City of L.A. Deferred Compensation Plan: Overview and Discussion of Selected Tax Issues

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Today's Goals

- Provide an overview of the tax rules that apply to the Deferred Compensation Plan (Plan) based on:
  - Inflows to Plan
  - Tax-exempt status of earnings
  - Outflows from Plan
- Tie that overview to the key provisions of the Plan
- Discuss, as sidebars, a number of selected tax issues that may be of increasing importance
- Answer questions you may have

Purpose of Plan: Tax-Favored Savings Vehicle

- The Plan is a tax-favored (not tax-free) savings vehicle governed by Section 457(b) of the Internal Revenue Code
- Because of significant revenue loss (a.k.a., “tax expenditure”) to Federal government, 457 and other tax-favored plans are subject to fairly strict limits on contributions and on timing of distributions
- Compare to true “tax free” employee benefits such as health care coverage

Tax Advantages

- No immediate taxation of pre-tax contributions (v. post-tax "Roth" contributions)
- Tax-free build up of earnings
- Favorable distribution rules (including rollovers)

Other Types of Tax-Favored Plans

- Defined benefit pension plans – pay an annual benefit v. an account balance
- Other types of defined contribution plans:
  - 401(k) plans
  - 403(b) plans
  - Profit Sharing Plans
  - Money purchase pension plans

Rules of the Road

- Subject to jurisdiction of the Internal Revenue Service (IRS)
- Sources of IRS guidance in addition to the Internal Revenue Code
  - Treasury regulations
  - Revenue rulings
  - Notices
  - Private Letter Rulings
  - Revenue Procedures

Did You Know?

- 457(b) plans are actually an exception to the general rule applicable to deferred compensation for governmental entities and tax-exempts
- General rule: deferred compensation is taxable once it is no longer subject to a "substantial risk of forfeiture"
- Stricter rules apply to deferred comp for governmental entities and tax-exempts than private sector
- Why?

Scope of Section 457 Rules

- Plans exempt from Section 457
  - Among others, qualified retirement plans and governmental excess benefit plans
  - Plans that do not provide for deferral are also exempt (e.g., vacation, severance, disability)

- Interaction of Section 457 and 409A
  - Section 409A rules only apply to 457(f) plans if they provide for deferrals beyond vesting date
  - Section 409A does **not** apply to 457(b) plans
  - A consideration if establishing deferred bonus program

Section 457(b) Plan Overview

- Governmental 457(b) plans
  - Any employee may be included by governmental employer without limitation
- Tax-exempt organization 457(b) plans
  - Must limit participation to "top hat" group of highly compensated employees to avoid becoming subject to ERISA
  - ERISA requires covered plans to be funded
  - Section 457 states that only governmental employers may sponsor funded 457(b) plans

Participation

- Eligible employee fills out a participation agreement to have contributions deducted from paycheck
- Participation agreement must be in place in the calendar month prior to the calendar month of the deferral
  - Exception exists for newly hired employees who make a deferral agreement prior to their first day of service
- Must specify contribution type (pre-tax or post-tax "Roth") and amount
- See Sections III and IV of the Plan document

Payroll Contribution Types

- Pre-tax (traditional) contributions – excluded from income on contribution, taxable on distribution
  - Hope for participant is that, in addition to tax deferral, lower income tax rate will apply when distributions are taken
- Post-tax (Roth) contributions – included in income on contribution, generally tax-free on distribution
  - To be eligible for income tax-free treatment, distributions must be made after age 59½ and after 5 tax years from first Roth contribution
  - The Roth concept (here and with other tax-favored vehicles) has increased today's tax revenues, but will lower tax revenues in future years

Payroll Contribution Limits

- Basic 457(b) annual contribution limit
  - For 2014, $17,500 or 100% of compensation whichever is less (same as in 2013)
    - See Section II(i)(1) of Plan document
- “Catch up” rules may be used to increase this limit

Sidebar Issue: Auto-Enrollment

- Much of the development of the auto-enrollment concept took place in the late 1990s out of a concern that flight from defined benefit plans to 401(k) plans was leaving private-sector workforce at risk
- Treasury/IRS guidance smoothed many of the obstacles, culminating in 2006 legislation
  - A provision pre-empting state law applies to ERISA plans
- Studies indicate that auto-enrollment plans have an average participation rate in excess of 85% versus a participation rate of 67% for plans without auto-enrollment

Sidebar Issue: Auto-Enrollment

- Concept is that employees are automatically enrolled in salary deferral election (e.g., at 3% rate) with an opportunity to "opt out"
- Plan design may also include an "escalator" increasing contribution rate each year (e.g., by 1%)
- Should be combined with good default investment option (e.g., target date retirement) to avoid chronically low returns for participants who do not take an active role in managing retirement

Catch-up Contributions for 457(b) Plans

- Catch-up for employees age 50+
  - Catch-up contribution is $5,500 in 2014
  - See Section II(i)(3) of Plan document
- Special “Double Limit” 457 plan catch-up:
  - Unlike 401(k) plans, 457(b) plans are allowed as much as double the annual contribution limit as a special retirement catch-up
  - Available only during one or more of the 3 years prior to normal retirement age to extent employee has previously under-contributed to plan

Double Limit Catch-up for 457(b) Plans

- Amount of special 457 catch up: lesser of (i) 2 times the normal contribution limit, or $35,000 for 2014 or (ii) regular limit plus underutilized limits from prior years
- Example of special catch-up on "underutilized" limitation
  - Employee contributes $1,000 for 2013
  - Contribution limit for 2013 is $17,500
  - Employee may be eligible to contribute $16,500 ($17,500-$1,000) toward the special catch-up amount
- Cannot be used together in same year as age 50+ catch up

Payroll Contributions To Other Plans

- Payroll contributions to all 457(b) plans must be aggregated for purposes of the annual contribution limits
- However, contributions to 457(b) plans are not aggregated with 401(k) or 403(b) plans (even if maintained by the same employer) for purposes of applying Section 457(b) or 402(g) contribution limits
- This means member may contribute the maximum amount allowed under a 457(b) plan and the maximum amount allowed under a 401(k) or 403(b) plan (if available)

Payroll Tax Withholding on Contributions

- Pre-tax contributions are not subject to federal and state income tax withholding
- However, contributions are subject to both current FICA and FUTA taxes
- Post-tax "Roth" contributions are subject to income taxes and therefore also subject to withholding

Sidebar Issue: Matching Feature

- Some governmental employers are considering (or have already implemented) a matching contribution feature tied to 457(b) payroll contributions
- Not always practical in 457(b) plan itself (would be counted toward annual payroll contribution limit), but plan sponsors get around this by making matching contribution to a companion 401(a) plan
- Federal government (and LA County) offer match, and matching contributions (with reduced pension) are a basic component of many governmental pension reform proposals

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Other Contributions: Rollovers to Plan

- 457(b) plan can accept rollovers (or transfers) from other types of plans
- Rollover portion must be separately accounted for since different tax rules may apply (e.g., pre-59 1/2 distribution penalty taxes)
- Rollover amounts rolled over from other eligible retirement plans do not count toward the annual contribution limits applicable to payroll contributions
- Generally, rollovers should be processed as a “trustee to trustee” direct rollover to avoid withholding taxes
- See Sections VI(a) and (c) of Plan document

Tax Deferral on Assets Held by Plan

- Section 457(g) provides that contributions to a governmental 457(b) plan must be held in trust (or by a custodian or in annuity contracts)
- Amounts are exempt from tax while held in trust (i.e., taxed only on distribution)

457(b) Plan Withdrawals

- In a 457(b) plan, payment can only be made under the following conditions:
  - Separation from service
    - Retirement
    - Termination of employment
    - Death (upon which beneficiary receives benefit amount)
    - See Section V(a) of Plan document
  - After member attains age 70½ (required)
    - See Section V(f) of Plan document

457(b) Plan Withdrawals (Cont.)

– "Unforeseeable emergency" (a.k.a., financial hardship) – see Plan section V(h)
  - Must be a severe financial hardship due to an unforeseeable and immediate need such as an illness or accident of the participant or beneficiary or loss of property due to casualty; or "similar extraordinary and unforeseeable circumstances arising beyond the control of the participant or beneficiary"
  - Can include imminent foreclosure or eviction or funeral expenses.
  - Payment can't be made to the extent emergency can be relieved through other means

Sidebar Issue: Financial Hardship

- "Unforeseeable emergency" under 457(b) is higher standard than for 401(k) hardship (where purchase of a home or college expenses may qualify)
- Situations that generally are not unforeseeable emergencies: purchase or repair of vehicle, costs of a divorce or child support, costs of bankruptcy, credit card debt, back taxes, costs of elective surgery, pay cuts

Sidebar Issue: Financial Hardship

- Unforeseeable emergency must be documented (merely relying on a self-certification is not enough)
- For example, in the case of a foreclosure, there should at least be a foreclosure notice (and amount needed to relieve emergency should be substantiated)
- Should be enough documentation there to show IRS that Plan admin folks were doing their jobs
- Can failure to follow these rules cause 457(b) plan to eventually lose its favorable tax status? Yes!

457(b) Plan Withdrawals (Cont.)

– In-service de minimis withdrawal
  - Account must be valued at $5,000 or less
  - Member has not made a Plan contribution in 2 years
  - Member has not received a prior de minimis distribution
  - See Section V(i) of Plan document

– Payments from a participant's rollover account may be made at any time

Cash Payment Methods

- Plan provides for a variety of cash payment methods: lump sum, partial lump sum, periodic payments
- Payment methods may also be changed
- May also designate source (pre-tax or post-tax)
- See Sections V(c), (d) and (j) of Plan document

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Withholding on Payments

- 20% Federal tax is withheld at the time of taxable distribution that is not rolled over
- State tax is also withheld based on the member's state of residency at the time of distribution
- Members receive a Form 1099-R by January 31 of the year following the year in which member receives a distribution
- Post-tax "Roth" 457 distributions are tax-free if the member is age 59½ or older and 5-year holding period has been fulfilled
- Pre-59 ½ penalty taxes do not apply to payouts of 457 plan payroll contributions

Service Credit Purchases

- A participant who also participates in a governmental defined benefit plan may transfer amounts to purchase permissive service credit under the defined benefit plan (subject to rules of that plan)
- See Section V(j) of the Plan document

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Rollovers/Transfers from 457(b) Plan

- Tax-free rollovers and transfers may be made from the Plan to other plans or IRAs that will accept them
- Also required to provide participants with a so-called "402(f) Notice" within a reasonable time before an eligible rollover distribution telling them of their distribution and rollover rights and tax treatment
- See Sections VI(b) and (d)

Sidebar Issue: In-Plan Conversion from Pre-Tax to Post-Tax

- Plan currently permits in-plan rollovers from pre-tax to post-tax account if participant otherwise eligible for a distribution (see Plan section VI(f))
  - By itself, not an extremely useful provision
- About a year ago, Congress expanded this concept as part of The American Taxpayer Relief Act, permitting in-plan conversions without the need for a distribution event
  - Plan sponsors were slow to implement this optional provision due to a lack of guidance on key issues (including whether the in-plan rollover rules apply)

Sidebar Issue: In-Plan Conversion from Pre-Tax to Post-Tax

- Last month, IRS issued guidance clarifying many of these issues (Notice 2013-74)
  - No withholding required (or even allowed) on transfer between accounts
  - As a result, a potential trap at tax-filing time for participants who did not increase their withholding during the year
  - If participant has not previously contributed to post-tax account, 5-year holding period begins first day of the year conversion took place
  - Plan amendment required by the end of the plan year provision becomes effective (or Dec. 31, 2014 if later)

Special Payment Type: Death Benefits

- Any remaining account balance for a participant may be paid to the participant's beneficiary(ies) upon death
- Participant allowed to designate beneficiary(ies)
- Default rules apply in the absence of a beneficiary designation (i.e., spouse/registered domestic partner, then children, then estate)
- See Sections V(e) and VII of Plan document

Sidebar Issue: Special Rollover Rules for Beneficiaries

- Rollover rules differ somewhat for spouse and non-spouse beneficiaries
- The easier case is a spouse beneficiary – he or she has the same rollover options as the participant (another qualified plan of the spouse or to the spouse's IRA) PLUS spouse has the option of rolling to an inherited IRA (can get spouse participant's RMD date if spouse participant had not yet started drawing benefits)

Sidebar Issue: Special Rollover Rules for Beneficiaries

- On the other hand, a non-spouse beneficiary (including a domestic partner, child, parent or sibling) may only roll over to an inherited IRA
  - Must be a direct rollover

- In either case, spouse or non-spouse beneficiary, 20% withholding applies to a cash distribution

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Special Payment Type: QDRO

- A Qualified Domestic Relations Order (QDRO)is a judgment, decree or court order for a retirement plan to pay child support, alimony or marital property rights to a spouse, former spouse, child or other dependent of a participant
- QDRO must contain certain specific information
- QDRO may not be awarded in a form of benefit or amount that is not allowed under the plan
- Recipient of QDRO benefits (spouse or former spouse) taxed on QDRO benefits received as if he or she were a plan participant
- QDRO distributions paid to a child or other dependent taxed to the plan participant
- See Section V(g) of Plan document

Special Feature: Loans

- 457 plans may allow a loan program
- If properly repaid, loans are not taxable
- Following general rules apply
  - Member may have up to 2 loans from his or her account at any given time
  - However, the sum of both loans cannot exceed 50% of the member's account balance or $50,000, whichever is less
  - $1,000 is the minimum loan amount
    - Member must have at least $2,000 in account to be eligible for a loan

Special Feature: Loans

- Interest is paid to member's account
- 2 types of loans available
  - General Purpose Loan
    - Duration of 1 to 5 years
    - Only a signed promissory note required
  - Principal Residence Loan
    - Duration of 1 to 15 years
    - Loan must be for only purchase of a primary residence
- See Section VIII of Plan document

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Sidebar Issue: Loan Defaults and Grace Periods

- A plan loan will be in default (and therefore become taxable) if loan becomes delinquent and not promptly corrected
- Late loan payment notice issued at end of calendar quarter in which payment is delinquent
- The IRS has provided significant flexibility to plan sponsors to avoid loan defaults through the permitted use of a "grace period" giving participant until the end of the calendar quarter ***after*** calendar quarter loan becomes delinquent to pay amount plus interest

Sidebar Issue: Loan Defaults and Grace Periods

- If not corrected, there is a deemed distribution of the loan and a 1099-R is issued
- Loan stays on the books until repaid or there is a distribution event

Special Rule: Military Service

- Under the Uniformed Services Employment and Reemployment Rights Act (USERRA), make up contributions are allowed for the period of qualifying military service
  - Amount based on the rate of pay the employee would have received while in service
- Makeup period begins on the date of reemployment and for a period that is the lesser of 3 times the period of qualifying military service or 5 years
  - See Section XI(d) of Plan document
- Participant also given extra time to repay plan loans

Sidebar Issue: Correcting Plan Errors

- ***Technically***, governmental 457(b) plan that is not operated in a manner that is consistent with the rules is "disqualified" (i.e., ceases to be an eligible plan) as of beginning of next plan year after receiving notice from IRS ***unless corrections are made beforehand***
  - Adverse consequences only apply to future deferrals
- IRS says that its voluntary correction program for qualified retirement plans (EPCRS) is available to governmental 457(b) plans on a "provisional" basis
  - Can correct things like excess deferrals, required minimum distributions or plan loan problems

Sidebar Issue: Correcting Plan Errors

- Voluntary correction program usually a better option than taking a chance on an IRS notice
  - Can be difficult (and costly) to go back and correct old problems
  - In fact, some errors arguably cannot be fixed (e.g., failure to provide 402(f) notice, getting hardship withdrawals back)
  - Also, some errors carry with them an excise tax on participants (e.g., failure to provide required minimum distribution) or other adverse tax consequences (income from bad loan program)
- May want to insist on use of IRS correction program when third-party administrator is responsible for error

Questions?

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