

Internal Revenue Service
memorandum

date: JUN - 9 1997

to: John Swieca, Chief, Technical Branch 1, Employee Plans
Division

from: Charles T. Deliee, Chief, Branch 1, Office of the Associate
Chief Counsel (Employee Benefits and Exempt Organizations)

subject: Request for Technical Assistance under Section 457 in
Private Letter Ruling Request

You asked for our technical assistance regarding the private letter ruling request that was made on behalf of (the "Employer"), with respect to a proposed transaction. Specifically, you have asked that we address ruling request 4 which involves section 457 of the Internal Revenue Code (the "Code"). As discussed below, the Employer has changed its Ruling Request #4.

FACTS:

Our understanding of the facts is as follows. The Employer has a frozen defined benefit plan (the "DB Plan"), a money purchase plan and several 457 plans (the "457 Plan"). The employees cannot adequately prepare for their retirement because they cannot convert the amount in their money purchase plan and 457 Plan accounts to an annuity value. To address these concerns, the Employer has proposed to reinstate the DB Plan. Employees would be allowed to purchase prior service credit under the DB Plan. Participants in the money purchase plan would be allowed to transfer balances in this account to the DB Plan to purchase this prior service credit. The cost of the prior service credit is equal to the mandatory employee contributions that the employee would have made to the DB Plan had the employee been a participant in the DB Plan during that prior year (5.5% of the employee's compensation for that prior year), plus interest at the rate of 8% per annum, compounded annually, from the date that such contributions would have been made to the DB Plan.

If an employee purchases prior service credit under the DB Plan, the Employer would be obligated to make the related Employer contribution (assumed to be 5.5% of the employee's compensation for that prior year) plus interest thereon compounded annually (assumed to be 8%) to the DB Plan for each year of service credit the participant purchases or is deemed to purchase under the 457 Plan (the "Employer Contribution").

Participants in a 457 Plan, however, cannot transfer the amounts credited to their names from the 457 Plan to the DB Plan. So that all of the Employer's employees would be treated equally,

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the Employer proposed allowing 457 Plan participants to execute an agreement (the "Agreement") which would provide the following:

1. The participants would give up the right to determine the investment of their accounts in the 457 Plan.
2. The participants would give up the right to select a distribution from the 457 Plan in any form other than a life annuity or a joint and survivor annuity over the lives of the participant and the participant's spouse.
3. The participants would waive any right to a distribution from the 457 Plan in the event of an unforeseeable emergency.
4. In return, the Employer will guarantee the participant that the sum of benefits received from the DB Plan plus the benefits payable from the 457 Plan will be equal to the amount of pension benefits the participant would have received if the participant had been able to transfer his or her 457 account balance to the DB Plan to purchase service credit.

LAW AND ANALYSIS:

Because the participant has a vested contractual right to the amount of the Employer Contribution, the employee is deemed to receive a contribution to the 457 Plan equal to the present value of the corresponding Employer Contribution at the time the Agreement is signed. For example, assume a participant in the 457 Plan signs the Agreement and the participant's account in the section 457 Plan is sufficient to "purchase" 3 years of prior service credit. The participant then may retire immediately and elect to receive a lump sum distribution of the full amount in his or her account, including the amount of the Employer Contribution.

Section 457(b)(1) provides that the maximum amount which may be deferred under an eligible section 457 Plan for a taxable year shall not exceed the lesser of (A) \$7,500 or (b) 33 1/3 percent of the participant's includible compensation. Based on our discussions with the Employer's legal counsel, it is likely that the amount of the Employer Contribution for many of the participants in the 457 Plan would exceed the statutory limit. The Employer Contribution of any employee that has a 457 Plan account balance in excess of \$7,500 would also be in excess of \$7,500 and would violate section 457(b).¹ Based on our

¹ It is quite possible that participants with small 457 Plan account balances would execute the Agreement. For example, an account balance of approximately \$8,300 would represent 4

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discussions with the Employer's attorney, we concluded that it is likely that the amount of the deemed Employer Contribution would exceed the contribution limits under section 457(b)(2) of the Code.

The 457 Plan participants who enter into the Agreement will not constructively receive the amount of the Employer Contribution when the Agreement is executed. Income is constructively received in the taxable year during which it is credited to a taxpayer's account or 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. Although the Employer Contribution is deemed to be credited to the participant's account in the 457 Plan, the electing participants cannot draw upon amounts in the 457 Plan and will not receive any portion of the Employer Contribution until they begin receiving payments under the terms of the 457 Plan.

Similarly, the 457 Plan participants who enter into the Agreement do not receive taxable income upon execution of the Agreement under the economic benefit doctrine. Under the economic benefit doctrine, an employee has currently includible income from an economic or financial benefit received as compensation, even though the compensation is 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. Under the Agreement, no assets are unconditionally and irrevocably paid into a trust for the electing participants' sole benefit.

REVISED RULING REQUEST:

The Employer has modified Ruling Request 4 to provide that the proposed transaction shall be available only for those "Electing Participants" for whom the present value of the Employer's additional liability resulting from the transaction will not violate the annual contribution limitations under section 457(b)(2) of the Code.

To accomplish this, the Employer will make the proposed arrangement available only to "Qualified Electing Participants as defined below.

years of prior service credit for an employee with compensation of \$30,000 each year.

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Qualified Electing Participant. A Qualified Electing Participant shall be an Electing Participant for whom the present value of the City's additional obligation resulting from the City's guarantee that the participant/employee will receive certain minimum aggregate benefits will not result in a violation of the annual limitations described in Section 457(b). For purposes of the preceding sentence, such present value shall be treated as an amount deferred under Section 457. The present value of the City's additional obligation as a result of the guarantee shall be calculated by a qualified actuary based on the same actuarial assumptions are utilized with respect to Plan A.

PROPOSED LANGUAGE FOR RULING:

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 other beneficiary.

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 it is 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 or 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.

Under the economic benefit doctrine, an employee has currently includible income from an economic or financial benefit received as compensation, even though the compensation is 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.

Section 457(b) (1) provides that the maximum amount which may be deferred under an eligible deferred compensation plan for a taxable year shall not exceed the lesser of (A) \$7,500 or (B) 33 1/3 percent of the participant's includible compensation.

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Provided: (i) that the 457 Plan otherwise meets the requirements of section 457 of the Code; (ii) a Qualified Electing Participant's ability to execute an Agreement with respect to the Participant's account under the 457 Plan is limited to an amount that, in combination with all other contributions taken into account for purposes of the limitation on contributions to the 457 Plan for the plan year during which the Agreement was executed, does not exceed the maximum permitted contribution under section 457(b)(2), the following shall apply as of the date of this ruling:

4(a) A Qualified Electing Participant's waiver of certain rights with respect to a portion of the Qualified Electing Participant's account balance in the Section 457 Plan and the Qualified Electing Participant's agreement to receive a portion of his or her benefits with respect to such portion of the 457 Plan in the form of certain installment payments (to the participant or the participant's spouse) will not cause any amount to be includable in the income of the Qualified Electing Participant under Section 457 of the Code, the Constructive Receipt Doctrine of Section 451 of the Code or the Economic Benefit Doctrine.

4(b) The City's unfulfilled contractual obligation to assure that the aggregate payments from Plan A and the other monthly installments are equal to the contractual minimum will not by itself cause any amount to be includable in the income of the Qualified Electing Participant under Section 457 of the Code, the Constructive Receipt Doctrine of Section 451 of the Code or the Economic Benefit Doctrine.