Office of Chief Counsel
Internal Revenue Service

memorandum

CC:TEGE:EB:EC
KMGriffin

FEB 26 2004

date:
to: Director, Employee Plans Rulings and Agreements (Tax-Exempt and Government Entities) T:EP:RA Attn.: Larry Isaacs or Jim Holland

from: Chief, Executive Compensation Branch
Office of Division Counsel / Associate Chief Counsel (Tax-Exempt and Government Entities) CC:TEGE:EB:EC

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subject: [redacted]
(PRENO-164580-03)

This replies to your November 4, 2003, request for technical assistance in the above-referenced ruling request. In particular, you asked for our views regarding ruling request number three. Attached to this reply are copies of supplemental submissions provided directly to this office.

The following legend will facilitate your reading of this reply.

<u>Legend</u>

Proposed Plan	[redacted]
Pension Plan	[redacted]
Trust	[redacted]

The information submitted provides that the Proposed Plan is intended to be an excess benefit plan within the meaning of § 3(36) of the Employee Retirement Income Security Act of 1974 ("ERISA"). The Proposed Plan provides supplemental retirement benefits to certain pay-status Pension Plan participants. The Pension Plan is a collectively-bargained, multi-employer, qualified, defined benefit plan. The Trust was established for the exclusive benefit of the participants (and their beneficiaries) in the Proposed

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Plan. The Trust is not a trust described in § 401(a) of the Internal Revenue Code ("Code"), nor is it exempt from tax under § 501(a).

Under the Proposed Plan, participants receive an amount ("Excess Benefit Amount") equal to the amount their benefit under the Pension Plan for the previous calendar month is reduced to satisfy the requirements of § 415 of the Code. In addition, the administrator of the Proposed Plan may gross-up the Excess Benefit Amount by an amount equal to the amount of tax (employee share only) attributable to the Excess Benefit Amount under the Federal Insurance Contributions Act ("FICA"). Separate accounts are maintained for each participant. Benefits payable under the Proposed Plan are calculated and paid on a monthly basis (or as soon as administratively feasible thereafter). Benefits payable under the Proposed Plan vest as contributions are made to the Trust. The Trust is not expected to generate earnings.

Contributions made to the Trust are irrevocable. No part of the Trust's principal or income may revert to any employer or be used for any purpose other than providing benefits under the Proposed Plan. Assets of the Trust are not subject to claims of creditors of participating employers.

Section 83(a) of the Code provides the general rule that, if, in connection with the performance of services, property is transferred to any person other than the service recipient, the excess of the fair market value of the property over the amount paid for the property is included in the service provider's gross income for the first taxable year in which the rights to the property are either transferable or not subject to a substantial risk of forfeiture.

For purposes of § 83 of the Code, the term "property" includes real and personal property other than either money or an unfunded and unsecured promise to pay money or property in the future. The term also includes a beneficial interest in assets, including money, transferred or set aside from the claims of the transferor's creditors, for example, in a trust or escrow account. See § 1.83-3(e) of the Income Tax Regulations ("regulations").

Under § 1.83-8(a)(4) of the regulations, if a transfer of property is subject to § 402(b) of the Code, § 83 applies to the transfer only as provided in § 402(b). Section 402(b) applies to transfers of property for the benefit of employees (or their beneficiaries) to an employees' trust, unless the trust is exempt from tax under § 501(a). See § 402(b).

Under the terms of the Proposed Plan and Trust, the Trust is an employees' trust that will receive irrevocable contributions for the exclusive purpose of providing benefits to participants. Because the Trust's assets are not subject to claims of creditors of participating employers, and because the Trust is not exempt from tax under § 501(a), employer contributions to, and distributions from, the Trust are governed by § 402(b).

Under § 402(b)(1) of the Code, employer contributions to an employees' trust that is not exempt from tax under § 501(a) are included in the employee's gross income in accordance with § 83. When § 83 is applied in this context, however, its terms are modified by substituting the phrase "the value of the employee's interest in the trust" for the phrase "the fair market value of the property." See § 402(b)(1). Under § 83, as modified by § 402(b)(1), such contributions are included as compensation in the employee's gross income for the taxable year the contribution is made, but only to the extent that the employee's interest in the contribution is "substantially vested" when the contribution is made. See §§ 1.402(b)-1(a)(1) and 1.83-3(b) of the regulations.

Under § 402(b)(4)(A) of the Code, however, if one of the reasons a trust is not exempt from tax under § 501(a) is the failure of the plan of which it is a part to meet the requirements of § 401(a)(26) or § 410(b), then, instead of including in gross income the amount computed under §§ 402(b)(1) & (2), a highly compensated employee includes in gross income for his or her taxable year with or within which the trust's taxable year ends an amount equal to the employee's vested accrued benefit (less the employee's investment in the contract) as of the close of the trust's taxable year. For this purpose, the term "highly compensated employee" is defined in § 414(q). See § 402(b)(4)(C).

In addition, under § 402(b)(4)(B) of the Code, if the only reason a trust is not exempt from tax under § 501(a) is the failure of the plan of which it is a part to meet the requirements of § 401(a)(26) or § 410(b), §§ 402(b)(1) & (2) do not apply to any employee who is not a highly compensated employee during the taxable year, or any preceding period for which service was creditable to such employee under the plan. For this purpose, the term "highly compensated employee" is defined in § 414(q). See § 402(b)(4)(C).

Under § 402(b)(2) of the Code, amounts distributed or made available to any distributee by a nonexempt trust are taxable in the year so distributed or made available under section 72.

Under the terms of the Proposed Plan and Trust, an employee's interest in contributions to the Trust is substantially vested when the contributions are made. Accordingly, if your office determines that the Proposed Plan fails to meet the requirements of § 401(a)(26) or § 410(b) of the Code, § 402(b)(4)(A) will apply to highly compensated employees who participate in the Proposed Plan. Section 402(b)(1) will apply to all other participants unless your office determines that the only reason the Trust is not exempt from tax under § 501(a) is because the Proposed Plan fails to meet the requirements of § 401(a)(26) or § 410(b). In such case, § 402(b)(1) will not apply to any participant who was not a highly compensated employee during the taxable year or any preceding period for which service was creditable to such participant under the plan.

Thus, regarding ruling request number three, we suggest using the following two

paragraphs:

Contributions to the Trust, including the FICA tax gross-up amounts, are taxable to Proposed Plan participants (and beneficiaries) when the contributions are made, unless the only reason the Trust is not exempt from tax under § 501(a) is because the Proposed Plan fails to meet the requirements of § 401(a)(26) or § 410(b). If the only reason the Trust is not exempt from tax under § 501(a) is because the Proposed Plan fails to meet the requirements of § 401(a)(26) or § 410(b), contributions to the Trust, including the FICA tax gross-up amounts, are taxable to Proposed Plan participants (and beneficiaries) when the contributions are made only with respect to participants who are highly compensated employees during the taxable year, or any preceding period for which service was creditable to such participants under the Proposed Plan.

Trust earnings, if any, are taxable to participants (and beneficiaries) when they are creditable to participant accounts, made available, or paid, depending on whether the Trust meets the requirements of § 401(a)(26) or § 410(b), and whether the participants are highly compensated employees during the taxable year, or any preceding period for which service was creditable to such participants under the Proposed Plan.

We hope this assistance will be helpful. Of course, this reply assumes that the Proposed Plan will be adopted as proposed. If you have any questions, please call Ken Griffin at 622-6030.