This responds to your faxed letter of February 17, 2000 to John Tolleris of my staff. You inquired concerning the application of the constructive receipt doctrine to the local section 457(b) plans your office oversees in light of your office’s dilemma regarding how to deal with various demands from creditors of County C’s ex-employees for immediate distributions from such ex-employees’ accounts in the County’s section 457(b) plans. You also asked us to discuss when ex-employees may obtain distributions from their section 457(b) plan accounts.

Since we do have not a request for a private letter ruling regarding specific taxpayers’ cases (including a copy of the relevant section 457 plans) filed in accordance with Revenue Procedure 2000-1, 2000-1 I.R.B. 4, we are unable to provide a definitive ruling or opinion concerning this issue. However, we are happy to provide you this general information letter\(^1\) regarding section 457, regulating deferred compensation plans of state and local governments, which we hope may be helpful to you.

A deferred compensation plan is an agreement or arrangement between an employer and employees under which the payment of compensation is deferred. The tax consequences of such plans are governed by the constructive receipt doctrine embodied in the regulations under section 451 of the Code, and, in the case of public and tax exempt employers, section 457 of the Code.

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\(^1\) Section 2.04 of Revenue Procedure 2000-1 defines an "information letter" as a statement issued by the Internal Revenue Service that calls attention to a well-established interpretation or principle of tax law without applying it to a specific set of facts. This section also provides that an information letter is advisory only and has no binding effect on the Service.
The constructive receipt of income doctrine has long been a part of the income tax laws. Under this doctrine, a taxpayer will be subject to tax upon an item of income if he has an unrestricted right to determine when such an item of income should be paid. This principle was expressed in a 1930 Supreme Court case, Corliss v. Bowers, 281 U.S. 376 (1930), in a statement by Justice Holmes, that "Income that is subject to a man’s unfettered command and that he is free to enjoy at his own option may be taxed to him as his income, whether he sees fit to enjoy it or not."

The doctrine is embodied in section 1.451-1(a) of the Income Tax Regulations, which states that an item of income (for example compensation for services) is includible in gross income for the taxable year in which it is actually or constructively received. Section 1.451-2(a) of the regulations states that income is constructively received in the year in which, although not actually received, it was made available so that the taxpayer could actually receive it at any time if notice of intention to receive it has been given. However, income is not constructively received if the taxpayer's control over its receipt is subject to substantial limitations or restrictions.

Section 457 of the Code provides for the income tax treatment of compensation for services deferred by an individual under an eligible deferred compensation plan of an eligible employer such as a state or local government entity or a tax-exempt organization. Section 457 provides special rules whereby an individual who participates in such a plan will not be deemed to be in constructive receipt of a portion of his compensation for services rendered to an eligible employer. For this purpose, a plan is treated as an eligible plan if the plan provisions conform to the requirements of section 457 of the Code and the plan is administered in conformance with those requirements. Section 457(a) provides that compensation deferred under an eligible plan and any income attributable to such deferred compensation are taxable only for the year in which the deferred amounts are "paid or made available" to the plan participant or the participant’s beneficiary, not in the year deferred. However, if a section 457 plan does not operate in compliance with the requirements for an eligible plan, it (and the amounts deferred thereunder) will lose its eligible (tax-deferred) status, and become an ineligible plan subjecting its participants and beneficiaries to adverse tax consequences under section 457(f) discussed later in this letter.

Section 1.457-1(b) of the Income Tax Regulations states, in part, that for purposes of section 457(a) of the Code, amounts deferred under an eligible plan will not be considered made available if, under the plan, the participant may irrevocably elect prior to the time the amounts become payable (under the distribution provisions of the plan) to defer payment of some or all of these amounts to a fixed or determinable future time. Conversely, amounts are "made available" if the participant’s election (1) is not irrevocable, (2) may be made after the amounts are payable or (3) is not to a fixed or determinable future date.
Examples (1) and (4) of § 1.457-1(b)(2) indicate that eligible deferred compensation plans may provide that their participants may change their distribution election up to 30 or 60 days (depending upon the specific terms of the plan) before the date upon which payments are to commence. Although section 457 of the Internal Revenue Code and the Income Tax Regulations thereunder establish some minimum requirements that a state or local governmental unit must meet in order to establish an eligible section 457 plan, the governmental unit is permitted to provide stricter requirements in its section 457 plan.

In order for the Service, as well as plan participants, to ascertain when deferred amounts become payable or are made available, an eligible plan must specify a fixed or determinable time of payment by reference to the occurrence of an event (for example, retirement) that triggers the individual's right to receive (or begin to receive) the amounts deferred under the plan.

Under section 457 of the Code and the regulations thereunder, as well as under the long established doctrine of constructive receipt of income, if a plan participant were able to receive his deferred income at any time without restriction after he retired, he would be in constructive receipt of these amounts in the taxable year of his retirement, even if they were not actually paid. Under section 457(a) of the Code, the participant's post-retirement ability after distribution has commenced to control the time when he would receive these amounts would make the deferred amounts available to him and includible in gross income for the year in which he retired. Example (2) of § 1.457-1(b)(2) indicates that if a section 457 plan permits a participant to change his distribution election after he has begun receiving distributions from his account, he would be currently taxable upon the entire value of his account whether or not he had elected to receive it immediately. For this reason, section 457(b) plans provide that once a participant has begun receiving distributions pursuant to an irrevocable election made before he began to receive such amounts, he cannot accelerate distribution of his account balance (absent a foreseeable emergency), in order to prevent immediate taxation of his (and other participants') entire account balance.

There is one exception to this general rule. The plan may, but is not required to, permit a participant to accelerate the payment of the amount remaining payable in the event of an unforeseeable emergency. The amount withdrawn must be limited to the amount reasonably necessary to satisfy the emergency. Benefits would not be "made available" merely because the plan contained such a provision. Eligible plans may include provisions authorizing separated employees as well as employees still on the eligible employer's payroll to receive such hardship withdrawals in unforeseeable emergencies.
As discussed above, participants in a section 457(b) plans are able to defer taxation of their contributions to an eligible plan (and the earnings thereon) only because the amounts in their accounts are not "made available" for their unrestricted, discretionary withdrawal. If a section 457(b) plan were to permit its participants to make any withdrawal anytime they please from their accounts without restriction, the plan would fail to comply with the above-discussed requirements for maintaining its status as an eligible (tax-deferred) plan, and all of its participants would generally be subject to immediate and full taxation of their section 457 plan account balances under section 457(f) of the Internal Revenue Code, regulating ineligible deferred compensation plans, regardless of whether they actually chose to withdraw any amounts from their plan accounts.

Section 457(f) provides that if a section 457 plan is not an eligible deferred compensation plan (because it violates one or more of the requirements that eligible plans must meet), then all compensation credited to the plan account shall be included in the gross income of the participant or beneficiary for the first taxable year in which there is no substantial risk of forfeiture of the rights to such compensation, and the tax treatment of any amount made available under the plan to a participant or beneficiary shall be determined under section 72 which provides complex rules relating to the taxation of annuities. Section 457(f)(3)(B) of the Code defines "substantial risk of forfeiture" by stating "The rights of a person to compensation are subject to a substantial risk of forfeiture if such person's rights to such compensation are conditioned upon the future performance of substantial services by any individual."

You also asked whether the recent enactment of section 457(g) imposing the trust requirement for amounts held in section 457(b) plan accounts affects the application of the constructive receipt doctrine to such amounts. Section 457(g) of the Internal Revenue Code of 1986, which Congress enacted in Section 1448 of the Small Business Job Protection Act (SBJPA) of 1996, provides that a plan maintained by an eligible governmental employer shall not be treated as an eligible deferred compensation plan unless all assets and income of the plan described in section 457(b)(6) are held in trust for the exclusive benefit of participants and their beneficiaries. Even after enactment of section 457(g), section 457(a) still provides that amounts in eligible plans shall be taxable when "paid or made available". Thus although the County's creditors can no longer get access to the amounts held in the County's section 457(b) plans, the County cannot make such amounts available for unrestricted, discretionary withdrawals if it wishes to maintain the plans' eligible status and allow all participants, including ex-employees to defer paying income tax upon the unpaid amounts in their accounts. Therefore, the enactment of the trust requirement has no impact upon the applicability of the constructive receipt doctrine.
Another issue you raised was whether an ex-spouse or other dependent entitled to support from a government employee or ex-employee has access to amounts in such employee’s section 457 plan account. The Service cannot definitively discuss this issue regarding a specific participant without examining the relevant section 457 plan. However, most of the section 457 plans we have seen include no provision authorizing or requiring a participant’s account to be split with his former spouse pursuant to a domestic relations order, with the second account recording the non-participant spouse’s interest in the plan. Section 457 and the regulations thereunder do not require a plan administrator to split a participant’s account with his former spouse in the event of their separation or divorce; in fact section 457 does not include any provision relating to divorce or separation.

A few section 457 plans we have seen include provisions authorizing the plan administrator to establish a separate account for the former spouse of a participant pursuant to a court-ordered divorce decree with the second account recording the former spouse’s interest in the plan. The Service has taken the position that a section 457 plan will not become an ineligible plan described in section 457(f) solely because it complies with a court order requiring the distribution of the benefits of a participant in pay status (currently eligible to receive distributions) under section 457(d)(1)(A) to the participant’s spouse to meet the participant’s alimony or support obligations.

Another question concerning ex-spouses is the earliest time that amounts from a participant’s section 457 account can be distributed to his former spouse pursuant to a domestic relations order. The Service has answered this question by reference to section 457(d)(1)(A). It provides that for a section 457 plan to be an eligible plan, amounts deferred under the plan may not be made available to participants or beneficiaries earlier than (i) the calendar year in which the participant attains age 70-1/2, (ii) when the participant is separated from service with the employer, or (iii) when the participant is faced with an unforeseeable emergency as determined under Treasury regulations. Section 1.457-2(h)(4) of the regulations defines an unforeseeable emergency as a severe financial hardship to the participant resulting from a sudden and unexpected illness or accident of the participant or of a dependent, loss of the participant's property due to casualty, or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant. Divorce or separation generally does not give rise to an unforeseeable emergency within the meaning of these regulations.

There are legislative proposals currently pending in the Congress that would provide divorced spouses and other alternate payees (including dependents entitled to child support) the same right to get immediate distributions from the participant’s section 457 plan account as they now have with respect to their qualified plan accounts (including section 401(k) plan accounts) by using a qualified domestic relations order. However such legislation has not yet been enacted.
Although the provisions and cases discussed in this letter do not provide sufficient guidance for us to furnish a definitive response to your general inquiry, the IRS National Office is authorized, under section 3 of Revenue Procedure 2000-1, 2000-1 I.R.B. 4, to issue letter rulings to answer written inquiries of individuals and organizations about the tax effects of their acts or transactions, when appropriate in the interest of sound tax administration. Section 2.01 of Revenue Procedure 2000-1 defines a “letter ruling” as a written statement issued to a taxpayer by the National Office of the Internal Revenue Service that interprets and applies the tax laws to the taxpayer’s specific set of acts. In light of the available guidance, we can only determine how these provisions apply to your clients’ cases in response to a request for a letter ruling filed in accordance with the requirements of Rev. Proc. 2000-1, including payment of the required user’s fee.

We hope the general information supplied above has been helpful. If you need further assistance, please contact John Tolleris of my staff at (202) 622-6030.

Sincerely,

Robert D. Patchell  
Assistant Branch Chief,  
Qualified Plan Branch 2  
Office of Division Counsel/  
Associate Chief Counsel  
(Tax Exempt & Government Entities)

Enclosure (3): *(Sent by mail)*

Section 457 of the IRC  
§ 1.457 of the Income Tax Regulations  
Revenue Procedure 2000-1