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Date:
May 04, 2015

Legend

State A =
Plan B =
Board C =
Statute D =
Statute E =

Dear :

This letter is in response to a ruling request submitted by your authorized representative on behalf of Plan B, dated June 29, 2011, as supplemented by correspondence dated November 5, 2012, and March 6, 2015, with respect to the federal income tax treatment of certain contributions to Plan B under sections 401(k), 414(h), 415(c), and 3401(a) of the Internal Revenue Code (the "Code").

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

Plan B is a cost-sharing, multiple employer, defined benefit plan that is intended to constitute a qualified plan under section 401(a), and a governmental plan within the meaning of section 414(d). The governing provisions of Plan B are statutorily promulgated by the legislature of State A. Plan B is administered by Board C.

Plan B has two different benefit structures, Tier 1 and Tier 2. The Tier 1 and Tier 2 benefit structures each have a benefit formula that multiplies three variables: (1) the member's "Final Average Salary" (as defined in the Plan, hereinafter referred to as

"FAS"); (2) a statutory multiplier specified in the Plan; and (3) the member's years of service.

In 2011, the legislature of State A enacted Statute D, which, among other things, provides Tier 1 members with certain elections with respect to their employee contribution rates and statutory multiplier. Under Statute D, an individual who is a Tier 1 member of Plan B on July 1, 2013 will have a one-time, irrevocable election, during a 90-day period established by Board C, to either:

(1) increase their employee contributions from 4% to 5% of compensation (effective January 1, 2014), and from 5% to 6% (effective January 1, 2015), and increase their multiplier from 1.75% to 1.85% of FAS, times years of service earned on and after January 1, 2014; or

(2) continue to make an employee contribution of 4% of compensation and have their multiplier drop from 1.75% to 1.4% of FAS, times years of service earned on and after January 1, 2014.

Statute D further provides that Tier 1 members that fail to make such an election during the applicable election period are treated as if they elected to increase their employee contributions and multiplier as specified in (1) immediately above.

With respect to Tier 2 members, Statute D provides that, effective July 1, 2013, a Tier 2 member will have a one-time irrevocable election, during a 90-day period established by Board C, to either:

(1) continue to make an employee contribution of 6%, have a multiplier of 1.75% of FAS times years of service, but without a cost-of-living adjustment ("COLA"); or

(2) continue to make an employee contribution of 6% of compensation, have a multiplier of 1.4% of FAS times years of service earned on and after January 1, 2014, with a COLA.

In 2012, the State A legislature enacted Statute E, which revised the amount of required member contributions and the benefit multiplier under Plan B for Tier 1 and Tier 2 members of the Plan as follows:

(1) An individual who is a Tier 1 Plan B member on July 1, 2013 will have the election provided in Statute D (described above) only if the Internal Revenue Service ("IRS") approves the election.[1] If the IRS does not

[1] The IRS does not approve or disapprove a statutory provision or a proposed transaction. However, upon receipt of a proper submission by a taxpayer, the IRS will issue a ruling regarding the federal tax

approve the election, the increase in the member contribution and the increase in the multiplier under Statute D will be automatic (i.e., members will not be permitted an election). Accordingly, under Statute E, if the IRS does not approve the member election allowed under Statute D for Tier 1 members, the following will occur:

(a) The required employee contributions for individuals who are Tier 1 members on July 1, 2013 will automatically increase from 4% to 5% of compensation (effective January 1, 2014) and from 5% to 6% (effective January 1, 2015); and

(b) The statutory multiplier with respect to such Tier 1 members will automatically increase from 1.75% to 1.85% of FSA, times years of service earned on and after January 1, 2014.

(2) An individual who is a Tier 2 Plan B member on July 1, 2013 will not have any election, and the following will occur

(a) The employee contribution rate will remain at 6% of compensation;

(b) Effective January 1, 2014, the multiplier automatically increases from 1.75% of FSA to 1.85%, times all years of service; and

(c) Members retiring on or after July 1, 2012 will no longer be entitled to a COLA that is provided to Tier 2 members retiring before such date.

The statutory provisions setting forth Plan B explicitly provide that each participating employer with respect to Plan B must pick up and pay, in accordance with section 414(h)(2), the contributions to Plan B that would otherwise by payable by members.

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

(1) That the elections permitted Tier 1 members of Plan B under Statute D, if implemented, will not constitute a cash or deferred arrangement within the meaning of section 401(k).

(2) That the mandatory member contributions required to be made under Statute E by a Tier 1 and Tier 2 active member of Plan B that are picked-up by State A or a participating employer, as employing units, on behalf of such member shall continue to be treated as employer contributions to Plan B under section 414(h)(2) for federal income tax purposes.

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consequences of a proposed transaction under its private letter ruling program. See Revenue Procedure 2015-1, 2015-1 I.R.B. 1.

(3) That the mandatory Tier 1 and Tier 2 member contributions made and picked up as described in ruling request 2, above, will not be included in a member's gross income for federal income tax purposes until distributed or otherwise made available to the member.

(4) That the mandatory Tier 1 and Tier 2 member contributions made and picked up as described in ruling request 2, above, do not constitute wages as described in section 3401(a).

(5) That the mandatory Tier 1 and Tier 2 member contributions made and picked up as described in ruling request 2, above, will not be treated as "annual additions," for purposes of section 415(c), with respect to Plan B.

With respect to your first requested ruling, section 401(a) 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) are met.

Section 401(k)(1) provides that a profit-sharing or stock bonus plan, a pre-ERISA money purchase plan, or a rural cooperative plan, shall not be considered as not satisfying the requirements of section 401(a) merely because the plan includes a qualified cash or deferred arrangement as defined in section 401(k)(2).

Section 1.401(k)-1(a)(1) of the Income Tax Regulations provides, in pertinent part, that a plan, other than a profit-sharing, stock bonus, pre-ERISA money purchase pension or rural cooperative plan, does not satisfy the requirements of section 401(a) if the plan includes a cash or deferred arrangement. Thus, a qualified defined benefit plan is not permitted to include a cash or deferred arrangement.

Furthermore, section 401(k)(4)(B)(ii) provides that "a cash or deferred arrangement shall not be treated as a qualified cash or deferred arrangement if it is part of a plan maintained by a State or local government or political subdivision thereof, or any agency or instrumentality thereof." Section 1116(f)(2)(B)(i) of the Tax Reform Act of 1986, P.L. 99-514, provides a transition rule pursuant to which the prohibition of section 401(k)(4)(B)(ii) of the Code does not apply to any cash or deferred arrangement adopted by a State or local government (or political subdivision thereof) before May 6, 1986. Thus, if a governmental employer maintains a qualified defined contribution plan, the plan cannot generally include a qualified cash or deferred arrangement within the meaning of section 401(k), unless the cash or deferred arrangement was adopted before May 6, 1986.

Section 1.401(k)-1(a)(2) provides that, subject to certain exceptions, which are inapplicable in this case, a cash or deferred arrangement is an arrangement under

which an eligible employee may make a cash or deferred election with respect to contributions to, or accruals or other benefits under, a plan that is intended to satisfy the requirements of section 401(a).

Section 1.401(k)-1(a)(3)(i) defines a cash or deferred election as any direct or indirect 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)(v) provides that a cash or deferred arrangement does not include a one-time irrevocable election made no later than the employee's first becoming eligible under the plan or any other plan or arrangement of the employer that is described in section 219(g)(5)(A), to have contributions equal to a specified amount or percentage of the employee's compensation (including no amount of compensation) made by the employer on the employee's behalf to the plan and a specified amount or percentage of the employee's compensation (including no amount of compensation) divided among all other plans or arrangements of the employer for the duration of the employee's employment with the employer.

In the present case, the employee elections provided under Plan B pursuant to Statute D result in Tier 1 members being given the option to have State A or a participating employer either (1) provide a greater or lesser amount to the member in the form of cash that is not currently available, or (2) contribute an amount to Plan B, or provide an accrual under Plan B, which is a plan deferring the receipt of compensation. Thus, employees are given a cash or deferred election right (within the meaning of §1.401(k)-1(a)(3)) with respect to their designated employee contributions under Plan B. Accordingly, the elections granted to Tier 1 members under Statute D with respect to employee contributions would, if implemented, constitute a cash or deferred arrangement within the meaning of §1.401(k)-1(a)(2).

In addition, even though the elections granted to Tier 1 members under Statute D would be one-time and irrevocable, the elections would not constitute one-time irrevocable elections within the meaning of §1.401(k)-1(a)(3)(v). In order to be a one-time irrevocable election under §1.401(k)-1(a)(3)(v), the election must be made no later than an employee's first becoming eligible under any plan (that is described in section 219(g)(5)(A)) of the employer. In this case, the employees are already participating in Plan B (a type of plan that is described in section 219(g)(5)(A)) during the time they are eligible to make the elections under Statute D. Accordingly, the Tier 1 member elections under Statute D would not be excluded from constituting a cash or deferred arrangement by reason of §1.401(k)-1(a)(3)(v), and would thus be an impermissible cash or deferred arrangement.

With respect to your second requested ruling, section 414(h)(1) provides that any amount contributed to an employees' trust described in section 401(a) shall not be treated as having been made by the employer if it is designated as an employee contribution.

Section 414(h)(2) 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)) has been described 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. Revenue Ruling 77-462 further held that, under the provisions of section 3401(a)(12)(A), 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). 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.

Revenue Ruling 2006-43, 2006-35 I.R.B. 329, amplifying and modifying Revenue Ruling 81-35, Revenue Ruling 81-36, and Revenue Ruling 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) so that the contributions are treated as employer contributions pursuant to section 414(h)(2). Specifically, Revenue Ruling 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) 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 §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), or to receive the contributed amounts directly instead of having them paid by the employing unit to the plan.

Revenue Ruling 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.

In the present case, Statute E provides that if the IRS does not "approve" the member elections described in Statute D, then increases in the member contribution rate and the statutory multiplier under Plan B will be automatic (i.e., members will not be permitted an election). Accordingly, because the IRS concluded with respect to ruling one, above, that the Tier 1 member elections would result in an impermissible cash or deferred arrangement, Statute E requires that the following occur:

(1) Effective January 1, 2014, required employee contributions for any individual who is a Tier 1 Plan B member on July 1, 2013 automatically increases from 4% to 5% of compensation;

(2) Effective January 1, 2015, required contributions with respect to such Tier 1 members further increases from 5% to 6%.

(3) Effective January 1, 2014, the statutory multiplier with respect to such Tier 1 members automatically increases from 1.75% to 1.85% of FSA, times years of service earned on and after such date.

Based on the facts represented, the employee contributions that are mandated by Statute E are to be picked up by each participating employer with respect to Plan B under section 414(h)(2). In accordance with Revenue Ruling 81-35, Revenue Ruling 81-36, and Revenue Ruling 2006-43, appropriate formal action has been taken to provide that such mandatory employee contributions, although designated as employee contributions, will be paid by the employing unit in lieu of employee contributions. The State A legislature specifically provided in the statutory provisions setting forth Plan B that, in accordance with section 414(h)(2), each participating employer with respect to Plan B must pick up and pay the contributions to Plan B that would otherwise be payable by members. Additionally, consistent with Revenue Ruling 87-10, because the relevant statutory Plan B provisions are prospective, the required specification of the designated employee contributions was completed before the period to which such contributions relate.

Furthermore, because the IRS concluded, with respect to ruling one, above, that the Tier 1 member elections that would otherwise be allowed under Statute D would result in an impermissible cash or deferred arrangement, Statute E does not allow for any member elections with respect to mandatory employee contributions to Plan B. Thus, as regards the mandatory employee contributions made in accordance with Statute E with respect to Tier 1 and Tier 2 Plan B members, which are picked up by the employing unit under the terms of Plan B, the Tier 1 and Tier 2 members are not given the option of choosing to receive the contributed amounts directly instead of having them paid by the employer to Plan B. Consequently, in accordance with Revenue Ruling 81-35, Revenue Ruling 81-36, and Revenue Ruling 2006-43, the Tier 1 and Tier 2 members are not permitted from and after the effective date of the pick-up to have a cash or deferred election right within the meaning of §1.401(k)-1(a)(3) with respect to the designated employee contributions. Therefore, the pick-up arrangement under Plan B, as described in the facts represented, is a valid pick-up arrangement consistent with Revenue Ruling 81-35, Revenue Ruling 81-36, and Revenue Ruling 2006-43.

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

Section 1.402(a)-1(a)(1)(i) provides that if an employer makes a contribution for the benefit of an employee to a trust described in section 401(a) 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), the employee is not required to include such contribution in his income except with respect to the year or years in which such contribution is distributed or made available to him.

In the present case, because the mandatory Tier 1 and Tier 2 member contributions that are made in accordance with Statute E, and picked up by a participating employer under the terms of Plan B, will be made pursuant to a valid pick-up arrangement, they will be treated as employer contributions. Therefore, pursuant to section 402(a) and §1.402(a)-1(a)(1)(i), the picked-up employee contributions to Plan B will not be included in gross income of the member for federal income tax purposes until distributed or otherwise made available to the member. Furthermore, consistent with Revenue Ruling 77-462, and in accordance with section 3401(a)(12)(A), the picked-up employee contributions to Plan B are excluded from wages for purposes of the collection of income tax at the source on wages.

In addition, all payments of remuneration by an employer for services performed by an employee are generally subject to taxes under the Federal Insurance Contributions Act (FICA) unless the payments are specifically excepted from the term "wages" or the services are specifically excepted from the term "employment." FICA taxes include social security and Medicare taxes. Section 3121(v)(1)(B) provides that, other than the social security tax wage base limitation, nothing in section 3121(a) excludes from the term "wages" any amount picked up as an employer contribution under section 414(h)(2) if the pickup is pursuant to a salary reduction agreement (whether evidenced by a written instrument or otherwise). For these purposes, the term "salary reduction agreement" includes any salary reduction arrangement, regardless of whether there is approval or choice of participation by individual employees or whether such approval or choice is mandated by State statute. H.R. Conf. Rep. No. 861, 98th Cong. 2d Sess. 1415 (1984); see also *Public Employees' Retirement Board v. Shalala*, 153 F.3rd 1160 (10th Cir. 1998).

Therefore, under section 3121(v)(1)(B), if an employee's services are covered [included in employment] for social security tax purposes, pickup contributions under section 414(h)(2) that are made pursuant to a salary reduction agreement are generally subject to social security taxes (unless the maximum wage base exception applies). Also, under section 3121(v)(1)(B), if an employee's services are covered [included in employment] for Medicare tax purposes, pick-up contributions under section 414(h)(2) that are made pursuant to a salary reduction agreement are subject to Medicare taxes (without any limit based on the amount of wages). This does not constitute a ruling on whether the pick-up contributions are made pursuant to a salary reduction agreement for FICA tax purposes.

With respect to your fifth requested ruling, section 401(a)(16) provides that a trust shall not constitute a qualified trust under section 401(a) if the plan of which such trust is a part provides for benefits or contributions which exceed the limitations of section 415.

Section 415(a)(1)(A) provides that a defined benefit plan is not a qualified plan if the plan provides for the payment of benefits with respect to a participant which exceed the limitation of section 415(b). Section 415(b)(1) prescribes limitations that are based on the annual benefit determined under section 415(b)(2). Section 415(b)(2)(B) provides for adjustments, in accordance with regulations, to the benefit determined under the plan if employees contribute or make rollover contributions to the plan.

Section 415(a)(1)(B) provides that a defined contribution plan is not a qualified plan if the contributions and other additions under the plan with respect to any participant for any taxable year exceed the limitation of section 415(c). Section 415(c)(1) places specified limitations on annual additions, as defined in section 415(c)(2), to a participant's account under a defined contribution plan.

Section 1.415(b)-1(b)(1) prescribes rules for the determination of the annual benefit for purposes of section 415(b). Section 1.415(b)-1(b)(1)(ii) provides that an annual benefit, for purposes of determining the section 415(b) limitation, does not include the annual benefit attributable to employee contributions. However, §1.415(b)-1(b)(2)(ii)(A) provides that, for purposes of determining the annual benefit under a defined benefit plan attributable to employee contributions, contributions that are picked up by a governmental employer as provided in section 414(h)(2) are disregarded. Accordingly, employee contributions that are picked up by a governmental employer as provided in section 414(h)(2) are treated as employer contributions for purposes of determining the section 415(b) limitation, and are not treated as annual additions for purposes of section 415(c).

Section 1.415(c)-1(a)(2)(ii)(B) provides that mandatory employee contributions (as defined in section 411(c)(2)(C) and §1.411(c)-1(c)(4)), regardless of whether the plan is subject to the requirements of section 411 to a defined benefit plan, are treated as contributions to a defined contribution plan. However, §1.415(c)-1(a)(2)(ii)(B) further states that, for this purpose, contributions that are picked up by the employer as described in section 414(h)(2) are not considered employee contributions.

In the present case, the mandatory Tier 1 and Tier 2 member contributions that are made in accordance with Statute E, and picked up by a participating employer under the terms of Plan B, will be made pursuant to a valid pick-up arrangement. Therefore, pursuant to §§1.415(b)-1(b)(2)(ii)(A) and 1.415(c)-1(a)(2)(ii)(B), the picked-up contributions will be treated as employer contributions to Plan B for purposes of section 415. Consequently, the picked-up contributions will not be treated as annual additions for purposes of section 415(c) with respect to Plan B. Rather, in accordance with §1.415(b)-1(b)(2)(ii)(A), such amounts are treated as employer contributions for

purposes of determining the member's annual benefit under Plan B for purposes of the limitation of section 415(b).

In summary, based on the represented facts we conclude:

(1) If implemented, the elections permitted Tier 1 members of Plan B under Statute D would constitute a cash or deferred arrangement within the meaning of section 401(k).

(2) If the elections permitted Tier members of Plan B under Statute D are not implemented, the mandatory employee contributions made under Statute E with respect to Tier 1 and Tier 2 members that are picked up by the employing unit shall be treated as employer contributions to Plan B under section 414(h)(2) for federal income tax purposes.

(3) The mandatory Tier 1 and Tier 2 member contributions made and picked up as described in (2), above, will not be included in the member's gross income for federal income tax purposes until distributed or otherwise made available to the member.

(4) The mandatory Tier 1 and Tier 2 member contributions made and picked up as described in (2), above, are excluded from wages as described in section 3401(a).

(5) The mandatory Tier 1 and Tier 2 member contributions made and picked up as described in (2), above, will not be treated as "annual additions," for purposes of section 415(c), with respect to Plan B. Rather such amounts will be treated as employer contributions for purposes of determining the member's annual benefit under Plan B for purposes of the limitation of section 415(b).

This ruling is based on the assumption that Plan B satisfies the qualification requirements set forth in section 401(a), and constitutes a governmental plan within the meaning of section 414(d), 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) provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

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)

cc: