Federal Legislative and Regulatory Report
August 2003

I. 457 Final Regulations
The IRS recently released final 457 regulations. To help you understand what has been changed or refined by this release.

The first chart – which begins on page 2 – provides a side-by-side comparison between the proposed and final regulations for 457(b) governmental plans. The regulations are applicable for plan years beginning after December 31, 2001. Plans may be operated in a reasonable good faith interpretation of EGTRRA for taxable years beginning January 1, 2002 and ending before January 1, 2004.

There is a special delayed effective date, however, for the rule requiring that 457 government plans not make distributions from a rollover account to a participant who is not yet eligible for a distribution from the 457 plan. This rule is not applicable until plan years beginning after December 31, 2003 since this issue is expected to be resolved in additional regulations that are anticipated to be released prior to this date. The final regulations do not specify when a plan must be amended to reflect the new or amended provision to remain in compliance.

The second chart – which begins on page 5 – details provisions that have not been changed, revised or altered by the release of the final 457 regulations.
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<th>Changes and Clarifications</th>
<th>Proposed Regulations</th>
<th>Final Regulations</th>
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<tr>
<td><strong>Service Credit Purchase</strong></td>
<td>457 governmental plans may permit participants to make in-service transfers of 457(b) assets to a governmental defined benefit plan within the same state for the purchase of permissive service credits. The proposed regulations appear to limit the amount of permissive service credit that could be purchased.</td>
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<td><strong>Election to Defer Accumulated Sick, Vacation and Back Pay</strong></td>
<td>Deferral election by terminating participants to contribute unused sick and vacation pay to a 457 plan must be made prior to the first day of the month the participant would have been paid for these amounts and the participant must still be employed in order to defer these amounts.</td>
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<td><strong>Rollovers In</strong></td>
<td>457 plans have the option to accept rollover contributions from other plans and IRAs. The plans must account for the rollover contribution in a separate rollover account and subject them to the distribution rules of the 457 plan. Amounts distributed from the rollover account that represent 401, 403(b) or IRA rolled in funds may be subject to an early 10% distribution tax if distributions are made prior to age 59½ and no exception applies. 457 plans cannot accept rollovers of after tax contributions.</td>
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<td><strong>Treatment of Excess Deferrals</strong></td>
<td>Excess deferrals and earnings must be distributed to the participant as soon as administratively possible or the entire plan will become an ineligible plan under 457(f) resulting in adverse tax consequences for all participants making subsequent deferrals to the plan. Excess deferrals are included in a participant's income in the year excess contributions were made. A participant may defer to 457 plans of different</td>
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<td>Final regulations clarify that excess deferrals are included in gross income in the year they were contributed, and earnings on excess deferrals are included in gross income in the year they are distributed.</td>
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<td>The final regulations clarify that if a participant contributes to multiple 457 plans and in the aggregate exceeds the deferral limit, the plans will retain their eligible status even if they do not return the excess amounts. These amounts will still be</td>
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This information is of a general and informational nature and is NOT INTENDED TO CONSTITUTE LEGAL OR INVESTMENT ADVICE. Rather, it is provided as a means to inform you of current information about legislative, regulatory changes and other information of interest. Plan Sponsors are urged to consult their own counsel regarding this information. NRS-0943 (07/2003)
<table>
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<td>employers, without exceeding the deferral limit in any one of the plans, but still may exceed his/her deferral limit based on total deferrals made to all 457 plans. <strong>In this case, none of the plans would become an ineligible plan.</strong> The excess amount would still be included in the participant’s gross income in the year of deferral.</td>
<td>included in participant’s gross income in the year of deferral.</td>
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<td><strong>Unforeseen Emergency</strong></td>
<td>Final regulations permit payment of funeral expenses of spouse or any dependent under 152(a) defined as:</td>
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<td>The definition of an unforeseen emergency was expanded to include a severe financial hardship resulting from illness or accident of the participant or beneficiary’s spouse or dependent (IRS 152(a)) which cannot be relieved by other means and may include:</td>
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<td>- Imminent eviction from or foreclosure on participant’s or beneficiary’s primary residence</td>
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<td>- Payment of medical expenses including prescription drugs</td>
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<td>- Payment of funeral expenses of a family member</td>
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<td>College tuition and home purchase would not be in most circumstances an unforeseeable emergency. The UE must be limited to the amount that is reasonably necessary to satisfy the need (plus any applicable taxes and penalties).</td>
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<td><strong>Age 50+ Catch-up</strong></td>
<td>The final regulations retain this requirement. If the Age 50+ Catch-up produces a greater deferral amount than the 457 special Catch-up would, the Age 50+ Catch-up is used.</td>
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<td>Participants age 50 by the end of the calendar year may make an additional contribution to the plan above the dollar limit for the year, provided their includible compensation can support it. Age 50+ Catch-up cannot be used in the same year as 457 Special Catch-up is being used.</td>
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<td><strong>Plan transfers between Eligible 457 Plans</strong></td>
<td>The final regulations retain these requirements and clarify that participants may also transfer amounts from one 457 plan to another 457 plan of the same employer without terminating service.</td>
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<td>The proposed regulation stated that there were two occasions that permitted transfers between eligible 457 plans. Instead of terminating the 457 plan, the plan may transfer all participant assets to another plan within the same state for administration. Participants could not make contributions to the receiving plan unless they are performing services for that plan. Participants may transfer assets from one 457(b) plan to another 457(b) plan of another employer</td>
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<td>only if they have terminated service. Transfers may only be made between eligible governmental plans. Transfers cannot be made between eligible plans of government and tax exempt entities or between eligible plans and 457(f) plan.</td>
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### Provisions Unchanged In Final Regulations

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<th>Salary Deferral Elections</th>
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<th>Coordination of Deferrals</th>
<th>Aggregation of Deferrals</th>
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<th>457 Special Catch-up</th>
<th>Participant Loans</th>
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<tr>
<td>Plan must be in writing, operated according to its terms and conform to all applicable laws and regulations governing 457(b) governmental plans.</td>
<td>All 457(b) plans of the employer will be treated as a single plan.</td>
<td>Includible compensation is gross compensation less all 414(h) mandatory contributions and is not reduced by any elective deferrals.</td>
<td>Deferral agreements must be made prior to the first day of the month in which participant receives payment for work performed. New employees may defer compensation payable in the calendar month during which the employee first becomes a participant as long as the agreement is entered into on or before the first day the participant performs services for the employer.</td>
<td>All contributions to a 457(b) plan will be treated as elective deferrals including any employer matching or non-elective contributions made to the plan. All such contributions will count against plan limits when they vest.</td>
<td>457(b) deferrals must be coordinated across all 457(b) plans in which employee participates regardless of employer. 457(b) deferrals no longer are required to be coordinated with non 457(b) deferral plans after 2001.</td>
<td>All 457(b) plans of the employer are treated as a single plan to determine if deferral limits have been exceeded. Individual 457(b) deferral contributions must be aggregated across all 457 plans in which the employee participates regardless of employer and including any 457(b) plans of tax exempt employers to determine if an individual's deferral limit has been exceeded for the taxable year.</td>
<td>457(b) plans may self-correct for excess deferrals to the plan as soon as administratively possible. Excess deferrals may not be corrected at this time under the IRS voluntary correction programs (EPCRS).</td>
<td>May be used in any or all three of the consecutive calendar years prior to the year participant reaches plan's Normal Retirement Age provided participant has unused deferrals from previous years and Catch-up amounts do not exceed the plan limits for the year. This option may not be used in the same year the Age 50+ Catch-up is used.</td>
<td>457 sponsors have the option of adding a loan provision to their plans. Loans must meet a pre-ERISA facts-and-circumstances general analysis. This analysis examines the availability of the loan feature for all participants, the rate of interest, and the overall prudence of a loan, in particular</td>
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whether:
- The proposed loan has a fixed repayment schedule and reasonable interest rate.
- There are repayment safeguards, which a prudent lender would follow.

Loans are subject to the rules of 72(p)(2) and related regulations.

**Normal Retirement Age**

The proposed regulations and final regulations require the 457 Plan Document to state the plan's Normal Retirement Age (NRA). There may not be more than one stated NRA regardless of the number of 457 plans the employer sponsors.

NRA can be defined as no earlier than age 65 or as an age that is between the age at which participants have the right to receive immediate and unreduced benefits from the state defined benefit plan, but no later than age 70½.

The plan may select an alternative definition for NRA allowing the participant to designate an NRA within this range of ages, but no later than age 70½.

**Optional Normal Retirement Age for Police and Firefighters**

The regulations provide a special rule for defining NRA in eligible plans of police and firefighters because these participants are often eligible for retirement at a younger age than other workers.

The 457 plans for police and firefighters may permit these participants to choose an NRA between ages 40 and 70½ or may use a stated age as early as age 40. If the plan permits one of these options, a police officer or firefighter planning to retire at age 40 could, if eligible, begin the Special Catch-up in the three consecutive calendar years (at age 37) prior to the calendar year (s) he attains an NRA of 40.

**Required Minimum Distributions**

457 plans will follow the required minimum distribution rules of 401(a)(9), which are the same rules that apply to qualified plans.

**Taxation of Benefits**

Benefits will be taxed when actually paid.

**Rollovers out of 457 plan**

457 plans must allow rollovers of 457 assets to another plan or IRA when there is a distributable event such as death, severance from service or attainment of age 70½.

**Plan Termination**

457 plans may be terminated and assets distributed to participants or rolled (directly or indirectly) to another plan or IRA at the election of the participant. Terminated plans must distribute the entire accounts balances to all participants as soon as administratively possible or the plan will be treated as a frozen plan and will have to be kept in compliance with all statutory requirements.

**QDRO**

The plan may provide for qualified domestic relations orders including permit benefits be paid to the alternate payee prior to participant being eligible for a distribution from the plan. QDRO payments to an alternate payee who is spouse or former spouse will be taxable to the alternate payee and not the participant, unless they are rolled over.

**II. IRS issues Proposed 401(k) Regulations**

The IRS has released proposed 401(k) regulations consolidating and updating current regulations and previously issued guidance. 401(k) plans will be permitted to comply with these regulations as early as the first day of the plan year beginning after the regulations have been finalized.

Although the majority of the proposed regulations deal with non-discrimination and testing issues, which are not applicable to governmental plans, the following general topics covered in the regulations apply to governmental 401(k) plans.
**Salary Deferral Elections**

Unlike the current regulations, the proposed regulations provide specific rules for making salary deferral elections that require:

- Employees be given at least annually the opportunity to make or change salary deferral agreements.
- Election to defer compensation be made before these amounts can be contributed to the plan.
- Deferral contributions be made after the employee performs services. Amounts contributed before services are performed are generally not treated as elective deferrals.
- Matching contributions cannot be made prior to deferral contributions.

**Plan Terminations**

Section 401(k) current and proposed regulations do not permit employers who terminate their 401(k) plans to distribute assets to participants if the employer maintains another defined contribution plan. The proposed regulations state that 457, SEPs, Simple IRAs, and 403(b) plans are not included in the definition of defined contributions plans for this purpose. Employers only maintaining one or more of these plans and not an alternative 401 defined contribution plan may terminate their 401(k) plan and distribute the assets to participants.

Terminating 401(k) plans are required to distribute assets to participants in a lump sum. The proposed regulations clarify that distribution in the form of annuity from the plan’s trust to the participant also will satisfy the lump sum requirement.

**Hardship Distributions**

The proposed regulations attempt to resolve some of the uncertainties concerning hardship distributions. Hardship distributions from 401(k) plans must meet two requirements:

1. There must be a heavy immediate financial need that cannot be relieved by other means. The financial need may be considered heavy and immediate even if it was reasonably foreseen and voluntarily incurred; and
2. The distribution must be necessary to satisfy the need and cannot exceed this amount, except the hardship distribution may be increased to pay federal, state and local taxes and any penalties.

Financial need for a hardship distribution from a 401(k) may be made to cover:

- Expenses for medical care for the employee, employee’s spouse or dependents.
- Costs directly associated with the purchase of a principal residence (excluding mortgage payments).
- Payment of tuition, related fees and room and board expenses for the next 12 months of post-secondary education for the employee, employee’s spouse, employee’s children or dependents.
• Payments necessary to prevent eviction from principal residence or to prevent foreclosure on mortgage of principal residence.

The proposed regulations require that if the participant has other means to relieve the financial need, those means, including plan loans and/or other distribution options must be used first to meet the financial need even if the amounts available from these sources would not satisfy the entire need.

Participants taking hardship distributions generally must cease making elective deferral contributions to all the employer’s elective contributions plans including cafeteria plans for six months after receiving a distribution. Mandatory employee contributions to defined benefit plan or health or welfare benefit plan are not subject to this requirement.

**Plan-to-Plan Transfers**

Plan assets are often moved between like plans by a non-taxable transfer of assets. Non-taxable transfers (except for transfers of 403(b) or 457 funds to purchase service credits in a governmental defined benefit plan) occur:

• Between like plans, 401 to 401, 403(b) to 403(b), 457(b) to 457(b), or IRA to IRA.

A distributable event does not need to occur to permit distribution of these transferred amounts from the plan.

The most common non-taxable transfers within the public sector 401(k) plans occur when the employer sponsors more than one plan of the same plan type. Participants can make non-taxable transfers between the two plans so they can take advantage of different investment options or plan features, such as loan and/or hardship distributions.

The proposed 401(k) regulations have retained the distribution restrictions on non-taxable transfers from 401(k) accounts to another qualified plan unless the receiving plan retains the required distribution restrictions on the deferral portion of the transferred amounts. Qualified plans accepting plan transfer of 401(k) deferral amounts must not distribute these amounts prior to:

• Age 59½;
• Death, disability or severance from employment; or
• Hardship.

A transferring plan is not permitted to make transfers to a qualified plan that will not maintain the 401(k) deferral distribution restrictions. The transferring plan may make the transfer if it reasonably determines the receiving plan will retain these distribution restrictions based on the similar rules related to accepting rollover contributions. These distribution restrictions do not apply to any amounts that are directly rolled to another plan or IRA because of a distributable plan event that qualifies for rollover.
III. Taxation of Accumulated Sick and Vacation Pay

The IRS Office of General Counsel has issued a General Counsel Memorandum (GCM) addressing the taxation of lump sum distributions representing the value of unused sick and vacation pay to retired government employees.

The IRS has become aware of rumors circulating among groups of retired government employees that payments representing the value of accumulated sick and vacation leave are exempt from taxation under IRC 457(e)(11). Section 457(e)(11) states that bona fide vacation leave, sick leave, compensatory time, severance pay, disability pay and death benefit plans are not deferred compensation plans and not subject to Section 457. The rumors wrongfully conclude that, since payments are not subject to IRC 457, they not taxable under any section of the IRC. The GCM states that:

- 457(e)(11) does not make these payments tax deferred or non-taxable.
- These payments are subject to IRC 451 and required to be included in gross income for taxation purposes in the year they are paid or made available.

Retired government employees are being advised to file Form 1040X to claim a refund of income tax paid on moneys received for unused sick leave and vacation leave. The GCM advises that, if the IRS receives a 1040X claim for refund of these amounts based on Section 457(e)(11), the return may be flagged for examination.

IV. 2003-2004 Priority Guidance Plan Released

The Department of the Treasury and the IRS recently released their Priority Guidance Program containing 268 guidance projects to be completed between July 2003 and through June 2004. IRS guidance may be issued in several forms including:

- Announcements
- Notices
- Revenue Procedures
- Revenue Rulings
- Private Letter Rulings
- Proposed, Interim, and Final Regulations

Guidance items for retirement and welfare benefit plans that may be of particular interest to public employers are listed below:

Find it online
Detailed information about this guidance may be found at www.ustreas.gov/press/releases/js600.htm and www.irs.gov/pub/irs-wd/0329014.pdf.
Retirement Plan Design
- Final regulations for Deemed IRAs
- Revenue Procedure for 457(b) model plan provisions
- 403(b) annuity plans

Contributions and Benefit
- 415 regulations
- Rollover Contributions

Distribution
- 457 plans (presumably dealing with distributions from non 457 rollover accounts)
- Regulations for Required Minimum Distributions
- Guidance for Equal and Periodic payments to avoid 10% early distributions tax from annuity contracts under IRC 72(q)
- Guidance on cross-border distributions

Health and Welfare Plans Guidance
- Election between taxable and non-taxable benefits
- Disability payments
- Health Reimbursement Arrangements – IRS has released its first private letter ruling for an HRA (PLR 200329014)
- Revenue Ruling under Section 125 for non-prescription drug

Education Savings Plans
- Regulations for 529 qualified tuition programs
- Reporting Requirements for Coverdell Savings Accounts (formerly Education IRAs)

The Priority Guidance Plan will be updated quarterly to address the need for additional guidance and to respond to new developments during the year.

V. Keeping watch
Nationwide Retirement Solutions monitors this and other regulatory activity. We report guidance that is relevant to government sector defined contribution plans through these communications:

- Plan Sponsor Voice newsletter – distributed quarterly
- Federal Legislative and Regulatory Report – distributed monthly
- Legislative and Regulatory Alerts – distributed on an ad hoc basis to announce fast breaking news