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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION
SIN 414.09-00

200307089

T:EP:RA:T2

NOV 18 2002

Attn:

LEGEND:

State A =

Agency M =

Plan X =

Plan Y =

Group B Employees =

Dear

This letter is in response to a request for a private letter ruling dated . supplemented by letter dated submitted on your behalf by your authorized representatives.

In support of your request you have submitted the following facts and representations.

Agency M is a public transportation agency organized under the laws of State A. Agency M currently maintains Plan X, a defined benefit plan intended to be qualified under the provisions of section 401(a) of the Internal Revenue Code ("Code") that apply to governmental plans.

Agency M proposes to establish Plan Y, a defined contribution plan effective Plan Y will provide an alternative retirement plan for existing eligible employees and would be the sole retirement plan for employees who first become eligible for a non-bargaining unit plan after . Plan Y is intended to be qualified in accordance with the provisions of section 401(a) of the Code.

Agency M proposes to make an employer contribution equal to eight percent of considered compensation to Plan Y on behalf of the Group B Employees. Section 4.4 of Plan Y provides that within 30 days after becoming an Eligible Employee (a Group B Employee), each such Group B Employee, other than an Option 1 Employee, shall make a one-time irrevocable election to contribute a percentage of his or her compensation to Plan Y. The contributions amount shall be any whole percentage between zero percent and fifteen percent, subject to maximum annual addition limits. A Group B Employee who fails to make an election during the specified period shall be deemed to have made an irrevocable election to contribute zero percent of his or her compensation to Plan Y. Once the election is made, it shall be irrevocable until the Group B Employee ceases to have compensation or ceases to be a Group B Employee.

Section 4.4 of Plan Y further provides that any contributions elected under this section shall be picked up and paid by Agency M. The Group B Employee's taxable compensation shall be reduced by the amount of the contributions picked up by Agency M, but the picked up contributions shall be included in considered compensation for the plan year in which such amounts are contributed to Plan Y. A Group B Employee shall not have any right to receive the picked up contributions until an occurrence of a distribution. Contributions made pursuant to this section 4.4 of Plan Y, although designated as employee contributions, are paid by Agency M in lieu of contributions by the Group B Employee. Section 4.4 of Plan Y also provides that the Group B Employee does not have the option of choosing to receive the contributed amounts directly instead of having them paid by Agency M to Plan Y.

Agency M proposes to offer its employees who participate in Plan X options with respect to participating in Plan Y. Option 1 Employees are current Plan X participants who elect to continue to accrue benefits under Plan X. Option 1 Employees will continue to receive credited service under Plan X and will not be eligible to receive allocations of employer contributions or to make pick-up contributions under Plan Y. Option 1 Employees may,

nonetheless, elect to make voluntary after-tax contributions to Plan Y.

A current Plan X participant (Group B Employee) who wishes to be eligible for employer contributions and to make pick up contributions to Plan Y must first elect to freeze his or her credited service under Plan X. Once this employee has elected to freeze his or her credited service under Plan X, the employee must then elect (a) to transfer the lump-sum present value of the accrued benefit under Plan X to Plan Y, or (b) have the ultimate benefit at retirement calculated under Plan X based on credited service through December 31, 2001, and final average salary through the date of actual termination of employment. A Group B Employee may not elect a distribution of the present value of his or her accrued benefit under Plan X as part of this election. The lump-sum present value of the Plan X accrued benefit will establish a beginning account balance in Plan Y for the Group B Employee who elects to transfer the present value of his or her accrued benefit from Plan X to Plan Y.

Plan X will continue in effect until it has satisfied its liabilities to each Option 1 Employee who elects to continue to accrue a benefit under Plan X and to each Option 1 Employee who elects to make voluntary after-tax contributions to Plan Y but does not transfer his or her interest under Plan X to Plan Y.

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

(1) That neither the option to transfer the present value of the accrued benefit under Plan X to Plan Y, nor an actual election by an employee to make such a transfer, will constitute a taxable event for the employee under section 72(t) or 402(a) of the Code.

(2) That the transferred amount will not be considered an "annual addition" to Plan Y in the year of the transfer under section 415(c) of the Code.

(3) That the fact that the present value of the accrued benefit is transferred from Plan X to Plan Y will not, by reason of the transfer, subject Plan Y to the Code section 415(b) limit.

(4) That the "picked-up" contributions will be treated as employer contributions for federal income tax purposes and will not be taxable to participants in the year in which the contribution is made to Plan Y.

(5) That no part of the contribution "picked up" by Agency M, nor any investment earnings on the contribution, is includible in the taxable income of the participant on whose behalf the contribution was made until the contribution amount is actually distributed from Plan Y.

Section 402(a) of the Code provides that, except as otherwise provided in this section, any amount actually distributed to any distributee by any employee's trust described in section 401(a) which is exempt from tax under section 501(c) shall be taxable to the distributee, in the taxable year of the distributee in which the amount is 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 59½, 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 section 401(a) are met.

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 participant's 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, it is represented that during the transfer of amounts from Plan X to Plan Y, no amount will be distributed or made available to the Group B Employee, but will instead be transferred directly from Plan X to Plan Y. Further, a Group B Employee who elects to transfer the lump sum present value of his or her accrued benefit from Plan X to Plan Y may not elect to receive a distribution of this Plan X amount in lieu of having such amount transferred directly to Plan Y.

Accordingly, we conclude with respect to ruling request one, that neither the option to elect to transfer the present value of the accrued benefit nor the actual transfer of the present value of the accrued benefit under Plan X to Plan Y will constitute a taxable event for the Group B Employee under section 402(a) of the Code. Furthermore, as the amounts transferred will not be includible in the Group B Employees' gross income at the time of the 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 requests two and three, section 415(a)(1)(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)(1)(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 a 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 participant's account in a defined contribution plan.

Section 1.415-3(b)(1)(iv) of the Income Tax Regulations (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 1.415-6(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.

Plan X and Plan Y are assumed to be qualified plans; therefore, the proposed transfer from Plan X to Plan Y is a

transfer from one qualified plan to another. Accordingly, with respect to ruling request numbers two and three, we conclude that pursuant to sections 1.415-3(b)(1)(iv) and 1.415-6(b)(2)(iv) of the regulations the amount transferred from Plan X to Plan Y will not be considered an annual addition to Plan Y in the year of the transfer and the annual benefit attributable to the assets transferred from Plan X to Plan Y does not have to be taken into account by Plan Y in applying the limitations of section 415. Of course, the annual benefit associated with the amounts transferred from Plan X to Plan Y continues to be taken into account by Plan X for purposes of 415(b).

With respect to ruling requests four and five, 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 consequences 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 district's 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 district's 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 of whether contributions have been picked up by an employer within the meaning of section 414(h)(2) of the Code 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.

Revenue Ruling 87-10, 1987-1 C.B. 136, provides that in order to satisfy Revenue Rulings 81-35 and 81-36, the required specification of designated employee contributions must be completed before the period to which such contributions relate. Thus, employees may not exclude from current gross income designated employee contributions to a qualified plan that relate to compensation earned for services prior to the date of the last governmental action necessary to effect the pick up.

Section 4.4 of Plan Y, as proposed, satisfies the criteria set forth in Revenue Ruling 81-35 and Revenue Ruling 81-36 because it specifies that contributions made pursuant to this section, although designated as Group B Employee contributions, are paid by Agency M in lieu of contributions by the Group B Employee, and that the Group B Employee does not have the option of choosing to receive the contributed amounts directly instead of having such amounts paid by Agency M to Plan Y.

Accordingly, we conclude that the "pick-up contributions" will be treated as employer contributions for federal income tax purposes and will not be taxable to the participant in the year in which the contributions are made to Plan Y. Furthermore, no part of the contribution "picked-up" by Agency M, or any investment earnings on the contribution is includible in taxable income of the participant on whose behalf the contribution was made until the contribution amount is actually distributed from Plan Y.

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

These rulings apply only if the effective date for the commencement of any proposed pick up is not any earlier than the later of the date the Plan Y is adopted by Agency M or the date it is put into effect.

These rulings are based on the assumption that Plan X and Plan Y meet the requirements for qualification under section 401(a) of the Code at the time of the transfer and at the time of the proposed contributions and distributions.

This ruling is further based on section 4.4 of Plan Y, as proposed, as set forth in your letter dated September 9, 2002.

This ruling is also based on the condition that a Group B Employee who elects to make contributions to Plan Y pursuant to the terms of section 4.4, as proposed, may not make more than one

irrevocable election to make such contributions, and that a one time irrevocable election made by a Group B Employee to contribute zero percent of compensation to Plan Y pursuant to the terms of section 4.4, as proposed, is an election that may not be subsequently altered or amended.

No opinion is expressed as to whether the amounts in question are subject to tax under the Federal Insurance Contributions Act. No opinion is expressed as to whether the amounts in question are paid pursuant to a "salary reduction" agreement within the meaning of section 3121(v)(1)(B) of the Code.

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.

This letter ruling 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 by others as precedent.

A copy of this letter is being sent to your authorized representative in accordance with a power of attorney on file in this office.

If you have any questions concerning this ruling, please contact EP:RA:T2, at

Sincerely yours,

(signed) JOYCE E. FLOYD

Joyce E. Floyd.
Manager, Employee Plans
Technical Group 2
Tax Exempt and Government
Entities Division

Enclosures:
Deleted copy of letter ruling
Notice 437