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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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T:EP:RA:T3

UIL Code: 414.00-00
414.09-00

Legend:

Employer A = xxxxxxxxxxxxxxxxxxxxx

Employer B = xxxxxxxxxxxxxxxxxxxx

Employer C = xxxxxxxxxxxxxxxxxxxxx

State X = xxxxxxxxxxxxxxxxxxxxx

Plan Y = xxxxxxxxxxxxxxxxxxxxx

Statute M = xxxxxxxxxxxxxxxxxxxxx

Statute N = xxxxxxxxxxxxxxxxxxxxx

Date 1 = xxxxxxxxxxxxxxxxxxxx

Date 2 = xxxxxxxxxxxxxxxxxxxxx

Date 3 = xxxxxxxxxxxxxxxxxxxxx

Dear xxxxxxxxxxxxx:

This letter is in response to your ruling request, dated June 15, 2012, with respect to the federal income tax treatment of certain contributions to a retirement plan pursuant to section 414(h) of the Internal Revenue Code.

The following facts and representations are submitted under penalties of perjury in support of your request:

Employer A, a political subdivision of State X, as well as Employer B, a school board, and Employer C, an economic development authority, each located in State X, are participating employers in Plan Y. Plan Y is a contributory defined benefit pension plan for employees

of State X and its participating political subdivisions and local school boards. Plan Y is intended to qualify under Internal Revenue Code (Code) section 401(a) as applicable to governmental plans as defined in Code section 414(d).

Participation in Plan Y is mandatory for all full-time, permanent salaried employees of State X, local school boards and participating local governments and political subdivisions. Under Statute M, contributions to Plan Y include amounts from participating employers and from participants (hereinafter "members"). Statute M requires members to contribute an amount equal to five percent of "creditable compensation" (such member contributions hereinafter referred to as "Mandatory Contributions"). Statute M further mandates that upon accepting employment, eligible employees are deemed to consent and agree to the deduction from their compensation.

Prior to Date 1, any participating employer could elect to pay the Mandatory Contributions as "pick-up" contributions under Code section 414(h) in lieu of requiring such contributions to be paid by members. Prior to such date, Employers A, B, and C each paid equivalent amounts to Plan Y in lieu of such employee contributions under the "in lieu of future increase" method.

On Date 2, a private letter ruling had previously been issued to Plan Y in which the Internal Revenue Service concluded that the employer payment of the equivalent amount in lieu of member contributions are to be treated as employer contributions and are excludable on the basis of Code section 402(a)(1) from members' gross income until such time as the amounts are distributed or made available to the members. The private letter ruling issued on Date 2 also held that such picked-up contributions to the retirement system are excluded from wages for purposes of the Collection of Income Tax at Source on Wages and, therefore, no withholding from the members' salaries is required with respect to such contributions for federal income tax purposes.

Effective as of Date 1, pursuant to changes made by the General Assembly of State X to Statute N, political subdivision employees who are Plan Y members are required to contribute the Mandatory Contributions by pre-tax salary reduction. Pursuant to the implementation clause of legislation amending Statute N, political subdivisions must also provide an offsetting salary increase. Under Plan Y procedures, the political subdivision must adopt a formal resolution implementing the salary reduction arrangement. The formal resolution must further specify that the members are not entitled to receive such contributed amounts directly, even though the amounts are designated as employee contributions.

Employers A, B, and C each passed resolutions on or before Date 3 specifying that all or a portion of the members' Mandatory Contributions will be made by salary reduction as of Date 1. Thus, effective Date 1, Employers A, B, and C will each pick up the Mandatory Contributions of their respective members under the "salary reduction" method. Simultaneously, Employers A, B, and C each passed a resolution increasing employee compensation by five percent.

Based on the above facts and representations, you request the following rulings:

1. The change from the prior method of picking up Mandatory Contributions in lieu of future salary increases to a pick-up contribution made by salary reduction with an offsetting salary increase does not change the federal tax treatment of the contributions.

2. The change from the prior method of picking up Mandatory Contributions in lieu of future salary increases to a pick-up contribution made by salary reduction with an offsetting salary increase does not change the withholding of the contributions for federal income tax purposes.

Section 414(h)(2) of the Code provides that contributions, otherwise designated as employee contributions, shall be treated as employer contributions if such contributions are made to a plan determined to be qualified under section 401(a) of the Code, established by a state government or a political subdivision thereof, or any agency or instrumentality of any one of the foregoing, and are picked up by the employing unit.

The federal income tax treatment to be afforded contributions that are picked up by the employer within the meaning of section 414(h)(2) of the Code has been developed in a series of revenue rulings. In Revenue Ruling 77-462, 1977-2 C.B. 358, the employer school district agreed to assume and pay the amounts employees were required by state law to contribute to a state pension plan. Revenue Ruling 77-462 concluded that the school district's picked-up contributions to the plan were excluded from the employees' gross income until such time as they were distributed to the employees. The revenue ruling further held that, under the provisions of section 3401(a)(12)(A) of the Code, the school district's contributions to the plan were excluded from wages for purposes of the collection of income tax at the source on wages. Therefore, no withholding was required for federal income tax purposes from the employees' salaries with respect to such picked-up contributions.

Revenue Ruling 81-35, 1981 C.B. 255, and Revenue Ruling 81-36, 1981 C.B. 255, established that the following two criteria must be met: (1) the employer must specify that the contributions, although designated as employee contributions, are being paid by the employer in lieu of contributions by the employee; and (2) the employee must not be given the option of choosing to receive the contributed amounts directly instead of having them paid by the employer to the pension plan.

Revenue Ruling 87-10, 1987-1 C.B. 136, provides that the required specification of designated employee contributions must be completed before the period to which such contributions relate. If not, the designated employee contributions paid by the employer are actually employee contributions paid by the employee and recharacterized at a later date. The retroactive specification of designated employee contributions as paid by the employing unit, i.e., the retroactive "pick-up" of designated employee contributions by a governmental employer, is not permitted under section 414(h)(2) of the Code. Thus, employees may not exclude from current gross income designated employee contributions

to a qualified plan that relate to compensation earned for services rendered prior to the date of the last governmental action necessary to effect the pick up.

Rev. Rul. 2006-43, 2006-35 I.R.B. 329, amplifying and modifying Rev. Rul. 81-35, 1981-1 C.B. 255, Rev. Rul. 81-36, 1981-1 C.B. 255, and Rev. Rul. 87-10, 1987-1 C.B. 136, describes the actions required 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) of the Code. Specifically, Rev. Rul. 2006-43 provides that a contribution to a qualified plan established by an eligible employer (i.e., a governmental employer) will be treated as picked-up by the employing unit under section 414(h)(2) of the Code if two conditions are satisfied:

1) First, the employing unit must 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 ordinance).

2) Second, the pick-up arrangement must not permit a participating employee from and after the effective date of the "pick-up" to have a cash or deferred election right within the meaning of section 1.401(k)-1(a)(3) of the Income Tax Regulations with respect to designated employee contributions. Thus, for example, no participating employee may be given the right to opt out of the pick-up arrangement described in section 414(h)(2) of the Code, or to receive the contributed amounts directly instead of having them paid by the employing unit to the plan.

Rev. Rul. 2006-43 states that the pick up rules expressed in Rev. Rul. 81-35 and Rev. Rul. 81-36 apply whether the employer picks up contributions through a reduction in salary or through an offset against future salary increases.

In this case, Plan Y satisfies the criteria set forth in Rev. Rul. 81-35, Rev. Rul. 81-36, and Rev. Rul. 2006-43, by specifically providing that Employers A, B. and C shall pick up the Mandatory Contributions of members; that such contributions, although designated as employee contributions, shall be paid (picked up) by Employers A, B, and C in lieu of contributions by members; and that members will not be given the option of choosing to receive the contributed amounts directly instead of having them paid by Employers A, B, and C to Plan Y. The fact that such contributions were previously made as an offset

against future salary increases and are now to be made on a salary reduction basis does not, by itself, cause Plan Y to fail to meet such criteria.

With respect to ruling request one, we conclude that the change from the prior method of picking up Mandatory Contributions in lieu of future salary increases to a pick-up contribution made by salary reduction with an offsetting salary increase does not change the federal tax treatment of the contributions. With respect to ruling request two, we conclude that the change from the prior method of picking up Mandatory Contributions in lieu of future salary increases to a pick-up contribution made by salary reduction with an offsetting salary increase does not change the withholding of the contributions for federal income tax purposes.

No opinion is expressed as to the federal tax consequences of the transaction described above under any other provisions of the Code.

This ruling is based on the assumption that Plan Y will be qualified under section 401(a) of the Code.

This ruling is directed only to the specific taxpayers that requested it. Code section 6110(k)(3) provides that it may not be used or cited by others as precedent.

Pursuant to a power of attorney on file with this office, a copy of this letter ruling is being sent to your authorized representative.

Should you have any questions or concerns regarding this ruling, please contact xxxxxxxxxx (I.D. Number xxxxxxxxxxxx), SE:T:EP:RA:T3 at (xxx) xxx-xxxx.

Sincerely yours,

Laura B. Warshawsky

Laura B. Warshawsky, Manager
Employee Plans Technical Group 3

Enclosures:

Deleted copy of this letter

Notice of Intention to Disclose

cc: xxxxxxxxxxxxxxxxxxx
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xxxxxxxxxxxxxxxxxxxx
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