IRS Approves as Tax-Free a Widow's Rollover of 457 Plan Distribution

In a private ruling, the IRS said that the lump-sum distribution from a deceased husband's 457 plan to his estate was eligible for a tax-free rollover to his widow's individual retirement account (IRA). Here are the details.

The husband, who died before reaching age 70.5, hadn't named a beneficiary for his deferred compensation 457 plan. As a result, the funds were distributed to his estate. The plan withheld federal and state taxes from the distribution before paying the remainder to the estate.

The widow was the estate's executor and sole beneficiary and she deposited the distribution, plus an amount equal to the taxes that were withheld, into her IRA. The transaction was completed within 60 days of the date of the initial distribution.

The widow asked the IRS for a private ruling that the rollover was tax-free. Private rulings are limited in their application to how a law would apply to a specific arrangement or event for a specific period of time. However, they can indicate how the IRS might act in a similar situation.

IRS Ruling

The IRS concluded that the surviving spouse:

- May be treated as having received the distribution,
- Was eligible to roll over the distribution to the IRA, and
- Won't be required to include the distribution in her gross income for federal income tax purposes.

Under the tax code, an eligible deferred compensation plan is subject to the rollover distribution rules that apply to qualified plans. For example, a payment made from a 457 plan isn't includible in gross income in the year its paid to the extent that:

1. Any portion of the balance of an employee's credit in the plan is paid to the employee in an eligible rollover distribution,

2. The employee timely transfers any portion of the property received in the distribution to an eligible retirement plan, including IRAs, and

3. Specified rollover requirements are met, including the 60-day limit on the period in which the rollover must be made.

An eligible rollover distribution is any distribution to an employee of all or a portion of the balance to the credit of an employee in a qualified trust, but not if the distribution is:

- One of a series of substantially equal periodic payments made under certain required time periods,
- A required minimum distribution (RMD), or
- Is made under hardship conditions.

The rules apply to payments from a 457 plan and, if any distribution attributable to an employee is paid to a surviving spouse, the rules apply to that distribution in the same way as if the spouse were the employee.

Name Your Beneficiaries

What necessitated the ruling request was the fact that the 457 plan was distributed to the husband's estate, rather than distributed "to the spouse of the employee" as required by the tax code.

The IRS has reached a similar conclusion where an IRA was unintentionally made payable to an estate rather than a surviving spouse and where a 401(k) plan was funneled to a surviving spouse through a marital trust, where the surviving spouse was the sole trustor, trustee and beneficiary of the trust. This case underscores the importance of naming beneficiaries in your estate plan.

Consult with your estate advisor to ensure you've properly named all your beneficiaries.

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