INTERNAL REVENUE SERVICE

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WIL: 401.00-00
403.00-00
457.00-00

DEC 16 2003

TEP RA T4

LEGEND:
Plan X =
State M =

Dear :

This letter is in response to your ruling request dated October 4, 2002 regarding whether certain participants of Plan X who previously purchased past service credit with after-tax contributions may purchase the same service credits with a plan-to-plan transfer or rollover of pre-tax amounts from another 401(a) plan, 403(b) plan or 457(b) plan, and receive a corresponding refund of after-tax contributions (with interest) from Plan X. The after-tax contributions would be returned prior to the purchase of the same service credits with pre-tax amounts.

Plan X is a qualified defined benefit plan that serves as the principal retirement plan for public school teachers in State M other than for schoolteachers in certain major cities. Plan X is established and administered pursuant to Chapters , , , of the State M Statutes.

Plan X permits the purchase of additional service credit for certain types of prior service. Currently, Plan X permits a teacher with at least three years of service and who performed service in the United States armed forces before becoming a teacher or who failed to obtain credit for military leave to purchase credit for such service by making a payment to Plan X provided that the teacher has not purchased such service under any other defined benefit public employee pension plan for the same period of service. All payments to purchase service under this provision have been made with after-tax funds.

On , Plan X was amended to provide that " [A]n eligible person may receive a refund of any prior military service credit purchase payment amount paid prior to the effective date of the federal Economic Growth and Tax Relief

Reconciliation Act of 2001 if the eligible person transfers pretax funds to Plan X, sufficient to purchase the identical prior military service credit.

An eligible person is a person who:

(1) was born on ;
(2) served in the United States armed forces from to ;
(3) had credit for years of service from the Plan X as of ;
(4) purchased years of prior military service credit from Plan X with a payment of on or before ."

The transfer or rollover of pre-tax funds to purchase the prior military service credit will take place prior to the refund of the after-tax contributions. Plan X will determine the amount necessary to purchase the prior service credit based upon the actuarial and Plan X requirements to purchase such credit at the time of purchase. Following the transfer or rollover of pre-tax funds, Plan X will refund to the eligible participant his or her prior after-tax monies, plus interest at the rate of six percent per annum, compounded annually, as determined by State M statutes. This will result in the refund of after-tax funds (with interest) differing from the amount of rollover or transfer necessary to purchase the prior service credit. The distribution of after-tax contributions (including interest) will take place prior to the eligible person's annuity starting date (as defined in section 72(e)(4) of the Code).

Based on the foregoing facts and representations, you request that

(1) The amount representing a return of after-tax contributions previously used to purchase past service credit will not be includible in gross income of the participant to the extent of such amount of after-tax contributions. If such amounts are includible in gross income, the distribution of after-tax contributions will be subject to the 10-percent additional tax on early distributions under section 72(t) of the Code,

(2) Payments of amounts to purchase prior service credit with pre-tax amount pursuant to an eligible rollover distribution under section 402(c) of the Internal Revenue Code (the "Code), or a transfer directly from a section 401(a) tax-qualified plan, a section 403(b) plan under section 403(b)(13) of the Code, or a governmental section 457(b) plan under section 457(e)(17) of the Code, and the refund of after-tax funds previously used to purchase such prior service credit will not cause Plan X to fail to qualify under section 401(a) of the Code, and

(3) The transfer or rollover of amounts to Plan X from another section 401(a) plan, section 403(b) plan or governmental section 457(b) plan will not result in currently taxable income to the participant under sections 72 or 402 of the Code.

Income Tax Regulation section 1.401-1(b)(1) provides that a pension plan within the meaning of section 401(a) is a plan established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to its employees over a period of years, usually for life, after retirement. A pension plan may also provide for the payment of pension due to disability or for the payment of incidental death benefit through insurance or otherwise.

Revenue Ruling 57-163, C.B. 1957-1, 128, refers to Revenue Ruling 56-693, C.B. 1956-2, 282, and holds that although a pension plan may provide incidental benefits prior to normal retirement, such as disability and death benefits, it will fail to satisfy section 401(a) of the Code if it permits participants, prior to severance of employment or termination of the plan, to withdraw all or part of the funds accumulated on their behalf, except their own contributions on discontinuance of participation.

Revenue Ruling 60-281, C.B. 1960-2, 146, holds that an employee may be permitted to withdraw his own contributions together with an amount which represents the increments actually earned thereon, but not in excess of such increments, where the employee discontinued participation prior to the termination of his employment.

Revenue Ruling 67-340, 1967-2 C.B. 147, holds that the return of employee contributions does not adversely affect the qualification of the plan, under section 401(a) of the Internal Revenue Code of 1954, merely because the plan also provides for the payment to the participants of an additional amount not in excess of the increments actually earned on their contributions.

Revenue Ruling 69-277, 1969-1 C.B. 116 holds that a pension plan does not fail to qualify under section 401(a) of the Code, merely because the participants are allowed to withdraw their voluntary contributions, together with the accumulated interest thereon, prior to the termination of their employment.

Section 402(a)(1) of the Code provides that the amount actually distributed to a distributee by an employee's trust described in section 401(a) which is exempt from tax under section 501(a) shall be taxable to the distributee, in the taxable year of the distributee in which distributed under section 72 of the Code.

Section 72(e)(2)(B) of the Code provides that if a distribution is received prior to the annuity starting date, in a form other than an annuity, such distribution shall be included in gross income to the extent allocable to income on the contract,

and shall not be included in gross income to the extent allocable to investment in the contract.

Section 72(e)(3) of the Code provides an amount is treated as allocable to income on the contract to the extent that such amount does not exceed the excess (if any) of - (i) the cash value of the contract immediately before the amount is received, over (ii) the investment in the contract at such time.

Section 72(e)(4) of the Code defines "annuity starting date" as the first day of the first period for which an amount is received as an annuity under the contract.

Section 72(e)(6) of the Code defines investment in the contract to mean, as of any date, the aggregate amount of premiums or other consideration paid for the contract before such date, minus the aggregate amount received under the contract before such date, to the extent such amount was excludable from gross income.

Section 72(e)(8)(A) of the Code provides that in the case of any amount received before the annuity starting date from a trust described in section 401(a) which is exempt from tax under section 501(a), section 72(e)(2)(B) shall apply to such amounts.

Section 72(e)(8)(B) of the Code provides that for purposes of section 72(e)(2)(B), the amount allocated to the investment in the contract shall be the portion of the amount described section 72(e)(8)(A) which bears the same ratio to such amount as the investment in the contract bears to the account balance. The determination under the preceding sentence shall be made as of the time of distribution or at such other time as the Secretary may prescribe.

Section 72(t)(1) of the Code provides that if a taxpayer receives any amount from a qualified retirement plan, the taxpayer's tax for the taxable year in which such amount is received shall be increased by an amount equal to 10 percent of the portion of the amount which is includible in gross income.

Section 72(t)(2) of the Code provides a number of exceptions to the 10 percent tax on early distributions if such distribution satisfies certain requirements as set forth in such subsection.

The refund from Plan X consists of a return of after-tax contributions to the participant together with interest. Thus, the distribution to the participant will consist of an amount equal to his investment in the contract, plus interest. However, section 72(e)(8) provides that in the case of any amount received from a trust described in section 401 of the Code, the amount allocated to investment in the contract is the portion of the distribution which bears the same ratio to such amount as the investment in the contract bears to the total accrued benefit of the participant. Accordingly, we rule that the amount of the refund that represents a

return of after-tax contributions will not be includible in the gross income of the participant pursuant to section 72(e)(8) of the Code to the extent such distribution represents investment in the contract. The investment in the contract is equal to the portion of the distribution which bears the same ratio as the consideration paid for the contract as of the date of distribution (minus the aggregate amount received before such date, if any) to the present value of the total accrued benefit of the participant under Plan X.

Additionally, we rule that to the extent the refund does not represent investment in the contract, and unless one of the exceptions in section 72(t)(2) is applicable, the refund will be subject to an additional tax equal to 10 percent of the portion of the refund that is includible in gross income pursuant to section 72(t)(1) of the Code.

Section 402(c) of the Code provides that if any portion to the balance to the credit of an employee in a qualified trust is paid to the employee in an eligible rollover distribution, the distributee transfers any portion of the property received in such distribution to an eligible retirement plan, and the amount so transferred consists of the property distributed, such distribution will not be includible in gross income for the taxable year in which paid.

Revenue Ruling 67-213 provides that if a participant's interest in a qualified plan is transferred from the trust forming part of that plan to the trust forming part of another qualified plan without being made available to the participant, no taxable income will be recognized by reason of such transfer.

Plan X will permit a participant to purchase past service credit for service performed in the United States Armed Forces through either an eligible rollover distribution as defined in section 402(c) of the Code or a transfer from a section 401(a) plan without such funds being made available to the participant. If the participant elects a transfer of funds to Plan X, such transfer will satisfy the requirements of Rev. Rul. 67-213. Alternatively, if the participant elects a rollover of funds to Plan X, such rollover will satisfy the requirements of Code section 402(c).

Additionally, the amount of service credit being purchase by the participant must be the actuarial equivalent of the amount of such transfer or rollover. If the amount of the funds being transferred or rolled over purchases either more or less than the actuarial equivalent service credit, such purchase may raise other qualification requirements.

Section 403(b)(13) 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 457(e)(17) 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).

Code section 415(n)(1) provides, in general, that, if an 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 certain requirements pertaining to the section 415 limits on annual additions are met.

Code section 415(n)(3)(A) states that, for purposes of this subsection, 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.

Under Code section 415(n)(3)(A)(ii), a governmental plan participant cannot purchase credit for service in the plan under which he has already received that service. Thus, Code section 415(n) operates only in situations where credit has not been provided by the plan to the employee for a period of service. In the present situation, a participant will purchase service credit under Plan X prior to such participant receiving a refund of after-tax contributions already used to purchase the identical service credit. Accordingly, Plan X has already provided service credit for the benefit that is provided by the transfer of funds from a 403(b) or 457 plan.

Plan X will only permit a participant to purchase past service credit for service performed in the United States Armed Forces through (1) an eligible rollover distribution as defined in section 402(c) of the Code, (2) a transfer from a section 401(a) plan without such funds being made available to the participant, (3) a trustee-to-trustee transfer from a 403(b) plan pursuant to section 403(b)(13) of the Code, and (4) a trustee-to-trustee transfer from a 457 plan pursuant to section 457(e)(17) of the Code. As such, we rule that the purchase of such past service credit with pre-tax amount pursuant to an eligible rollover distribution under section 402(c) of the Code or a transfer directly from a section 401(a) tax-qualified plan, will not cause Plan X to fail to qualify under section 401(a) of the Code if the amount of service credit purchased is the actuarial equivalent of the amount or transfer or rollover. Additionally, an eligible rollover distribution under section 402(c) of the Code or a transfer directly from a section 401(a) tax-qualified plan will not result in amounts rolled over or transferred being included in taxable income in the year of rollover or transfer.

This ruling letter assumes that Plan X has met the requirements of Code section 401(a) at all times relevant thereto.

This ruling is directed solely 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.

If you have any questions, please contact at

Sincerely,

Alan Pipkin, Manager
Employee Plans, Technical Group 4

Enclosures:

Deleted copy of letter ruling
Form 437

Cc: