StatonWalsh
Financial Clarity Through Transparency

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Qualified Deferred Compensation Plan

IRC Sec. 457

Employees (or independent contractors) of state and local governments and tax-exempt employers can elect to defer future income (and taxation) under an eligible deferred compensation plan described in IRC Sec. 457.

Eligible Deferred Compensation Plan

- The plan must be established and maintained by an eligible employer, which includes states, political subdivisions of states, agencies of state and local governments, as well as any other organization exempt from income tax under IRC Sec. 501(c), e.g., charitable organizations, trade associations, farmers' cooperatives, etc.
- The Small Business Job Protection Act of 1996 requires the assets of state and local government plans to be held in a trust or custodial account.
- In general, the plan cannot provide for distribution of amounts payable prior to the earlier of the participant's separation from service or attainment of age 72, unless the participant is faced with an unforeseeable emergency. However, the plan may adopt provisions permitting in-service distribution of benefits if the total benefit is less than a specified amount, currently $5,000. Such in-service distributions may be either voluntary or involuntary and are subject to strict conditions. Beginning in 2020, plans sponsored by state and local *governmental* organizations could allow in-service distributions as early as age 59½.
- The plan must provide that the income deferred, plus assets purchased with those funds, plus the income earned on those assets remain the property of the employer. The IRS has permitted the use of a rabbi trust to prevent the employer from using the funds for other purposes. See PLR 9205002[1].
- There must be a limit of $22,500[2] of income that can be deferred in one year. For individuals who are participants in state or local government plans, and who are at least age 50, catch-up contributions of $7,500 may also be made.[2]

[1] An IRS Private Letter Ruling is applicable only to the taxpayer who requested it and may not be cited as precedent.
[2] 2023 value.

- The age 50 and over catch-up contributions are not available to participants in plans sponsored by tax-exempt organizations.
- During the three years prior to normal retirement age, other catch-up limits apply.[1]
- Plan loans (only available for plans sponsored by state or local governmental employers) are made under the same rules applicable to qualified plans..

Excise and Penalty Taxes

The 10% penalty on early distributions from qualified and 403(b) plans does not apply to IRC Sec. 457 plans. However, the required minimum distribution (RMD) rules effective at age 72[2] or later for retirement do apply.

Life Insurance

The premium paid for life insurance in an IRC Sec. 457 plan will not be taxable to the insured if:

- The employer retains all incidents of ownership in the policy,
- The employer is the beneficiary, and
- There is no requirement to transfer the policy or its proceeds.

The death benefits paid from an IRC Sec. 457 plan to an employee's heirs are included as taxable income to those heirs under deferred compensation rules. See Treasury Reg. 1.457-10(d).

Roth 457 Plan Feature

If the employer permits, and the written plan so provides, plan participants in a 457(b) governmental plan may choose to have some or all of their salary deferral contributions treated as contributions to a designated Roth account, sometimes referred to as a "Roth 457." Unlike normal 457 contributions, which are made *before-tax*, Roth 457 contributions are made on an *after-tax* basis. If certain requirements are met, distributions from the Roth 457 are received income tax free. Contributions to a Roth 457 account are subject to the same employee elective deferral limits as the 457 plan itself.

[1] These other limits are two times the normal contribution limits.

[2] The age 72 "trigger" date applies to distributions required to be made after December 31, 2019, to individuals who reach age 70½ after that date. Under prior law, age 70½ was the mandated age for beginning RMDs.

Important Notice

This report is intended to serve as a basis for further discussion with your other professional advisors. Although great effort has been taken to provide accurate numbers and explanations, the information in this report should not be relied upon for preparing tax returns or making investment decisions.

Assumed rates of return are not in any way to be taken as guaranteed projections of actual returns from any recommended investment opportunity. The actual application of some of these concepts may be the practice of law and is the proper responsibility of your attorney.

Disclosure Notice

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