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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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Legend:

State B =

Retirement System U =

Retirement System V =

Retirement System W =

Retirement System X =

401(k) Plans =

This is in response to a ruling request dated August 6, 2002, as supplemented by additional correspondence dated August 29, 2002, concerning the federal income tax consequences and treatment under sections 72, 401(k)(2)(B), and 415 of the Internal Revenue Code of a proposed transfer of assets from one qualified retirement plan to another to purchase prior or additional service credit on behalf of the participants under the plan receiving the transferred assets.

The following facts and representations have been submitted:

State B (or "the Employer") established Retirement Systems U, V, W, and X (collectively referred to herein as "Retirement Systems") to provide retirement allowances and other benefits for the respective members of each Retirement System. Retirement Systems U, V, W, and X are contributory defined benefit plans which are intended to meet the requirements of Code section 401(a) as applicable to governmental plans as defined in section 414(d), and their related trusts are exempt from taxation under section 501(a). Employees participating in the Retirement Systems are required to contribute a percentage of their compensation. This amount is deducted by the Employer each payroll period and paid to the applicable Retirement System. Pursuant to State Statute, these employee contributions are required to be "picked up" by the Employer, so that they are treated as employer contributions under Code section 414(h)(2). These contributions are separately accounted for and are held in individual member accounts ("employee annuity savings fund").

Effective January 1, 1985, State B adopted the "401(k) Plans" which are supplemental retirement income plans to provide benefits for certain employees of State B or any county, municipality, or political subdivision thereof, which elects to participate in them. The 401(k) Plans are cash or deferred arrangements under Code section 401(k) and satisfy the qualification requirements of section 401(a) and the "grandfather" rules of section 1.401(k)-1(h)(4) of the Income Tax Regulations (the "Regulations"). In addition, their related trusts are tax exempt under Code section 501(a). The 401(k) Plans provide for pre-tax salary deferral contributions, employer contributions, and rollover contributions from other qualified plans, annuity contracts described in Code section 403(b), eligible governmental plans under section 457(b), or conduit IRAs under section 408(d). All contributions to the 401(k) Plans are immediately 100% vested. The pre-tax salary deferral contributions and their earnings, the rollover contributions and their earnings and the employer contributions and their earnings are separately accounted for and held in the member's salary deferral contribution account, rollover account, and employer account respectively.

In order to provide the maximum benefit under Retirement System U, V, W, or X, a member may purchase prior or additional service credit. Since a member's normal retirement benefit under each Retirement System is based on the individual's years of creditable or membership service under the Retirement System of which he or she is a member, the purchase of such service credits will enhance a member's benefit payable from the Retirement System.

Since most employees find it difficult from a financial point of view to purchase prior or additional service credit under the Retirement Systems, State B desires to amend Retirement Systems U, V, W, and X as well as the 401(k) Plans to allow an employee to use his or her vested accumulated funds under the 401(k) Plans for the limited purpose of purchasing such service credits under the Retirement Systems by means of an elective plan-to-plan transfer of the necessary amounts from the applicable 401(k) Plan to the applicable Retirement System. The amounts transferred will be held in individual member accounts under the employee annuity savings fund portion of the Retirement System and shall be credited with regular interest determined pursuant to the provisions of the applicable Retirement System. These amounts would be separately identifiable and would not be available for withdrawal from the Retirement System prior to the employee's termination of employment.

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

1) The amounts to be voluntarily transferred by a member from the applicable 401(k) Plan to the member's account under the applicable Retirement System in order to purchase prior or additional service credit for the member will not be deemed to be either actually or constructively distributed to the member of the 401(k) Plan on whose behalf such amounts are to be transferred within the meaning of Code sections 402(a) and 72(t) by reason of such transfer.

2) The voluntary transfer of a portion of an employee's 401(k) Plan account from the applicable 401(k) Plan to the member's account under the applicable Retirement System to purchase prior or additional service credit on behalf of the employee under the applicable Retirement System is neither an impermissible actual or constructive distribution under Code section 401(k)(2)(B) nor a violation of the separate accounting requirements under section 1.401(k)-1(e)(3) of the Regulations.

3) The amounts to be transferred from the applicable 401(k) Plan to the applicable Retirement System to purchase prior or additional service credit will not be considered to be contributions for the year of transfer subject to the limitation on maximum annual additions under Code section 415(c) and the benefit attributable to these transferred monies will not be subject to the section 415 limits on benefits otherwise payable from the Retirement System.

4) The amounts to be voluntarily transferred from the applicable 401(k) Plan to the member's account under the applicable Retirement System will not be considered a distribution in the year of transfer subject to withholding requirements under Code section 3405 or tax reporting under section 6047(d).

Regarding ruling request one, Code section 402(a) provides that, except as otherwise provided in this subsection, 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).

Revenue Ruling 67-213, 1967-2 C.B. 149, provides that if an employee's interest in a tax qualified plan is transferred from that plan's trust to the trust of another tax qualified plan without being made available to the employee, no taxable income will be recognized on account of the transfer.

In this case, amounts are being transferred directly from one qualified plan to another. Accordingly, with respect to ruling request one, we conclude that the amounts to be voluntarily transferred by a member from the applicable 401(k) Plan to the member's account under the applicable Retirement System in order to purchase prior or additional service credit for the member will not constitute a distribution to the member of the 401(k) Plan on whose behalf such amounts are to be transferred within the meaning of Code sections 402(a) and 72(t) by reason of such transfer.

Regarding ruling request two, section 1.401-1(b)(1)(i) of 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.

Rev. Rul. 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.

Section 401(k)(2)(B), as amended by the Economic Growth and Tax Relief Reconciliation Act of 2001, provides that a plan meeting the requirements of section 401(k) may not make distributions prior to a participant's severance from employment, death, disability or attainment of age 59&1/2. Code section 401(k)(2)(B) does allow for plan distributions upon an employee's hardship (with regards to amounts described in section 402(e)(3)) or a plan termination.

Section 1.401(k)-1(d)(6)(iv) of the Regulations provides that the distribution limitations of paragraph (d) (as also stated in Code section 401(k)(2)(B)) generally continue to apply to amounts attributable to elective contributions (including amounts treated as elective contributions) that are transferred to another qualified plan of the same employer or another employer. Thus, the transferee plan will generally fail to satisfy the requirements of section 401(a) and this section if transferred amounts may be distributed before the times specified in paragraph (d).

Section 1.401(k)-1(e)(3) of the Regulations sets forth the additional requirement for qualified cash or deferred arrangements of separate accounting, which is treated as satisfied if amounts held under the plan are treated as nonforfeitable and subject to certain distribution limitations—i.e., in pertinent part, the employee's retirement, death, disability, separation from service or termination of the plan. Separate accounting is not acceptable unless gains, losses, withdrawals, and other credits or charges are separately allocated on a reasonable basis to accounts subject to the nonforfeitability requirement and distribution limitations and to other accounts.

We have already ruled that the subject transfers will not cause a taxable event. Accordingly, with respect to ruling request two, we conclude that the voluntary transfer of a portion of an employee's 401(k) Plan account from the applicable 401(k) Plan to the member's account under the applicable Retirement System to purchase prior or additional service credit on behalf of the employee under the applicable Retirement System will not constitute a distribution under Code section 401(k)(2)(B)

With respect to separate accounting, the subject transfers will be nonforfeitable under the applicable Retirement System and since all benefits provided under the applicable Retirement System, including the subject transfers, will be subject to withdrawal and distribution restrictions that meet the requirements of Code section 401(k)(2)(B), separate accounting is deemed satisfied. Accordingly, with respect to ruling request two, we further conclude that the subject transfers will not constitute a violation of the separate accounting requirements under section 1.401(k)-1(e)(3) of the Regulations.

Regarding ruling request three, Code section 415(a)(1)(A) 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.

Code section 415(a)(1)(B) 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 1.415-3(b)(1)(iv) of the Regulations states that for purposes of limitations for defined benefit plans, when there is a transfer of assets or liabilities 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 tax qualified plan to another will not be considered an annual addition for the limitation year in which the transfer occurs.

Because Retirement Systems U, V, W, and X and the 401(k) Plans are qualified plans, the transfers from the 401(k) Plans to Retirement Systems U, V, W, and X are transfers from one qualified plan to another. Therefore, with respect to ruling request three, we conclude that the amounts to be transferred from the applicable 401(k) Plan to the applicable Retirement System to purchase prior or

additional service credit will not be considered to be contributions for the year of transfer subject to the limitation on maximum annual additions under Code section 415(c) and the benefit attributable to these transferred amounts will not be subject to the section 415 limits on benefits otherwise payable from the Retirement System. This ruling relates only to transfers that are equal to the actuarial cost of the service being purchased.

With respect to ruling request four, Code sections 3405(a)(1) and (b)(1) provide generally that the payer of any periodic payment or nonperiodic distributions must withhold amounts from such payments and distributions. Sections 3405(e)(2) and (3) define a "periodic payment" and "nonperiodic distributions" to mean all designated distributions.

Code section 3405(e)(1)(A) defines the term "designated distribution" to include any distribution or payment from or under an employer deferred compensation plan. Q&A-3 of section 35.3405-1 of the Regulations provides that an employer deferred compensation plan is any pension, annuity, profit sharing, stock bonus, or other plan that defers the receipt of compensation. Q&A-22 of section 35.3405-1 also provides that a retirement plan maintained by a state or local government on behalf of its employees is a plan that defers the receipt of compensation.

Code section 3405(e)(1)(B)(ii) provides, however, that the term "designated distribution" shall not include any portion of any distribution or payment which it is reasonable to believe is not includible in income. Q&A-2 of section 35.3405-1 of the Regulations provides similarly that a designated distribution does not include any portion of a distribution which it is reasonable to believe is not includible in income.

Code section 6047(d) provides, in part, that an employer maintaining a qualified plan (or the plan administrator) from which designated distributions (as defined in Code section 3405(e)(1)) may be made, must make returns and reports regarding such plan to the Secretary, to the participants and beneficiaries of such plan, and to such other persons as the Secretary may by regulations prescribe.

It has been represented that the transfers to the applicable Retirement System will not be within the control of a member but will be transferred by the trustee of the applicable 401(k) Plan directly to the trustee of the applicable Retirement System. Further, such transfers will be subject to withdrawal and distribution restrictions so that a participant in the applicable Retirement System may not withdraw or receive a distribution of amounts representing the applicable 401(k) Plan transfer amounts prior to death, disability, or severance from employment. We have also ruled with respect to ruling requests one and two that the amounts

transferred to the applicable Retirement System from the applicable 401(k) Plan will not result in ordinary income to the member under Code section 402 nor will the transfer constitute a distribution under section 401(k)(2)(B). Thus, with respect to ruling request four, we conclude that the amounts to be voluntarily transferred from the applicable 401(k) Plan to the member's account under the applicable Retirement System will not be considered a designated distribution in the year of transfer subject to withholding requirements under Code section 3405 or tax reporting under section 6047(d).

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

This ruling is based on the assumption that Retirement Systems U, V, W, and X and the 401(k) Plans are qualified under Code section 401(a) at all relevant times.

If you have any questions, please call , T: EP: RA:T1
, at

Sincerely yours,

Andrew E. Zuckerman

Manager, Employee Plans
Technical Group 1

Enclosures:
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