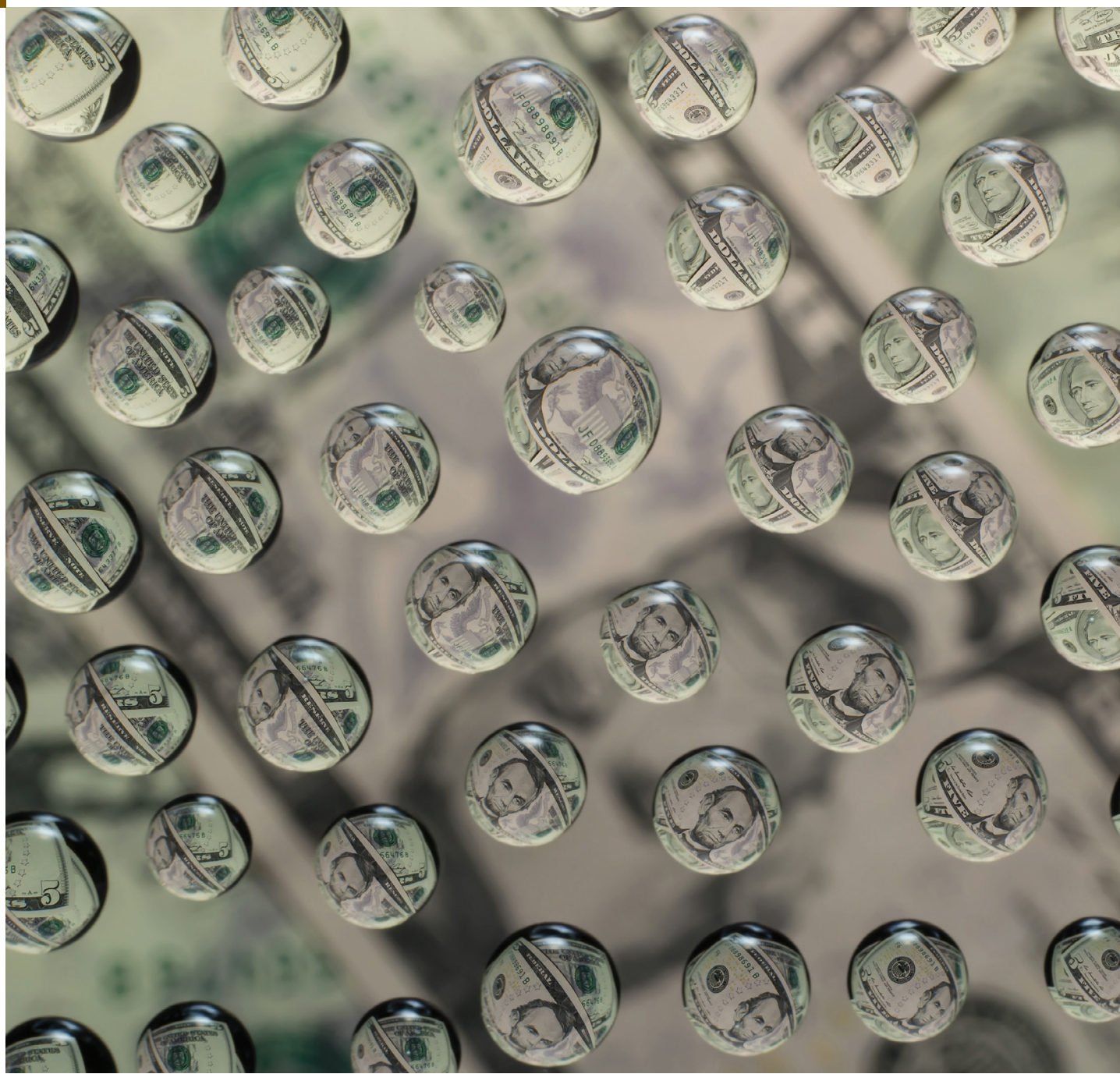

Sec. 457 government plan distributions compared to 401(k) distributions

By: Vorris J. Blankenship, J.D.

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State and local governments and their agencies and instrumentalities (state government units) may establish as many as three different types of tax-favored retirement plans, including qualified plans. If they are public school systems, they may establish Sec. 403(b) plans, generally known as tax-sheltered annuities (TSAs).[1]

In addition, they may establish Sec. 457 government plans.[2] Most have done so, and those plans are in widespread use by state government units throughout the country. Thus, tax and financial planners who counsel retirees should have more than a nodding acquaintance with the tax treatment of distributions from this type of plan.

Sec. 457 government plans originated as *unfunded* deferred compensation plans, a historical fact that in some respects makes them fundamentally different from most other tax-favored retirement plans. Not until 1996 did Congress require that state government units actually fund the plans using trusts, annuity contracts, or custodial accounts.[3] Since then these plans have assumed a significantly larger role as a substitute for 401(k) plans, particularly since state government units are generally not allowed to maintain 401(k) plans.[4]

A comparison of 457 government plans with 401(k) plans seems particularly apt since practitioners are generally more familiar with 401(k) plans, and cash or deferred arrangements are significant features of both types of plans.[5] Under a cash or deferred arrangement, a participant may generally elect either cash compensation or employer contributions to a retirement plan. This article refers to such elective contributions as qualifying elective contributions (QECs), even though some types of plans use the term elective deferrals or salary reductions. QECs are generally excluded from gross income; however, QECs that are Roth contributions are taxable.[6]

Over the years, Congress has substantially conformed the treatment of 457 government plans to the treatment of 401(k) plans. The latest conforming change was the reduction of the age of qualification for in-service distributions from 70½ to 59½ for years after 2019. Other conforming changes over the years have included changes in the timing of income inclusions, the treatment of plan loans, required minimum distributions, and the availability of Roth conversions. Nevertheless, some of the tax rules for distributions from 457 government plans continue to differ in significant ways from those for 401(k) plans.[7] Those differences are discussed in this article.

Note that this article does not explain the differences between 457 government plans and 401(k) plans to the extent those differences relate to formation and administration of the plans. Nor does it attempt to compare the rules governing the extent of coverage of employees (nondiscrimination rules) or the qualifications for coverage for various types of employees. Instead this article focuses on a comparison of accumulations in and distributions from 457 government plans and 401(k) plans and on other closely related matters that more directly affect individuals who are admittedly qualified participants in valid plans.

Statutory limitations on contributions to 457 government plans and other plans

Generally, QECs for a tax year are limited by statute to the lesser of an employee's compensation or an inflation-adjusted dollar amount ($19,500 for 2020 and 2021).[8] This basic limit applies to the aggregate of all QECs made on behalf of an employee to 401(k) and 403(b) plans.[9] This same basic limit is, however, determined and applied separately to QECs made to 457 government plans (i.e., without regard to

1. Sec. 403(b)(1)(A)(ii). Sec. 403(b) plans may also be established by (1) tax-exempt educational, charitable, scientific, literary, sports, religious, or public safety testing organizations (hereafter "501(c)(3) organizations"); (2) Indian tribal schools; (3) employers of religious ministers or self-employed ministers; and (4) certain health and hospital service organizations (Sec. 403(b)(1)(A); IRS, *Employee Plan News* 2015-5 (May 6, 2015)).
2. Secs. 457(a)(1)(A) and (e)(1)(A). An eligible government plan may be administered by a labor union for the benefit of its members, provided the employers of the members adopt the plan (Rev. Rul. 2004-57).
3. Small Business Job Protection Act of 1996, P.L. 104-188, §1448(a); Sec. 457(g); Regs. Sec. 1.457-8(a).
4. Sec. 401(k)(4)(B)(ii). State and local governments and their agencies were and are generally not allowed to adopt 401(k) plans after May 6, 1986 (Regs. Sec. 1.401(k)-1(e)(4)(i)).
5. For a similar comparison of distributions from 403(b) plans and 401(k) plans, see Blankenship, "Sec. 403(b) Retirement Plans: A Comparison With 401(k) Plans," 52 *The Tax Adviser* 30 (January 2021), available at tinyurl.com/y5swwks7.
6. Regs. Secs. 1.401(k)-1(f)(1) and 1.457-4.
7. Regs. Secs. 1.457-2(k)(2) and 1.457-11(b). Note that other types of tax-favored plans cannot qualify as 457 government plans. For example, qualified plans, qualified state judicial plans, qualified governmental excess benefit arrangements (QGEBAs), or plans or arrangements subject to special transitional rules cannot be 457 government plans (Regs. Sec. 1.457-2(k)). For qualified state judicial plans, see *Yegan*, T.C. Memo. 1989-291.
8. Secs. 402(g)(1) and (4); Notice 2019-59; Notice 2020-79. The basic limit on QECs does not apply to rollover contributions (Sec. 402(g)(3); Regs. Secs. 1.403(b)-4(a) and (b)(1)).
9. Secs. 402(g)(1), (3), and (4); Regs. Sec. 1.401(g)-1(a). The Code states that the basic limit also applies to IRAs that are simplified employee pensions (SEPs) or SIMPLE retirement accounts (Sec. 402(g)(3)). SEPs may, however, contain only legacy cash or deferral features existing before 1997 and, in addition, an employer maintaining a 403(b) plan is necessarily a tax-exempt entity or state government unit that is not allowed to maintain even a legacy cash or deferred feature in a SEP (Secs. 408(k)(6)(E) and (H)). Further, an employer may not adopt a SIMPLE retirement account with a cash or deferred feature if the employer maintains an active 403(b) or 401(k) plan (Sec. 408(p)(2)(D)).

application of the limit to 401(k) and 403(b) plans).[10]

If an employee over age 50 has already made the maximum allowed QECs (equal to the basic limit) to 401(k) and 403(b) plans for the tax year, the plans may nevertheless allow the employee to make additional QECs that are catch-up contributions.[11] Catch-up contributions for a tax year are limited in the aggregate to the lesser of (1) an inflation-adjusted dollar amount ($6,500 for 2020 and 2021), or (2) the amount of the employee's compensation reduced by the QECs already made under the basic limit.[12]

In addition, if an employee has completed 15 years of service, 403(b) plans of certain educational, medical, welfare, and church organizations may allow an employee to make additional QECs that are special catch-up contributions. This special catch-up provision is specifically designed to compensate for allowable QECs not taken in prior years. It is limited to $3,000 in any one tax year and to an aggregate of $15,000 for all tax years.[13] An employee eligible to take both the special catch-up contribution and the over-50 catch-up contribution may elect both without offsetting one against the other.[14]

In addition, 401(k) and 403(b) plans are subject to various complicated nondiscrimination provisions that might have the effect of further limiting contributions by or for highly compensated employees.[15] Of note is a provision that limits the amount of an employee's compensation that may be taken into account in computing contributions to the plan (maximum compensation of $285,000 for 2020 and $290,000 for 2021).[16]

Finally, for each employee, the aggregate of contributions and forfeitures to 401(k), 403(b), and other defined contribution plans (not including 457 government plans) generally may not exceed an overall inflation-adjusted dollar amount ($57,000 for 2020 and 58,000 for 2021).[17] Rollover funds and over-50 catch-up contributions are, however, not subject to this limitation.[18]

10. Secs. 457(b)(2), 402(g)(1), and 402(g)(3).
11. Note that the plan can impose its own basic limit on QECs if the plan limit is less than the statutory limit. In that event, the over-50 catch-up contributions would consist of contribution amounts that exceed the lesser plan limit (Regs. Sec. 1.414(v)-1(b)(2)).
12. Secs. 402(g)(1)(C) and 414(v); Regs. Secs. 1.402(g)-2 and 1.414(v)-1(c)(1); Notice 2019-59; Notice 2020-79. If the plan basic limit applies and puts a cap on QECs, the catch-up contributions cannot exceed the employee's compensation reduced by the basic plan limit (Regs. Sec. 1.414(v)-1(b)(2)).
13. Sec. 402(g)(7); Regs. Sec. 1.403(b)-4(c)(3).
14. Regs. Secs. 1.403(b)-4(c)(3)(iv) and (c)(5), Example 4.
15. Secs. 403(b)(12), 401(k)(3), and 401(m); Regs. Secs. 1.401(k)-2 and 1.403(b)-5.
16. Sec. 401(a)(17); Regs. Sec. 1.401(a)(17)-1; Notice 2019-59; Notice 2020-79.
17. Secs. 415(a) and (c); Notice 2019-59; Notice 2020-79. The overall contribution limitation applicable to defined contribution plans is not changed or otherwise affected by the fact that the employer also maintains one or more defined benefit plans (Small Business Job Protection Act of 1996, P.L. 104-188, §§1452(a) and (d)(1)).
18. Secs. 415(a), (c), and (k)(1).

EXECUTIVE SUMMARY

- State and local governments and their agencies and instrumentalities can establish Sec. 457 plans but not Sec. 401(k) plans (unless adopted before May 7, 1986).
- Although many of the rules for contributions and distributions are the same for 457 plans and 401(k) plans, there are still significant differences, including the provision that independent contractors can participate in 457 plans but not 401(k) plans.
- Some other significant differences relate to the rules for commencement of distributions. Also, the 10% additional tax on early distributions generally does not apply to 457 plans.
- Both Sec. 457 plans and 401(k) plans may accept rollovers from other retirement plans, but a 457 plan may accept the rollovers only if it maintains separate accounts for them.
- Many of the rules that apply to 401(k) plans are optional for Sec. 457 plans, including the date an employer is required to begin making distributions and the requirement that the plan provide spousal annuities. There are also different rules for qualified domestic relations orders.
- Community property rules apply to 457 plans but not to most 401(k) plans, so if contributions are made to a 457 government plan while the participant is living in a community property state, the participant's spouse generally will have an interest in the plan.
- An employee who participates in both a 457 government plan and a 403(b) plan may be able to make contributions to the plans that are double the contributions available if he or she had participated in only one of the plans.

Separate limitations on deferrals in 457 government plans

Similar to 401(k) and 403(b) plans, annual deferrals in a 457 government plan are limited to the lesser of an employee's compensation or an inflation-adjusted dollar amount (also $19,500 for 2020 and 2021). Unlike 401(k) and 403(b) plans, however, this basic limit for 457 government plans applies not only to QECs but also to all other non-QEC contributions to the plan by or for the employee (except rollover contributions). On the other hand, as noted above, the basic limit is not reduced or otherwise affected by contributions made to 401(k) or 403(b) plans.[19]

If a 457 government plan permits, an employee who is over age 50 by the end of the tax year, or his or her employer, may also be able to make catch-up contributions in excess of the basic deferral limit.[20] These catch-up contributions are themselves limited to the lesser of (1) an inflation-adjusted dollar amount ($6,500 for 2020 and 2021), or (2) the amount of the employee's compensation reduced by deferrals already made under the basic limit.[21] But unlike for 401(k) or 403(b) plans, the over-50 catch-up contributions for a 457 government plan are not reduced or otherwise affected by catch-up contributions made to other types of plans.[22]

Alternatively, if a 457 government plan permits, an employee or his or her employer may make special catch-up contributions for each of the three years ending before the employee reaches his or her normal retirement age. The total amount of these special catch-up contributions generally may equal the amount of contributions the employee could have made, but did not make, for prior years. Nevertheless, total contributions for a tax year, including both contributions equal to the basic limit and the special catch-up contribution, may not exceed twice the normal dollar limit on contributions for the tax year (e.g., twice $19,500, or $39,000 for 2020 and 2021).[23]

If an employee participating in a 457 government plan is eligible for both the over-50 catch-up and the special catch-up, the employee may take only the one yielding the larger overall contribution for the tax year.[24]

Potential doubling-up of QECs to a 457 government plan and a 403(b) plan

An employee who participates in both a 457 government plan and a 403(b) plan may be able to make QECs to the plans that are double the QECs available if he or she had participated in only one of the plans. For example, for 2020 and 2021, the employee could potentially make QECs totaling $19,500 to the 457 government plan and QECs totaling $19,500 to the 403(b) plan, for a total QEC deferral of $39,000.[25] Observe though that, because the 457 plan limitation on contributions also applies to non-QEC contributions to the plan, non-QEC contributions may crowd out potential QEC contributions.[26]

The employee may also double up permitted over-50 catch-up contributions since the catch-up limitation ($6,500 for 2020 and 2021) is applied separately to the 403(b) plan and to the 457 government plan.[27] In addition, an employee of a qualifying educational, medical, or welfare organization who is participating in both types of plans may still potentially take advantage of the special 403(b) catch-up contribution for employees with 15 years of service (limited to $3,000 per year, as discussed above).[28]

Furthermore, if the 457 government plan permits, the employee or his or her employer may also be able to make the special catch-up contributions to the plan that are generally available to employees in the last three years ending before they reach normal retirement age. But, as discussed above, the special catch-up is available only in lieu of the over-50 catch-up and only if the special catch-up is larger than the permitted over-50 catch-up.[29]

Unfortunately, though, only a limited number of state government units with 457 government plans can also maintain a 401(k) plan or a 403(b) plan. A state government unit may adopt and maintain a 403(b) plan only if the governmental unit is a public school system[30] or if it is a 501(c)(3) organization with significant governmental attributes.[31] A state government unit may generally maintain a 401(k) plan only if the plan was adopted before May 7, 1986.[32] Note though that an employee participating in both a 457 government plan and a legacy 401(k) plan may also be able to double up the basic limit and the over-50 catch-up limit in a way similar to the double-up described above for

19. Sec. 457(b)(2); Regs. Secs. 1.457-4(c) and 1.457-2(b).
20. Regs. Sec. 1.414(v)-1(c).
21. Secs. 414(v) and (u)(2)(c); Regs. Sec. 1.457-4(c)(2); Notice 2019-59; Notice 2020-79.
22. Sec. 414(v)(2)(D); Regs. Sec. 1.414(v)-1(f)(1).
23. Secs. 457(b)(3) and (c)(18); Regs. Sec. 1.457-4(c)(3).
24. Secs. 414(v)(6)(C) and 457(e)(18); Regs. Secs. 1.457-4(c)(2)(ii) and (iii), Examples 2 and 3.
25. IRS Letter Ruling 200934012.
26. Sec. 457(b)(2); Regs. Secs. 1.457-4(c) and 1.457-2(b).
27. Sec. 414(v)(2)(D); Notice 2019-59; Notice 2020-79.
28. Sec. 402(g)(7); Regs. Sec. 1.403(b)-4(c)(3); IRS Letter Ruling 200934012.
29. Secs. 457(b)(3) and 414(v)(6)(C); Regs. Secs. 1.457-4(c)(3) and (c)(2)(ii).
30. Sec. 403(b)(1)(A)(ii).
31. Notice 2015-7; Announcement 2011-78; REG-155608-02.
32. Regs. Sec. 1.401(k)-1(e)(4)(i). In addition, though, Indian tribal government units and rural cooperatives that are state government units may adopt 401(k) plans (Secs. 401(k)(4)(B)(ii) and (iii)).

A plan receiving a rollover from a 457 government plan may eliminate constraints on subsequent distribution of the rolled-over amount, provided the plan separately accounts for the rollover.

simultaneous participation in 403(b) and 457 government plans.[33]

It might also be possible for a public school system, or a tax-exempt charitable organization with sufficient governmental attributes, to simultaneously maintain a 457 government plan, a 403(b) plan, and a legacy 401(k) plan. Even with all three types of plans, though, an employee could do no more than double the QECs, since a single basic limit applies to the 401(k) and 403(b) plans. Note also that an employer has the option of not allowing an employee to participate in a 403(b) plan if the employee is a participant in a 457 government plan.[34]

Independent contractors may participate in 457 government plans

Only employees may participate in Sec. 401(k) plans. But due to the unfunded deferred compensation history of 457 government plans, these plans may allow independent contractors as well as employees to participate.[35] An independent contractor will be precluded from participating only if he or she is among a group of independent contractors who have the same or a similar relationship with a plan sponsor that is making nonelective contributions to the plan for them. Contributions are nonelective for this purpose if the plan does not provide the independent contractors with individual variations or options as part of their coverage.[36]

For this purpose, requiring an independent contractor to complete an initial service period to qualify for participation in the plan is not a sufficient variation or option.[37] For example, a plan that provided mandatory contributions for all trustees of a cooperative who had three years of service was not a 457 government plan because the plan provided coverage to the trustees without any distinguishing variations or options, other than whether they had completed an initial service period.[38]

Earliest date distributions may begin

The terms of a 457 government plan generally determine when the plan may commence distributions. The tax law does, however, limit how soon distributions may begin. That is, a plan generally may not make distributions before the earliest of (1) the participant's severance from employment; (2) the calendar year the participant reaches age 59½ (70½ before 2020); (3) the participant's unforeseeable emergency; (4) a qualified birth or adoption; (5) the participant's death; (6) active duty in the uniformed services for more than 30 days; or (7) termination of the plan.[39] In addition, if and when a "lifetime income investment" may no longer be held as an investment option under the plan, the plan may distribute or transfer the investment to the participant or to another retirement plan.[40]

These constraints on commencement of distributions from 457 government plans are similar to the constraints on distributions from most 401(k) plans. The primary differences relate to (1) the types of plan funds subject to the constraints and (2) the treatment of distributions commencing on disability, severance from employment, and unforeseeable emergencies.[41]

33. Sec. 414(v)(2)(D); IRS Letter Ruling 200934012.
34. Regs. Secs. 1.403(b)-5(b)(4)(i) and (ii)(A).
35. Sec. 457(e)(2); Regs. Sec. 1.457-2(e). Sponsors of 457 government plans may decide to use separate plans for employees and independent contractors. The concern is that the exemption from the Employee Retirement Income Security Act of 1974 (ERISA) of a government plan "for its employees" may be lost if the plan also includes independent contractors (ERISA, 29 U.S.C. §§1002(32) and 1003(b)(1)); see also Labor Department Advisory Opinion 94-02A). If the exemption from ERISA were lost, the plan would be required to provide for spousal annuities, non–alienation of benefits, earlier vesting, and more (ERISA, 29 U.S.C. §§1052 through 1060).
36. Sec. 457(e)(12); Regs. Sec. 1.457-2(k)(1).
37. Id.
38. IRS Letter Ruling 201447002.
39. Secs. 457(d)(1)(A) and 72(t)(2)(H); Regs. Sec. 1.457-6(a); Prop. Regs. Sec. 1.457-6(b)(1). The distribution limitations do not, however, apply to distributions of excess deferrals (Regs. Secs. 1.457-6(a) and (e)). Nor do they apply to qualified domestic relations orders (QDROs) (Regs. Sec. 1.457-10(c)). Note also that for purposes of item (6) in the above text, uniformed services include the armed forces, the Army National Guard, the Air National Guard, and certain other miscellaneous services (id., Secs. 414(u)(12)(B) and 3401(h)(2)(A); 38 U.S.C. §4303(16); Notice 2010-15).
40. Secs. 401(a)(38), 457(d)(1)(A)(iv), and 457(d)(1)(D). Transferable lifetime income investments include optional annuities payable in substantially equal annual installments (or more frequent periodic intervals) over the life of the participant or the joint lives of the participant and his or her designated beneficiary. Those investments also include an optional investment with a feature guaranteeing a minimum level of income annually (or more frequently) for at least the life of the participant or the joint lives of the participant and his or her designated beneficiary (Sec. 401(a)(38)(B)(iii)).
41. Sec. 401(k)(2)(B)(i); Regs. Sec. 1.401(k)-1(d)(3). Coronavirus pandemic-related distributions are also allowed (Coronavirus Aid, Relief, and Economic Security (CARES) Act, P.L. 116-136, §2202).

Plan funds subject to constraints on commencement of distributions

The 457 government plan constraints on commencement of distributions apply to all plan distributions; whereas the similar 401(k) constraints apply only to distributions from funds attributable to the participant's QECs, qualified nonelective contributions (QNECs), and qualified matching contributions (QMACs). QMACs are employer contributions to a 401(k) plan that match an employee's QECs; those matching contributions must satisfy the same nonforfeitability and distribution commencement constraints that apply to QECs. QNECs are employer contributions, other than QECs or QMACs, that also satisfy the 401(k) nonforfeitability and distribution commencement constraints applicable to QECs.[42]

Commencement of distributions upon disability

Under a 401(k) plan, distributions may commence upon the participant's disability.[43] Under a 457 government plan, however, disability is not an event allowing distributions to begin. Nevertheless, a disability may be severe enough that it is accompanied by a severance from employment or an unforeseeable emergency, either of which events may allow distributions to begin.

Severance from employment by an independent contractor

As discussed above, unlike in a 401(k) plan, an independent contractor may participate in a 457 government plan. A severance from employment that will allow commencement of distributions, however, is defined differently for an independent contractor than for an employee. An independent contractor will separate from "employment" upon the good-faith termination of all his or her service contracts with the plan sponsor. A termination is not in good faith, however, if the plan sponsor expects to renew the relationship in the form of either an employee or independent contractor arrangement.

Fortunately, the regulations provide a safe harbor if the deferred compensation is not payable to the terminating contractor until after 12 months following termination. The safe harbor is lost, however, if the independent contractor renders any additional services to the plan sponsor before the scheduled payment date and the deferred compensation is nevertheless paid.[44]

Severance due to reservist's call to active duty

A severance from employment that allows commencement of distributions under a 401(k) plan includes when an employee who is a military reservist reports to active duty. The plan may make a distribution of elective deferrals to the employee if the period of active duty is at least 179 days or an indefinite period. The employee will not incur the penalty for early distributions. Within a two-year period after completion of active duty, the reservist may make voluntary nondeductible contributions to an IRA or Roth IRA in an aggregate amount not exceeding the active-duty distributions.[45]

There is no comparable reservist provision for 457 government plan participants.

Unforeseeable emergencies

The right to distributions after an unforeseeable emergency is an optional provision that an employer may provide in a 457 government plan. An unforeseeable emergency is a severe financial hardship of the participant or beneficiary due to illness or accident of the participant or the participant's spouse,[46] beneficiary, or dependent. It also includes severe financial hardship due to casualty or other similar circumstances beyond the participant's control.

For example, damage or destruction of a residence requiring repairs or rebuilding may constitute an unforeseeable emergency. Medical expenses or funeral expenses incurred by the participant or a foreclosure on the participant's residence may also give rise to an unforeseeable emergency.[47] Significant damage to the participant's home from a water leak is an unforeseeable emergency, as are expenses incurred for the funeral of an adult child (even though the child was not a dependent).[48] The purchase of a residence and the payment of college tuition, however, are not unforeseeable emergencies.[49] Nor is the need to pay accumulated credit card debt.[50]

The amount distributed for the emergency may not exceed the amount reasonably necessary to meet the need but may include reimbursement for income taxes and penalties incurred on the distribution. In no event, though, may the plan make a distribution to the extent the emergency can be relieved by reimbursement or compensation from insurance or otherwise. Furthermore, the participant must liquidate assets to relieve the emergency, to the extent that would not itself create a severe financial

42. Secs. 401(k)(2)(B) and (3)(D)(ii). See also the definitions of QNECs and QMACs at Regs. Sec. 1.401(k)-6.
43. Sec. 401(k)(2)(B)(i)(I); Regs. Sec. 1.401(k)-1(d)(1)(i).
44. Regs. Sec. 1.457-6(b)(2).
45. Secs. 72(t)(2)(G) and 401(k)(2)(B)(i)(V); Regs. Sec. 1.401(k)-1(d)(1)(iv); Notice 2010-15.
46. The term spouse includes either individual in an opposite-sex or same-sex marriage. The term marriage also includes both opposite-sex and same-sex marriages (*Windsor*, 570 U.S. 744 (2013); *Obergefell v. Hodges*, 576 U.S. 644 (2015); Regs. Secs. 1.7701-1(a) and 301.7701-18; Rev. Rul. 2013-17).
47. Regs. Sec. 1.457-6(c)(2).
48. Rev. Rul. 2010-27.
49. Regs. Sec. 1.457-6(c)(2)(i).
50. Rev. Rul. 2010-27.

hardship.[51] The participant, however, need not cease making contributions to the plan.[52]

By comparison, Sec. 401(k) plans do not specifically allow distributions for unforeseeable emergencies. Instead, they generally allow a plan the option of including a provision for distributions for "hardship." The 401(k) hardship rules are much more lenient than the unforeseeable emergency rules for 457 government plans.[53] In fact, a hardship need not even be unforeseeable or involuntary.[54]

Although the types of events that justify the two types of distributions are similar, the events are not identical. Unlike a distribution for an unforeseeable emergency, a 401(k) hardship distribution may be used to pay tuition and other college expenses,[55] to purchase a principal residence, or to make mortgage payments or pay rent if necessary to avoid foreclosure or eviction.[56] The distribution may also be used to compensate for expenses and losses (including loss of income) for a federally declared disaster.

Procedurally, the 401(k) rules may also be substantially easier to navigate. Before obtaining a hardship distribution, a participant generally needs to do only two simple things. First, he or she must obtain all other available distributions from the 401(k) plan and from all other deferred compensation plans (whether qualified or nonqualified). Second, he or she must represent in writing to the plan administrator that he or she has insufficient liquid funds reasonably available to meet the need.[57] Unfortunately, though, the terms of the plan may also impose their own additional conditions on the hardship distribution.[58]

Over the years, Congress has gradually made 401(k) hardship distributions more readily available. It is unclear why Congress has not also liberalized the harsher unforeseeable emergency rules for participants in 457 government plans.

The 10% penalty on premature distributions

Unlike for 401(k) plans, the 10% penalty on early distributions does not apply to distributions by 457 government plans from compensation that was originally deferred under the plan (including earnings thereon). Nor does the penalty apply to amounts of deferred compensation (including earnings) that are rolled over to a 457 government plan from another 457 government plan if the compensation has never been held in any other type of tax-favored plan. The penalty does apply, however, to distributions from a 457 government plan of amounts that were previously held in tax-favored plans that are not 457 government plans. The rules for and exceptions from the penalty on those distributions are the same as those that generally apply to early distributions from qualified plans (even if the funds were actually rolled over from an IRA or a Sec. 403(b) plan).[59]

One of the exceptions to the early-distribution penalty is for payments under qualified domestic relations orders (QDROs). The QDRO exception is, however, effectively broader in scope for 457 government plans since, as discussed below, QDROs for those plans are not subject to the more stringent requirements for QDROs under most qualified plans (other than church and government plans). Nevertheless, if a domestic relations order for a 457 government plan does not qualify for the QDRO exception despite the more lenient treatment for 457 government plans, payments under the order will be subject to the early-distribution penalty if no other exception applies.[60]

More generally, a participant in a 457 government plan can avoid the early-distribution penalty by taking distributions from those separate accounts containing deferrals that have been held only by 457 government plans. Only when those accounts have been depleted should the participant take distributions from the other rollover accounts that are subject to the early-distribution penalty.[61] For example, after separation from service, a participant under age 55 would want to avoid the penalty by drawing down only amounts in separate accounts containing the 457 government plan deferrals.[62] Similarly, after an unforeseeable emergency, a participant under age 59½ who is not retired should draw down funds only from those accounts containing the 457 government plan deferrals.[63]

Rollovers to and from other plans

By its terms, a 457 government plan may accept rollovers from other plans,

51. Regs. Secs. 1.457-6(c)(2)(ii) and (iii).
52. Regs. Sec. 1.401(k)-1(d)(3)(iii)(C).
53. Sec. 401(k)(2)(B)(i)(IV); Regs. Sec. 1.401(k)-1(d)(3).
54. Regs. Sec. 1.401(k)-1(d)(3)(ii)(A).
55. Regs. Sec. 1.401(k)-1(d)(3)(ii)(B)(3).
56. Regs. Secs. 1.401(k)-1(d)(3)(ii)(B)(2) and (4).
57. Regs. Sec. 1.401(k)-1(d)(3)(iii)(B).
58. Regs. Sec. 1.401(k)-1(d)(3)(iii)(C).
59. Secs. 72(t)(2), (t)(9), and 457(a)(2). See Blankenship, "Retirement Plans, IRAs, and Annuities: Avoiding the Early Distribution Penalty," 42 *The Tax Adviser* 254 (April 2011).
60. Secs. 72(t), 414(p)(11), and 414(p)(1)(A)(i); 29 U.S.C. §1003(b)(1)–(2).
61. Preamble to the regulations (T.D. 9075, ¶5.d).
62. If the participant retired during or after the year he or she reached age 55, however, an exception to the early-distribution penalty would apply to any otherwise penalized amount distributed by the 457 government plan (Sec. 72(t)(2)(A)(v)).
63. Merely experiencing an unforeseeable emergency is not an exception to the early-distribution penalty. Possible other exceptions, though, might be triggered by the unforeseeable emergency, for example, the participant's disability or the incurrence of medical expenses (Secs. 72(t)(2)(A)(iii) and (2)(B)).

including plans that are not 457 plans. Those other plans may not, however, roll over any after-tax investment to 457 government plans,[64] and 457 plans are required to separately account for any rollovers they do receive.[65] A 457 plan may, however, eliminate normal plan constraints on subsequent distributions of the rolled-over amounts.[66]

Similarly, employees may roll over amounts from 457 government plans to other plans to the same extent employees in 401(k) plans may make rollovers to other plans. As with 401(k) plans, an employee in a 457 government plan may roll over only "eligible rollover distributions." Among other things, the Code provides that eligible rollover distributions do not include "hardship" distributions.[67] Since 457 government plans do not provide for hardship distributions but instead may allow distributions for unforeseeable emergencies, the question arises whether rollovers of distributions from 457 government plans for unforeseeable emergencies are forbidden. The IRS has indicated the answer is yes.[68] But it is doubtful, in any event, that a participant would want to roll over such a critically needed distribution.

A plan receiving a rollover from a 457 government plan may eliminate constraints on subsequent distribution of the rolled-over amount, provided the plan separately accounts for the rollover. When the recipient plan distributes the rolled-over amount, though, the distribution will be subject to the rules that apply to the recipient plan regarding the early-distribution penalty, the spousal annuity requirements, and the minimum distribution requirements.[69]

For example, if the recipient plan is a 401(k) plan, the spousal annuity requirements (see below) may apply to the recipient plan's later distribution of the rolled-over amounts even though the spousal annuity rules would not have applied to distributions by the transferring 457 government plan. In addition, the early-distribution penalty would apply to distributions of the rolled-over amount (in the absence of an exception) even though the penalty would not have applied to the 457 government plan's distribution of amounts it deferred. Further, the recipient plan must apply the minimum distribution rules applicable to it and not those applicable to the transferring 457 government plan.[70]

It appears likely that independent contractors cannot roll over amounts from 457 government plans to other plans. Sec. 457, which governs the treatment of 457 government plans, specifically provides that "employees" may roll over eligible rollover distributions to other plans but does not mention independent contractors. The provision pointedly does not use the term "participant" that Sec. 457 uses elsewhere when referring to both employees and independent contractors. In this connection, the regulations specifically define a participant as including both employees and independent contractors.[71]

That said, the IRS has muddied the waters a bit. The regulations state that *participants* can make trustee-to-trustee rollovers from a 457 government plan to another plan (without also specifying the type of individual allowed to make a 60-day rollover).[72] The IRS has also stated in a private letter ruling that both employees and independent contractors may roll over amounts from a 457 government plan.[73] But in a very similar private letter ruling issued only 20 days later, the IRS referred only to rollovers allowed for employees and did not mention rollovers by independent contractors.[74] Perhaps this was a course correction. Of course, these private letter rulings do not constitute precedent.[75]

Many other 401(k) plan rules do not apply to 457 government plans

A number of other requirements, prohibitions, and options generally applicable to distributions by 401(k) plans (other than church or government plans) are not imposed on 457 government plan distributions.[76] Perhaps the most significant of those are the four discussed immediately below.

Vesting schedules and forfeitures

It is axiomatic that a plan's benefit may be distributed only to the extent it has vested and become nonforfeitable. For 401(k) plans, however, the benefit attributable to *employee* contributions, and attributable to *employer* contributions of elective deferrals (QECs), are always vested and can never become forfeitable.[77] Nor can amounts attributable to

64. Sec. 402(c)(2).
65. Sec. 402(c)(10); Regs. Sec. 1.457-10(e).
66. Rev. Rul. 2004-12.
67. Sec. 402(c)(4).
68. Rev. Proc. 2004-56. The IRS has also indicated that distributions from other plans for rollovers to a 457 government plan will not qualify as eligible rollover distributions if they are distributions for *either* unforeseeable emergencies or hardships (id.).
69. Rev. Rul. 2004-12.
70. Id.
71. Sec. 457(e)(16); Regs. Sec. 1.457-2(j).
72. Regs. Sec. 1.457-7(b)(2).
73. IRS Letter Ruling 201819007.
74. IRS Letter Ruling 201822004. In an earlier ruling, the IRS also said "participants" in a 457 government plan can roll over distributions to another plan. The plan itself provided, however, that independent contractors could not participate in the plan (IRS Letter Ruling 200727005).
75. Sec. 6110(k)(3).
76. These requirements are imposed by ERISA. Churches and government units are, however, exempt from ERISA requirements (Secs. 411(e)(1) and 401(a) (flush language); 29 U.S.C. §§1002(32), 1002(33), 1003(b)(1), and 1003(b)(2)).
77. Sec. 411(a)(1); 29 U.S.C. §1053(a).

other *employer* contributions become forfeitable merely because a participant withdraws amounts attributable to *employee* contributions if the participant already had a nonforfeitable right to at least 50% of the plan's accrued benefit.[78]

Equally important, the benefit attributable to *employer* contributions to a 401(k) plan must (1) be totally vested after three years of service or (2) be 20% vested after two years of service, reaching 100% vesting after six years of service.[79] The rate of accrual of the benefit may not be slowed because of age.[80]

By contrast, the terms of a 457 government plan need not contain any of these requirements or prohibit any of these provisions.[81]

Mandatory commencement of distributions

A 401(k) plan is generally required to begin paying retiree benefits by a specific date. If the retiree does not elect to delay the payments (or the plan does not allow a delay),[82] the specified date is the 60th day after the *latest* of the plan years the retiree (1) reaches age 65, or reaches the plan's normal retirement age if earlier; (2) reaches the 10th anniversary of initial participation in the plan; or (3) terminates his or her service with the employer sponsoring the plan. If a retiree separated from service after meeting all the requirements for early retirement benefits except the age requirement, the plan must provide the retiree with a retirement benefit when he or she subsequently reaches the early retirement age.[83]

A 457 government plan, however, need not provide any similar mandatory date for the commencement of distributions.

Spousal annuity requirements

Sec. 401(k) plans are generally required to pay a participant's retirement benefit in the form of annuities that are designed to protect spouses and surviving spouses.[84] A 401(k) plan subject to spousal annuity requirements must generally make provision for two different types of annuities: (1) a qualified joint and survivor annuity for the participant and his or her spouse, and (2) a qualified preretirement survivor annuity for the surviving spouse of a participant who dies before retirement.[85] A participant may, however, waive these annuities with the consent of his or her spouse.[86]

Sec. 457 government plans, however, are not required to provide these annuities.[87]

Assignment or alienation

The benefits under a 401(k) plan generally may not be assigned or alienated, although there are exceptions for certain small voluntary and revocable assignments, for QDROs, and for certain judgments and settlements related to the plan.[88] A 457 government plan, however, need not prohibit assignments or alienations.

Inclusion of optional provisions

Although 457 government plans need not provide for the types of requirements and prohibitions discussed immediately above, an employer nevertheless has the option to draft a 457 government plan that includes similar provisions. For example, the IRS has clearly indicated that a 457 government plan may include anti-alienation provisions[89] and may include optional vesting provisions that are too harsh to qualify for inclusion in a 401(k) plan.[90] Other optional provisions include loans, acceptance of rollovers, catch-up contributions, and unforeseeable emergency distributions.[91]

Optional provisions need only "meet, in both form and operation, the relevant requirements under section 457" and the regulations thereunder.[92] Thus, for example, an optional provision to commence distributions upon the participant's disability could not be added because it would violate the statutory language limiting commencement to other types of events. If a 457 government plan does have validly added optional provisions, however, one would not expect those provisions to be overly onerous, considering an employer's interest in retaining satisfied and productive employees.

78. Sec. 401(a)(19); 29 U.S.C. §1056(c).
79. Sec. 411(a)(2)(B); 29 U.S.C. §1053(a)(2)(B). If an employer adopts a "simple" 401(k) plan, all contributions to the plan must be immediately nonforfeitable (Secs. 401(k)(11)(A)(iii) and 408(p)(3)).
80. Sec. 411(b)(2); 29 U.S.C. §1054(b)(1)(H)(i).
81. See Regs. Sec. 1.457-4(c)(1)(iv), Example 3, for an example of vesting provisions in a 457 government plan that would not meet the requirements for 401(k) plans. In the example, all the employer contributions to a 457 government plan vested in the same year but only well after three years of service had elapsed.
82. Regs. Sec. 1.401(a)-14(b).
83. Sec. 401(a)(14); 29 U.S.C. §1056(a).
84. Secs. 401(a)(11) and 417; 29 U.S.C. §§1055(a) and (b). See also Blankenship, "Required Spousal Annuities Under Qualified Retirement Plans," 117 *Tax Notes* 783 (Nov. 19, 2007).
85. Secs. 417(b) and (c); 29 U.S.C. §§1055(d) and (e). A participant may waive these annuities but only with the consent of his or her spouse (Sec. 417(a); 29 U.S.C. §§1055(c)(1) and (2)).
86. Secs. 417(a)(1) and (2).
87. 29 U.S.C. §§1002(32), 1002(33), 1003(b)(1), and 1003(b)(2); Secs. 401(a) (last sentence), 411(e)(1), and 414(d).
88. Sec. 401(a)(13)(A); 29 U.S.C. §1056(d)(1).
89. Rev. Proc. 2004-56.
90. Regs. Sec. 1.457-4(c)(1)(iv), Example 3.
91. Regs. Sec. 1.457-3(a).
92. Id.

QDROs

The tax law uses the term "qualified domestic relations orders" (QDROs) to refer to domestic relations orders of a court that direct a plan to pay benefits to a participant's spouse, former spouse, children, or other dependents (alternate payees). The tax law generally imposes strict requirements on QDROs. Thus, a QDRO under a 401(k) plan generally may not require any benefit or option not otherwise available under the plan.[93] Nor may such a QDRO require payment of benefits with a value greater than the value of benefits otherwise provided under the plan.[94]

QDROs issued for 457 government plans are, however, not subject to the same strict rules applicable to most QDROs. Instead they are subject to the more lenient rules applicable to QDROs under qualified government plans.[95] They need only provide for the payment of plan benefits to an alternate payee, without any additional requirements or prohibitions.

Note that the QDRO rules do not apply to pre-2002 domestic relations court orders for 457 government plans.[96] Payments to a spouse or former spouse under those old orders continue to be taxable to the participant.[97] No similar provision applies to 401(k) plans.

Applicability of state community property laws

If a participant resides in a community property state while working, the participant's spouse may acquire a 50% ownership interest in amounts the participant earns. These state community property laws generally do not apply to participants in 401(k) plans.[98] They do, however, apply to participants in 457 government plans.[99] Thus, if a participant was covered by a 457 government plan while residing in a community property state, his or her spouse may have acquired a community property interest in plan benefits as they accrued.[100]

Nevertheless, community property laws do not apply to the determination of compensation for applying the limits on the amount of contributions that can be made to a 457 government plan.[101] Note also that special rules may apply to community income of spouses who live apart, and in certain other unusual circumstances.[102] Community property states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin.

Transfers to buy service credits or repay contributions

Plan-to-plan transfers from a 457 government plan to a qualified governmental plan that is a defined benefit plan are not taxable to a participant or beneficiary if certain conditions are met. Participants or beneficiaries may request those transfers to purchase permissive service credits for otherwise nonqualifying or nonexistent periods of service under the recipient defined benefit plan.[103] Alternatively, participants or beneficiaries may use the transfers to reinstate service credits in the recipient defined benefit plan that were forfeited because of previous distributions.[104] The regulations do not treat these transfers as distributions; thus, the plan may make the transfers before age 59½ and before retirement.[105]

The tax law generally imposes strict requirements on QDROs. Thus, a QDRO under a 401(k) plan generally may not require any benefit or option not otherwise available under the plan.

Lump-sum distributions for participants born before 1936

If a participant in a 401(k) plan was born before Jan. 2, 1936, the participant (or more likely his or her beneficiary) may be entitled to special tax treatment for a lump-sum distribution from the plan. The recipient may be able to choose to (1) pay tax on a portion of the distribution at a 20% tax rate or (2) compute the tax on some or all of the distribution by averaging the income and applying a special tax rate schedule.[106] This special provision is not available for participants in 457 government plans.[107]

93. Sec. 414(p)(3)(A).
94. Sec. 414(p)(3)(B).
95. Secs. 414(p)(11) and (p)(1)(A)(i).
96. Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16, §§635(a)(1) and (2); Sec. 414(p)(11).
97. *Platt*, T.C. Memo. 2008-17.
98. *Boggs v. Boggs*, 520 U.S. 833 (1997).
99. 29 U.S.C. §§1002(32) and 1003(b)(1). Note that community property laws do not apply in determining the compensation on which deferrals are based (Sec. 457(e)(7)).
100. IRS Letter Rulings 201021048 and 201021050.
101. Sec. 457(e)(7); Regs. Sec. 1.457-2(g).
102. Sec. 66.
103. Sec. 415(n)(3).
104. Sec. 415(k)(3).
105. Sec. 457(e)(17); Regs. Sec. 1.457-10(b)(8); IRS Letter Ruling 200550042.
106. Tax Reform Act of 1986, P.L. 99-514, §1122(h)(3); Sec. 402(e)(4)(H) (1986); Notice 2018-74. IRS Form 4972, *Tax on Lump-Sum Distributions*, also states that a participant is qualified if he or she was born before Jan. 2, 1936.
107. *Rheal*, T.C. Memo. 1989-525; *Adamcewicz*, T.C. Memo. 1994-361.

Designated Roth accounts of 457 government plans

Since 2011, state government units have been able to establish a Roth program as part of a 457 government plan. The Roth program need only be part of an existing cash or deferred arrangement within the plan. In most respects, the tax treatment of a Roth program in a 457 government plan is the same as the treatment of a Roth program in a 401(k) plan. Under those arrangements, an employee in the Roth program may choose to take cash compensation or make taxable elective deferrals.[108] An employee may also convert amounts in a non-Roth account to a Roth account in a taxable transaction.[109]

It seems unlikely, though, that an independent contractor may make elective deferrals to a Roth program. The Code section prescribing most aspects of a Roth program refers only to "employees" and not participants or independent contractors.[110] It also seems unlikely that independent contractors in a 457 government plan may roll over amounts from a non-Roth account to a Roth account (a Roth conversion). Qualification as a rollover is a necessary condition for a valid Roth conversion and, as discussed above, it seems unlikely an independent contractor would be allowed to make any kind of rollover.[111]

Nevertheless, it might be possible to argue that the Code allows an in-plan transfer by an independent contractor if the transfer is done before distributions are otherwise allowed to commence. The Code states that such a transfer "shall be treated as" a Roth conversion.[112] It is possible that means the transfer is a Roth conversion whether or not it meets the other usual requirements for a Roth conversion. More likely, though, it means the transfer is deemed to be a Roth conversion despite occurring before the allowed commencement of distributions from the 457 government plan, but that it must still meet other Roth conversion requirements such as the identification of the participant as an employee and not an independent contractor.[113]

The same restrictions on the commencement of distributions from a plan that apply to non-Roth accounts also apply to distributions from Roth accounts. Thus, as explained above, both 457 government plans and 401(k) plans may commence distributions from Roth accounts after the date a participant severs employment, reaches age 59½, dies, etc.[114] Unlike Roth accounts in 401(k) plans, however, Roth accounts in 457 government plans cannot commence distributions upon the participant's disability or when a participant who is a reservist is called to active duty. Nor can Roth accounts in 457 government plans make distributions upon hardship, the Code allowing instead distributions for unforeseeable emergencies.

457 plans vs. 401(k) plans

The tax treatment of distributions from 457 government plans and 401(k) plans differs in some significant ways. The differences are partly due to the historical origin of 457 government plans as unfunded deferred compensation plans (e.g., participation by independent contractors). Other differences can be attributed to congressional sensitivity to the different policies and prerogatives of state governments for their own employees (e.g., vesting, spousal annuities, QDROs). ■

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108. Sec. 402A; Prop. Regs. Sec. 1.457-4(b)(2); Small Business Jobs Act of 2010, P.L. 111-240, §2111; Joint Committee on Taxation, *Technical Explanation of the Tax Provisions of the Small Business Jobs Act of 2010* (JCX-47-10) (Sept. 16, 2010).
109. Sec. 402A(c)(4).
110. Sec. 402A.
111. Secs. 408A(e)(1)(B)(ii) and 457(e)(16).
112. Sec. 402A(c)(4)(E)(ii).
113. Secs. 402A(c)(4)(E) and 408A(e)(1)(B)(ii).
114. Secs. 401(k)(2)(B)(i) and 457(d)(1)(A); Regs. Secs. 1.457-2(a) and (b); Prop. Regs. Sec. 1.457-4(b)(2).