NAGDCA

2010 ISSUE BROCHURE

THE EVOLUTION OF THE GOVERNMENT DEFERRED COMPENSATION PLAN MARKET: THE ROAD TOWARD RETIREMENT SUFFICIENCY

Many public and non-profit employers provide tax sheltered retirement saving programs for their employees. In the public sector these voluntary arrangements typically supplement defined benefit plans. This paper will trace the history of these different types of supplemental plans and give detail on some of the differences between them.

The most common tax sheltered retirement saving arrangements for public employees are 403(b) tax sheltered annuity programs and 457 deferred compensation plans. These plans are similar in many functional respects to the 401(k) plan prevalent in the private sector. An interesting historical note is that these programs predate the 401(k) plan. 403(b) for example, was created in 1958 when Congress authorized the tax sheltered annuity, which allowed employers and employees of non-profit organizations to contribute a portion of salary to an annuity contract on a tax deferred basis. The program was expanded in 1961 to allow participation by employees of public educational institutions, and in 1974 to allow investment in mutual fund custodial accounts along with traditional insurance annuities. In both cases the arrangements were typically structured as contractual arrangements between the employee and the investment provider, with employer involvement limited to selection of the investment vehicles that received the contributions. At the college level, employer contributions to fund a full retirement benefit were common.

Elsewhere, the arrangements were largely supplemental, voluntary contributions through payroll deductions, and there was broader participation in the 403(b) market by several large insurance companies and mutual fund providers.

The early 1970's saw the birth of the structured governmental deferred compensation plan. These plans originated with Internal Revenue Service private letter rulings that authorized voluntary employee payroll deduction contributions that were then invested in a menu of options selected by the employer with the account balance payable at retirement or other separation from service. Contributions out of salary were tax deductible and could be made without limit; earnings were also tax free, all under the theory that the amounts were "owned" by the government until actually paid.

In 1978 Congress enacted code section 457 which specifically authorized these plans for government employees and regulated both the limit on the annual contribution ($7500/year) and the manner in which amounts could be distributed. That same year saw Congressional authorization of qualified 401(k) plans, although these plans did not have any significant market adoption until Treasury regulations were issued in 1981. All three plan types were available to government employers, but 457 plans predominated in the government sector, and 403(b) arrangements in the college and public school sector. After 1978, 403(b) arrangements generally had the highest potential employee contribution. 1978 legislation also allowed 403(b) arrangements to transfer account values to an I.R.A. on separation from employment. In the meantime assets in 457 plans were rapidly growing through a combination of sales efforts by large financial entities, legal confidence produced by the 1978 legislation, and the growth of state wide multi-employer arrangements where a state would sponsor a single plan for all state and municipal employees. These arrangements allowed for favorable economies of scale for both investment availability and administrative cost.

1986 saw the next major change in the regulation of individual account tax sheltered retirement savings. Overall contribution limits were tightened in various ways for both 401(k) and 403(b), chiefly through cross-plan coordination requirements; governments were prohibited from establishing new 401(k) plans, although pre-existing government 401(k) plans were allowed to continue; and 403(b) contracts were restricted from distributions during employment and subjected to a 10% penalty tax on most lump sum distributions prior to age 59 ½. Both 457 plans and 403(b) contracts were required to follow the minimum distribution rules of I.R.C. §401(a)(9). Non-profit organizations were brought into the realm of 457 when their non-qualified tax deferred salary contribution plans were required to follow the rules (including the rules on limits and distributions) of 457. Because of the coordination requirement for contributions this effectively limited employee contributions to the dollar limit of a single plan, even if their employee sponsored multiple arrangements, such as a 403(b) and a 457 plan.

The next major change occurred in 1996. Legislation required 457 plan assets to be held in trust for the exclusive benefit of employees. Prior law had treated these assets as "owned" by the employer and subject to the claims of the employer's creditors. The Orange County bankruptcy of the early 90's was a major inducement for this legislation. The major effect of the legislation however was that it put governmental plans on a track towards parity with arrangements available to the private sector: similar treatment for contribution limits, rollover treatment, loans and other benefits.

This parity was largely achieved in 2001 with EGTRRA – the Economic Growth and Tax Relief Reconciliation Act. This bill adopted major reforms across all tax sheltered retirement savings plans, including:

- a % contribution limit of 100% salary
- uniform (and much higher) maximum deferral limits, automatically adjusted for cost of living increases
- special additional contributions for employees over 50
- elimination and modification of numerous % limits where employees participated in both a defined contribution and defined benefit plan
- greatly increased rollover capability to and from all plans, including, for the first time, transfers to and from IRA's and 457 plans
- elimination of the constructive receipt rule for 457 plans, which had severely limited employee flexibility on distribution planning
- authorization of deemed IRA accounts within plans, and a special tax credit for low income savers
- elimination of the requirement that 457 plan contributions be coordinated with the dollar limits of 403(b) or 401(k), effectively allowing government (or non-profit) employees to contribute the maximum amount to each plan.

Since 2001 the major changes have been regulatory, with the most significant change occurring in 2007 with the introduction of new regulation for 403(b) plans. These regulations (effective in 2009) were the first major overhaul of 403(b) rules in 40 years. They:

- required a written plan document
- universal ability to make contributions, and annual notification of this ability
- restrictions on transfers of assets outside the plan during employment
- specific imposition of responsibility on the employer for observance of plan limits and rules
- authority and procedures from termination of the 403(b) plan.

Continuing Difference Between Plans

EGTRRA greatly simplified and conformed operations for the 3 major tax sheltered retirement vehicles (401(k), 403(b) and 457) but some key differences remain. These are:

- **The 10% penalty tax**. Both 401(k) and 403(b) require a 10% penalty tax (in addition to regular tax) on any distribution prior to age 59 ½ unless it is part of a long term annuity type distribution, or meets other IRS requirements. 457 distributions can be made any time after severance from employment without a penalty.

- **Distribution at 59 ½.** Both 403(b) and 401(k) allow distribution once the employee reaches 59 ½, even if she is still employed. 457 plan participants may only receive distributions if they have terminated service with the employer, or have reached 70 ½.

- **Catch-up Contributions.** All plans allow the $5,500 additional catch-up contribution if the participant is at least age 50; 403(b) plans allow certain employees with lengthy service to make special additional contributions; 457 participants are allowed a special election in the last 3 years prior to the year they retire. This allows them to make additional contributions (effectively doubling the regular annual limit) if their contributions in earlier years of service with that employer were below the limits available to them under that plan.

- **Roth.** Both 403(b) and 401(k) can have Roth accounts; at this time, 457 plans may not have Roth accounts.

Overall Administrative Practice

The last 30 years of defined contribution plan growth have seen significant changes in plan administration. In 1980 individual account plans received little overall attention from the employer, and the primary focus was on the employer's defined benefit plan. Individual account plans with voluntary contributions were largely an oddity for the tax lawyer or the insurance company, and extensive employer management was rare. Enormous growth in assets, aging of the employee population, and increasingly volatile financial markets have all contributed to demands that employers (whether subject to ERISA or not) pay more attention to their plans: what they cost, what is the quality of investments, and are employees receiving accurate and helpful communication about the plans and their risks, rewards and complexities. These trends are often a jumble of efforts: societal encouragement for automatic enrollment in target date funds one year; SEC hearings on inadequacy of target date funds the next. Meanwhile regulation of investment fee disclosure (and fiduciary litigation about those fees) continues. The most striking thing about governmental plans in this 30 year context is that even though they are not subject to the ERISA standards or Labor Department regulation they have been direct participants in the long term administration reform movement, with a typically equal (or greater) focus on employee cost, investment quality, and adequate disclosure. Sometimes the amount of money involved will simply outweigh the absence of specific regulatory requirements, and demand that attention be paid. That, at least, has been the history of the last 30 years.