Internal Revenue Service

Number: **202020019**
Release Date: 5/15/2020

Index Number: 414.07-00

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.
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Refer Reply To:
CC:EEE:EB:QP1
PLR-125881-19

Date:
February 13, 2020

In Re:

State =
Taxpayer =
System A =
System B =
Date 1 =
Date 2 =
Bill =

Dear :

This is in response to your request dated July 23, 2019, in which your authorized representatives request a private letter ruling on your behalf regarding the Taxpayer's administration of its retirement plans.

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

Facts

Taxpayer consists of two separate retirement plans, System A and System B that are administered by its Board of Directors on behalf of qualified judges and legislators of State. All justices of the State Supreme Court, Judges of the Court of Appeals, Circuit, Family, and District Court Judges (Qualified judges) are eligible for membership in System A, and all members of the State General Assembly (Legislators) are eligible for membership in System B. Qualified judges electing membership prior to Date 2

participate in the single-employer defined benefit tier of System A. Legislators of State electing membership prior to Date 2 participate in the single-employer defined benefit tier of System B. Qualified judges and legislators electing membership in their respective systems on or after Date 2 participate only in that system's hybrid cash balance plan.

Pursuant to State law, each member of System A or System B must contribute percent of the member's creditable compensation to the member's respective defined benefit plan if that member became a member of System A or System B on or before Date 1. Each member of System A or System B must contribute percent to the member's respective defined benefit plan if that member became a member on or after Date 1, but not before Date 2. These members' contributions include a percent contribution to an account to pay medical benefits under § 401(h) of the Internal Revenue Code. Members of System A or System B who became members after Date 2 are required to contribute percent of creditable compensation to the hybrid cash balance plan. These members' contributions also include a percent contribution to an account to pay medical benefits under § 401(h). Employee contributions are picked-up by each employer and treated as employer contributions in accordance with § 414(h).

State legislature enacted Bill that would provide a one-time irrevocable election by System A and System B members to receive benefits under and participate in their System's hybrid cash balance plan instead of receiving the benefits they are currently eligible to receive under their respective defined benefit plan. The respective hybrid cash balance plans were created by separate legislation and became a new benefit tier under the systems as of Date 2, and thus did not exist for employees who became members of the systems prior to Date 2. The election to participate in the hybrid cash balance plan must be made in writing and on a form prescribed by the Taxpayer's Board of Directors. Any service credit accrued prior to Date 2 will be considered service credit earned on or after Date 2 for purposes of determining benefits under the hybrid cash balance plan. On the member's effective election date, the value of the member's accumulated contributions, not to include any interest credit, will be credited into the hybrid cash balance plan account and an employer pay credit will be added to the accumulated account balance for each month the member contributed to the System A or System B defined benefit plans prior to the member's effective election date. The mandatory picked-up employee contribution amount for some, but not all members would remain the same before and after the election. This election is not available until Taxpayer receives a favorable private letter ruling from the Internal Revenue Service.

Rulings Requested

1. In accordance with Rev. Rul. 2006-43, 2006-35 I.R.B. 329, the mandatory employee contributions required to be made by current members of System A or System B who elect to participate in the hybrid cash balance plan in lieu of participating in the defined benefit tiers of System A and System B, and which are picked-up by the participating employer, shall continue to be treated as

employer contributions pursuant to a valid pick-up under § 414(h)(2), provided that the mandatory, pre-tax employee contributions to the hybrid cash balance plan are exactly the same as the employee contributions to the defined benefit tiers of System A or System B for those members who became members on or after Date 1;

2. The sections of Bill permitting members of System A or System B who became members on or after Date 1 but before Date 2 to make a one-time, irrevocable election to participate in the hybrid cash balance plan in lieu of participating in the defined benefit tiers will not result in an "impermissible cash or deferred arrangement" within the meaning of § 401(k);

3. The sections of Bill permitting members of System A or System B who became members prior to Date 1 to make a one-time, irrevocable election to participate in the hybrid cash balance plan in lieu of participating in the defined benefit tiers will result in an "impermissible cash or deferred arrangement" within the meaning of § 401(k);

4. Under § 414(h)(2), the mandatory employee contributions made and picked up as described in Ruling Request 1 will not be reported as gross income for federal tax purposes for members of System A or System B until System A or System B, as applicable, distributes the mandatory employee contributions to the member;

5. The mandatory employee contributions made and picked up as described in Ruling Request 1 do not constitute wages as described in § 3401(a); and

6. The mandatory employee contributions made and picked up as described in Ruling Request 1 will not be treated by Taxpayer as "annual additions" for purposes of § 415(c).

Applicable Law

Section 72 provides that, generally, gross income includes any amount received as an annuity (whether for a period certain or during one or more lives) under an annuity, endowment, or life insurance contract. For amounts received as an annuity under a qualified retirement plan, § 72(d) applies. For amounts not received as an annuity under an annuity, endowment, or life insurance contract, § 72(e) applies.

Section 72(d)(2) provides that employee contributions (and any income allocable thereto) under a defined contribution plan may be treated as a separate contract.

Section 1.72-2(a)(3)(i) of the Income Tax Regulations states that for purposes of applying § 72 to distributions and payments from an employees' plan, each separate program of the employer consisting of interrelated contributions and benefits shall be considered a single contract.

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 § 401(a) merely because the plan includes a qualified cash or deferred arrangement as defined in § 401(k)(2).

Section 401(k)(2)(A) defines a cash or deferred arrangement as any arrangement which is part of a profit-sharing or stock bonus plan, a pre-ERISA money purchase plan, or a rural cooperative plan which meets the requirements of § 401(a) under which a covered employee may elect to have the employer make payments as contributions to a trust under the plan on behalf of the employee, or to the employee directly in cash.

Section 1.401(k)-1(a)(1) provides 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 § 401(a) if the plan includes a cash or deferred arrangement. For this purpose, a cash or deferred arrangement is part of a plan if any contributions to the plan, or accruals or other benefits under the plan, are made or provided pursuant to the cash or deferred arrangement. Because a defined benefit plan is not a profit-sharing, stock bonus, pre-ERISA money purchase pension, or rural cooperative plan, if a defined benefit plan includes a cash or deferred arrangement, it does not satisfy the requirements of § 401(a).

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 § 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 § 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.

Section 402(a) provides that except as otherwise provided, any amount actually distributed to any distributee by any employees' trust described in § 401(a) which is exempt from tax under § 501(a) shall be taxable to the distributee, in the taxable year of the distributee in which distributed, under § 72 (relating to annuities).

Section 414(h)(2) provides that, for purposes of § 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 § 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 415 provides limits on benefits from defined benefit plans under § 415(b) and limits on contributions to defined contribution plans under § 415(c). Section 415(c) limits also apply to employee after-tax contributions to a defined benefit plan, subject to special service purchase rules and special rules regarding certain repayments of previously distributed benefits.

Section 1.415(c)-1(a)(2)(i) provides that for purposes of § 415 and regulations promulgated under § 415, the term defined contribution plan means a defined contribution plan within the meaning of § 414(i) (including the portion of a plan treated as a defined contribution plan under the rules of § 414(k)) that is—

(A) A plan described in § 401(a) which includes a trust which is exempt from tax under § 501(a);

(B) An annuity plan described in § 403(a); or

(C) A simplified employee pension described in § 408(k).

Section 1.415(c)-1(a)(2)(ii)(B) provides that mandatory employee contributions to a defined benefit plan are treated as contributions to a defined contribution plan. However, contributions that are picked up by the employer under § 414(h)(2) are not considered employee 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 to a trust described in § 401(a) that is exempt from tax under § 501(a) at the time of such payment.

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.

The federal income tax treatment to be afforded contributions that are picked up by the employer within the meaning of § 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 § 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 § 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, 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 § 401(a) so that the contributions are treated as employer contributions pursuant to § 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 § 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 § 414(h)(2), or to receive the contributed amounts directly instead of having them paid by the employing unit to the plan.

Analysis

Taxpayer represents in its submission that employee contributions to System A and System B are picked up and treated as employer contributions under § 414(h). In addition, Taxpayer has submitted relevant sections of State law that mandate compliance with § 414(h). Any election by employees that causes a difference in the amount of employee contributions required to be made by the employee results in a cash or deferred arrangement under § 401(k). A governmental plan is generally prohibited from creating such an arrangement pursuant to § 1.401(k)-1(e)(4), and the creation of a cash or deferred arrangement invalidates the pick-up of the employee contributions. The Taxpayer intends to offer an election to members of Systems A and B who became members prior to Date 2 between continuing participation in the defined benefit plan and transferring participation to the hybrid cash balance plan. For members who became members before Date 1, the amount of contributions will change as a result of the election. For members who became members after Date 1 but before Date 2, the amount of contributions will not change as a result of the election.

Therefore, with respect to the first request, the mandatory employee contributions required to be made by current members of System A and System B who elect to participate in the hybrid cash balance plan in lieu of participating in the defined benefit tiers of System A and System B and which are picked-up by the participating employer, shall continue to be treated as employer contributions pursuant to a valid pick-up under § 414(h)(2), provided that the mandatory, pre-tax employee contributions to the hybrid cash balance plan are exactly the same as the employee contributions to the defined benefit tier of System A and System B.

With regard to the second request, making the one-time irrevocable election to participate in the hybrid cash balance plan in lieu of the defined benefit plan would not create an impermissible cash or deferred arrangement, assuming the mandatory employee contributions are the same between the defined benefit plan and the hybrid cash balance plan. Taxpayer’s submission shows that the picked-up mandatory

contributions would remain the same before and after the election for members of System A and System B who became members on or after Date 1 but before Date 2. Thus, employees are not given a choice between an amount in the form of cash (or some other taxable benefit) that is not currently available and an accrual or other benefit under a plan deferring the receipt of compensation. Therefore, the sections of the Bill permitting members of System A and System B who became members on or after Date 1 but before Date 2 to make a one-time, irrevocable election to participate in the hybrid cash balance plan in lieu of participating in the defined benefit plans will not result in an impermissible cash or deferred arrangement within the meaning of § 401(k).

With regard to the third request, implementing the one-time irrevocable election for members of System A and System B who became members prior to Date 1 to participate in the hybrid cash balance plan in lieu of the defined benefit plan would create an impermissible cash or deferred arrangement. This election is an impermissible cash or deferred arrangement because there is a difference in total contributions between the two options. The member has the choice to remain in the defined benefit plan and make a contribution of percent or join the hybrid cash balance plan and make a contribution of percent. The difference between the election options arises from the additional percent contribution to the § 401(h) account that would be required if the member elects to join the hybrid cash balance plan. Therefore, the sections of the Bill permitting members of System A and System B who became members prior to Date 1 to make a one-time, irrevocable election to participate in the hybrid cash balance plan in lieu of participating in the defined benefit plan will result in an impermissible cash or deferred arrangement within the meaning of § 401(k).

With regard to the fourth request, Taxpayer represents that the mandatory employee contributions made by members of System A and System B are properly made and picked up by Taxpayer under § 414(h). Rev. Rul. 77-462 states that picked-up contributions made to a plan are excluded from employees' gross incomes until such time as they are distributed to the employees. Therefore, the Taxpayer will not report as gross income to the employees, mandatory employee contributions made and picked up by the Taxpayer for federal income tax purposes for members of System A or System B until System A or System B, as applicable, distributes the mandatory employee contributions to the member.

With regard to the fifth request, Rev. Rul. 77-462 states that picked-up contributions to a plan are excluded from wages for purposes of the withholding rules under § 3401(a)(12)(A). In addition, § 3401(a) excludes from the definition of “wages” employer contributions paid on behalf of an employee to a trust described in § 401(a) that is exempt from tax under § 501(a) at the time of such payment. Taxpayer represents that all contributions under the election being offered to Tier 1 members will be paid either to a defined benefit pension plan, a hybrid cash balance plan, and/or a § 401(h) account, all of which are trusts exempt from taxation under § 501(a). Thus, assuming the mandatory employee contributions are properly made and picked up

under § 414(h), they are to be treated as employer contributions that will not constitute wages under § 3401(a).

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 § 3121(a) excludes from the term “wages” any amount picked up as an employer contribution under § 414(h)(2) if the pick-up 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 § 3121(v)(1)(B), if an employee's services are covered [included in employment] for social security tax purposes, pick-up contributions under § 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 § 3121(v)(1)(B), if an employee's services are covered [included in employment] for Medicare tax purposes, pick-up contributions under § 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 picked-up contributions are made pursuant to a salary reduction agreement for FICA tax purposes. Furthermore, consistent with Revenue Ruling 77-462, and in accordance with § 3401(a)(12)(A), the picked-up contributions to System A and System B are excluded from wages for purposes of the collection of income tax at source on wages.

With regard to the sixth request, § 1.415(c)-1(a)(2)(ii)(B) provides that mandatory employee contributions to a defined benefit plan are considered a separate defined contribution plan maintained by the employer that is subject to the limitations on contributions and other annual additions described in § 415(c). The regulation further states that contributions that are picked up by the employer as described in § 414(h)(2) are not considered employee contributions. Therefore, the mandatory employee contributions for members of System A and System B made and picked up by Taxpayer will not be treated as annual additions for purposes of § 415(c).

The rulings contained in this letter are based upon information and representations submitted by your authorized representatives and accompanied by a penalties of perjury statement executed by an appropriate party, as specified in Rev. Proc. 2020-1, 2020-1 I.R.B. 1, § 7.01(16)(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. 2020-1, § 11.05.

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.

Sincerely,

Laura B. Warshawsky
Chief, Qualified Plans Branch 1
Office of Associate Chief Counsel
(Employee Benefits, Exempt Organizations, and Employment Taxes)

cc: