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Date:
January 25, 2017

State B =
Plan X =
Plan Y =
Plan H =
Plan O =
System S =
Public Law 1 =
Public Law 2 =

Dear :

This letter is in response to your ruling request, dated July 26, 2016, and supplemented and updated by correspondence dated November 10, 2016 and January 4, 2017, submitted by your authorized representative, regarding the federal income tax treatment of certain contributions under sections 414(h)(2) and 3401(a) of the Internal Revenue Code.

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

State B established Plans X, Y, H, and O. Plans X, Y, H, and O are intended to qualify under section 401(a) as applicable to governmental plans as defined in section 414(d).

The Treasurer of State B administers Plans X, Y, H and O. System S, an instrumentality of State B, is the general administrator of Plans X, Y, and H (the “System S plans”). The Treasurer of State B appoints the director of System S who is responsible for the daily operations of System S.

Plan X is a defined benefit plan that provides retirement benefits to employees of State B and political subdivisions of State B electing to participate in the plan. Plan Y is a defined benefit plan for teachers employed with local education agencies. Membership in Plan X and Plan Y is a condition for employment for full-time state employees, K-12 teachers, certain higher education employees, and employees of participating political subdivisions of State B who enter service on or before June 30, 2014.

Plan X generally requires mandatory employee contributions of 5% of earnable compensation. However, for state employees who become members of Plan X on or after July 1, 1981, but before July 1, 2014, the State assumes mandatory employee contributions up to 5% of the employees' earnable compensation. In addition, political subdivisions of State B that become participating employers in Plan X may also assume mandatory employee contributions up to 5% of the employees' earnable compensation. Plan Y requires mandatory employee contributions of 5% of the employees' earnable compensation for K-12 teachers employed with local education agencies. Mandatory employee contributions to Plan X and Plan Y are currently picked up under section 414(h) in accordance with a private letter ruling issued to State B in 1986.

Plan H is a defined benefit plan with a defined contribution component providing retirement benefits to state employees, certain higher education employees, K-12 teachers employed with local education agencies, and employees of participating political subdivisions. All state employees, certain higher education employees, and K-12 teachers of local education agencies who are hired on or after July 1, 2014, are required to participate in Plan H as a condition of employment. Mandatory employee contributions to Plan H are set at 5% of the employees' earnable compensation. Pursuant to the State B statute establishing Plan H, mandatory employee contributions to Plan H are currently picked up under section 414(h).

Plan O is a defined contribution retirement plan for higher education employees who are exempt from the Fair Labor Standards Act. For higher education employees hired prior to July 1, 2014, State B assumes employee contributions up to 5% of the employees' earnable compensation and such employees may elect to participate in Plan O in lieu of System S plans. Higher education employees hired on or after July 1, 2014, may elect to participate in Plan O in lieu of Plan H and are subject to mandatory employee contributions at the rate of 5% of the employees' earnable compensation under either Plan O or Plan H. Such mandatory contributions are currently picked up under section 414(h) in accordance with a State B statute.

Plan X, Plan Y, Plan H, and Plan O provide that the mandatory employee contributions that are picked up shall be treated as employer contributions pursuant to section 414(h), that employee contributions will be paid by the employer in lieu of contributions by the employee, and that the employee will not have the option of choosing to receive the contributions in the form of cash or cash equivalents instead of having them paid by the employer into the plan in which the employee participates.

Political subdivisions of State B are not required to participate in System S. Certain political subdivisions of State B maintain Closed Plans that are defined benefit plans established either prior to the establishment of System S or in lieu of participation in System S. A political subdivision of State B may elect to participate in System S by executing an adoption resolution prior to the political subdivision participating in System S as an employer.

Starting July 1, 2014, political subdivisions of State B may opt to participate in Plan H. In particular, political subdivisions of State B that are not otherwise participating in Plan X may adopt a resolution to participate in Plan H and political subdivisions of State B that are already participating in Plan X may adopt a resolution to change their participation prospectively to Plan H, but only with regard to their employees hired on or after July 1, 2012.

Public Law 1 was signed into law by State B on , permitting, in relevant part, (1) employees of political subdivisions of State B to elect to transfer membership from the Closed Plans to Plan X or Plan H and (2) K-12 teachers of local education agencies to elect to transfer membership from Plan Y to Plan H.

Public Law 2, signed into law on , expands Public Law 1 by permitting, in relevant part, political subdivision employees currently participating in Plan X to transfer their membership to Plan H. Employee contributions to Plan H remain at the same rate for employees who switch membership.

Public Law 2, amending Public Law 1, also provides that employees of a political subdivision currently participating in a Closed Plan may elect to transfer membership either to Plan X or Plan H. However, if the Closed Plan of the political subdivision does not have a mandatory employee contribution equal to 5%, as required by both Plan X and Plan H, the political subdivision must set the employee contribution to the same contribution rate under Plan X and Plan H as it was under the political subdivision's Closed Plan. If the employee contribution rate under the political subdivision's Closed Plan is less than 5%, then the employer contribution rate in Plan X or Plan H will be increased by the percentage difference between 5% and the mandatory employee contribution rate in the Closed Plan.

Section of Public Law 2 also permits certain higher education employee members to make an irrevocable election to participate in either Plan H or Plan O upon the employee's initial date of employment with a state-supported institution of higher education.

You represent that in all instances, the election to transfer from one plan to another is only available to an employee for whom the mandatory employee contribution rate will remain the same before and after the employee's transfer between plans.

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

1. If current employees of political subdivisions that are participating employers in Plan H elect to transfer on a prospective basis from Plan X to Plan H, the mandatory employee contributions that are picked up by the participating employer will be treated as employer contributions pursuant to a valid pick-up under section 414(h)(2).

2. If current employees of political subdivisions elect to switch from any of the Closed Plans to Plan X or Plan H, the mandatory employee contributions that are picked up by the participating employer will be treated as employer contributions pursuant to a valid pick-up under section 414(h)(2).

3. If K-12 teachers in Plan Y elect to transfer on a prospective basis to Plan H, the mandatory employee contributions that are picked up by the participating employer will be treated as employer contributions pursuant to a valid pick-up under section 414(h)(2).

4. If certain higher education employees elect to participate in Plan H or Plan O upon their initial date of hire, the mandatory employee contributions that are picked up by State B as the participating employer will be treated as employer contributions pursuant to a valid pick-up under section 414(h)(2).

5. The mandatory employee contributions made pursuant to ruling requests 1- 4 above and picked up by the employer will not be included in employees' gross income for federal income tax purposes until distributed.

6. The mandatory contributions made pursuant to rulings requests 1- 4 above and picked up by the employer will not constitute wages subject to federal income tax withholding under section 3401(a).

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 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) of the Income Tax Regulations provides, in pertinent part,

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 or her income except for the year or years in which such contribution is distributed to him or her.

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.

Section 3401(a) provides the definition of wages for purposes of federal income tax withholding. Section 3401(a)(12)(A) provides, in part, an exception from wages for employer contributions paid on behalf of an employee or his beneficiary to a trust described in section 401(a) that is exempt from tax under section 501(a) at the time of such payment.

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 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), 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 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) 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 (that is, 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 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 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.

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 request, the mandatory contributions to Plan X and Plan H satisfy the criteria for picked-up contributions set forth in Rev. Rul. 81-35, Rev. Rul.

81-36, Rev. Rul. 87-10, and Rev. Rul. 2006-43. You have represented that you previously received a private letter ruling on the validity of Plan X's pick-up arrangement. Plan H currently provides that each employer shall pick up the mandatory employee contributions to Plan H. State B took formal action by enacting a statute providing that mandatory employee contributions to Plan H, although designated as employee contributions, will be paid by the employing unit in lieu of employee contributions. No provision of Plan X or Plan H permits employees the option to choose to receive the contributed amounts directly instead of having them paid by the participating employer to Plan X or Plan H. Because the rate of the contribution is the same regardless of whether an employee is a participant in Plan X or Plan H, there is no cash or deferred election with respect to the contributions. We conclude that if a current employee of a political subdivision that is a participating employer in Plan H elects to transfer from Plan X to Plan H, the mandatory contributions picked up by the participating employer will be treated as employer contributions pursuant to a valid pick-up under section 414(h).

With respect to your second ruling request, as discussed above, the mandatory contributions to Plan X and Plan H satisfy the criteria for picked-up contributions. Contributions to Plan X and Plan H are mandatory for employees of political subdivisions of State S, and Public Law 2 provides that if a Closed Plan of a political subdivision does not have a mandatory employee contribution equal to 5%, as required by Plan X or Plan H, the political subdivision must set the employee contribution to the same rate under Plan X or Plan H as it was under the political subdivision's Closed Plan. Because the rate of the contribution is the same regardless of whether an employee is a participant in a Closed Plan, Plan X, or Plan H, there is no cash or deferred election with respect to the contributions. We conclude that, to the extent that a Closed plan provides for a valid pick-up arrangement, if an employee in any of the Closed Plans elects to transfer from the Closed Plans to Plan X or Plan H, mandatory contributions to Plan X or Plan H that are picked up by the participating employer will be treated as employer contributions pursuant to a valid pick-up under section 414(h).

With respect to your third ruling request, as discussed above, the mandatory contributions to Plan H satisfy the criteria for picked-up contributions.
In addition, the mandatory contributions to Plan Y satisfy the criteria for picked-up contributions set forth in Rev. Rul. 81-35, Rev. Rul. 81-36, Rev. Rul. 87-10, and Rev. Rul. 2006-43. You have represented that you previously received a private letter ruling on the validity of Plan Y's pick-up arrangement. Because the rate of the contribution is 5% of compensation regardless of whether an employee is a participant in Plan Y or Plan H, there is no cash or deferred election with respect to the contributions. We conclude if K-12 teachers in Plan Y elect to transfer on a prospective basis to Plan H, the mandatory contributions made by the K-12 teachers to Plan H and picked up by their respective employers will be treated as employer contributions pursuant to a valid pick-up under section 414(h).

With respect to your fourth ruling request, as discussed above, the mandatory employee contributions to Plan H satisfy the criteria for picked-up contributions. In addition, Plan O currently provides that each employer shall pick up the mandatory employee contributions to Plan O for employees hired after July 1, 2014. State B took formal action by enacting a statute providing that mandatory employee contributions to Plan O, although designated as employee contributions, will be paid by the employing unit in lieu of designated employee contributions. No provision of Plan H or Plan O allows higher education employees who participate in Plan H or Plan O the option to choose to receive the contributed amounts directly instead of having them paid by their respective employers to Plan H or Plan O. Because the amount of the mandatory employee contribution is 5% of compensation regardless of whether an employee is a participant in Plan H or Plan O, there is no cash or deferred election with respect to the contributions. We conclude that if a higher education employee makes an irrevocable election between participating in Plan H or Plan O upon the initial date of hire, as required under section of Public Law 2, the mandatory employee contributions that are picked up by the participating employer will be treated as employer contributions pursuant to a valid pick-up under section 414(h).

With respect to your fifth ruling request, we conclude that the picked-up amounts in ruling requests 1, 2, 3 and 4 above 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. These amounts will be includible in the employees' (or their beneficiaries') gross income only in the taxable year in which they are distributed.

With respect to your sixth ruling request, because we have determined that the picked-up amounts in ruling requests 1, 2, 3, and 4 above are to be treated as employer contributions, based on section 3401(a)(12)(A) and Rev. Rul. 77-462, we conclude that the contributions described in ruling requests 1, 2, 3, and 4 that are picked up as employer contributions under section 414(h)(2) are excluded from wages for purposes of federal income tax withholding.

In general, all payments of remuneration by an employer for services performed by an employee are 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).

In addition, 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.

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, as specified in Rev. Proc. 2017-1, 2017-1 I.R.B. 1, § 7.01(15)(b). This office has not verified any of the material submitted in support of the request for ruling, and such material is subject to verification on examination. The Associate office will revoke or modify a letter ruling and apply the revocation retroactively if there has been a misstatement or omission of controlling facts; the facts at the time of the transaction are materially different from the controlling facts on which the ruling was based; or, in the case of a transaction involving a continuing action or series of actions, the controlling facts change during the course of the transaction. See Rev. Proc. 2017-1, § 11.05.

Sincerely,

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(Tax Exempt & Government Entities)