TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

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Uniform Issue List: 401.29-00
402.01-00
72.00-00
72.20-00
414.09-00

Legend:

State A =

DB Plan =

DC Plan =

Dear

This is in response to a letter dated November 8, 2011, in which you request rulings under sections 414(h)(2), 72 and 401(k) of the Internal Revenue Code ("Code").

The following facts and representations have been submitted under penalty of perjury in support of the rulings requested.

State A established and maintains the State A Retirement System ("SARS"). The SARS includes the DB Plan, a governmental defined benefit plan within the meaning of section 414(d) of the Internal Revenue Code of 1986, as amended, (the "Code"). The DB Plan is a qualified plan within the meaning of Code section 401(a) and received a determination letter from the Internal Revenue Service (the "Service") dated September 14, 2012.

In 2000, State A adopted the DC Plan, an optional defined contribution retirement plan for eligible members of SARS. The DC Plan is a defined contribution plan designed to constitute a qualified plan under Code section 401(a) that received a determination letter from the Service dated November 14, 2013.

Beginning in June 2002, persons eligible to participate in the DB Plan could elect to participate in the DC Plan in lieu of participating in the DB Plan. In addition, eligible employees who participate in the DB Plan have the one-time opportunity to move from the DB Plan to the DC Plan. Finally, eligible employees who initially elected to participate in the DC Plan could make a subsequent election to move to the DB Plan.

On July 27, 2001, the Service issued a private letter ruling ("2001 PLR") concluding that in the case of a transfer of amounts from the DB Plan to the DC Plan, and from the DC Plan to the DB Plan, either upon initial election, or during the one-time additional opportunity for such transfers, the amounts transferred are not distributions and the transfers will not result in currently taxable income to the participant under section 72 of the Code, or section 402 of the Code, and will not result in imposition of an early distribution tax under section 72(t) of the Code. The 2001 PLR also determined that neither the initial election to permit an eligible employee to participate in the DC Plan in lieu of the DB Plan nor the additional one-time election to transfer from the DB Plan to the DC Plan or from the DC Plan to the DB Plan while an employee constitute a cash or deferred arrangement within the meaning of Code section 401(k).

In 2011, the Legislature of State A adopted legislation (2011 Legislation) requiring mandatory employee contributions to the DB Plan and DC Plan (Plans), which would be picked up by participating employers and treated as employer contributions. The new legislation requires that each employee contribute 3% of compensation to either Plan in which he or she is a participant. The employer deducts the contribution from the employee's monthly salary, and the contributions are reported as employer-paid employee contributions and credited to the account of the employee.

The 2011 Legislation provides that contributions shall be deducted from employees' salaries before the computation of applicable federal taxes, and these contributions shall be treated as employer contributions under section 414(h)(2) of the Code. The 2011 Legislation specifies that the contributions, although designated as employee contributions, are being paid by the employer in lieu of contributions by the employees. Employees do not have the option of choosing to receive the contributed amounts directly, instead of having them paid by the employer to the Plans. Such contributions are mandatory and each employee is considered to have consented to payroll deductions.

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

(1) For federal income tax purposes, mandatory contributions deducted from employees' salaries and contributed by the employer to the Plans will be considered picked up by participating employers and will not be currently included in the gross income of the participants on whose behalf the pick-up is made and will not constitute wages subject to federal income tax withholding.

(2) The election of eligible employees to participate in the DC Plan or the DB Plan and, if participation in the DC Plan is elected, any transfer of amounts from the DB Plan to the DC Plan upon such initial election of an eligible employee to participate in the DC Plan, and the additional opportunity of an eligible employee to elect to move from the DB Plan to the DC Plan or from the DC Plan to the DB Plan after the period during which the employee made the initial election between the Plans, and the transfer of amounts from the DB Plan to the DC Plan or from the DC Plan to the DB Plan upon such election, (i) will not result in currently taxable income to the participant under Code section 72, Code section 402, or any other Code provision, and (ii) will not result in imposition of an early distribution tax under Code section 72(t).

(3) Neither the initial election to permit an eligible employee to participate in the DC Plan in lieu of the DB Plan nor the additional one-time election to transfer from the DB Plan to the DC Plan or from the DC Plan to the DB Plan while an employee will constitute a cash or deferred arrangement within the meaning of Code section 401(k).

With respect to the your first requested ruling, 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.

Rev. Rul. 2006-43, 2006-35 I.R.B. 329, amplifying and modifying Rev. Rul. 81-35, 1981-1 C.B. 255, and 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 an ordinance).

(2) Second, the pick-up arrangement must not permit a participating employee from and after the date of 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 ("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 applies even if the employer picks up contributions through either a reduction in salary or an offset against future salary increases.

The federal income tax treatment to be afforded contributions which are picked up by the employer within the meaning of section 414(h)(2) of the Code is specified in Revenue Ruling 77-462, 1977-2 C.B. 358. In that revenue ruling, 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 are excluded from the employees' gross income until such time as they are distributed to the employees. The revenue ruling held further that, under the provisions of section 3401(a)(12)(A) of the Code, the school district's contributions to the plan are excluded from wages for purposes of the collection of income tax at source on wages. Therefore, no withholding is required from the employees' salaries with respect to such picked-up contributions.

The issue of whether contributions have been picked up by an employer within the meaning of section 414(h)(2) of the Code is addressed in Revenue Ruling 81-35, 1981-1 C.B. 255, and Revenue Ruling 81-36, 1981 C.B. 255. These revenue rulings 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. Furthermore, it is immaterial, for purposes of the applicability of section 414(h)(2), whether an employer picks up contributions through a reduction in salary, an offset against future salary increases, or a combination of both.

In order to comply with Revenue Ruling 81-35 and Revenue Ruling 81-36, with respect to particular contributions, Revenue Ruling 87-10, 1987-1 C.B. 136 provides the required specification of designated employee contributions must be completed before the period to which such contributions relate. If not, the designated employee contributions being 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.

With respect to your first requested ruling, we have determined that the 2011 Legislation satisfies the criteria set forth in Revenue Ruling 2006-43, Revenue Ruling 81-35 and Revenue Ruling 81-36 by specifically providing that the employer shall pick up the mandatory contributions of employees to the Plans; that such contributions, although designated as employee contributions, shall be paid (picked up) by the employer in lieu of contributions by the employees; and that employees will not be given the option of choosing to receive the contributed amounts directly instead of having them paid by the employer.

Accordingly, with respect to your first requested ruling, we conclude that the mandatory contributions made by the employees to the Plans and picked up by employer shall be treated as employer contributions and will not be included in the current gross income of the employees for federal income tax purposes in the year in which contributions are made to the Plans. These amounts will be includible in the employees' (or their beneficiaries') gross income only in the taxable year in which they are distributed, to the extent they represent contributions made by the employer. Because we have determined that the picked-up amounts are to be treated as employer contributions, they are excepted from wages as defined in section 3401(a)(12)(A) of the Code for federal income tax withholding purposes. In addition, no part of the amounts picked up by the employer will constitute wages for federal income tax withholding purposes in the taxable year in which they are contributed to the Plans.

With respect to your second requested ruling, section 402(a) of the Code provides, in general, that the amount actually distributed 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 year in which so distributed, under section 72(relating to annuities).

Section 72(t) of the Code provides for an additional tax on any amount received from a "qualified retirement plan" (as defined in section 4974(c), which includes plans described in section 401(a)). The additional tax for the taxable year in which such amount is received is equal to 10 percent of the portion of such amount which is includible in gross income, except where such income is distributed on or after an

employee attains the age of 59[1/2], or on account of one or more exceptions provided for under section 72(t)(2) of the Code.

Revenue Ruling 67-213, 1967-2 CB 149, 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, there is no distribution of the participant's interest in the plan and no taxable income will be recognized by reason of such transfer.

In the case of a transfer of amounts from the DB Plan to the DC Plan, either upon initial election, or during the one-time additional opportunity for such transfers, the amounts transferred to the DC Plan will not be distributed to the participant. Similarly, in the case of a transfer of amounts from the DC Plan to the DB Plan, during the one-time opportunity for such transfers, the amounts transferred to the DB Plan will not be distributed to the participant. The only choice a participant has is to transfer to the other plan. The amount so transferred is then subject to the distribution rules in the transferee plan. Thus, the 2001 PLR extends to your second requested ruling, and accordingly, the amounts transferred from the DB Plan to the DC Plan, and from the DC Plan to the DB Plan, whether at time of initial selection, or during the one-time additional opportunity for transfer of such amounts, are not distributions and the transfers will not result in currently taxable income to the participant under section 72 of the Code or section 402 of the Code, and will not result in imposition of an early distribution tax under section 72(t) of the Code.

With respect to your third requested ruling, section 1.401(k)-1(a)(3)(i) of the regulations provides that a cash or deferred election is any election (or modification of an earlier election) by an employee to have the employer either (A) provide an amount to the employee in the form of cash or some other taxable benefit that is not currently available, or (B) contribute an amount to a trust, or provide an accrual or other benefit, under a plan deferring the receipt of compensation.

Section 1.401(k)-1(a)(3)(iii) of the regulations provides that an amount is currently available if it has been paid to the employee or if the employee is able currently to receive the cash or other taxable amount at the employee's discretion. An amount is not currently available if there is a significant limitation or restriction on the employee's right to receive the amount currently. Similarly, an amount is not currently available as of a date if the employee may under no circumstances receive the amount before a particular time in the future.

With respect to your third requested ruling, neither the initial election to permit an eligible employee to participate in the DC Plan in lieu of the DB Plan or the additional one-time election to transfer from the DB Plan to the DC Plan or from the DC Plan to the DB Plan while an employee, provides an amount to the employee in the form of cash or other taxable benefit not currently available. The 2011 legislation requires that each employee contribute 3% of compensation to either Plan in which he or she is a participant, without regard to the election of which plan to participate in or to transfer to.

Employees do not have the option of choosing to receive the contributed amounts directly, instead of having them paid by the employer to the Plans. Thus, the 2001 PLR extends to your third requested ruling, and accordingly, neither the initial election to permit an eligible employee to participate in the DC Plan in lieu of the DB Plan or the additional one-time election to transfer from the DB Plan to the DC Plan or from the DC Plan to the DB Plan while an employee constitutes a cash or deferred arrangement within the meaning of Code section 401(k).

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

The above rulings are based on the assumption that the Plans are qualified under Code section 401(a) and their related trusts exempt from tax under section 501(a) at all relevant times.

No opinion is expressed as to whether the amounts picked up by State A are subject to tax under the Federal Insurance Contributions Act. No opinion is expressed as to whether the amounts in question are paid pursuant to a "salary reduction agreement" within the meaning of Code section 3121(v)(1)(B).

This ruling is directed only to the specific taxpayer 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 ruling has been sent to your authorized representative.

If you have any questions, please contact (I.D. #' by phone at or fax at . Please address all correspondence to SE:T:EP:RA:T1.

Sincerely yours,

Carlton A. Watkins

Carlton A. Watkins, Manager
Employee Plans Technical Group 1

Enclosures:
Deleted Copy of Ruling Letter
Notice of Intention to Disclose

cc: