Private Letter Ruling
Number: **9631031**
Internal Revenue Service
May 10, 1996

Internal Revenue Service
Department of the Treasury
Washington, DC 20224

Uniform Issue List No.: 401-04-01

Ladies and Gentlemen:

This is in response to your request for a private letter ruling dated November 21, 1995, which was submitted by your authorized representative, concerning the distribution restrictions under section 1.401(a)(4)-5(b)(3) of the Income Tax Regulations.

The following facts and representations have been submitted on your behalf by your authorized representative:

Company A, which is incorporated under the laws of State N, maintains Plan X, a defined benefit plan which your authorized representative asserts is qualified under section 401(a) of the Internal Revenue Code ("Code") and the trust of which is tax-exempt under section 501(a) of the Code.

The normal method of payment of benefits under Plan X is in the form of a life annuity or a qualified joint and survivor annuity, depending on the participant's marital status at the time benefit payments commence. Plan X also provides in Section 5.7(b) that a participant who has attained at least age 60 as of the annuity starting date or if such participant has retired due to disability may elect to receive his monthly retirement benefit in one lump sum in cash.

Section 5.14 of Plan X contains restrictions on the benefits Plan X can pay to any member of the group consisting of the twenty-five highest paid employees and former employees with the greatest annual compensation who are subject to the restrictions of section 1.401(a)(4)-5(b)(3) of the regulations.

Participant B is a resident of State N. Participant B's date of birth is August 16, 1930, and he began employment with Company A on October 10, 1955. Participant B began participating in Plan X on January 1, 1959, and his normal retirement date under Plan X is September 1, 1995. Participant B has accrued a benefit in Plan X and is currently eligible for a normal retirement benefit from Plan X. Participant B is subject to the restrictions of section 1.401(a)(4)-5(b)(3) of the regulations.

Section 5.14 of Plan X permits distributions of restricted benefits if an acceptable arrangement to secure the repayment of the restricted benefits (Restricted Amount) to Plan X is agreed upon. Your authorized representative has represented that the term Restricted Amount as used herein is defined in Revenue Ruling 92-76, 1992-2 C.B. 76. Revenue Ruling 92-76 defines the Restricted Amount as the, excess of the accumulated amount of distributions made to the employee over the accumulated amount of the employee's nonrestricted limit. The employee's nonrestricted limit is equal to the payments that could have been distributed to the employee, commencing when distribution commenced to the employee, had the employee received payments in the form described in section 1.401(a)(4)-5(b)(3)(i)(A) and (B) of the regulations. An "accumulated amount" is the amount of a payment increased by a reasonable amount of interest from the date the payment was made (or would have been made) until the date for the determination of the Restricted Amount.

Section 5.14 of Plan X provides that the Restricted Amount may be distributed in full to an individual if the individual enters into a written agreement with Plan X to secure repayment of the Restricted Amount to Plan X if Plan X terminates and' repayment is necessary. Various means of securing repayment of the Restricted Amount, including repayment from amounts held in escrow, may be used.

Pursuant to section 5.14(c) of Plan X, the following four options are arrangements which the individual can make for securing the repayment of the Restricted Amount to Plan X:

(1) entering into an agreement for promptly depositing in escrow with an acceptable depositary, property having a fair market value equal to at least 125 percent of the Restricted Amount;

(2) providing a bank letter of credit in an amount equal to at least 100 percent of the Restricted Amount;

(3) posting a bond equal to at least 100 percent of the Restricted Amount, where the bond must be furnished by an insurance company, bonding company or other surety for federal bonds; or

(4) any combination of options (1), (2), or (3); however, any combination that includes option (1) shall be in an aggregate amount equal to at least 125 percent of the Restricted Amount.

Under Option (1), a participant's obligation under a repayment agreement would be secured by depositing in escrow with an acceptable depositary property with a fair market value equal to one hundred twenty-five (125) percent of the Restricted Amount. If the market value of the property in the escrow account falls below one hundred ten (110) percent of the Restricted Amount, then the individual is obligated to deposit additional property to bring the value of the property held by the depositary up to one hundred twenty-five (125) percent of the Restricted Amount. Under Option (2), a participant's obligation under a repayment agreement would be secured by a bank letter of credit. The letter of credit would be for an amount equal to at least one hundred (100) percent of the Restricted Amount. Under Option (3), a participant's obligation

under a repayment agreement would be secured by a bond furnished by an insurance company, bonding company, or other surety for federal bonds. The bond would be in an amount equal to at least one hundred (100) percent of the Restricted Amount.

Under Option (4), a participant's obligation under a repayment agreement would be secured by depositing property in escrow with an acceptable depositary, obtaining a bank letter of credit, and/or obtaining a bond furnished by an insurance company, bonding company, or other surety approved for federal bonds.

Where the participant elects to secure repayment of the Restricted Amount by any combination of Options (1), (2) and (3), the aggregate value of the security shall equal at least one hundred twenty-five (125) percent of the Restricted Amount. Where Option (1) is combined with Option (2) and/or Option (3) to secure the repayment, if the fair market value of the property in the escrow account falls and causes the aggregate value of the security to fall below one hundred ten (110) percent of the Restricted Amount, then the individual is obligated to either deposit additional property in the escrow account and/or increase the value(s) of the letter of credit or bond, so that the aggregate value of the security equals at least one hundred twenty-five (125) percent of the Restricted Amount.

Where the participant elects to secure repayment of the Restricted Amount by a combination of Options (2) and (3), the aggregate value of the security shall equal at least one hundred (100) percent of the Restricted Amount.

Participant B desires to receive his benefit from Plan X in the form of a lump sum distribution which will be rolled over into an individual retirement arrangement ("IRA") qualified under section 408 of the Code. Participant B has elected to secure repayment of the Restricted Amount pursuant to Option (4) under section 5.14 of Plan X. Participant B desires to use a combination of Options (1) and (2) to secure his repayment obligation.

Your authorized representative represents that Participant B will establish two IRA accounts with the Custodian. One IRA (the "Restricted IRA") will hold the Restricted Amount and will be subject to an escrow agreement with Participant B as the obligor. A letter of credit, subject to the terms of the said escrow agreement, will also be issued by the Custodian in favor of Plan X. At the time of the rollover, the value of the letter of credit will equal twenty-five (25) percent of the Restricted Amount, so that the total value of the security in favor of Plan X will equal one hundred twenty-five (125) percent of the Restricted Amount (i.e. security in the form of the Restricted IRA equal to one hundred (100) percent of the Restricted Amount and the letter of credit equal to twenty-five (25) percent of the Restricted Amount). Participant B will also establish an additional IRA (the "Unrestricted IRA") with the Custodian to hold amounts not considered part of the Restricted Amount. The Custodian has agreed to accept a rollover of Participant B's distribution from Plan X and enter into an escrow agreement with Participant B and Plan X.

Your authorized representative represents that the escrow agreement provides that its terms will remain in effect after Participant B's death and that such terms will be binding upon his estate, heirs and beneficiaries to the same extent the escrow agreement was applied to Participant

B during his lifetime. The escrow agreement also provides for the termination of Participant B's repayment obligation and the release of any security in the event repayment should' no longer be required by the regulations, Revenue Ruling 92-76 or other Code authority. The escrow agreement also provides that the escrow will terminate should the value of Plan X's assets exceed one hundred ten (110) percent of Plan X's current liabilities, should the value of Participant B's future benefits (had the payment not been made) be less than one (1) percent of Plan X's current liabilities, or if Plan X terminates where the benefit received by Participant B is not discriminatory under Code section 401(a)(4).

The escrow agreement also provides that if distributions to Participant B are required pursuant to Code section 408(a)(6), the total required distributions will be made from the Unrestricted IRA and all other IRA accounts of Participant B until they are exhausted. Upon exhaustion of the funds in the Unrestricted IRA and other IRA accounts, or as otherwise required by Code section 408(a)(6), required distributions would be made from the Restricted IRA. In the event distributions required by Code section 408(a)(6) following Participant B's death result in the aggregate fair market value of the assets in the Restricted IRA and the value of the letter of credit to fall below one hundred ten (110) percent of the Restricted Amount, Participant B's successor(s) in interest will be required to establish an escrow agreement similar to that established by Participant B or as otherwise permitted under Revenue Ruling 92-76 and place sufficient assets in the escrow agreement so that the aggregate fair market value of the assets and any letter of credit equals at least one hundred twenty-five (125) percent of the Restricted Amount.

The escrow agreement also provides that Participant B will take certain action in the event that the aggregate fair market value of the assets in the Restricted IRA and the value of the letter of credit fall below one hundred ten (110) percent of the Restricted Amount. In such a case, Participant B will have assets in the Unrestricted IRA transferred to the Restricted IRA. In the alternative, the letter of credit will be increased. In either case, the aggregate value of the Restricted IRA and the letter of credit will be increased to at least one hundred twenty-five (125) percent of the Restricted Amount.

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

(1) Plan X will not be disqualified under Code section 401(a) and the accompanying trust will not lose its tax-exempt status under Code section 501(a) merely because a payment is made to a Plan X participant who is subject to the restrictions of section 1.401(a)(4)-5 of the regulations, where the payment consists, in part, of a restricted benefit (the Restricted Amount) and a contingent obligation to repay such restricted benefit is evidenced by a repayment agreement secured under a bond or letter of credit;

(2) Plan X will not be disqualified under Code section 401(a) and the accompanying trust will not lose its tax-exempt status under Code section 501(a) merely because a payment is made to a Plan X participant who is subject to the restrictions of section 1.401(a)(4)-5 of the regulations, where the payment consists, in part, of a restricted benefit (the Restricted Amount) which would be placed in an IRA escrow account with a contingent obligation to

repay such restricted benefit if required, and a bond or letter of credit in favor of Plan X, in an amount equal to twenty-five (25) percent of the Restricted Amount, would be obtained;

(3) the assignment of the IRA account containing the Restricted Amount by Participant B to Plan X by way of the escrow agreement will not violate the prohibition of Code section 401(a)(13); and

(4) the use of an IRA to hold the Restricted Amount and the IRA's contingent obligation pursuant to the escrow agreement will not cause the distribution of the Restricted Amount held in the IRA escrow to be deemed a distribution to the IRA owner.

Section 401(a) of the Code provides the requirements for the qualification of employees' retirement plans. Section 401(a)(4) provides that neither the contributions nor the benefits under a plan may discriminate in favor of employees who are highly compensated.

Section 1.401(a)(4)-5(b)(1) of the regulations provides that a defined benefit plan must incorporate certain provisions restricting benefits and distributions so as to prevent the prohibited discrimination that may occur in the event of early termination of the Plan. Section 1.401(a)(4)-5(b)(2) requires a defined benefit plan to provide that, in the event of plan termination, the benefit of any highly compensated employee (and any highly compensated former employee) is limited to a benefit that is nondiscriminatory under section 401(a)(4) of the Code. In any one year, the total number of employees whose benefits are subject to restriction under section 1.401(a)(4)-5(b) may be limited by a plan to a group of not less than 25 highly compensated employees and former employees. If this group is so limited under a plan, the group must consist of those highly compensated employees and former employees with the greatest compensation in the current or any prior plan year.

Section 1.401(a)(4)-5(b)(3)(i) of the regulations further requires a defined benefit plan to provide that the annual payments to an employee subject to restrictions on distributions must be limited to an amount equal in each year to the payments that would be made to the employee under:

(1) a straight life annuity that is the actuarial equivalent of the accrued benefit and other benefits to which the employee is entitled under the plan (other than a social security supplement); and

(2) the amount of the payments that the employee is entitled to receive under a social security supplement.

Section 1.401(a)(4)-5(b)(3)(iv) of the regulations provides that the above referenced restrictions do not apply if any of the following conditions is satisfied:

(1) after payment to a restricted employee of all benefits payable under a plan, the value of the plan assets equals or exceeds 110 percent of the value of the plan's current liabilities, as defined in section 412(1)(7) of the Code;

(2) the value of the benefits payable to a restricted employee under a plan is less than one percent of the value of current liabilities before the distribution; or

(3) the value of the benefits payable to a restricted employee under a plan does not exceed the amount described in section 411(a)(11)(A) of the Code ($3500).

Section 1.401(a)(4)-5(b)(3)(v) of the regulations provides that, for purposes of paragraph (b), any reasonable and consistent method may be used for determining the value of current liabilities and the value of plan assets.

Revenue Ruling 92-76 holds that a lump sum distribution in an amount in excess of that otherwise permitted under section 1.401(a)(4)-5(b) of the regulations may be made, provided there is adequate provision for repayment of any part of the distribution representing the Restricted Amount in the event the plan is terminated while the restrictions are still applicable. Revenue Ruling 92-76 states that one permissible method of securing the agreement for repayment of the Restricted. Amount is the deposit with an acceptable depositary of property having a fair market value equal to one hundred twenty-five (125) percent of the amount that would be repayable if the plan terminated on the date of the distribution by the trust. Under the Revenue Ruling, if the market value of such property falls below one hundred ten (110) percent of the Restricted Amount, the employee is obligated to deposit whatever additional property is necessary to bring the value up to one hundred twenty-five (125) percent of the Restricted Amount. Another permissible method for securing the agreement for repayment of the Restricted Amount under Rev. Rul. 92-76 is obtaining a bond or bank letter of credit in an amount equal to at least one hundred (100) percent of the Restricted Amount.

With respect to ruling requests (1) and (2), section 1.401(a)(4)-5(b) of the regulations permits a plan to make a distribution to a plan participant which would otherwise violate the provisions of Code section 401(a)(4), so long as the requirements of section 1.401(a)(4)-5(b) of the regulations are met. Rev. Rul. 92-76 provides a range of options among which a plan and a participant can choose to secure the plan's interest in a distribution to a participant who is subject to the restrictions of section 1.401(a)(4)-5(b) of the regulations.

In this case, in accordance with the terms of Plan X, Participant B will enter into an escrow agreement with the administrator of Plan X and the Custodian to secure the repayment of the Restricted Amount to Plan X. Pursuant to this agreement, the portion of the Plan X distribution to Participant B equal to the Restricted Amount will be rolled over into the Restricted IRA. In addition, a letter of credit, equal in value to twenty-five (25) percent of the Restricted Amount, will be issued by the Custodian in favor of Plan X. This depositary arrangement with the Custodian is comparable to the arrangement established in Revenue Ruling 92-76. Adequate provisions to secure the plan's interest in the restricted benefit are made in the event the aggregate fair market value of the assets in the Restricted IRA and the value of the letter of credit falls below one hundred ten (110) percent of the restricted benefit. Participant B's escrow agreement with the administrator of Plan X and the Custodian also provides adequately for repayment in the event that the requirements of section 408(a)(6) of the Code reduce the value of the Restricted IRA and the letter of credit to less than one hundred ten (110) percent of the Restricted Amount.

Accordingly, we conclude, with respect to ruling request (1) that Plan X will not be disqualified under Code section 401(a) and the accompanying trust will not lose its tax-exempt status under Code section 501(a) merely because (i) a payment is made to a Plan X participant who is subject to the restrictions of section 1.401(a)(4)-5 of the regulations, where the payment consists, in part, of the Restricted Amount and (ii) a contingent obligation to repay the Restricted Amount is evidenced by a repayment agreement secured under a bond or letter of credit with a value at least equal to 100 percent of the Restricted Amount.

With respect to ruling request (2), we conclude that Plan X will not be disqualified under Code section 401(a) and the accompanying trust will not lose its tax-exempt status under Code section 501(a) merely because (i) a payment is made to Participant B who is subject to the restrictions of section 1.401(a)(4)-5 of the regulations, where the payment Consists, in part, of the Restricted Amount which is placed in the Restricted IRA subject to the terms of the escrow agreement described above with a contingent obligation to repay the Restricted Amount if required, and (ii) a contingent obligation to repay the Restricted Amount is further secured by a bond or bank letter of credit obtained by Participant B in favor of Plan X, in an amount equal to twenty-five (25) percent of the Restricted Amount, and subject to the terms of the escrow agreement described above.

With respect to ruling request (3), section 1.401(a)-13(a) of the regulations states that section 401(a)(13) of the Code applies only to plans to which the minimum vesting rules of section 411 apply. Since IRAs are not subject to section 411, section 401(a)(13) is not applicable.

Accordingly, with respect to ruling request (3), we conclude that Participant B's assignment of the Restricted IRA to Plan X under the escrow agreement described above will not cause Plan X to violate Code section 401(a)(13).

With respect to ruling request (4), section 408(e)(4) of the Code provides that, if an individual uses the IRA account balance as security for a loan, that portion is treated as a distribution to that individual. However, since the contingent obligation to return certain restricted amounts to Plan X is not a loan, section 408(e)(4) is not applicable.

Accordingly, with respect to ruling request (4), we conclude that the assignment referred to in ruling request (3) above will not result in a deemed distribution under section 408(e)(4) of the Code.

This letter ruling is based on the assumption that Plan X meets the requirements of section 401(a) of the Code at all times relevant hereto.

Pursuant to a power of attorney on file with this office, a copy of this letter ruling is being sent to your authorized representative.

Sincerely,

John G. Riddle, Jr.

Chief, Employee Plans
Technical Branch 4