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Person To Contact:
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Date:
April 20, 2015

State S =

Employer A =

Plan X =

Plan Y =

Statute S =

Ordinance A =

Ordinance B =

Date 1 =

Date 2 =

Dear :

This letter is in response to your request, dated July 16, 2014, and followed by correspondence dated March 25, 2015, for a ruling on the proper federal income tax treatment of certain contributions to two retirement plans under section 414(h) of the Internal Revenue Code (the "Code").

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

Employer A is a municipal corporation and political subdivision of State S. Employer A sponsors Plan X, a defined benefit plan intended to qualify under section 401(a) of the Code as applicable to governmental plans as defined in section 414(d) of the Code. Employer A also sponsors Plan Y, a defined contribution plan intended to qualify under section 401(a) of the Code as applicable to governmental plans as defined in section 414(d) of the Code.

Other than public safety employees and elected officials, participation in Plan X is mandatory for employees of Employer A hired before July 1, 2014, and is optional for employees hired on or after July 1, 2014 (and certain employees rehired on or after that date). Plan X membership consists of classes 1, 2, 3 and 4.

Class 1 consists of employees hired on or after July 1, 1979, and before July 1, 2014, and employees hired before July 1, 1979, who elected to transfer from Class 3 or Class 4 membership to Class 1 membership. Class 2 members are those employees hired, or in some cases rehired, on or after July 1, 2014. Class 3 and 4 members are employees who are required to make employee contributions only on an after-tax basis. Class 1 and Class 2 members are the subject of this ruling request.

Other than public safety employees and elected officials, participation in Plan Y is mandatory for employees of Employer A hired or rehired on or after July 1, 2014. Employees hired, or in some cases rehired, on or after July 1, 2014, may elect to participate in both in Plan X and Plan Y.

Ordinance A was passed on Date 1, amending Statute S to require Class 1 employees to begin making contributions to Plan X. The amount of the mandatory employee contributions is: 1% of compensation from July 1, 2013, through June 30, 2014; 2% of compensation from July 1, 2014, through June 30, 2015; 3% of compensation from July 1, 2015, through June 30, 2016; 4% of compensation from July 1, 2016, through June 30, 2017; and 5% of compensation for fiscal years (July 1–June 30) beginning on and after July 1, 2017.

Statute S, as amended by Ordinance A, provides that the scheduled increases for Class 1 employees apply only for fiscal years in which a minimum 2% salary raise has become effective after negotiation with the appropriate employee organization or professional organization. If a minimum 2% salary increase becomes effective after July 1 of a particular fiscal year, the contribution increase in effect for such fiscal year will be suspended until the date the raise becomes effective and is applied pro rata from the effective date of the raise through the end of the fiscal year. For the July 1, 2013 fiscal year, the 2% salary increase was not effective until the pay period commencing October 12, 2013. Consequently, a pro-rata mandatory employee contribution of 1.37% became effective as of the beginning of that pay period for Class 1 members.

Ordinance B was passed on Date 2, amending Statute S to require employees, other than public safety employees and elected officials, hired or in some cases rehired on or after July 1, 2014, to make a one-time irrevocable election between two retirement plan options. Employees electing Option 1 ("Hybrid Members") become Class 2 participants in Plan X and also participants in Plan Y. Employees who elect Option 2 ("Non-Hybrid Members") become participants in Plan Y but are not participants in Plan X.

Statute S, as amended by Ordinance B, requires Hybrid Members to begin making employee contributions at 5% of compensation to Plan X as of the first full pay period after Class 2 membership begins. Class 2 participation begins on the first anniversary of the date of employment or reemployment. Hybrid Members are not required to make employee contributions to Plan Y.

Statute S, as amended by Ordinance B, provides that Employer A intends to pick up the employee contributions for Class 1 and Class 2 members and that the contributions, although designated as employee contributions, will be treated as employer contributions for federal income tax purposes. Statute S does not provide employees the option of choosing to receive contributions directly instead of having such contributions paid by Employer A into Plan X.

Statute S as amended requires members of Plan Y who are Non-Hybrid members to begin making employee contributions at 5% of compensation to Plan Y as of the first full payroll period on or after Plan Y participation begins. Plan Y membership begins on the 180th day after the date of employment. Statute S provides that mandatory contributions to Plan Y, although designated as employee contributions, are paid by Employer A in lieu of contributions by members. In addition, members may not receive the contributions directly. The mandatory contributions are intended to be treated as employer contributions for federal income tax purposes.

Employer A treats all mandatory employee contributions into Plan X and Plan Y as being made pursuant to a salary reduction agreement under section 3121(v)(1)(B) and as wages subject to tax under the Federal Insurance Contributions Act.

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

1. That the mandatory contributions made by Class 1 and 2 members of Plan X and picked up by Employer A will not be included in the current gross income of Class 1 or Class 2 members on whose behalf the pick-up is made for federal income tax purposes.

2. That the mandatory contributions made by Class 1 and 2 members of Plan X and picked up by Employer A will be treated as employer contributions for federal income tax purposes; and will not constitute wages subject to federal income tax withholding.

3. That the mandatory contributions made by Non-Hybrid members of Plan Y and picked up by Employer A will not be included in the current gross income of Plan Y members on whose behalf the pick-up is made for federal income tax purposes.

4. That the mandatory contributions made by Non-Hybrid members of Plan Y and picked up by Employer A will be treated as employer contributions for federal income tax purposes; and will not constitute wages subject to federal income tax withholding.

Section 401(a) of the Code provides that a trust created or organized in the United States and forming a part of a qualified stock bonus, pension, or profit sharing plan of an employer constitutes a qualified trust only if the various requirements set out in section 401(a) of the Code are met.

Section 402(a) of the Code generally provides that any amount actually distributed to any recipient by any employees' trust described in section 401(a) of the Code, which is exempt from tax under section 501(a) of the Code, shall be taxable to the recipient, in the taxable year of the distribution, under section 72 of the Code (relating to annuities).

Section 1.402(a)-1(a)(1)(i) of the Income Tax Regulations (the "Regulations") provides that if an employer makes a contribution for the benefit of an employee to a trust described in section 401(a) of the Code for the taxable year of the employer which ends within or with a taxable year of the trust for which the trust is exempt under section 501(a) of the Code, the employee is not required to include such contribution in his or her income except for the year or years in which such contribution is distributed or made available to him or her.

Section 414(h)(1) of the Code provides that any amount contributed to an employees' trust described in section 401(a) of the Code shall not be treated as having been made by the employer if it is designated as an employee contribution.

Section 414(h)(2) of the Code provides that, for purposes of section 414(h)(1), in the case of any plan established by the government of any State or political subdivision thereof, or by any agency or instrumentality of any of the foregoing, or a governmental plan described in the last sentence of section 414(d) (relating to plans of Indian tribal governments), where the contributions of employing units are designated as employee contributions but where any employing unit picks up the contributions, the contributions so picked up shall be treated as employer contributions.

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 or made available to the employees. The revenue ruling also 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, 1981-1 C.B. 255, and Revenue Ruling 81-36,1981-1 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 pickup.

Revenue Ruling 2006-43, 2006-35 I.R.B. 329, amplifying and modifying Rev. Rul. 81-35, Rev. Rul. 81-36, and Rev. Rul. 87-10, describes the actions required for a state or political subdivision of a state, or an agency or instrumentality of either, 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). 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 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 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 Revenue Ruling 81-35 and Revenue Ruling 81-36 apply even if the employer picks up contributions through a reduction in salary or through an offset against future salary increases.

With respect to your first ruling requested, Plan X satisfies the criteria set forth in Rev. Rul. 81-35, Rev. Rul. 81-36, and Rev. Rul. 2006-43. Section 8 of Statute S, as amended by Ordinance A, provides that Employer A shall pick up the mandatory contributions deducted from Class 1 and 2 employees' salaries and contributed by Employer A to Plan X. Employer A took formal action by enacting Ordinance A on Date 1, before October 25, 2013, the first pay period during which mandatory employee contributions were made for Class 1 members. Class 2 employees will make mandatory contributions no earlier than July 1, 2015.

In addition, no provision of Statute S permits Class 1 or Class 2 employees the option to choose to receive the contributed amounts directly instead of having them paid by Employer A to Plan X. Therefore, employees are not permitted to make a cash or deferred election with respect to the contributions.

We conclude that the mandatory contributions made by the employees to Plan X and picked up by Employer A 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 Plan X. 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.

With respect to your second ruling requested, because we have determined that the picked-up amounts are to be treated as employer contributions, they are excluded from wages as defined in section 3401(a)(12)(A) of the Code for federal income tax withholding purposes.

With respect to your third ruling requested, Plan Y satisfies the criteria set forth in Rev. Rul. 81-35, Rev. Rul. 81-36, and Rev. Rul. 2006-43. Ordinance B, amending Statute S,

provides that Employer A shall pick up the contributions deducted from non-Hybrid employees' salaries and contributed by the Employer A to Plan Y and that such contributions, although designated as employee contributions, will be paid by Employer A in lieu of contributions by participants. Employer A took formal action by enacting Ordinance B on Date 2 and employees will begin to make mandatory contributions prospectively starting no earlier than January 1, 2015.

In addition, Ordinance B provides that employee contributions are mandatory and that participants may not receive the contributed amounts directly instead of having them paid by Employer A to Plan Y. The amount of the contribution is 5% of compensation regardless of whether the employee is a Hybrid member and the contribution is to Plan X or the employee is a non-Hybrid member and the contribution is to Plan Y. Therefore, we find that the employees are not permitted to make a cash or deferred election with respect to the contributions.

We conclude that the mandatory contributions made by the employees to the Plan Y and picked up by Employer A 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 Plan Y. 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 Employer A.

With respect to your fourth ruling request, because we have determined that the picked-up amounts are to be treated as employer contributions, they are excluded from wages as defined in section 3401(a)(12)(A) of the Code for federal income tax withholding purposes.

No opinion is expressed as to whether the amounts picked up by Employer 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 based on the assumption that Plan X and Plan Y satisfy the qualification requirements set forth in section 401(a) of the Code, and constitute governmental plans within the meaning of section 414(d) of the Code, at all relevant times.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

Laura B. Warshawsky
Senior Tax Law Specialist
Qualified Plans Branch 2
(Tax Exempt and Government Entities)