Uniform Issue List Number 415.00-00

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

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XXXXXX
XXXXXX

OP:E:EP:T1

AUG 9 2001

LEGEND:

System A = XXXX

Excess Plan = XXXX

Trust T = XXXX

State M = XXXX

City C = XXXX

Dear XXXX:

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

System A is a state defined benefit plan established primarily for teachers and administrators of primary and secondary public schools of State M (employed outside of City C). Each school covered by System A is treated as a participating employer, collectively referred to as the "Employer." System A is governed by a ten-member retirement board ("Retirement Board") which sets policy and oversees operations consistent with applicable state and local laws. System A provides service, deferred and disability retirement benefits, as well as death benefits, for its members and their beneficiaries. You represent that System A is a qualified plan within the meaning of section 401(a) of the Code and a governmental plan within the meaning of section 414(d). System A includes an Employer contribution and a mandatory employee

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contribution feature. Each participating Employer picks up the member's contributions required to be made by System A. The Employer contribution rate is established annually by the Retirement Board, at the beginning of each school year, based on the actuarial valuation of System A's assets and liabilities. The amounts due from each participating Employer are premised on the rate of contribution, as established by the Retirement Board at the beginning of each school year, and on the amount of compensation paid by the Employer during the year. Annuities available under System A are based on total member contributions, life expectancy, date of membership, final average salary and the form of retirement benefit selected by the members. Retirement benefits are also subject to certain maximums, and all benefits under System A are potentially limited by section 415(b) of the Code. So far, the limits under section 415(b) have primarily affected members who retired under a retirement incentive allowing retirement before age 55.

Recently, State M enacted legislation that authorizes System A to establish a qualified governmental excess benefit arrangement under section 415(m). Pursuant to this authority, the Retirement Board established an excess benefit plan ("Excess Plan") that will not take effect until 90 days following the receipt of a favorable ruling from the Service under section 415(m). The Excess Plan will be administered by the Retirement Board. As designed, the Excess Plan will only provide benefits to participants that would otherwise exceed the section 415(b) limits as applicable to governmental plans. Under the Excess Plan, a participant will be paid that part of a retirement benefit that would otherwise have been payable by System A, except for the limitations of Code section 415(b). Under no circumstances will participants be given an election to defer compensation either directly or indirectly.

Each member or participant in System A receiving retirement or survivor benefits thereunder whose benefit amount for any limitation year exceeds the dollar limits of Code section 415(b) will participate in the Excess Plan. Participation in the Excess Plan ceases for any year in which the participant's benefit does not exceed the requisite limits on benefits under System A.

The amount payable under the Excess Plan for a limitation year will equal the difference between (i) the annual benefit for each participant receiving retirement benefits under System A calculated pursuant to the applicable statutory formula without regard to the applicable section 415 limitations, and (ii) the dollar limitations under section 415(b) reduced actuarially for ages below 62 or increased for ages above 65. Subject to certain exceptions for disability and death benefits, the benefits will be reduced for teachers retiring with fewer than ten years of participation in System A.

Although the Excess Plan will be part of System A, the assets from System A will not be used to pay any excess benefits under the Excess Plan. Trust T will be established to hold the assets of the Excess Plan separate and apart from the assets in System A. Trust T, consistent with the purpose of the Excess Plan, will be used solely for the purpose of holding employer contributions intended to pay benefits in excess of the 415(b) limit to participants. Each participating employer will deposit into Trust T the

amount of necessary contributions as annually determined by System A's actuary. The contributions will constitute the aggregate of (i) the excess benefit payable to all participants for such year and (ii) an amount determined to be a necessary and reasonable expense of administering the Excess Plan. The amounts contributed will not be allowed to accumulate in Trust T from year to year for the purpose of advance funding of the Excess Plan's liabilities. Any contributions not used to pay the excess benefit for a current plan year will be used to defray the cost of administration for the current year.

You represent that Trust T is designed as a grantor trust of which State M is the grantor within the meaning of sections 672 through 677 of the Code. All assets held in Trust T, all property rights and beneficial interests acquired through the use of the Excess Plan's assets will remain the general, unpledged, unrestricted assets of Trust T. The interests of participants and their beneficiaries in Trust T are not senior to the claims of unsecured creditors of State M. If the assets of Trust T are not sufficient to pay excess benefits, each participating employer, not System A, will pay such benefits from its general assets with respect to its employees.

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

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

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

3. that the income accruing to Trust T is exempt from federal income tax under sections 115 and 415(m)(1) of the Code, as income derived from the exercise of an essential governmental function.

Code section 415(m) sets forth the treatment of qualified governmental excess benefit arrangements. Section 415(m)(3) provides that a qualified governmental excess benefit arrangement means a portion of a governmental plan (1) if 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"), (2) under such portion no election is provided at any time to the participant (directly or indirectly) to defer compensation, and (3) 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 Excess Plan and Trust T will be part of System A which is represented to be a governmental plan as described in section 414(d) of the Code. The Excess Plan only provides "excess benefits" and does not

allow participants to elect to defer compensation. Benefits provided under the Excess Plan are paid from Trust T which has no other purpose than to provide excess benefits. Accordingly, we conclude that the Excess Plan being implemented by System A constitutes a qualified governmental excess benefit arrangement under section 415(m).

With respect to the second requested ruling, section 415(m)(2) of the Code provides, in part, that (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.

We concluded in Ruling 1 that the Excess Plan is a qualified governmental excess benefit arrangement under section 415(m) of the Code. Accordingly, the tax treatment of the amounts distributed under the Excess Plan to the participants is determined as if the Excess Plan 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.

Section 402(b) of the Code provides that contributions made by an employer to an employees' 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 employees' 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

For purposes of determining the taxation of nonqualified deferred compensation arrangements, 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 (the "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 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 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.

In this case, State M has represented that Trust T will be a grantor trust pursuant to State M law and for Federal tax purposes. Accordingly, the benefit payments from the Excess Plan will be taxed to the recipients as gross income only as actually paid or made available under the Excess Plan.

With respect to your third requested ruling, section 415(m)(1) of the Code provides that, income 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) is exempt from tax under section 115. In Ruling 1, we concluded that the Excess Plan is a qualified governmental excess benefit arrangement. Accordingly, we conclude, with respect to ruling request 3, that income accruing to Trust T is exempt from tax under sections 115 and 415(m)(1) of the Code.

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

A copy of this ruling has been sent to your authorized representative in accordance with a power of attorney on file in this office. Should you have any questions pertaining to this ruling, you may contact xxxxxxxx this office.

Sincerely,

John Swieca, Manager
Employee Plans Technical Group 1
Tax Exempt and Government Entities
Division

Enclosures

Deleted copy of the ruling
Notice 437

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