UIL # 415.00-00

200317047

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

JAN 24 2003

LEGEND:

System A:

Plan W:

Plan X:

Plan Y:

Plan Z:

Arrangement:

State M:

Dear

This is in response to your request for a private letter ruling dated September 17, 2001, as supplemented by a letter dated December 19, 2002, concerning the applicability of section 415(m) of the Internal Revenue Code ("Code") to an excess plan and the tax consequences of certain related transactions. You have submitted the following facts and representations in support of your request.

System A is an independent state agency of State M which is governed by a board of nine trustees. System A operates Plan W, Plan X, Plan Y and Plan Z (collectively, "the Plans"),

which are contributory defined benefit plans intended to be qualified under Code section 401(a) and which are also governmental plans as defined in Code section 414(d). The Plans were established pursuant to State M statute.

State M has enacted legislation which authorizes System A to establish and maintain a qualified governmental excess benefit arrangement within the meaning of Code section 415(m). In accordance with this legislation, System A has adopted the Arrangement, which is intended to be a qualified governmental excess benefit arrangement as described in Code section 415(m). The Arrangement will be administered by System A, which has established a separate trust fund for segregation of the assets related to the Arrangement.

Participants in the Plans will become eligible for benefits from the Arrangement if their benefits calculated under the respective benefit formula are limited by Code section 415(b) as that section applies to governmental plans. Section 2.1 of the Arrangement provides that each eligible employee shall be a participant in the Arrangement commencing with the date he first becomes, or again becomes, an eligible employee. Section 2.2 of the Arrangement further provides that each eligible employee who becomes a participant shall be or remain a participant for so long as he is entitled to future benefits under the terms of the Arrangement. Eligibility for the Arrangement will be determined at the time of retirement and annually for each limitation year thereafter after any benefit increases due to the cost of living adjustment provided annually under the Plans and after any applicable section 415(b) limits from time to time.

The Arrangement is funded on a pay-as-you-go basis. The Arrangement's trust fund will not accumulate assets from year to year for the purpose of advance funding of the Arrangement's liabilities. Assets will exist in the Arrangement's trust fund from year to year solely as may be incidental to the timing of cash flow. Arrangement benefits will not be paid or funded from the trusts related to the Plans. To the extent that the Arrangement has any assets at any given time, they will be held in a separate state law grantor trust apart from the Plans. Pursuant to section 2.3 of the Arrangement's trust, it is intended to be a grantor trust for Federal income tax purposes. Accumulated assets in the Arrangement's trust fund at the end of a plan year will be designated for the purpose of offsetting administrative expenses.

The Arrangement will be funded through contributions required to be paid by the participating employers. The contribution rates are sufficient to pay the Plans' retirement benefits without regard to the Code section 415 limit. As necessary to provide "pay-as-you-go" funding for the actual cash flow needs of the Arrangement, a portion of the employer contributions to the Plans will be paid to the Arrangement's trust fund. Such payment will be made before such contributions are deposited into System A's general qualified trust fund.

Participants in the Plans will not be given an election regarding payment of Arrangement benefits. The benefits will be paid at the same time and in the same manner and form as the Plans' benefits are paid to the member or beneficiary. The Arrangement does not allow loans to participants or beneficiaries. The trustees are not empowered to pledge trust assets and borrow money.

Employer contributions made to provide excess benefits may not be commingled with the Plans' related trusts, nor may the Arrangement receive any transfer of monies from Plans' related trusts.

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

1. The Arrangement is a qualified governmental excess benefit arrangement within the meaning of Code section 415(m);

2. The amounts of benefits payable under the Arrangement will be includible in gross income for the taxable year or years in which amounts are paid or otherwise made available to a participant or a participant's beneficiary in accordance with the terms of the Arrangement;

3. Income accruing to the Arrangement's trust fund established to hold assets of the Arrangement is exempt from federal income tax under Code sections 115 and 415(m)(1) as income derived from the exercise of an essential governmental function; and

4. The amounts of Employer contributions to the Arrangement Fund to provide benefits in excess of the Code section 415(b) limits under the Arrangement, as well as the benefits payable under the Arrangement, are not wages for purposes of Federal Insurance Contributions Act ("FICA") taxation, and, therefore, there is no FICA tax liability with respect to these contributions or benefits.

Code section 415(m) sets forth the treatment of qualified governmental excess benefit arrangements. Code section 415(m)(1) provides in part that, in determining whether a governmental plan (as defined in section 414(d)) meets the requirements of section 415, benefits provided under a qualified governmental excess benefit arrangement shall not be taken into account.

Section 415(m)(3) defines such an arrangement as a portion of a governmental plan which meets the following three requirements: (A) such portion is maintained solely for the purpose of providing to participants in the plan that part of the participant's annual benefit otherwise payable under the terms of the plan that exceeds the limitations on benefits imposed by section 415 ("excess benefits"); (B) under such portion no election is provided at any time to the participant (directly or indirectly) to defer compensation; and (C) excess benefits are not paid from a trust forming a part of such governmental plan unless such trust is maintained solely for the purpose of providing such benefits.

With respect to your first requested ruling, the Arrangement is a portion of the Plans, which your authorized representative has stated are governmental plans as described in Code section 414(d). According to the terms of the Arrangement, its only stated purpose is to restore the benefits lost by application of the limitation on annual benefits under Code section 415(b) as applicable to governmental plans. The Arrangement does not allow participants to elect to defer compensation. The terms of the Arrangement limit participation to participants in the Plans for whom benefits would exceed the Code section 415 limits. Therefore, we have determined that the Arrangement is a portion of a governmental plan which is maintained solely for the purpose of providing to participants in the Plans that part of the participant's annual benefit otherwise payable under the terms of the Plans that exceeds the section 415 limits, and, as such, meets the requirements of section 415(m)(3)(A).

Your authorized representative has stated in accordance with the terms of the Arrangement that participation is automatic for participants in the Plans for whom benefits are limited by Code section 415. Thus, we have determined that no direct or indirect election is provided at any time to participants to defer compensation, and, accordingly, the requirements of section 415(m)(3)(B) are met.

Code section 415(m)(3)(C) requires that the trust from which excess benefits are paid must not form a part of the governmental plan (in this case, the Plans) which contains the excess benefit arrangement, unless such trust is maintained solely for the purpose of providing such benefits. In the present case, the Arrangement is part of the Plans, but it is maintained separately. Contributions to the Arrangement consist only of the amount required to pay the excess benefits for the plan year. Funds are not accumulated to pay benefits in future plan years. Any assets of the Arrangement Fund not used for paying benefits for a current plan year shall be used for the payment of the administrative expenses of the Arrangement for the plan year. Therefore, we have determined that the requirements of section 415(m)(3)(C) are met.

Since the Arrangement satisfies all of the requirements of Code section 415(m)(3), we conclude with respect to your first requested ruling that the Arrangement is a qualified governmental excess benefit arrangement within the meaning of Code section 415(m).

With respect to the second requested ruling, section 415(m)(2) provides that "for purposes of this chapter, (A) the taxable year or years for which amounts in respect to a qualified governmental excess benefit arrangement are includible in gross income by a participant, and (B), the treatment of such amounts when so includible by the participant, shall be determined as if such qualified governmental excess benefit arrangement were treated as a plan for the deferral of compensation which is maintained by a corporation not exempt from tax under this chapter and which does not meet the requirements for qualification under section 401."

Ruling 1 has already determined that the Arrangement meets the legal requirements of section 415(m) of the Code for qualified governmental excess benefit arrangements. Accordingly, the tax treatment of the amounts distributed under the Arrangement to the participants is determined as if such qualified governmental excess benefit arrangement were treated as a plan for the deferral of compensation which is maintained by a corporation not exempt from tax under this chapter and which does not meet the requirements for qualification under section 401. State M has represented that the trust established in connection with the Arrangement is a grantor trust pursuant to State M law and for Federal tax purposes.

Section 83(a) of the Code provides that the excess (if any) of the fair market value of property transferred in connection with the performance of services over the amount paid (if any) for the property is includible in the gross income of the person who performed the services for the first taxable year in which the property becomes transferable or is not subject to a substantial risk of forfeiture.

Section 1.83-3(e) of the Income Tax Regulations provides that for purposes of section 83 the term "property" includes real and personal property other than money or an unfunded and unsecured promise to pay money or property in the future. Property also includes a beneficial interest in assets (including money) transferred or set aside from claims of the transferor's creditors, for example, in a trust or escrow account.

Section 402(b) of the Code provides that contributions made by an employer to an employee's trust that is not exempt from tax under section 501(a) are included in the employee's gross income in accordance with section 83, except that the value of the employee's interest in the trust will be substituted for the fair market value of the property in applying section 83. Under section 1.402(b)-1(a)(1) of the regulations, an employer's contributions to a nonexempt employee's trust are included as compensation in the employee's gross income for the taxable year in which the contribution is made, but only to the extent that the employee's interest in such contribution is substantially vested, as defined in the regulations under section 83.

Section 451(a) of the Code and section 1.451-1(a) of the regulations provide that an item of gross income is includible in gross income for the taxable year in which actually or constructively received by a taxpayer using the cash receipts and disbursements method of accounting. Under section 1.451-2(a) of the regulations, income is constructively received in the taxable year during which it is credited to a taxpayer's account, set apart for him or otherwise made available so that the taxpayer may draw on it at any time. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

Various revenue rulings have considered the tax consequences of nonqualified deferred compensation arrangements. Rev. Rul. 60-31, Situations 1-3, 1960-1 C.B. 174, holds that a mere promise to pay, not represented by notes or secured in any way, does not constitute receipt of income within the meaning of the cash receipts and disbursements method of accounting. See also Rev. Rul. 69-650, 1969-2 C.B. 106, and Rev. Rul. 69-649, 1969-2 C.B. 106.

Under the economic benefit doctrine, an employee has currently includible income from an economic or financial benefit received as compensation, though not in cash form. Economic benefit applies when assets are unconditionally and irrevocably paid into a fund or trust to be used for the employee's sole benefit. Sproull v. Commissioner, 16 T.C. 244 (1951), aff'd per curiam, 194 F.2d 541 (6th Cir. 1952), Rev. Rul. 60-31, Situation 4. In Rev. Rul. 72-25, 1972-1 C.B. 127, and Rev. Rul. 68-99, 1968-1 C.B. 193, an employee does not receive income as a result of the employer's purchase of an insurance contract to provide a source of funds for deferred compensation because the insurance contract is the employer's asset, subject to claims of the employer's creditors.

Accordingly, with respect to your second requested ruling, we conclude that the amounts of benefits payable under the Arrangement will be includible in gross income of the recipients for the taxable year or years in which amounts are paid or otherwise made available to a participant or a participant's beneficiary in accordance with the terms of the Arrangement.

With respect to your third requested ruling, Code section 415(m)(1) provides that "[I] ncome accruing to a governmental plan (or to a trust that is maintained solely for the purpose of providing benefits under a qualified governmental excess benefit arrangement) in respect of a qualified governmental excess benefit arrangement shall constitute income derived from the exercise of an essential governmental function upon which such governmental plan (or trust) shall be exempt from tax under section 115." Ruling 1 has already determined that the Arrangement meets the legal requirements of section 415(m) of the Code for qualified governmental excess benefit arrangements.

Accordingly, with respect to your third requested ruling, we conclude that income accruing to the Arrangement Fund established to hold assets of the Arrangement is exempt from federal income tax under Code sections 115 and 415(m)(1) as income derived from the exercise of an essential governmental function.

With respect to your fourth requested ruling, section 5.15 of Revenue Procedure 2001-1, 1 C.B. 1, 17, provides that the Internal Revenue Service will not issue a letter ruling if the ruling request presents an issue that cannot be readily resolved before a regulation or any other published guidance is issued. After careful consideration of your request, we have concluded that the question of FICA tax treatment of a qualified governmental excess benefit arrangement under Code section 415(m) cannot readily be resolved before published guidance is issued. Consequently, we are unable to rule on that portion of the request.

This ruling letter is based on the assumption that System A is a governmental plan as described in Code section 414(d) and that it meets all of the applicable requirements under Code section 401.

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

A copy of this letter has been sent to your authorized representative in accordance with the power of attorney on file in this office.

If you have any questions about this letter, please contact
Please refer to T:EP:RA:T:3.

Sincerely yours,

Frances V. Sloan

Frances V. Sloan, Manager
Employee Plans Technical Branch 3
Tax Exempt and Government Entities Division

Enclosures:
Deleted copy of ruling letter
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