Internal Revenue Service Department of the Treasury

Washington, DC 20224

Significant Index #:402.08-01 Person to Contact:

********** Telephone Number: **********
********** ID#50-*****
********** Refer Reply to: (202) 622-*****
****

Date: T:EP:RA:*****

JUN 2 8 2000

Attention: **********
****

Legend:

State A = **********
Employer M = **********
System A = **********
System B = **********
****
System C = **********
Statute Y = **********
****
****
****
****
****
Legislative Body N = **********
Option E = **********

Dear M**********

This is in response to a letter dated May 26, 1999, as supplemented by correspondence dated October 22, and 26, 1999, submitted on your behalf by your authorized representative for a ruling concerning the federal income tax treatment under sections 414(h)(2) and 402(c)(4) of the Internal Revenue Code of certain contributions to System C.

The following facts and representations have been submitted:

System A and System B are responsible for administration of System C, a defined benefit retirement plan that provides retirement, death, and disability benefits for police employees of Employer M, including Employer M cadets. System C was established on July 1, 1949, and as of April 1999, has approximately 1634 active

****

members. Of this group, System A estimates that as of July 1, 1999, approximately 318 members may be eligible to elect to participate in Option E.

The terms and conditions of System C are set forth in Statute Y. System C is a governmental plan within the meaning of section 414(d) of the Code, and is intended to be qualified under section 401(a). System C received a favorable determination letter from the Internal Revenue Service dated April 19, 1965, and most recently received a determination letter dated October 22, 1999, which applies to the amendments executed on April 27, 1999 (which relate to Option E, as described below). Under System C, to receive a normal service retirement allowance, a member must terminate employment, attain age 50 or have at least 25 years of service and apply for the benefits by completing a System A application. Except for the Secretary of Employer M, a member is required to retire at age 60. On retirement, a member receives a "normal service retirement allowance" equal to the sum of 1/45th of the member's average final compensation multiplied times each year of the member's first 25 years of creditable service, and 1/90th of the member's average final compensation multiplied times each year of creditable service in excess of 25 years.

Statute Y enhanced the normal service retirement allowance payable to a member of System C. Effective July 1, 1999, a member of System C is eligible to receive a service retirement allowance on attaining age 50 or 22 years of service (regardless of age). On retirement on or after July 1, 1999, a member receives a normal service retirement allowance equal to 2.55 percent of the member's average final compensation for each year of service; provided however, that the allowance may not exceed 71.4 percent of the member's average final compensation.

System C is a contributory plan. A member is required to make mandatory contributions equal to 8 percent of the member's earnable compensation if the member has 25 years or less of creditable service plus 4 percent of the member's earnable compensation if the member has more than 25 years of creditable service. As a result of the enactment of Statute Y, effective July 1, 1999, a member's contribution is 8 percent of the member's earnable compensation.

System C members' contributions are picked up by State A within the meaning of section 414(h)(2) of the Code. A favorable private letter ruling dated July 10, 1987, was issued to System B with respect to the "pick-up". There have been no substantive amendments to the pick-up program since receipt of this ruling.

Option E is a program under which a member of System C

318

****

who has at least 22 and less than 28 years of eligibility service and is less than 60 years of age may elect to accrue future retirement benefits in the manner provided by Option E, rather than in the manner provided under System C. This method is achieved by treating the Option E participant as though retired from System C, even though the participant continues in employment. As a "retiree" from System C, the Option E participant retains the participant's previously accrued rights to normal service retirement benefits under System C; however, as a System C "retiree", the Option E participant may not accrue additional service credit in System C during the period of Option E participation. The period of Option E participation may not exceed four years.

The Option E participant, as a System C "retiree" accrues additional retirement benefits in Option E in the following manner. During the period beginning on the effective date of participation in Option E, System A credits the following amounts to an individual's Option E account: (1) the normal service retirement allowance to which the member would have been entitled had the member in fact terminated employment and retired accrue for the participant's benefit as if the allowance had been paid into a separate account maintained by System A; (2) the cost-of-living adjustment on July 1 of each year; and, (3) interest on the balance in the Option E account at the rate of 6 percent per year, compounded monthly.

Although no individual Option E account is actually established, a participant's accrued Option E benefit is calculated annually on a separate basis, and account statements are to be provided to each participant. An Option E participant may not elect to receive a distribution of benefits in the Option E account in lieu of the accruals under Option E unless the participant shortens the time period for participation in Option E and terminates employment with Employer M.

During the period beginning on the effective date of participation in Option E, as a System C "retiree", the Option E participant does not earn any additional years of service credit in System C. Nor is the member required to make any member contributions to System C, and accordingly, State A does not pick up any contributions for the Option E participant.

Upon termination of the Option E participation period, which may not exceed four years, an Option E participant terminates the employment relationship with Employer M. At that time, System A commences payment to the Option E participant (or designated beneficiary) of the normal monthly service retirement allowance that previously had accrued within Option E. In addition to this monthly

****

benefit, the Option E participant (or designated beneficiary) is entitled to receive in a lump sum the amount accrued in the Option E account during the period of Option E participation (the "accumulated Option E benefit").

Distribution of the accumulated Option E benefit is governed by participant election. That election can only be made at the end of the Option E participation period, i.e., when the member terminates employment with Employer M and may not exceed four years. The Option E participant may elect to receive the amount accrued in a lump sum reduced by applicable withholding taxes. Alternatively, the participant may elect to roll over all or part of the accrued Option E benefit into an "eligible retirement plan", that is, an individual retirement account described in section 408 of the Code, an individual retirement annuity, other than an endowment contract, described in section 408(b), a qualified trust described in section 401(a), or an annuity plan described in section 403(a) of the Code.

Based upon the aforementioned facts, your authorized representative has requested rulings that:

1. Mandatory member contributions required under section 24-205 of Statute Y and made by State A under section 22-313 of Statute Y for those members of System C who are not in Option E shall continue to qualify for pick up treatment under section 414(h)(2) of the Code, and accordingly the contributions will be excluded from the members' wages for federal tax withholding purposes and will not constitute gross income for federal income tax purposes until distributed to the members (or their beneficiaries) ; and,
2. The lump sum distribution to Option E participants (or their beneficiaries) of the accumulated Option E benefit constitutes an eligible rollover distribution within the meaning of section 402(c)(4) of the Code, and accordingly under section 3405(c) of the Code the Trustees should withhold 20 percent of any such distribution which is not directly rolled over to another qualified plan or individual retirement account.

With respect to ruling request number one, as noted above, a favorable ruling was issued with respect to the "pick up" under section 414(h)(2) on July 10, 1987. There is nothing in the Code nor the regulations thereunder which, when applied to the facts presented above, would affect the conclusions reached in that private letter ruling. Therefore, with respect to ruling request number one, we conclude that mandatory member contributions required under section 24-205 of Statute Y and made by State A under section 22-313 of Statute Y for those members of System C who are not in Option E shall continue to qualify for pick

320

****

up treatment under section 414(h)(2) of the Code, and accordingly the contributions will be excluded from the members' wages for federal tax withholding purposes and will not constitute gross income for federal income tax purposes until distributed to the members (or their beneficiaries).

With respect to ruling request number two, section 402(a) of the Code provides that 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). However, section 402(c) provides that if any portion of the balance to the credit of an employee in a qualified trust is paid to the employee in an "eligible rollover distribution" and the distributee transfers, within 60 days of receipt, any portion of the property received in such distribution to an "eligible retirement plan", and 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.

An "eligible rollover distribution" is defined in section 402(c)(4) of the Code as any distribution to an employee of all or any portion of the balance to the credit of the employee in a qualified trust; except (A) any distribution which is one of a series of substantially equal periodic payments (not less frequently than annually) made (I) for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of the employee and the employee's designated beneficiary, or (ii) for a specified period of 10 years or more and (B) any distributions to the extent such distribution is required under section 401(a)(9).

Section 402(c)(8)(A) defines a "qualified trust" as an employees' trust described in section 401(a) which is exempt from tax under section 501(a). An "eligible retirement plan" is defined in section 402(c)(8)(B) of the code as (I) an individual retirement account described in section 408(a), (ii) an individual retirement annuity described in section 408(b) (other than endowment contracts), (iii) a qualified trust, and (iv) an annuity plan described in section 403(a).

Section 1.402(c)-2, Q&A 6 provides, generally, that a payment is treated as independent of the payments in a series of substantially equal payments, and thus not part of the series, if the payment is substantially larger or smaller than the other payments in the series. Further, an independent payment is an eligible rollover distribution if

****

it is not otherwise excepted from the definition of eligible rollover distribution. This is the case regardless of whether the payment is made before, with, or after payments in the series.

Section 3405(c)(1)(B) of the Code provides that in the case of any designated distribution, which is an eligible rollover distribution, the payor of such distribution shall withhold from such distribution an amount equal to 20 percent of such distribution.

Section 3405(c)(2) of the Code provides that paragraph (1)(B) shall not apply to any distribution paid directly to an eligible retirement plan.

Section 3405(c)(3) of the Code provides that, for purposes of this subsection, the term "eligible rollover distribution" has the meaning given such term by section 402(f)(2)(A).

Section 402(f)(2)(A) of the Code provides that the term "eligible rollover distribution" has the same meaning as when used in section 402(c).

You represent that the lump sum payments under Option E of the accumulated Option E benefit will generally far exceed the normal monthly retirement service retirement allowance which constitutes regular periodic payments and are part of a series. Therefore, the lump sum distribution will be treated as an independent payment if it is substantially larger than the normal monthly retirement service retirement allowance.

Accordingly, we conclude with respect to ruling request number two that the lump sum distribution to Option E participants (or their beneficiaries) of the accumulated Option E benefit constitutes an eligible rollover distribution within the meaning of section 402(c)(4) of the Code in those instances in which it is substantially larger than the normal monthly retirement service retirement allowance, and therefore under section 3405(c) of the Code the Trustees should withhold 20 percent of any such distribution which is not directly rolled over to another qualified plan or individual retirement account.

These rulings are based on the assumption that System C, as amended by Statute Y, will be qualified under section 401(a) of the Code at the time of the proposed contributions and distributions.

****

In accordance with a power of attorney form on file with this office, we are sending a copy of this letter to your authorized representative.

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 this Letter
Notice of Intention to Disclose

****
****

****
****
****
****
****