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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

200617038

U.I.L. 415.00-00

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Attn: **********

LEGEND:

Employer A = **********

State C = **********

Plan X = **********

Plan Y = **********

Dear **********

This is in response to a request for a private letter ruling dated April 22, 2004, as supplemented by correspondence dated June 8, 2004, which was submitted on your behalf by your authorized representative concerning the tax treatment of certain proposed trustee-to-trustee transfer of funds from Plan Y to Plan X.

The following facts and representations were made in support of your ruling requests:

Employer A, a political subdivision of State C, maintains Plan X and Plan Y for the benefit of its employees. Plan X is a governmental defined benefit plan which you represent is qualified under section 401(a) of the Internal Revenue Code (the "Code"). You represent that Plan Y is an eligible deferred compensation plan as described in Code section 457(b).

Plan X provides its eligible participants with retirement benefits based upon years of service and certain specified percentages of a participant's compensation. Since , Plan X has offered two benefit formula: the "Pre-Amended Plan Formula" and the "Amended Plan Formula". Prior to , benefits under Plan X were solely provided through contributions made by Employer A.

In , Employer A amended Plan X to allow then-current participants to make a one-time election to (1) either remain under Plan X's "Pre-Amended Plan Formula" with benefits funded solely from Employer A contributions, or (2) make a contribution and receive the "Amended Plan Formula", including a "Rule of 75" retirement option.

The "Pre-Amended Plan Formula" calculates retirement benefits as follows: total years of service from date of hire until January 1, 1989, multiplied by one percent of a participant's average annual compensation up to $6,000, plus, two percent of a participant's average annual compensation above $6,000 plus $36; plus years of service from January 1, 1989, up to 35, multiplied by 1.7 percent of the participant's average annual compensation up to $10,000, plus two percent of the participant's average annual compensation above $10,000 plus $36.

The "Amended Plan Formula" calculates retirement benefits as follows: years of service multiplied by two percent of a participant's average annual compensation, plus $36.

The "Rule of 75" retirement option allows for a participant who has attained age 50, and whose age plus years of service equal 75, to receive an unreduced pension benefit.

All eligible employees hired after April 1, 1995, and prior to the establishment of Employer A's defined contribution plan (in) participated in Plan X under the Amended Plan Formula.

Employees of Employer A who continue to participant in Plan Y and those eligible employees hired after April 1, 1995, are required to contribute to Plan X, an amount determined by Plan X to meet its funding obligations, but in no event more than six percent of their compensation. The actual contribution amount is determined each April 1 and may increase .5 percent per year. You represent that these amounts are picked up by Employer A pursuant to section 414(h) of the Code.

Employer A intends to amend Plan X in order to provide for an enhanced formula by replacing the two formula currently used by Plan X with a third formula. The new proposed benefit formula would calculate retirement benefits as follows: 2.25 percent of compensation multiplied by the participant's years of service. Employer A also intends to offer an optional enhanced benefit under which Plan X benefits would be calculated using a factor of 2.5 percent (the "New Enhanced Formula").

You represent that the actuary for Plan X has determined that this New Enhanced Formula requires a participant to make contributions of approximately 7.25 percent of compensation for at least three years. The New Enhanced Formula will require a participant to contribute the difference between 7.25 percent, for example, and the amount he or she contributed to Plan X over the prior three years. During an election period, Plan X will allow participants who choose the New Enhanced Formula to elect to make the required contributions by (1) authorizing an additional withholding from current compensation; (2) making an after-tax contribution; or (3) authorizing the transfer of money from their Plan Y accounts. For participants who remain employed, this

contribution for the prior three (3) years will be made by the participant over the subsequent three (3) years, and in such case will be picked up by Employer A pursuant to section 414(h) of the Code.

For participants who elect to make this contribution over the subsequent three years but terminate employment or otherwise cease participating in Plan X before the completion of this three year period may have their retirement benefit calculated using the Amended Plan Formula, in which case Plan X would refund to them the additional contributions they made to supplement the contributions needed under the formula they had previously elected (either the Amended Plan Formula or the New Amended Plan Formula), plus earnings.

Employer A also proposes to amend Plan X to allow participants who elect the New Enhanced Formula and who are eligible for retirement and who terminate employment before completing the required three years from the date of their election to pay a lump sum that Plan X's actuary will determine is necessary to purchase the New Enhanced Formula. Employer A intends to amend Plan X to allow such participants to pay this additional contribution either by making an after-tax contribution or, by making an elective trustee to trustee transfer of all or a portion of their Plan Y account to Plan X.

Furthermore, Employer A also intends to amend Plan X to allow participants to purchase up to five (5) years of service credit for time spent working for any employer other than Employer A by transferring funds from their Plan Y account to Plan X. The amount required to purchase additional years of service will be determined by the actuary for Plan X and will be an amount needed to fund these additional years of service. This service credit would apply to any formula available under Plan X: the Pre-Amended plan Formula, the Amended Plan Formula, or the New Enhanced Plan Formula, whichever is applicable.

Based upon the aforementioned facts and representations, you request the following rulings:

1. That a participant's purchase of a new, enhanced benefit formula under Plan X, which would require additional contributions to supplement the prior three years' contributions, by authorizing a trustee-to-trustee transfer of money from their Plan Y account to Plan X meets the requirements of Code section 457(e)(17) because the supplemental contributions are for the purchase of permissive service credit, such that the amount transferred is not included in the participants' gross income under Code sections 61 and 72(t) at the time of the transfer.

2. That an elective purchase by participants in Plan X in the form of a transfer from their Plan Y account of up to five (5) years of service the participant worked with any employer other than Employer A meets the requirements of Code section 457(e)(17) because it is for the purchase of permissive service credit, so that a trustee-to-trustee transfer of amounts needed to fund this

additional service credit is not included in participants' gross income pursuant to Code section 61 or 72(t).

Section 72 of the Code provides that, except as otherwise provided, gross income, as defined in section 61 of the Code, includes any amount received as an annuity, an endowment, or a life insurance contract.

Section 72(t)(1) provides for the imposition of an additional 10 percent tax on early distributions from qualified plans, including IRAs. The additional tax is imposed on that portion of the distribution that is includible in gross income.

Section 72(t)(2)(A)(iv) of the Code provides that section 72(t)(1) shall not apply to distributions that are part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the employee or joint lives (or joint life expectancies) of such employee and his designated beneficiary.

Section 457(e)(17) of the Code provides that no amount shall be includible in gross income by reason of a direct trustee-to-trustee transfer to a defined benefit governmental plan (as defined in section 414(d) of the Code) if such transfer is for the purchase of permissive service credit (as defined in section 415(n)(3)(A) of the Code).

Section 415(n) of the Code provides special rules relating to the purchase of permissive service credit.

Section 415(n)(1) of the Code provides that if the employee makes one or more contributions to a defined benefit governmental plan (within the meaning of section 414(d)) to purchase permissive service credit under such plan, then the requirements of this section shall be treated as met only if—

(A) the requirements of such subsection (b) are met, determined by treating the accrued benefit derived from all such contributions as an annual benefit for the purposes of subsection (b), or

(B) the requirements of subsection (c) are met, determined by treating all such contributions as annual additions for the purpose of subsection (c).

Section 415(n)(3)(A) provides that the term "permissive service credit" means 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 415(n)(3)(B) of the Code provides the limitation of nonqualified service. Section 415(n)(3)(B) provides that a plan shall fail to meet the requirements of this section if--

(i) more than 5 years of permissive service credit attributable to nonqualified service are taken into account for purposes of this subsection, or

(ii) any permissive service credit attributable to nonqualified service is taken into account under this subsection before the employee has at least 5 years of participation in the plan.

Section 415(n)(3)(C) of the Code generally defines the term "nonqualified service" as service other than (i) service as an employee of the federal government, any state or political subdivision or agency or instrumentality thereof; (ii) service as an employee of certain educational organizations who are described in section 170(b)(1)(A)(ii) of the Code; (iii) service as an employee of an association of employees who are described in (i); or (iv) military service. Section 415(n)(3)(C) further provides that in the case of such service previously described in (i), (ii), and (iii), such service will be nonqualified service if recognition of such service would cause a participant to receive a retirement benefit for the same service under more than one plan.

In this case, Employer A intends to amend Plan X to offer participants an opportunity to elect to have their benefits calculated under the "New Enhanced Formula", under which benefits are based on a factor of 2.5 percent of compensation. You also represent that the actuary for Plan X has determined that in order for a participant to accrue this benefit calculated using a factor of 2.5 percent of compensation, he or she would have to contribute to Plan X for three years subsequent to the election, an amount equal to the difference between the rate determined by the actuary and the amount the participant actually contributed to Plan X over the prior three years of service. Employer A proposes to allow participants who elect to have their benefits calculated under the "New Enhanced Formula" the ability to pay the cost of such enhanced benefit by transferring assets from their Plan Y account directly to Plan X.

The "New Enhanced Formula" allows participants in Plan X to make additional voluntary contributions to Plan X that will increase the percentage of annual compensation that is used to calculate their retirement benefits, thereby satisfying clauses (i) and (iii) of Code section 415(n)(3)(A). However, Code section 415(n)(3)(A)(ii) provides that "permissive service credit" does not include service for which the participant has already received credit for under the governmental plan. In this case, the amount that each participant will contribute to Plan X is the difference between the amount determined by the actuary for Plan X and the amount the participant contributed to Plan X for his or her prior three years of service, service for which he or she has already received credit for under the terms and provisions of Plan X. As such, these additional contributions will purchase additional benefits with respect to service that has already been recognized by Plan X. Because the additional member contributions proposed to be made to Plan X are not

contributions that meet the requirements of Code section 415(n)(3)(A)(ii), we conclude, with respect to your first ruling request that a participant's purchase of the "New Enhanced Formula" under Plan X, which would require additional contributions to supplement the three prior years' contributions, by authorizing a trustee-to-trustee transfer of money from a member's Plan Y account to Plan X will be included in the participants' gross income under Code section 61 and Code section 72(t) at the time of transfer because the transfer is not for the purchase of "permissive service credit" as described in Code section 457(e)(17) and Code section 415(n)(3)(A).

With respect to your second ruling request, Employer A intends to amend Plan X to allow participants to purchase up to five (5) years of service credit for time worked with another employer other than Employer A by transferring funds from their Plan Y account to Plan X. Section 415 of the Code provides special rules relating to the purchase of permissive service credit, and subsection (3)(B) specifically limits the purchase of nonqualified service to no more than five (5) years of permissive service credit attributable to nonqualified service.

"Permissive service credit" relates to an actual period of service or period of employment for which the employee has not yet been credited with performing service for an employer under the terms and provisions of a plan, and for which the employee would be credited with performing under the terms and provisions of a plan once payment is made. In this case, the additional service that a Plan X participant can purchase is linked to a period of employment with any other employer other than Employer A for which the participant has not previously received credit for under the terms of Plan X. The participant has not received credit with performing service for Employer A for these periods of prior employment but would be credited with performing service once payment is made. The additional service that would be purchased under the proposed amendment to Plan X is recognizable by Plan X for purposes of calculating a member's benefit as one of the criteria used to calculate the retirement benefit under Plan X is the participant's years of service. Since the prior employment with any employer, other than Employer A, relates to an actual period of employment for which the participant has ~~not~~ received credit under the terms of Plan X and ~~such~~ additional service can only be purchased by a member making an additional voluntary contribution to Plan X, we conclude that such service that is purchasable under proposed amendment to Plan X is permissive service credit under Code section 415(n)(3)(A). Having concluded that such service is permissive service credit, we conclude, with respect to your second ruling request that an elective purchase by participants in Plan X in the form of a transfer from their Plan Y account to Plan X of up to five (5) years of service the participant worked with any employer other than Employer A meets the requirements of Code section 457(e)(17) because it is for the purchase of permissive service credit, and the trustee-to-trustee transfer of amounts from Plan X to Plan X to fund this additional service credit will not be includable in the participants' gross income pursuant to Code section 61 or Code section 72(t).

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This ruling is based on the assumption that Plan X meets the qualification requirements of section 401(a) of the Code and qualifies as a governmental plan as the term is defined in section 414(d).

This ruling is based on the assumption that Plan Y meets the qualification requirements of Code section 457.

No opinion is expressed as to the tax consequences of purchasing service credit under the enhanced benefit formula by making additional withholdings from current compensation or with after-tax contributions.

No opinion is expressed as to the validity of the pick up of the participants' required contributions made to Plan X pursuant to Code section 414(h)(2). Further, no opinion is expressed as to the validity of the proposed pick up of contributions made to Plan X under the New Enhanced Formula of Plan X pursuant to Code section 414(h)(2).

No opinion is expressed as to whether the proposed transfer of assets as contemplated in this ruling meets the requirements of Rev. Rul. 67-213, 1967-2 C.B. 149.

This letter ruling is directed only to the taxpayer that 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 has been sent to your authorized representative in accordance with a power of attorney on file in this office.

If you have any questions, please contact **********SE:T:EP:RA:T2.

Sincerely yours,

(signed) JOYCE E. FLOYD

Joyce E. Floyd, Manager
Employee Plans Technical Group 2

Enclosures:
Deleted copy of ruling letter
Notice of Intention to Disclose