200410024

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C.20224

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

UIL: 415.00-00

DEC 11 2003

T:EP:RA:T3

LEGEND:

System A:

State M:

This is in response to your request for a private letter ruling, dated November 26, 2002, as supplemented by letters dated January 16 and 20,2003, May 19,2003, and October 2 and 23, 2003, concerning the applicability of section 415(m) of the Internal Revenue Code to an excess plan and the tax consequences of certain related transactions. You have submitted the following facts and representations in support of your request.

System A is a defined benefit plan created by the State M legislature and set forth in the State M statute. System A is a governmental plan as described in Code section 414(d), and meets the requirements of Code section 401(a). System A is administered by a seven-member board of trustees ("System A Board"). It includes an employer contribution and a mandatory employee contribution feature, which may be picked up by the employer. System A has various funds, which have been established to hold the reserves for current and future obligations of System A. One of these funds holds reserves to pay the monthly benefits of retired members and beneficiaries currently receiving a benefit.

State M has enacted legislation which authorizes the System A Board to establish a qualified governmental excess benefit arrangement within the meaning of Code section 415(m). In accordance with this legislation, the System A Board has passed a resolution adopting an excess benefit arrangement ("Proposed Arrangement") pursuant

to the provisions of Code section 415(m). System A participants who participate in the Proposed Arrangement shall not be permitted to elect to defer compensation to the Proposed Arrangement either directly or indirectly under any circumstances. The System A Board proposes to establish a trust fund ("Trust Fund") to hold all assets of the Proposed Arrangement, with the System A Board acting as trustees. The Trust Fund will be separate and apart from the funds of System A. The Proposed Arrangement is a part of System A but under no circumstances will System A pay Proposed Arrangement benefits from System A assets, and under no circumstances will the Proposed Arrangement pay System A benefits from Proposed Arrangement assets. All payments will always be accounted for separately. The payment mechanism (i.e., the Trust Fund and accounts) of the Proposed Arrangement will be completely separate from the payment mechanism of System A. The Proposed Arrangement will be administered as a separate plan from System A; however, the administrative staff and trustees will be the same for both the Proposed Arrangement and System A.

The Trust Fund will be a grantor trust pursuant to state law and for Federal income tax purposes.

The Proposed Arrangement will operate in accordance with Code section 415(m). Under the Proposed Arrangement, a participant will be paid that part of a retirement benefit that would otherwise have been payable by System A except for the limitations of Code section 415. A participant in the Proposed Arrangement shall receive a monthly benefit equal to the difference between the participant's monthly retirement benefit otherwise payable from System A prior to any reduction or limitation because of Code section 415 and the actual monthly retirement benefit payable from System A as limited by Code section 415. Benefits under the Proposed Arrangement shall be paid only if the participant is receiving benefits from System A. Participation in the Proposed Arrangement is automatic and mandatory. Participation in the Proposed Arrangement ceases for any portion of a plan year in which the participant's benefit does not exceed the requisite limit on benefits under the System A defined benefit plan. The benefit payable to a participant from the Proposed Arrangement will be paid in the same manner and at the same time as the retirement benefit payable under System A.

The System A Board shall determine the amount necessary to pay the excess benefit under the Proposed Arrangement for each plan year. The required contribution shall be the aggregate of the excess benefits payable to all participants for such plan year and an amount determined by the Board to be a necessary and reasonable expense of administering the Proposed Arrangement. The amount determined to be necessary to pay the excess benefit of a participant and the administrative expenses of the Proposed Arrangement shall be paid by employer deposits. Any contribution not used to pay the excess benefit for a current plan year that remain after paying administrative expenses of the Proposed Arrangement for the plan year shall be used to fund benefits under the Proposed Arrangement for participants in future years.

All contributions to the Proposed Arrangement shall be made by deposits of the employers; there will be no employee contributions deposited to the Proposed Arrangement.

Based on the above facts and representations, you have requested the following rulings:

1. The Proposed Arrangement is a qualified governmental excess benefit arrangement within the meaning of Code section 415(m);

2. The benefits payable under the Proposed Arrangement will be includible in gross income for the taxable year or years in which amounts are paid or otherwise made available to a participant or a participant's beneficiary in accordance with the terms of the Proposed Arrangement;

3. Income accruing to the Trust Fund established to hold assets of the Proposed Arrangement is exempt from federal income tax under Code sections 115 and 415(m)(1) as income derived from the exercise of an essential governmental function; and

4. The amounts of employer contributions to the Trust Fund providing benefits in excess of the Code section 415(b) limits under the Proposed Arrangement, as well as the benefits payable under the Proposed Arrangement, are not wages for purposes of Federal Insurance Contributions Act ("FICA) taxation, and, therefore, there is no FICA tax liability with respect to these contributions or benefits.

Code section 415(m) sets forth the treatment of qualified governmental excess benefit arrangements. 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 section 415 ("excess benefits"); (B) under such portion no election is provided at any time to the participant (directly or indirectly) to defer compensation; and (C) excess benefits 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.

With respect to your first requested ruling, the Proposed Arrangement is a portion of System A, which your authorized representative has stated is a governmental plan as described in Code section 414(d). According to the terms of the Proposed Arrangement, its only stated purpose is to provide participants in System A that portion of a participant's benefits that would otherwise be payable under the terms of System A

except for the limitations on benefits imposed by Code section 415. The Proposed Arrangement does not allow participants to defer compensation. The terms of the Proposed Arrangement limit participation to System A participants for whom contributions would exceed the Code section 415 limits. Therefore, we have determined that the Proposed Arrangement is a portion of a governmental plan which is maintained solely for the purpose of providing to System A participants that part of the participant's annual benefit otherwise payable under the terms of System A that exceeds the section 415 limits. As such, the Proposed Arrangement meets the requirements of section 415(m)(3)(A).

Your authorized representative has stated in accordance with the terms of the Proposed Arrangement that participation is automatic for System A participants for whom contributions are limited by Code section 415. Your authorized representative has also stated that under no circumstances will a participant be given any election to defer compensation under the Proposed Arrangement, either directly or indirectly. 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, System A) which contains the excess benefit arrangement, with a certain exception for trusts maintained solely for the purpose of providing such benefits. In the present case, the Trust Fund is a grantor trust: and it is maintained separately from System A. System A will never pay Proposed Arrangement benefits, and the Proposed Arrangement will never pay System A benefits. Contributions to the Trust Fund consist only of the amount required to pay the excess benefits for the plan year and the amount required to pay administrative expenses. Any assets of the Proposed Arrangement not used for paying benefits or administrative expenses for a current plan year shall be used to fund benefits of participants under the Proposed Arrangement in future years. Therefore, we have determined that the requirements of section 415(m)(3)(C) are met.

Since the Proposed Arrangement satisfies all of the requirements of Code section 415(m)(3), we conclude with respect to your first requested ruling that the Proposed Arrangement is a qualified governmental excess benefit arrangement within the meaning of Code section 415(m).

With respect to the second requested ruling, section 415(m)(2) provides that "for purposes of this chapter, (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."

Ruling 1 has already determined that the Proposed Arrangement meets the legal requirements of section 415(m) of the Code for qualified governmental excess benefit arrangements. Accordingly, the tax treatment of the amounts distributed under the Proposed Arrangement to the participants is 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. State M has represented that the trust established in connection with the Arrangement is a grantor trust pursuant to State **M** law and for Federal tax purposes.

Section 83(a) of the Code 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 Income Tax 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 nonexempt 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.

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 regard to your second requested ruling, we conclude that the benefits payable under the Proposed Arrangement will be includible in gross income for the taxable year or years in which amounts are paid or otherwise made available to a participant or a participant's beneficiary in accordance with the terms of the Proposed Arrangement;

With respect to your third requested ruling, Code section 415(m)(1) provides that "[I]ncome accruing to a governmental plan (or to a trust that is 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) shall be exempt from tax under section 115." Ruling 1 has already determined that the Proposed Arrangement meets the legal requirements of section 415(m) of the Code for qualified governmental excess benefit arrangements.

Accordingly, with respect to your third requested ruling, we conclude that income accruing to the Trust Fund established to hold assets of the Proposed Arrangement is exempt from federal income tax under Code sections 115 and 415(m)(1) as income derived from the exercise of an essential governmental function.

With respect to your fourth requested ruling, section 5.15(3) of Revenue Procedure 2003-1, 2003-1 I.R.B. 1, 15, 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 FICA tax treatment of a qualified governmental excess benefit arrangement under Code section 415(m) cannot readily be resolved before published guidance is issued. Consequently, we are unable to rule on that portion of the request.

The rulings granted herein apply only if System A revises section 6.03 and the third sentence of section 5.02(a) of the Proposed Arrangement as provided in its submissions of October 2 and 23, 2003.

This ruling letter is based on the assumption that System A is a governmental plan as described in Code section 414(d) and that it meets all of the applicable requirements under Code section 401.

This ruling letter is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that this ruling may not be used or cited as precedent.

A copy of this letter has been sent to your authorized representative in accordance with the power of attorney on file in this office.

If you have any questions about this letter, please contact at Please refer to SE:T:EP:RA:T3.

Sincerely yours,

Frances V. Sloan, Manager
Employee Plans Technical Group 3

Enclosures
Notice 437
Deleted copy of ruling letter