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Internal Revenue Service

Department of the Treasury

Washington, DC 20224

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Contact Person:

Telephone Number:

In Reference to:
OP:E:EP:T:4

Date:
MAR 22 1999

Legend:

Employer X =

Plan A =

Plan B =

Dear

This is in response to a ruling request submitted on your behalf by your authorized representatives dated May 31, 1996, supplemented by additional correspondence dated September 12, 1996, June 13, 1997, and February 5, 1998. By the letter dated February 5, 1998, ruling request 3 was withdrawn. The ruling request concerns the proper tax treatment of elective deferrals to a cash or deferred arrangement in coordination with a nonqualified plan of deferred compensation. The following facts and representations were submitted by your authorized representative.

Employer X currently maintains Plans A and B. Plan A is a qualified plan under section 401(a) of the Internal Revenue Code (the "Code"), its related trust is exempt under section 501(a) of the Code and its cash or deferred arrangement is qualified under section 401(k) of the Code. Plan B is an unfunded nonqualified plan established to benefit highly compensated management employees of Employer X. Plans A and B operate on a calendar year basis. You are a participant in both Plans.

Under Plan A, participants are eligible to make both pre-tax and after-tax contributions from base salary. Pre-tax contributions to Plan A are limited to the maximum elective deferral permitted under section 402(g) of the Code. Contributions to Plan A are also limited by application of section 415 of the Code and by the actual deferral percentage test and the actual contribution percentage test under sections 401(k) and 401(m) of the Code. Under Plan A, Employer X matches each participants' contributions in an amount based on the participant's years of service and Employer X's profitability.

Under Plan B, participants may elect to defer up to 100% of their base salary plus all or a portion of other forms of compensation from Employer X. Participants under Plan B may also elect to defer amounts equal to excess deferrals, excess contributions, and excess annual additions attributable to a prior year that were returned to the participant under Plan A. Employer X also matches Plan B participants' contributions from base salary predicated on the same formula used under Plan A. Unlike Plan A, however, elective deferrals and matching contributions are not subject to the limitation of sections 402(g) and 415 of the Code, or the limitations imposed by either the actual deferral percentage test or the actual contribution percentage test of sections 401(k) and 401(m) of the Code.

Employer X credits Plan B participants' accounts with earnings based on a predetermined formula. Earnings are fully vested except with respect to any participants who voluntarily terminate employment. In such case, earnings are vested based on the participant's years of eligibility under Plan B at the rate of 20% for each full year.

All deferrals, matching contributions and earnings credits under Plan B are general assets of Employer X. Those credits may be maintained as a book account or by the allocation of assets to a Rabbi Trust established by Employer X.

Plan A requires that participants in Plan B make an irrevocable election to make a salary deferral by the December 31 preceding the calendar year in which the compensation to which the salary deferral election relates is earned. In addition, Plan A provides that the amount subject to the salary reduction election will be the lesser of:

1) the maximum amount of pre-tax deferrals that could be made to Plan A for the calendar year under sections 402(g), 401(k)(3), and 401(m) of the Code; or

2) the amount of base salary such participant actually elects to defer under the terms of Plan B for the calendar year.

Plan B permits the transfer of pre-tax deferrals from base salary plus any related matching contributions (but without earnings, gains or losses allocable thereto) from Plan B to Plan A. The transfer must be completed before March 15 of the calendar year following the year in which the salary deferral was made. It is expected that the transfer provision will enable Employer X to calculate for each participant of Plan B the maximum permitted contribution under Plan A under the limitations of sections 401(k), 401(m) and 402(g) of the Code.

Plan B requires that participants make an election to defer on or before December 20 of the calendar year preceding the year for which compensation is earned. For a new participant, an election may be made within thirty days following a participant's initial selection for membership provided the election relates to compensation for services to be performed subsequent to the election to defer. By electing to defer from base salary under Plan B, a participant also authorizes

a transfer from Plan B to Plan A. The determination of the amount of elective contributions transferred from Plan B to Plan A will be calculated pursuant to a formula contained in Plan A and Plan B, as reflected in the election form for Plan B. Plan A requires Employer X to contribute this amount to Plan A. These provisions preclude employer discretion with respect to the amount of elective deferrals. The election form for Plan B also serves as the election form for Plan A.

Plan B permits refunds of deferrals to participants under certain circumstances. The amount of refund will be determined as follows: (1) if a participant's deferrals from base salary under Plan B are equal to or greater than the maximum pre-tax contributions the participant could have contributed to Plan A for a year, then the difference between the actual pre-tax contributions a participant authorized to be made to Plan A for such year and the maximum amount the participant could have contributed to Plan A will be refunded; and (2) if a participant's deferrals from base salary under Plan B are less than the maximum pre-tax contributions the participant could have contributed to Plan A for a year, but are greater than the pre-tax contributions the participant authorized to be made to Plan A for such year, then the difference between the amount of deferrals from base salary under Plan B for such year and the amount that the participant authorized to be made to Plan A will be refunded. Any refund of deferrals will be included in a participant's taxable income for the year with respect to which the deferral is made. Earnings and matching contributions attributable to the refunded amount will continue to be credited to the participant under Plan B.

With respect to the foregoing, the following rulings are requested:

(1) Assuming that Plan A otherwise satisfies the requirements for a qualified cash or deferred arrangement and that the elective deferrals and actual deferral percentage limitations of sections 402(g) and 401(k)(3) of the Code are not exceeded, elective deferrals made by you under Plan A that are initially held by Employer X pursuant to the terms of Plan B will be excluded from gross income under section 402(e)(3) of the Code.

(2) For purposes of satisfying section 402(g) of the Code, elective deferrals under Plan A made by you for a given plan and calendar year that are initially held by Employer X pursuant to the terms of Plan B will be treated as having been made in the calendar year in which they would have been otherwise received as wages by you.

Section 401(k)(2) of the Code provides, in pertinent part, that a qualified cash or deferred arrangement is any arrangement which is a 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), and 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.

Section 1.401(k)-l(a)(3)(i) of the Income Tax Regulations ("Regulations") 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.

Under section 1.401(k)-l(a)(3)(ii) of the Regulations, 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.

Under section 1.401(k)-l(a)(3)(iii) of the Regulations, 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.

Under section 1.401(k)-l(b)(4)(i) of the Regulations, an elective contribution is taken into account for purposes of the actual deferral percentage test for a plan year only if (A) the elective contribution is allocated to the employee's account under the plan as of a date within that plan year, and (B) the elective contribution relates to compensation that either (1) would have been received by the employee in the plan year but for the employee's election to defer under the arrangement, or (2) is attributable to services performed by the employee in the plan year and, but for the employee's election to defer, would have been received by the employee within two and one-half months after the close of the plan year. An elective contribution is considered allocated as of a date within the plan year only if: (1) the allocation is not contingent upon the employee's participation in the plan or performance of services on any date subsequent to that date, and (2) the elective contribution is actually paid to the trust no later than the end of the 12-month period immediately following the plan year to which the contribution relates.

Section 402(e)(3) of the Code provides, in pertinent part, 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 a 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.

Under section 402(g)(1) of the Code, the elective deferrals of any individual for any taxable year are included in such individual's gross income to the extent the amount of such deferrals for the taxable year exceeds $7,000 (as adjusted under section 402(g)(5) of the Code), notwithstanding section 402(e)(3) of the Code regarding elective deferrals under a qualified cash or deferred arrangement.

With respect to ruling request one, you are eligible to defer compensation under Plan B by making two irrevocable elections. The election under Plan B is required to be made on or before December 20 of the calendar year preceding the year for which compensation is earned. The election under Plan A is required to be made no later than December 31 of the calendar year preceding the year for which the compensation is earned. Plan B provides for the transfer of pre-tax deferrals from base salary, plus any related matching contributions from Plan B to Plan A. The election form for Plan B also reflects the transfer. The amount to be transferred is determined in accordance with the provisions of Plan A and Plan B. Plan A requires Employer X to contribute such amount to Plan A. These provisions preclude employer discretion with respect to the amount of elective deferrals.The transfer must be completed on or before March 15 of the calendar year following the year for which the deferral was made under Plan B. If your Plan B pre-tax deferral from base salary is more than the pre-tax deferral you authorized to be made to Plan A, then the difference between the maximum permissible contribution to Plan A and the pre-tax deferral you authorized to be made to Plan A will be refunded to you. Any refund will be taxable income for the year with respect to which the deferral was made.

In addition, for purposes of the actual deferral percentage test under section 401(k)(3) of the Code for a calendar year plan year, elective deferrals irrevocably and prospectively elected under Plan B made by you for a calendar year plan year that are initially held in the general assets of Employer X and then contributed to Plan A will be treated as having been made under Plan A in the calendar year in which the compensation to which the deferrals relate was earned by you, provided that the elective deferrals are allocated to your account by the end of that calendar plan year and the elective deferrals continue to relate to compensation that either would have been received by you in the calendar year plan year but for his election, or is attributable to services performed by you in the calendar year plan year and would have been received by you within 2 ½ months after the calendar year plan year but for your election. An election to make a contribution to Plan A is a cash or deferred election within the meaning of section 1.401(k)-1(a)(3)(i) of the Regulations because it is an election to have Employer X provide a benefit under a plan deferring compensation rather than providing an amount in cash to the employee.

Accordingly, with respect to ruling request one, we conclude that, assuming Plan A otherwise satisfies the requirements for a qualified cash or deferred arrangement and that the elective deferral and actual deferral percentage limitations of sections 402 (g) and 401 (k) (3) of the Code are not exceeded, elective deferrals made by you under Plan A that are initially held by Employer X pursuant to the terms of Plan B will be excluded from gross income under section 402 (e) (3) of the Code when contributed to Plan A, provided such contribution is timely paid and allocated.

With respect to ruling request two, you will make an irrevocable election to have your maximum permissible contribution to Plan A transferred from Plan B to Plan A. If your Plan B pre-tax deferral from base salary is more than the pre-tax deferral you authorized to be made to Plan A, then the difference between the maximum permissible contribution to Plan A and the pre-

tax deferral you authorized to be made to Plan A will be refunded to you. The amount distributed will be taxable income to you in the year it was earned, rather than the year it was actually distributed. If the maximum permissible deferral under Plan A is contributed to Plan A, it would be subject to the 402(g) limitation applicable to the year when it was earned rather than the year in which it was contributed to Plan A.

Accordingly, with respect to ruling request two, we conclude that for purposes of satisfying the limitations of section 402(g) of the Code, contributions made to Plan A by Employer X on your behalf (assuming that such contributions are timely made and timely allocated to your account under Plan A), which are initially held by Employer X pursuant to the terms of Plan B, will be treated as deferrals under Plan A having been made in the year in which they would have been taxable to you but for your election under Plan B to have such deferrals contributed to Plan A.

The above rulings are based on the assumption that at all times relevant to these rulings, Plan A is qualified under section 401 (a) of the Code, and its cash or deferred arrangement is qualified under section 401 (k) (2) of the Code.

This ruling is directed only to the taxpayer that requested it and applies only with respect to Plan A as submitted with this request. Section 6110(k)(3) of the Code provides that this private letter ruling may not be used or cited as precedent. Title I of Employee Retirement Income Security Act of 1974 (ERISA) is within the jurisdiction of the Department of Labor. Accordingly, we express no opinion as to whether the subject transactions comply with Title I of ERISA. Finally, no opinion is expressed as to the income tax consequences of establishing Plan B and participating in it, except as expressly stated herein.

In accordance with a power of attorney on file with this office, a copy of this ruling is being sent to your authorized representatives.

Sincerely yours,

John G. Riddle, Jr.

John G. Riddle, Jr.
Chief, Employee Plans
Technical Branch 4

Enclosures:
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