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TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

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72.07-00 through 72.07-05

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Legend:

State A .....

Statute M..... .....

Statute N.....

Option E.....

System X.....

This is in response to a letter dated November 4, 2003, as supplemented by correspondence dated January 21, 2004, April 8, 2004, April 22, 2004, September 7, 2004, and September 14, 2004, submitted on your behalf by your authorized representatives regarding rulings under sections 72, 402(c) and 415(b) of the Internal Revenue Code (the "Code"). The following facts and representations were submitted in connection with your request.

System X is a defined benefit plan that provides for retirement, death, and disability benefits. It is a multiple employer public employee retirement system. For the year ending , there were participating employers. System X is a governmental plan under Code section 414(d) and is intended to be qualified under section 401(a). The terms and conditions of System X and Option E are provided for in Statutes M and N. Membership in System X is mandatory under State A law for all full-time police officers employed by State A municipalities. Full-time firefighters employed

by townships, municipalities, township joint fire districts or other political subdivisions must become members of System X if satisfactory completion of an approved firefighter training course is required for employment. System X, including the Option E amendment, received a favorable determination letter from the Internal Revenue Service dated November 7, 2002.

System X is funded by employer and employee contributions. Employee contributions have been picked up within the meaning of section 414(h)(2) of the Code since 1982 and thus are contributed on a pre-tax basis. However many current members have made after-tax contributions.

To be eligible for normal retirement, a participant must have 25 years of active service as a contributing member of System X and/or due to a service purchase, and must have attained age 48.

Option E is a program under which a member of System X, who is eligible for normal retirement, may elect to accrue future retirement benefits in the manner provided by Option E, rather than in the normal manner provided under System X. This method is achieved by treating the Option E participant as though retired from System X, even though the participant continues in employment. As a "retiree" from System X, the Option E participant retains the participant's previously accrued rights to normal retirement benefits under System X. However, as a System X "retiree," the Option E participant may not accrue additional service credit in System X during the period of Option E participation.

The period during which the member continues to work after having made the election to participate under Option E is considered the Option E accrual period. During the Option E accrual period a lump sum amount ("Option E accrual amount") is being calculated, which is equal to 100 percent of the monthly pension benefit that would have been paid during the period had the member retired.

For ease of explanation to members, this calculation of a lump sum is referred to as the monthly payments being "credited" to the member's accrual under Option E. However, these are notional accounts, used only for the purpose of calculation of the Option E accrual amount. There is no change in System X assets, and there is certainly no distribution available to the member. The Option E accrual amount is also "credited" with any cost of living adjustments that would have been made had the member retired. In addition, interest is credited to the Option E accrual amount at a fixed rate of five percent. The interest credit is not related to asset performance.

During the Option E accrual period, the Option E accrual amount is also "credited" with an amount equivalent to a certain percentage of employee contributions during each year of Option E participation. The calculation of the Option E accrual from year to year does not affect where employee and employer contributions are held by System X. The

term "crediting" is only meant to convey that the employee contributions are to be used in the calculation of the Option E accrual. All employee contributions (under Statute M) for an Option E participant are in fact held in the police officers' or firefighters' contribution account until a member's retirement, at which time the monies are moved to the retirement reserve, along with the transfers of employer contributions, and are made available to fund the member's defined benefit. If an Option E lump sum is payable, a lump sum amount is calculated, which is then paid, depending on the option selected, from the retirement reserve.

Upon termination of service, a member may choose between taking the Option E accrual amount in a total lump sum (or partial lump sum) or in monthly withdrawals. It is represented that the payment of the Option E accrual amount will be significantly larger than the amount of the System X annuity payments.

Based on the above facts and representations, you request the following rulings:

(1) That in the situation where an Option E participant withdraws the total Option E accrual amount in a single lump sum within ninety days of the commencement of the annuity payments, the single lump sum distribution will be considered a lump sum payment in connection with the commencement of annuity payments under a qualified employer retirement plan for purposes of Code section 72(d)(1)(D), such that the pro-rata method of allocating basis to the lump sum under Code section 72(e)(8)(B) shall be applied to that lump sum payment.

(2) That the lump sum payment referred to in request one is eligible for rollover treatment pursuant to section 402(c)(4) of the Code.

(3) That the lump sum payment referred to in request one is a benefit that must be converted to an actuarially equivalent annual benefit and included in the participant's annual benefit when determining System X's compliance with section 415(b) of the Code.

With regard to the ruling request one, Code section 72(a) provides that, except as otherwise provided in this chapter, gross income includes any amount received as an annuity (whether for a period certain or during one or more lives) under an annuity, endowment, or life insurance contract.

Code section 72(e) generally applies to any amount received under an annuity contract but which is not received as an annuity.

Code section 72(e)(2)(A) provides that any amount not received as an annuity and which is received on or after the annuity starting date shall be included in gross income.

Code section 72(d)(1)(D) provides that if, in connection with the commencement of

annuity payments under any qualified employer retirement plan, the taxpayer receives a lump sum payment, then such payment will be taxable under subsection (e) as if received before the annuity starting date, and the investment in the contract shall be determined as if such payment had been so received.

Code section 72(e)(8)(A) provides that notwithstanding any other provision of Code section 72(e), in the case of any non-annuity amount received before the annuity starting date from a qualified plan, section 72(e)(2)(B) shall apply to such amounts.

Code section 72(e)(2)(B) provides that a non-annuity payment which is received before the annuity starting date (i) shall be included in gross income to the extent allocable to the income on the contract, and (ii) shall not be included in gross income to the extent allocable to the investment in the contract.

Section 72(e)(8)(B) provides that for purposes of paragraph 72(e)(2)(B) the amount allocated to the investment in the contract shall be the portion of the amount described in section 72(e)(8)(A) which bears the same ratio to such amount as the investment in the contract bears to the account balance.

Code section 72(e)(6) defines the "investment in the contract" for purposes of subsection (e) as of any date to be the aggregate amount of premiums or other consideration paid for the contract as of such date minus the aggregate amount received under the contract before such date, to the extent that such amount was excludable from gross income.

In this case, with respect to ruling request (1), System X prior to 1982 provided for after-tax employee contributions. Thus, a retiring participant's after-tax employee contributions held by System X minus any amounts previously received under System X by the participant, to the extent that such amounts were excludable from gross income, constitute the participant's "investment in the contract" under Code section 72(e)(6), which definition applies for purposes of section 72(e)(8)(B).

The payment of the entire Option E accrual amount in a single sum within the 90-day period constitutes a lump sum payment made in connection with the commencement of annuity payments within the meaning of Code section 72(d)(1)(D). As such, it is treated as an amount received before the annuity starting date under section 72(e). Thus, such payment of the entire Option E accrual amount within the 90-day period constitutes a lump sum payment made in connection with the commencement of annuity payments under a qualified plan as described in section 72(d)(1)(D), such that the payment is taxable under section 72(e) as if received before the annuity starting date and is subject to the pro rata basis recovery rule of section 72(e)(8)(B).

With respect to ruling request one, we conclude:

(1) That in the situation where an Option E participant withdraws the total Option E accrual amount in a single lump sum within ninety days of the commencement of the annuity payments, the single lump sum distribution will be considered a lump sum payment in connection with the commencement of annuity payments under a qualified employer retirement plan for purposes of Code section 72(d)(1)(D), such that the pro-rata method of allocating basis to the lump sum under Code section 72(e)(8)(B) shall be applied to that lump sum payment.

With respect to ruling request two, section 402(c) of the Code provides that rollovers from exempt trusts are excluded from gross income. Section 402(c)(4) defines "eligible rollover distribution" as any distribution to an employee of all or a portion of the balance to the credit of the employee in a qualified trust except:

a) Any distribution of a series of substantially equal payments over the life/lives of the employee and the designated beneficiary, or over a period equal to at least 10 years;

b) Any distribution required under section 401(a)(9); and

c) Any hardship distribution under section 401(k)(2)(B)(i)(IV).

Section 1.402(c)-2, Q&A-6 of the income tax regulations provides that a payment will generally be treated as independent of and not part of a series of substantially equal payments if the payment is substantially larger or smaller than the other payments in the series. Also, such independent payment must not otherwise be excepted from the definition of eligible rollover distribution. This treatment is regardless of whether the independent payment is made before, with or after the other payments.

However, section 402(c)(2) of the Code provides that the portion of an eligible rollover distribution that would otherwise not be includible in gross income cannot be rolled over unless such previously taxed amounts are transferred either (i) in a direct trustee-to-trustee transfer to a defined contribution plan qualified under section 401(a) that agrees to separately account for such amounts or (ii) to an IRA. See Rev. Rul. 2004-12, 2004-7 I.R.B. 478.

It is represented that the lump sum payment of the Option E accrual amount will be significantly larger than the amount of the monthly annuity.

Thus, with regard to ruling request two, because the lump sum payment of the Option E accrual amount referred to in request one will be significantly larger than the amount of the monthly annuity, such lump sum is considered independent of the other payments in the series. Accordingly, such lump sum is eligible for rollover treatment pursuant to section 402(c)(4) of the Code.

With respect to request three, section 415(a)(1)(A) of the Code provides that a qualified defined benefit plan may not pay benefits in excess of the limitations of section 415(b). Section 415(b)(1) provides that a participant's annual benefit may not exceed the lesser of the specified dollar amount or 100 percent of the participant's final average compensation. Section 415(b)(11) provides that the 100 percent of compensation limit does not apply to governmental plans.

Section 415(b)(2)(B) provides that if a benefit is payable in a form other than a straight life annuity, then the benefit must be converted to an actuarially equivalent straight life annuity. Section 415(b)(2)(E)(ii) provides that, for purposes of adjusting any benefit under section 415(b)(2)(B) for any benefit form subject to section 417(e)(3), the interest rate used must be the greater of the applicable 417(e)(3) rate or the rate specified in the plan. That section also provides that, for purposes of adjusting any benefit under section 415(b)(2)(B), the mortality table used shall be the table that is based on the prevailing commissioners' standard table (see section 807(d)(5)(A) of the Code) used to determine reserves for group annuity contracts issued on the date the adjustment is being made.

Section 417(e)(3) of the Code provides rules for determining the present value of benefits. This section defines "applicable mortality table" as the table that is based on the prevailing commissioners' standard table (see section 807(d)(5)(A) of the Code) used to determine reserves for group annuity contracts issued on the date the adjustment is being made. In general, this section defines "applicable interest rate" as the annual rate on 30-year Treasury securities for the month before the date of distribution.

For purposes of the application of section 415(b) of the Code, the lump sum payment of the Option E accrual amount referred to in request one is merely part of a participant's accrued benefit. Because it is made in the form of a lump sum distribution, section 415(b)(2)(B) provides that such distribution must be converted to an actuarially equivalent straight life annuity using the rules of section 417(e)(3). Once the lump sum is actuarially converted, such benefit must be counted as applying to a participant's benefit limitation under section 415(b).

Therefore, with regard to ruling request three, as stated above, the lump sum payment of the Option E accrual amount referred to in request one is part of a participant's accrued benefit. Thus, the equivalent straight life annuity is added to the annuity benefit for purposes of determining whether a participant's benefit complies with the benefit limitation under section 415(b) of the Code.

This ruling expresses no opinion with respect to the taxability of the lump sum payment referred to in request one that is received after 90 days of the date the annuity benefit payments commence.

No opinion is expressed as to the federal tax consequences of the transaction

described above under any other provisions of the Code.

The above rulings are based on the assumption that System X is qualified under Code section 401(a) and its related trust exempt from tax under section 501(a) at all relevant times.

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

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

Should you have any questions or concerns regarding this letter, please contact , , .

Sincerely yours,

Frances V. Sloan

Frances V. Sloan, Manager
Employee Plans Technical Group 3

Enclosures:
Notice of Intention to Disclose
Deleted Copy of Ruling