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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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Uniform Issue List: 414.06-00.414.07-00

T:EP:RA:T4

Attention:

Legend:

DC Plan =

DB Plan 1 =

DB Plan 2 =

State A =

Employer B =

State System =

Dear

This is in response to a request for a private letter ruling dated October 17, 2001, submitted on your behalf by your authorized representative, as supplemented by telephone conversations with your authorized representative. In support of your request, your authorized representative has submitted the following facts and representations.

Employer B is a political subdivision of State A. Employer B maintains the DC Plan, a qualified money purchase pension plan under section 401 (a) of the Internal Revenue Code (the “Code”) for its employees and such plan constitutes a governmental plan within the meaning of section 414(d) of the Code.

The assets of each employee’s individual account under the DC Plan consist of employer contributions and the earnings thereon. The DC Plan provides for a five-year cliff vesting schedule, and distributions upon normal retirement age 55 (or the employee’s fifth anniversary of participation, if later) or an employee’s earlier termination of employment. Benefits are payable in the form of lump sum payments or annuities.

The State System is a multiple employer public employee retirement system established pursuant to State A statute. The State System comprises a number of pension systems, including DB Plan 1 and DB Plan 2 (collectively, the “DB Plans”), which are governmental plans within the meaning of section 414(d) of the Code. The DB Plans are both defined benefit plans in which participants are vested after five years. Under DB Plan **1,** participants are eligible for full retirement benefits upon the earlier of attaining age 62 with 5 years of service (or later age with less service) or accumulating 30 years of service. Under DB Plan 2, participants are eligible for full retirement benefits upon the earlier of attainment of age 50 or accumulating 25 years of service.

The DB Plans provide for mandatory contributions by the participant. Mandatory contributions are held in an annuity fund (“Annuity Fund’) until retirement, when such amounts are transferred to an accumulation fund (“Accumulation Fund”) at the time a participants retirement allowance is determined. The amounts held in the Annuity Fund, although referred to as an individual account herein, are not individual accounts within the meaning of section 414(i) of the Code, but are merely used for accounting for mandatory contributions. The participant does not have a right to receive actual earnings on contributions to the Annuity Fund, but receives instead a stated interest rate. A participant may withdraw his or her contributions plus interest (“accumulated contributions”) in a lump sum upon terminating employment prior to reaching normal retirement age, but the member then forfeits his or her right to the normal retirement benefit under the DB Plans. If a participant dies before retirement, his or her accumulated contributions are paid to a designated beneficiary. State A statutes provide that participant contributions may be “picked-up” by a participating governmental employer to the State System, so that such amounts are treated as employer contributions under section 414(h)(2) of the Code.

Employer B is eligible to join the State System. Upon the effective date of Employer B’s participation in the State System, Employer B employees who are eligible and who elect to participate in the State System automatically will be credited with prior service (“Prior Service Credit”) for their years of employment with Employer B prior to the effective date. The funds in each electing employee’s individual account under the DC Plan will be transferred directly to the participants individual account in the Annuity Fund of the State System, to be held along with required participant contributions to the State

System until the participants retirement date, when the participants Annuity Fund account will be used to fund the participants retirement allowance under the Accumulation Fund. The retirement allowance that Employer B employees receive under the State System will be determined by the plan formula of the applicable plan, DB Plan 1 or DB Plan 2, taking into account the years of service with Employer B and will not depend on the amount transferred from the DC Plan to the State System. If a Employer B participant terminates employment prior to reaching normal retirement age, he or she will be entitled to receive an immediate cash-out of the amounts in his or her Annuity Fund account (including the transferred assets) in lieu of a retirement allowance from the State System. In the event of the participants death before retirement, his or her Annuity Fund account (including the transferred assets) will be paid to a designated beneficiary.

Employer B will make annual contributions to the State System determined on an actuarial basis for the normal cost of benefits and the cost of amortizing the "special accrued liability" attributable to the Prior Service Credit. The funds transferred from the DC Plan to the State System will be taken into account in determining Employer B's annual contribution obligation to the State System.

Employer B has adopted a resolution (the "Resolution") that contributions to the State System, although designated as employee contributions, are being paid by Employer B in lieu of contributions by the employee, and that employees will not have the option of choosing to receive the contributed amounts directly instead of having them paid by Employer B to the State System.

Based on the foregoing, your authorized representative has requested the following rulings:

1) The trustee-to-trustee transfer of an employee's account in the DC Plan to the State System, to be applied to the cost of Prior Service Credit on behalf of the employee under the State System, will not be deemed to be an actual or constructive distribution to the employee of the amounts transferred subject to taxation at the time of the transfer under sections 402(a) and 72(t) of the Code.

2) Employees' benefits may be transferred from the DC Plan to the DB Plans without jeopardizing the qualified status of the DC Plan or the State System.

3) Employer contributions and earning thereon transferred from the DC Plan and held in employees' individual accounts under the Annuity Fund of the State System, which otherwise consist of "picked-up" employee contributions, will retain their character for federal income tax purposes as employer contributions. Additionally, if such amounts transferred from the DC Plan are eventually distributed from the State System in the form of a lump sum, they will be treated as allocable to income on the contract for purposes of section 72(e) of the Code

and will qualify as an eligible rollover distribution within the meaning of sections 402(c) and 401 (a)(31) of the Code.

4) The amounts transferred from the DC Plan will not be treated, for purposes of the limits on benefits and contributions under sections 415(b) or 415(c) of the Code, either as part of the annual benefits accrued under the State System or as annual additions for the year of the transfer, and further will not be treated as employee contributions made to purchase permissive service credit that are subject to the requirements and limitations of section 415(n) of the Code.

5) Employee contributions to the State System which are "picked up" by Employer B will not be included in the employee's gross income in the year of the contribution pursuant to section 414(h)(2) of the Code, and will be excepted from "wages" as defined in section 3401 (a)(12)(A) of the Code for federal income tax withholding purposes.

With respect to ruling request one, section 402(a) of the Code provides that, except as otherwise provided in this section, any amount actually distributed to any distributee by any employees' trust described in section 401 (a) which is exempt from tax under section 501(a) shall be taxable to the distributee, in the taxable year of the distributee in which distributed, under section 72 (relating to annuities).

Section 72(t) of the Code provides for an additional tax on any amount received from a "qualified retirement plan" (as defined in section 4974(c), which includes plans described in section 401 (a)). The additional tax for the taxable year in which such amount is received is equal to 10 percent of the portion of such amount which is includible in gross income, except where such income is distributed on or after an employee attains the age of 59 ½, or on account of one or more exceptions provided for under section 72(t)(2) of the Code.

Section 401 (a) of the Code provides that a trust created or organized in the United States and forming part of a qualified stock bonus, pension, or profit sharing plan of an employer constitutes a qualified trust only if the various requirements set out in 401(a) are met.

Section 411 (e) of the Code provides that section 411, with the exception of certain requirements of sections 401(a)(4) and 401(a)(7) in effect on September 1, 1974, does not apply to governmental plans as defined in section 414(d).

Section 1.401-I (b)(l)(i) of the Income Tax Regulations (the "regulations") provides, in part, that a pension plan is a plan established and maintained by an employer primarily to provide for the payment of definitely determinable benefits to employees over a period of years, usually for life, after retirement. This section also provides that a pension plan may provide for the payment of a pension due to disability, and may also provide for incidental benefits.

Revenue Ruling 56-693, 1956-2 C.B. 282, as modified by Rev. Rul. 60-323, 1960-2 C.B. 148, provides that a pension plan fails to meet the requirements of section 401 (a) if it permits an employee to withdraw any part of the employee's accrued benefit (other than a benefit attributable to voluntary employee contributions) prior to certain distributable events; e.g., retirement, death, disability, severance of employment, or termination of the plan.

Rev Rul. 67-213. 1967-2 C.B. 149, involves the transfer of funds directly from the trust forming part of a qualified pension plan to the trust forming part of a qualified stock bonus plan. The revenue ruling provides, in part, that if a participants interest in a qualified plan is transferred from the trust forming part of that plan to the trust forming part of another qualified plan without being made available to the participant, no taxable income will be recognized by reason of such transfer.

In the case at issue, the transferred amounts from the DC Plan to the State System will not be distributed to nor made available to the participant, but will instead be transferred directly from the DC Plan to the State System.

Accordingly, we conclude with respect to ruling request one, that the trustee-to-trustee transfer of an employee's account in the DC Plan to the State System, to be applied to the cost of the Prior Service Credit on behalf of the employee under the State System, will not be deemed to be an actual or constructive distribution to the employee of the amounts transferred subject to taxation at the time of the transfer under section 402(a). Furthermore, as the amounts transferred will not be includible in the employees' gross income at the time of transfer, such transfer will not result in the imposition of an early distribution tax under section 72(t) of the Code.

With respect to ruling request two, section 6.03 of Revenue Procedure 2002-4, 2002-I IRB 127, provides that the Employee Plans Technical office ordinarily will not issue letter rulings on matters involving a plan's qualified status under sections 401 through 420 of the Code and section 4975(e)(7) of the Code and that matters involving a plan's qualified status are generally handled by the Employee Plans Determination program as provided in Rev. Proc. 2002-6 of 2002-I IRB 203, Rev. Proc. 93-10, and Rev. Proc. 93-12. However, assuming the DC Plan and the State System are qualified in all other respects, the transfer of assets from the DC Plan to the State System as set forth above will not affect the qualified status of either the DC Plan or the State System.

With respect to ruling request three, Rev. Rul. 67-213 provides, in part, that, because no distribution is considered to take place as a result of a trustee-to-trustee transfer of funds from one qualified plan to another, the transferred funds retain their original characteristics as funds derived from employer contributions and do not constitute employee contributions.

In this case, the transfer is being made directly from the trust of a qualified money purchase pension plan to the trust of a qualified defined benefit pension plan. Thus, the transferred amounts are not considered distributed to the participant when transferred, as set forth in ruling one above. To the extent the transferred funds are derived from employer contributions (including those funds "picked up" by the employer), they continue to be funds derived from employer contributions and do not constitute employee contributions. Because all of the funds transferred in this case are derived from employer contributions, we conclude that, after the transfer, they will retain their characteristics as employer contributions.

Additionally, since the transferred amounts are all considered derived from employer contributions, there will be no investment in the contract under section 72(e). As a result, if any of the transferred amounts are eventually distributed in a lump sum from the State System, they will be allocable to income under section 72 of the Code, and such amounts shall be includible in gross income under section 72 of the Code upon distribution. Furthermore, if such transferred amounts are eventually distributed in a lump sum distribution from the State System, such amounts would qualify as an eligible rollover distribution, provided the requirements of section 402(c) and 401(a)(31) have been satisfied.

With respect to ruling request four, section 415(a)(l)(A) of the Code provides that a defined benefit plan is not a qualified plan if the plan provides for the payment of benefits with respect to a participant which exceed the limitation of section 415(b) of the Code. Section 415(b) of the Code limits the amount of annual benefits in a defined benefit plan.

Section 415(a)(l)(B) of the Code provides that a defined contribution plan is not a qualified plan if contributions and other additions made to the plan with respect to any participant in a taxable year exceed the limitation of section 415(c) of the Code. Section 415(c) limits the amount of annual contributions and other additions to a participants account in a defined contribution plan.

Section 415(n) of the Code generally provides that if an employee makes contributions to purchase permissive service credit under a defined benefit governmental plan, the plan may satisfy the Code section 415 limits either by treating the accrued benefit derived from all such contributions as an annual benefit in applying the Code section 415(b) limit or by treating the contributions as annual additions for purposes of Code section 415(c).

Section 415(n)(3) defines permissive service credit to mean service credit—

(i) recognized by the governmental plan for purposes of calculating a participants benefit under the plan,

(ii) which such participant has not received under such governmental plan, and

(iii) which such participant may receive only by making a voluntary additional contribution, in an amount determined under such governmental plan, which does not exceed the amount necessary to fund the benefit attributable to such service credit.

Section 1.415-3(b)(1)(iv) of the regulations provides that when there is a transfer of funds from one qualified plan to another, the annual benefit attributable to the assets transferred does not have to be taken into account by the transferee plan in applying the limitations of section 415.

Section 1.415-3(d)(l) of the regulations provides that mandatory contributions to a defined benefit plan are considered a separate defined contribution plan that is subject to the limitations on contributions and other additions described in section 1.415-6 of the regulations.

Section 1.415-6(b)(2)(iv) of the regulations provides that the transfer of funds from one qualified plan to another will not be considered an annual addition for the limitation year in which the transfer occurs.

Because the DC Plan and the DB Plans are all qualified plans, the transfers from the DC Plan to the DB Plans are transfers from one qualified plan to another. Therefore, with respect to ruling request four it is concluded as follows: As provided under section 1.415-3(b)(1)(iv) of the regulations, the benefits attributable to the amounts transferred from the DC Plan to the State System do not constitute an "annual benefit" within the meaning of section 415(b)(2)(A) of the Code, for the purpose of determining limitations for defined benefit plans. Of course, the benefit attributable to the transfer must be determined on the basis of reasonable actuarial assumptions. Furthermore, as provided under section 1.415-6(b)(2)(iv) of the regulations, the amounts transferred from the DC Plan to the State System will not constitute an "annual addition" within the meaning of section 415(c)(2) of the Code, for purposes of determining limitations for defined contribution plans. In addition, because the amounts transferred from the DC Plan to the State System are amounts transferred from one qualified plan to another and not contributions to the plan, no employee is making a contribution to purchase past service credit. Accordingly, the special rules of Code section 415(n) relating to the purchase of permissive service credit do not apply to such amounts.

With respect to ruling request five, section 414(h)(2) of the Code provides that contributions, otherwise designated as employee contributions, shall be treated as employer contributions if such contributions are made to a plan described in section 401 (a) established by a state government or a political subdivision thereof and are picked up by the employing unit.

The federal income tax treatment to be accorded contributions that are picked up by the employer within the meaning of section 414(h)(2) of the Code is specified in Revenue Ruling 77-462, 1977-2 C.B. 358. In that revenue ruling, the employer school district agreed to assume and pay the amounts employees were required by state law to contribute to a state pension plan. Revenue Ruling 77-462 concluded that the school districts picked-up contributions to the plan are excluded from the employee's gross income until such time as they are distributed to the employees. The revenue ruling held further that under the provisions of section 3401(a)(12)(A) of the Code, the school districts contributions to the plan are excluded from wages for purposes of the Collection of Income Tax at Source on Wages; therefore, no withholding is required from the employees' salaries with respect to such picked-up contributions.

The issue whether contributions have been picked up by an employer within the meaning of Code section 414(h)(2) is addressed in Revenue Ruling 81-35, 1981-1 C.B. 255, and Revenue Ruling 81-36, 1981-1 C.B. 255. These revenue rulings established that the following two criteria must be met: (1) the employer must specify that the contributions, although designated as employee contributions, are being paid by the employer in lieu of contributions by the employee; and (2) the employee must not be given the option of choosing to receive the contributed amounts directly instead of having them paid by the employer to the pension plan.

State A statutes and the Resolution adopted by Employer B satisfy the criteria set forth in Revenue Ruling 81-35 and Revenue Ruling 81-36 by providing that Employer B will make contributions to the State System in lieu of Employer B employees' contributions and that such employees shall not be given the option to receive such contributions directly.

Accordingly, we conclude, with respect to ruling request five, that employee contributions to the State System that are picked up by Employer B will not be included in such employees' gross income in the year of the contribution. These amounts will be includible in the gross income of the employees or their beneficiaries only for the taxable year in which they are distributed.

Because we have determined that the picked-up amounts are to be treated as employer contributions, they are excepted from wages as defined in section 3401 (a)(12)(A) of the Code for federal income tax withholding purposes. Therefore, no withholding of federal income tax is required from an Employer B employee's salary with respect to such picked-up contributions.

For purposes of the application of section 414(h)(2) of the Code, it is immaterial whether an employer picks up contributions through a reduction in salary, an offset against future salary increases, or a combination of both.

These conclusions are only applicable if the effective date for any proposed pick-up as specified in the final resolution of participation passed by Employer B with regard to

Employer B's participation in the State System cannot be any earlier than the later of the date the final resolution is signed or the date it is put into effect.

No opinion is expressed as to the tax treatment of the transactions described herein under the provisions of any other section of either the Code or the regulations that may be applicable thereto.

These rulings are based on the assumption that the DC Plan and the DB Plans will be qualified under section 401 (a) of the Code at the time of the proposed contributions and distributions.

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

If you wish to inquire about this ruling, please contact at or (I.D.) at

Sincerely yours,

Alan C. Pipkin
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Employee Plans