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LTR: IRS Addresses Treatment of Deferred Retirement Option Plan With Guarantee Feature.

In technical advice, the IRS concluded that an employee plan for firefighters, which was amended to add a deferred retirement option plan (DROP) with a guarantee feature, is a defined benefit plan that doesn't provide a benefit derived from employer contributions that's based partly on the balance of the separate account of a participant.

The plan, which is maintained by a municipality within a state, is a section 414(d) governmental plan and a section 414(j) defined benefit plan. A DROP participant's DROP pension amount is a normal retirement pension based on a defined benefit formula plus a benefit based on the amount of his DROP account.

The IRS analyzed whether the DROP account is considered a separate account under section 414(k) based on a determination of whether the DROP account meets the requirements of section 414(i). The IRS determined that the plan, after being amended to add the DROP, 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 IRS suggested that if the municipality didn't want the DROP accounts to be considered a defined contribution plan it should amend the plan to add a guarantee feature. Accordingly, the plan was amended to provide a guaranteed rate of return on the DROP account. Once that amendment is adopted, the DROP pensions are not solely based on the earnings of the DROP accounts. As a result, the IRS determined that the DROP accounts are no longer considered a separate account of a DROP participant, and the plan is subject only to the provisions of section 415(b).

The IRS also determined that after the adoption of the plan amendment adding the guarantee feature, the allocations to the DROP accounts aren't annual additions subject to the limitations under section 415(c)(1). Thus, the IRS concluded that the plan isn't a plan described under section 414(k), and the benefits paid from the plan, including the DROP benefits, are subject only to the provisions of section 415(b).

ISSUES

(1) Whether the Plan, after the amendment dated December 12, 2002, adding the deferred retirement option plan (DROP), 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.

FACTS

The above-named Plan is maintained by the Taxpayer, a municipality within the State, and is a governmental plan within the meaning of section 414(d) of the Code.1 The Plan is also a defined benefit plan under section 414(j) of the Code. Only firemen employed by the Taxpayer are eligible to

participate in the Plan.

The Plan was established by the Taxpayer effective January 1, 1986. The most recent determination letter issued to the Plan is dated May 7, 1997. 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 December 31, 2002.

On December 12, 2002, the Plan's Board of Trustees adopted a resolution to adopt the DROP. The provisions of the DROP were effective as of January 1, 2002, and the Plan has been operating accordingly since the amendment was adopted.

Article I of the Plan describes the various definition of terms used in the Plan in determining retirement benefits. Section 1.02 of this article defines "accrued benefit" as a participant's normal retirement pension, deferred vested pension, and DROP pension.

Section 1.09 defines "compensation" as total regular salary and regular hourly wages of the employee concerned as determined by the employer under its current employment policies.

Section 1.12 defines the "DROP pension" as the benefit provided in Article XV.

Section 1.13 defines "effective date" as the plan year and limitation year beginning on or after January 1, 2002.

Section 115 defines "employee" as any person (a) who is employed by the employer on the effective date, (b) whose most recent employment commenced prior to April 8, 1978, (or whose most recent service commenced prior to April 8, 1978, but before January 1, 1980, and who complies with the requirements set forth in the revised statutes of the State), (c) who is paid by the employer on a full-time salary basis, (d) whose duties are directly involved with the provision of fire protection as certified by the employer, and (e) who can normally be expected to be credited with at least 1,600 hours of service each plan year.

Section 1.16 defines "employer" as the Taxpayer.

Section 1.17 defines "employment commencement date" as the date the employee first performs an hour of service for the employer.

Section 1.24 defines "normal retirement pension" as the benefit described in Article V.

Section 1.25 defines "participant" as an employee who is eligible to be and who becomes a participant in accordance with section 2.01.

Section 1.30 defines "service" as any period of time the employee is in the employ of the employer as an employee.

Section 1.35 defines "valuation date" as the accounting date or other date chosen to value the assets in the Plan.

Article II of the Plan describes the eligibility rules for the Plan. Section 2.01 provides that only those employees employed on January 1, 1986, and who were eligible to accrue retirement benefits then provided by the employer under the revised statute of the State, shall be participants in the Plan.

Article III of the Plan describes employer contributions to the Plan. Section 3.01(b) provides that the employer will contribute to the Plan on behalf of each eligible DROP participant who has elected the

DROP pension pursuant to Article XV an amount which equals 8% of such participant's plan year compensation each plan year.

Section 3.06(a)(6) defines "year of participation" as a year of service, but only if the Plan was in existence for such year of service.

Article IV of the Plan describes participant contributions to the Plan. Section 4.01(b) provides that any eligible DROP participant who has elected the DROP pension pursuant to Article XV shall be required to contribute an amount which equals 8% of such participant's plan year compensation each plan year.

Article V of the Plan describes the normal retirement pension under the Plan. Section 5.01 provides that the "normal retirement age" is the date the participant attains 50 years of age, and that each participant who retires from service on or after reaching the normal retirement age and after accruing 10 years of service shall receive a normal retirement pension.

Section 5.02 provides that a participant's normal retirement pension shall be computed on a monthly basis as a percentage of the amount of the monthly compensation being paid to such participant as of the date of such participant's actual retirement based on a schedule set forth in this section according to years of participation as of the participant's actual retirement date.

Section 5.03 provides that the participant's normal retirement pension shall be computed in the form of a straight life annuity commencing at the participant's normal retirement age and shall be paid in accordance with the provisions of Article IX.

Article IX of the Plan describes the optional forms of payment available for a participant's accrued benefit.

Article XV of the Plan describes the DROP. Section 15.02 provides that in order to be eligible to elect a DROP pension, a participant must be an eligible DROP participant and comply with the requirements of Article XV.

Section 15.03 defines "eligible DROP participant" as any participant who has attained normal retirement age and who is entitled to a normal retirement pension under section 5.01.

Section 15.04 provides that in order to accrue and receive a DROP pension, an eligible DROP participant must execute a written DROP participant agreement with the employer. Such agreement shall contain an irrevocable election by the eligible DROP participant to (a) elect to participate in the DROP pension and a DROP participation date, (b) to waive all rights to his or her normal retirement pension, (c) to agree to continue employment with the employer after the DROP participation date for a period not to exceed 5 years (the "maximum DROP employment period"), (d) agree to have the employer make the participant DROP contribution required under section 4.01(b) on his or her behalf, (e) to elect and agree to freeze the normal retirement pension determined as of the DROP participation date, (f) to elect payment on a monthly basis, determined as of the DROP participation date, of the normal retirement pension into the DROP account in the form of a straight life annuity or one of the other annuity distribution methods described provided in Article IX.

Section 15.05 describes the DROP account. Section 15.05(a) provides that commencing on the participant's DROP participation date, an individual DROP account will be established for each eligible DROP participant who has elected to participate in the DROP pension. Each DROP account will continue to be an asset of the Plan, but shall be held in an individual investment account in the name of each eligible DROP participant. The investment of each DROP account is subject to

participant self-direction pursuant to section 15.09. Each DROP account receives all income it earns and bears all expense or loss it incurs. The Trustees shall be authorized to charge each DROP account for fees associated with the administration of the account.

Section 15.05(b) provides that commencing on the DROP participation date, the following amounts will be allocated and credited to the participant's DROP account: (i) the monthly payment of the DROP participant's normal retirement pension, (ii) the employer DROP contributions as required by section 3.01(b), and (iii) the participant DROP contribution required by section 4.01(b).

Section 15.06 provides that commencing on the participant's DROP participation date, the DROP participant shall remain an active participant of the Plan, but shall earn no additional years of participation, service credit or additional benefits with respect to the normal retirement pension, the normal retirement pension will be frozen, and the participant will only be entitled to the DROP pension.

Section 15.07 provides that the amount of the DROP pension shall be equal to the fair market value of the DROP participant's DROP account as of the valuation date, plus the balance of the participant's normal retirement pension. For purposes of a distribution, the fair market value of the DROP participant's DROP account is its fair market value as of the valuation date immediately preceding the date of the distribution. Upon the actual separation from service of a DROP participant, the portion of the DROP pension attributable to the DROP account shall be paid in accordance with the provisions of Article IX, and the balance of the normal retirement pension elected pursuant to section 15.04(f) shall continue to be payable from and after the DROP participant's actual separation from service in the manner so selected.

Section 15.09 describes participant direction of investment, Section 15.09(a) provides that the DROP participant has the right to direct the investment or reinvestment of the DROP account if the Plan trustees consent in writing to such self direction.

APPLICABLE LAW

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

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 1.415-6(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 dose 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 15,07 of the Plan states that upon separation from service, a participant in the DROP shall receive, at his or her option, the portion of the DROP pension attributable to the DROP account paid in accordance with the provisions of Article IX, and the balance of the normal retirement pension that had been paid in to the DROP account prior to the participant's separation from service. Based on this section of the Plan, a DROP participant's DROP pension is the sum of two amounts:

(a) a normal retirement pension 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.

Under Section 15.05(a) of the Plan, an individual DROP account is established for each eligible DROP participant who has elected to participate in the DROP pension commencing on the participant's DROP participation date. While this section of the Plan states that each DROP account continues to be an asset of the Plan, the DROP account is held in an individual investment account in the name of each DROP participant. The investment of each DROP account is subject to participant self-direction pursuant to section 15.09. Each DROP account receives all income it earns and bears all expense or loss it incurs. The Trustees shall be authorized to charge each DROP account for fees associated with the administration of the account.

Clearly, the normal retirement pension 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 Plan 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.

The Plan, after being amended to add the DROP, 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. During the conference of right held on May 9, 2007, we explained to the Taxpayer's authorized representative that if the Taxpayer desired 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 would be 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.

In a letter dated May 30, 2007, the Taxpayer's authorized representative provided a copy of an executed amendment to the Plan which was adopted on May 29, 2007, and effective January 1, 2002 (unless expressly set forth to the contrary). This amendment added a new section 15.09(c) to the Plan (effective January 1, 2002) providing a guaranteed rate of return on the DROP account. Under this section, if the trustees of the Plan consent to a DROP participant's self-direction of investment under section 15.09(a), and if the actual net income and earnings of such DROP participant's DROP account do not equal at least 4% on an annualized basis for any plan year, then the Plan shall guaranty any such DROP participant an aggregate guaranteed rate of return on the DROP account of 4% on an annualized basis for such plan year. Hence, after the adoption of this amendment, DROP pensions are not solely based upon the earnings of the DROP accounts. Accordingly, the DROP accounts are no longer considered a separate account of a DROP participant and the Plan is subject solely to the provisions of section 415(b) of the Code.

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 being amended to add the DROP, 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 being amended to add the DROP, will be treated as consisting of a defined contribution plan with respect to the DROP account, and will be treated as a defined benefit plan with respect to the normal retirement pension under the Plan, The allocations made to the DROP participant's DROP account would be considered annual additions under section 415(c)(2) of the Code, and these annual additions would be subject to the limitations under section 415(c)(1) of the Code.

However, after the adoption of the May 29, 2007, amendment described above adding guaranteed rate of return in the DROP accounts, the DROP account is no longer considered a separate account

of a DROP participant because the DROP benefits are not solely based upon the earnings of the DROP accounts. The allocations made to the DROP participant's DROP account would not be considered annual additions under section 415(c)(2) of the Code, and these annual additions would not be subject to the limitations under section 415(c)(1) of the Code. Hence, the Plan is not a plan described under section 414(k) of the Code, and the benefits paid from the Plan, including the DROP benefits, are subject solely to the provisions of section 415(b) of the Code.

CONCLUSIONS

(1) The Plan, after being amended to add the DROP on December 12, 2002, and after being amended to add the guaranteed rate of return on DROP accounts on May 29, 2007, is a defined benefit plan which does not provide a benefit derived from employer contributions which is based partly on the balance of the separate account of a participant. The Plan is not a 414(k) plan after the amendment adding the DROP.

(2) Allocations to the DROP accounts under the Plan are not annual additions subject to the limitations under section 415(c)(1) of the Code.

FOOTNOTE

1 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.

Citations: TAM 071907