

elections to be taken into account in determining includible compensation.

On May 8, 2002, a notice of proposed rulemaking (REG-105885-99) was published in the **Federal Register** (67 FR 30826) to issue new regulations under section 457, including amending the 1982 regulations to conform them to the legislative changes that had been made to section 457 since 1982.

Following publication of the proposed regulations, comments were received and a public hearing was held on August 28, 2002. After consideration of the comments received, the proposed regulations are adopted by this Treasury decision, subject to a number of changes that are generally summarized below.

## Summary of Comments Received and Changes Made

### 1. Excess Deferrals

The proposed regulations addressed the income tax treatment of excess deferrals and the effect of excess deferrals on plan eligibility under section 457(b). The proposed regulations provided that an eligible governmental plan may self-correct and distribute excess deferrals and continue to satisfy the eligibility requirements of section 457(b) (including the distribution rules and the funding rules) by reason of a distribution of excess deferrals. However, the proposed regulations provided that if an excess deferral arose under an eligible plan of a tax-exempt employer, the plan was no longer an eligible plan.

Commentators objected to the less favorable treatment for eligible plans of tax-exempt employers.

After consideration of the comments received, the regulations extend self-correction for excess deferrals to eligible plans of tax-exempt employers. If there is an excess deferral under such plan, the plan may distribute to a participant any excess deferrals (and any income allocable to such amount) not later than the first April 15 following the close of the taxable year of the excess deferrals, comparable to the rules for qualified plans under section 402(g). In such a case, the plan will continue to be treated as an eligible plan. However, in accordance with section 457(c), any excess deferral is included in the gross income of a participant for the taxable year of the excess deferral. If an excess deferral is not corrected by distribution, the plan is an ineligible plan under which benefits are taxable in accordance with ineligible plan rules.

The income tax treatment and payroll tax reporting of distributions of excess deferrals from eligible section 457(b) governmental plans are similar to the

treatment and reporting of distribution of excess deferrals from tax-qualified plans. Such amounts should be reported on Form 1099 and taxed in the year of distribution to the extent of distributed earnings on the excess deferrals. For eligible section 457(b) tax-exempt plans, the excess deferrals are subject to income tax in the year of distribution to the extent of distributed earnings on the excess deferrals and such earnings should be reported on Form W-2 for the year of distribution. See also Notice 2003-20, 2003-19 I.R.B. 894, for information regarding the withholding and reporting requirements applicable to eligible plans generally.

### 2. Aggregation Rules in the Proposed Regulations

The proposed regulations included several rules that aggregate multiple plans for purposes of meeting the eligibility requirements of section 457(b). These regulations retain all of these rules. For example, the regulations provide that in any case in which multiple plans are used to avoid or evade the eligibility requirements under the regulations, the Commissioner may apply the eligibility requirements as if the plans were a single plan. Also, an eligible employer is required to have no more than one normal retirement age for each participant under all of the eligible plans it sponsors. In addition, all deferrals under all eligible plans under which an individual participates by virtue of his or her relationship with a single employer are treated as though deferred under a single plan for purposes of determining excess deferrals. Finally, annual deferrals under all eligible plans are combined for purposes of determining the maximum deferral limits.

Few comments were received with respect to the aggregation rules under the proposed regulations. However, one commentator requested that, where it is determined that multiple eligible plans maintained by a single employer, which have been aggregated pursuant to the proposed regulations, contain excess deferrals, the employer have the ability to disaggregate those plans solely for the purpose of either (1) distributing the excess deferrals under the self-correcting mechanism or (2) limiting the characterization of such plans as "ineligible" to the one(s) that actually contain the excess deferrals. Taking into account the ability for all eligible plans to self-correct by distribution, these regulations retain without material revision the aggregation rules that were in the proposed regulations.

### 3. Deferral of Sick, Vacation, and Back Pay

The proposed regulations would have allowed an eligible plan to permit participants to elect to defer compensation, including accumulated sick and vacation pay and back pay, only if an agreement providing for the deferral is entered into before the beginning of the month in which the amounts would otherwise be paid or made available and the participant is an employee in that month. Comments requested that terminating participants be allowed to elect deferral for accumulated sick and vacation pay and back pay even if the participant is not employed at the time of the deferral.

The final regulations retain the rule under which the deferral election must be made during employment and before the beginning of the month when the compensation would have been payable. However, the regulations include a special rule that allows an election for sick pay, vacation pay, or back pay that is not yet payable (subject of course to the maximum deferral limitations of section 457 in the year of deferral). Under the special rule, an employee who is retiring or otherwise having a severance from employment during a month may nevertheless elect to defer, for example, his or her unused vacation pay after the beginning of the month, provided that the vacation pay would otherwise have been payable before the employee has a severance from employment and the election is made before the date on which the vacation pay would otherwise have been payable.

### 4. Unforeseeable Emergency Distributions

The proposed regulations added examples that would illustrate when an unforeseeable emergency occurred. In particular, one example provided that the need to pay for the funeral expenses of a family member may constitute an unforeseeable emergency. Several commentators requested clarification in the final regulations of the definition of family member. The regulations have been modified to define a family member as a spouse or dependent as defined in section 152(a).

### 5. Plan Terminations, Plan-to-Plan Transfers, and Rollovers

The regulations include certain rules regarding plan terminations, plan-to-plan transfers, and rollovers. These topics have been affected by the statutory changes that impose a trust requirement on eligible governmental plans. The direct rollovers that were permitted by EGTRRA beginning in