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The Government Finance Officers Association (GFOA) has developed this publication to provide deferred compensation administrators, finance officers, other government officials, and the public with a comprehensive review of state and local government deferred compensation programs. Over the past decade, deferred compensation programs have become ever more critical in filling the gap between retirement financial needs and retirement income from employer-provided programs. The increased importance is due in part to:

- The growing acceptance of individual responsibility for retirement;
- Uncertainty about the future of Social Security and state and local traditional pension plans; and
- The growing consensus that the “income replacement ratio”—e.g., retirement income at 70 percent to 80 percent of employee income—may need to be increased.

In 1992 the GFOA, in cooperation with the ICMA Retirement Corporation, published the first edition of *State and Local Government Deferred Compensation Programs*. At that time, deferred compensation programs under Section 457 of the Internal Revenue Code were substantially different from the other salary deferral programs under Sections 403(b) and 401(k) and from qualified retirement plans and Individual Retirement Accounts. Since the initial publication, Congress has enacted statutory changes that make Section 457 plans closely resemble other retirement programs in many respects, while leaving some significant differences in place.

Despite the statutory changes, deferred compensation plans remain unique employer-sponsored plans in their value to the employee and their flexibility and simplicity of design and operation for the employer. I trust this publication will assist readers in understanding deferred compensation programs and how their value can be maximized.

I wish to thank the authors, Kathy Jenks Harm and John Saeli of ICMA-RC, for writing this publication. Additionally, I thank Keith Overly, Executive Director, Ohio Public Employees Deferred Compensation Program, and John Barry, Assistant Attorney General, State of Maryland, who served as reviewers of this publication along with Nicholas Greifer, formerly of the GFOA.

Jeffrey L. Esser
Executive Director, Government Finance Officers Association
1

Introduction

State and local government deferred compensation programs have become increasingly important to both employers and employees over the past three decades. For employees, the programs have come to represent the greatest single opportunity for voluntary, tax-deferred savings available, with features that put the programs on a par with 401(k) plans in the private sector. For employers, deferred compensation plans have become a basic employee benefit, seen as an important tool to recruit and retain valuable employees.

The Growing Importance of Deferred Compensation Plans to Retirement Security

Much like private sector 401(k) programs, Section 457 deferred compensation plans are assuming a greater role in retirement security. The proverbial three-legged “stool” for retirement income consisting of Social Security, employer pensions, and personal savings is increasingly challenged, with the future of Social Security uncertain. Moreover, the mobility of the workforce, including the public sector workforce, can in some cases limit the accrual of employer pension benefits. Given these realities, and given the growing acceptance of individual responsibility for retirement security, investment of personal assets has become a more important element for achieving retirement security.

In addition to the relative importance of personal savings, these assets have become significant in absolute terms. Although accurate data on the current participation levels in deferred compensation plans nationally is extremely difficult to obtain, there is no question that their importance to local government employees is increasing dramatically. A reasonable current estimate is that over 4.5 million employees participate in 457 plans, with assets of approximately $120 billion in 2004. These figures contrast dramatically with estimates made in 1992 of 2 million participants with $28 billion in assets.

Additional industry estimates indicate that plans may be available to state employees in all 50 states and to over 95 percent of local government employees. Average penetration rates amount to an estimated 30 to 40 percent of eligible employees, as contrasted with participation rates in 1992 that were under 25 percent.

Another factor underscoring the importance of 457 plans is the growing consensus that the traditional views of “income replacement ratios” (the amount of post-retirement income that a retiree will need to maintain their standard of living) may not reflect the reality for the retirees of today and the future. Until recently, the rule of thumb for planning purposes has been to aim for a replace-
ment ratio of 60 to 80 percent of pre-retirement income. Current wisdom recognizes that the required replacement ratio will be higher for lower income individuals than for those with higher incomes and that age and level of activity greatly influence income needs. Healthy, newly retired individuals may have many activities that they have not been able to indulge while employed. Their expenses will reflect the costs of travel and other postponed dreams and desires, perhaps being close to 100 percent of the level of pre-retirement spending. Expenses may go down in following years, and in the last years may increase dramatically as long-term health care costs increase.

What a Deferred Compensation Plan Is

An “eligible deferred compensation plan” of a state or local government (or their agency or instrumentality) complies with Internal Revenue Code (IRC or “the Code”) Section 457 and allows employees to set aside through payroll deduction an amount up to 100 percent of gross wages (after reduction for 414[h] picked-up pre-tax employee contributions to qualified retirement plans) or the specified dollar amount shown in Exhibit 3.1 in Chapter 3, whichever is less.

Contributions and any increase from investment gains are excluded from income subject to current federal income taxation until paid to the participant.

To meet Code requirements for eligibility, a plan must:

- Be established and maintained by a state or local government or agency or instrumentality of state or local government or by a tax-exempt organization for individuals who perform service for that employer;
- Be documented in writing;
- Have assets held in a trust, custodial account, or annuity contract for the exclusive benefit of participants and their beneficiaries;
- Permit only allowable maximum deferrals; and
- Provide for distributions meeting certain minimum requirements and not earlier than separation from service, attainment of age 70½, or unforeseeable emergency.

Plans may also have provisions that allow for additional features, such as transfers to and from other eligible retirement plans and IRAs, issuance of loans, withdrawal of funds for unforeseen emergencies, establishment of deemed or “sidecar” IRAs, and distributions of small account balances under certain circumstances.

Ineligible Deferred Compensation Plans

Arrangements for state and local government employee deferrals that do not meet the provisions of Section 457 will result in ineligible, non-qualified deferred compensation arrangements. These plans, ineligible as Section 457 plans, are covered by Section 457(f) and will provide deferral of current taxes if rights to the compensation are conditioned on the future performance of substantial services to the employer and subject to forfeiture until that time. For example, an employer could provide $5,000 annually in ineligible deferred compensation which will be subject to a substantial risk of forfeiture by requiring the employee to complete an additional five years of service with the employer. Until the end of five years, the funds will not be taxable to the employee.

While these Section 457(f) plans have an advantage in their lack of contribution ceilings, all assets in the plan become fully taxable in the first year in which there is no substantial risk of forfeiture, a fixed time in the future that must be indicated in the agreement between the employer and employee. In the example
given, the deferrals plus earnings would be fully taxable at the end of five years. Section 457(f) plans will probably be used most by highly compensated governmental employees who wish to exceed the annual maximum deferral limit and whose employers are willing to provide additional compensation for purposes of attracting or retaining the employee.

<table>
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<tr>
<th>Fiduciary Responsibilities and Key Players in a Deferred Compensation Plan</th>
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Under the combination of state law and federal trust requirements, plan sponsors generally act as fiduciaries with respect to their deferred compensation plans. When a plan sponsor employs third parties to provide administrative or investment services for participants, the plan sponsor’s core fiduciary responsibility is to exercise prudence and due diligence in selecting these vendors and the funds offered to plan participants. The plan sponsor also has a fiduciary duty to monitor the performance and suitability of both the administrator/record keeper and the investment options offered by the plan, based on overall plan guidelines and objectives.

Public sector deferred compensation plans are not covered under the Employee Retirement Income Security Act (ERISA). However, administering the plan in accordance with ERISA Section 404(c) can give some comfort to plan sponsors in limiting their exposure to fiduciary liability in connection with plan losses, when participants can exercise control over their account assets. According to 404(c), in order to have such control, participants must be provided with a broad range of investment alternatives, sufficient information to make informed decisions regarding those alternatives, and the opportunity to make investment directions at least quarterly. In addition, information regarding plan fiduciaries must be provided. To the extent that these requirements are met, plan sponsors likely would be relieved from liability with respect to losses resulting from participant-directed investments.

Accordingly, vendors should assist plan sponsors in meeting their fiduciary responsibility by providing:

- A range of investment options that enables participants to construct diversified portfolios that are appropriate to their individual circumstances;
- Information to the plan sponsor regarding changes in the legislation, rules, and regulations that impact and/or govern the operation and reporting requirements of the plan;
- Educational materials and information to employees to assist informed decision making concerning plan participation and investment allocations; and
- Timely and accurate quarterly participant statements.

In addition to participant reporting, vendors also should provide timely, accurate, and informative reports to help plan sponsors evaluate the effectiveness of their program. These detailed annual reports and quarterly updates should include:

- Aggregate participant activity, including the allocation of assets, transactions, and level of participation in the plan;
- An investment review, including performance vs. benchmarks and a discussion on funds that do not meet proscribed quantitative targets or that have encountered qualitative issues;
- Participant services provided, including the number of on-site educational seminars and individual consultations delivered; and
- Full fee disclosure, including wrap fees, fund expenses, fund revenue retained by the vendor, and termination charges.
Medium and large sized plans generally receive more detailed reports and personal on-site delivery of annual reviews. These presentations should include the establishment of objectives for the plan and the vendor’s success in meeting objectives set the previous year. Such objectives should focus on quantitative measures, including participation, contribution levels, asset allocations, and the level/quality of vendor services. Should any aspect of service in the report or through observation not be satisfactory, it is incumbent upon the plan sponsor to mandate that the vendor take corrective action and to closely monitor conformance with those decisions.

Plan sponsors should have online access to plan asset allocations, transaction activity, and fund performance, as well as to account information of individual participants. In addition to structured reports, vendors should provide plan sponsors the flexibility to design their own reports; for example, by enabling data to be downloaded to common spreadsheet software or providing online report generation (with the government plan administrator defining fields and parameters for the report). Employers also should be able to implement a wide range of transactions efficiently over the Internet. When evaluating vendor online capabilities, it is important for the plan sponsor to access a sample account to determine the scope of online reports and transactions available, as well as the system’s ease of use.

In order to make proper use of these reports, all members of the governing board need to be knowledgeable on their fiduciary responsibility and how the information delivered should be assessed to discharge that obligation. Vendors should provide board members access to written information and/or seminars that help build knowledge of current best practice in the deferred compensation plan community. This service is particularly important for new board members, whose professional background often has not included topics on which the governing board provides oversight.

Useful information on fiduciary responsibility and deferred compensation plans is contained in a recommended practice adopted by the Government Finance Officers Association (GFOA). (Please see recommended practices on the GFOA Web site at www.gfoa.org.)

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<th>Comparison of Qualified Plans and Eligible Deferred Compensation Plans</th>
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<td>All state governments and most units of general purpose local government provide retirement benefits for their employees in the form of qualified plans that provide certain tax benefits to the participants by meeting provisions of the Internal Revenue Code Section 401(a). Section 457 deferred compensation plans are not qualified plans but must meet a separate set of requirements under the Code (see Exhibit 1.1).</td>
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<tr>
<td>Qualified plans (pension and profit-sharing plans of state and local governments) are more structured in terms of plan design, normally leaving a somewhat limited opportunity for an employee to tailor the contributions or benefit payments to individual needs. Deferred compensation plans provide the chance for individuals to assume a more active role in saving and investing for retirement. Legislation over the last decade has resulted in narrowing the differences</td>
</tr>
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</table>

1 Service levels provided by deferred compensation plan vendors vary according to the plan size, as well as the average participant balance in a plan. Generally, available services also have increased over time for small, medium, and large plans. For purposes of discussions in this publication, as of early 2005 large plans are considered to have $50 million or more in assets, medium plans are considered to have $10 million to $50 million in assets, and small plans are considered to have less than $10 million in assets.
Ownership of Assets. The assets in both qualified plans and deferred compensation plans now have the advantage of being trusteed plans; funds that are fully vested (non-forfeitable) in the qualified plan and all contributions to the deferred compensation plan are beneficially owned by the participant and may not be used for any purpose other than providing benefits under the plan. As such, the plans are not subject to any claims against the employer. Some courts have found that the trust aspect is sufficient to give 457 assets the same protection in personal bankruptcy as that for qualified plans.

Taxability of Employer Contributions. While all employer contributions to both qualified and non-qualified plans are federally tax-deferred for the employee, only employer contributions to qualified plans are exempt from FICA.

Taxability of Employee Contributions. Mandatory employee contributions to a qualified plan may be made on a pre-tax or after-tax basis depending on the plan design, although few public sector plans are maintained with after-tax contributions; all employee contributions to deferred compensation plans are made on a federal tax-deferred basis. All employee contributions to both qualified and non-qualified plans are FICA-taxable.

Tax Treatment on Withdrawal. Payouts from both qualified plans and deferred compensation plans are eligible for rollover treatment (see page 25), and this allows a tax-free transfer to an IRA or another retirement plan. Withdrawals from qualified plans also may be subject to a 10 percent tax penalty for premature distributions (generally prior to age 59½, disability, death or, if the individual is separating from service with the employer, prior to age 55). No such early withdrawal penalty exists for distributions from deferred compensation plans.

Catch-up Provision. In addition to the age 50 catch-up provision contained in 403(b), 401(k), and 457 plans, Section 457 continues to have a normal catch-up provision that allows contributions that are up to double the normal maximum contribution in eligible years (see page 15).

Loan Provisions. Deferred compensation plans that hold assets in trust may now provide for loans on the same terms as qualified plans (see page 23).
Nondiscrimination Testing. Until 1997, public sector qualified plans were exempt from nondiscrimination tests for coverage, participation, contributions, and benefits. In that year, the exemption from nondiscrimination rules was made permanent. Prior to 1997, deferred compensation programs offered a substantial advantage in not being subject to nondiscrimination testing. Deferred compensation and qualified retirement plans are now similar in regard to their exemption from nondiscrimination testing.

Scope of the Publication

This monograph will provide information primarily on elective deferrals (voluntary employee contributions) in eligible deferred compensation plans in state and local governments. Although not dealt with in depth, non-elective deferrals, ineligible plans, and issues for tax-exempt entities are important additional topics; the purpose of the discussion of those topics in this report is to alert affected employers to their existence. All further references to deferred compensation programs or plans will relate to eligible Section 457 plans for state and local governments unless otherwise indicated.
Section 457 plans are among the most important tools for state and local government employers and employees to achieve a variety of objectives, chief of which is accumulating assets to enhance retirement income. Employees not only can obtain pre-tax investment returns by participating in a 457 plan, but also benefit through its portable plan design that allows an employee to transfer assets from job to job. From an employer’s perspective, 457 plans serve as a low-cost recruitment and retention tool.

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<th>Participant Benefits</th>
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<td>Employees who participate in deferred compensation programs derive three primary benefits: lower taxable income through current deferral, accumulation of tax-deferred assets to produce income in retirement when individual marginal tax rates may be lower, and a portable retirement benefit.</td>
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**Tax Deferral.** The importance of tax deferral to the individual taxpayer cannot be stressed too strongly. Over time, the effect of tax deferral on contributions and earnings results in a significantly larger accumulation of assets than the same savings on an after-tax basis. This is true even for those taxpayers who do not lower their marginal tax rates in retirement. The example in Exhibit 2.1 compares the effect of tax deferral on savings accumulation.

**Effect of Saving Pre-tax Dollars.** Deferring compensation from current income allows the same dollar amount dedicated to savings to result in a higher immediate investment than an investment made after the current tax liability is paid. In Exhibit 2.1, considering federal income taxes only, an individual who wishes to save $200 would be able to save the full $200 if it were deferred from current income and contributed to a

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<th>Exhibit 2.1 • Effect of Tax Deferral on Savings Accumulation</th>
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<td><strong>Method</strong></td>
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<td>Conventional savings</td>
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<td>Deferred compensation</td>
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Note: Assumes contribution of $200 monthly, earning 8 percent annually and taxpayer is in the 25 percent marginal tax rate. For illustrative purposes only; actual results will be higher or lower.
deferred compensation program. The same individual in a 28 percent income tax bracket would have only $144 to invest if the taxes were paid first.

Almost all states follow the federal tax treatment on compensation deferred through Section 457 plans, and this can provide substantial additional savings. Exceptions are the states of New Jersey and Pennsylvania, which tax contributions as current wages.

*Tax Credit for Low Income Filers.* While it is not specifically a 457 plan provision, an employer may utilize a 457 plan to allow low-income filers to take a federal income tax credit of up to $1,000. The amount of the available credit is based on the first $2,000 of plan contributions and the amount of the available credit will depend on the adjusted gross income (AGI) of the individual, as shown in Exhibit 2.2.

*Compounding Earnings at Higher Effective Rate.* Not only does the individual have the advantage of saving more initially, the deferral of taxes on earnings results in higher effective returns being credited during the accumulation phase. In our example, a rate of return of 8 percent on a tax-deferred basis would effectively yield only 5.76 percent if taxes must be paid during the accumulation phase.

*Tax Rates in Retirement.* A concern to some is what happens if an individual’s tax rate is not lower in retirement. The example shown demonstrates the effect of compounding of tax-deferred earnings on a higher initial investment and paying the same tax rate in retirement as compared to paying taxes during the accumulation phase. The individual will earn higher effective rates on greater savings, which will more than offset the payment of taxes on withdrawal. The overall impact on amounts available in retirement is quite substantial and becomes more pronounced if higher rates of return are earned.

*Portability.* Portability of retirement benefits was the primary reason for initial popularity of deferred compensation plans. Provisions in many defined benefit plans often required employee service of ten or more years before any benefits were vested (owned by the participant). Individuals could find themselves at the end of their careers without retirement benefits or with benefit levels substantially below what they would have been had they remained with a single employer. EGTRRA provided the ability to transfer assets between public and private sector retirement programs and IRAs, further increasing the popularity of 457 plans.

*Protection of Assets.* Like qualified defined contribution plans, deferred compensation plans are not subject to the claims of creditors of either the employer or the participant. The initial Internal Revenue Code provision for employer ownership of assets was probably the single greatest concern of employees who considered participation. The Small Business Job Protection Act (1996) removed this concern by providing that the assets for deferred compensation plans must be held in a trust, custodial account, or annuity contract for the exclusive benefit of participants and their beneficiaries, similar to the requirements for qualified pension plans under Internal Revenue Code Section 401(a). The assets are no longer subject to the claims of the employer’s creditors.

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1. See Internal Revenue Code Section 25B. The tax credit is currently available through 2006.
Most employers have chosen trusts as the vehicle to hold plan assets. In the case of trusteeed assets, state or local law governs the creation and operation of the trust. Local governments or individuals may be named as trustee for the trust.

Custodial accounts have three requirements: (1) they must be maintained by a bank or trust company specifically approved by the IRS; (2) the custodial account agreement must be in writing; and (3) the account must be for the exclusive benefit of the plan participants. Annuity contracts also need to be written with a specific mention of the exclusive benefit provision.

**Employer Benefits**

An estimated 90 percent of full-time state and local government employees are covered by defined benefit plans.\(^2\) A growing number of governmental employees (about 9 percent in 1990,\(^3\) increasing to 14 percent in 1998\(^4\)) now participate in qualified defined contribution plans that utilize individual participant accounts for employer and employee contributions. When eligible for benefits, the participant may receive the account value including contributions plus earnings, often in the form of an annuity payment from an insurance company.

Section 457 plans are non-qualified defined contribution plans. The plans are a sound complement to qualified plans and provide employers an excellent tool for employee recruitment, retention, and benefits negotiation, which is relatively simple to administer and low in cost to the employer.

**Easy to Administer.** Employers normally opt for outside providers for all or some of the aspects of plan administration, including investment vehicles, record keeping, education, and investment advice. Employers may design their program and select outside service providers with or without the assistance of a benefits consultant. One purpose of this publication is to provide all the tools that a plan sponsor may need to secure and evaluate proposals for administrative services. As discussed above, the selection of outside service providers generally is considered an activity subject to fiduciary obligations.

For ongoing operations, deferred compensation programs can be among the simplest employee benefit programs to administer, requiring only recurring payroll deductions and contribution remittals to investment providers or third-party administrators.

While the requirements of the Internal Revenue Code must be followed for a plan to remain eligible, Internal Revenue Service scrutiny of the operation of Section 457 plans continues to be relatively minimal. Should the Secretary of the Treasury find that a plan is not administered in compliance with the requirements of the Code, the employer will have until the beginning of the first plan year that is more than 180 days after the notification to correct the inconsistency. If the inconsistency is not corrected, the plan will subsequently be considered ineligible for the tax benefits of Section 457. This provision does not protect the individual participants from the affects of an error in a transaction, such as a contribution over the maximum; however, it does protect the group of employees from losing their tax benefits because of an error that affects other employees.

**Low in Cost.** Most plans are structured to have no direct cost to employers. Participants generally pay plan costs, either directly as a charge against an ac-

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count or indirectly as a reduction in the investment returns credited to an account. Plans with large asset levels may be able to negotiate additional services with their third-party plan providers for no additional cost.

**Recruitment.** Many public sector employees, particularly mobile individuals in management-level positions, have come to view portable retirement benefits in the form of a deferred compensation program as an expected and vital part of their compensation package. Many employment agreements for key local government staff positions specify annual employer contributions to deferred compensation in addition to any other retirement benefits for which the individual may be eligible. In these circumstances the availability of a Section 457 plan may be a condition of accepting employment.

Other employees may not have the clout to negotiate a similar compensation agreement but have become accustomed to the advantages of deferred compensation with prior employers. They expect their new employer to provide similar benefits, particularly where the program is viewed as one that may be provided at no direct cost to the employer. So few public employers are without deferred compensation programs that they will be at a competitive disadvantage in recruiting employees.

**Retention.** Employers can offer an added incentive for seasoned employees to remain with the organization through contributions to deferred compensation based on longevity. Typically an employer might contribute $500 annually for each five years of service. While the amount may not be particularly large, the recognition of the value of experienced employees can produce good will far in excess of the actual expenditure. Employers may also consider the use of ineligible 457 plans.

**Bargaining Tool.** Many employers have used deferred compensation contributions as an effective bargaining tool in employee benefits negotiation. To the employee, an employer contribution or match of individual contributions to the plan can be a demonstrable indication of a growing employer-provided benefit with the quarterly receipt of every account statement. Some employers have even withheld eligibility for deferrals as a negotiating tactic, although this often appears to employees to be a somewhat extreme position.

**457 as Alternative to Increases in a Defined Benefit Plan.** Deferred compensation programs provide a particularly effective negotiating tool when employees are bargaining for higher benefit levels or cost of living adjustments in defined benefit plans, increases that can be extremely costly to implement for which additional future costs can only be estimated. Such increases are rarely decreased in future negotiations. By contrast, deferred compensation contributions can be projected into the future as accurately as salaries, and such a contribution can be put back on the negotiating table far more readily than an increase in a defined benefit plan. The use of deferred compensation to supplement defined benefit plans in lieu of an increase in a benefit formula also involves a shift of investment risk from the employer to the employee.

**457 as an Alternative to Social Security Coverage.** Under the Omnibus Budget and Reconciliation Act of 1990 (OBRA), state and local government employees that are not covered by a public pension plan must be covered by Social Security or an equivalent retirement plan. 457 plans with contributions totaling at least 7.5% from either the employer or employee are considered an alternative for meeting the requirements. OBRA coverage is most often required for part-time, temporary, and seasonal employees in entities not covered by Social Security where the individuals do not meet the eligibility provisions for participation (frequently service of at least 1,000 hours per year) in the pension plan.
Volunteer Firefighter Plans. Public sector employers may use Section 457 deferred compensation to provide length of service awards to certain volunteers, providing firefighting, emergency medical, and ambulance services. These length of service awards may not exceed $3,000 per year.

Complement to Qualified Plans. Review of the features of qualified and non-qualified plans (chapter 1) leads to the conclusion that the plans complement each other, with the availability of both types of plans offering employees the greatest flexibility and opportunity for individual retirement planning. For example, since there is a 10 percent penalty for premature distributions from qualified plans, public employees who retire early may wish to first withdraw funds from deferred compensation plans, for which the Code does not impose a penalty. At a later age, when there are no penalties for withdrawal, distributions from the qualified plan can begin.
Deferred compensation plans have straightforward provisions for funding that normally result in periodic contributions to the plan, usually tied to the payroll cycle. Although simple in concept, the administration of contributions is subject to somewhat complex provisions of Section 457(b) of the code that limit the contributions that may be made to the plan.\(^1\) If these provisions are not followed, a plan may not be eligible for favorable tax treatment for participants.

Contributions to 457 plans may be made by both employers and participants. Most 457 plans are entirely financed by employee voluntary salary deferrals, since participation is usually optional and supplements the primary defined benefit plan. Nonetheless, one of the most effective ways for an employer to encourage more employees to participate in deferred compensation programs is to make an employer contribution, frequently as a match of the participant contribution up to a certain dollar level or percentage of salary. Moreover, providing an employer match may be a way to alleviate pressure to increase the benefits—and long-term costs—of a defined benefit plan.

### Maximum Annual Contributions

The maximum contribution per calendar year to a Section 457 plan from all sources is the lesser of:

(a) 100 percent of gross wages (less “picked-up”\(^2\) pre-tax contributions to qualified retirement plans), or

(b) The annual dollar limit, including any catch-up contributions for which the participant may be eligible (refer to Exhibit 3.1).

Amounts contributed as the result of permissible transfers in from other retirement plans are not counted toward the annual contribution maximum.

The contribution limits in Exhibit 3.1 are for a calendar year. A participant’s total contributions in the plan administrator’s annual statement of activity may not agree with the employer’s payroll records, normally due to the recording of

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1. The term “contributions” is used instead of deferrals to make it clear that reference is to all amounts going into plans, regardless of whether from employee deferral or non-elective employer contribution.
2. An employer pick-up is a pre-tax mandatory employee contribution to a qualified retirement plan.
the last payroll deduction of the year as a contribution transaction in the follow-
ing year. In such circumstances, the employer’s pay records will be used.

Participation in More Than One Deferred Compensation Plan. A participant
may make contributions to more than one eligible deferred compensation plan
in a taxable year. However, the total deferral to all plans cannot exceed the an-
nual maximum deferral as defined above.

Participation in More Than One Salary Deferral Plan. Effective with plan
years beginning after December 31, 2001, individuals may participate in and de-
fer the maximum annual contributions to each of the following plans: Section
457 deferred compensation plans, Section 403(b) tax sheltered annuities, and
401(k) salary reduction plans. Prior to that time, a participant who contributed to
a 401(k) and/or a 403(b) plan was required to aggregate the deferrals, which
were then subject to the annual limitation of the Section 457 plan. Even though
no longer in effect, this provision is still important for the limitations imposed on
the calculation of unused deferral for the normal catch-up provision.

Taxability of Contributions

Federal. Federal income tax liability on eligible deferrals under Section 457 oc-
curs in the year in which the funds are paid to the participant. As such, the con-
tributions are usually federally tax-deferred in the year in which the contribu-
tion is made.

FICA. All contributions to deferred compensation, whether from employer or
employee, are subject to FICA taxation if the employer is a participating entity in
the Social Security System. For employers not participating in Social Security,
delayed compensation contributions are considered as covered wages for em-

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**Exhibit 3.1 • Annual Limits on Section 457 Plan Contributions**

<table>
<thead>
<tr>
<th>Year(s)</th>
<th>Ordinary Contribution Limit</th>
<th>Limit Using Normal Catch-Up Contribution</th>
<th>Age 50 Catch-Up Contribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>1979 – 1997</td>
<td>$7,500</td>
<td>$15,000</td>
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<td>1998 – 2000</td>
<td>$8,000</td>
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<td>$13,000</td>
<td>$26,000</td>
<td>$3,000</td>
</tr>
<tr>
<td>2005</td>
<td>$14,000</td>
<td>$28,000</td>
<td>$4,000</td>
</tr>
<tr>
<td>2006</td>
<td>$15,000</td>
<td>$30,000</td>
<td>$5,000</td>
</tr>
<tr>
<td>Later</td>
<td>Indexed to inflation in $500 increments</td>
<td>Double the annual limitation</td>
<td></td>
</tr>
<tr>
<td>2010*</td>
<td>$8,500</td>
<td>$15,000</td>
<td></td>
</tr>
</tbody>
</table>

*If Congress does not act to extend the contribution maximums contained in EGTRRA, the limits will revert to the
pre-EGTRRA level.

Note: Qualifying employees can use one catch-up provision but not both; for example, in 2006 no more than
$30,000 could be contributed to a 457 plan.
employees who are required to pay Medicare-only tax (generally new hires after April 1, 1986).

State. Of the states that assess income taxes, all follow the federal lead in providing current deferral of tax liability except in two states. In Pennsylvania and New Jersey, employee contributions are currently taxable while employer contributions are made on a tax-deferred basis.

The topic of taxability of funds upon distribution is covered in chapter 4.

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**Excess Deferrals**

Excess deferrals for an individual occur when contributions made in a given year exceed the maximum annual limitation. The excess may be the result of excess contributions to the employer’s plan or may be a result of the participant’s contributing to more than one employer’s plan. For governmental plans, the excess contribution (plus any investment income) resulting from contributions to just that employer’s plan must be returned as soon as practical. If the excess is not distributed, the plan becomes a 457(f) ineligible deferred compensation plan. If the excess is a result of individual contributions to multiple deferred compensation plans, the employer’s plan can choose: (1) to return the excess and income as soon as practical; or (2) maintain the excess as an after-tax account. As a practical matter, employers are most likely to elect to return the excess.

The excess deferral (plus income) is included in the gross income of the participant in the tax year in which the excess deferral occurred, and the employer must issue the taxpayer a Form 1099.

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**Catch-up Contributions**

Section 457 is unique among retirement plans in having two catch-up provisions. The first of these, the normal catch-up provision, has been in place since 1979 and provides significantly higher annual contribution limits for a three-year period before retirement. This allows participants to “catch up” for eligible deferrals that were not made in prior years of government employment. The second provision is available to qualified plans as well and gives higher annual deferral limits to individuals age 50 and over, without regard to previous 457 contributions.

**Normal Catch-up.** Participants a) who have not contributed the maximum deferral amount to their current employer’s deferred compensation plan in prior years, b) whose earnings may be relatively high just prior to retirement, and c) who possess a desire to postpone the taxability of that compensation may benefit substantially from the use of the normal “catch-up” provision. Under this provision, a plan may allow participants to “catch up” on deferrals not made while they were previously eligible to participate in a plan maintained by their current employer. Starting with the 2002 tax year, the catch-up limitation is twice the annual deferral limitation (refer to Exhibit 3.1).

The deferred compensation plan may establish a normal retirement age, which may be any age that is on or after the earlier of age 65 or the age at which the participant has the right to retire and receive benefits from the pension plan which are not reduced due to age. The plan may specify a normal retirement age

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3. In the past, many plans had allowed participants to catch up for unused deferrals from previous employers, but the final 457 regulations issued in 2003 clearly prohibit this practice. Participants may, however, catch up with a current employer and subsequently be rehired by a former employer and, if they have sufficient unused deferral, catch up on unused deferral with that employer as well.
up to age 70½. Alternatively, a plan may permit a participant to designate a normal retirement age within that range.

A plan may establish a normal retirement age as early as age 40 for qualified police and firefighters (full-time employees providing police protection, firefighting services, or emergency medical services for an eligible employer, who will have 15 years of creditable service under the pension plan by age 40). The plan may alternatively allow the qualified police or firefighter participant to designate a normal retirement age between age 40 and age 70½.

To determine under-utilization of deferral, the participant must take the following steps (using data from employer payroll, W-2 wage reports and deferred compensation statements):
1. Determine the maximum amount that could have been deferred under an eligible plan each year.
2. Subtract the amount the participant actually deferred for that year.
3. Calculate the sum of these annual differences.

The sum is the total amount that the participant may “catch up” during the last three years prior to normal retirement age.

In calculating unused deferral, it is critical to take into account that for years prior to 2002, salary deferrals to 403(b), 401(k), and simplified employee pensions (SEPs) also reduced the maximum 457 contribution on a dollar-for-dollar basis, treating deferrals under those arrangements as though from the Section 457 plan and therefore reducing the $7,500 limitation (as indexed). For example, if an individual participated in both a 457 and 401(k) plan in 1998 and was eligible by virtue of compensation to defer $8,000 to 457 and $10,000 to Section 401(k), the individual’s total contribution limit was $8,000, not $8,000 to 457 and the remaining $2,000 to 401(k).

Age 50 Catch-up. To encourage older workers to make larger contributions to qualified plans, 457 deferred compensation plans, and IRAs, Congress included a special catch-up provision in those retirement plans that applies to all wage-earners over age 50. The age 50 catch-up cannot be used in any year in which the participant is using the more generous normal catch-up provision. However, as long as the employee is over age 50, he or she may contribute the ordinary contribution maximum plus the age 50 catch-up amount. For example, in 2006, so long as the participant is not using the normal catch-up, he or she may contribute up to the lesser of $20,000 ($15,000 maximum dollar contribution plus $5,000 in age 50 catch-up) or 100 percent of compensation (reduced by picked up contributions to qualified plans).

Plan-to-Plan Transfers from Other 457 Plans

Strictly speaking, plan-to-plan transfers are not considered deferrals and are not subject to annual contribution limits. The final 457 regulations clarified the circumstances under which plan-to-plan transfers among governmental 457 plans can occur. Most 457 plans accept transfers in, as the additional assets improve the economics of plan administration. In order for a participant to make such a transfer, the transferring plan must permit the transfer and the receiving plan must provide for receipt of the transfer. There is also a requirement that the deferred amount transferred be at least equal after the transfer to the amount deferred immediately before the transfer.

Three types of transfers are permitted among eligible governmental plans:

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From one governmental employer’s plan to another, regardless of whether the plans are in the same state, where the individual had been employed by transferring employer and then is currently performing services for the receiving employer;

From one governmental employer’s plan to another within the same state for the entire plan’s assets for all participants and beneficiaries; and

Among eligible plans of the same employer.

The provisions permitting plan-to-plan transfer among governmental 457 plans specifically does not apply to transfers between governmental and tax-exempt 457 plans.

Rolling over assets

EGTRRA and the final 457 regulations authorize and regulate the transfer (or “rollover”) of assets from a qualified plan or IRA to an eligible 457 plan.

Rolled-in assets from other eligible 457 plans and from other types of retirement plans must be maintained in separate sub-accounts, or subsequent distributions of rolled-in 457 assets will be subject to a 10 percent early withdrawal penalty. Rolled-in assets are eligible for in-service withdrawals. Thus, to give the greatest potential benefit to employees, plans permitting the transfer in of assets will need to establish separate accounts for rolled-in assets from (1) other eligible deferred compensation plans (not subject to early withdrawal penalties) and (2) qualified plans and IRAs (subject to early withdrawal penalties). If each of these accounts is established, a participant may have three separate accounts within the plan: two for rollovers and one for current activity.

Other Key Provisions

USERRA. The Uniformed Services Employment and Reemployment Rights Act of 1994 requires that employers sponsoring 457 plans permit returning reservists to make up for deferrals they would have made had they been continuously employed. The returning employee has three times the period of active service or five years, whichever is less, to make up the missed contributions. Contributions are made on a pre-tax basis by payroll deduction. The total amount that may be made up is based on what the returning reservist was contributing on a per pay basis prior to being called up. USERRA contributions are in addition to the normal annual contribution maximums that apply to the participant. The employer may require the returning reservist to supply appropriate verification of active service.

Minimum Contributions. While the Code does not provide for minimum contributions, the employer or administrator may wish to design a plan that provides for minimum contributions for two reasons:

(i) A participant account with minimal contributions may have administrative fees assessed that amount to a fairly significant percentage of the account value, and

(ii) Participants who contribute small amounts due to financial circumstances may better use their limited resources to first establish a fund to provide for emergencies before saving funds in a 457 plan, which are then relatively unavailable to the participant.

The individuals who have financial constraints are quite likely to save minimal amounts for a period of time and then seek to withdraw funds to meet a financial need.
need that may not meet the strict Section 457 requirements for an unforeseeable emergency.

**Designation of Contribution Amount in Prior Month.** Compensation may be deferred only if an agreement providing for the deferral has been entered into before the beginning of the month of the deferral.\(^6\) However, a plan may permit newly hired employees to enter into an agreement before the first day of employment to be able to defer during the first calendar month of employment.\(^7\)

**Frequency of Change of Contribution Amounts.** The Code is silent regarding the frequency of changes in contribution amounts. However, increases in the amounts deferred must be initiated prior to the first of the month to become effective for that month. For administrative convenience, some employers may choose to limit the change in contribution amount to an annual open enrollment period or to a certain number of changes per year, generally permitting a participant to stop contributing at his or her discretion.

**Aggregation Rules.** An employer that maintains multiple 457 plans must consider all plans as a single plan for purposes of determining annual deferral limits and other eligibility requirements of Section 457(b). An eligible employer is also required to have no more than one normal retirement age for each participant under all the eligible plans it sponsors.

**“Vesting” of Employer Contributions.** Employer contributions may be subject to a vesting schedule but there are two significant disadvantages in doing this, particularly where an employer is using a deferred compensation plan as its primary retirement vehicle.

First, application of a vesting schedule risks running afoul of federal regulations governing annual contribution maximums. Plans that condition a right to a benefit on the completion of future service provide a “substantial risk of forfeiture.” Employer contributions are counted toward the annual maximum in the year in which there is no longer any substantial risk of forfeiture, not in the year in which the contribution is made.\(^8\) As a result, the amount counted as employer contributions to the eligible plan in the year the funds become vested will likely be in excess of the participant’s annual maximum contribution, particularly if the vesting schedule is lengthy or contribution levels are high.

Secondly, FICA becomes payable on the employer contribution in the year in which the funds are vested and no longer subject to a substantial risk of forfeiture. This may be operationally difficult, especially if the vesting schedule is graded, requiring a portion of past employer contributions to be “FICA-taxed” each year additional vesting is granted.

Two solutions present themselves. The employer could choose a qualified defined contribution plan with a vesting schedule, either as the primary or supplemental retirement vehicle. This has the advantage that no FICA contributions are payable on employer contributions. The employer could also institute a graduated schedule of fully vested employer contributions, such as 0 percent of compensation in year one of employment, 2 percent in year two and 4 percent in year three and thereafter. This has the effect of providing the employee a higher contribution in future years rather than vesting the contributions already made.

**Sick and Vacation Leave Accruals Not Considered Deferred Compensation Subject to Section 457.** IRS Notice 87-13 temporarily defined plans that provided accrual of sick and vacation leave banks were deferred compensation plans subject to the provisions of Section 457. The effect was to bring this type of benefit under the annual contribution limits, thereby lowering the amount of elective

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6. Internal Revenue Code Section 457(b)(4).
7. Treasury Regulation Section 1.457-4(b).
deferral the participant would be eligible to make. For example, a participant who had accrued and carried over three days of sick leave would have that amount of wages applied toward the allowable annual deferral limit of the 457 plan.

After significant response from state and local government employers, the IRS clarified that “bona fide vacation leave, sick leave, compensatory time, severance pay, disability pay and death benefits are not deferred compensation plans subject to section 457.” This notice clarified that accruals under these plans do not lower the deferral available to participants. The Technical and Miscellaneous Revenue Act of 1988 (TAMRA) incorporated this position into the Code.10

Deferral of Final Sick and Vacation Accrual. Many employees wish to take advantage of deferrals in their final year of employment when compensation may be at the highest point in their careers, and they may be looking for ways to decrease their overall tax liability. A popular technique for doing so is to contribute as much as possible to the 457 plan from the final check issued for accumulated sick and vacation pay.

While the final 457 regulations issued by the IRS in 2003 made such contributions difficult by requiring the leave to be deferred before the participant separates from service, the proposed 415 regulations provide a different and more administratively reasonable treatment available beginning with plan years starting after January 1, 2005: so long as all other requirements of Section 457 (b) are met, the individual may enter into a deferral agreement prior to the beginning of the month when the sick and vacation leave would be payable and then may be contributed up to 2½ months following separation from service.

Deemed or “Sidecar” IRAs. With the adoption of EGTRRA, 457 plans, along with 401 qualified plans and 403(b) plans, may contain sidecar or deemed IRAs, beginning January 1, 2003. The sidecar IRA is the individual’s IRA held as a sub-account within another retirement plan. The convenience of having an employer payroll-deduct the contributions to an IRA may encourage greater use of the already popular retirement savings vehicle. An employee can take advantage of dollar cost averaging in the IRA vehicle, and, since the investment choices are generally the same as in the deferred compensation plan, the investment choices may be simplified.

If a sidecar IRA fails to meet the requirements of IRA rules, it will not result in loss of eligibility of the 457 plan, so long as the sidecar IRA assets are held in a separate trust. This protection is extended to 457 plans in which the sidecar IRAs was established after August 1, 2003.

9. Internal Revenue Service Notice 88-68.
10. Internal Revenue Code Section 457(E)(11).
Distribution requirements for 457 plans were so highly structured prior to the passage of the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) in 2001 that participants rightfully found the provisions excessively restrictive. Passage of EGTRRA resulted in changes to 457 distribution requirements that in most respects eliminated the negative features that previously existed when compared to qualified plans and IRAs, while retaining the most advantageous provisions. As a result, 457 plans have become more flexible to administer and have gained in popularity.

Eligibility For Distributions

The Internal Revenue Code permits funds to be made available to Section 457 plan participants no earlier than the following:

- In the event of an unforeseeable emergency;
- When the participant severs employment with the employer; or
- Calendar year in which participant attains age 70½.

Plans may also include loan provisions (not considered distributions) and small balance account distributions in their plans, both covered below.

Most plan documents are written with retirement and death as specific events that provide eligibility for distributions. Since these are separations from service, the inclusion of these additional events is consistent with the Code and permitted in eligible plans. Plans may now include in-service withdrawals of rollover assets as an eligible distribution; for these distributions, there must be separate accounting for the rolled-in assets.

In addition to the requirement that funds be paid no earlier than the events listed above, plans must meet the minimum distribution requirements of Section 401(a)(9) (which also applies to qualified Section 401 plans, Section 403[b] plans, and traditional IRAs). These requirements are covered later in this chapter.

Payment Date and Schedule Election. Prior to the adoption of EGTRRA, assets in eligible 457 plans were subject to taxation in the year in which the funds were paid or “otherwise made available.” In order to maintain their tax-deferred status and have funds not be available to the participant, plan design generally allowed a participant to select an irrevocable future payment date on separation.
from service and to select an irrevocable payment schedule prior to reaching that date. EGTRRA eliminated the “otherwise made available” wording, resulting in assets being taxable only when paid to participants.

As a result, participants are eligible to receive distributions from their accounts without the requirements for irrevocable payment date and schedule. So long as they meet the eligibility requirements and take the minimum distribution required, participants may receive payments on any schedule they wish that is provided by the plan and may change that schedule at any future time. Participants who elected irrevocable payment schedules pre-EGTRRA are permitted the same flexibility; they may stop or restart their payment schedules and change the payment amounts.

**Plan Document Specifies Modes of Distribution.** One of the chief advantages of 457 is that participants typically have the flexibility to choose from a variety of pay-out methods. Plans normally allow payment schedules to include a lump sum, a partial lump sum, equal amounts on a regular frequency until the account balance is exhausted, purchase of an immediate annuity, an amount estimated to exhaust the account within a specified time period, the IRS required minimum distributions, or a schedule of irregular payments. If a participant begins a payment schedule, he or she is generally free to amend it on notification to the plan administrator. The exception is if the participant purchases an annuity, where the payment stream normally may not be altered once the first payment is made.

Plan documents may provide a default payment schedule in case a participant fails to elect a form of payment. The default schedule is often the IRS required minimum distribution.

**Employer Approval Required for Distributions.** The employer’s written approval is required before a participant’s distributions can begin, verifying that the participant is eligible according to the terms of the plan.

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**Distributions at Age 70½**

The Internal Revenue Code states that funds may be available in the calendar year in which a participant reaches age 70½. Moreover, payments are required to begin no later than April 1 of the calendar year following the year in which the participant reaches age 70½ or retires, whichever is later. Many employer plans do not permit withdrawals at age 70½ without separation from service.

**Severance from Employment**

Participants are eligible for distributions on severance from employment with the plan sponsor providing the deferred compensation plan. Prior to EGTRRA, a participant would have been eligible on separation from service. Under this earlier provision, commonly referred to as the same desk rule, a separation from service did not occur where, for whatever purpose, an employer terminated its enterprise, and a successor employer continued the business. That the successor employer operated its business under a form different from that of the predecessor employer (such as a private not-for-profit taking over the function of a local government) was immaterial. The replacement of “separation from service” with “severance from employment” has broadened the eligibility for distributions.

Due to the budgetary problems many governmental entities have faced in recent years, a frequent question now arises regarding the status of employees who are laid off from their positions and wish to receive funds from their deferred compensation plans under separation from service provisions. If there is a
reasonable expectation of continued performance of service in the future, a true separation of service may not have occurred and funds may not be made available. If employers do not expect to rehire the employees and wish to have funds be made available, they should consider a bona fide termination, which would permit distributions, rather than a lay-off, which may not.

The Treasury Regulations have separate requirements for independent contractors who may participate in a 457 plan. The regulations specify what is required for severance from employment for independent contractors: (1) they are separated on termination of the contractual relationship when there is no consideration for renewal under a new contract; or (2) a plan may provide that no amount shall be paid before a date at least 12 months after the contract expiration, and if the participant performs additional service before that date, no amounts shall be payable on the date set.

### Retirement
Deferred compensation plans may provide for “retirement” as being both the separation from service and attainment of a specific age, such as age 65 or older. This definition may establish a default payment date.

Retirement should not be confused with “normal retirement age” which is very specifically defined in the Code and is the basis for use of the normal “catch-up” provision. Refer to Chapter 3 for a discussion of the normal retirement age in the context of catch-up provisions.

### Unforeseeable Emergencies
Beginning with the adoption of Section 457, participants and beneficiaries have been eligible to withdraw funds from their accounts while still employed if they or their beneficiary (or spouse or dependent of participant or beneficiary) had a severe financial hardship that couldn’t be met with available assets, such as other investments or insurance settlements. Examples of situations that the IRS will consider to qualify as “unforeseeable emergencies” are:
- Loss of property due to casualty not otherwise covered by insurance;
- Imminent foreclosure of or eviction from the participant’s or beneficiary’s primary residence;
- Medical expenses; and
- Funeral expenses of a spouse or a dependent.

The purchase of a home and the payment of college tuition are specifically listed as ineligible for consideration as unforeseeable emergencies. The withdrawal amount may also include the anticipated tax liability on the emergency withdrawal.

Determination of whether the participant meets the requirements for an unforeseeable emergency must be made by the employer, who may require documentation sufficient to verify the financial requirement and the employee’s available resources. Unforeseeable emergency withdrawals are not eligible for rollover treatment. (See the section on eligible rollover distributions later in this chapter.)

### Loans
Loans to participants are not treated as taxable distributions, unless they are in default. Rather, they are treated as an investment of the plan in the promissory note of the individual and are repaid on an after-tax basis. Although adoption of

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1. Treasury Regulation 1.457.6(b)(2).
a loan provision has been available to employers since 1997, the majority of employers have chosen not to implement this plan feature. The reluctance of employers to provide for loans may be based on the additional administrative complexity created and a concern that participants may abuse the provision and have less saved for retirement as a result.

There is no sound guidance from the IRS on what constitutes a permissible loan program in a 457 plan, since the 457 regulations state that the determination of whether a loan is a violation of Section 457(b) depends on the facts and circumstances. Given this ambiguity, employers typically make 457 loans available according to the same well-defined guidelines and procedures that apply to loans from a qualified plan.

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**Small Account Balance Distributions**

Plans may provide that participants with small account balances may be eligible for distributions while the participant is still employed. The conditions that must be met are:

1. The account balance must be under $5,000;
2. The participant must have made no contributions for a period of at least 24 months (transfers into the plan are not considered contributions); and
3. The participant must have received no prior distributions, other than an emergency withdrawal, from the account.

In addition, the plan provision may also specify that the employer may initiate the distribution to the participant. The plan could have a specified dollar amount for plan-initiated automatic distributions that is lower than the $5,000 participant-initiated amount.

Beginning with the effective date of the Department of Labor safe harbor rules (March 28, 2005), mandatory distributions of amounts between $1,000 and $5,000 must be transferred to an IRA unless the participant provides alternate instructions. 457 plans will need to implement the IRA transfer provisions as of that date even though the safe harbor rules will not apply.

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**Plan-to-Plan Transfers**

If a participant is subsequently employed by another government maintaining an eligible deferred compensation plan (note that plans of tax-exempt organizations are specifically excluded), the assets in the former employer’s plan may be transferred to the new employer’s plan, without regard to whether or not the employers are in the same state.

The following requirements must be met:

- The transferring plan must permit the transfer;
- The receiving plan must provide for receipt of the transfer; and
- The deferred amount transferred must be at least equal after the transfer to the amount deferred immediately before the transfer.

**Purchase of Service Credit.** Participants are permitted to use assets in 457 plans to purchase creditable service time in the qualified defined benefit plans of their employer without triggering a taxable event. Defined benefit plans may offer the opportunity to buy service credit towards the pension formula for prior eligible service for which a credit has not yet been granted. Creditable service time is frequently available for military service or service with another local government, generally up to a fixed number of years of service. Five years of service credit is normally the maximum that can be purchased, and the cost of the additional credit is normally calculated on an actuarial basis. A participant may also
use deferred compensation assets to repay amounts that have previously been withdrawn from the qualified plan.

Any purchase of service credit must be made prior to separation from service with the employer. The purchase of service credit is not subject to Section 415 limits for annual additions to qualified plans.

“Air Time.” Some defined benefit plans permit employees to buy credits for years not based on actual employment that can be added to the credits earned by virtue of years of service. This practice, known as “air time,” is permitted by the California Public Employees’ Retirement System (CalPERS), which allows its participants to purchase additional service credit for up to five years not based on otherwise creditable service. There is no definitive guidance from the IRS that 457 plan assets are eligible for purchase of “air time.”

| Eligible Rollover Distributions | Eligible rollover distributions are those plan distributions that are eligible for rollover treatment. Initially, the treatment was available only to traditional IRAs and eligible employer plans. An eligible employer plan included only qualified retirement plans until EGTRRA added Section 457 and 403(b) plans as eligible employer plans in 2002.

Eligible rollover distributions from 457 plans now include all distributions except the following:
- Payments spread over a long period of time (lifetime, joint lifetime with a beneficiary, or a period of over ten years);
- Minimum required distributions (see page 26);
- Unforeseeable emergency withdrawals (see page 23);
- Distributions of excess contributions (see page 14); and
- Loans that are treated as distributions due to default (see page 23).

An automatic 20 percent federal tax withholding applies to eligible rollover distributions that are not rolled over to another eligible plan (see page 29).

| Trustee-to-Trustee Transfers (Direct Rollovers) | When a participant separates from service, he or she is eligible to move (rollover) assets directly between 457 plans and other eligible retirement plans (traditional IRAs, qualified 401 plans, and 403[b] contracts) on a non-taxable basis. These trustee-to-trustee transfers are permitted so long as the assets distributed are an eligible rollover distribution (see previous section). A direct transfer is not subject to 20 percent automatic withholding.

A rollover may be accomplished by a participant who takes a distribution directly, so long as the taxpayer then deposits the assets (up to the gross amount of the eligible rollover distribution) with their new retirement plan or IRA. The distribution will not be taxed if the participant deposits the assets with the new administrator within 60 days of receipt. Even so, automatic 20 percent withholding and state tax withholding will apply to the distribution taken by the participant. The participant will report the withholding as a credit on his or her income tax return for the year of the distribution and may receive the withheld tax back as a refund.

If assets in a 457 plan are transferred to a traditional IRA, 401 plan, or 403(b) plan, the assets transferred will be subject to a 10 percent early withdrawal penalty if withdrawn before age 59½, unless another exception to the penalty applies.

Under current IRS rules, 457 assets may not be rolled over to a Roth IRA.
Distribution of Rolled-In Assets

Assets that are rolled in from other plans to a 457 plan and that, at a later date, are distributed to plan participants, will be subject to the same early withdrawal penalties that would have applied had they remained in their plan of origin. For example, rolled-in assets from qualified plans, 403(b) plans, and traditional IRAs will be subject to the 10 percent penalty tax applicable to distributions from qualified plans prior to age 59½, according to the early withdrawal provisions of those plans. If the employer has only one separate account for rolled-in assets, all distributions (including those that are attributable to rolled-in 457 assets) will be subject to early withdrawal penalties.

Death

In the event of the death of a participant, the designated beneficiary becomes eligible for benefits from the account of the participant in accordance with plan provisions and the Code. The Code provisions regarding beneficiary payments are complex, particularly if the beneficiary seeks to defer receipt, and may be daunting at what can be a stressful time for beneficiaries. Beneficiaries may be well served by consulting appropriate disinterested professionals who do not have an interest in earning commissions on the distribution payment selected by the beneficiaries.

The Code considers two situations for two types of beneficiaries: distributions where the participant has either started or not started receiving benefit payments and distributions to either a spouse or non-spouse beneficiary. The requirements are summarized in Exhibit 4.1.

Beneficiary Designations. Plans may allow participants to designate one or more primary and contingent beneficiaries. Beneficiaries may be individuals, trusts, estates, or institutions. If a married participant resides in a community property state, the consent of the spouse is necessary to designate someone other than the spouse as the beneficiary of the account.

If a participant designates a trust as beneficiary, the trust must be irrevocable or become irrevocable on the death of the participant and a copy of the trust must be filed with the plan sponsor. Payment options to beneficiaries of the trust may be limited unless certain “look-through” provisions are complied with. Participants considering the naming of a trust as beneficiary should consult with tax or legal counsel.

Plans generally provide a default in the event that a participant is not survived by a designated beneficiary, most commonly paying a lump sum to the estate of the participant.

Required Minimum Distributions

In order to fulfill the mission of deferred compensation plans as a retirement security vehicle—rather than as a tax shelter—the tax code requires plan participants to draw down assets in their 457 plans (and other tax-advantaged plans) over time. While distributions can be delayed, they must begin no later than the later of age 70½ or separation from service, as discussed below. Minimum distributions from 457 plans are governed by Code Section 401(a)(9). Final regulations for 401(a)(9), published in 2002, provided simplified treatment for required distributions. These rules also apply to 401 qualified retirement plans, 403(b) plans, and traditional IRAs.

The penalty for not taking the required minimum distribution (RMD) is severe: the taxpayer, in addition to owing any tax that is payable on the distribution at the time that it should have been paid, is liable for a penalty of 50 percent of the amount of the RMD which was not paid on a timely basis. Take, for exam-
<table>
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<th>Exhibit 4.1 • Beneficiary Distribution Options</th>
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<tbody>
<tr>
<td><strong>Payment option</strong></td>
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<td></td>
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<tr>
<td>100% immediate payment to beneficiary</td>
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<td>100% or partial rollover to</td>
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<td>—Traditional IRA or</td>
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<td>—Eligible employer plan</td>
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<td>Five-year rule (payments must exhaust the</td>
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<td>account by 12/31 of the year containing the</td>
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<td>fifth anniversary of the participant’s death)</td>
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<td>Begin payments now</td>
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<td>—Continue participant’s periodic payments</td>
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<td>—New periodic payment schedule</td>
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<td>—Partial lump sum followed by deferred</td>
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<td>—IRS RMD payments</td>
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Note: Any IRS required minimum distributions due in the year of the participant’s death will be paid to the beneficiary before beneficiary payments begin.

<sup>1</sup> RBD = Required beginning date. In general, a participant’s RBD is April 1 of the calendar year following the later of (1) the calendar year that the participant reaches age 70½, or (2) the calendar year in which the participant separates from service with the employer sponsoring the plan.

<sup>2</sup> Life expectancies are recalculated each year for spousal beneficiaries only. Life expectancy tables can be found in IRA Publication 590, available on the IRS Web site at www.irs.gov. Chart assumes separate accounting for each beneficiary and notification of the death to plan administrator on a timely basis (prior to 12/31 of the year after the year of death).
ple, a participant who is required to take an RMD in the amount of $20,000 in 2006 and the participant only withdraws $15,000. A distribution of the required additional $5,000 in 2007 would result in the additional taxable income attributed to 2006 (requiring the re-filing of the 2006 tax return) and a penalty payment of 50 percent of the amount of the underpayment, which would be $2,500. Between the taxes payable and the penalty, the participant will likely pay over 75 percent of the underdistribution as tax and penalty.

All participants who have reached age 70½ and have separated from service must take the RMD. The first RMD may be deferred to April 1 of the following year, but subsequent payments must be withdrawn by December 31 of each year. For example, if the first distribution is required for 2008, the first RMD must be withdrawn by April 1, 2009, and the second RMD must be withdrawn by December 31, 2009.

The amount of the RMD is calculated by taking the participant’s account value at the end of the previous year and an IRS-designated life expectancy factor based on the participant’s age and an assumed beneficiary ten years younger. The participant’s actual named beneficiary does not affect the life expectancy factor unless the named beneficiary is the spouse and is more than ten years younger than the participant. In that case the participant may have the RMD calculated using the joint life expectancy table with the actual ages of the participant and his or her spouse.

While all IRAs of an individual taxpayer may be aggregated to determine the total RMD and the total then withdrawn from one or more of the IRAs, the regulations require the 457 participant to withdraw the RMD from each of the employer’s 457 plans in which the participant may have an account balance.

**QDROs**
EGTRRA provides that an eligible 457 plan may comply with a qualified domestic relations order (QDRO) issued pursuant to a divorce decree or court order. A QDRO is a standard form of order awarding all or a portion of a participant’s benefit to an “alternate payee.” Distributions may be made pursuant to the QDRO prior to the participant’s reaching a distributable event. The QDRO must order the plan, not the participant, to pay or set aside the funds in question. The application of these rules may vary from state to state, as some states restrict or prohibit the application of QDROs against governmental plans.

Taxes are withheld from the distribution as required by the court order and generally are withheld in the name of the recipient of the distribution. Until EGTRRA was adopted, distributions were generally taxable to the participant.

**Taxation of Distributions**
*Income Taxes.* Under the federal income tax laws, distributions from a 457 plan are treated as regular income when received by participant. States that levy income taxes normally treat 457 distributions as taxable income as well. As of the date of this printing, exceptions are (1) distributions to participants who have deferred compensation in Illinois and who are residents of the state when receiving payments and (2) distributions that are attributable to contributions that have been previously taxed by the state, which may include deferrals in Pennsylvania and New Jersey.

*FICA.* 457 distributions are not subject to FICA tax, and the distributions are not considered earnings for purposes of determining reductions to FICA payments. However, 457 payments are included in the income base that determines the taxability of Social Security recipients.
Penalty Taxes. As discussed, the federal government imposes a severe tax penalty upon 457 participants who take less than the required minimum distribution of 50 percent of the amount that should have been distributed to the participant.

Automatic 20 Percent Withholding. Eligible rollover distributions received by participants (all payments with the exceptions noted earlier) are subject to automatic withholding of 20 percent of the amount of the distribution. This withholding is not a penalty. The amount may not be adequate to cover the tax that is payable on the withdrawn amount when the taxpayer files his or her income taxes, and the recipient of an eligible rollover distribution may wish to elect more withholding or make estimated tax payments to avoid underwithholding.

Reporting of Distributions. All 457 distributions, including direct rollovers and payments to participants, are reported on a 1099-R Form. The type of withdrawal requested will determine the applicable withholding.

A Special Tax Notice regarding plan payments must be provided to participants receiving distributions from Section 457 plans. The IRS in Notice 2002-3 published a safe harbor notice for 457 plans (see www.treasury.state.tn.us/tax-notice.htm). The participant will not be able to receive a distribution from the 457 plan for a period of thirty days after receipt of the Special Tax Notice unless the participant waives the thirty-day notice period.

Plan Terminations. An employer may amend its plan to limit future participation or contributions (essentially freezing the plan). A plan may also be terminated, but only if all amounts are paid to participants as soon as administratively practicable. If the amounts are not distributed, the plan is considered a frozen plan and will have to meet all applicable requirements to continue to provide plan eligibility.

On occasion, an employer will cease to be an eligible employer, by either ceasing existence entirely or by changing its status to become ineligible. For example, a public hospital or nursing home facility may be converted to private or private not-for-profit ownership. In these circumstances, the options include plan termination or transfer of assets to an eligible governmental plan in the same state that accepts the assets. If the formerly eligible plan is maintained by the newly ineligible employer, the assets are then subject to the treatment provided in 402(b).
Plan Investments and Fees

The investments offered by the plan and the associated fees and expenses are often the most visible aspects of the plan evaluated by employees. Offering a diverse and competitive investment fund lineup at a reasonable cost is a key component to both employee satisfaction and properly exercising fiduciary responsibility.

Evolving Roles of Vendors and Plan Sponsors

As deferred compensation plans have matured, the roles of plan vendors and many public employers have changed significantly with regard to the investments offered to plan participants. Initially, deferred compensation plan vendors most frequently offered an inflexible investment lineup bundled with the administration, record keeping, and education services provided for the plan. While the vendor might agree to omit funds not acceptable to the plan sponsor, it would not add funds outside of its bundled lineup. If employers wanted different funds, they could either replace the vendor or add a co-provider for the plan.

Over time plans also encountered fund proliferation. In order to provide maximum choice, some vendors offered 50 or more funds as part of their bundled lineup. Some plan sponsors also hired multiple vendors to add even more investment choice, at times providing their employees more than 100 options. This approach had the advantage of providing multiple choices in each asset class for the experienced investor, but had the disadvantage of confusing the average participant.

Today, vendors commonly provide medium- and large-sized plans (over $5 to $10 million in assets) “open architecture,” allowing access to dozens of fund companies with hundreds or even thousands of mutual funds for employers to select for use in their program. Due to economies of scale, small plans generally continue to receive a “bundled” investment lineup, delivered as a standard package by the vendor to all employers not large enough to deal with selection of individual funds. Open architecture provides plan sponsors greater flexibility and responsibility, while vendors are expected to conduct a greater degree of due diligence on the bundled fund lineup they provide for hundreds or thousands of plans.

Trends regarding the scope of plan investments have also changed. Through the 1990s, plans expanded the number of investments offered to participants. There is now a countervailing trend to curtail the complexity. In part, this new-
est trend is driven by academic research showing that more investment options (well beyond the number needed to comply with fiduciary requirements) are producing unintended consequences. For example, some research has shown that in private sector plans with an extremely large investment lineup, some individuals simply divide their investment portfolio among all the investment funds—“equal weighting” the portfolio. This usually conflicts with the primary task of asset allocation, which is to choose the combination of equity, fixed income, and cash investments that is appropriate for the individual’s objectives. Second, excessive choice may confuse employees enough so that they do not participate in the plan or do not make any affirmative decision at all about their asset allocation preferences, causing them to be placed in a default fund.

Therefore, in order to minimize employee confusion and promote reasoned asset allocation, many employers are now choosing to reduce the number of funds to one fund per asset class, plus access to a family of risk-based lifestyle or time-based lifecycle funds. Some employers constructing their investment lineup in this way also choose to offer self-directed brokerage services with access to several thousand mutual funds to satisfy the requirements of experienced investors.

Employer Responsibilities

These changes in the way investment options in plans are structured have put more accountability for the selection and monitoring of mutual funds in their plan onto deferred compensation committees and finance officers or others responsible for plan operations. To discharge this responsibility in a consistent and defined fashion in an open architecture environment, it is best practice for the employer to maintain a written investment policy statement.

The GFOA has published *Recommended Practice: Investment Policies Governing Assets in a Deferred Compensation Plan*, which provides general guidelines on the elements that should be contained in an investment policy statement. This document and a detailed checklist can be obtained at no cost from GFOA at www.gfoa.org.

The following section provides additional detail regarding the scope of investments and performance of due diligence that employers should consider as they compose and implement investment policy statements.

The Scope of Investment Options Offered by the Plan. The employer’s goal should be to 1) provide adequate choice to support participant development of diversified investment portfolios, and 2) provide clarity by selecting one fund per asset class wherever possible. Deferred compensation plans today offer many of the following asset classes:

- Domestic equity funds, often subdivided by both style (growth, blend, or value) and size, with size referring to the market capitalization of companies:

<table>
<thead>
<tr>
<th>Large-cap value</th>
<th>Large-cap blend</th>
<th>Large-cap growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mid-cap value</td>
<td>Mid-cap blend</td>
<td>Mid-cap growth</td>
</tr>
<tr>
<td>Small-cap value</td>
<td>Small-cap blend</td>
<td>Small-cap growth</td>
</tr>
</tbody>
</table>

Some plan sponsors choose to use index funds for the “blend” style boxes.

- International equity funds, including the foreign large-cap growth, blend, and/or value, as well as foreign mid/small-cap categories.
• Domestic bond funds, including intermediate term bonds and high-yield bonds.
• A stable value fund, insurance company general account, and/or money market fund.

Stable value funds and insurance company general accounts hold fixed income securities, with principal guaranteed by insurance companies.

In addition to having the core asset classes just listed that allow a plan participant to build his or her own portfolio, there are additional options that 457 plans can provide:
• A balanced fund—This type of fund provides exposure to both equity and fixed income markets, with fund managers allocating assets between them based on their assessment of future market trends.
• Risk-based lifestyle or time-based lifecycle funds—Like balanced funds, these investment options combine both equity and fixed income asset classes. The manager rebalances the fund so that it adheres to a defined portfolio allocation; some employers make this the default option.
• Specialized options—These include assets that may be riskier than broadly diversified equity funds, since they usually are not as well diversified (such as sector funds) or operate in inherently risky markets (such as emerging markets).

Lastly, a small number of mainly large employers offer self-directed brokerage windows. This feature can be structured so that the participant can select an essentially unlimited number of mutual funds, or even select individual securities. GFOA generally does not recommend that government employers offer brokerage windows. (Readers can obtain this recommended practice at www.gfoa.org at no cost.)

Selection and Monitoring. Plan sponsors must define the standards by which funds will be selected and monitored for adherence to minimum performance and risk expectations appropriate for successful retirement investing. Selection criteria include:
• Objective measurement of fund performance against appropriate market benchmarks and peers to ensure that each fund is performing in line with expectations for the pertinent asset class and style—These measurements should be made over one-, three-, and five-year periods as well as over rolling three-year periods to determine whether recent performance has been exceptionally volatile and whether performance is consistently meeting plan objectives.
• Non-performance related factors that can impact the appropriateness of the fund option in the lineup—Such factors include but are not limited to:
  – Company management, to ensure that the fund organization is stable and adequately supports fund management;
  – Fund management, to ensure that portfolio management resources are stable and positioned to produce successful results;
  – Commitment to consistent application of an investment style and process;
  – Regulatory compliance, including whether the fund or fund company is under investigation or has recently been found not to be in compliance with federal and/or state laws and regulations; and
  – Fund fees, to ensure that they are in line with peers and do not have an inordinate negative impact on net-of-fee performance results.
• A definition of the process by which the funds will be reviewed and monitored—This should include quarterly review of performance vs. benchmarks and qualitative changes of which the employer is aware. The process also should entail a more detailed annual review of the quantitative and qualitative measures of
each fund with assistance of the deferred compensation plan vendor. The committee should determine quarterly which funds should be placed on probation, removed from probation, or eliminated and replaced.

The aforementioned GFOA investment policy checklist illustrates some of the selection criteria discussed above.

**Vendor Support.** While plan sponsors retain fiduciary responsibility for the funds in their plan, they receive support from vendors in several ways. The following are key attributes of these vendor services:

- **Due diligence support**—Vendors should provide plan sponsors quarterly fund and benchmark performance reports. Important qualitative information (such as changes in ownership, significant regulatory actions, etc.) should be provided to the employer shortly after they are received. More detailed annual reports should include return, risk and expense data, as well as qualitative information necessary to perform evaluations consistent with the investment policy statement.

- **Scope of investment choice**—The level of plan choice in designing an investment lineup is based on several factors, including the number of fund families covered, the number of funds available, and the vendor’s requirements for use of proprietary funds (such as the general account or stable value fund).

- **Fund replacement process**—Fund replacement is a multi-stepped process that includes: a) deciding to terminate a fund, b) evaluating and selecting replacements, c) informing participants of the change, and d) transferring assets to the new funds. The vendor should have a process in place to smoothly implement such changes, including providing the plan sponsor with funds to consider as replacements and communications to participants regarding the change.

### General Accounts and Stable Value Funds

Historically, the general account or stable value fund has been the most significant investment option in a deferred compensation plan, and, among most plans, still commands a large portion of assets. Moreover, they are subject to relatively less federal regulatory oversight than mutual funds. As a result, it is important to understand the attributes of these investment vehicles and review the structure of any such investment options proposed.

General accounts and stable value funds are unregistered securities that operate under less stringent rules than registered mutual funds. In contrast, the U.S. Securities and Exchange Commission (SEC) strictly regulates registered mutual funds offered under the Investment Company Act of 1940 and numerous other laws designed to ensure consistent disclosure of key information to the public regarding these investment vehicles.

In addition to evaluating the attributes of these investment vehicles using the quantitative and qualitative measures described above, there are structural differences between general accounts and stable value funds to consider (refer to Exhibit 5.1). These qualitative differences have led some plan sponsors to require use of stable value funds for this asset class.

### Fees

Fees are a critical component for assessing the total value delivered by a deferred compensation plan, and they represent the component over which plan sponsors may exert the greatest control. In fact, *Washington Post* columnist Albert Crenshaw has written, “You want top performance, of course. But remember: Performance is uncertain, but fees are guaranteed.”
While other factors, such as the quality of investments and most particularly the allocation of assets by participants also are important to plan value, a plan paying significantly more than the market rate in administrative fees and fund expenses damages the interests of participants. Indeed, some would argue that a key fiduciary obligation is to ensure reasonable fee levels for participants.

Cost is only one variable in the value equation plan sponsors use to assess the quality of a vendor’s program. Most RFPs weight fees at between 10 percent and 30 percent of the total score. The investment options, participant and plan sponsor services, and educational programs provided by a vendor can significantly add to the total value of a retirement program and may well be worth higher fees.

Vendors base their revenue requirements on a combination of plan size, average account balances, client service requirements, and contract term. Because most, if not all, revenue typically is asset-based, plan size determines both total revenue and the degree to which economies of scale reduce the vendor’s unit costs. The number of participants is the key determinant of total cost and average participant account balances therefore is the key determinant of revenue per unit of cost. The degree of service customization required by the client also will affect vendor cost (see Exhibit 5.2).

The contract term frames the environment in which vendors will determine their fees. Vendors are in business to achieve a return over a contract term. With plan contribution flow and average market growth increasing profitability over time, vendors often lose money at the beginning of the contract term and strive to meet overall financial objectives by the end of the contract. When putting a plan out to bid, it is particularly important to have a sufficiently long contract term (preferably five years or more) in order to amortize the cost of the transition for non-incumbents and thereby provide for a truly competitive process.

Costs for retirement plan record keeping, administration, education, and investment management services typically are borne solely by participants. These costs are reflected in a complex array of charges and fees, making it incumbent upon plan sponsors to compare total costs for the program. The challenge is to apply an “apples to apples” comparison to total costs for a vendor’s program. Additionally, plan sponsors should scrutinize fees to identify any “handcuffs” that would hamper the change from one vendor to another when the contract term expires.

### Exhibit 5.1 • Profile of Stable Value Funds and General Accounts

<table>
<thead>
<tr>
<th>Attribute</th>
<th>Stable Value Funds</th>
<th>General Accounts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit risk</td>
<td>Bond portfolio diversified among multiple guaranteed investment contract (GIC) issuers</td>
<td>Promise to pay based on solvency of single insurance company managing general account</td>
</tr>
<tr>
<td>Ownership</td>
<td>Fund owns assets, which are disclosed by the manager</td>
<td>Insurance company owns assets, which are not publicly disclosed</td>
</tr>
<tr>
<td>Fee structure</td>
<td>Disclosed expense ratio</td>
<td>Spreads not publicly disclosed</td>
</tr>
<tr>
<td>Investment return</td>
<td>Rate based on return of asset minus disclosed fees</td>
<td>Rate set by insurance company</td>
</tr>
<tr>
<td></td>
<td>Single portfolio rate on all assets</td>
<td>Can have higher “teaser” new money rates and lower old money rates</td>
</tr>
</tbody>
</table>
Plan participants typically provide compensation to vendors through revenue received from investment funds administered and usage fees for ancillary services. Participants of smaller plans may also pay an asset-based fee or per participant fee in addition to fund expenses. Some bid processes have required vendors to disclose the revenue they receive from both proprietary and non-proprietary funds and state their asset-based revenue requirement over the term of the contract. Revenue received above that level is returned as an administrative allowance either to participant accounts or to the plan sponsor for the costs it incurs in administering the plan. Further, as indicated in Exhibit 5.3, certain insurance companies may obtain income from the spread on general account funds.

In addition to the types of expenses identified in Exhibit 5.3, general account and stable value funds may have additional expenses or costs. Insurance companies and mutual funds are compensated in different ways for these investment instruments. Insurance companies receive undisclosed spreads between the return received on underlying investments in the general account and the rate paid to participants. This is similar to the revenue banks receive on savings accounts or CDs. In contrast, stable value funds have disclosed expenses. If insurance companies were to provide their spread, a direct comparison of the spread and fund expenses would be possible. It is very unlikely, however, that an insurance company would disclose its spread. Therefore, expenses can typically only be evaluated indirectly by comparing general account and stable value fund rates. Because rates at any particular point in time can fluctuate based on the state of the market and the way in which these portfolios are invested, such comparisons are more accurately made over a substantial period of time.

If all stable value funds and general accounts have a single portfolio rate on all assets, one could simply compare rates net of all fees/expenses. However, many insurance company general accounts have “new money” and “old money” rates. When this is the case, the insurance company would need to provide the “new money” rates and the “old money” rates over a defined period of time, and provide an estimate of the percentage of assets in each category over the term of your contract in order to make a valid comparison.

### Exhibit 5.2 • Cost Drivers Impact on Participant Costs

<table>
<thead>
<tr>
<th>Cost Drivers</th>
<th>Impact on Unit Costs (Basis Points)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Plan size (number of participants)</td>
<td>Increase in plan size makes it possible to lower unit costs</td>
</tr>
<tr>
<td>Average account balance</td>
<td>Increase in average balances facilitates lower unit costs</td>
</tr>
<tr>
<td>Client service requirements/customization</td>
<td>Greater requirements/customization promotes higher unit costs</td>
</tr>
<tr>
<td>Contract term</td>
<td>Longer term facilitates lower unit costs</td>
</tr>
</tbody>
</table>

**Back-End Charges**  
**Sales Charges.** Securities laws and regulations provide for investment companies to receive compensation for marketing costs of up to 8 percent of assets either upon the receipt or distribution of assets. In the public sector retirement plan community, these most typically are called “contingent deferred sales charges” and can be assessed when participants move to a competing vendor or when the plan sponsor terminates the vendor as a provider. Often, charges de-
Historically, contingent deferred sales charges protected a vendor’s initial investment in enrolling and educating employees at the inception of retirement plans, when assets and vendor compensation were low. As plan assets have grown exponentially, these charges now typically serve more to protect the vendor from competition. This clearly may make it very costly to remove a vendor that becomes non-competitive.

Some vendors have no contingent deferred sales charges. Others have eliminated such charges when forcefully pressed by plan sponsors and given a contract renewal for a defined period of time with the elimination of the charge as a condition of renewal. Plan sponsors also can make the incumbent’s access to the bid process contingent on dropping the charges prior to the RFP.

<table>
<thead>
<tr>
<th>Category</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Plan-level asset fees</td>
<td>Vendors can charge plan-level asset fees, which are often described as administration or risk and mortality fees. Some vendors assess the fees on all assets, while others assess the fee only on assets in variable funds.</td>
</tr>
<tr>
<td>Participant fees</td>
<td>Vendors can charge a flat dollar fee for each participant served. Plan sponsors who wish to pay this fee on behalf of their participants may be able to arrange to do so.</td>
</tr>
<tr>
<td>Investment fund fees and expenses</td>
<td>Each fund will have an expense ratio, and may provide revenue to the vendor, which typically is used to reduce fees. These fund-specific fees and expenses often comprise the bulk of total plan costs.</td>
</tr>
<tr>
<td>Transaction fees</td>
<td>Many vendors assess activity fees on participants using specific ancillary services, such as third-party investment advice, loans and brokerage services. Some also may charge the plan sponsor for certain services rendered for serving the plan.</td>
</tr>
<tr>
<td>Sales charges and market value adjustments</td>
<td>Vendors may assess back-end sales charges and/or market value adjustments on assets in general accounts when assets are withdrawn either by the employer (by terminating the relationship with the vendor) or by participants (in some circumstances). In rare cases, front-end sales charges also may be assessed. The basis of these charges and issues to consider regarding these charges are described in detail below. Unless a plan sponsor knows that their vendor will provide the best available service forever and that they therefore will never leave the vendor, these charges are a cost to the plan that need to be assessed. The difficulty is in estimating both the duration of the relationship and determining the fee that would be assessed for leaving the plan. If the current vendor has back-end charges, the plan sponsor should request an estimate of the cost of leaving the vendor’s program, the basis of the calculation, and the specific contractual language permitting the charge. If a prospective vendor has such charges, consider the discussion below before selecting that vendor to serve your plan.</td>
</tr>
<tr>
<td>Administrative allowances</td>
<td>Once plans reach a size and average participant balance that provides money above the level necessary to meet the vendor’s revenue requirement, the vendor may use that excess revenue to pay the plan sponsor an administrative allowance. Such monies are designed to be used either to offset the employer’s expense for administering the plan or to be paid by the vendor to participant accounts on a basis defined by the plan sponsor.</td>
</tr>
<tr>
<td>Other charges</td>
<td>There may be other charges assessed by vendors but not addressed here. It is important to ask vendors to fully disclose all fees, including those not anticipated.</td>
</tr>
</tbody>
</table>

Exhibit 5.3 • Types of Compensation for 457 Plan Vendors
Employers changing vendors while subject to a contingent deferred sales charge typically ask the successor vendors to pay the charge. The new vendor will structure its compensation to cover this charge, and amortize the cost over a defined period of time (which may or may not be disclosed by the vendor). The plan sponsor should make certain that the plan would be free of all contingent deferred sales charges at the conclusion of this amortization.

**Market Value Adjustments.** General accounts of insurance companies determine the market value of accounts when participants transfer assets out of the account or when the plan sponsor terminates the vendor as a provider, and often apply a fee or adjustment to the account(s). Since general accounts are structured to hold fixed income securities until maturity, the charge is designed to protect the general account from loss of market value when assets are sold prior to maturity in a rising interest rate environment.

Many general accounts, however, have contracts that permit the insurance company to assess market value adjustments that appear independent of the interest rate environment and its impact on the sale of fixed income securities prior to maturity. Under such circumstances, market value adjustments again serve as an impediment to competition. The adjustments restrict the freedom of action of the plan sponsor and participants should the general account or the vendor’s services become non-competitive. Costs are also extremely difficult to estimate, since fluctuations in interest rates can greatly impact the level of market value adjustments. Plan sponsors can request the formula by which market value adjustments are assessed from their vendor in order to determine whether the adjustments are based solely on economics related to the underlying securities of the general account.

Market value adjustments often can be avoided by transferring assets out of the general account over a prolonged period of time. Because this can be administratively cumbersome or confusing to participants, some plan sponsors choose to ask the successor vendor to pay these charges. As described above, the new vendor will structure its compensation to cover this charge, and amortize the cost over a defined period of time. Numerous vendors offer stable value investment options that avoid market value adjustments altogether, providing the plan sponsor and participants freedom to change vendors as circumstances change without any back-end charges.

A spreadsheet to help compare costs and obtain fee/cost information from vendors is referenced in Appendix E and enclosed on the accompanying CD.
Employees only capture the potential value of their 401k plan if they participate in it and know how to invest the money they contribute. Sustained on-site education is vital to achieving significant participation in plans and to promoting knowledgeable investment. Accordingly, the GFOA has published a document, *Recommended Practice: Retirement and Financial Planning Services*, which recommends that employers establish a comprehensive education and planning program and establish guidelines for such a program.¹

Unlike the private sector, most public plans do not offer matching contributions to induce participation, so vendors are normally expected to deliver a high level of on-site enrollment and education. For all but the smallest plans (those with $1 million in assets or less), educational seminars should be delivered and individual consultations should be available on a sustained and consistent basis at key physical locations within the jurisdiction.

**Objective and Scope**

Ultimately, the goal of any retirement education program is to help employees make sound decisions that achieve retirement security. Accordingly, the scope of the employee education program should address four key decisions that they will make regarding their plan:

- Whether to participate;
- How much to contribute;
- How to invest their assets; and
- How to withdraw their assets after retirement.

These seminars should describe the benefits offered by the plan to encourage participation and a high level of contributions, consistent with the participant’s financial abilities and total financial objectives. Participants should be encouraged to regularly consider their time horizon and risk tolerance and make applicable changes to their asset allocation. Finally, retirement income planning tools and seminars should be provided to help participants effectively manage their assets and income after retirement.

¹ This document can be obtained for free from www.gfoa.org.
Factors Determining Quality

The quality of employee experience with their deferred compensation plan is determined by a number of factors, including:

- **Coordination with employer**—Since each plan has different needs, vendors should work in close consultation with plan sponsors to identify issues that the employer may wish to resolve (such as the level of participation, allocation of assets, etc.). The employer may also raise issues that may pertain primarily to one department. Once objectives are established, the vendor then should develop an education program that targets outreach to achieve the employer’s goals.

- **Level of on-site service**—Vendors sometimes focus on the number of registered representatives available to the plan rather than the level of on-site service delivered. The number of educational seminars, number of seminar attendees, the amount of time representatives are available for one-on-one consultations, and the number of consultations given are better measures of service actually delivered.

- **Capabilities of representatives**—The quality of on-site educational service is essential and is primarily determined by the on-site representative’s knowledge and ability to communicate effectively with a diverse range of public employees. Representatives should be fully knowledgeable on plan features and the vendor’s services and be able to communicate technical information in language that the average employee can easily understand and use. They should have access to participant account information and the ability to perform benefit projections from laptops with participants during individual consultations. Representatives should have Series 6 or 7 and Series 63 registrations. In cases where multiple providers serve a deferred compensation plan, on-site representatives often dedicate significant effort to compete with each other, diluting resources for education. Under such a structure, the plan sponsor should strictly define permissible on-site activity by representatives and closely monitor adherence to those policies.

- **Access to financial planning**—Retirement savings and investment is only one aspect of our financial lives. Purchasing a house and paying for college tuition are just two examples of other major financial events that affect many individuals. Some vendors add value by providing broader financial planning seminars by Certified Financial Planners (CFP®) as well as access to fee-only personal financial plans.

Channels of Communication

Vendors are able to deliver information to participants through a variety of “channels,” including on-site service, publications, statements, a telephone call center, and Web sites, which should all convey a consistent and coherent message in support of the plan’s overall education objectives.

- **Publications**—Vendors publish a wide range of communication materials that are used in coordination with the delivery of on-site services and as stand-alone material for independent use by participants. This package should be both comprehensive and easy to understand. Moreover, in addressing the four fundamental decisions cited on page 42, the materials should be tailored to the different career stages of each employee. For example, materials for new hires, mid-career employees, employees near retirement, and employees in retirement should be considered.

- **Participant statements**—Every participant receives a quarterly statement that can convey important messages in support the plan’s educational efforts. The
statements should provide a comparison of individual asset allocations with peers, show a personal rate of return, and clearly present holdings and activity. Many vendors deliver statements by mail or online at the discretion of the participants.

- **Toll-free phone service**—Participants use vendor toll-free phone call centers to implement transactions and inquire about plan features, fund characteristics, and the markets. The quality of the participant experience is based on the capabilities of phone representatives (knowledge of 457 plans and the vendor’s services, instant access to specific plan features, and the ability to communicate effectively) along with quantitative measures, including the average wait time, abandon rate, and average call time of the call center over a significant period of time.

- **Web-based services**—Employees use vendor Web sites to receive information about the deferred compensation plan, track investments, conduct financial planning, receive investment advice, and implement transactions. Vendor Web sites can be assessed based on their ease of use, focus on deferred compensation, and the comprehensiveness of educational material and transaction capabilities. Increasingly, vendors are customizing Web sites for the specific features and needs of medium and large size plans.

### Investment Advice and Managed Portfolios

Vendors have provided third-party investment advisory services to deferred compensation plan participants for a number of years. While this service typically has been delivered online, some vendors now provide advice via their phone center and on-site representatives using the third-party advice provider’s online service. Use of the service — even when provided at no cost — has been very low. In light of concerns about the ability of participants to construct and consistently maintain a diversified portfolio based on their objectives, time horizon, and risk tolerance, there is increased interest in managed accounts. This service delegates investment discretion to a third-party vendor, with a customized portfolio created by an investment professional of the firm. While this takes investment responsibility completely off the hands of the participants, asset-based fees for this service can be high due to the relatively low level of assets for service delivered.

### Compensation of Representatives and Cross-Selling

Beyond the quality factors that are directly observable by the plan administrators and participants, governments should consider a) the compensation of representatives and b) cross-selling of products. Regarding compensation, some vendors compensate representatives on a salary with incentives for increasing cash flow into the plan (through enrollments or increased contributions). Others use a commission-based compensation structure that may not align the interests of representatives with that of the plan. Plan sponsors should know how the representatives serving their plan are compensated and avoid compensation structures that encourage activity contrary to the plan’s interests.

With respect to cross-selling, registered representatives often have a range of financial services they can sell to participants outside of the plan (life insurance, property insurance, auto insurance, etc.). While broad-based financial planning is beneficial to knowledgeable investment, emphasis on cross selling can be detrimental to the plan’s objectives. Plan sponsors should prohibit cross selling that is harmful to their plan.
Measuring Value

Participant satisfaction with on-site service can be measured by surveys conducted immediately following educational seminars and individual consultations and/or through annual surveys conducted by the vendor or the employer. Employers should directly observe the delivery of educational seminars and provide feedback to the vendor.

The value delivered by on-site service also can be evaluated by measuring four key participant activities:

- **Participation**—A deferred compensation plan is only of value to those who participate. Without an employer match, sustained on-site education services typically are necessary to achieve a reasonable level of participation. Enrollment rates should be monitored and active participation (those making contributions through payroll) should grow over time to at least 50 percent of eligible employees.

- **Contributions**—The value delivered by the plan to participants is directly affected by the amount contributed by participants. This is not a one-time decision at the time of enrollment. Participants should be encouraged to increase their level of contributions as their disposable income increases. The vendor should regularly report on changes in the level of contributions.

- **Asset allocations**—Studies have shown that asset allocation is the primary driver of investment success. Some plans are heavily weighted toward a single asset class (typically in the general account or stable value fund) while others are invested in aggregate very close to that of a professionally managed defined benefit plan. High use of lifestyle and lifecycle funds can be beneficial, as these funds provide consistent diversified investment for those who do not wish to construct their own portfolio.

  The vendor should regularly report on the allocation of plan assets for the entire plan, by age, and by gender and compare plan asset allocations to those of all plans they serve. The education program should be adjusted as necessary to address asset allocation imbalances.

- **Disbursements**—Deferred compensation plans should be viewed in the context of the overall structure of retirement income available to employees. Disbursement decisions made by the average participant with access to Social Security, a defined benefit plan, and a deferred compensation plan should differ from decisions made by those with access only to a deferred compensation plan.

  Vendors should regularly report on the number of participants purchasing annuities, taking regular distributions (monthly, quarterly, annual), and taking lump sum distributions. Employers should pay particular attention to the level of annuity use, a product that can be oversold to participants with significant secure income from Social Security and a defined benefit plan.

These four measures of participant behavior in response to vendor education efforts should be measured by the vendor and reviewed regularly by the plan sponsor.
Most plan sponsors conduct a bid process from time to time to ensure that their plan is receiving the most competitive combination of service, investments, and fees consistent with the specific needs of the deferred compensation plan. This chapter reviews the key stages in the process and provides guidelines for making the process more effective.

### Soliciting Proposals for Deferred Compensation Vendors

Before starting the bid process, it is essential for the plan sponsor to know what it wants to achieve. This can be accomplished by:

- **Discussing plan objectives and accomplishments**—Annually, the plan’s governing board should thoroughly review accomplishments against the prior year’s objectives and set objectives for the coming year. Issues that arise in this process should be addressed with the vendor; any unreconciled problems should be covered in the bid process.

- **Evaluating the current vendor(s)**—Once the end of the contract term is approaching or when serious issues arise with the current vendor, the board should evaluate whether it is likely that the vendor can/will meet plan objectives.

- **Surveying participants and non-participants**—While larger plan sponsors often survey their participants annually, employers should determine their employees’ opinions before a bid process. The survey results and their application to formal RFI/RFP objectives should be reported to participants before the bid process. A sample employee survey is provided on the enclosed CD.

- **Communication**—Up-front and on-going communication throughout the bid process should facilitate acceptance of the board’s ultimate decision. Participants should be informed of the selection schedule, the bid process objectives, the selection of finalists, and the reasons why the winning vendor was selected.

- **Determining needed support**—Plan sponsors need to determine whether they will conduct the bid process on their own or use a consultant to support the process. Larger plans (e.g., those with more than $25-$50 million in assets) often hire consultants for this purpose due to the level of plan assets and the overall financial implications of the decision to the total employee population. Smaller plans often opt to conduct vendor evaluations on their own due to the
cost of using a consultant. The decision also can be affected by budget considerations, the level of in-house expertise, and time/resources available for the process.

After completing these evaluations, the board needs to determine whether its objectives can best be met through a negotiation with the vendor(s), through a request for information (RFI) to benchmark the vendor’s competitiveness, or through a formal request for proposals (RFP). Plans typically conduct a formal RFI or RFP if (a) there are mandates in local or state procurement or deferred compensation laws, (b) there is a lack of knowledge regarding the competitive landscape, (c) there is significant dissatisfaction with the current vendor, or (d) if the board is unable to successfully complete negotiations with the current vendor(s).

An RFI is a procurement method that lets the plan sponsor efficiently test whether it is getting competitive treatment from the current vendor. This short questionnaire usually focuses on employee services, investments and fees (detailed in previous chapters), as well as other issues of concern. Responses can be used in negotiations with the current vendor to enhance their services or fees or to determine that a formal in-depth RFP process is necessary.

Formal RFP processes can be arduous and time consuming. It is important to structure the RFP carefully to obtain the best possible bids from vendors and to minimize the work necessary to identify the vendor that is most likely to meet plan objectives. This should include:

- **Defining objectives**—The governing board should identify the weighting it will give to each criterion in the RFP (employee service, investments, fees, etc.) and whether it plans to maintain the current vendor structure (one provider or multiple providers) or change it. Many plans hired multiple providers in the early years of deferred compensation when vendors only offered a small number of proprietary investments. In today’s open investment architecture environment for plans with more than $5-10 million in assets, some plans have moved to a single provider to simplify investment choice and maximize their negotiating power (which is largely based on assets and average account balances).

- **Understanding the current contract**—It is important that the RFP include any impediments to the transfer of assets to the successful bidder. This includes deferred sales charges, market value adjustments on general accounts, and provisions on the timing of transferring general account or stable value assets. These items, along with detailed financial information regarding the plan, should be included in the RFP.

  Generally, the new vendor is expected to pay back-end charges. This gives the incumbent with such charges a competitive advantage contrary to the best interests of plan participants. Deferred sales charges, which were applied in the early years of deferred compensation plans to protect the investment vendors made in building up the plan, are not appropriate for mature plans. These often can be negotiated away prior to the bid process.

- **Defining the contract term**—The length of the contract term plays a role in the competitiveness of bids the plan sponsor will receive. Non-incumbents will need to amortize the cost of transition and any service customization, as well as the cost of paying any back-end fees of the incumbent vendor. Longer contract periods generally yield more competitive bids from non-incumbents. Many contracts are five years in length, assuming such a term is consistent with local procurement law.
• **Structuring the RFP**—Vendors need to be asked questions to accomplish two tasks: 1) determine which vendor offers the best service and value for the plan; and 2) conduct due diligence to ensure the successful vendor can in fact deliver what was promised. These dual objectives usually lead to a large number of questions, increasing the time and resources necessary to evaluate the responses.

To simplify the process, one can focus first on topics that will drive the final selection of a vendor – services to participants and the plan sponsor, investments offered to the plan, and fees charged for services. Once vendors who make competitive offers in these key areas are identified, the due diligence aspects of their proposals should be reviewed to confirm fundamental competence before inviting finalists to present to the governing body of the deferred compensation plan.

• **Determining the fund structure**—Vendors can provide a “bundled” investment structure of proprietary and non-proprietary funds offered as a package to many of their clients, or provide “open architecture” where the plan sponsor selects the fund lineup. Vendors may provide a higher level of due diligence on a bundled lineup, while open investment architecture gives plan sponsors greater control over a key component of their plan. Plan sponsors choosing open architecture usually request fund recommendations and ask that the fee proposal be based on that lineup. Plans with more than $5-$10 million often opt for open architecture and smaller plans usually receive a bundled investment lineup in the bid process.

• **Establishing the selection schedule**—The bid process should give all parties sufficient time to give the plan sponsor high quality information to consider. Ideally, key milestones of the bid process would be scheduled as follows:

  - Vendor RFP response: 4 to 6 weeks
  - Plan sponsor RFP review: 6 to 8 weeks
  - Finals presentation lead time: 2 to 4 weeks
  - Transition lead time: 12 to 16 weeks

These lead times can be truncated somewhat if dictated by the plan sponsor’s deadlines.

A sample RFP is contained on the enclosed CD. It should be modified as necessary to address the specific needs of your plan and local purchasing requirements.

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**Reviewing/Evaluating Proposals**

The RFP process is analogous to the procedure for hiring employees. The review of vendor proposals is comparable to the vetting of resumes, while the finals presentation really is the vendors’ employment interview.

The RFP evaluation process should be structured both to maximize efficiency and to ensure that finalists are selected on an objective basis. Prior to the release of the RFP, each section of the RFP and then each question within each section should be weighted. Individuals should be selected as reviewers either of the entire RFP or sections of the RFP within their specific areas of expertise. There should be at least two reviewers for each section of the RFP, with the exception of the fee section, where the analysis should be strictly quantitative.

A spreadsheet for use by evaluators is referenced on the enclosed CD. It includes all questions in the sample RFP and default evaluation weightings. The spreadsheet should be customized to the specific RFP questions and needs of the plan sponsor.
Each reviewer should assign a qualitative rating for each response between 0 (response of no value) to 5 (response with best possible value). The evaluator’s spreadsheet will automatically calculate the weighted average score for each chapter evaluated. These totals should then be transcribed from each evaluator’s spreadsheet onto the master scoring sheet to obtain a total score for each vendor. The fee analysis should be conducted as described in Chapter 5.

To facilitate the review process, the plan sponsor can require that responses be provided on a CD and then design an integrated file that provides all vendor responses in one place under each question. As described above, the process can be simplified by evaluating vendors first for key attributes: participant services, plan sponsor services, investments, and fees. Due diligence components of the RFP may then be evaluated only for vendors passing the first screen.

Once both screens have been evaluated, the board will decide which vendors to invite to a finals presentation. Any vendor that the board believes it may want to hire should be invited to the finals. Typically, two to five vendors (including the incumbent) are invited.

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<tr>
<th>Conducting and Evaluating Finals Presentations</th>
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<td>The objective of conducting finals presentations is to garner all the qualitative information necessary to select the vendor that will best meet the needs of the plan and its participants. The finals presentation process should be used to go beyond the quantitative analysis of vendor capabilities conducted in the review of vendor proposals. The board ultimately needs to determine which vendor will best match the employer’s culture and will best take the plan to a higher level of service in the coming years.</td>
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The board should control the agenda for the presentation, clearly stating to each finalist the topics to be addressed and the time available for presenting and questions. While each vendor should be given an identical opportunity in terms of time and agenda, plan sponsors also often identify issues of particular concern to individual vendors.

If aspects of a vendor’s RFP response were unclear or a cause for concern, the plan sponsor should require clarification in writing prior to the finals presentation. Board members should prepare questions in advance that are designed to help determine whether the vendor is the right fit for the plan in the coming years. Spontaneous questions and dialog also should be encouraged.

The duration of finals presentations varies according to the needs of the plan, the relative strengths of the remaining bidders (whether it appears the finals will be used to validate the winner or whether there is real uncertainty as to which firm should be the winning bidder), and the time available to board members. Although finals presentations have been as short as 10 minutes and as long as one-half day per vendor, in most cases an hour and a half to two hours should provide sufficient opportunity for the vendor’s presentation and questions.

Board members should grade vendors and take notes as presentations are conducted. A meeting to discuss the relative merits of each vendor should be scheduled immediately following the last presentation, while the experience is fresh in everyone’s memory. All members should be encouraged to describe their observations and an attempt should be made to reach a consensus on the selection of a vendor, or, if that is not possible, who should still be under consideration.

If necessary, follow-up questions can be sent to the top two or three vendors to further clarify issues that arose during the presentation. Once a decision is
made, each vendor should be informed of the choice and a letter announcing the decision should be sent to all participants.

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<th>Implementing New Plans and Transitioning to New Providers</th>
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<td>Plan sponsors securing bids for 457 plan services may decide to replace the incumbent vendor. When this occurs, the subsequent transition will demand careful oversight by the plan sponsor in ensuring timely, accurate, and coordinated action by the two vendors. If participant satisfaction with the new vendor is to be attained, it is critical to have both a flawless execution of the transfer of records and assets as well as effective communication of the activities surrounding the transition.</td>
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**Transition Schedule.** Upon selection, the new vendor should work as a partner with the employer to implement the transition. The plan sponsor should immediately inform the existing vendor of their termination, confirm whether there are any fees or other impediments to transferring all assets, and provide written instructions to cooperate fully with their successor. The new vendor should work with the employer to establish a schedule that includes:

- Announcement of the change to plan participants.
- Negotiation of a contract.
- Vendor design and employer approval of a plan for transferring assets from the funds of the old provider to the new fund line-up, including any required blackout period.
- Vendor development of communication materials for participants with plan sponsor review and approval.
- Delivery of on-site transition seminars that give each participant the opportunity to hear about enhancements as a result of the change.
- At least one and preferably two tests of the transfer of data by the incumbent and new vendor. This should identify and rectify flaws in current records and minimize the blackout period.
- The transfer of assets/data and their reconciliation by the two vendors. This process is handled by the vendors and should be relatively transparent to the plan sponsor and participants.
- Mailing of letters to participants announcing the successful conclusion of the transition and the end of the blackout period.

The two vendors and the employer should meet by phone regularly to confirm adherence with the transition schedule and discuss any issues that may arise. With proper testing, vendors typically should be able to complete the reconciliation within one to two business days of the asset/data transfer. The total length of the blackout period (during which participants cannot make transfers) is equal to the time prior to the transfer of assets during which the prior vendor prohibits transactions (which should be approximately one week) plus the reconciliation period. Most standard transitions typically take three to four months from the time of selection to the transfer of data/assets to the new vendor.

**Transition Communication.** Changing vendors can cause concern among plan participants, especially with regard to their investments. Timely and effective communication of the transition is essential to maintaining and enhancing participant satisfaction with the plan.

The new vendor should provide a sample letter for the employer to inform participants of the change and the benefits it will bring as soon after selection as possible. This should include a sheet showing how assets in the incumbent’s line-up will be transferred to the new provider’s funds. This information should include returns and expenses for both the incumbent and replacement funds.
Providing information to participants quickly can allay concerns regarding the change.

Subsequently, the vendor should design a transition kit to be provided to all participants and used in transition seminars. This document should focus on the new investment line-up, including fund performance and expense ratios, as well as a description of participant services. Similar information may be made available on a transition Web site, particularly for large employers.

Transition seminars should be conducted throughout the jurisdiction and be scheduled to give all participants a reasonable opportunity to attend. The schedule of seminars can be publicized through internal communications, on posters and via the transition Web site. Seminars review material in the transition kit, focusing on the new investment lineup and the direct educational services that will be provided by the new vendor. The goal should be not just to gain acceptance, but to breed excitement about enhancements made by the employer.

Participant satisfaction with the decision made by the employer and the effectiveness of the new vendor can be measured with a formal survey or via a less formal request for feedback shortly after the transition is complete.
The following organizations provide information on administration of deferred compensation programs:

Government Finance Officers Association
www.gfoa.org

ICMA-RC
www.icmarc.org

U.S. Internal Revenue Service
www.irs.gov

National Association of Government Defined Contribution Administrators
www.nagdca.org

American Benefits Council
www.americanbenefitscouncil.org

U.S. Securities and Exchange Commission
www.sec.gov

Investment Company Institute
www.ici.org

Defined Contribution News
www.dcnews.com

Plan Sponsor
www.plansponsor.com

Employee Benefits Research Institute
www.ebri.org

Benefits Link
www.benefitslink.com
B Eligibility of Employers and Employees

Employers

Section 457 plans may be adopted by any “State, political subdivision of a State, and any agency or instrumentality of a State or political subdivision of a State,”\(^1\) and the Tax Reform Act of 1986 added any other tax-exempt organization.\(^2\) While there is no question as to whether or not an organization is tax-exempt, a question may arise occasionally regarding the categorization of an entity as an agency or instrumentality of a state or political subdivision or as a 501(c)(3) organization. For example, organizations of local governments, such as councils of governments, may be instrumentalities of the local governments, and thus eligible employers—whereas associations of local government officials are associations of individuals rather than local governments and may be eligible as tax-exempt organizations.

**Governmental vs. Tax-exempt.** The distinction between eligibility as a state or political subdivision, agency or instrumentality, or as another tax-exempt organization is an important one. As a practical matter, only “key management and highly compensated employees” of non-governmental tax-exempt employers may benefit from Section 457 plans due to the applicability of ERISA to non-governmental plans.\(^3\) Governmental plans thus have significantly more latitude in participation than tax-exempt organizations. Private not-for-profit entities again became eligible for 401(k) plans with the adoption of the Small Business Job Protection Act (1996).

Where a question exists as to the eligibility of an organization based on how it is organized, the best source of information generally is the entity’s legal counsel. Frequently the organization’s charter, articles of incorporation, or bylaws may provide additional information about the legal form of the organization.

**Union Sponsorship of 457 Plans.** With Revenue Ruling 2004-57, the IRS ruled that a union-created deferred compensation plan does not fail to be an eligible governmental plan provided that (1) the governmental employer must “adopt” the plan, and (2) the plan must be “established and maintained” by the governmental employer.

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1. Internal Revenue Code Section 457(e)(1)(A).
2. Internal Revenue Code Section 457(e)(1)(B).
Employees  Section 457 plans provide the employer with a wide degree of latitude in designating employees (and other compensation earners) who may participate. Unless participation is limited to a specific defined group by the adopting resolution or personnel policy, the plan is available to all employees. Those covered may be either full- or part-time employees (including seasonal and temporary), elected officials (to the extent their earnings are derived from their governmental service), and independent contractors such as attorneys, engineers, etc. Section 457 plans are not subject to any non-discrimination testing.

Independent Contractors. Individuals who provide services to an eligible employer as independent contractors are specifically eligible to defer compensation under Section 457. The independent contractor must enter into an agreement with the employer to defer the compensation, and any Form 1099 issued to the contractor will then be issued net of the compensation deferred.

Special Considerations for Part-Time, Temporary, and Seasonal Employees. The Omnibus Budget Reconciliation Act of 1990 (OBRA) expanded coverage under Social Security to those employees of previously exempt state and local government employers who are not members of a retirement system. In order to satisfy OBRA requirements the retirement system must meet certain contribution or benefit level standards. Most public employee retirement systems currently meet these requirements for full-time, permanent employees. Part-time, temporary, and seasonal employees may require additional consideration as a result of not being eligible for the employer’s basic retirement plan. The costs for adding these employees to the basic plan may be expensive for the employer, administratively burdensome, and disproportionate to the benefits they may derive, leading to the preference for an alternative method for meeting the requirement.

A defined contribution plan, including a Section 457 plan, which has a contribution level of at least 7.5 percent of annual compensation is considered a qualifying retirement plan. Thus deferred compensation plans may be an appropriate vehicle for providing the necessary benefits to employees not currently covered by the employer’s primary pension plan. Employers may avoid including employees in the Social Security system, which requires both employers and employees to contribute in excess of 7 percent of compensation, by funding or requiring employees to contribute a total of at least 7.5 percent of compensation to an eligible Section 457 plan.

Deferred compensation can also be used to provide a retirement plan to a full-time, permanent employee during a probationary period when the employee is ineligible to participate in the employer’s primary pension plan due to a waiting period or during a period when an employee is in a provisional status and not required to join the primary pension plan.
State Requirements for Adoption of Deferred Compensation Programs by Local Governments

All states listed in this appendix have been identified as having requirements for adoption of local government deferred compensation plans. Employers in states not listed may wish to verify that their state does not have statutory or regulatory provisions governing adoption of plans.

**Florida**—Request for proposals must be announced in paper of general circulation and plan must be adopted by ordinance.

**Massachusetts**—Selection by treasurer. If offering other than state plan, must bid unless an administrator has previously been selected by common group procurement provisions.

**Minnesota**—No requirements for adoption but if employee requests, state deferred compensation must be provided.

**New Jersey**—Special adoption package available from the New Jersey Department of Community Affairs.

**New York**—If adopting other than state plan, must advertise in state register, bid, review, and adopt by legislative body.

**Ohio**—Local government must adopt state plan if deferred compensation is going to be available. May then provide additional administrators.

**Utah**—Every employer using state defined benefit plan for local governments automatically adopts state deferred compensation plan. Local governments not required to use plan. State plan does not allow transfers of assets to other administrators of employer.

Prior to 1979 when Section 457 was added to the Internal Revenue Code with the passage of the Revenue Act of 1978, deferred compensation arrangements existed in local governments solely under private letter rulings issued by the IRS to adopting employers. One of the earliest deferred compensation arrangements to be issued a private letter ruling was established by a school district in Utah. This local plan and others that followed were typically funded with investments in annuity contracts issued by insurance companies. Since that time, a number of legislative and regulatory changes have altered 457 plans and enabled them to expand to more employees.

The following provides a chronology of legislative and regulatory changes to 457 plans.

**Nationally Available Plan Document.** The first plan designed for national availability and adoption without the need for an employer to seek a separate private letter ruling was developed in 1972 through the efforts of the International City Management Association to meet the needs of its membership, which was among the most mobile groups of public sector employees.

**No Contribution Maximum - IRS Threat to End Deferrals.** Prior to the adoption of Section 457 in 1978, as long as compensation was not “constructively received” by the participant in accordance with an agreement between the local government employer and employee, the deferrals were excluded from current federal income tax without an annual dollar limit. In fact, some individuals deferred virtually 100 percent of their compensation at a time when individual marginal tax rates were significantly higher than they are currently. The Internal Revenue Service generally advocated elimination of the availability of deferred compensation arrangements to public sector employees for this reason. In 1977, the IRS suspended the issuance of private letter rulings and announced that it was reviewing deferred compensation plans in the public sector. The result was Proposed Regulation 1.61-16, issued in 1978, which provided that if receipt of compensation was electively deferred by an employee to a later year, the deferred amount would be treated as taxable in the year in which the deferral was made.
Section 457 Adopted by Congress – Revenue Act of 1978. Legislation to counter the IRS proposals and include deferred compensation in the Code was introduced in 1978 and supported by a coalition of organizations, including the Government Finance Officers Association, International City Managers Association, National League of Cities, U.S. Conference of Mayors, National Conference of State Legislators, National Association of Counties, and others. With the Revenue Act of 1978, Congress added Section 457 to the Code (effective January 1, 1979) in order to provide the benefit on a statutory basis and to set limits on the amount of tax deferral. Regulations elaborating the IRS position on Code Section 457 were proposed in 1980 and adopted on September 23, 1982.

Tax Reform Act (TRA), 1986, and Technical and Miscellaneous Revenue Act (TAMRA), 1988. TRA and TAMRA represented the most fundamental revision to the Code in decades, as evidenced by the change in citation of the Code from the Internal Revenue Code of 1954, as amended, to the Internal Revenue Code of 1986, as amended. Although there were changes made to Section 457, their relatively minor nature indicated that state and local government deferred compensation arrangements were on solid ground with Congress. This was not the case for 401(k) Cash or Deferred Arrangements that can no longer be adopted by governmental entities.

Small Business Job Protection Act (SBJPA). In 1996, a fundamental and welcome change was made to Section 457 plans. Prior to this legislation, assets of deferred compensation plans were considered assets of the employer and subject to its general creditors. In the aftermath of the highly publicized investment difficulties encountered by the deferred compensation plan for the employees of Orange County, California, the SBJPA required that all assets be held in a trust, custodial account, or annuity contract for the exclusive benefit of participants and their beneficiaries. This statutory change removed what had been at least a deterrent for many public employees. The act also provided that the maximum contribution amount was indexed for increases in the cost-of-living for tax years beginning after December 31, 1996. Other changes made to Section 457, in the area of distribution commencement date and small account balance payouts, have been superseded by later legislation. An official Congressional “Conference Report” released with the Act stated that employers have the option of allowing participant loans under their 457 plans.

Taxpayer Relief Act of 1997 (TRA ’97). TRA amended the small account balance payout provisions of SBJPA.

Economic Growth and Tax Relief Reconciliation Act (EGTRRA ’01). Significant changes to Section 457 plans were made in 2001 (largely effective January 1, 2002) with the enactment of EGTRRA; the changes included a substantial increase of maximum contribution limits (and linked 457 plans to the contribution limits for 401[k] and 403[b] salary deferrals); addition of an age-50 catch-up provision; change in the normal catch-up provision to allow double the current annual limitation as maximum contribution; portability to and from other retirement plans and IRAs; repeal of coordination of contributions with 403(b) and 401(k) plans; assets taxed when actually paid, not “when made available,” resulting in the ability of participants to change distribution schedules; availability of a tax saver credit for low income tax filers; and assets permitted to purchase service credits in defined benefit plans. Unless Congress extends or makes permanent some or all of its provisions, EGTRRA will expire on December 31, 2010. The expiration of EGTRRA would return maximum contributions to the level specified in the original legislation of the Revenue Act of 1978, as amended by the SMJPA of 1996, as well as reinstate the constructive receipt rule.
**IRS Final Regulations for Required Minimum Distributions (2002).** These regulations simplified and generally decreased the minimum distributions required annually from all retirement plans and IRAs.

**IRS Final Regulations for 457 Plans (2003, effective January 1, 2002).** Among a number of issues dealt with, the final regulations specified provisions for treatment of sick and vacation accrual contributions at termination of employment; catch-up contributions, including treatment for multiple employers; loans from 457 plans; additional situations qualifying for emergency withdrawals; and treatment of assets distributed by qualified domestic relations orders.

**IRS Final Regulations for Deemed or “Sidecar” IRAs (2004).** Under EGTRRA (2001), plan sponsors of 401, 403(a) and (b), and governmental 457 plans may permit IRA accounts within the employer’s retirement plan, effective January 1, 2003. The most important provision of the regulations for plan sponsors is that the failure of the Sidecar IRA to meet all requirements of the statute and regulations will not result in disqualification of the underlying retirement plan.
Review and scoring of RFP responses is often the most time-consuming aspect of the vendor selection process. To simplify the process, one can focus first on the key elements that will drive the final selection of a vendor—services to participants and the plan sponsor, investments offered to the plan, and fees charged for services. Once vendors who make competitive offers in these key areas are identified, the due diligence aspects of the proposals should be reviewed to confirm fundamental competence before inviting finalists to present to the governing body of the deferred compensation plan.

The enclosed CD contains a sample RFP, which should be modified as necessary to address the specific needs of the government’s plan and local purchasing requirements. This sample RFP assumes that a government will use a provider that offers a comprehensive package of 457 plan administration services, including recordkeeping, employee education, customer servicing, and investment management. Employers seeking bids for less than a full range of services may modify and use appropriate portions of the RFP. Additionally, GFOA generally does not recommend use of self-directed brokerage “windows” and is therefore not included within the scope of requested services.

The RFP is in a five-part format, which can be modified if a government uses an alternative format for RFPs:

A. Background
B. Procurement Schedule and Instructions
C. Minimum Requirements
D. Questionnaire on Core Services
E. Due Diligence Questionnaire

**CD Enclosure**

The CD contains the following documents:

- *Sample RFP*—A sample request for proposals for comprehensive deferred compensation plan services, which should be modified to the specific needs of the plan sponsor;
- *RFP vendor scoring mechanism*—Spreadsheets for reviewers to score the relative quality of each RFP response and for the plan sponsor to tabulate scores and rank bidders;
• Guide to using RFP vendor scoring mechanism—This explains how to use the foregoing document;
• Vendor fee comparison spreadsheet—A spreadsheet for distribution to vendors to obtain full disclosure of all fees and to analyze their comparative costs; and
• Sample participant surveys—A survey of current participants for use prior to the RFP process to quantify satisfaction and receive additional comments regarding the deferred compensation plan.