

INTERNAL REVENUE SERVICE

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457.05-00 3402.00-00

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September 30, 1999

Employer =

Plan A =

Plan B =

Trust C =

State X =

This is in reply to your letter of March 10, 1999, and subsequent correspondence requesting a ruling that the Deferred Compensation Plan ("Plan") and Trust ("Fund") of State X constitute an eligible deferred compensation plan and trust within the meaning of section 457 of the Internal Revenue Code of 1986 (the "Code") and the Income Tax Regulations. In addition, you have requested rulings concerning the status of Trust C as a group trust under section 401(a)(24) of the Code and the proper treatment under section 3402 of the Code of elective contributions made on behalf of employees of Plan A.

Employer, State X, is an eligible employer within the meaning of section 457(e)(1)(A) of the Code.

The State Personnel Board ("Board") is a statutory body in State X responsible for the establishment of nonqualified plans, such as section 457 deferred compensation plans. Effective July 25, 1979, the Board established Plan B. Plan B is meant to be an eligible deferred compensation plan under section 457(b) of the Code.

The Employee Benefit Plan Council ("Council") is a statutory body responsible for the establishment of qualified retirement plans enacted by State X's legislature. The Council established Plan A effective on December 18, 1985. It is represented that Plan A is a defined contribution plan with a cash or deferred arrangement and meets the requirements of sections 401(a) and 401(k) of the Code. A favorable determination letter was issued by the Internal Revenue Service on June 26, 1987. Plan A was

subsequently amended and received its most recent favorable determination letter on September 4, 1998. Plan A allows certain employees of State X to make pre-tax contributions of up to ten percent of their compensation. In addition, Plan A provides for discretionary matching contributions and other employer contributions if appropriated by the legislature. Although state and local governments may not currently adopt section 401(k) plans, Plan A was adopted prior to May 6, 1986; and State X may continue to maintain Plan A.

The Council and the trustees of Plan A established Trust A to hold the assets of Plan A for the exclusive benefit of Plan A participants and beneficiaries. It is represented that Trust A meets the requirements of section 401(a) of the Code and is exempt from tax under section 501(a) of the Code.

In order to comply with the trust requirements for section 457 plans under section 457(g), the Board and the trustees of Plan B established the State X Deferred Compensation Plan Trust Agreement, Trust B, effective January 1, 1999, to hold the assets of Plan B for the exclusive benefit of Plan B participants and beneficiaries.

Subsequently, Trust C was established by appropriate governmental authorities to pool the assets of Trust A and the assets of Trust B to improve the overall investment return. It is represented that after the pooling of assets, Trust A and Trust B will each continue to retain its own accounting system and the assets of each trust will be held for the exclusive benefit of the respective participants and beneficiaries in Plan A and Plan B .

The first ruling requested is that Plan B, as amended, constitutes an eligible deferred compensation plan within the meaning of section 457(b)

Under Plan B, the amounts of compensation that may be deferred under the annual maximum limitation are within the limitations of section 457, including the section 457(c) coordinated deferral provision and the catch-up computation for amounts deferred for one or more of the participant's last three taxable years ending before he or she attains normal retirement age. The participant's election to defer compensation must be filed prior to the beginning of the month in which his or her salary reduction agreement becomes effective. The Plan does not provide that a loan may be made from assets held by the Plan to any participant or beneficiary under the Plan.

With certain limitations, a participant may elect the manner in which his or her deferred amounts will be distributed. The election must be made prior to the date any amounts become payable to the participant under Plan B. If the participant fails to make a timely election, distribution will commence at the time and in the manner set forth in Plan B. Under Plan B, no amounts will be made available to the participant or beneficiary earlier than the calendar year the participant attains age 70 ½, when the participant is separated from service with State X, or when the participant is faced with

an unforeseeable emergency as defined under Plan B in accordance with the requirements of section 457. The manner and time of benefit payout must meet the distribution requirements of sections 401(a)(9) and 457(d)(2) of the Code.

However, Plan B does permit one exception to the above distribution requirements. The Plan, in accordance with section 457(e)(9)(A), includes a provision permitting an in-service distribution of \$5,000.00 or less from a participant's account within the requirements of that section.

Plan B further provides that all amounts of compensation deferred pursuant to Plan B, all property and rights purchased with such amounts and all income attributable to such amounts, property, or rights shall be held in trust for the exclusive benefit of participants and beneficiaries under Plan B for the exclusive benefit of the participants and beneficiaries of Plan B. The trust under Plan B is established pursuant to a writing that constitutes a valid trust under the laws of State X and is represented to be a valid trust under state law.

The rights of any participant or beneficiary to payments pursuant to Plan B are generally nonassignable and not subject in any manner to anticipation, alienation, sale, transfer, assignment, pledge, encumbrance, attachment, or garnishment by creditors of the participant or the participant's beneficiary.

The terms of Trust B make it impossible prior to the satisfaction of all liabilities with respect to plan participants and their beneficiaries for any part of the assets and income of the trusts to be used for, or diverted to, purposes other than the exclusive benefit of plan participants and their beneficiaries.

Section 457 of the Code provides rules for the deferral of compensation by an individual participating in an eligible deferred compensation plan as defined in section 457(b).

Section 457(a) of the Code provides that in the case of a participant in an eligible deferred compensation plan, any amount of compensation deferred under the plan and any income attributable to the amounts so deferred shall be includible in gross income only for the taxable year in which such compensation or other income is paid or otherwise made available to the participant or beneficiary.

Section 457(d)(1)(A) provides that for a section 457 plan to be an eligible plan, the plan must have distribution requirements providing that under the plan amounts will not be made available to participants or beneficiaries earlier than i) the calendar year in which the participant attains age 70 $\frac{1}{2}$, ii) when the participant is separated from service with the employer, or iii) when the participant is faced with an unforeseeable emergency as determined under Treasury regulations. However, section 401(a)(9)(C)(i) generally allows plans to postpone the required beginning date until April 1 of the calendar year following the later of the calendar year in which the

employee retires or in which he attains age 70 ½.

A basic requirement prescribed by section 457(b)(5) is that an eligible section 457 plan must meet the section 457(d) distribution requirements described above in order to retain its tax-deferred eligible status. A section 457 plan would violate these provisions of section 457(b)(5) and the regulations thereunder if the participant or anyone else received a distribution earlier than the earliest date established in section 457(d)(1)(A).

Section 457(e)(9)(A) provides that the total amount payable to a participant under the plan will not be treated as made available merely because the participant may elect to receive such amount (or the plan may distribute such amount without the participant's consent) if (i) such amount does not exceed \$5,000, and (ii) such amount may be distributed only if--(I) no amount has been deferred under the plan with respect to such participant during the 2-year period ending on the date of the distribution, and (II) there has been no prior distribution under the plan to such participant under this option.

Section 1.457-2(h)(4) of the Income Tax Regulations defines an unforeseeable emergency as severe financial hardship to the participant resulting from a sudden and unexpected illness or accident of the participant or of a dependent, loss of the participant's property due to casualty, or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant.

Section 457(g)(1) provides that a plan maintained by an eligible governmental employer shall not be treated as an eligible deferred compensation plan unless all assets and rights purchased with such deferred compensation amounts and all income attributable to such amounts, property, or rights of the plan are held in trust for the exclusive benefit of participants and their beneficiaries.

Section 457(g)(2) provides that a trust described in section 457(g)(1) shall be treated as an organization exempt from tax under section 501(a). Section 457(g)(2)(B) provides that the amounts in the trust are treated as includible in the gross income of participants and beneficiaries only to the extent, and at the time, provided in section 457.

Under the terms of Plan B and Trust B, the trustee must hold all of the section 457(b) plan assets for the exclusive benefit of the participants and their beneficiaries, and all amounts deferred under the Plan must be transferred to a trust meeting the requirements of section 457(g) of the Code within an administratively reasonable time period.

Based upon the provisions of the amended plan summarized above, the other documents presented and the representations made, we conclude as follows:

1. The Deferred Compensation Plan established by State X is an eligible deferred compensation plan as defined in section 457(b) of the Internal Revenue Code of 1986. All assets and income of the Plan described in section 457(b)(6) will be held in trust for the exclusive benefit of participants and their beneficiaries.
2. Plan B satisfies the requirements of section 457(b), and assuming that Plan A otherwise satisfies the requirements of section 401(a), the pooling of assets of Trust A with the assets of Trust B in Trust C will not result in Plan B failing to satisfy the requirements of section 457(b).

The next ruling requested is whether, since Plan B satisfies the requirements of section 457(b), and assuming Plan A otherwise satisfies the requirements of section 401(a), Trust C meets the definition of a group trust as stated in section 401(a)(24) of the Code and is exempt from tax under section 501(a) of the Code.

Section 401(a)(24) of the Code provides that any group trust which otherwise meets the requirements of section 401(a) shall not be treated as meeting such requirements on account of the participation or inclusion in such trust of the moneys of any plan or governmental unit described in section 818(a)(6).

Section 818(a)(6) of the Code describes the following plans and governmental units: A) a governmental plan (within the meaning of section 414(d) or an eligible deferred compensation plan (within the meaning of section 457(b)) or B) the Government of the United States, the government of any State or political subdivision thereof, or any agency or instrumentality of the foregoing, or any organization (other than a government unit) exempt from tax under this subtitle, for use in satisfying an obligation of such government, political subdivision, agency or instrumentality, or organization to provide a benefit under a plan described in subparagraph (A).

The Committee Report pertaining to section 401(a)(24) of the Code contained in Rep. No. 760, 97th Cong., 2d Sess. 639 (1982), reprinted in 1982-2 C.B. 600, 682, states as follows: Under the conference agreement, the tax-exempt status of a group trust will not be adversely affected merely because the trust accepts monies from (a) a retirement plan of a State or local government, whether or not the plan is a qualified plan and whether or not the assets are held in trust, (b) any State or local government monies intended for use in satisfying an obligation of such State or local government to provide a retirement benefit under a governmental plan.

Thus, sections 401(a)(24) and 818(a)(6) of the Code would permit the assets of a section 401(a) plan and a section 457(b) plan to be pooled in a group trust. In addition, the committee report indicates that the intent of Congress in enacting section 401(a)(24) was to allow the group trust in which governmental plan assets are pooled to retain the tax-exempt status under section 501(a).

In this case, Employer indicates that Trust A and Trust B will be held together in a common group trust, Trust C, in order to obtain economies of scale in the investment of the trust assets. It has been represented that each plan's trust has separate accounting and that the assets are pooled in group trust for investment purposes only. In addition, it is stated that the assets of both plans are held for the exclusive benefit of the participants and beneficiaries of each plan respectively.

Based upon the information provided, the documents submitted and the representations made, we conclude as follows:

3. Since Plan B satisfies the requirements of section 457(b), and assuming Plan A otherwise satisfies the requirements of section 401(a), Trust C meets the definition of a group trust as stated in section 401(a)(24) of the Code and is exempt from tax under section 501(a) of the Code.

The final ruling requested is, assuming that Plan A otherwise satisfies the requirements of sections 401(a) and 401(k), that the elective contributions made by its participants in the manner represented will not constitute "wages" subject to income tax withholding under section 3402 of the Code.

Section 401(k)(2) states, in part, that a qualified cash or deferred arrangement is any arrangement which is part of a profit-sharing or stock bonus plan, a pre-ERISA money purchase plan, or a rural cooperative plan which meets the requirements of section 401(a) under which a covered employee may elect to have the employer make payments as contributions to a trust under the plan on behalf of the employee, or to the employee directly in cash. Such arrangements must meet special standards governing withdrawals, forfeitures, and discrimination in order to qualify for tax benefits.

The Tax Reform Act of 1986 (Public Law 99-514) added Section 401(k)(4)(B)(ii) which provides that a cash or deferred arrangement shall not be treated as a qualified cash or deferred arrangement if it is part of a plan maintained by a State or local government or political subdivision thereof, or any agency or instrumentality thereof. However, a transition rule included in section 1116(f)(2)(B) of the Tax Reform Act of 1986 states that Section 401(k)(4)(B)(ii) added above shall not apply to any cash or deferred arrangement adopted by a state or local government (or political subdivision thereof) before May 6, 1986.

Section 402(e)(3) provides that contributions made by an employer on behalf of an employee to a trust which is a part of a qualified cash or deferred arrangement (as defined in section 401(k)(2)) 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.

Section 1.401(k)-1(a)(2) of the Income Tax Regulations provides that generally, a cash or deferred arrangement is 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) provides that a cash or deferred election is any election (or modification of an earlier election) by an employee to have the employer either— (A) provide an amount to the employee in the form of cash or some other taxable benefit that is not currently available, or (B) contribute an amount to a trust, or provide an accrual or other benefit, under a plan deferring the receipt of compensation. A cash or deferred election includes a salary reduction agreement between an employee and employer under which a contribution is made under a plan only if the employee elects to reduce cash compensation or to forgo an increase in cash compensation.

Section 1.401(k)-1(a)(3)(ii) provides that a cash or deferred election can only be made with respect to an amount that is not currently available to the employee on the date of the election. Further, a cash or deferred election can only be made with respect to an amount that would (but for the cash or deferred election) become currently available after the later of the date on which the employer adopts the cash or deferred arrangement or the date on which the arrangement first becomes effective.

Section 1.401(k)-1(a)(3)(iii) provides that cash or another taxable amount is currently available to the employee if it has been paid to the employee or if the employee is able currently to receive the cash or other taxable amount at the employee's discretion. An amount is not currently available to an employee if there is a significant restriction or limitation on the employee's right to receive the amount before a particular time in the future. The determination of whether an amount is currently available to an employee does not depend on whether it has been constructively received by the employee for purposes of section 451.

Section 1.401(k)-1(a)(4)(i) of the regulations provides that a qualified cash or deferred arrangement is a cash or deferred arrangement that satisfies the requirements of paragraphs (b), (c), (d), and (e) of section 1.401(k)-1 and that is part of a plan that otherwise satisfies the requirements of section 401(a).

Section 1.401(k)-1(a)(4)(ii) of the regulations provides that, except as provided in section 1.401(k)-1(f), elective contributions under a qualified cash or deferred arrangement are treated as employer contributions.

Section 1.401(k)-1(a)(4)(iii) of the regulations provides that, except as provided in section 402(g) and in section 1.401(k)-1(f), elective contributions under a qualified cash or deferred arrangement are neither includible in an employee's gross income at the time the cash or other taxable amounts would have been includible in the

employee's gross income (but for the cash or deferred election), nor at the time the elective contributions are contributed to the plan.

Federal income tax withholding under section 3402(a) is imposed on "wages" as defined in section 3401(a). Section 3401(a)(12)(A) excepts from the definition of wages remuneration paid to, or on behalf of, an employee or his beneficiary from or to a trust described in section 401(a) which is exempt from tax under section 501(a) at the time of such payment, unless such payment is made to an employee of the trust as remuneration for services rendered as such employee and not as a beneficiary of the trust.

Section 31.3401(a)(12)-1(a)(1) of the regulations further provides that the term "wages" does not include any payment made by an employer, on behalf of an employee or his beneficiary, into a trust, or (2) to or on behalf of, an employee or his beneficiary from a trust, if at the time of such payment the trust is exempt from tax under section 501(a) as an organization described in section 401(a).

Based on the information provided, the documents presented and the representations made, we conclude as follows:

4. The elective contributions made on behalf of an employee under Plan A will not constitute wages subject to income tax withholding under section 3402. This ruling is based on the assumption that Plan A will otherwise be qualified under sections 401(a) and 401(k).

This ruling letter is directed only to State X and the participants of State X's Plan and applies only to the Plans and Trusts originally submitted and revised, including the amended plan submitted on July 29, 1999. Section 6110(k)(3) of the Internal Revenue Code provides that it may not be used or cited as precedent.

Temporary or final regulations pertaining to one or more of the issues addressed in this ruling have not yet been adopted. Therefore, this ruling may be modified or revoked if the adopted temporary or final regulations are inconsistent with any conclusion in the ruling. See section 12.04 of Rev. Proc. 99-1, 1999-1 I.R.B. 6, 47. However, when the criteria in section 12.05 of Rev. Proc. 99-1 are satisfied, a ruling is not revoked or modified retroactively except in rare or unusual circumstances.

Sincerely yours,

ROBERT D. PATCHELL
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Office of the Associate Chief Counsel
(Employee Benefits and Exempt Organizations)

Enclosure:

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