Bond Case Briefs

Municipal Finance Law Since 1971

IRS LTR: Employee Plan Constitutes Defined Benefit Plan

In technical advice, the IRS concluded that an employee plan for police officers and firefighters, after the adoption of a deferred retirement option plan (DROP) amendment, is a defined benefit plan that provides a benefit derived from employer contributions that is based partly on the balance of the separate account of a participant.

The plan is maintained by a municipality in Michigan and is a governmental plan within the meaning of section 414(d). The plan is also a defined benefit plan under section 414(j).

The IRS determined that allocations of 75 percent of the otherwise payable pension benefits to the DROP accounts are annual additions subject to the limitations of section 415(c)(1). Moreover, the distribution of the DROP account to a retired plan participant is an eligible rollover distribution under section 402(c)(4) and is eligible for the direct rollover provision of section 401(a)(31).

ISSUES

(1) Whether the Plan, after the deferred retirement option plan (DROP) amendment, is a defined benefit plan which provides a benefit derived from employer contributions which is based partly on the balance of the separate account of a participant.

(2) Whether allocations to the DROP accounts are annual additions subject to the limitations under section 415(c)(1) of the Code.

(3) Whether the distribution of the DROP account to a retired plan participant is an eligible rollover distribution under section 402(c)(4) of the Code and eligible for the direct rollover provision of section 401(a)(31) of the Code.

FACTS

The above-named Plan is maintained by the Taxpayer, a municipality within the State of Michigan, and is a governmental plan within the meaning of section 414(d) of the Code.2 The Plan is also a defined benefit plan under section 414(j) of the Code. Only policemen and firemen employed by the Taxpayer are eligible to participate in the Plan.

The System and Plan were established by the Taxpayer effective July 1, 1941. The most recent determination letter issued to the Plan is dated March 5, 1987. The Taxpayer submitted a request for a determination letter (Form 5300, Application for Determination for Employee Benefit Plan) to the Internal Revenue Service (Service), on January 26, 2004.

During the processing of the determination letter request, the Service determined that the Plan had not been timely amended with respect to TRA ’86, UCA ’92, OBRA ’93, GATT, SBJPA, TRA ’97, and GUST in violation of section 401(a) of the Code. On June 10, 2004, the Service and the System entered into a closing agreement to resolve these issues.

On February 27, 2002, the System’s Board of Trustees adopted a resolution pursuant to the collective bargaining process to adopt the DROP. The provisions of the DROP are effective the later of (1) March 1, 2003, and (2) the date the Service issues a determination that the DROP does not adversely affect the qualified status of the Plan.

Article II of the Plan describes the various definition of terms used in the Plan in determining retirement benefits. Section 2 of this article defines “policemen” as all employees of the Taxpayer’s Police Department.

Article II, section 3 defines “firemen” as all employees of the Taxpayer’s Fire Department, except those excluded by their classification as civilian employees.

Article II, section 4 defines “member” as any policeman or fireman.

Article II, section 8 defines “service” as service as a policeman or fireman.

Article II, section 10 defines “membership service” as the total service rendered as a policeman or fireman.

Article II, section 14 defines “average final compensation” as:

(a) the average earnable compensation of a member during his last 5 years of service, or total years of service if less than five, for a member described in article IV, section 1(a), (b), or (c); or

(b) the highest average annual compensation received by a member during any 5 consecutive years of credited service selected by the member contained within his 10 years of credited service immediately preceding the date of his employment with the city last terminated, or total years of service if less than five, for a member described in article IV, section 1(d).

Article II, section 15 defines “final compensation” as the annual rate of earnable compensation of a member at the time of termination of employment.

Article II, section 16 defines “earnable compensation” as the compensation fixed by the budget for the rank, grade, or position of member.

Article II, section 17 defines “annuity” as the payments derived from the accumulated contributions of a member.

Article II, section 18 defines “pension” as the payments derived from money provided by the Taxpayer.

Article II, section 19 defines “retirement allowance” as the sum of the annuity and the pension.

Article II, section 20 defines “retirement” as withdrawal from active service with a retirement allowance or pension.

Article IV of the Plan describes membership. Section 1 states that membership of the System generally consists of:

(a) All policemen and firemen, as defined in section 2 and 3 of Article II, who are in service on or after July 1, 1941, but prior to January 1, 1969;

(b) All persons who become policemen and firemen on or after July 1, 1941, but prior to January 1, 1969, and who are confirmed, subject to special provisos for those who are at an attained age of 31 years or more, appointive officials of the Police Department or Fire Department, and any policeman or fireman who is killed or totally incapacitated on active duty prior to being confirmed;

(c) Any member described in (a) or (b) who is transferred to a civilian position in his department;

(d) All persons who become policemen or firemen on or after January 1, 1969, and who are confirmed, subject to special provisos for those who are at an attained age of 31 years or more, appointive officials of the Police Department or Fire Department, any policeman or fireman who is killed or totally incapacitated on active duty prior to being confirmed, any member who under section 1(a), (b), or (c) who separated from service and was subsequently again becomes a member, and any member described in section 1(d) who is transferred to a civilian position in his department.

Article VI, Part A of the Plan describes the service retirement allowance. Section 1 describes the petition for and mandatory age for retirement. Section 1(a) states that any member described in article IV, section 1(a), (b), or (c) in service may file a written application for retirement setting forth a date not less than 15 days nor more than 90 days subsequent thereof, with a total creditable service of 25 years or more. However, firemen with 25 years of creditable service or more may be retired by the Board of Trustees upon recommendation of the Board of Fire Commissioners.

Article VI, Part A, section (1)(b) states that any member described in article IV, section 1(d) in service may file a written application for retirement setting forth a date not less than 15 days nor more than 90 days subsequent thereof, with a total creditable service of 25 years or more and attained age of 55. However, firemen with 25 years of creditable service or more, and who have attained age 55, may be retired by the Board of Trustees upon recommendation of the Board of Fire Commissioners.

Article VI, Part A, section (1)(c) states that any member described in article IV, section 1(a), (b), (c), or (d) who shall reach age 60 shall be retired forthwith. However, such member may continue in service for a maximum of two 2-year terms beyond age 60 with written permission.

Article VI, Part A, section (2) states that upon retirement, a member described in article IV, section 1(a), (b), or (c) shall receive a straight life retirement allowance described in (a) and (b) below:

(a) an annuity which will be the actuarial equivalent of his accumulated contributions standing to his credit in the Annuity Savings Fund at the time of his retirement, and

(b) a pension, which when added to the annuity in (a), will provide a straight life retirement allowance equal to 2% of his average final compensation, multiplied by the number of years, and fraction of a year, of his creditable service, not to exceed 25 years, provided that the pension of a policeman will not exceed 15/22 of the maximum earnable compensation of a patrolman and the pension of a fireman will not exceed 15/22 of the maximum earnable compensation of a firefighter.

Article VI, Part A, section 2.1 states that upon retirement, a member as defined in Article IV, section 1(d) who has at least 25 years of service and who has attained at least age 55 shall receive a straight life retirement allowance descried in (a) and (b) below, and shall have the right to elect an option provided for in part H of Article VI:

(a) an annuity which will be the actuarial equivalent of his accumulated contributions standing to his credit in the Annuity Savings Fund at the time of his retirement, and

(b) a pension, which when added to the annuity in (a), will provide a straight life retirement allowance equal to 2% of his average final compensation, multiplied by the number of years, and fraction of a year, of his creditable service, not to exceed 35 years.

Article VI, Part H, describes the optional forms of benefit election including a cash refund annuity, a joint and last survivorship retirement allowance, a modified joint and last survivorship retirement allowance, and a single sum distribution of his accumulated contributions to the Annuity Savings Fund.

The DROP applies with respect to those members of the System who are covered by a collective-bargaining agreement with a DROP program.

Section 1 of the DROP states that in lieu of terminating employment and accepting a service retirement allowance under the Plan provisions, any applicable member of the System who is eligible for the DROP program and who is eligible to immediately receive a 25-year service retirement allowance may elect to participate in the DROP and defer receipt of retirement benefits, effective for DROP eligible members retiring on or after the later of March 1, 2002, or after Service approval of the DROP provisions.

Section 2 of the DROP states that no additional service credit will be earned by a participant in the DROP.

Section 3 of the DROP states that there is no limit to the duration of participation in the DROP.

Section 5 of the DROP states that upon the effective date of commencement of participation in the DROP, active membership in the System shall terminate. However, employer contributions shall continue to be paid to the System for the DROP participant as if the DROP participant was not a DROP participant. For purposes of this section, compensation and credit service shall remain as they existed on the effective date of commencement of participation in the DROP. Seventy-five (75%) percent of the monthly retirement benefits (including applicable escalator increases) that would have been payable had the member elected to cease employment and receive a service retirement allowance, shall be paid into the DROP account, a separate account established for each DROP participant. Upon termination of employment, deferred benefits (the DROP account balance) shall be paid as provided in the DROP.

Section 6 of the DROP names the DROP Trust as the initial DROP depositor entity.

Section 7 of the DROP states that the DROP applicable amounts will be invested as directed by the member within the investment choices provide by the DROP Trust.

Section 9 of the DROP states that upon termination of employment, a participant in the DROP shall receive, at his or her option, either a single sum payment from the DROP account equal to the payments to the account plus earnings adjusted for any losses, a true annuity based upon his or her adjusted account, or any other method of payment allowed by the DROP Trust. The participant's monthly benefits that would have been otherwise paid at retirement prior to participation in the DROP shall be paid to the retiree. Termination of employment includes termination of any kind.

Section 18 of the DROP states that the effective date of the DROP provisions is subject to confirmation from the Service that the DROP does not adversely affect the qualified status of the Plan.

Section 33(N) of the Master Agreements between the Taxpayer and Association 1 (Agreement 1) references the DROP and states the DROP shall be made available July 21, 2000.

Section 33(N)(1) of Agreement 1 states that a member covered by Agreement 1 must have at least 25 years of active service with the Taxpayer as a member of the System, Section 33(N)(2) states that there will be no limit on the number of years that a member may participate in the program.

Section 33(N)(4) of Agreement 1 states that a DROP accumulation account will be established with an outside investment company chosen by the Union.

Section 33(N)(5) of Agreement 1 states that the amount paid into the DROP accumulation account shall be 75% of the member's regular retirement allowance plus the annual escalator (2.25% times the full regular retirement allowance times 75%).

Section 33(N)(6) of Agreement 1 states that once a member has chosen to place his DROP proceeds into the DROP accumulation account, the member shall not be allowed to remove those funds until the member permanently retires.

Section 33(N)(7) of Agreement 1 states that upon permanent retirement, the member shall be given the right to remove funds from the DROP accumulation account.

Section 33(N)(8) of Agreement 1 states that when the member permanently retires, the member will receive a regular retirement allowance calculated as if the member retired on the day that the DROP account started. The member's retirement allowance shall include all annual escalator amounts (2.25%) that would have been added while the member was participating in the DROP.

Section 33(N)(9) of Agreement 1 states that the DROP will not be put into effect unless it is approved by the Service.

Section 42 of the Master Agreement between the Taxpayer and Association 2 (Agreement 2) references the DROP.

Section 42(1) of Agreement 2 states that a member covered by Agreement 2 must have at least 25 years of active service with the Taxpayer as a member of the System. Section 42(2) states that there will be no limit on the number of years that a member may participate in the program.

Section 42(4) of Agreement 2 states that a DROP accumulation account will be established with an outside investment company chosen by the Union.

Section 42(5) of Agreement 2 states that the amount paid into the DROP accumulation account shall be 75% of the member's regular retirement allowance plus the annual escalator (2.25% times the full regular retirement allowance time 75%).

Section 42(6) of the Agreement 2 states that once a member has chosen to place his DROP proceeds into the DROP accumulation account, the member shall not be allowed to remove those funds until the member permanently retires.

Section 42(7) of Agreement 2 states that upon permanent retirement, the member shall be given the right to remove funds from the DROP accumulation account.

Section 42(8) of Agreement 2 states that when the member permanently retires, the member will receive a regular retirement allowance calculated as if the member retired on the day that the DROP account started. The member's retirement allowance shall include all annual escalator amounts (2.25%) that would have been added while the member was participating in the DROP.

Section 42(9) of Agreement 2 states that the DROP will not be put into effect unless it is approved by the Service.

Section 22(B)(14)(p) of the Master Agreement between the Taxpayer and Association 3 (Agreement 3) references the DROP.

Section 22(B)(14)(p)(1) of Agreement 3 states that a member covered by Agreement 3 must have at least 25 years of active service with the Taxpayer as a member of the System. Section 33(N)(2) states that there will be no limit on the number of years that a member may participate in the program.

Section 22(B)(14)(p)(4) of Agreement 3 states that a DROP accumulation account will be established with an outside investment company chosen by the Union.

Section 22(B)(14)(p)(5) of Agreement 3 states that the amount paid into the DROP accumulation account shall be 75% of the member’s regular retirement allowance plus the annual escalator (2.25% times the full regular retirement allowance times 75%).

Section 22(B)(14)(p)(6) of Agreement 3 states that once a member has chosen to place his DROP proceeds into the DROP accumulation account, the member shall not be allowed to remove those funds until the member permanently retires.

Section 22(B)(14)(p)(7) of Agreement 3 states that upon permanent retirement, the member shall be given the right to remove funds from the DROP accumulation account.

Section 22(B)(14)(p)(8) of Agreement 3 states that when the member permanently retires, the member will receive a regular retirement allowance calculated as if the member retired on the day that the DROP account started. The member’s retirement allowance shall include all annual escalator amounts (2.25%) that would have been added while the member was participating in the DROP.

Section 22(B)(14)(p)(9) of Agreement 3 states that the DROP will not be put into effect unless it is approved by the Service.

APPLICABLE LAW

Section 401(a) of the Code provides the requirements for a qualified pension plan.

Section 401(a)(25) of the Code provides that a defined benefit pension plan shall not be treated as providing definitely determinable benefits unless, whenever the amount of any benefit is to be determined on the basis of actuarial assumptions, such assumptions are specified in the plan in a way which precludes employer discretion.

Section 401(a)(31)(A) of the Code provides that a trust shall constitute a section 401(a) qualified trust only if the plan of which such trust is a part provides that if the distributee of any eligible rollover distribution (i) elects to have such distribution paid directly to an eligible retirement plan, and (ii) specifies such eligible retirement plan to which such distribution is to be paid (in such form and at such time as the plan administrator may prescribe), such distribution shall be in the form of a direct trustee-to-trustee transfer to the eligible retirement plan so specified.

Section 402(c)(4) of the Code provides that the term “eligible rollover distribution” means any distribution to an employee of all or any portion of the balance to the credit of the employee in a qualified trust except the following distributions: (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 period of 10 years or more; (B) any distribution to the extent the distribution is required under section 401(a)(9); and (C) any distribution which is made upon hardship of an employee.

Section 414(d) of the Code provides, in part, that the term "governmental plan" means a plan established and maintained for its employees by a State or political subdivision thereof.

Section 414(i) of the Code provides that the term "defined contribution plan" means a plan which provides for an individual account for each participant and for benefits based solely on the amount contributed to the participant's account, and any income, expenses, gains and losses, and any forfeitures of accounts of other participants which may be allocated to such participant's account.

Section 414(j) of the Code provides that the term "defined benefit plan" is any plan that is not a defined contribution plan.

Section 414(k) provides that a defined benefit plan which provides a benefit derived from employer contributions which is based partly on the balance of the separate account of a participant shall:

(1) for purposes of section 410 (relating to minimum participation standards), be treated as a defined contribution plan,

(2) for purposes of sections 72(d) (relating to treatment of employee contributions as separate contract), 411(a)(7)(A) (relating to minimum vesting standards), 415 (relating to limitations on benefits and contributions under qualified plans), and 401(m) (relating to nondiscrimination tests for matching requirements and employee contributions), be treated as consisting of a defined contribution plan to the extent benefits are based on the separate account of a participant and as a defined benefit plan with respect to the remaining portion of benefits under the plan, and

(3) for purposes of section 4975 (relating to tax on prohibited transactions), be treated as a defined benefit plan.

Section 415 of the Code provides for certain limitations on contributions and benefits under qualified plans. Section 415(c) of the Code limits the annual additions to which a participant may be entitled under a defined contribution plan during any limitation year.

Section 415(c)(1) provides that, in general, contributions and other additions with respect to a participant exceed the limitation of this subsection if, when expressed as an annual addition (within the meaning of paragraph (2)) to the participant's account, such annual addition is greater than the lesser of (A) $40,000, or (B) 100 percent of the participant's compensation.

Section 415(c)(2) of the Code provides that for purposes of paragraph (1), the term "annual addition" means the sum for any year of (A) employer contributions, (B) the employee contributions, and (C) forfeitures. For the purposes of this paragraph, employee contributions under subparagraph (B) are determined without regard to any rollover contributions (as defined in sections 402(c), 403(a)(4), 403(b)(8), 408(d)(3), and 457(e)(16)) without regard to employee contributions to a simplified employee pension which are excludable from gross income under section 408(k)(6). Subparagraph (B) of paragraph (1) shall not apply to any contribution for medical benefits (within the meaning of section 419A(f)(2)) after separation from service which is treated as an annual addition.

Section 415(d) of the Code requires that the Commissioner annually adjust these limits for years after 1987 for cost-of-living increases using procedures similar to procedures used to adjust benefit amounts under § 215(i)(2)(A) of the Social Security Act. Sections 1.415-5 and 1.415-6 of the regulations provide rules regarding these adjustments.

Section 1.401(a)(31)-1, Q&A-1, of the regulations provides that for purposes of section 401(a)(31) of the Code, eligible rollover distribution has the meaning set forth in section 402(c)(4) of the Code and section 1.402(c)-2 of the regulations.

Section 1.402(c)-2, Q&A-3(a), of the regulations provides that, unless specifically excluded, an eligible rollover distribution means any distribution to an employee of all or any portion of the balance to the credit of the employee in a qualified plan.

Section 1.402(c)-2, Q&A-3(b), of the regulations provides that an eligible rollover distribution does not include the following:

(1) Any distribution that is one of a series of substantially equal periodic payments made (not less frequently than annually) over any one of the following periods — (i) the life of the employee (or the joint lives of the employee and the employee's designated beneficiary); (ii) the life expectancy of the employee (or the joint life and last survivor expectancy of the employee and the employee's designated beneficiary); or (iii) a specified period often years or more;

(2) Any distribution to the extent the distribution is a required minimum distribution under section 401(a)(9) of the Code; or

(3) The portion of any distribution that is not includible in gross income.

Section 1.402(c)-2, Q&A-4, of the regulations provides that an eligible rollover distribution does not include the following:

(1) Elective deferrals, as defined in section 402(g)(3), that, pursuant to § 1.415-6(b)(6)(iv), are returned as a result of the application of the section 415 limitations, together with the income allocable to these corrective distributions.

(2) Corrective distributions of excess deferrals as described in § 1.402(g)-1(e)(3), together with the income allocable to these corrective distributions.

(3) Corrective distributions of excess contributions under a qualified cash or deferred arrangement described in § 1.401(k)-2(b)(2) and excess aggregate contributions described in § 1.401(m)-2(b)(2), together with the income allocable to these distributions.

(4) Loans that are treated as deemed distributions pursuant to section 72(p).

(5) Dividends paid on employer securities as described in section 404(k).

(6) The costs of life insurance coverage (P.S. 58 costs).

(7) Similar items designated by the Commissioner in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin.

Section 1.402(c)-2, Q&A-6(a), of the regulations provides 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. 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. For example, if an employee elects a single payment of half of the account balance with the remainder of the account balance paid over the life expectancy of the distributee, the single payment is treated as independent of the payments in the series and is an eligible rollover distribution unless otherwise excepted.

Section 1.415-6(b)(1) of the regulations (as in effect prior to April 5, 2007) provides the definition of annual addition for a defined contribution plan. In general, for limitation years beginning after December 31, 1986, annual addition means the sum credited to a participant's account for any limitation year of (a) employer contributions, (b) employee contributions, and (c) forfeitures.

Section 1.415-6(b)(2)(iv) of the regulations (as in effect prior to April 5, 2007) provides that for purposes of determining the limitation under section 415(c) of the Code, the transfer of funds from one qualified plan to another will not be considered an annual addition for the limitation year for which the transfer occurs.

Section 1.415-6(b)(3) of the regulations provides that the term "annual additions" Includes, to the extent employee contributions would otherwise be taken into account under this section as an annual addition, mandatory employee contributions as well as voluntary employee contributions. The term "annual addition" does not include the direct transfer of employee contributions from one qualified plan to another.

Section 1.415-6(b)(5) of the regulations provides that forfeitures (as well as any income attributable to the forfeiture) will be considered to be an annual addition to the plan if such forfeitures are allocated to the account of the participant.

On April 5, 2007, a new set of final regulations (new regulations) under section 415 of the Code were issued with a general effective date of limitation years beginning on or after July 1, 2007. For governmental plans, the effective date of the new regulations is limitation years that begin more than 90 days after the close of the first regular legislative session of the legislative body with authority to amend the plan that begins on or after July 1, 2007. However, a governmental plan is permitted to apply the provisions of the new regulations to limitation years beginning on or after July 1, 2007.

Section 1.415(c)-1(b)(1) of the new regulations provides the definition of annual addition for a defined contribution plan. In general, annual addition means the sum credited to a participant's account for any limitation year of (a) employer contributions, (b) employee contributions, and (c) forfeitures.

Section 1.415(c)-1(b)(4) of the new regulations provides that the Commissioner may in an appropriate case, considering all of the facts and circumstances, treat transactions between the plan and the employer, transactions between the plan and the employee, or certain allocations to participants' accounts as giving rise to annual additions. Further, where an employee or employer transfers assets to a plan in exchange for consideration that is less than the fair market value of the assets transferred to the plan, there is an annual addition in the amount of the difference between the value of the assets transferred and the consideration. A transaction described in this paragraph may constitute a prohibited transaction.

Rev. Rul. 79-259, 1979-2 C.B. 197, provides that for purposes of section 414(k), the plan provisions regarding a participant's separate account must satisfy the requirements of a defined contribution plan under 414(i).

ANALYSIS

Issue 1

Section 9 of the DROP states that upon termination of employment, a participant in the DROP shall receive, at his or her option, either a single sum payment from the DROP account equal to the payments to the account plus earnings adjusted for any losses, a true annuity based upon his or her adjusted account, or any other method of payment allowed by the DROP Trust. The participants monthly benefits that would have been otherwise paid at retirement prior to participation in the DROP shall be paid to the retiree. Termination of employment includes termination of any kind. Based on this section of the DROP, a member's retirement benefit is the sum of two amounts:

(a) a retirement allowance based on the defined benefit plan formula in the Plan, as of the date the participant elected to participate in the DROP, and

(b) a benefit based on the amount in his DROP account.

In a letter dated January 26, 2007, the System's authorized representative argued that the DROP benefit is merely an internal crediting to the DROP account from within the Plan of 75% of the monthly retirement benefit that would have been paid to the participant had the participant retired and that the benefit under the Plan with the DROP is not based on the balance of a separate account of a participant.3 Furthermore, the representative argues that the amounts allocated to the DROP account are not employer contributions but are based upon the internal transfer within the Plan, and that employer contributions are only made to fund the pension benefits.

Plainly, the retirement allowance part of the benefit is based upon a defined benefit formula, thus causing the Plan to be a defined benefit plan. The focus of our analysis is whether the DROP account is considered a separate account within the meaning of section 414(k) of the Code. Therefore, it must be determined whether the DROP account meets the requirements of section 414(i) of the Code.

While we do not have a copy of the DROP Trust, it is our understanding that the amounts contributed to the DROP are placed in an individual account for each participant, and that the DROP benefit is based solely on the amounts contributed to the participant's DROP account, adjusted for income, expenses, and gains and losses based on the investment choices made by the participant. In other words, after the allocations to the DROP account, the DROP accounts are maintained the same as any defined contribution plan.

Based on the letter dated January 26, 2007, it appears that the Taxpayer's representative does not dispute our understanding of how the DROP accounts operate. Rather, the representative has focused upon the character of the allocations to the DROP accounts. By characterizing the allocations as transfers, the representative seeks to assert that the DROP account is not an individual account with benefits based solely on the amount contributed to the account (and earnings thereon).

Whether the funds are contributed directly by the Taxpayer to the DROP account, or indirectly contributed to the DROP account through the System, does not affect the analysis of the transaction. The pension benefits are funded by employer contributions and earnings thereon. Had an employee continued to work and could not (because there was no DROP account) make the DROP election, or chose not to make the election, the benefits otherwise paid would be lost to the employee. Because these amounts are not paid to the Taxpayer, the Taxpayer has an economic gain,4 which would result in lower future contributions to the System. It is this gain that allows the Taxpayer to create the DROP accounts at no increase over already expected costs in the Plan. The Taxpayer is in the same approximate economic position as if the DROP accounts were funded directly by new employer contributions while future contributions for pension benefits were reduced because of the economic gain. Furthermore, the original source of the funds allocated to the DROP accounts (the unpaid retirement allowances) are the employer contributions and earnings thereon. The amount of pension benefits otherwise payable is simply a convenient way to measure the amount allocated to the DROP accounts but the source of the funds is employer contributions.

Note that a defined contributions plan does not necessarily have forfeitures reallocated to participants' accounts. Instead, a defined contribution plan can use forfeitures to reduce employer contributions or to pay expenses. Thus, whether or not these are forfeitures (however defined) does not affect the analysis of whether an arrangement is a defined contribution plan. Therefore, we have not addressed the question of whether the unpaid pension benefits, or a portion thereof, are forfeitures when employment continues.

The Plan, after the DROP amendment, is a defined benefit plan which provides a benefit derived from employer contributions which is based partly on the balance of the separate account of a participant. If the Taxpayer desires to have the DROP accounts not considered as a defined contribution plan, and thus subject to the provisions of section 415(b) of the Code, it is relatively easy to do so. A plan amendment introducing a guarantee feature (such as principal protection) would bring about such a result, because the DROP benefits would not be based solely upon the earnings of the DROP accounts.

Issue 2

Section 414(k) provides in part, that a defined benefit plan which provides a benefit derived from employer contributions which is based partly on the balance of the separate account of a participant shall be treated as consisting of a defined contribution plan to the extent benefits are based on the separate account of a participant and as a defined benefit plan with respect to the remaining portion of benefits under the plan for purposes of section 415 of the Code (relating to limitations on benefits and contributions under qualified plans).

As discussed in Issue 1 above the Plan, after the DROP amendment, is a defined benefit plan which provides a benefit derived from employer contributions which is based partly on the balance of the separate account of a participant. Following that analysis, the Plan, after the DROP amendment, will be treated as consisting of a defined contribution plan with respect to the DROP benefits, and will be treated as a defined benefit plan with respect to the retirement allowance under the Plan. The allocations of 75% of the unpaid pension benefits made to the participant's DROP account are considered annual additions under section 415(c)(2) of the Code, and these annual additions are subject to the limitations under section 415(c)(1) of the Code.

The Taxpayer's representative has misread the regulations under section 415 of the Code. On page 3 of the representative's letter dated January 26, 2007, the second sentence in the last paragraph misstates the rule on transfers between plans. The quoted regulation section talks merely about the limitation year for which the transfer occurs. One purpose is not to cause an annual addition simply due to transfers covered by or similar to those described in section 414(l) of the Code. For example, the transfer of accounts and assets from one defined contribution plan to another would not constitute an annual addition. Note that in this case there is no transfer from one plan to another covered by or similar to those described in section 414(l) of the Code, merely an allocation within one plan. The Taxpayer has not even addressed the provisions of section 1.415-6(b)(3) and (5) of the regulations.5

Issue 3

As discussed in Issue 1 above, a participant who elects to participate in the DROP receives a two-tiered retirement benefit upon termination of employment:

(a) a retirement allowance based on the defined benefit plan formula in the Plan, as of the date the participant elected to participate in the DROP, and

(b) a benefit based on the amount in his DROP account.

Essentially, the retirement allowance described in (a) is a benefit that can be considered to be derived from a defined benefit plan, and the benefit in (b) can be considered to be derived from a defined contribution plan. Under section 9 of the DROP, the participant may elect to receive his DROP benefit in the form of a single sum distribution of his DROP account balance.

Section 402(c)(4) of the Code provides that the term "eligible rollover distribution" means any distribution to an employee of all or any portion of the balance to the credit of the employee in a qualified trust except the following distributions: (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 period of 10 years or more; (B) any distribution to the extent the distribution is required under section 401(a)(9); and (C) any distribution which is made upon hardship of an employee. Because the distribution of the DROP benefit as a single sum does not fall into any of the exceptions under section 402(c)(4), and is a distribution to an employee of all of the balance to the credit of the employee in his DROP account, the distribution is an eligible rollover distribution under section 402(c)(4) of the Code.

The Plan does not currently provide for the direct rollover of the distribution of the DROP account as a single sum. However, because this distribution is an eligible rollover distribution, the distribution would be eligible for the direct rollover provision of section 401(a)(31)(A) of the Code if the Plan is amended accordingly.

CONCLUSIONS

(1) The Plan, after the DROP amendment, is a defined benefit plan which provides a benefit derived from employer contributions which is based partly on the balance of the separate account of a participant. The Plan is a 414(k) plan after the amendment adding the DROP.

(2) The allocations of 75% of the otherwise payable pension benefits to the DROP accounts are annual additions subject to the limitations under section 415(c)(1) of the Code.

(3) The distribution of the DROP account to a retired plan participant is an eligible rollover distribution under section 402(c)(4) of the Code, and such distribution would be eligible for the direct rollover provision of section 401(a)(31) of the Code if the Plan is amended as described above.

FOOTNOTES

1 For purposes of this memorandum, "System" is generally used to refer to the administration of the Plan, while "Plan" is used to refer to the terms of the Plan. However, either term can be used interchangeably.

2 We are accepting the Taxpayer's representation that it is a governmental plan within the meaning of section 414(d) of the Code. We have neither analyzed this issue, nor are we ruling on this issue.

3 However, the representative states in the same letter that there is a DROP account for each participant in the DROP, that the participants in the DROP may direct the investment of their account balances, and, upon termination of employment, the DROP account balance is paid in the form of a single-sum distribution or other form of distribution allowed by the Plan.

4 Because the amount going into the DROP account is only 75% of the normal retirement allowance, the other 25% represents a net gain to the System.

5 It should be noted that section 1.415(c)-1(b)(4) of the new regulations allows transactions to give rise to annual additions.

Citations: TAM 053107A