Significant Index No. 0415.00-00

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY 200219042
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

FEB 15 2002

T:EP:RA:T1

In re:

This letter is in response to a request by your authorized representative dated September 13, 2001 for rulings on the tax treatment of lump sum distribution from the Plan. Your conference of right was held in our offices on January 16, 2002 and was attended by your authorized representative. Pursuant to correspondence from your authorized representative dated February 6, 2002, requests for three of the five rulings were withdrawn.

The Employer is a subdivision of the State. The Employer maintains the Plan, which is intended to be a qualified plan under § 401(a) of the Internal Revenue Code. The Plan is a governmental plan as described in § 414(d). The Plan is a defined benefit plan and has received its most recent favorable determination letter on July 23, 2001. The Plan covers both collectively bargained employees and non-collectively bargained employees. The Plan operates on an April 1-March 31 plan year basis.

As mentioned above, the Employer originally requested five rulings. As referred to above, Ruling Requests 2, 3 and 5 have been withdrawn. Accordingly, we are ruling on Ruling Requests 1 and 4:

- **Ruling Request 1** – Whether a lump sum distribution of the accumulated retroactive deferred retirement option program (the "total DROP" or "lump sum DROP") from the Plan to a Plan participant constitutes an eligible rollover within the meaning of § 402(c)(4) of the Code, and thus, may be directly transferred trustee-to-trustee into an eligible retirement plan pursuant to § 401(a)(31).
- **Ruling Request 4** – Whether the lump sum DROP benefit is a benefit that must be converted to an actuarially equivalent annual benefit and included in the participant's annual benefit when determining the Plan's compliance with § 415(b).

233

The Plan provides for an optional form of benefit known as the Back DROP Benefit. This option is available to participants that elect to retire after January 1, 2000. The participant must elect to receive the Back DROP Benefit. This benefit is a two-part benefit:

1. The "lump sum DROP Benefit" and
2. An early or normal (as applicable) retirement monthly annuity calculated as of the Back DROP date.

To receive the Back DROP Benefit, the participant needs to select a date in the past (the "Back DROP Date"). Such date is used to calculate the both parts of the Back DROP Benefit. Such date cannot be earlier than when the participant was first eligible for retirement and no later than one year prior to when the participant leaves active service.

Such participant benefits are calculated as of the Back DROP date. Final average salary and years of service are frozen as of that date.

The lump sum DROP Benefit (part 1 of the Back DROP Benefit) is equal to the total of the monthly DROP benefit payments the participant would have received from the Back DROP date to the actual retirement date. These monthly DROP payments include COLAs as if the benefits had commenced on the Back DROP date. The lump sum DROP Benefit also includes compounded (monthly) interest (at the Plan's rate) that would have accrued on a hypothetical account had the participant commenced monthly benefits on the Back DROP date,

The participant can receive the lump sum DROP Benefit in a direct lump sum payment. However, if the Service approves, the Employer would like to have the Plan provide that such amounts may be rolled over to an IRA or other eligible retirement plan.

The Plan provides that the lump sum DROP Benefit is considered to be an annual benefit for purposes of § 415(b) of the Code. This lump sum is converted to an actuarially equivalent straight life annuity.

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 § 401(a)(9); and
c) Any hardship distribution under § 401(k)(2)(B)(i)(IV).

Section 1.402(c)-2,Q&A-6, of the 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 series payments.

The Employer states that a participant's lump sum DROP Benefit will be significantly larger than the amount of the monthly annuity.

Thus, with regard to Ruling Request 1, because the lump sum DROP Benefit 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 § 402(c)(4) of the Code.

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 § 415(b). Section 415 (b)(1) provides that a participant's annual benefit may not exceed the lesser of the specified dollar amount (currently $140,000) or 100% of the participant's final average compensation. Section 415(b)(11) provides that the 100% 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 § 415(b)(2)(B) for any benefit form subject to § 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 § 415(b)(2)(B), the mortality table used shall be the table that is based on the prevailing commissioners' standard table (see § 807(d)(5)(A)) 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 § 807(d)(5)(A)) 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 § 415(b) of the Code, the lump sum DROP Benefit is merely part of a participant's accrued benefit. Because the DROP Benefit is made in the form of a lump sum distribution, § 415(b)(2)(B) provides that such distribution must be converted to an actuarially equivalent straight life annuity using the rules of § 417(e)(3). Once the lump sum DROP Benefit is actuarially converted, such benefit must be counted as applying to a participant's benefit limitation under § 415(b).

Therefore, with regard to Ruling Request 4, as stated above, the lump sum DROP Benefit 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 § 415(b) of the Code.

This ruling letter 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.

These rulings are based on the assumptions that the Plan is qualified under § 401(a) of the Code and that its related trust is tax-exempt under § 501(a) at all times relevant to this ruling.

We have sent a copy of this letter to your authorized representative pursuant to a Form 2848 (Power of Attorney) on file with our office. If you have any questions, please contact me. Or, you may contact

Sincerely,

James E. Holland, Jr.

James E. Holland, Jr., Acting Manager
Employee Plans Technical