Private Letter Ruling
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Internal Revenue Service
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This is in response to a ruling request submitted on behalf of your client, Individual A, in your letter dated *****, as supplemented by subsequent letters.

The facts upon which you base your request are as follows.

Employer M maintains Plan X, a defined benefit pension plan. Plan X was determined by the appropriate Key District Director's office to be qualified under section 401(a) of the Internal Revenue Code, with its trust exempt under section 501(a) from tax. The latest determination letter for the plan was issued *****, 1985. Effective January 1, 1984, the plan formula was significantly increased for plan participants.

Individual A has been a participant in Plan X for approximately 21 years. In addition, Individual A is among the 25 highest paid employees of Employer M. Individual A was among the highest 25 paid employees as of January 1, 1984, which is the effective date of the significant increase in pension benefits under Plan X.

Individual A separated from service with Employer M in December, 1988. Individual A has requested a distribution from Plan X to the extent legally permissible.

Plan X restricts distributions to the 25 highest paid employees of Employer M in conformity with the rules set forth in section 1.401-4(c) of the Income Tax Regulations. In addition, Plan X also applies the distribution restrictions as of the effective date of any amendment that substantially increases pension benefits under Plan X. These restrictions apply to the 25 highest paid employees of Employer M during the 10 year period following the effective date of the amendment that significantly increases the pension benefits for participants under Plan X.

Individual A would like to receive a distribution from Plan X during 1989 to the extent legally permissible. A minor portion of the accrued benefits that are payable to Individual A from Plan X may not be paid to Individual A until he attains age 65. These minor benefits are payable from an insurance company. Individual A is currently age 47. The balance of Individual A's accrued benefits from Plan X are payable as cash. The monetary portion of Individual A's accrued benefits is in excess of 95 percent of the total value of his accrued benefits.

In order for Individual A to receive a distribution to the extent legally permissibles, he must satisfy the requirements of section 1.401-4(c) of the regulations since he is entitled to an anticipated annual Normal Retirement Benefit which exceeds $1,500.00.

Individual A proposes to enter into an escrow agreement with the Trustees of Plan X in order to satisfy the restrictions under section 1.401-4(c) of the regulations. The escrow agreement will provide that the distribution that Individual A receives from Plan X will be either paid directly to an individual retirement account (IRA) that Individual A has established or will be paid to Individual A and he shall endorse the check immediately over to the IRA that he has established. Individual A's spouse will execute the appropriate spousal consent forms that waive her rights to a qualified preretirement survivor annuity.

The IRA established by Individual A in connection with the distribution he receives from Plan X shall consist of two parts or components. One component shall be a restricted component and the other component shall be an unrestricted component. The restricted portion of the IRA would receive an amount equal to no less than 125 percent of the restricted portion of the distribution that he receives from Plan X. The unrestricted portion of the IRA would receive the balance of the distribution to Individual A from Plan H. Any amounts accumulated in excess of 125 percent of the restricted amount during the restriction period may be transferred from the restricted portion of the IRA to the unrestricted portion. If at any time the value of the assets in the restricted portion of the IRA falls below 110 percent of the then restricted amount, additional property would be transferred from the unrestricted portion of the IRA to the restricted portion of the IRA to bring the fair market value of all property held as security to 125 percent of the then restricted amount. Alternatively, in the event the value of the assets of the restricted portion of the IRA falls to below 110 percent of the then restricted amount, other security may be substituted and transferred directly to the trustees of Plan X to bring the fair market value of all property, inclusive of the restricted portion of the IRA, held as security to 125 percent of the then restricted amount.

The escrow agreement will also provide that if Plan X terminates while the participant's benefits are subject to the early termination restrictions of regulation section 1.401-4(c), then Individual A, through the IRA arrangement, will repay to Plan X the then restricted portion of his benefits by transferring sufficient assets from the then restricted component of the IRA to Plan X unless there are then sufficient assets in Plan X to satisfy the full amount of accrued benefits that are due to all participants and beneficiaries in Plan X. In addition, the escrow agreement will provide that if there is a default in the payment of full current costs during the restriction period, Individual A, through the IRA arrangement will repay to the trustees of Plan H the then restricted portion of his benefits by transferring sufficient assets from the restricted component of the IRA to Plan X.

The IRA that is established by Individual A with respect to the distribution that he receives from Plan X will contain specific provisions authorizing the security arrangement outlined above and providing for the payment to the trustees of Plan X of the then restricted portion of Individual A's IRA as may be required to satisfy Individual A's obligation to Plan X.

Based upon the above facts, you request the following rulings:

1.) That securing Individual A's contingent obligation to Plan X to repay a portion of the distribution that is subject to the "high-25" restriction with amounts rolled over from Plan H into an IRA satisfies the requirements of Revenue Ruling 81-135 and therefore will not violate the requirements of regulation section 1.401-4(c).

2.) That the IRA established by Individual A with the amounts rolled over from Plan X which secures Individual A's contingent obligation to repay the portion of the distribution from Plan X that is subject to the "high-25" restrictions of regulation section 1.401-4(c) is not disqualified under section 408(a)(4) of the Code.

3.) That the portion of the IRA described above that secures Individual A's contingent obligation to repay the portion of the distribution from Plan X that is subject to the "high-25" restrictions of regulation 1.401-4(c) will not be treated as a deemed distribution under section 408(e)(4) of the Code.

4.) That the IRA arrangement described above will not result in the disqualification of the IRA under section 408(e)(2)(A) and 4975(c)(1)(D) of the Code.

5.) That the partial distribution to Individual A during 1989 is eligible for rollover treatment as a partial distribution under section 402(a)(5)(D)(i) of the Code.

6.) That the partial distribution described in ruling request 5 above is deemed a rollover of a partial distribution to an IRA even if the distribution is made directly from Plan X to the IRA established by Individual A provided that Individual A elects to treat a contribution of the partial distribution to an IRA as rollover contribution under temporary regulation section 1.402(a)(5)-1T.

7.) That Individual A will satisfy temporary regulation section 1.402(a)(5)-1T by designating in writing to the trustee or custodian of the IRA established by Individual A on or about the date the check from Plan X is given directly to the trustee or custodian of the IRA that Individual A elects to treat the contribution of a partial distribution to the IRA as a rollover contribution.

Section 401(a) of the Code sets forth the requirements for the qualification of employees' retirement plans. Section 401(a)(4) provides that the contributions or benefits under a plan must not discriminate in favor of employees who are members of the prohibited group.

Section 1.401-4(c)(1) of the Income Tax Regulations provides that although a qualified plan may provide for termination at will by the employer or discontinuance of contributions thereunder, this will not, of itself, prevent a trust from being a qualified trust. However, a qualified pension plan must expressly incorporate provisions which comply with the restrictions contained in section 1.401-4(c)(2) of the regulations. That regulation limits amounts that may be distributed to an employee who is among the 25 highest-paid employees of the employer at the time the plan is established and whose anticipated annual pension under the plan will exceed $1,500, if for instance, the plan is terminated, or the benefits of such employee become payable within 10 years after the establishment of the plan. In accordance with section 1.401-4(c)(5) of the regulations, if a plan has been changed so as to substantially increase the extent of possible discrimination in favor of the prohibited group, the 10-year restricted period begins again as of the date of the change.

Section 1.401-4(c)(2) of the regulations further states, in pertinent part, that employer contributions which may be used for the benefit of such an employee shall not exceed the greater of (1) $20,000 or (2) 20 percent of the first $50,000 of the annual compensation of such employee multiplied by the number of years between the date of the establishment of the plan and, for instance, if benefits of the employee become payable within ten years of the plan's establishment, the date the benefits become payable (if before the date of the termination of the plan). The number of years may be recomputed each year if the full current costs of the plan are met for such year.

Revenue Ruling 81-135, 1981-1 C.B. 203, holds that a lump sum distribution in an amount in excess of that otherwise permitted under section 1.401-4(c) of the regulations may be made, provided there is adequate provision for repayment of any part of the distribution representing the restricted portion in the event of a termination of the plan within the first ten years after its establishment. In Rev. Rul. 81-135, the agreement for repayment was secured by the deposit, with an acceptable depository, of property having a fair market value equal to 125 percent of the amount that would have been repayable if the plan had terminated on the date of the distribution by the trust. The employee also agreed that if the market value of such property fell below 110 percent of the amount that would be repayable if the plan should then terminate, additional property necessary to bring the value up to 125 percent would be deposited.

Section 408(a)(6) of the Code provides that under regulations prescribed by the Secretary, rules similar to the required distribution rules of section 401(a)(9) and the incidental death benefit requirements of section 401(a) shall apply to the distribution of the entire interest of an individual for whose benefit the trust is maintained.

With respect to ruling request one, Individual A will enter into an agreement with the trustee of Plan X wherein he will agree that the accrued benefit distributable to him will be rolled over into an IRA, subdivided into two components, a restricted and unrestricted component. Under the escrow agreement, upon plan termination or failure to pay full current costs during the restriction period, Individual A through the IRA will repay to Plan X the then restricted portion of his benefits in Plan X by transferring sufficient assets from the restricted component of the IRA to Plan X unless there are then sufficient assets in Plan X to satisfy the full amount of accrued benefits that are due to all participants and beneficiaries in Plan X. The escrow arrangement with the IRA is comparable to the arrangement established in Revenue Ruling 81-135. Within this escrow arrangement, an amount equal to at least 125 percent of the restricted portion will be placed into the restricted portion of the IRA. Adequate provisions are made in the event the value of the assets in such restricted IRA or the restricted class of assets in the IRA falls below 110 percent of the restricted amount. The repayment agreement also provides adequate provision for repayment in the event that the requirements of section 408(a)(6) of the Code reduce the value of the restricted portion of the IRA or the restricted class of assets in the restricted portion to less than the restricted amount.

Accordingly, with respect to ruling request one, we conclude that securing Individual A’s contingent obligation to Plan X to repay a portion of the distribution that is subject to the “high-25” restriction with amounts rolled over from Plan X into an IRA satisfies the requirements of Revenue Ruling 81-135 and therefore will not violate the requirements of regulation section 1.401-4(c).

Section 408(a)(4) of the Code provides that in order for an IRA to satisfy the requirements of section 408(a) of the Code, the written governing instrument of an IRA must state that the interest of an individual in his IRA account is nonforfeitable. In this case, the escrow agreement expressly provides that the Trustee of Plan X will have a security interest in Individual A's IRA until the early termination restrictions applicable to Plan X lapse. However, the potential return of the restricted amount to the Trustee of Plan X would not derive from the assertion of any right by Employer M. On the contrary, such a return would result from Plan X's right to the restricted amount under the escrow agreement and such return would not constitute a forfeiture in violation of section 408(a)(4) of the Code.

With respect to ruling request two, we conclude that the IRA established by Individual A with the amounts rolled over from Plan X and which secures Individual A's contingent obligation to repay the portion of the distribution from Plan X that is subject to the "high-25" restrictions of regulation section 1.401-4(c) is not disqualified under section 408(a)(4) of the Code.

Section 408(e)(4) of the Code provides that if, during any taxable year of the individual for whose benefit an IRA is established, that individual uses the account or any portion thereof as security for a loan, the portion so used shall be treated as distributed to that individual. The use of the IRA to secure repayment to Plan X of the restricted distribution is not a pledge or use of the IRA as security for a loan for purposes of section 408(e)(4). The primary purpose of section 408(e)(4) is to assure that the funds in the IRA will be held for retirement purposes rather than used to defray living expenses or finance other activities of the participant. Thus, the arrangement in this case, the sole purpose of which is to enable Individual A to transfer his interest in Plan X to the IRA, is not a loan to Individual A for purposes of section 408(e)(4). Therefore, the assignment to the Trustee of Plan X in this case will not result in a distribution under section 408(e)(4).

Accordingly, with respect to your third ruling request, we conclude that the portion of the IRA described above that secures Individual A's contingent obligation to repay the portion of the distribution from Plan X that is subject to the "high-25" restrictions of regulation 1.401-4(c) is not a deemed distribution under section 408(e)(4) of the Code.

Section 408(e)(2)(A) of the Code provides, in pertinent part, that if, during any taxable year of the individual for whose benefit any individual retirement account is established, that individual or his beneficiary engages in any transaction prohibited by

section 4975 with respect to such account, such account ceases to be an individual retirement account as of the first day of such taxable year.

Section 408(e)(2)(B) of the Code provides that in any case in which any account ceases to be an individual retirement account by reason of section 408(e)(2)(A), as of the first day of any taxable year, paragraph (1) of subsection (d) applies as if there were a distribution on such first day in an amount equal to the fair market value (on such first day) of all assets in the account (on such first day).

Section 4975(c)(1)(D) of the Code prohibits the transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan. Section 408(e)(2)(A) provides that section 4975(c)(1)(D) shall apply to an individual for whose benefit any IRA is established if he engages in such transaction with his IRA. If a transaction described in section 4975(c)(1)(D) occurs, the account ceases to be an IRA as of the first day of the taxable year in which the transaction occurred.

An assignment or alienation of a plan benefit (e.g., that of an IRA) would be a prohibited transaction under section 4975(c)(1)(D) of the Code if the assignment or alienation is for the use or for the benefit of a disqualified person (including an IRA participant). In the instant case, Revenue Ruling 81-135 permits the distribution of amounts restricted under section 1.401-4(c)(2) of the regulations conditioned upon the pledge of security sufficient to secure the promise to repay the restricted amount. Congress has developed rules under section 402(a)(5) which permits rollovers between qualified plans and IRAs (e.g. See Conference Report 93-1280, 93rd Cong. 2d Sess. 249, 341, 1974-3 C.B. 415, 502 in which Congress declared its intention to facilitate the portability of pensions by providing rules for the reinvestment of distributions from a qualified plan to an IRA on a tax-free basis). Accordingly, we are of the opinion that Congress did not intend that an assignment of rights in an IRA to the administrator of a qualified plan for the purpose of securing a promise to repay an amount distributed but restricted under section 1.401-4(c)(2) of the regulations would be a transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan under section 4975(c)(1)(D) of the Code, provided that the assignment is made in connection with a rollover to an IRA under section 402(a)(5). We therefore hold that the assignment of Individual A's rights in an IRA to the Trustee of Plan X in order to secure Individual A's promise to repay that amount of Individual A's distribution which is restricted under section 1.401-4(c)(2) of the regulations would not be a prohibited transaction under section 4975(c)(1)(D).

Accordingly, with respect to your fourth ruling request, we conclude that the IRA arrangement described above will not result in the disqualification of the IRA under section 408(e)(2)(A) and 4975(c)(1)(D) of the Code.

Section 402(a)(5) of the Code provides that--(A)--If (i) any portion of the balance to the credit of an employee in a qualified trust is paid to him, (ii) the employee transfers any portion of the property he receives in such distribution to an eligible retirement plan, and (iii) in the case of a distribution of property other than money, the amount so transferred consists of the property distributed, then such distribution (to the extent so transferred) shall not be includible in gross income for the taxable year in which paid.

Section 402(a)(5)(E)(i)(II) of the Code defines the term "qualified total distribution" to include 1 or more distributions which constitute a lump sum distribution within the meaning of subsection (e)(4)(A) (determined without reference to subparagraphs (B) and (H) of subsection (e)(4)).

Section 402(e)(4)(A) of the Code defines a lump sum distribution as the distribution or payment within one taxable year of the recipient of the balance to the credit of an employee which becomes payable to the recipient--(i) on account of the employee's death, (ii) after the employee attains age 59-1/2, (iii) on account of the employee's separation from the service, or (iv) after the employee has become disabled (within the meaning of section 72(m)(7)) from a trust which forms a part of a plan described in section 401(a) and which is exempt from tax under section 501. Clause (iii) of this subparagraph shall be applied only with respect to an individual who is an employee without regard to section 401(c)(1), and clause (iv) shall be applied only with respect to an employee within the meaning of section 401(c)(1).

Section 402(a)(5)(E)(v) of the Code defines a partial distribution as any distribution to an employee of all or any portion of the balance to the credit of such employee in a qualified trust, except that such term shall not include any distribution which is a qualified total distribution.

Section 402(a)(5)(D)(i) of the Code provides, in pertinent part, that section 402(a)(5)(A) shall apply to a partial distribution only if--(I) such distribution is payable as provided in clause (i), (iii), or (iv) of subsection (e)(4)(A) (without regard to the second sentence thereof), and is of an amount equal to at least 50 percent of the balance of the credit of the employee in a qualified trust (determined immediately before such distribution and without regard to subsection (e)(4)(C), (II) such distribution is not one of a series of periodic payments, and (III) the employee elects (at such time and in such manner as the Secretary shall by regulations prescribe) to have subparagraph (A) apply to such partial distribution.

Section 402(a)(5)(D)(ii) of the Code provides that in the case of a partial distribution, a trust or plan described in subclause III (relating to qualified trusts) or IV (relating to annuity plans described in section 403(a)) of subparagraph (E)(iv) shall not be treated as an eligible retirement plan.

Accordingly, partial distributions may only be rolled over to individual retirement accounts or individual retirement annuities within the meaning of section 408 of the Code.

You represent that during 1989 Individual A will receive a monetary portion of his accrued benefit in Plan X. This amount will be in excess of 95 percent of the total value of Individual A's accrued benefit in Plan X. You have also represented that this distribution will not be one of a series of periodic payments occurring in more than one calendar year, and that the distribution will occur on account of Individual A's separation from service.

Accordingly, we conclude, with respect to your fifth request, that the partial distribution to Individual A during 1989 is eligible for rollover treatment as a partial distribution under section 402(a)(5)(D)(i) of the Code.

Section 1.408-8, Question and Answer A-8, Paragraph (A), of the Proposed Income Tax Regulations provides, in pertinent part, that a qualified trust or plan described in section 401(a) or an annuity described in section 403(a) or 403(b) can not make a transfer to an IRA. However, an IRA may accept a rollover contribution that satisfies the requirements of section 402(a)(5) even if such contribution is distributed by a qualified trust, plan, or annuity directly to the IRA at the direction of the employee (or the employee's surviving spouse). Such contribution will not be treated as a transfer to an IRA. Instead, such contribution will be treated as though it was distributed by the qualified trust, plan, or annuity to the employee (or the employee's surviving spouse) and subsequently rolled over to an IRA within the requisite 60 day period. Paragraph (b) of this Question and Answer states that transfers directly from such a qualified trust or plan described in section 401(a) or annuity described in section 403(a) or 403(b) to an IRA may adversely affect both the qualified status of the trust, plan or annuity from which the transfer is made and the qualified status of the IRA which receives the transfer.

Section 1.402(a)(5)-1T, Q&A-3, of the Income Tax Regulations provides, in pertinent part, that section 402(a)(5)(D)(i)(III) of the Code requires the employee to elect, in conformance with Treasury regulations, to treat a contribution of a partial distribution to an IRA as a rollover contribution. An election is made by designating, in writing, to the trustee or issuer of the IRA at the time of the contribution that the

contribution is to be treated as a rollover contribution. This requirement of a written designation to the trustee or issuer of the IRA is effective for contributions paid to the trustee or issuer of the IRA after March 20, 1986.

You represent that Individual A will designate in writing to the trustee of the IRA at the time of the contribution that the contribution is to be treated as a rollover.

Accordingly, we conclude, with respect to your sixth request, that the payment to the IRA of the partial distribution described in ruling requests 4 and 5 above is deemed a rollover of a partial distribution to an IRA even if the distribution is made directly from Plan X to the IRA established by Individual A provided that Individual A elects to treat a contribution of the partial distribution to an IRA as a rollover contribution under temporary regulation section 1.402(a)(5)-1T.

We also conclude, with respect to your seventh ruling request, that Individual A will satisfy section 1.402(a)(5)-1T by designating in writing to the trustee or custodian of the IRA established by Individual A on or about the date the check from Plan X is given directly to the trustee or custodian of the IRA that Individual A elects to treat the contribution of a partial distribution to the IRA as a rollover contribution.

The above rulings are based upon the condition that Plan X is qualified under section 401(a) of the Code with an associated trust exempt under section 501(a) from tax at all times relevant to the proposed transaction.

A copy of this ruling has been sent to Individual A in accordance with a power of attorney on file in this office.

Private Letter Ruling
Number: 9005011
Internal Revenue Service
November 2, 1989

supplementing LTR **8945009**

Symbol: Not given

Uniform Issue List Nos.: 0401.03-00, 0402.08-00, 0402.08-01, 0408.02-00, 0408.03-00, 0408.07-00, 4975.03-00, 4975.03-02

The purpose of this letter is to correct an error in the ruling issued to your client, Individual A, on August 9, 1989.

In the last line of the third full paragraph of page 2 of the ruling, the words "preretirement survivor" are deleted and the words "joint and survivor" are inserted in their place.

Therefore, the third full paragraph of page 3 of the ruling, is corrected to read in its entirety as follows:

"Individual A proposes to enter into an escrow agreement with the Trustee of Plan X in order to satisfy the restrictions under section 1.401-4(c) of the regulations. The escrow agreement will provide that the distribution that Individual A receives from Plan X will be either paid directly to an individual retirement account (IRA) that Individual A has established or will be paid to Individual A and he shall endorse the check immediately over to the IRA that he has established. Individual A's spouse will execute the appropriate spousal consent forms that waive her rights to a qualified joint and survivor annuity."

A copy of this correction to our ruling dated August 9, 1989, has been sent to Individual A in accordance with a power of attorney on file in this office.