Internal Revenue Service

Department of the Treasury

Washington, DC 20224

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Significant Index Nos. 72.20-00; 401.00-00; 402.00-00; 415.00-00

Contact Person:

Telephone Number:

In Reference to:

T:EP:RA:T:A1

Date:

MAY 04 2001

Re:

Legend:

DB Plan =

DC Plan =

State A =

Dear

This is in response to the request from your representative for rulings in connection with the establishment of the DC Plan by State A and proposed elections and transfers between the DC Plan and the DB Plan currently maintained by the Department. Applications have been filed for determination letters on the DC Plan and for the amendments to the DB Plan enabling the proposed elections and transfers between the DB and DC Plan.

State A has established and maintains the State A Retirement System ("SARS"). The SARS includes the DB Plan, a defined benefit retirement plan, which is a government plan within the meaning of section 414(d) of the Internal Revenue Code of 1986, as amended, (the "Code"). The DB Plan is a qualified plan within the meaning of Code section 401(a) and received a determination letter from the Internal Revenue Service (the "IRS") dated December 12, 1997.

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In 2000, State A adopted the DC Plan, an optional defined contribution retirement plan for eligible members of SARS. The DC Plan is a defined contribution plan designed to constitute a qualified plan under Code section 401(a).

The DC Plan provides that amounts attributable to employer contributions to that plan will become fully vested after "one work year". The DB Plan generally provides a six-year cliff vesting schedule.

Beginning June 1, 2002, persons eligible to participate in the DB Plan, who on that date or thereafter are employed in a regularly established position with a State A employer (as defined by State A statute) may elect, within 90 days after June 1, 2002, to participate in the DC Plan in lieu of participating in the DB plan.

State A employees who were participants in the DB Plan who elect to participate in the DC Plan will have their benefit accruals frozen at the time of such election. These employees may also elect to transfer to the DC Plan a sum representing the present value of the employee's accumulated benefit obligation under the DB plan. The amounts transferred from the DB Plan to the employee's account under the DC Plan vest upon the participant's meeting the service requirements for the participant's service class as set forth under the DB Plan. Because the vesting schedules differ for the DB and DC Plans, separate accounts will be maintained for amounts contributed by the employer to the DC Plan and for amounts transferred from the DB Plan to the DC Plan, at least until all amounts in the DC Plan become fully vested.

State A employees eligible to participate in the DB Plan who commence employment after June 1, 2002, are enrolled by default in the DB Plan, but may within 180 days after commencement of employment, elect to participate in the DC Plan.

In addition, subject to approval from the IRS, all employees will have an additional one-time opportunity, at the employee's discretion, to switch from the DB Plan to the DC Plan and to transfer their accruals under the same transfer and vesting rules described above.

Similarly, subject to approval from the IRS, all employees, including employees who had previously been participants in the DB Plan and elected to participate in the DC Plan, will have an additional one-time opportunity, at the employee's discretion, to switch from the DC Plan to the DB plan. In this situation, the employee must transfer from the DC Plan to the DB Plan an amount equal to what would have been contributed on their behalf, plus interest at the actual earned rate of the invested assets of the DB Plan, had the employee been a member of the DB Plan during the time the employee was a member of the DC Plan. Any balance following such a transfer will remain invested in the DC Plan. In the event employee assets from the DC Plan are insufficient, the employee must make up the shortfall from other monies. The benefits associated with the amounts transferred from the DC Plan to the DB Plan will vest under the DB Plan's vesting schedule. Thus, if a participant were to elect to transfer from the DC Plan to the DB Plan before completing six years of service, the participant would lose their vested right to benefits to the extent of funds transferred from the DC Plan to the DB Plan, if the participant were thereafter to terminate employment before completing six years of service.

Currently, State A statutes provide that upon termination of employment prior to satisfying the vesting requirements, the nonvested accumulation in the DC Plan, including both amounts attributable to employer contributions to the DC Plan and amounts attributable to any accumulated benefit obligation transferred from the DB Plan, shall be transferred from the participant's account to a suspense account of the SBA. If the terminated employee is reemployed within 5 years, the amount transferred to the suspense account of the SBA is to be transferred back to the participant's regular account under the DC Plan, plus interest at 3% per annum on amounts attributable to employer contributions to the DC Plan and 6% per annum on amounts attributable to accumulated benefit obligations transferred from the DB Plan to the DC Plan.

State A statutes are silent on what happens to amounts that are forfeited under the DC Plan. The SBA proposes to limit the application of forfeitures to (1) payment of plan administrative expenses and (2) reduction of future employer contributions to the plan.

In accordance with the foregoing, you request the following rulings:

(1) The election of eligible employees to participate in the DC Plan or the DB Plan and, if participation in the DC Plan is elected, any transfer of amounts from the DB Plan to the DC Plan upon such initial election of an eligible employee to participate in the DC Plan, (i) will not cause the DC Plan or the DB Plan to fail to be a qualified plan within the meaning of section 401(a) of the Code, (ii) will not result in currently taxable income to the participant under section 72 of the Code, section 402 of the Code or any other provision of the Code, and (iii) will not result in imposition of an early distribution tax under section 72(t) of the Code.

(2) The one additional opportunity of an eligible employee to elect to move from the DB Plan to the DC Plan or from the DC Plan to the DB Plan after the period during which the employee made the initial election between the plans, and the transfer of amounts from the DB Plan to the DC Plan or from the DC Plan to the DB Plan upon such election, (i) will not cause the DC Plan or the DB Plan to fail to be a qualified plan within the meaning of section 401(a) of the Code, (ii) will not result in currently taxable income to the participant under section 72 of the Code, section 402 of the Code or any other provision of the Code, and (iii) will not result in imposition of an early distribution tax under section 72(t) of the Code.

(3) Amounts transferred directly from the DB Plan to the DC Plan at the election of the participant are not annual additions to the DC Plan within the meaning of section 415(c) of the Code.

(4) Amounts transferred directly from the DC Plan to the DB Plan upon the participant's election to transfer from the DC Plan to the DB Plan are not annual additions within the meaning of section 415(c) of the Code, are not contributions subject to the limitations of Code section 415(n), and the annual benefit under the DB Plan attributable to the amounts transferred from the DC Plan to the DB Plan will not be subject to the limitations of Code section 415(b).

(5) Neither the initial election to permit an eligible employee to participate in the DC Plan in lieu of the DB Plan nor the additional one-time election to transfer from the DB Plan to the DC Plan or from the DC Plan to the DB Plan while an employee will constitute a cash or deferred arrangement within the meaning of Code section 401(k).

(6) The proposed use of forfeitures under the DC Plan will not cause the DC Plan to fail to be a qualified plan within the meaning of section 401(a) of the Code.

Section 5.03 of Revenue Procedure 2001-4, 2001-1 IRB 131, 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. 2001-6 of 2001-1 IRB 194, Rev. Proc 93-19, and Rev. Proc.93-12. Accordingly, because ruling requests 1(i) and 2(i) are covered under determination letter procedures, we will not rule on these requests.

Section 402(a) of the Code provides, in general, that the amount actually distributed 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 year in which so 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 59-1/2, or on account of one or more exceptions provided for under section 72(t)(2) of the Code.

Revenue Ruling 67-213, 1967-2 CB 149, provides 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 of a transfer of amounts from the DB Plan to the DC Plan, either upon initial election, or during the one-time additional opportunity for such transfers, the amounts transferred to the DC Plan will not be distributed to nor made available to the participant. Similarly, in the case of a transfer of amounts from the DC Plan to the DB Plan, during the one-time opportunity for such transfers, the amounts transferred to the DB Plan will not be distributed to nor made available to the participant. The only choice a participant has is to transfer to the other plan. The amount so transferred is then subject to the distribution rules in the transferee plan.

Accordingly, with respect to ruling requests (1)(ii), (1)(iii), (2)(ii), and (2)(iii), the amounts transferred from the DB Plan to the DC Plan, and from the DC Plan to the DB Plan, whether at time of initial selection, or during the one-time additional opportunity for transfer of such amounts, are not distributions and the transfers will not result in currently taxable income to the participant under section 72 of the Code, section 402 of the Code, or any other provision of the Code, and will not result in imposition of an early distribution tax under section 72(t) of the Code.

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). Section 415(b) 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 any participant in a taxable year exceed the limitation of section 415(c). Section 415(c) limits the amount of annual contributions and other additions to a participant's 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 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 participant's 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 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 1.415-3(d)(1) 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.

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.

In the case of a transfer from the DB Plan to the DC Plan, the amounts being transferred are moving from one qualified plan to another. Accordingly, with respect to the third ruling request, the amounts directly transferred to the DC Plan from the DB Plan are not annual additions to that plan within the meaning of section 415(c) of the Code.

Section 415(n) provides special rules if an employee makes one or more contributions to a defined benefit governmental plan to purchase permissive service credit. Employees who move from the DC Plan to the DB Plan are required to provide to the DB Plan a sum representing all contributions (with interest) that would have been made to the DB Plan on the employee's behalf during the period the employee was a member of the DC Plan had the employee never left the DB Plan. The amounts to be provided to the DB Plan are first made from amounts transferred from the DC Plan, and then, if the amounts transferred from the DC Plan are insufficient, from after-tax employee contributions to make up the difference.

The Taxpayer's representative has represented that the term "amounts transferred directly from the DC Plan to the DB Plan" in the fourth ruling request, specifically excludes after-tax monies, if any, contributed by the employee to complete the move. Therefore, any "amounts transferred directly from the DC Plan to the DB Plan" are transfers from one qualified plan to another. Therefore, as provided under section 1.415-6(b)(2)(iv) of the regulations, the amounts directly transferred to the DB Plan from the DC Plan are not annual additions to that plan within the meaning of section 415(c) of the Code. Because the term "amounts transferred from the DC Plan to the DB Plan" excludes the employee contributions made to complete the move, the amounts transferred from the DC Plan to the DB Plan are not employee contributions to purchase permissive service credit and are thus not subject to the limitations of Code section 415(n).

The annual benefit under the DB Plan attributable to the amounts transferred from the DC Plan to the DB Plan may fall into two categories: (1) the annual benefit attributable to service during participation in the DC Plan and (2) in the case of a participant who had previously made a DB Plan to DC Plan transfer, the annual benefit attributable to service during prior participation in the DB Plan.

The sources of the amounts transferred, if any, from the DC Plan to the DB Plan representing the annual benefit attributable to service during prior participation in the DB Plan were amounts previously transferred from the DB Plan to the DC Plan. Because the transfers of funds from the DB Plan to the DC Plan was a transfer of funds from one qualified plan to another, these transfers were not annual additions to the DC Plan within the meaning of section 415(c) of the Code. Thus, the annual benefit associated with the amounts previously transferred from the DB Plan to the DC Plan continued to be taken into account under the limitations of section 415(b).

Accordingly, with respect to the fourth ruling request, amounts transferred directly from the DC Plan to the DB Plan upon a participant's election to transfer from the DC Plan to the DB Plan are not annual additions within the meaning of section 415(c) of the Code, are not contributions subject to the limitations of Code section 415(n), and any portion of the annual benefit under the DB Plan representing service while participating in the DC Plan, attributable to the amounts transferred from the DC Plan to the DB Plan, will not be subject to the limitations of Code section 415(b). However, the annual benefit associated with the amounts previously transferred from the DB Plan to the DC Plan are taken into account, along with future accruals under the DB Plan, for purposes of applying the limitations of 415(b).

Section 1.401(k)-1(a)(3)(i) of the regulations provides that a cash or deferred election is any election (or modification of an earlier election) by an employee to have the employer either (A) provide an amount to the employee in the form of cash or some other taxable benefit that is not currently available, or (B) contribute an amount to a trust, or provide an accrual or other benefit, under a plan deferring the receipt of compensation.

Section 1.401(k)-1(a)(3)(iii) of the regulations provides that an amount is currently available if it has been paid to the employee or if the employee is able currently to receive the cash or other taxable amount at the employee's discretion. An amount is not currently available if there is a significant limitation or restriction on the employee's right to receive the amount currently. Similarly, an amount is not currently available as of a date if the employee may under no circumstances receive the amount before a particular time in the future.

Neither the initial election to permit an eligible employee to participate in the DC Plan in lieu of the DB Plan or the additional one-time election to transfer from the DB Plan to the DC Plan or from the DC Plan to the DB Plan while an employee provides an amount to the employee in the form of cash or other taxable benefit not currently available. Accordingly, with respect to the fifth ruling request, neither the initial election to permit an eligible employee to participate in the DC Plan in lieu of the DB Plan or the additional one-time election to transfer from the DB Plan to the DC Plan or from the DC Plan to the DB Plan while an employee constitutes a cash or deferred arrangement within the meaning of Code section 401(k).

Section 401(a)(2) of the Code provides that if under the trust instrument it is impossible, at any time prior to the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust, for any part of the corpus or income to be (within the taxable year or thereafter) used for, or diverted to, purposes other than for the exclusive benefit of his employees or their beneficiaries.

Neither the use of forfeitures from the DC Plan for the payment of plan administrative expenses or for the reduction of future employer contributions to the plan constitutes a diversion of any part of the corpus or income for purposes other than for the exclusive benefit of the employees or their beneficiaries. Accordingly, assuming that the DC Plan otherwise satisfies the applicable requirements of section 401(a) the proposed use of forfeitures under the DC Plan will not cause the DC Plan to fail to be a qualified plan within the meaning of section 401(a) of the Code.

A separate ruling was not requested with respect to the section 415 treatment of supplemental after-tax employee contributions that may be required, in the event of a shortfall in funds available for transfer from the DC Plan, to be contributed to the DB Plan upon an election to transfer to the DB Plan. Accordingly, we are not ruling on that issue. We note that, if the total of such required after-tax employee contributions and all other annual additions meets the requirements of section 415(c), the requirements of section 415 would be satisfied. In addition, if the required after-tax employee contributions to the DB Plan are 'picked up' under section 414(h)(2) of the Code, such contributions would be treated as employer contributions to the DB Plan and the requirements of section 415(c) would not apply.

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

A copy of this letter is being furnished to your authorized representative pursuant to a power of attorney (Form 2848) on file.

Sincerely,

James E. Holland, Jr., Manager
Employee Plans Actuarial Group 1
Tax Exempt and Government
Entities Division

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