Significant Index Nos. 0401.00-00, 0402.00-00, 0414.00-00, 0415.00-00

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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

200721022

FEB 26 2007

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Re:

DROP =
State =

Dear

This letter is in response to your request for a ruling concerning the Plan which was submitted by your authorized representative on May 5, 2006, as amended on February 6, 2007, concerning the DROP under the Plan. Specifically, you asked us to rule on the following issues:

(1) The DROP is not a separate defined contribution plan.

(2) The limitation for defined benefit plans under section 415(b) of the Internal Revenue Code ("Code") applies to the DROP rather than the limitation for defined contribution plans under section 415(c) of the Code, and the annuity equivalent of the DROP single sum plus the normal annuity benefit under the Plan will be tested for purposes of section 415(b).

(3) The DROP complies with the definitely determinable requirement of section 401(a) of the Code.

(4) The mere fact that Participant contributions that are already being picked-up under the Plan pursuant to section 414(h)(2) of the Code will continued unchanged during participation in the DROP will not result in said contributions being ineligible for pick-up.

(5) Credits to a participant's DROP account are not distributions from the Plan and are not subject to current income taxes or to the additional 10% tax on early distributions under section 72(t) of the Code.

(6) Single sum distributions from a participant's DROP account will be eligible for rollover under section 402(c)(4) of the Code.

The System is an instrumentality of political subdivisions of the State and was established under chapter 411 of the Code of the State ("State Code"). The Plan is a governmental plan within the meaning of section 414(d) of the Code[1] and a defined benefit plan under section 414(j) of the Code. The System provides pension benefits to its participants, who are police officers and firefighters employed by participation political subdivisions of the State. There are approximately 3800 active participants in the System. Participation in the Plan is required as a condition of employment. Cities whose police officers and/or firefighters are appointed under the civil service law of the State are generally required to participate in the System. The Plan received a favorable determination letter regarding its qualified status under section 401(a) of the Code in a letter dated November 22, 1994.

Section 411.1 of the State Code describes the various definition of terms used in the Plan in determining retirement benefits.

Section 411.1(1) defines "actuarial equivalent"as a benefit of equal value when computed upon the basis of mortality tables adopted by the Plan and interest computed at the rate established by the System's actuary.

Section 411.1(3) defines "average final compensation" as the average earnable compensation of the member during the three years of service the member earned the member's highest salary as a police officer or firefighter, or if the member has less than three years of service, the average earnable compensation of the member's entire period of service.

Section 411.1(7) defines "city" as any city participating in the statewide fire and police retirement system.

Section 411.1(8) defines "earnable compensation" as the annual compensation which a member receives for service rendered as a police officer or firefighter in the course of employment with a participating city. However, the term shall not include amounts received for overtime compensation, meal or travel expenses, uniform allowances, fringe benefits, severance pay, or any amount received upon termination or retirement in payment for accumulated sick leave or vacation. Contributions made by a member from the member's earnable compensation to a plan of deferred compensation shall be included in this term.

Section 411.1(9) defines " firefighter" as only the members of a fire department who have passed a regular mental and physical civil service examination for firefighters and who shall have been duly appointed to such a position.

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[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.

Section 411.1(11) defines "member" as a member of the System as defined by section 411.3 of the State Code.

Section 411.1(13) defines "membership service" as service as a police officer or firefighter rendered for a city which is credited for service pursuant to section 411.4 of the State Code.

Section 411.1(15) defines "pension" as the annual payments for life derived from appropriations provided by the participating cities and the state and from contributions of the members which are deposited in the System. All pensions shall be paid in equal monthly installments.

Section 411.1(16) defines "police officer" as only members of a police department who have passed a regular mental and physical civil service examination and who shall have been duly appointed to such positions.

Section 411.1(17) defines "retirement allowance" as the pension granted to a member upon retirement.

Section 411.3 of the State Code states that all persons who become police officers or firefighters after the date the city is required to come under the retirement system shall become members of the Plan as a condition of employment.

Section 411.4 of the State Code states that service of fewer than six months of a year is not creditable as service. Service of six months or more of a year is equivalent to one year of service.

Section 411.6 of the State Code describes benefits under the Plan. Section 411.6(1) states that any member in service may retire upon written application to the System setting forth a date of retirement not less than thirty days but not more than ninety days from the date of the application. However, the member must have attained age fifty-five and have served twenty-two years or more upon the selected date of retirement.

Section 411.6(2)(a) states that the service retirement allowance for a member who terminates service, other than by death or disability, prior to July 1, 1990, shall consist of a pension which equals fifty percent of the member's average final compensation.

Section 411.6(2)(b) states that the service retirement allowance for a member who terminates service, other than by death or disability, on or after July 1, 1990, but prior to July 1, 1992, shall consist of a pension which equals fifty-four percent of the member's average final compensation.

Section 411.6(2)(c) states that commencing July 1, 1992, for members who terminate service other than by death or disability, on or after that date but prior to July 1, 2000, the System shall increase the percentage multiplier of each member's average final

compensation by an additional two percent each July 1 until reaching sixty percent of the member's average final compensation. The applicable percentage multiplier shall be the rate in effect on the date of the member's termination from service.

Section 411.6(2)(d) states that upon retirement from service on or after July 1, 2000, a member shall receive a service retirement allowance which will consist of a pension which equals sixty-six percent of the member's average final compensation.

Section 411.6(2)(e) sets forth an additional benefit for members with more than 22 years of service. If a member has completed more than 22 years of creditable service, the service retirement allowance shall consist of a pension which equals the amounts provided in section 411.6(2)(a), (b), (c), or (d), plus an additional percentage set forth below:

(1) For a member who terminates service other than by death or disability on or after July 1, 1990, but before July 1, 1991, and who does not withdraw the members contributions, upon the member's retirement there shall be added three-tenths percent of the member's average final compensation for each year of service over twenty-two years, excluding years of service after the member's fifty-fifth birthday, but not more than eight years of service.

(2) For a member who terminates service other than by death or disability on or after July 1, 1991, but before October 16, 1992, and who does not withdraw the members contributions, upon the member's retirement there shall be added six-tenths percent of the member's average final compensation for each year of service over twenty-two years, excluding years of service after the member's fifty-fifth birthday, but not more than eight years of service.

(3) For a member who terminates service other than by death or disability on or after October 16, 1992, but before July 1, 1998, and who does not withdraw the members contributions, upon the member's retirement there shall be added six-tenths percent of the member's average final compensation for each year of service over twenty-two years, but not more than eight years of service.

(4) For a member who terminates service other than by death or disability on or after July 1, 1998, but before July 1, 2000, and who does not withdraw the members contributions, upon the member's retirement there shall be added one and one-half percent of the member's average final compensation for each year of service over twenty-two years, but not more than eight years of service.

(5) For a member who terminates service other than by death or disability on or after July 1, 2000, and who does not withdraw the members contributions, upon the member's retirement there shall be added two percent of the member's average final compensation for each year of service over twenty-two years, but not more than eight years of service.

Section 411.6(12) provides for an annual readjustment, similar to a cost-of-living increase, to the pension.

Section 411.6A provides optional forms of benefit under the Plan.

Section 411.6B of the State Code provides for the rollover of a member's accrued benefit to an eligible retirement plan.

The State legislature amended chapter 411 of the State Code in 2006 to add the DROP as a distribution option under the System. The DROP is codified as section 411.6C of the State Code. The legislature conditioned implementation of the DROP on the receipt of favorable ruling from the Service.

Section 411.6C(1)(a) defines "applicable percentage" as the percentage, not greater than one hundred percentage points, equal to fifty-two percentage points plus two percentage points for each month for the period between the eligible member's plan eligibility month and the month the eligible member commences membership in the DROP.

Section 411.6C(1)(b) defines "DROP benefit" as an amount credited to the participant's account each applicable month equal to the member's applicable percentage multiplied by the member's participant retirement amount.

Section 411.6C(1)(c) defines "eligible member" as a member who has attained fifty-five ears of age with at least twenty-two years of membership service.

Section 411.6C(1)(d) defines "participant account" as the administrative record maintained by the System reflecting the participant's accumulated DROP benefit.

Section 411.6C(1)(e) defines "participant retirement amount" as the amount equal to the monthly retirement allowance the eligible member would have received under section 411.6 of the State Code if the member retired on the date the eligible member commenced participation in the DROP, based on earnings through the previous full quarter of earnable compensation earned by the member.

Section 411.6C(1)(g) defines "plan eligibility month" as the first full calendar month in which the participant is an eligible member.

Section 411.6C(2)(a) states that an eligible member may elect to participate in the DROP. A decision by an eligible member to participate in the DROP is irrevocable. Upon commencing membership in the DROP, the member shall remain an active member in the System and shall have credited to a participant account on behalf of the member the DROP benefit for each month the member participates in the DROP. The amounts credited will be invested by the System in risk-free assets of a short-term nature and interest and earnings shall not be credited to the member's participant

account but remain in the System. The annual readjustment to pensions under section 411.6(12) of the State Code shall not apply to the participant's DROP benefit or to amounts credited to the member' participant account.

Section 411.6C(2)(b) states that upon termination of an eligible member's participation in the DROP, the eligible member shall be deemed to be retired under the System as of that date for purposes of the System and shall begin receiving a retirement allowance equal to the member's participant retirement amount or such optional retirement benefits based upon that amount pursuant to section 411.6A of the State Code. In addition, the eligible member shall receive the moneys credited to the member's participant account while participating in the DROP. The eligible member shall select whether to receive the amount in the member's participant account in the form of a single sum distribution or as a rollover to an eligible retirement plan as defined in section 411.6B of the State Code.

Section 411.6C(2)(c) states that if an eligible member terminates participation in the DROP prior to the date selected by the member upon commencing membership in the DROP ad the termination is not due to the death or disability of the member, then the System shall assess a twenty-five percent penalty on the amount credited to the member's participant account prior to distributing the amount to the member. The penalty amount shall be transferred to and remain with the System. The administrative rules implementing this section provided that an amount equal to seventy-five percent of the member's DROP benefit shall accrue to the benefit of the member for each month of participation in the DROP and that an amount equal to twenty-five percent of the member's accumulated DROP benefit shall accrue to the benefit of the member upon the occurrence of any of the following events: (1) termination of participation in the DROP on the selected plan termination date; (2) termination of participation prior to the selected DROP termination date as the result of entitlement to a disability benefit under either section 411.6(3) or section 411.6(5) of the State Code; or (3) death prior to the selected DROP termination date.

Section 411.6C(3) provides that to participate in the DROP, the eligible member must make written application to the System. The application shall include the following:

a. The month the eligible member intends to commence participation in the DROP.

b. The eligible member's selection of a DROP termination date. The DROP termination date shall be either three, four, or five years after the date the eligible member commences membership in the DROP. However, for the two-year period beginning with the first of the month following the implementation date of the DROP, an eligible member between sixty-two and sixty-four years of age may also select a plan termination date that is one or two years after the date the eligible member commences participation in the DROP.

Section 411.6C(5) provides that the members' contribution rate shall be increased as necessary if the DROP has been determined by the System's actuary to increase the actuarial cost to the System.

Section 411.6C(6) provides that the DROP will not be implemented until the System has received a favorable ruling from the Service.

Section 411.8 of the State Code describes the financing of the Plan. Section 411.8(g) provides for mandatory member contributions to the Plan. Section 411.8(f) and (h) specify the percentages of these mandatory contributions.

Section 411.8(i)(1) provides that beginning January 1, 1995, for federal income tax purposes, and beginning January 1, 1999, for state income tax purposes, member contributions to the Plan required under section 411.8(f) or (h) which are picked up by the city shall be considered employer contributions for federal and state income tax purposes., and each city shall pick up the member contributions to be made under section 411.8(f)(or (h) by its employees. Each city shall pick up these contributions by reducing the salary of each of its covered employees by the amount which each employee is required to contribute under section 411.8(f) or (h) and shall pay the amount picked up in lieu of the member contributions to the board of trustees.

Section 411.8(i)(2) provides that member contributions picked up by each city under section 411.8(1) shall be treated as employer contributions for federal and state income tax purposes only and for all other purposes shall be treated as employee contributions and deemed part of the employee's earnable compensation or salary.

Section 72(a) of the Code provides that gross income includes any amounts received as an annuity under an annuity, endowment, or life insurance contract.

Section 72(t) of the Code imposes a 10 percent additional tax on early distributions from qualified retirement plans.

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(a) of the Code provides that any amount actually distributed to a distributee by any employees' 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 in which distributed, under section 72 (related to annuities).

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(h)(1) of the Code provides in general that amounts contributed to a plan qualified under section 401(a) shall not be treated as having been made by the employer if they are designated as employee contributions. Section 414(h)(2) provides an exception to section 414(h)(1) in the case of any plan established by the government of a State or political subdivision thereof where the contributions or employees of an employing unit are picked up by the employing unit. In that case, the contributions so picked up shall be treated as employer contributions.

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(b) of the Code limits the annual benefit to which a participant may be entitled under a defined benefit pension plan during any limitation year. Section 415(b)(1) provides that, in general, benefits with respect to a participant exceed the limitation if such annual benefit is greater than the lesser of (A) $160,000 or (B) 100 percent of the participant's average compensation for the participant's high 3 years.

Section 415(b)(2)(A) of the Code provides that, in general, the term annual benefit for purposes of section 415(b)(1) means a benefit payable annually as a straight life annuity (with no ancillary benefits) under a plan to which employees do not contribute and under which no rollover contributions are made.

Section 415(b)(2)(B) of the Code provides that if the benefit under the plan is payable in any form other than the form described in section 415(b)(2)(A), or if the employees contribute to the plan or make rollover contributions, the determinations as to whether the limitation described in section 415(b)(1) has been satisfied shall be made in accordance with regulations prescribed by the Secretary of the Treasury, by adjusting such benefit so that it is equivalent to the benefit described in section 415(b)(2)(A).

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 1.401-1(b)(1)(i) of the regulations provides that a pension plan within the meaning of Code 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. Retirement benefits are generally measured by, and based on, such factors as years of service and compensation received by employees. A plan designed to provide benefits for employees or their beneficiaries to be paid upon retirement or over a period of years after retirement will, for the purposes of Code section 401(a), be considered a pension plan if the employer contributions under the plan can be determined actuarially on the basis of definitely determinable benefits.

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 of ten years or more;
(2) Any distribution to the extent the distribution is a required minimum distribution under section 402(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 rollove 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 1.415-3(a)(1) of the regulations provides that the annual benefit to which a participant is entitled at any time under a defined benefit plan may not during the limitation year exceed the dollar and compensation limitations of section 412(b)(1) of the Code. Section 1.415-3(c)(1) provides the rules concerning the adjustment of the limitations of section 415(b)(1) of the Code where the form of benefit is other than a straight life annuity.

Rev. Rul. 69-427, 1969-2 C.B. 87, provides that benefits are not definitely determinable if such benefits are contingent upon the amount of actual employer contributions to the plan.

Rev. Rul. 72-97, 1972-1 C.B. 106, provides that pre-retirement death benefits are not definitely determinable if such benefits are based on the amount of pension benefits funded at each participant's death.

Rev. Rul. 74-385, 1974-2 C.B. 130, provides that, in the case of a defined benefit plan, the definitely determinable requirement of section 1.401(b)(1)(i) of the Regulations is satisfied where the benefits for each participant can be computed in accordance with an express formula contained in the plan that is not subject to the discretion of the employer.

Rev. Rul. 79-90, 1979-1 C.B. 155, provides that whenever the amount of a benefit in a defined benefit plan is to be determined by some procedure (such as "actuarial equivalent", "actuarial reserve", or "actuarial reduction") which require the use of actuarial assumptions (interest, mortality, etc.) the assumptions to be used must be specified within the plan in a manner which precludes employer discretion. For the purposes of that revenue ruling, employer discretion includes discretion of the employer, plan administrator, fiduciary, actuary, etc.

Rev. Rul. 2006-43, 2006-35 I.R.B. 329, provides what actions are required in order for a State or political subdivision thereof, or an agency or instrumentality of any of the foregoing, to "pick up" employee contributions to a plan qualified under section 401(a) of the Code so that the contributions are treated as employer contributions pursuant to section 414(h)(2). Under the authority of section 7805(b)(8) of the Code, the Service will not treat any plan that on or before August 28, 2006, includes designated employee contributions that were intended to be picked up as employer contributions pursuant to section 414(h)(2) as failing to meet the requirements of such section prior to January 1, 2009, solely on account of the failure to satisfy the requirement that the "pick-up" be pursuant to a formal action, by a person duly authorized to take such action with respect to the employing unit, that is evidenced by contemporaneous writing, but only if the following conditions are satisfied: (1) the employing unit has taken contemporaneous action evidencing an intent to establish a "pick-up" (e.g., provided information to employees relating to the establishment of the "pick-up") and has operated the plan accordingly; and (2) the employing unit takes formal action in writing prior to January 1, 2009, with respect to future contributions to specify that the contributions, although designated as employee contributions, are being paid by the employer. For this purpose, the employing unit must take formal action to provide that the contributions on behalf of a specific class of employees of the employing unit, although designated as employee contributions, will be paid by the employing unit in lieu of employee contributions. A person duly authorized to take such action with respect to the employing unit must take such action. The action must apply only prospectively and be evidenced by a contemporaneous written document (e.g., minutes of a meeting, a resolution, or an ordinance).meet the requirements set forth above in paragraph (1) of Law and Analysis in the revenue ruling.

Issue 1

Under the terms of the Plan, a police officer or firefighter who has reached the age of 55 and has 22 years of creditable service is eligible for a retirement allowance. Such police officer or firefighter is also eligible to participate in the DROP at the same time. If the eligible member elects to participate in the DROP, the member remains an active member in the System. However, his retirement allowance is then "frozen" as of the date of participation in the DROP, and this frozen retirement allowance becomes the participant's retirement amount. After participation in the DROP commences, a DROP benefit equal to the member's applicable percentage multiplied by the member's participant retirement amount shall have credited to a participant account on behalf of

the member the DROP benefit for each month the member participates in the DROP. The amounts credited will be invested by the System in risk-free assets of a short-term nature and interest and earnings on such amounts shall not be credited to the member's participant account but remain in the System. The annual readjustment to pensions under section 411.6(12) of the State Code shall not apply to the participant's DROP benefit or to amounts credited to the member' participant account.

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. Where the amounts placed in an account for a participant do not receive their share of the actual earnings and losses of the plan, the account is not an individual account within the meaning of section 414(i). The DROP benefit is based solely on the amounts contributed to the participant's DROP account, which is not adjusted for income, expenses, and gains and losses of the invested assets. Accordingly, the Plan, after the DROP amendment, is a not a separate defined contribution plan. The Plan is also not 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 as described in section 414(k) of the Code.

Issue 2

Under section 411.6C(2)(b) of the State Code, upon termination of an eligible member's participation in the DROP, the eligible member shall be deemed to be retired under the System as of that date for purposes of the System and shall begin receiving a retirement allowance equal to the member's participant retirement amount or such optional retirement benefits based upon that amount pursuant to section 411.6A of the State Code. In addition, the eligible member shall receive the moneys credited to the member's participant account while participating in the DROP. The eligible member shall select whether to receive the amount in the member's participant account in the form of a single sum distribution or as a rollover to an eligible retirement plan as defined in section 411.6B of the State Code.

Hence, the DROP benefit under the Plan allows a participant to elect an optional form of benefit which provides for a retirement allowance from the Plan and a separate payment from the DROP. Since the Plan, after the DROP amendment, is a defined benefit plan that does not provide any benefits based partly on the balance of a separate account for a participant, the limitation on annual benefits under section 415(b) of the Code applies to the entire benefit under the Plan. Furthermore, for purposes of testing whether the member's benefit exceeds the limitation under section 415(b)(1) of the Code, the annuity equivalent of the DROP single sum plus the normal annuity benefit under the Plan will be tested for purposes of section 415(b).

Issue 3

Once a member under the Plan has attained age 55 and 22 years of service, the member is eligible to elect to participate in the DROP under section 411.6C(2)(a) of the State Code. If a member elects to participate in the DROP, the member receives a participant retirement amount and a DROP payment. The calculation of the DROP payment is described above. The calculation of the DROP payment does not include interest, and the DROP payment is never placed in a separate account.

Section 411.6C of the State Code clearly defines the calculation of the participant retirement allowance and DROP payment for each member in accordance with an express formula that is not subject to employer discretion. The benefit under the DROP is not contingent upon the amount of actual employer contributions to the Plan. The benefit under the DROP is also not based on the amount of pension benefits funded at each member's retirement date. Furthermore, section 411.8 defines the actuarial assumptions used for calculating actuarial equivalent benefits under the Plan in accordance with section 401(a)(25) of the Code and Rev. Rul. 79-90.

Because the benefit under the DROP is based on a member's service and compensation, and upon contributions paid by the member while he participated in the Plan, is not contingent upon the amount of actual employer contributions to the Plan, is not based on the amount of pension benefits funded at each member's retirement date, and the employer and employee contributions under the Plan can be determined actuarially by projecting service and compensation to an assumed retirement age, the Plan with the DROP meets the definitely determinable requirement for pension plans under section 1.401-1(b)(1)(i) of the Income Tax Regulations.

Issue 4

Section 411.8(i)(1) of the State Code provides that beginning January 1, 1995, for federal income tax purposes, and beginning January 1, 1999, for state income tax purposes, member contributions to the Plan required under section 411.8(f) or (h) which are picked up by the city shall be considered employer contributions for federal and state income tax purposes., and each city shall pick up the member contributions to be made under section 411.8(f) or (h) by its employees.

Section 411.8(i)(2) provides that member contributions picked up by each city under section 411.8(1) shall be treated as employer contributions for federal and state income tax purposes only and for all other purposes shall be treated as employee contributions and deemed part of the employee's earnable compensation or salary.

Rev. Rul. 2006-43, 2006-35 I.R.B. 329, provides what actions are required in order for a State or political subdivision thereof, or an agency or instrumentality of any of the foregoing, to "pick up" employee contributions to a plan qualified under section 401(a) of the Code so that the contributions are treated as employer contributions pursuant to section 414(h)(2). Generally, any plan that includes designated employee contributions

that were intended to be picked up as employer contributions pursuant to section 414(h)(2) will meet the requirements of such section if the following conditions are satisfied: (1) the employing unit has taken contemporaneous action evidencing an intent to establish a "pick-up" (e.g., provided information to employees relating to the establishment of the "pick-up") and has operated the plan accordingly; and (2) the employing unit takes formal action in writing with respect to future contributions to specify that the contributions, although designated as employee contributions, are being paid by the employer.

The Plan meets the conditions of Rev. Rul. 2006-43 because the State Code clearly spells out an intent to establish a "pick up" and the Plan has been operated accordingly, and the provision does not permit a participating employee to have a cash or deferred election with regard to the designated employee contributions.

After the DROP is adopted, participant contributions for participants in the DROP will continue at the same rates as spelled out in section 411.8 of the State Code and these provisions apply equally to participants who participate in the DROP and those that do not. Furthermore, DROP participant contributions will be credited to System assets and not participant accounts. Hence, the mere fact that Participant contributions that are already being picked-up under the Plan pursuant to section 414(h)(2) of the Code will continue unchanged during participation in the DROP will not result in said contributions being ineligible for pick-up.

Issue 5

Under section 411.6C(1)(b), the DROP benefit is credited to the participant's account during the participation period. Such amounts are held in the System and remain assets of the System. No part of the DROP benefit is distributed to a member until the member terminates participation in the DROP. Accordingly, the crediting of the DROP benefit to the participant's account is not a plan distribution to the member from the Plan. Hence, the DROP benefit is neither subject to tax under section 402(a) of the Code nor the 10 percent additional tax under section 72(t) of the Code prior to the time when an actual distribution takes place.

Issue 6

Section 411.6B of the State Code provides for the eligible rollover of distributions from the Plan to another eligible retirement plan in accordance with section 401(a)(31) of the Code.

As already discussed above, the benefit under the DROP allows the member to elect an optional form of benefit which provides for a participant retirement amount and DROP payment. Under section 411.6C(2)(b), upon termination of participation in the DROP, the distribution of the DROP payment must be either in the form of a single sum distribution or as a rollover to an eligible retirement plan as described in section 411.6B.

The DROP payment is independent of the participant retirement amount and is substantially larger than the monthly participant retirement amount. Hence, in accordance with section 1.402(c)-2, Q&A-6(a), of the regulations, the DROP payment is treated as independent of the monthly participant retirement amount payments (which are a series of substantially equal payments) and thus not part of the series of monthly participant retirement amount payments, because the DROP payment is substantially larger than the monthly participant retirement amount payments. Since the DROP payment is an independent payment, it is, in accordance with this same section of the regulations, 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 DROP payment is made before, with, or after the monthly annuity payments commence.

Furthermore, the DROP payment is not a distribution required under section 401(a)(9) of the Code, made upon the participant's hardship, or otherwise excluded from the term "eligible rollover distributions" by section 402(c)(4) of the Code or section 1.402(c)-2 of the Regulations. Hence, because the DROP payment is a distribution to the member of all or any portion of the balance to the credit of the member in the Plan, the DROP payment is an "eligible rollover distribution" within the meaning of section 402(c)(4) of the Code and section 1.402(c)-2 of the Regulations. Likewise, in accordance with section 1.401(a)(31)-1, Q&A-1, of the Regulations, the DROP payment is an eligible rollover distribution for purposes of section 401(a)(31)(A) of the Code.

Based on the foregoing analysis of the issues presented in your ruling request, the following ruling is issued:

(1) The DROP is not a separate defined contribution plan.

(2) The limitation for defined benefit plans under section 415(b) of Code applies to the Plan with the DROP. The Plan with the DROP satisfies the defined benefit plan limitations under section 415(b) of the Code as long as the provisions continue to be interpreted and administered as described above.

(3) The Plan with the DROP meets the definitely determinable requirement for pension plans under section 1.401-1(b)(1)(i) of the Income Tax Regulations as the Plan is currently written.

(4) The mere fact that Participant contributions that are already being picked-up under the Plan pursuant to section 414(h)(2) of the Code will continued unchanged during participation in the DROP will not result in said contributions being ineligible for pick-up.

(5) Credits to a participant's DROP account are not distributions from the Plan and are not subject to current income taxes or to the additional 10% tax on early distributions under section 72(t) of the Code.

(6) Single sum distributions from a participant's DROP account will be eligible for rollover under section 401(a)(31)(A) of the Code.

This 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.

We have sent a copy of this letter to your authorized representative pursuant to a power of attorney on file in this office.

If you require further assistance in this matter, please contact

Sincerely yours,

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