Supplemental 457(b) Plan Guide

A quick reference for governmental plan sponsors
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Introduction
Voluntary deferred compensation plans governed under Internal Revenue Code (IRC) 457(b) enable eligible employees to set aside a portion of their salary for retirement on a pretax basis. These plans have become a useful supplement to public pension plans and Social Security (where applicable).

Although often compared to 401(k) and 403(b) plans, 457(b) plans have some significant differences. This guide provides a quick reference of the key features and requirements of 457(b) plans.

A deferred compensation plan is sometimes offered or mandated to a municipality through the State or County plan. Should this be the case, it is important that plan administrators understand their responsibilities and available options under the plan so they and their employees can fully benefit from it.

457(b) Plans
Two types of 457 deferred compensation plans are available:

- Eligible plans, known as 457(b) plans, which meet all IRC 457(b) requirements
- Ineligible plans, known as 457(f) plans, which do not meet IRC 457(b) requirements and are subject to different rules and tax treatment

Eligible 457(b) plans offer numerous benefits to employees, including:

- Tax-deferred retirement savings and investment earnings
- Portability of retirement savings from one employer to another

Eligible governmental 457(b) plans
Government employers eligible for 457(b) plans include:

- States, including the District of Columbia
- Local governments, including:
  - Counties
  - Special districts
  - Cities, towns, and other municipalities

The federal government, its agencies and instrumentalities are not eligible to establish 457(b) plans.

Eligible employees
Employees who perform services for an eligible governmental employer are eligible to defer compensation into a 457(b) plan. The plan document, which establishes eligibility requirements, may restrict eligibility to certain employment categories (e.g., union or non-union) or employment status (e.g., full-time, part-time or seasonal), and may include or exclude independent contractors.

Contributions
Contributions to 457(b) plans — made by either the employee or the employer — are regulated by federal laws and limits. This section outlines some of the key contribution rules for 457(b) plans. For additional details, plan sponsors should review Section 457(b) of the IRC and the corresponding Treasury regulations with their tax or legal advisors.

Salary deferral agreements
457(b) plans have stricter deferral administrative requirements than typical 401(k) or 403(b) plans. In general, compensation may be deferred by salary reduction for a calendar month only if a salary reduction agreement is in place before the first day of the month in which the compensation would otherwise be paid or made available. By contrast, a 403(b) or 401(k) deferral agreement can be initiated any time before the pay is “paid or made available.” The agreement remains in place until the employee changes the election in order to increase, reduce or stop deferrals.

Maximum deferral limits
An eligible plan must provide that the annual employee deferral amount not exceed a statutory limit. For 2013, the limit is the lesser of $17,500 or 100% of includible compensation. 457(b) contribution limits apply to all contributions an employee makes to all eligible 457(b) plans,
regardless of which employer sponsors the plans. Employer contributions also will count against the annual deferral limits.

**Coordination of 457(b) plan deferrals**

457(b) plan deferrals do not count against deferrals to 401(k) or 403(b) plans, so government employees participating in both an eligible 457(b) plan and either a 401(k) plan or 403(b) can contribute up to twice the annual deferral limit (i.e., $17,500 to each plan for 2013). However, 457(b) deferrals must be coordinated with all deferrals an employee makes to all eligible 457(b) plans, regardless of which employer sponsors them. An individual’s total contribution to all 457(b) plans cannot exceed the annual maximum deferral limit.

**457(b) Special Catch-up contributions**

Participants within three years of normal retirement age as defined by the plan are eligible to increase annual contributions so they can “catch up” for prior years in which they did not contribute the maximum. The catch-up limit is the lesser of: 1) twice the annual contribution limit; or 2) the annual contribution limit for the current year, plus underutilized amounts from prior taxable years.

Only years during which the employee was eligible to participate in the 457(b) plan can be considered when determining underutilized amounts. Years prior to January 1, 1979 cannot be considered.

**Age 50+ Catch-up contributions**

If permitted by the plan, employees who are at least age 50 by the end of the year are eligible to contribute an additional catch-up contribution. It must not exceed the limit specified by the IRC, which is $5,500 in 2013. Those who contribute to another 457(b) plan through a different employer may defer the additional $5,500 under only one plan.

**How Catch-up contributions work together**

An employee may not utilize both the 457(b) Special Catch-up and Age 50+ Catch up contribution in a given year. The greater of the two must be used.

**Matching employer contributions**

Matching employer contributions are available as an option in 457(b) plans. However, because these contributions count against the annual deferral limit, most plan sponsors choose to utilize a separate 401(a) plan to receive them.

**Deferring sick, vacation or back pay**

An eligible 457(b) plan may allow unused sick, vacation or back pay to be deferred given that the participant is still actively employed by the plan provider and the deferral is arranged at the beginning of the month during which the pay would otherwise be paid. Any deferrals made from this type of pay must be below the annual total maximum contribution limit.

**Purchase of defined benefit service credit transfers**

If permitted under state law, an eligible 457(b) state government plan may permit participants to transfer amounts deferred to the plan to the state defined benefit plan for the purchase of permissive service credits, given the deferrals do not exceed the amount needed to fund the benefit resulting from the past service credit.

**Roth elective deferrals**

Since January 2011, sponsors of eligible governmental 457(b) plans have been able to allow employee contributions to designated Roth accounts in their plans. The plan must contain a designated Roth elective deferral account and permit the conversion of pretax contributions to Roth elective deferral contributions within the same plan.

**Roth conversions: Expanded eligibility**

The Small Business Jobs Act of 2010 established in-plan Roth conversions. However, until recently, employees could convert account balances from pretax retirement accounts to a Roth inside the plan only if the amount was available due to a “distributable event” such as turning age 59½, termination, death or disability.

Since the enactment of the American Taxpayer Relief Act of 2012, the distributable event prerequisite no longer applies. Employees can now convert all or part of their pretax account balance to a Roth account in the same plan, regardless of whether the amount is distributable.

Because distributions from a Roth account are free of income tax if certain minimum requirements are met, they can be an attractive investment option. However, the tax implications of a Roth conversion may be significant, so it is not right for all investors. 457(b) plan sponsors may wish to take the opportunity to evaluate their plans to determine if this new feature would provide a value add for their employees.
Investments
As noted previously, contributions to 457(b) plans are protected by specific federal laws and limits. This section outlines the funding and investment rules for 457(b) plans.

Funding rules for eligible plans
To be an eligible 457(b) plan, all contributions, property and rights purchased by contributions, and all income attributable to these contributions, property or rights, must be held in trust for the exclusive benefit of participants and their beneficiaries. The terms of the trust must prevent participant assets from being diverted to any other purposes.

Permitted investments
Subject to requirements under state laws, an eligible 457(b) plan may permit participants to defer their contributions to a range of permitted investments, including mutual funds, annuities, and stable value arrangements.

Life insurance contracts
Some 457(b) plans offer life insurance contracts — most often universal life products — as an investment option. Because special requirements must be met, this investment vehicle has become increasingly rare as plan sponsors prefer to focus on less complex ways to meet their participants’ life insurance needs. Premiums are paid on a pretax basis, but death benefit proceeds are taxable.

Distributions
Federal rules and regulations govern when participants may, or must, take distributions from their 457(b) plans. This section outlines some key distribution rules. For full details and examples of distribution calculations, plan sponsors should review IRC section 457(b) and corresponding Treasury regulations with their tax or legal advisors.

Distribution eligibility
Participants may not be paid amounts deferred under an eligible 457(b) plan until they turn age 70½ or stop working for the eligible employer. Exceptions are unforeseeable emergency withdrawals, distributions related to plan terminations, or distributions of small accounts.

Exemption from IRC 72(t) 10% early withdrawal penalty
Generally, amounts contributed to eligible 457(b) plans are not subject to a 10% early withdrawal penalty. This exemption provides a unique benefit to participants of 457(b) plans and the flexibility of their retirement dollars.

Unforeseeable Emergency Withdrawals
An eligible 457(b) plan may allow a participant faced with an unforeseeable emergency to request an in-service distribution from his or her account. The law limits unforeseeable emergency withdrawals to specific situations that result in severe financial hardship on behalf of the participant, dependent or beneficiary. Such situations include:
- An illness or accident that befalls the participant, beneficiary, participant’s spouse or a dependent, as defined by the IRC
- Loss of property not covered by insurance
- Other events beyond the control of the participant or beneficiary

According to 457 regulations, examples of unforeseeable emergencies include:
- Imminent foreclosure or eviction from the participant’s or beneficiary’s primary residence
- The need to pay medical expenses, including non-refundable deductibles and prescription drug costs
- The need to pay the funeral expenses of a spouse or dependent

Purchasing a home and paying for college tuition do not qualify as unforeseeable emergencies. It’s important to carefully review specific situations to ensure they meet the requirements of an unforeseeable emergency withdrawal.

**Loans**
Sponsors of eligible 457(b) plans can establish plan rules that permit participants to take a loan against contributions to their plan. Loans must have a fixed repayment schedule and a reasonable interest rate.

**Distributions for qualified health and long-term care premiums for public safety officers**
Under the Healthcare Enhancement for Local Public Safety Officers Act, eligible public safety retirees can receive a tax-free distribution of up to $3,000 annually to help pay for health or long-term care insurance for themselves, their spouses or their dependents. The distribution must be made directly from the retirement plan to the insurance provider. Eligible retirement plans include qualified defined benefit pension, 457(b), 401(k), 403(a), and 403(b) plans.

**Risk management best practices**
457(b) plans play an increasingly important role in retirement planning for government employees. Because plan sponsors have a responsibility to ensure that the plan rules, structure, administration, and investment practices are appropriate, we have outlined some key risk management considerations.

**Structuring retirement benefits policy**
Plan sponsors must first determine the plan’s overall purpose in order to integrate an appropriate level of risk. Taking into account a government’s core pension plan and Social Security, if applicable, a supplemental 457(b) plan can be a vehicle for accumulation, income replacement at retirement, or both. Risk tolerance, which varies based on these objectives, must be considered before investment options and plan rules are defined.
Assessing the risk of the 457(b) plan

Many plan sponsors first think of risk in terms of investments — risks such as inadequate investment return, inflation, an inappropriate asset allocation, etc. However, behavioral risks are also inherent in supplemental 457(b) plans. These include the risk that employees will fail to participate or vest, or that they may outlive their retirement assets. Often overlooked is the risk that excessive administrative costs and investment fees can erode participant savings over time.

Applying risk managed approach to protecting employee savings

Supplemental 457(b) plan sponsors can help mitigate risk by adopting industry risk management best practices, such as those outlined in the following chart.

<table>
<thead>
<tr>
<th>Plan design feature</th>
<th>Best practices</th>
<th>Risk benefit</th>
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<tbody>
<tr>
<td>Eligibility and participation</td>
<td>▪ No age limits</td>
<td>▪ Reduces risk of nonparticipation</td>
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<tr>
<td></td>
<td>▪ No waiting period</td>
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<td></td>
<td>▪ Auto enroll (where legally permitted)</td>
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</tr>
<tr>
<td>Vesting of matching employer contributions (Typically made to a separate 401(a) plan)</td>
<td>▪ 100% after 1 year</td>
<td>▪ Reduces risk of forfeiture</td>
</tr>
<tr>
<td>Contributions</td>
<td>▪ Amount needed to achieve replacement income goal taking into account core pension and Social Security</td>
<td>▪ Reduces risk of under-saving</td>
</tr>
<tr>
<td>Investments</td>
<td>▪ Mandatory or default into lifecycle/target date, qualified managed account (QMA), or advice service</td>
<td>▪ Helping participants allocate their assets reduces risk of poor investment decision-making</td>
</tr>
<tr>
<td></td>
<td>▪ Limited array of 15-20 participant-directed investments covering the major asset classes</td>
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<td>▪ Individual investment advice for participant-directed investments into the plan</td>
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<td>▪ Broad-based employee investment education</td>
<td></td>
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<tr>
<td>Distributions</td>
<td>▪ Limited hardship and loan features for employer contributions</td>
<td>▪ Reduces risk of “retirement asset leakage” before retirement</td>
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<tr>
<td></td>
<td>▪ Offer guaranteed life income annuity features*</td>
<td>▪ Reduces participants’ risk of outliving their DC benefit</td>
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<td>▪ Helps maintain participants’ standard of living during retirement</td>
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* Guarantees based upon the issuer’s claims-paying ability.
Additional resources
For additional information on 457(b) plans and access to helpful government resources, please contact:

Internal Revenue Service

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

About TIAA-CREF
Given its history of nearly a century of serving the nonprofit segment, TIAA-CREF is qualified to make recommendations to public policymakers and government leaders on key factors to consider when designing an employee retirement program.

Our risk-managed defined contribution retirement plan offerings have been adopted by a number of government entities to address their retirement plan structure issues.

TIAA-CREF is the not-for-profit retirement market leader. In our largest market segment — higher education — we serve public plan sponsors in 46 of 50 states. Managing more than $50 billion in 401(a) and 457(b) public sector plan assets, we are now a top 10 provider in the public 457(b) market.

For more information on how TIAA-CREF works with governments, please visit www.tiaa-cref.org/government.

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1 Source: LIMRA, Not-for-Profit Market Survey, second-quarter 2013 results. Based on a survey of 28 companies. TIAA-CREF ranked first in total assets. Ranking does not reflect investment performance. Note: TIAA-CREF does not offer tax or legal advice; please consult with your advisors. TIAA-CREF products may be subject to market and other risk factors. See the applicable product literature or visit tiaa-cref.org for details. The tax information contained herein is not intended to be used, and cannot be used by any taxpayer, for the purpose of avoiding tax penalties that may be imposed on the taxpayer. It was written to support the promotion of the products and services addressed herein. Taxpayers should seek advice based on their own particular circumstances from an independent tax advisor.

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