

402(c)(10), *i.e.*, only for rollovers from IRAs, qualified plans and section 403(b) contracts. Section 72(t)(9) provides that the early withdrawal income tax applies to distributions from rollovers attributable to IRAs, qualified plans, and section 403(b) contracts. Thus, if an eligible governmental plan accepts a rollover from another eligible governmental plan of an amount that was originally deferred under an eligible governmental plan and commingles that rollover in the same separate account that includes a rollover amount from an IRA, qualified plan, or section 403(b) contract, then distributions from that account will be subject to the early withdrawal income tax. Accordingly, in order to avoid this result, eligible governmental plans may choose to establish *three separate accounts* for a participant even though these regulations only require that a single separate rollover account be maintained for all amounts that are rolled into an eligible governmental plan: First, an account for all amounts deferred under that plan; second, an account for any rollover from another eligible governmental plan (disregarding any amounts that originated from an IRA, qualified plan, or section 403(b) contract); and third, an account for any rollover amount from an IRA, qualified plan, or section 403(b) contract (including any amounts rolled over from another eligible governmental plan that originated from an IRA, qualified plan, or section 403(b) contract). These regulations include an example illustrating that the early withdrawal income tax would not apply to a partial distribution from a plan with such accounts assuming that the plan debits either of the first two such other accounts to reflect the distribution.

6. Ineligible Plans

The proposed regulations included guidance regarding ineligible plans under section 457(f). Section 457(f) generally provides that, in the case of an agreement or arrangement for the deferral of compensation, the deferred compensation is included in gross income when deferred or, if later, when the rights to payment of the deferred compensation cease to be subject to a substantial risk of forfeiture. Section 457(f) was in section 457 when it was added to the Code in 1978 for governmental employees, and extended to employees of tax-exempt organizations (other than churches or certain church-controlled organizations) in 1986, because unfunded amounts held by a tax-exempt entity compound tax free like an eligible plan, a qualified plan, or a section 403(b) contract.

Section 457(f) was viewed as essential in order to provide an incentive for employers that are not subject to income taxes to adopt an eligible plan, a qualified plan, or a section 403(b) contract.¹

Section 457(f) does not apply to an eligible plan, a qualified plan, a section 403(b) contract, a section 403(c) contract, a transfer of property described in section 83, a trust to which section 402(b) applies, or a qualified governmental excess benefit arrangement described in section 415(m). The proposed regulations stated that section 457(f) applies if the date on which there is no substantial risk of forfeiture with respect to the compensation deferred precedes the date on which there is a transfer of property to which section 83 applies. The proposed regulations included several examples, including an example illustrating that section 457(f) does not fail to apply merely because benefits are subsequently paid by a transfer of property. Comments were requested on the coordination of sections 457(f) and 83 under the proposed regulations.

In response, a number of commentators objected to the proposed coordination of sections 457(f) and 83, including arguing that the proposed regulation would place tax-exempt organizations at a competitive disadvantage when it comes to attracting and retaining executive talent because it would effectively eliminate the use of discounted mutual fund options as a tax effective component of total compensation. Some commentators also asserted that the proposed regulations were ambiguous as to their applicability to steeply discounted mutual fund options, and recommended that, if the provision is not removed, at a minimum future guidance should be more specific.

The final regulations retain the interpretation of the coordination of sections 457(f) and 83 that was in the proposed regulations, and also clarify the application of the rule by adding an example involving an option grant. The regulations also include a clarification that, when benefits are paid or made available under an ineligible plan, the amount included in gross income is equal to the amount paid or made available, but only to the extent that the amount exceeds the amount the participant included in gross income

when he or she obtained a vested right to the benefit.

7. Severance Pay and Other Exceptions

In 2000, the IRS issued Announcement 2000-1 (2000-1 C.B. 294), which provided interim guidance on certain broad-based, nonelective plans of a state or local government that were in existence before 1999. Comments were requested on arrangements, such as those maintained by certain state or local governmental educational institutions, under which supplemental compensation is payable as an incentive to terminate employment, or as an incentive to retain retirement-eligible employees, to ensure an appropriate workforce during periods in which a temporary surplus or deficit in workforce is anticipated. Treasury and the IRS continue to be interested in receiving comments on this issue, which should be sent to the following address: Internal Revenue Service, Attn: CC:DOM:CORP:R (Section 457 Plans), Room 5201, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Written comments may be hand delivered Monday through Friday between 8 a.m. and 4 p.m. to: Internal Revenue Service, Courier's Desk, Attn: CC:PA:RU (Section 457 Plans), 1111 Constitution Avenue, NW., Washington, DC 20224. Alternatively, written comments may be submitted electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting them directly to the IRS Internet site at: http://www.irs.gov/tax_regs/reglist.html. Comments should be received by October 9, 2003.

8. Effective Date of the Regulations

The proposed regulations included a general effective date under which the regulations would have applied to taxable years beginning after December 31, 2001. This is the general effective date for the changes made in section 457 by EGTRRA. Commentators did not express concern about this effective date and some commentators also stated that eligible governmental plans have adopted plan amendments to address the changes that have been allowed by EGTRRA, so that it would be appropriate to have the final regulations effective date coincide with the effective date for EGTRRA.

These regulations are generally applicable to taxable years beginning after December 31, 2001, subject to certain specific transition rules. Under one of these transition rules, for taxable years beginning after December 31, 2001, and before January 1, 2004, a plan will not fail to be an eligible plan if it

¹ See generally the *Report to the Congress on the Tax Treatment of Deferred Compensation under Section 457*, Department of the Treasury, January 1992 (available from the Office of Tax Policy, Room 5315, Treasury Department, 1500 Pennsylvania Avenue NW., Washington DC 20220).