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Department of the Treasury

Washington, DC 20224

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Date:

April 26, 2001

School District =  
Compensation Plan =

This is in response to your letter dated November 20, 2000, on behalf of the School District requesting a ruling on whether contributions the School District makes to its health benefits program and its section 457(a) Deferred Compensation Program are non-taxable to the School District's employees at the time of the contributions.

The School District is continually in the process of hiring employees. As part of the hiring process due to the tight labor market, the School District offers health insurance coverages and/or retirement benefits to prospective employees in order to satisfy the School District's hiring needs. It is a policy of the School District to assure that all of its' employees have health insurance coverage. Thus, the School District provides health insurance coverage through the School District's Group Health Insurance Program

If the School District decides to hire a prospective employee, the employee is asked if he or she is covered by health insurance. If the answer is no, the employee is automatically enrolled in the School District's group medical insurance plan for which the taxpayer pays the entire premium. If the answer is yes, the employee is enrolled in the School District Compensation Plan. At no time does the employee have a choice between funds contributed as premiums for medical insurance or funds contributed to the Compensation Plan. Once enrolled in either the medical insurance plan or the

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Compensation Plan, the employee may not change his or her enrollment.

An eligible person may become a participant in the Compensation Plan by executing a Participation Agreement in accordance with the Compensation Plan. Compensation will be deferred for any calendar month only if a Participation Agreement providing for the deferral has been entered into before the beginning of the month.

The Compensation Plan provides for a maximum amount that may be deferred by a participant in any taxable year and also provides for a catch-up contribution for amounts deferred for one or more of the participant's last three years ending before he or she attains normal retirement age under the Compensation Plan. The amounts that may be deferred are within the limitations set out in section 457 of the Internal Revenue Code.

All contributions to the Compensation Plan, including any annuity contract held to fund the Compensation Plan, and all accumulations thereon, shall be held for the exclusive benefit of the participants and their beneficiaries under the plan, which is intended to be an eligible deferred compensation plan under section 457 of the Code. Such amounts and accumulations shall not be subject to claim of right by the employer or any of its creditors. No part of any contract under the plan may be diverted or repaid to the employer except as permitted by applicable law. All annuity contracts shall provide that such contracts shall be held for the exclusive benefit of a participant and his or her beneficiary. For this purpose, the term "annuity contract" does not include a life, health or accident, property, casualty or liability insurance contract. To comply with this requirement, all amounts of compensation deferred under the plan shall be transferred to a contract described in section 401(f) of the Code not later than 15 business days after the end of the month in which the compensation would otherwise have been paid to the participant.

Payments to participants may begin upon their separation from service. Payments to their beneficiaries may begin upon the participant's death. All payouts must conform to sections 401(a)(9) and 457(d) of the Code.

The Compensation Plan can accept a transfer of compensation previously deferred under another plan of deferred compensation maintained by another employer as an eligible section 457 plan. A participant who separates from service with the School District and accepts employment with another employer that maintains an eligible 457 plan may elect to transfer his or her compensation deferred under the Compensation Plan to that other plan, if the other plan can accept such transfers. Employer shall mean any school district that is a governmental entity and has adopted the Compensation Plan.

The Compensation Plan also includes a provision permitting a participant to elect an in-service distribution of \$5,000 or less from his or her account in certain limited

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circumstances set forth thereunder and in accordance with section 457(e)(9)(A).

Section 61(a) of the Code provides that, unless otherwise excepted, gross income includes all compensation received for services performed including fringe benefits.

Section 106 of the Code provides that the gross income of an employee does not include employer-provided coverage under an accident or health plan.

Section 1.106-1 of the Income Tax Regulations states that the gross income of an employee does not include contributions which his employer makes to an accident or health plan for compensation (through insurance or otherwise) to the employee for personal injuries or sickness incurred by the employee, the employee's spouse, or the employee's dependents, as defined in section 152 of the Code. The employer may contribute to an accident or health plan either by paying the premium on a policy of accident or health insurance covering one or more of the employees, or by contributing to a separate trust or fund which provides accident or health benefits directly or through insurance to one or more of the employees. However, if the insurance policy, trust, or fund provides other benefits in addition to accident or health, section 106 applies only to the portion of the contributions allocable to the accident or health benefits.

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) of the Code 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 70-1/2, 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 70-1/2.

A basic requirement prescribed by section 457(b)(5) of the Code 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

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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) of the Code 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) of the Code 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) of the Code 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.

Section 457(g)(3) of the Code provides that for purposes of section 457(g), custodial accounts and contracts described in section 401(f) shall be treated as trusts under rules similar to the rules under section 401(f).

Under the terms of the Compensation Plan, the custodian 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 Compensation Plan must be transferred to a contract described in section 401(f) of the Code within 15 business days after the end of the month in which the compensation would otherwise have been paid to the employee.

Based upon the documents presented and the representations made, we conclude the following:

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1. The premiums paid under the School District's group medical insurance plan covering an employee and his or her spouse and dependents (as defined in section 152 of the Code) are excludable from the employee's gross income under section 106 of the Code.

2. Amounts of compensation deferred in accordance with the Compensation Plan, including any income attributable to the deferred compensation, will not be includible in gross income until the taxable year or years in which amounts are paid or otherwise made available to a participant or beneficiary in accordance with the terms of the Compensation Plan.

No opinion is expressed concerning the timing of the inclusion in income of amounts deferred under any deferred compensation plan other than the Compensation Plan described above. In addition, this ruling applies only to deferrals made after the date this ruling was issued. If the Compensation Plan is significantly modified, this ruling will not necessarily remain applicable. This ruling is directed only to School District and the participants in the Compensation Plan and the School District's health benefit program. Section 6110(k)(3) of the Internal Revenue Code provides that it may not be used or cited as precedent. No opinion is expressed or implied concerning the tax consequences under any other provision of the Code or regulations other than those specifically stated above.

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. 2001-1, 2001-1 I.R.B. 1, 46. However, when the criteria in section 12.05 of Rev. Proc. 2001-1 are satisfied, a ruling is not revoked or modified retroactively except in rare or unusual circumstances.

Sincerely,

Robert D. Patchell  
Acting Chief, Qualified Plans Branch 2  
Office of Division Counsel/  
Associate Chief Counsel  
(Tax Exempt and Government Entities)

Enclosures:

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Copy of this letter