Internal Revenue Service

Uniform Issue List: 401.29-00
402.01-00
404.02-00

Department of the Treasury

Washington, DC 20224

200149036

Person to Contact:

Telephone Number
ID

Refer Reply to:

Date: T:EP:RA:T2
JUL 25 2001

Attn:

LEGEND:

Employer A =

State B =

Law C =

Entity D =

Plan X =

Plan Y =

Dear Ladies and Gentlemen:

This letter is in response to a request, submitted on your behalf by your authorized representative, for a private letter ruling dated , supplemented by correspondence dated and , and as further revised and superceded by correspondence dated and You have requested rulings regarding the federal income tax treatment of certain contributions to Plan X and Plan Y under sections 402 and 404 of the Internal Revenue Code (the "Code").

The following facts and representations have been submitted:

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Employer A is engaged in various diverse business operations, including the recruitment and placement of professional, engineering, design, data processing, scientific and technical support personnel for varying periods of time to companies and other organizations (including government agencies) in a broad range of industries which have a need for such personnel but are unable, or do not choose, to engage such personnel as their own employees.

Employer A maintains Plan X and Plan Y (the "Plans"), both of which qualify under sections 401(a) and 401(k) of the Code. Employer A is subject to Federal Insurance Contributions Act and Federal Withholding Tax as well as workers compensation and unemployment insurance laws of the state in which the individual is employed. Employer A maintains a large presence in State B and in accordance with Law C of State B, Employer A must withhold approximately .5% of each employee's after tax salary for state disability benefits. Although Law C provides that amounts withheld may be contributed to a state-operated fund, Law C permits the employer to establish a private or voluntary fund upon approval of the employer's application for such fund. The employer is required to separately account for contributions, earnings and accretions to its voluntary fund.

Employer A maintains a voluntary fund (the "Disability Plan") which currently holds assets that far exceed expected claims. Law C permits employers who maintain disability plans with excess assets to withdraw such assets for certain limited purposes. One of those purposes is to apply such excess to the purchase of other employee benefits for employees covered by the voluntary plan. The use of excess funds in such manner is subject to the approval of Entity D.

Employer A has determined that it will make a contribution to a 401(k) plan, for the benefit of each employee entitled to a refund, in an amount equal to the refund which will be treated as a qualified elective contribution. Such contributions will be accomplished in the following manner: Employer A will provide a refund directly to the employee exclusively from the excess assets of the Disability Plan. At the same time an elective deferral contribution, in an amount equivalent to the amount of the refund, will be made to the 401(k) plan unless the employee signs an election to receive such amount in cash.

Employees subject to the above described automatic election will receive notice that explains the automatic

compensation reduction and the employee's right to elect to have no such compensation reduction contributions to the 401(k) plan or to alter the amount of the contribution. Each participant in the plan will be notified annually of his or her compensation reduction percentage and the participant's right to change the percentage, including the procedure for exercising that right and the timing for the implementation of such right. Where an employee makes an affirmative election to receive cash in lieu of compensation reduction contributions, such employee would receive his or her entire compensation, plus the refund from the Disability Plan.

Based on the aforementioned facts and representations, you have requested the following rulings:

1) Employer A is entitled to a deduction for contributions made to the Plans pursuant to the employees' election to the extent that such contributions are otherwise deductible pursuant to sections 162 and 404 of the Code;

2) Each contribution, on behalf of an employee, will result in no additional income to the individual;

By correspondence dated December 21, 2000, your authorized representative withdrew ruling request three of the original letter ruling request dated September 1, 1999.

Section 401(k) of the Code and section 1.401(k)-1 of the Income Tax Regulations (the "regulations") set forth the requirements that a cash or deferred arrangement must satisfy in order to be a qualified cash or deferred arrangement.

Section 1.401(k)-1(a)(2)(i) of the regulations defines a cash or deferred arrangement as an arrangement under which an eligible employee may make a cash or deferred election with respect to contributions to, or accruals or other benefits under, a plan that is intended to satisfy the requirements of section 401(a).

Section 1.401(k)-1(a)(3)(i) of the regulations defines a cash or deferred election as any election (or modification of an earlier election) by an employee to have the employer either provide an amount to the employee in the form of cash (or some other taxable benefit) that is not currently available or contribute an amount to a trust (or provide an accrual or other benefit) under a plan deferring the receipt

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of compensation. Section 1.401(k)-1(a)(3)(iv) of the regulations provides that a cash or deferred election does not include a one-time irrevocable election, made at the time an employee commences employment with the employer or upon the employee's first becoming eligible under any plan of the employer, to have contributions made by the employer on the employee's behalf to the plan (or any other plan of the employer) equal to a specified amount or percentage of the employee's compensation.

Section 1.401(k)-1(g)(3) of the regulations defines elective contributions as employer contributions made to a plan that were subject to a cash or deferred election under a cash or deferred arrangement. Such contributions are elective contributions without regard to whether the cash or deferred arrangement is a qualified cash or deferred arrangement.

Revenue Ruling 2000-8, 2000-7 I.R.B. 617 (February 14, 2000), holds that where a newly hired or current employee has an effective opportunity to elect to receive an amount in cash or have that amount contributed by the employer to a profit-sharing plan, those employer contributions made on the employee's behalf to the plan in lieu of receipt of cash compensation will not fail to be considered elective contributions within the meaning of section 1.401(k)-1(g)(3) made under a qualified cash or deferred arrangement within the meaning of section 401(k) merely because they are made pursuant to an arrangement under which, in any case in which an employee does not affirmatively elect to receive cash, the employee's compensation is reduced by a fixed percentage and that amount is contributed on the employee's behalf to the plan.

Revenue Ruling 2000-8 also provides that the definition of a cash or deferred election in section 1.401(k)-1(a)(3)(i) requires that the employee have an election between the employer paying cash (or some other taxable benefit) to the employee or making a contribution to a trust on behalf of the employee. The regulation does not require that the employee receive an amount in cash in any case in which the employee does not make an affirmative election to have that amount contributed to the trust. Thus, a cash or deferred election will not fail to be made under a qualified cash or deferred arrangement merely because, when an employee fails to make an affirmative election with respect to an amount of compensation, that amount is contributed on the employee's behalf to a trust, provided that the employee had an effective opportunity to elect to receive that amount in cash. The employee has an effective opportunity to elect

to receive an amount in cash as required under section 1.401(k)-1(a)(3)(i) if the employee receives notice of the availability of the election and the employee has a reasonable period before the cash is currently available to make the election.

In this case, the compensation reduction contributions, in an amount equivalent to the amount of the refund from the Disability Plan, made by Employer A to Plan X or Plan Y on behalf of employees who have not filed an election to the contrary, are amounts contributed pursuant to a procedure under which the employee receives a notice explaining his or her right to not have the compensation reduction contributions made. Also, after receiving the notice, the employee has a reasonable period before the cash is currently available to elect to receive that amount in cash or have a contribution made to Plan X or Plan Y. Thus, an employee has an effective opportunity to elect to receive cash or have a contribution made to the plan. In addition, the employee is not able to receive, prior to a distributable event described in section 401(k)(2)(B) of the Code, the amounts contributed to Plan X or Plan Y. Finally, compensation reduction contributions, in an amount equivalent to the amount of a refund from the Disability Plan, are not contributions made pursuant to a one-time irrevocable election because the employee will be notified annually of the amount of compensation reduction contributions and can change the election after receiving such notice. Consequently, the compensation reduction contributions described above are contributions made pursuant to a cash or deferred arrangement described in section 401(k) of the Code.

Section 404 of the Code sets forth the rules governing the employer's deduction for contributions to a qualified plan. Section 404(a) provides generally that contributions paid by an employer to or under a qualified stock bonus, pension, profit-sharing or annuity plan, if otherwise deductible, are deductible under section 404, subject to various limitations as to the amounts deductible in any taxable year.

Section 402(a) of the Code provides in general that any amount actually distributed to any distributee by any employees' trust described in section 401(a) which is exempt from tax under section 501(a) is taxable to the distributee in the year of the distribution under section 72 of the Code.

Section 1.402(a)-1(a)(1)(i) of the regulations provides that if an employer makes a contribution for the benefit of an employee to a trust described in section 401(a) for the taxable year of the employer which ends within or with a taxable year of the trust for which the trust is exempt under section 501(a), the employee is not required to include such contribution in his or her income except for the year or years in which such contribution is distributed or made available to him or her.

Section 402(e)(3) of the Code provides, in part, that contributions made by an employer on behalf of an employee to a trust which is part of a qualified cash or deferred arrangement shall not be treated as distributed or made available to the employee nor as contributions made to the trust by the employee merely because the arrangement includes provisions under which the employee has an election whether the contribution will be made to the trust or received by the employee in cash.

With respect to ruling request number one, we conclude that, since the compensation reduction contributions, in an amount equivalent to the amount of the refunds from the Disability Plan, are contributions made pursuant to a cash or deferred arrangement described in section 401(k) of the Code, Employer A is entitled to a deduction for such contributions made to Plan X or Plan Y to the extent such contributions are deductible under section 404(a) of the Code.

With respect to ruling request number two, we conclude that, since Employer A will make the above-described compensation reduction contributions for the benefit of employees to Plan X or Plan Y, which are plans described in section 401(a) of the Code, the employee is not required to include such contributions in his or her income until such time as the amounts are actually distributed to him or her in accordance with section 402(a) of the Code.

These rulings are based on the assumption that Plan X and Plan Y are qualified under sections 401(a) and 401(k) of the Code and that their related trusts are tax-exempt under Code section 501(a) at all times relevant to these rulings.

These rulings are also based on the assumption that the Disability Plan complies with all of the requirements of Law C and that any refunds of excess assets from such Disability Plan are authorized by Entity D.

This letter ruling is directed only to the taxpayer that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited by others as precedent.

The original of this letter ruling is being sent to your authorized representative in accordance with a power of attorney on file in this office.

Sincerely yours,

Joyce E. Floyd

Joyce E. Floyd
Manager, Employee Plans
Technical Group 2
Tax Exempt and Government
Entities Division

Enclosures:
Deleted copy of letter ruling
Notice 437

cc: