This responds to your letter of May 29, 2001, addressed to the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities), Internal Revenue Service. Your letter inquired regarding the reasons that the rules regulating distributions and transfers from section 457 deferred compensation plans are less flexible than the rules regarding distributions from section 401(k) plans such as the ones offered by your former employer.

We do not have sufficient information regarding your employer (i.e., whether it is a governmental entity or a tax-exempt organization) or the section 457 plan it sponsors, including a copy of the plan, to definitively discuss your case and options under that plan. However, we can provide some general information that may be helpful to you.

A deferred compensation plan, such as an eligible section 457 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 currently governed by the constructive receipt doctrine embodied in the regulations under section 451 of the Internal Revenue Code, and, in the case of state and local governmental and tax-exempt employers, section 457 of the Code.

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 "[i]ncome 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. Also, as discussed below, a special exception in section 457 allows participants and beneficiaries in an eligible deferred compensation plan to request and receive limited accelerated withdrawals from their accounts to meet their hardship needs due to an unforeseeable emergency.

Section 457, which Congress enacted in 1978, 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 such as a state or local government entity or a tax-exempt organization. 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 otherwise made available" to the plan participant or the participant's beneficiary, not in the year deferred.

Section 1.457-1(b) of the 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 become payable or (3) is not to a fixed or determinable future date.

In keeping with the doctrine of constructive receipt, this means the participant’s election must be one to delay the payment date rather than accelerate it. 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. In order for the Internal Revenue Service, as well as plan participants, to ascertain when deferred amounts become payable, 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.

Your description of the distribution provisions of your former employer's section 457 plan sounds similar to those of many section 457 plans we've seen which establish a mandatory default provision governing the time and manner of distribution for participants who do not make a timely distribution election within 60 days of their separation from service. However, we are unable to determine whether your plan administrator accurately describes its plan's distribution provision without examining the plan document.
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 ability 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.

There is an exception to this general rule relating to emergencies. Under section 457(d)(1)(A)(iii) of the Internal Revenue Code, the plan (and its sponsoring employer or administrator) 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. Section 1.457-2(h)(4) of the regulations defines an unforeseeable emergency as 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. Benefits would not be "made available" merely because the plan contained such a provision. This is a section 457 statutory exception that permits a plan sponsor or administrator to release funds from a participant's section 457 plan account before the time otherwise authorized in the section 457 plan document.

The Congress developed the current rules for section 457 plans based on nonqualified plan concepts. Section 457 plans therefore are currently subject to different, and often less stringent, regulations than are funded, qualified retirement plans, such as section 401(k) plans, which must comply with complex rules to assure parity in who they cover, and how much can be deferred. An attendant feature of section 457 plans is that, in some respects, they may provide less flexibility to participants than do qualified plans.

For example, one advantage of qualified plans is that employees who separate from service or retire are eligible to roll over the amounts in their accounts to individual retirement accounts (IRA) or other qualified plans, where the money may remain until that employee is required to take a distribution under the minimum distribution rules of the Code. This is in marked contrast to present law regarding a section 457 plan, where once the participant is eligible to receive the funds, there is no way, under current law, that a participant can further defer them income tax free unless that participant transfers the funds to another eligible section 457 deferred compensation plan. The transfer of deferred amounts from one eligible section 457 plan to another eligible plan under section 457(e)(10) is the only exception that is currently provided.
No similar exception is now provided for a rollover or transfer of funds to any other type of plan or arrangement, including an IRA.

Making section 457 plans similar to section 401(k) plans requires the Congress to enact statutory revisions such as the ones it has just enacted and the President has just signed into law as the Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16. This new law provides that, after 2001, distributions from a section 457 plan are includible in income when paid, rather than when “paid or made available.” That would authorize section 457 plans to provide more flexible distribution provisions, if they are revised to permit such flexibility. In addition, the new law provides that, after 2001, section 457 plan distributions that qualify as “eligible rollover distributions” may be rolled over into an IRA, or, subject to certain restrictions, to other plans such as section 401(k) or 403(b) plans. However, these revisions, easing the application of the constructive receipt doctrine and authorizing certain rollovers from section 457 plans to IRAs, do not become effective until 2002, and they generally apply only to section 457 plans sponsored by state and local governmental entities, not to plans sponsored by tax-exempt employers. However, for a governmental section 457 plan participant to be able to take advantage of these new provisions after 2001, his governmental employer’s plan must be revised to permit the use of these new provisions.

We trust this information will be helpful to you.

Sincerely,
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Office of Associate Chief Counsel
(Tax Exempt and Government Entities)