduced 10 percent for losses on investments in the pool.

Los Angeles County Intended to Use Deferred Amounts for Payroll Expenses

In 1992, Los Angeles County intended to borrow $250 million of amounts deferred under its 457 plan to make payroll payments. SEC staff learned of Los Angeles County's intentions and questioned the proposed action as potentially impairing the status of the plan under the federal securities laws. The SEC staff asserted that borrowing amounts set aside to pay the county's obligations under its 457 plan for any reason other than satisfying obligations to the locality's general creditors would conflict with representations made earlier to the SEC staff. These representations had been made in connection with a request by the insurance company that operated the separate accounts for participants when it sought the SEC staff's no-action assurance that the separate accounts and the interests therein did not need to be registered under federal securities laws.[24] The SEC raised concerns that the disposition of the assets needed to pay the county's obligations under the plan as proposed by Los Angeles County conflicted with the representations made in seeking the no-action letter.

As a result of both SEC's questioning and media reports accusing local officials of wrongdoing, the county created a new investment option under its plan in the form of a loan fund, offering at least a 6-percent return over 15 years. A few participants agreed to have their deferrals treated as though invested in the fund and the county was able to raise $19 million of the $250 million it originally intended to borrow. We note, however, that SEC does not regulate 457 plans and its ability to influence the operation of 457 plans is limited to instances in which an unregistered collective trust or separate account seeks to rely on certain exemptions from federal

[24]The no-action process is an informal procedure whereby the public may obtain the informal views of SEC staff on proposed transactions that appear to raise issues under applicable federal securities laws and the rules thereunder. No-action requests were filed by a number of banks and insurance companies that wanted to offer collective trust funds or separate accounts to 457 plans without registration of the funds/account or the interests in them under federal securities laws.

securities laws in order to hold funds earmarked to pay a 457 plan obligation.

Although the county chose not to do so, it could have simply used the assets without paying interest on their use because statutory provisions governing section 457 mandate that amounts deferred remain the property of the employer. There is no requirement that sponsoring governments actually invest amounts participants have deferred or credit their deferrals with interest earned. Instead, the governments are only responsible for making payments to participants under the terms of the plan, usually when they retire or change jobs. The terms of the plans usually provide that the amounts deferred will be treated as though they were invested in some identified asset or fund and that the benefit paid will include earnings that would have accrued on those amounts had they been so invested as well as any gains or losses that might have been experienced had the amounts been so invested. Although it is not required under section 457, sponsors and administrators normally make the actual investments referenced under the arrangement to insure that they will have the amounts necessary to meet their 457 plan obligations. Notwithstanding this normal administration of 457 plans, 457 plan deferrals can never be invested solely for the benefit of the participant. They must always be available to the general creditors of the employer. Also, unless amounts set aside by the employer to meet its obligations are placed in a rabbi trust, these assets may be used for nonplan purposes.

A Rabbi Trust May Provide Some Protection

Under IRC, 457 plans have a means to restrict a government's nonplan use of amounts deferred to 457 plans—the rabbi trust.[25] Under such a trust, the plan sponsor typically has no access to the funds but in an insolvency or bankruptcy, such funds can be reached by the general creditors.[26] If the deferrals held by Los Angeles County for its 457 plan had been placed in a rabbi trust, the county may not have been in a position to use them to meet its payroll. However, a rabbi trust arrangement would not have protected Orange County employees, because that government declared bankruptcy.

[25]The trust is so named because the first such arrangement was established by a synagogue for the benefit of its rabbi. IRS Prv. Ltr. Rul. 81-13-107 (Dec. 31, 1980). IRS will rule favorably only on the model rabbi trust set out in Revenue Procedure 92-64, 1992-2 C.B. 11.

[26]Insolvency is defined in section 3(a) of the Model Rabbi Trust as: (i) the government being unable to pay its debts as they become due or (ii) the government being subject to a pending proceeding as a debtor under the U.S. Bankruptcy Code.

Provisions of 457 Plans Disadvantage Participants

Section 457 plans are substantially different from 401(k) and 403(b) plans. In addition to the differences discussed in chapter 1, these plans have limited portability and in some cases participants in 457(b) plans must irrevocably select a date to begin receiving their benefits. In addition, participants cannot defer as much as participants in 401(k) or 403(b) plans.

Participants' 457 Plan Benefits Have Limited Portability

Participants in 457 plans who leave their government employer before retirement are restricted in their ability to move the amounts in their 457 plan accounts to a funded tax-sheltered account. The plan accounts can only be transferred to another eligible 457 plan if the new government employer will accept the transfer. Amounts deferred under section 457 cannot be rolled over to an IRA and have tax deferred on the distribution as can 401(k) and 403(b) plan funds. Participants in 457 plans who leave government service and do not have another 457 plan that they can transfer their bookkeeping accounts to have only two options: (1) commence immediate payment of benefits and pay income tax on the distribution or (2) defer the commencement of benefits to any date in the future that is before they turn 70-1/2 years old. IRS officials told us that under current law, allowing nonqualified, unfunded deferred compensation amounts to be transferred to an IRA makes the amounts immediately taxable to the participant because any distribution, even to an IRA, results in the participant having an economic benefit in the funds and being in constructive receipt of the money. The mere promise of the employer to pay will have been fulfilled. Additionally, under the qualified plan rules, a transfer of nonqualified, unfunded plan amounts into a qualified, funded plan could disqualify the qualified plan and make funds in it immediately taxable to the participants.

Date That Benefits Begin Is Irrevocable

If a participant cannot transfer the deferred amounts to another 457 plan or chooses not to do so, he or she must, after leaving employment, select a date to begin receiving benefits. Selecting the date may be difficult because the employee's retirement date may be years in the future. Moreover, once selected, this date cannot be changed, except for emergencies. In contrast, separating participants in 401(k) and 403(b) plans are not required to declare a date for benefits to begin. These participants may begin collecting their benefits at any time after turning 59-1/2 years old. IRS officials said that the tax principle of constructive

receipt would be compromised if participants in 457 plans were permitted to change the date previously selected for receiving benefits.[27]

Maximum Annual Deferrals Allowed Are Lower

The maximum annual amount that employees may defer and employers may contribute is lower for 457 plans than for the other two plan types. For example, the maximum allowable employee deferral to a 457 plan is $7,500,[28] a limit that is about $2,000 lower than the limits of the other two tax-deferred plans. In 1995, the maximum employee deferral to a 401(k) plan was $9,240, and deferrals to a 403(b) plan could not exceed $9,500.

Although employees can defer no more than $7,500 under a 457 plan, this does not include employer contributions to another plan, usually the employers' regular or basic pension plan. Employers sponsoring 401(k) or 403(b) plans can make annual contributions of no more than $30,000.

Moreover, the tax-free deferral limit of a participant in 401(k) and 403(b) plans is reduced if the participant also defers any amounts under a 457 plan.[29] The maximum total deferral a participant can make to a 401(k) or 403(b) plan is governed by the maximum deferral allowed under section 457 when a participant actually makes deferrals under a 457 plan. That is, total deferrals by participants contributing to both a 457 plan and one of the other two plan types cannot exceed $7,500. Thus, any deferrals, even if it is only $1, made to a 457 plan, limits the maximum annual deferral the participant can make to a 401(k) or 403(b) plan to $7,500. Additionally, any employer contribution to a 457 plan will limit the deferral the employee can make under a 401(k) or 403(b) plan to $7,500.

Maximum Annual Deferral Cap Is Not Indexed

When the Congress enacted IRC section 457 in 1978, it set the annual deferral limit at $7,500, an amount that exceeded the $7,000 deferral limit set for 401(k) plans in 1986. However, the 401(k) plan limit was indexed for inflation, and the 457 plan limit was not. In time, the 401(k) limit surpassed the 457 limit. Section 403(b) limits will be indexed for inflation

[27]As noted in chapter 1, income is taxable even when an employee has not actually received compensation, but could have elected to receive the compensation after it has been earned. The constructive receipt doctrine limits the extent to which a taxpayer can time the inclusion of amounts into gross income once those amounts have been earned.

[28]This limit refers only to the maximum annual amount an employee may defer from his or her pay. It does not refer to the $15,000 catch-up provision included in section 457, which allows participants to make a deferral of up to $15,000 during the 3 years prior to retirement. They may do so only to the extent that they did not defer income at the maximum annual deferral limit in past years.

[29]The interaction of these deferrals is coordinated through section 457(c).

when the 401(k) limit reaches $9,500, the current deferral limit for 403(b) plans.

Over time, inflation will continue to reduce the section 457 deferral limit relative to earnings, and the maximum percentage of income participants will be able to defer will decrease. For example, using an average annual inflation rate of 4 percent, 10 years from now the deferral limits for employee contributions in the other two plans will be $13,677, $6,177 more than the current section 457 limit.

IRS officials said that the limit on deferrals and the lack of a cost-of-living adjustment, as in sections 401(k) and 403(b), could be changed by the Congress without compromising either the nature of 457 plans as nonqualified, unfunded plans or the tax principles of constructive receipt and economic benefit. Any such changes to section 457(b) would, however, cause a tax revenue loss in the future if participants took advantage of higher deferral limits.

Summary and Conclusions and Agency Comments

With enactment of IRC section 457 in 1978, the Congress specifically authorized a tax-deferred, nonqualified, and unfunded compensation plan to enable employees of state and local governments to provide themselves with additional retirement income. The Congress' action had been prompted by proposed IRS regulations that would have subjected all nonqualified, unfunded deferred compensation amounts to immediate taxation. Eight years later, in the belief that 457 and 401(k) plans offered duplicative benefits, the Congress excluded state and local employers from establishing new 401(k) plans for their employees.

As a nonqualified, unfunded deferred plan, however, section 457 provides significantly less protection for plan participants compared with qualified, funded deferred plans such as 401(k) and 403(b) plans. Until recently, there was little or no evidence that greater protections were needed; however, events in Orange and Los Angeles Counties have posed possible financial risks to participants' deferred amounts in 457 plans that suggest greater protections may be needed.

Section 457 plan participants voluntarily forego current income in order to provide for themselves in their retirement years. Yet the money that these participants forego is at risk. This is because 457 plans are nonqualified, unfunded deferred plans that require that the amounts deferred may not be set aside for the exclusive benefit of the employee but must remain the property of the employer, subject to the claims of the employer's general creditors. To date, the use of the Orange County Investment Pool to calculate how amounts deferred under its 457 plan are to be treated as invested has resulted in financial paper losses that ultimately may affect county employees' retirement benefits. Los Angeles County intended to use funds of its plan to meet its payroll. Under current law, potential bankruptcies and financial difficulties of other state and local governments pose similar risks to the salary deferrals that employees have made under 457 plans.

Apart from the greater risk to plan participants, as compared with other salary reduction plans, employees who participate in 457 plans are treated differently from those in 401(k) and 403(b) plans. For example, as a result of IRC provisions, the maximum annual amount that may be deferred under an eligible 457 plan is notably less than the maximum annual amount that may be contributed to 401(k) and 403(b) plans. Further, those deferred amount limits are not indexed for inflation. This is particularly noteworthy because a 457 plan is often the only deferred compensation plan available

to most state and local employees to supplement their regular government pension.

Other disadvantages occur because of differences between nonqualified, unfunded and qualified, funded plans. For example, participants who leave employment before retirement have limited portability for their funds. Participants transferring to another state or local government may transfer account balances in a 457 plan to another 457 plan only if their new employer will accept that transfer and their old employer permits transfers. In lieu of such a transfer, participants leaving state or local government who choose to withdraw their 457 plan amounts are subject to immediate taxation. No legal barrier exists under the principles of constructive receipt and economic benefit for raising the limits that participants could defer or for indexing the limits for inflation. However, changes to portability would not comport with these two principles.

Given the risk of financial loss associated with deferrals under 457 plans, imposing a rabbi trust requirement, where a plan sponsor could not use such amounts for its own interest, would not be successful in fully assuring the security of these funds for plan participants. Such a trust requirement would not preclude a bankruptcy court from securing such funds for the general creditors of the state or local government employer. Moreover, a trust may not be successful in barring an employer's creditors access to these funds, for example, if an employer experiences a temporary liquidity shortfall or financial insolvency. Thus, the existence of a rabbi trust would not have eliminated the risks posed by events in Orange County and may not have eliminated risks of nonplan use in Los Angeles County. However, under the tax theories that drive section 457 and other nonqualified, unfunded deferred compensation plans, any trust that would not subject its assets to the claims of the employer's creditors and would provide the participant an unconditional and irrevocable right to receive the deferred amounts in it would create an immediate—not a deferred—tax liability for the employee. The complexity of IRC makes amending section 457 very difficult, as proposed in H.R. 2491, for example, because of the many ways section 457 dovetails with other provisions.

Agency Comments and Our Evaluation

SEC provided written comments on a draft of this report (see app. I). SEC found the report informative and said that it would serve as a reference for SEC staff as they consider section 457 issues. SEC said it agreed with our recommendation that the Congress amend IRC section 401(k) to permit state and local governments to establish 401(k) plans. We did not

recommend that the Congress make such an amendment; rather we concluded that addressing all the problems with section 457 plans that we identified merely by amending IRC section 457 would be difficult. SEC added that if the Congress proceeds with legislation relating to public plans, it should consider statutory changes to clarify the status of 457 plans under federal securities laws. SEC said all qualified plans are now exempt from SEC regulation. Those governmental plans, as defined in IRC section 414(d), that are established for the employees' exclusive benefit and which cannot be used by the employer for other purposes (exclusivity and impossibility requirements) are exempt. SEC staff told us that they have received numerous inquiries with respect to whether 457 plans also may be considered exempt under federal securities laws, although IRC prevents 457 plans from meeting the exclusivity and impossibility requirements. SEC also noted some technical changes that we incorporated into our report where appropriate.

IRS also provided written comments on a draft of this report (see app. II). IRS made several general comments primarily concerning technical terms. IRS pointed out the distinction between the tax-favored status of 401(k) plans and the tax-deferred status of 457 plans. We clarified these differences throughout the report. IRS emphasized the fact that 457 plan deferrals may be treated as invested in a certain way, but in fact there is no requirement to invest such amounts. As a result, if the sponsor becomes insolvent, the rights of participants in a 457 plan are no greater than other general, unsecured creditors. IRS also pointed out that most state and local governments have basic pension plans for employees and 457 plans are additional plans. We refer to them as supplemental plans to reflect this relationship. IRS suggested that we should clarify that only state and local governments can offer nonqualified plans to their rank-and-file employees, which we did. IRS clarified some features of rabbi trusts that we did not include in the report, though the major feature of a rabbi trust—the inability of the sponsor to have access to the assets therein—is the focus of chapter 3. IRS also made technical comments that we incorporated into our report where appropriate.

Comments From the Securities and Exchange Commission

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

DIVISION OF
INVESTMENT MANAGEMENT

February 16, 1996

Ms. Jane L. Ross
Director, Income Security Issues
General Accounting Office
Health, Education and Human Services Division
Washington, DC 20548

Dear Ms. Ross:

See pp. 8-15.

We appreciate the opportunity to comment on the General Accounting Office's draft report entitled "Public Pensions: Section 457 Plans Pose Greater Risk Than Other Supplemental Retirement Plans" (GAO/HEHS-96-38). We found the report most informative and commend you and your staff on its thoroughness. The report will, among other things, serve as an ongoing and important reference tool for the staff of the Securities and Exchange Commission as we consider issues regarding Section 457 plans that may arise under the federal securities laws. Particularly useful is the comparison detailed in the report between Section 457 plans, which are supplemental retirement plans offered to public employees, and Section 401(k) plans, which serve a similar purpose for employees in the private sector.

See pp. 22-23.
See comment 1.

The report's principal conclusion is that a Section 457 plan's assets could be subject to a risk of loss in the event the governmental entity sponsoring the plan becomes insolvent or bankrupt. The report notes that Section 401(k) plans assets, in contrast, must be placed in trust for the exclusive benefit of employee participants, and therefore are not subject to this type of risk. The report suggests that public plan participants should be afforded the same protections as Section 401(k) plan participants and, thus, recommends that Congress consider amending Section 401(k) of the Internal Revenue Code to permit state and local governments to establish 401(k) plans.

We agree as a matter of policy with the report's recommendation. While the recommendation, if implemented, would not eliminate the risk of loss of assets held in existing Section 457 plans, it would provide public employers with the opportunity to offer their employees a supplemental retirement plan the assets of which are afforded greater protection than assets currently held in Section 457 plans.

We offer one substantive comment on the report. Whereas Section 401(k) plans clearly are exempt from registration and regulation under the federal securities laws, Section 457 plans have sometimes raised difficult interpretive issues under those laws. We would recommend, therefore, that if Congress proceeds with legislation relating to public plans, it also consider statutory changes that would clarify the status of Section 457 plans under the federal securities laws, particularly the Securities Act of 1933 and the Investment Company Act of 1940.

See comment 2.

We have marked on the enclosed copy of the draft report technical changes that principally are designed to set out in greater detail the nature of the Commission's role with respect to the operation of Section 457 plans. As we have discussed with you previously, that role is limited to assessing whether the plans and pooled vehicles in which they invest are subject to registration and regulation under the federal securities laws.

Please contact Jack W. Murphy, Associate Director and Chief Counsel of the Division of Investment Management, at (202) 942-0660 if you have any questions regarding our comments. I respectfully request that this letter be appended to the final report delivered to Congress.

Very truly yours,

Barry P. Barbash
Director

The following are GAO's comments on the SEC letter dated February 16, 1996.

GAO Comments

1. Deferrals under section 457 could be at risk of loss in the event of a sponsor's insolvency, and our review and IRS officials' statements led us to conclude that fixing this problem, as the Congress proposed to do, cannot easily be accomplished merely by amending section 457. While some of the disadvantages of section 457 plans, such as lower deferral limits, indexing of the limits, and imposing a rabbi trust requirement (which is a grantor trust owned by the employer) could be altered by legislation without contradicting tax principles, other changes, such as a funded trust whose assets are set aside from the claims of the employer's creditors and are held for the exclusive benefit of participants, portability, and the date of benefit receipt, could not be accomplished within the context of nonqualified plans.

SEC recommended that the Congress make statutory changes to clarify the status of 457 plans under federal securities laws, if it proceeds with legislation relating to these plans. We do not comment on this recommendation in this report, as it is outside the scope of our review.

2. SEC also made technical comments on the draft of this report that clarified its role with respect to 457 plans, which we incorporated.

Comments From the Internal Revenue Service

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

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

OFFICE OF
CHIEF COUNSEL

MAR 1 1996

Ms. Jane L. Ross
Director, Income Security Issues
Health, Education and Human Services Division
General Accounting Office
Washington, D.C. 20548

RE: Public Pensions: Section 457 Plan Assets at Greater Risk Than Those of Similar Plans (GAO/HEHS-96-38) - DRAFT
RECEIVED BY LETTER DATED: January 19, 1996

Dear Ms. Ross:

On behalf of the Commissioner, this responds to your request for written agency comments on the above-captioned GAO report that compares salary reduction plans available to employees of state and local governments under sections 401(k), 403(b), and 457(b) of the Internal Revenue Code ("Code").

See pp. 36-33.
See comment 1.

The Commissioner commends the GAO on this report identifying many of the distinctions among the various salary deferral arrangements that may be offered by state and local governments. We have enclosed at Appendix I a brief historical overview that may be useful. The technical comments contained in this letter are offered with a view toward clarification. Solely for your convenience, we have enclosed, at Appendix II, our work copy of your report so that you might more easily identify the place in the text where technical clarification might prove useful.

Our general comments relate primarily to terms of art. We believe confusion may be avoided by slightly altering certain terms. Additionally, some comments concern section 457 and other unfunded plans, rabbi trusts, and technical mark-ups in our work copy of the report concerning, among other things, certain requirements that attach to qualified, funded plans and funded tax-sheltered annuities.

See pp. 11-12.

Terms of Art

The report correctly identifies qualified and qualified-type funded plans as tax-favored plans and explains that special rules, such as the rules concerning nondiscrimination, are required in order for these plans to obtain and maintain their tax-favored status. The tax-favored status of these funded plans occurred because Congress wanted to encourage employers to adopt secure retirement plans that covered rank and file workers and, to this end, used its authority to override fundamental tax law principles of constructive receipt and economic benefit. The

report also correctly explains that these principles (constructive receipt and economic benefit) do apply to nonqualified, unfunded deferred compensation plans. Because nonqualified, unfunded plans, such as section 457 plans, are governed essentially by these general tax law principles, they are generally not considered "tax-favored." We suggest the term "tax deferred" rather than "tax-favored" be used to describe nonqualified, unfunded deferred compensation plans.

In a similar vein, the words "contribution" and "fund" are terms of art in the world of deferred compensation. "Funding" occurs when amounts are "contributed" to a plan that sets those "contributions" aside from the claims of creditors. Under the concept of economic benefit, funding means amounts have been set aside from the claims of the employer's creditors and the employee is in actual receipt of a current economic benefit. Nonqualified, unfunded deferred compensation plans work to defer tax because nothing has been paid or made available to the participants. All a participant receives is a promise to be paid. Thus, there are no funds or contributions with respect to nonqualified, unfunded deferred compensation plans. Rather, amounts are deferred under the plan and an employer may, at its discretion, set aside amounts to assist it in meeting its obligations under the plan. Since, technically, there are no "funds" in an unfunded plan, there can be no withdrawal or borrowing of funds from such a plan.

See pp. 13-14.

Another term of art is the phrase "qualified plan." This refers only to plans that meet the requirements of section 401(a) and includes section 401(k) plans. There is no requirement that section 403(b) tax sheltered annuities meet the requirements of section 401(a). Thus, section 403(b) tax sheltered annuities are not referred to as qualified plans.

457 and Other Unfunded Plans

See pp. 12-13 and 17-18.

We wish to emphasize the fact that in a nonqualified, unfunded plan, where deferrals are treated as invested in a certain way but there is no requirement to invest actual amounts, mismanagement of investments will not lead to a loss of benefits. The amount of benefit due will be the amount of salary deferred adjusted by earnings and losses attributed to the deferred salary AS IF the deferred amounts had been invested as prescribed by the plan. Even if an employer never invested the amounts deferred and no earnings were actually received on the amounts deferred, if the plan so provides, the account balance due under the employer's promise to pay would be the total of the amounts deferred and the earnings that would have accrued to those amounts if they had been invested.

We note, however, that if a financially strapped employer has not prepared to meet its nonqualified, unfunded plan obligations and if those obligations come due at a time when the employer cannot meet them, the employer will be deemed insolvent. In that event, the rights of a participant will be no greater than other general unsecured creditors of the employer. It is only in these insolvency and bankruptcy situations that the participants are at risk.

See comment 2.

We wish to clarify that most state governments have qualified, funded plans to which they contribute on behalf of their employees and to which employees may contribute under the section 414(h) pick-up provisions. Section 457 works in addition to those plans. Thus, section 457 plans are generally not the only plans available to all of these employees. As a result, the maximum amount contributed toward retirement between both the employer and the employee can well exceed $7,500. It would be more appropriate to describe section 457 plans as additional benefit plans similar to the excess benefit plans provided for executives who often wish to defer more than can be deferred or has been deferred under their qualified, funded plans.

See pp. 10-11.

It might be helpful if your report indicated that both taxable and nontaxable employers may provide nonqualified, unfunded deferred compensation plans for their executives but only state and local governments may provide these plans for their rank and file employees. With regard to executives providing services to taxable entities there is no limit on the amounts that may be deferred under these plans. The purpose of section 457 is to limit the amounts that employees of state and local governments and tax-exempt organizations can defer under nonqualified, unfunded deferred compensation plans, since the denial of a compensation deduction to a nontaxable entity until an amount is includible in the income of the person providing services does not act as a restraint on the amounts that nontaxable entities are willing to let employees defer, as it does when a taxable entity is involved. Section 457(f) prescribes the results for plans when the section 457(b) deferral limit is exceeded.

See p.8, fn. 2.

Rabbi Trusts.

See p. 18, fn. 25.

With respect to rabbi trusts, you may be interested in the fact that although there are many different trust documents that can be drawn to provide the security sought of a rabbi trust, there is only one document on which the Service will rule favorably. That is the model rabbi trust set out in Revenue Procedure 92-64, 1992-2 C.B. 11. Under the model rabbi trust, if the trust is made irrevocable, as most are, the employer will have no access whatsoever to amounts in the trust. Only the creditors of the employer will be able to reach those amounts.

See pp. 14-15.

See pp. 13-14.

- 4 -

Jane L. Ross

We note that on page 4 of chapter 4, a footnote to the discussion on rabbi trusts refers to section 11458 of H.R. 2491 where Congress proposed requiring the funding of eligible 457 plans. We would like to clarify that the full funding proposed by Congress is very different from the use of a rabbi trust. A rabbi trust is considered a grantor trust owned by the employer and, thus, is significantly different from a funded trust with assets set aside from the claims of creditors of the employer for the purpose of securing participants' section 457 plan interests.

Technical Mark-ups.

The report summarizes various requirements, such as the nondiscrimination rules, that attach to qualified, funded plans and funded tax-sheltered annuities. These requirements pose very complex issues both in what they require and when they are required. Rather than burden you with a detailed explanation of these intricate issues, we have provided you with broad language describing these requirements on our enclosed marked-up copy of the report. The footnoted descriptions of qualified plans, eligible section 457 plans and ineligible section 457(f) plans have been similarly marked up.

We hope you find these comments useful in making technical clarifications to you report. If you have any further questions, please feel free to contact Judy Alden at 622-6030.

Sincerely,

Mary Oppenheimer

MARY OPPENHEIMER
Assistant Chief Counsel
(Employee Benefits and
Exempt Organizations)

Enclosure

cc: Donald Snyder, Assistant Director, GAO
Amanda Michanczyk, Legislative Affairs

Appendix I

Public Pensions: **Section 457 Plans Pose Greater Risk Than Other Supplemental Retirement Plans (GAO/HEHS-96-38): Draft received by letter dated January 19, 1996**

Historical Background

We commend the GAO for this report clarifying a number of important distinctions among various salary deferral arrangements used by employees of state and local governments to augment their basic employer provided pension benefits. These arrangements include: (1) qualified, funded cash or deferred arrangements defined in section 401(k) that are available through most taxable employers but only available through those state and local governments that adopted them prior to 1986; (2) funded tax sheltered annuities described in section 403(b) that are available only through a limited segment of nontaxable employers; and (3) nonqualified, unfunded deferred compensation plans defined in section 457 that are available to all state and local governments, as well as nontaxable employers.

As the report states, section 457 plans provide less security than section 401(k) and section 403(b) plans because section 457 plans are driven by fundamental tax law theories rather than the special policy considerations that support the tax-subsidy granted qualified and qualified-type funded plans. The tax law principles driving section 457 require that, under section 457, an employee deferring current compensation can receive no more than a promise to be paid in the future and that the amounts deferred must remain the property of the employer, subject to the claims of the employer's creditors. Thus, amounts deferred under nonqualified, unfunded plans are always at risk in the event of the employer's insolvency. Conversely, under the policy considerations that provide the tax-subsidy granted in sections 401(k) and 403(b), deferrals by employees must be set aside for the exclusive benefit of the employees, so that the employees are assured they will receive their plan benefits in the future. The following historical information is provided to highlight the differences between qualified, funded and nonqualified, unfunded plans.

The Employee Income Retirement Security Act of 1974 (ERISA) was enacted to encourage employers to maintain safe and secure pension plans covering rank and file workers as well as executives. Under ERISA, employer contributions to a qualified plan (a plan that meets the requirements of section 401(a) of the Code) are set apart from creditors (funded), invested through a tax-exempt trust, and, although the taxable employer receives a deduction for contributions to the trust, the participant is not taxed on either the contributions or the investment growth

attributable to the contributions until those amounts are actually paid to a participant. To qualify for this tax-favored treatment, Congress has required that a plan meet stringent requirements ensuring broad coverage and benefits for rank and file workers. These requirements include nondiscrimination, minimum participation and minimum coverage rules. To limit the extent of the tax subsidy provided by these plans, Congress has also limited the maximum annual amount that may be deferred under these plans, generally to $30,000, as well as the maximum amount that may be paid out through these plans.

Section 401(k) and section 403(b) arrangements are developments in the qualified, funded plan area that permit employees to make elective salary reduction deferrals to the extent that their employer has not already contributed the maximum annual amount permitted under the qualified plan rules. However, because the primary policy under ERISA is to encourage employers, rather than employees, to provide retirement benefits for workers, the amount employees may contribute to these plans is less (currently about one-third) then the maximum annual amount permitted to be contributed to a participant's qualified plan account balance. Section 401(k) and 403(b) plans function like employer funded qualified plans in that they provide the special tax-subsidized benefits of funding and tax-free growth if they meet requirements designed to ensure that the benefit of being able to make salary deferrals to the plan will be equitably distributed between both highly compensated workers and nonhighly compensated workers.

Because of a special exemption contained in ERISA, if highly compensated employees in either the taxable or nontaxable sector wish to set aside more for their retirement than is allowed under the qualified plan rules, they may do so through nonqualified, unfunded deferred compensation plans. Another exemption found in ERISA permits state and local governments to set up these nonqualified, unfunded plans for their rank and file workers as well as for their executives. Generally, state governments use these plans to augment benefits they pay under their qualified, funded plans.

Nonqualified, unfunded deferred compensation plans are not tax subsidized plans, as are 401(k) and 403(b) plans. Rather, they are plans designed to avoid the fundamental tax law principles of constructive receipt and economic benefit. These concepts provide for taxation of amounts that have not actually been paid if those amounts are available to the taxpayer or if the taxpayer has received a beneficial interest in assets set aside exclusively for him. To avoid being in constructive receipt of wages, an employee can elect to defer unearned wages to a set future date, so long as the employee receives no more than an unsecured promise from the employer that these amounts will be paid at that predetermined future time. To avoid being

taxed on deferred amounts under the economic benefit doctrine, the amounts deferred cannot be set aside for the exclusive benefit of the employee. Thus, under a nonqualified, unfunded deferred compensation plan, the employee receives no more than a mere unsecured promise of the employer and any amounts deferred remain assets of the employer that are available to the employer's creditors.

In the taxable sector, earnings on amounts deferred by executives under a nonqualified, unfunded deferred compensation plan are taxable to the employer with no corresponding deduction until the deferred compensation is paid or made available to the employee. This creates a natural tension between the employer and the executive that may limit the amount an employer will permit executives to defer. This tension is absent in the nontaxable sector because the amounts deferred belong to the nontaxable employer and thus do not create an employer tax liability.

Congress enacted section 457 to limit the amount that may be deferred by employees of state and local governments since the tension to limit deferrals does not exist in that context. Section 457 provides that an eligible nonqualified, unfunded deferred compensation plan of a state or local government (or a tax-exempt organization) can defer taxation only if, among other things, the participant is limited in the amount that may be deferred. If a participant is not limited as prescribed by section 457(b), the plan will be an ineligible plan. A participant deferring amounts under an ineligible plan will be taxed on those deferrals in the year the amounts are deferred unless rights to the deferred compensation are conditioned upon the future performance of substantial services.

Accordingly, the primary distinction between qualified, funded plans and nonqualified, unfunded plans is that amounts in qualified, funded plans are paid out to trusts that are created to protect these amounts from claims of the employer's creditors by the employer. The driving force of nonqualified, unfunded deferred compensation plans is that amounts have not been paid or made available.

To require funding (payment) in nonqualified, unfunded deferred compensation plans would invoke the doctrine of economic benefit, the avoidance of which is one of the bases of those plans. Similarly, the portability scheme suggested for participants in qualified, funded plans makes amounts available to the participants. Absent additional statutory change, to allow this with respect to amounts deferred under nonqualified, unfunded deferred compensation plans would be inconsistent with the principle of constructive receipt.

Finally, we note that the benefits of qualified, funded plans are provided to encourage employers to meet the requirements ensuring that relatively equivalent benefits will flow to rank and file workers. Consideration should be given to the effects of providing the benefits of a qualified, funded plan without also imposing the burdens extracted in order to acquire tax-favored status.

We hope this brief historical background distinguishing between qualified, funded plans and nonqualified, unfunded plans proves helpful in your considerations aimed at providing more secure salary deferral arrangements to employees of state and local governments.

The following are GAO's comments on the IRS letter dated March 1, 1996.

GAO Comments

1. We have included appendix I with the IRS letter. We agree that certain terms pertaining to supplemental qualified (tax-favored) and nonqualified, unfunded (tax-deferred) plans can cause confusion. We have altered the text throughout the report to reflect this distinction and other "terms of art." We also made other IRS technical markups to the draft as appropriate.

2. We recognize that most state and local government employers offer a basic qualified, funded pension plan and that section 457 plans operate in addition to the basic plan. We call these plans supplemental plans and include 401(k) and 403(b) plans in the same category as nearly all these plans in the state and local sector are in addition to a basic plan.

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