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Department of the Treasury
Washington, DC 20224

Third Party Communication: None
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, ID No.

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Refer Reply To:
CC:EEE:EB:QP2
PLR-104199-22

Date:
October 27, 2022

City =

State=

Plan A =

Plan B =

Statute A=

Group 1=

Date 1 =

Date 2 =

Resolution=

Dear

This is in response to your request dated February 16, 2022 and your subsequent correspondence, in which you request a private letter ruling regarding City'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

City is a political subdivision of State. City operates through an elected city council composed of a mayor and ten council members.

Pursuant to State Statute A, Group 1 employees receive certain retirement benefits through the State retirement system unless the municipality provides those retirement benefits through its own retirement plan.

Effective as of Date 1, City withdrew from the State retirement system and created Plan A, a defined contribution pension plan, to provide retirement benefits to Group 1 employees. Plan A is intended to satisfy the qualification requirements of section 401(a). Plan A has received several favorable determination letters.

Participation in Plan A is mandatory for Group 1 employees and required as a condition of employment. Plan A currently provides for mandatory employee contributions of 12 percent of compensation. Since Date 1, City has treated the mandatory employee contributions as employer contributions pursuant to a valid pick-up arrangement under section 414(h)(2). No option to receive this amount in cash has ever been permitted. Plan A provides that the mandatory employee contributions must be deducted from employee compensation, and employees do not have the option of receiving the payroll deduction directly in cash instead of having the contribution picked up by City.

Effective as of Date 2, City established Plan B, a defined benefit pension plan intended to qualify under Section 401(a). Plan B covers Group 1 employees who elect to participate in Plan B. While participation in Plan A remains mandatory for Group 1 employees, City also amended Plan A to permit Group 1 employees to elect to participate in both Plan A and Plan B.

Under the terms of both Plan A and Plan B, Group 1 employees may make a one-time irrevocable election to participate in both Plan A and Plan B. Group 1 employees electing this option will continue to make mandatory employee contributions of 12 percent of compensation; but, only 3.75 percent of compensation will continue to be contributed to Plan A while 8.25 percent of compensation would be contributed to Plan B. Group 1 employees not making this election will continue to contribute 12 percent of compensation to Plan A. Regardless of any election to participate in Plan B, all Group 1 employees are required to make aggregate mandatory employee contributions equal to 12 percent of compensation. Plan A's and Plan B's definition of compensation are

substantially the same. While all amounts are deducted by City each payroll period, the terms of Plan A and Plan B require City to pick up and contribute the mandatory employee contributions to Plan A and Plan B pursuant to section 414(h).

Group 1 employees hired on or before Date 2, must make an irrevocable election within eighteen months of Date 2 if they want to participate in both Plan A and Plan B. Group 1 employees who do not make this election participate solely in Plan A.

Group 1 employees hired after Date 2, must make an irrevocable election within thirty-six months of the date of hire if they want to participate in both Plan A and Plan B. Group 1 employees who do not make this election participate solely in Plan A.

Plan A and Plan B provide that Group 1 employees may purchase credited service in Plan B through a direct trustee-to-trustee transfer of vested amounts in Plan A to Plan B. An employee must elect the transfer before termination of employment and must be fully vested in the amounts transferred. No after-tax contributions, including Roth contributions, may be transferred. An employee's benefit in Plan B will be equal to or greater than the benefit the individual would have received prior to the transfer had Plan A terminated immediately before the transfer and the transferred funds will become part of a contribution accumulation account in Plan B. The employee must receive a benefit from Plan B at least equal to the contribution accumulation account.

In addition to the terms of Plan A and Plan B which provide for mandatory employee contributions to be picked up by City pursuant to section 414(h)(2), City adopted Resolution. Resolution provides that all future mandatory employee contributions (the first pay period of City's payroll period on or after Date 2) to Plan A and Plan B must be (i) picked up by City and paid by City to Plan A and Plan B; (ii) treated as employer contributions pursuant to a valid pick-up arrangement under section 414(h)(2); and (iii) treated as employer contributions to the maximum extent permitted by the Internal Revenue Code. Resolution also provides that Group 1 employees in Plan A and Plan B are not permitted to opt out of the pick-up arrangement or to receive the picked-up contributions instead of having them contributed to the plans by City. Finally, Resolution states that City intends that all mandatory employee contributions to Plan A and Plan B be treated as employer contributions pursuant to a valid pick-up under section 414(h)(2) and Rev. Rul. 2006-43, 2006-35 IRB 329.

Rulings Requested

1. The one-time irrevocable election by Group 1 employees to participate in both Plan A and Plan B in lieu of participating solely in Plan A will not result in an "impermissible cash or deferred arrangement" within the meaning of section 401(k);

2. The election by Group 1 employees to transfer amounts in a direct trustee-to-trustee transfer from Plan A to Plan B to purchase credited service in Plan B will

not result in an “impermissible cash or deferred arrangement” within the meaning of section 401(k);

3. On and after Date 2, mandatory employee contributions to Plan A made by Group 1 employees not electing to participate in Plan B that are picked up by City, are treated as employer contributions pursuant to a valid pick-up arrangement under section 414(h)(2);

4. On and after Date 2, mandatory employee contributions to Plan A and Plan B made by Group 1 employees who elect to participate in both Plan A and Plan B, and which are picked-up by the City, shall be treated as employer contributions pursuant to a valid pick-up arrangement under section 414(h)(2), provided that the total mandatory employee contributions to Plan A and Plan B are exactly the same as the employee contributions required to be made to Plan A if an election is not made;

5. Under section 414(h)(2), mandatory employee contributions under Plan A and Plan B that are picked up and treated as employer contributions pursuant to section 414(h)(2), as described in Ruling Requests 3 and 4 do not constitute wages as described in section 3401(a) and will not be reported as gross income for Federal tax purposes for Group 1 employees of Plan A or Plan B until City distributes the picked up contributions to the individual;

6. Amounts transferred in a direct trustee-to-trustee transfer from Plan A to Plan B to purchase credited service will not result in taxable income for Federal tax purposes of sections 72 and 402, is not subject to the imposition of an early distribution tax under section 72(t), and does not constitute wages for purposes of section 3401(a).

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, section 72(d) applies. For amounts not received as an annuity under an annuity, endowment, or life insurance contract, section 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 72(t)(1) imposes a tax on any amount received from a "qualified retirement plan", as described in section 4974(c), equal to 10 percent of the portion of the distribution that is includible in gross income, unless the distributee has attained age 59 ½ or one or more of the exceptions under section 72(t)(2) applies.

Treas. Reg. § 1.72-2(a)(3)(i) states that for purposes of applying section 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 section 401(a) merely because the plan includes a qualified cash or deferred arrangement as defined in section 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 section 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 section 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 section 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 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)(iv) provides that an amount is currently available to an employee if it has been paid to the employee or if the employee is able currently to receive the cash or other taxable amount at the employee's discretion. An amount is not currently available if there is a significant limitation or restriction on the employee's right to receive the amount currently. An amount is not currently available as of a date if the employee may under no circumstances receive the amount before a particular time in the future.

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 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.

Section 1.401(k)-1(e)(4) provides that a governmental plan is generally prohibited from creating a cash or deferred arrangement and 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 section 401(k).

Section 402(a) provides that except as otherwise provided, any amount actually distributed to any distributee by any employees' trust described in section 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 section 72 (relating to annuities).

Section 1.402(a)(1)(i) provides that an employee is only required to take into income a contribution made on behalf of an employee to a section 401(a) trust when the contribution is distributed.

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 to a trust described in section 401(a) that is exempt from tax under section 501(a) at the time of such payment.

Revenue Ruling 67-213 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 section 414(h)(2) has been developed in a series of revenue rulings. In Revenue Ruling 77-462, 1977-2 CB 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 picked-up 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 CB 255, and Revenue Ruling 81-36,1981-1 CB 255, established that the following two criteria must be satisfied: (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 CB 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 (specifically, 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 affect 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 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.

Analysis

Under the terms of Plan A, Group 1 employees must participate in Plan A and make mandatory employee contributions equal to 12 percent of compensation. Effective as of Date 2, City offered Group 1 employees who are currently participants in Plan A a one-time irrevocable election between participating solely in Plan A or participating in both Plan A and Plan B. The election must be made within eighteen months of Date 2. The mandatory employee contributions will not change as a result of the election because all Group 1 employees will continue to have 12 percent of compensation deducted from compensation, regardless of whether an employee participates solely in Plan A or participates in both Plan and Plan B. The definition of compensation in Plan A and Plan B are substantially the same.

Group 1 employees hired after Date 2 must participate in Plan A, but they may also make a one-time irrevocable election to participate in both Plan A and Plan B. The election must be made within thirty-six months of date of hire. The amount of mandatory employee contributions required will not change as a result of the election, because Group 1 employees will continue to have 12 percent of compensation deducted from their compensation regardless of whether a Group 1 employee participates only in Plan A or in Plan A and Plan B.

With respect to the first ruling request, a decision by Group 1 employees to make a one-time irrevocable election to participate in Plan A and Plan B will not result in an impermissible cash or deferred arrangement, provided that the aggregate mandatory employee contributions are the same whether contributed solely to Plan A or contributed to Plan A and Plan B and the plans' definitions of compensation remain substantially the same. City's submission of plan documents and Resolution provides that the mandatory employee contributions will remain the same regardless of any

election to participate in Plan B. Thus, Group 1 employees are not given a choice between receiving an amount in the form of cash (or some other taxable benefit) that is not currently available or deferring the receipt of compensation so that the one-time irrevocable election will not result in an impermissible cash or deferred arrangement within the meaning of section 401(k).

With respect to the second ruling request, regarding a Group 1 employee's election to transfer funds from Plan A to Plan B to purchase credited service, the amounts transferred to Plan B will not be distributed to the Group 1 employee. The choice a Group 1 employee has is whether to transfer funds from Plan A to Plan B to purchase credited service and not whether to receive a distribution. Thus, a Group 1 employee is 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. Thus, the sections of the Plans permitting Group 1 employees in Plan A to transfer funds from Plan A to Plan B will not result in an impermissible cash or deferred arrangement within the meaning of section 401(k).

City submitted the plan documents and Resolution that mandate compliance with section 414(h). The pick-up of mandatory employee contributions equal to 12 percent of each individual's compensation regardless of which plan in which the individual participates satisfies the criteria set forth in Rev. Rul. 81-35, Rev. Rul. 81-36, Rev. Rul. 87-10, and Rev. Rul. 2006-43. The governing body of City formally adopted Resolution, which provides that the mandatory employee contributions under Plan A and Plan B, although designated as employee contributions, shall be picked-up by City pursuant to section 414(h)(2) before the period to which such contributions relate. According to the represented facts, Plan A and Plan B are intended to be qualified plans under section 401(a), and governmental plans within the meaning of section 414(d). Therefore, Resolution does not provide for a retroactive pick-up of designated mandatory employee contributions under Plan A or Plan B by City. Plan A requires Group1 employees to participate in Plan A as a condition of their employment, and to make mandatory employee contributions equal to 12 percent of compensation. While employees may also elect to participate in Plan B, Group 1 employees do not have the ability to opt in or out of participation in a retirement plan. In addition, in accordance with Resolution and the terms of the plans, employees shall not have the option of choosing to receive any portion of such mandatory employee contributions in cash instead of having them paid directly by City to the plans.

With respect to the third ruling request, on and after Date 2, the mandatory employee contributions to Plan A made by Group 1 employees not electing to participate in Plan B, and that are picked up by City, will be treated as employer contributions pursuant to a valid pick-up arrangement under section 414(h)(2). Similarly, with respect to the fourth ruling requests, on and after Date 2, the mandatory employee contributions required to be made by Group 1 employees of Plan A who elect to participate in both Plan A and Plan B, and that are picked-up by City, will be treated as employer contributions pursuant to a valid pick-up under § 414(h)(2).

With respect to the fifth ruling request, section 402(a) and § 1.402(a)-1(a)(1)(i), and Rev. Rul. 77-462 state that picked-up contributions made to a plan are excluded from employees' gross incomes until such time as they are distributed to the employees. Because the mandatory employee contributions made by Group 1 employees are properly made and picked up by City under section 414(h), City will not report as gross income to the employees the mandatory employee contributions made and picked up by City for Federal income tax purposes for Group 1 employees until Plan A or Plan B, as applicable, distributes the mandatory employee contributions to the employee.

Also with respect to the fifth ruling request, Rev. Rul. 77-462 states that picked-up contributions to a plan are excluded from wages for purposes of the withholding rules under section 3401(a)(12). In addition, section 3401(a) excludes from the definition of "wages" employer contributions paid on behalf of an employee to a trust described in section 401(a) that is exempt from tax under section 501(a) at the time of such payment. City represents that all contributions under the election offered to Group 1 employees will be paid either to a defined benefit pension plan or a defined contribution pension plan, both of which are trusts exempt from taxation under section 501(a). Thus, the mandatory employee contributions are properly made and picked up under section 414(h) and are to be treated as employer contributions that will not constitute wages under section 3401(a).

With respect to ruling request six, pursuant to Rev. Rul. 67-213, the trustee-to-trustee transfer of assets from Plan A to Plan B, to purchase past credited service under Plan B, is not deemed to be an actual distribution to a Group 1 employee of the amounts transferred. Therefore, such amounts are not subject to taxation at the time of the transfer under section 402(a). Furthermore, as the amounts transferred will not be includible in a Group 1 employee's gross income at the time of transfer, such transfer will not result in the imposition of an early distribution penalty under section 72(t).

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. 2022-1, 2022-1 IRB 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 transaction. See Rev. Proc. 2022-1, § 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 letter is based on the assumption that Plan A and Plan B are qualified under section 401(a) at all relevant times.

This ruling letter 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,

_____

Cheryl E. Press, Senior Counsel
Qualified Plans Branch 4
Office of Associate Chief Counsel
(Employee Benefits, Exempt
Organizations, and Employment Taxes)

cc: