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Internal Revenue Service

Department of the Treasury
Washington, DC 20224

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Person To Contact:

Telephone Number:

Refer Reply To: T:EP:RA:T3

Date: JUL 16 2001

LEGEND:

System A:

State B:

Arrangement X:

Plan Y:

Plan Z:

Dear

This is in response to a request for a private letter ruling, dated February 15, 1998, as supplemented by letters dated November 2, 1998, February 19, 2001, and June 4, 2001, which your authorized representative submitted on your behalf concerning certain proposed transactions. Your authorized representative submitted the following facts and representations in support of the ruling request.

System A is an "institution of higher education" under the State B Education Code and is an instrumentality of the State of B. System A is comprised of various universities located throughout State B.

The State B legislature established Plan Y, a governmental plan under section 414(d) of the Internal Revenue Code ("Code") which is a defined benefit plan, and Plan Z, a governmental

242

plan under section 414(d) which is a tax-sheltered annuity plan under section 403(b). Plan Z is a defined contribution plan. Employees of the component institutions of System A who meet the participation requirements for Plan Y are required to participate in Plan Y, but some statutory classifications of System A employees may choose to make a one-time irrevocable election to opt out of participation in Plan Y and to participate in Plan Z instead. No eligible employee may elect out of both Plan Y and Plan Z.

Plan Z participants are required to contribute 6.65% of their current compensation to Plan Z. These contributions are made by automatic payroll deduction. The participant's employer contributes an amount equal to 8.5% (6% for post-August 31, 1995 participants) of the participant's current compensation to Plan Z. Participants are offered certain investment options, but they cannot alter the applicable employer or employee contribution percentages, nor can they elect to receive funds prior to the participant's benefit commencement date.

In 1997, the State B legislature amended that part of the State B Government Code which contains Plan Z to enable an institution of higher education to establish a qualified governmental excess benefit arrangement as provided by Code section 415(m). Effective October 1, 1997, System A established Arrangement X, which is intended to be such an arrangement. Arrangement X is a portion of Plan Z. Arrangement X states in its Introduction that its purpose is to provide participants in Plan Z that portion of a participant's benefits that would otherwise be payable under the terms of Plan Z except for the limitations on benefits imposed by Code section 415. Benefits payable to or on behalf of an Arrangement X participant equal the participant's account balance. All employees of System A and its components are required to participate in Arrangement X if they are participants in Plan Z and if contributions to Plan Z by them and on their behalf exceed the limits of Code section 415(c)(1). Contributions to Arrangement X may be made only with respect to compensation for periods of service commencing on or after October 1, 1997. Your authorized representative has represented that a participant's contribution to Arrangement X is mandatory, and no election is provided at any time to the participant, directly or indirectly, to defer compensation. Your authorized representative has also represented that there are no after tax contributions to Arrangement X. A participant's contribution to Arrangement X is determined as follows:

(a) Each month, a participant's compensation as defined in Arrangement X is multiplied by the Plan Z employee contribution rate, disregarding any limitations on participant contributions under Plan Z or Code section 415(c).

(b) Participant contributions actually made and credited to Plan Z (as limited by Code section 415(c)) are subtracted from the dollar amount calculated under (a) above, and the resulting difference is the participant's contribution to Arrangement X.

The employer's contribution to Arrangement X is calculated in a similar way:

(a) Each month the Plan Z employer contribution rate is multiplied by each participant's compensation, disregarding any limitations on employer contributions under Plan Z or Code section 415(c).

(b) The amount calculated pursuant to (a) above shall be reduced by employer contributions actually made and credited to Plan Z, and the resulting difference is the employer's contribution to Arrangement X.

Employer contributions to Arrangement X are fully vested after one year of service. Participant contributions to Arrangement X are fully vested at all times. A participant's right to benefit payments cannot be alienated.

Arrangement X's related trust ("Trust") was established and is maintained for the purpose of providing benefits under Arrangement X. The Trust is intended to be a "rabbi trust" under Revenue Procedure 92-64, 1992-2 C.B. 422, is represented as such, and is maintained separately from Plan Z. Its assets may be used to pay benefits under Arrangement X and to defray reasonable administrative costs, so long as System A is not insolvent, as determined under the terms of the Trust. In the event of insolvency as determined under the terms of the Trust, Trust assets are subject to the claims of System A's creditors. Trust principal and earnings thereon are held separately from the other funds of System A. The Trust does not accept contributions from Plan Z, invest Plan Z funds, or pay Plan Z benefits.

No participant shall be paid benefits under Arrangement X before the participant's benefit commencement date specified in Arrangement X. Participants cannot make withdrawals from Arrangement X before the benefit commencement date. Participants elected in writing before October 1, 1997, the form in which their benefits would be paid. Since that date, participants have been (and will be) required to make an election of benefits at the time of enrollment in Arrangement X, with these enrollments occurring prior to any pay period for which compensation is deferred.

Based on the above facts and representations, your authorized representative has requested the following rulings on your behalf:

1. Arrangement X is a "qualified governmental excess benefit arrangement" as defined in Code section 415(m)(3).

2. The limits on contributions contained in Code section 415(c) are inapplicable to contributions under Arrangement X.

3. Neither the adoption of Arrangement X, the establishment of the Trust, the contemplated contribution of funds to the Trust, nor the crediting of earnings on the trust assets will constitute a transfer of property to a participant for purposes of Code section 83 or section 1.83-3(e) of the Income Tax Regulations.

4. Neither the adoption of Arrangement X, the establishment of the Trust, the contemplated contribution of funds to the Trust, nor the crediting of earnings on the trust assets will constitute a contribution to a non-exempt employee's trust under Code section 402(b).

5. Neither the adoption of Arrangement X, the establishment of the Trust, the contemplated contribution of funds to the Trust, nor the crediting of earnings on the trust assets will cause any amount to be included in the gross income of a participant or his or her beneficiaries under the cash receipts and disbursements method of accounting pursuant to either the constructive receipt doctrine under Code section 451, or the economic benefit doctrine.

6. Under Code section 451, amounts distributed under Arrangement X and from the Trust will be included in the gross income of a recipient who is on the cash receipts and disbursements method of accounting in the year in which such amounts are actually paid or otherwise made available to the recipient, whichever is earlier.

7. No amount will be considered to have been made available to a participant as a result of the fact that the participant has a right to designate the "deemed investment" of amounts credited to that participant's account under Arrangement X.

8. The limits on contributions contained in Code section 457(b)(2) and Code section 457(c)(1) do not apply to contributions under Arrangement X.

9. Participants in Arrangement X will not be taxable pursuant to Code section 457(f) on any amounts contributed to or held or distributed by the Trust.

10. Income of the Trust will constitute income derived from the exercise of an essential governmental function exempt from tax under Code section 115.

11. Neither contributions to Arrangement X on a participant's behalf or distributions from Arrangement X to a participant will be taken into account as wages under Code sections 3121(a) or 3306(b).

With respect to your first and second requested rulings, Code section 415 limits the amount of benefits that can be paid under a defined benefit plan and the amount of contributions

that can be made to a defined contribution plan. Specifically, concerning the latter, section 415(c) states that contributions and other additions with respect to a participant exceed the limitation of this subsection if, when expressed as an annual addition to the participant's account, such annual addition is greater than the lesser of $30,000 or 25 percent of the participant's compensation. "Annual addition" is generally defined in section 415(c)(2) as the sum for any year of employer contributions, employee contributions, and forfeitures.

Code section 415(m) describes the treatment of a qualified governmental excess benefit arrangement. 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 this section ("excess benefits"), (B) under such portion no election is provided at any time to the participant (directly or indirectly) to defer compensation, and (C) benefits described in subparagraph (A) 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.

In the present case, Arrangement X is a portion of Plan Z, which your authorized representative has stated is a governmental plan as defined in Code section 414(d). According to the terms of Arrangement X, its only stated purpose is to provide participants in Plan Z that portion of a participant's benefits that would otherwise be payable under the terms of Plan Z except for the limitations on benefits imposed by Code section 415. The terms of Arrangement X limit participation to Plan Z participants for whom contributions would exceed the Code section 415 limits. Contributions to Arrangement X are determined solely with reference to contributions (limited by section 415) actually made to Plan Z and contributions that could be made under the terms of Plan Z without the limits of section 415. Participant benefits under Arrangement X are based solely on the accumulated contributions (with related earnings) that represent the difference between the section 415-limited contributions made under the terms of Plan Z and the contributions payable without the limits of section 415. Therefore, we have determined that Arrangement X is a portion of a governmental plan which is maintained solely for the purpose of providing to Plan Z participants that part of the participant's annual benefit otherwise payable under the terms of Plan Z 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 Arrangement X that participation is automatic and mandatory for Plan Z participants for whom contributions are limited by Code section 415. The employee contribution percentages to Plan Z are mandatory

and fixed. 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, Plan Z) which contains the excess benefit arrangement, with a certain exception not relevant here. In the present case, since the Trust is maintained separately from Plan Z and does not accept contributions from Plan Z, invest Plan Z funds, or pay Plan Z benefits, it is not part of Plan Z. Therefore, we have determined that the requirements of section 415(m)(3)(C) are met.

Since Arrangement X satisfies all of the requirements of Code section 415(m)(3), we conclude with respect to your first requested ruling that Arrangement X is a "qualified governmental excess benefit arrangement" as defined in Code section 415(m)(3). Therefore, in accordance with section 415(m)(1), benefits provided under Arrangement X shall not be taken into account in determining whether Plan Z meets the requirements of section 415. Since the benefits provided under Arrangement X are derived solely from contributions (and related earnings) to Arrangement X, we conclude with respect to your second requested ruling that the limits on contributions contained in section 415(c) are inapplicable to contributions under Arrangement X.

With respect to your third, fourth, and fifth requested rulings,.Code section 415(m)(2) 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 the first ruling that Arrangement X is a qualified governmental excess benefit arrangement as defined in Code section 415(m)(3). Accordingly, the tax treatment of the amounts distributed to the participants is determined as if Arrangement X 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(a).

For purposes of determining the taxation of nonqualified deferred compensation arrangements, Code section 83 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 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 non-exempt 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.

In this case, Arrangement X's related trust ("Trust") was established and is maintained for the purpose of providing benefits under Arrangement X. The Trust is intended to be a grantor trust ("rabbi trust") under Revenue Procedure 92-64, 1992-2 C.B. 422, is represented as such, and is maintained separately from Plan Z. Accordingly, with respect to your third requested ruling, assuming that the Trust is a "rabbi trust" pursuant to Revenue Procedure 92-64, we conclude that neither the adoption of Arrangement X, the establishment of the Trust, the contemplated contribution of funds to the Trust, nor the crediting of earnings on the Trust assets will constitute a transfer of property to a participant for purposes of Code section 83 or section 1.83-3(e) of the regulations. In addition, with respect to your fourth requested ruling, we conclude that neither the adoption of Arrangement X, the establishment of the Trust, the contemplated contribution of funds to the Trust, nor the crediting of earnings on the Trust assets will constitute a contribution to a non-exempt employee's trust under Code section 402(b).

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.

Accordingly, with respect to your fifth requested ruling, we conclude that neither the adoption of Arrangement X, the establishment of the Trust, the contemplated contribution of funds to the Trust, nor the crediting of earnings on the Trust assets will cause any amount to be included in the gross income of a participant or his or her beneficiaries under the cash receipts and disbursements method of accounting pursuant to either the constructive receipt doctrine under Code section 451, or the economic benefit doctrine.

In addition, with respect to your sixth requested ruling, we conclude that, under Code section 451, amounts distributed under Arrangement X and from the Trust will be included in the gross income of a recipient who is on the cash receipts and disbursements method of accounting in the year in which such amounts are actually paid or otherwise made available to the recipient, whichever is earlier. With respect to your seventh requested ruling, we conclude that no amount will be considered to have been made available to a participant as a result of the fact that the participant has a right to designate the "deemed investment" of amounts credited to that participant's account under Arrangement X.

With respect to your eighth and ninth requested rulings, Code section 457(a) 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.

Code Section 457(e)(14) provides that subsections (b)(2) and (c)(1) of Code section 457 do not apply to any qualified governmental excess benefit arrangement (as defined in section 415(m)(3)), and benefits provided under such an arrangement will not be taken into account in determining whether any other plan is an eligible deferred compensation plan within the meaning of Code section 457(b).

Code section 457(f)(1) governs the tax treatment of a participant in a plan of an eligible employer, if the plan provides for a deferral of compensation, but is not an eligible deferred compensation plan. The term "eligible employer" is defined in Code section 457(e)(1), and includes a state or any political subdivision or any agency or instrumentality of a state, and any

other tax-exempt organization. Code section 457(f)(2) states that section 457(f)(1) does not apply to a qualified governmental excess benefit plan described in section 415(m).

In the first ruling, we concluded that Arrangement X is a qualified governmental excess benefit arrangement as defined in section 415(m)(3). Accordingly, with respect to your eighth requested ruling, we conclude that the limits on contributions contained in Code section 457(b)(2) and Code section 457(c)(1) do not apply to contributions under Arrangement X. With respect to your ninth requested ruling, we conclude that participants in Arrangement X will not be taxable pursuant to Code section 457(f) on any amounts contributed to or held or distributed by the Trust.

With respect to your tenth requested ruling, section 415(m)(1) provides that income accruing to a governmental plan (or to a trust 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 the first ruling we concluded that Arrangement X is a qualified governmental excess benefit arrangement as defined in section 415(m)(3). Accordingly, we conclude with respect to your tenth requested ruling that income of the Trust will constitute income derived from the exercise of an essential governmental function exempt from tax under Code section 115.

With respect to your eleventh requested ruling, the Federal Unemployment Tax Act ("FUTA") imposes a tax on every employer, with respect to having individuals in its employ, equal to a certain percentage of the total wages (as defined in section 3306(b)) paid by the employer during the calendar year with respect to employment (as defined in section 3306(c)). See Code section 3301.

Code section 3306(c)(7) provides an exception from the definition of "employment", for purposes of the FUTA, for services performed in the employ of a State, or any political subdivision thereof, or any instrumentality of one or more of the foregoing which is wholly owned by one or more States or political subdivisions; and any service performed in the employ of any instrumentality of one or more States or political subdivisions to the extent that the instrumentality is, with respect to such service, immune under the Constitution of the United States from the tax imposed by section 3301.

Based on the above, we conclude that, to the extent contributions to and benefits paid from Arrangement X are paid for services for the System A, neither contributions to Arrangement X on a participant's behalf nor distributions from Arrangement X to a participant will be taken into account as wages for FUTA purposes under Code section 3306(b).

250

Revenue Procedure 2001-1, 2001-1 I.R.B. 1, section 5.15(3), 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 Federal Insurance Contributions Act ("FICA") tax treatment of a qualified governmental excess benefit arrangement under section 415(m) cannot readily be resolved before published guidance is issued. Consequently, we are unable to rule on that portion of your eleventh requested ruling.

This ruling letter assumes that Plan Z is a governmental plan as defined in Code section 414(d) and that it is qualified under section 403(b). In addition, this ruling letter assumes that the Trust is a "rabbi trust" meeting the requirements of Revenue Procedure 92-64.

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.

Pursuant to a power of attorney on file in this office, copies of this letter are being sent to your authorized representatives as listed below.

Sincerely yours,

Frances V. Sloan

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

Enclosures
Notice 437
Deleted copy of ruling letter

Copies to:

251