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Person To Contact:
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Date:
October 30, 2015

State S =

Employer A =

Plan X =

Statute S =

Ordinance A =

Dear :

This letter is in response to your request, dated September 9, 2013, as supplemented by correspondence dated May 20, 2015, June 15, 2015 and September 14, 2015 for a ruling on the proper federal income tax treatment of certain contributions to a retirement plan under section 414(h)(2) 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, which is intended to be a qualified plan under section 401(a) of the Code and a governmental plan under section 414(d).

Plan X is mandated by Statute S, which requires that all active participants allow a withholding of a specified percentage of compensation (9% or 10.25%, determined by when participation in Plan X began). The pick-up feature of the Plan (which was implemented by Ordinance (A)), specifies that these amounts will be picked up by Employer A, so that the contributions of all active participants are intended to qualify as pick-up contributions under section 414(h)(2) of the Code. As such, these contributions, while designated as employee contributions, will be treated as employer contributions for federal income tax purposes.

Ordinance A, was signed on May 22, 1996, and was effective at the beginning of the following pay period. Under Ordinance A, participants of Plan X do not have the option to receive the specified contribution amounts directly instead of having such contributions paid by Employer A into Plan X.

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

1. The provisions of Plan X regarding the pick-up contributions satisfy the requirements of section 414(h)(2).
2. The mandatory contributions made by employees, pursuant to salary reduction, and picked up by Employer A in accordance with section 414(h)(2) will be treated as employer contributions for federal income tax purposes.
3. No part of the pick-up contributions picked up by Employer A in accordance with 414(h)(2) will be includible as gross income for federal income tax purposes in the year of the contribution.

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 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. 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 pick-up arrangement.

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 certain conditions are satisfied, including that 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.

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.

Summarizing the requirements of Revenue Ruling 81-35, Revenue Ruling 81-36, Revenue Ruling 87-10, and Revenue Ruling 2006-43, in order to have a valid pick-up arrangement:

(1) Employer A must specify that the contributions, although designated as employee contributions, are being paid by the employer in lieu of contributions by the employee and the required specification of designated employee contributions must be completed before the period to which such contributions relate.
(2) Employer A must take formal action, through a person duly authorized to do so, 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. The action must apply only prospectively and be evidenced by a contemporaneous written document.
(3) An employee must not be given the option of choosing to receive the contributed amounts directly instead of having them paid by Employer A to the pension plan. Further, 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.

In the present case, Plan X satisfies the criteria set forth in Rev. Rul. 81-35, Rev. Rul. 81-36, and Rev. Rul. 2006-43. Ordinance A, as authorized by Statute S, provides that Employer A shall pick up the mandatory contributions deducted from employees' salaries and contributed by Employer A to Plan X. Employer A took formal action by

enacting Ordinance A on May 22, 1996, prior to the first pay period during which mandatory employee contributions were made for active participants. In addition, no provision of Statute S provides active participants with the option to choose to receive the contributed amounts directly instead of having them paid by Employer A to Plan X. Also, employees do not have a cash or deferred election right with respect to the designated employee contributions. Accordingly, the contributions being picked up by Employer A meet the requirements of 414(h)(2) of the Code.

Having concluded that the contributions meet the requirements of section 414(h)(2) of the Code, we also 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 that the contributions are being made pursuant to a salary reduction agreement, in general, all payments of remuneration by an employer for services performed by an employee are subject to taxes under 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) of the Code 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 pick-up arrangement 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).

In addition, under section 3121(v)(1)(B) of the Code, if an employee's services are covered (i.e., included in employment) for social security tax purposes, pick-up contributions under section 414(h)(2) of the Code 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) of the Code, if an employee's services are covered (i.e., 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.

This ruling is based on the assumption that Plan X satisfies the qualification

requirements set forth in section 401(a) of the Code, and constitutes a governmental plan 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.

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 yours,

Pamela R. Kinard
Senior Technician Reviewer
Qualified Plans Branch 4
(Tax Exempt and Government Entities)

cc: