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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

SEP 25 2013

Uniform Issue List: 414.00-00, 414.09-00

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Legend:

Board A = xxxxxxxxxxxxxxxxxxxxxxxx

Fund B = xxxxxxxxxxxxxxxxxxxxxxxx

Department C = xxxxxxxxxxxxxxxxxxxxxxxx

State X = xxxxxxxxxxxxxxxxxxxxxxxx

Plan Y = xxxxxxxxxxxxxxxxxxxxxxxx

Plan Z = xxxxxxxxxxxxxxxxxxxxxxxx

Statute M = xxxxxxxxxxxxxxxxxxxxxxxx

Statute N = xxxxxxxxxxxxxxxxxxxxxxxx

Statute O: = xxxxxxxxxxxxxxxxxxxxxxxx

Year 1 = xxxxxxxxxxxxxxxxxxxxxxxx

Date 1 = xxxxxxxxxxxxxxxxxxxxxxxx

Date 2 = xxxxxxxxxxxxxxxxxxxxxxxxx

Dear xxxxxxxxxxx:

This letter is in response to your ruling request, dated September 4, 2012, submitted by your authorized representative, with respect to whether the implementation of Statute M will adversely affect the qualification of Plan Y or Plan Z under section 401(a) of the Internal Revenue Code ("Code").

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

State X sponsors and maintains Plan Y and Plan Z, each of which State X operates under section 401(a) of the Code, and each of which is a governmental plan under section 414(d) of the Code. Plan Y is a contributory defined benefit plan governed by Statute N. Statute N and the regulations thereunder essentially serve as the plan document. Plan Y generally provides a benefit at retirement under a formula taking into account age, years of credited service and average applicable regular compensation.

Plan Z is a money purchase pension plan governed by Statute O. It is operated under a separate plan document. Under Plan Z, a member chooses the investments of his or her account balance and receives a benefit at retirement based on that account balance.

Employees of State X's public higher education institutions who are eligible for Plan Z coverage must elect the retirement plan under which their benefits will accrue. That election must be made within the 180-day period beginning on the employee's date of hire, or if later, date of initial eligibility. Under current law, once a choice of plans is made, it cannot be changed. If an eligible employee does not elect to participate in Plan Z within the 180-day election period, by default he or she will be enrolled in Plan Y.

Under State X law, Plan Z has the identical mandatory employee contribution rate as Plan Y. Under both plans, the mandatory employee contributions are picked-up by the employer in accordance with section 414(h)(2) of the Code and treated as employer contributions. The pick-up of employee contributions under Plan Z and Plan Y by State X is authorized by statute under State X law.

In addition to the mandatory employee contribution, which is the same for both Plan Y and Plan Z, each plan requires employer contributions. As a defined benefit plan, Plan Y requires the employer to contribute an actuarially determined amount necessary for funding the promised benefit. Plan Z instead provides for an employer contribution equal to a specified percentage of each employee's compensation for the benefit of each participating employee.

In Year 1, the State X legislature passed Statute M, which was signed into law on Date 1. Statute M would allow a one-time opportunity for certain eligible Plan Z members to change their retirement coverage to Plan Y. An eligible active member of Plan Z is provided one opportunity to transfer participation to Plan Y and to purchase service credit under Plan Y for time spent in Plan Z. An eligible inactive member of Plan Z who is currently an active member of Plan Y (due, for example, to a change in employment position), is provided with one opportunity to purchase service credit under Plan Y for the time spent in Plan Z, even though there is not otherwise an election to transfer participation between plans.

Statute M further sets forth the process for transferring participation from Plan Z to Plan Y. A member who transfers participation from Plan Z purchases service credit, through either a single lump sum payment or in installments upon such terms as Board A, as a plan administrator of Plan Y and Plan Z, may provide. The amount required of an employee to purchase service credit under Plan Y is equal to the larger of: (a) the amount of contributions that such employee would have otherwise paid into Plan Y as a member of that plan, plus actuarial–assumed interest, for the years spent as an actively contributing member of Plan Z, or (b) the amount of assets accrued on his or her behalf under Plan Z, minus amounts attributable to employer-funded contributions. Plan Z is also required to transfer the assets attributable to the employer contributions to Fund B as assets of Plan Y.

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

1. The direct transfer of assets from Plan Z to Plan Y for the purchase of service credit and the funding of the Plan Y benefit will not result in the receipt of currently taxable income to a member under sections 72 and 402 of the Code.

2. A member's transfer of participation from Plan Z to Plan Y and the concurrent transfer of assets does not constitute a cash or deferred election within the meaning of section 401(k) of the Code.

3. The right to transfer participation from Plan Z to Plan Y and the concurrent transfer of assets does not affect the treatment of accrued and future employee contributions as being "picked-up" by an employer under section 414(h)(2) of the Code and does not impair the compliance of Plan Z or Plan Y with section 401(a) of the Code, and, specifically, does not adversely impact the qualification status of Plan Z or Plan Y.

Section 72(t) of the Code provides for an additional tax on any amount received from a "qualified retirement plan" (as defined in section 4974(c), which includes plans described in section 401(a)). The additional tax for the taxable year in which such amount is received is equal to 10 percent of the portion of such amount which is includible in gross income, except where such income is distributed on or after an employee attains the age of 59½, or on account of one or more exceptions provided for under section 72(t)(2) of the Code.

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 401(k) of the Code provides the rules relating to cash or deferred elections. Section 1.401(k)-1(a)(1) of the Income Tax Regulations ("Regulations") 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 ("CODA"). Thus, a qualified defined benefit plan is not permitted to include a CODA.

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

Section 1.401(k)-1(a)(3) of the Regulations generally 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: (i) provide an amount to the employee in the form of cash (or some other taxable benefit) that is not currently available, or (ii) 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) of the Regulations provides that a CODA does not include certain one-time irrevocable elections. Under section 1.401(k)-1(a)(3)(v), such an election must be made no later than the employee's first becoming eligible under the plan or any other plan or arrangement of the employer. The election must be to have contributions equal to a specified amount or percentage of the employee's compensation made by the employer on the employee's behalf to the plan and a specified amount or percentage divided among all other plans or arrangements of the employer. Furthermore, pursuant to section 1.401(k)-1(a)(3)(v), such an election must be for the duration of the employee's employment with the employer.

Section 414(h)(2) of the Code provides that contributions, otherwise designated as employee contributions, shall be treated as employer contributions if such contributions are made to a plan determined to be qualified under section 401(a) of the Code, established by a State government or a political subdivision thereof, or any agency or instrumentality of any one of the foregoing, and are picked up by the employing unit.

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 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. The revenue ruling further 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 employer, 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.

Revenue Ruling 2006-43, 2006-35 I.R.B. 329, amplifying and modifying Rev. Rul. 81-35, 1981-1 C.B. 255, Rev. Rul. 81-36, 1981-1 C.B. 255, and Rev. Rul. 87-10, 1987-1 C.B. 136, describes the actions required for a State or political subdivision thereof, 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) of the Code. Specifically, Revenue Ruling 2006-43 provides that a contribution to a qualified plan established by an eligible employer (i.e., a governmental employer) will be treated as picked-up by the employing unit under section 414(h)(2) of the Code 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 on and after the effective date of the pick-up to have a cash or deferred election right within the meaning of section 1.401(k)-1(a)(3) of the Regulations with respect to designated employee contributions. Thus, for example, no participating employee may be given the right to opt out of the pick-up arrangement described in

section 414(h)(2) of the Code, or to receive the contributed amounts directly instead of having them paid by the employing unit to the plan.

Revenue Ruling 2006-43 states that the pick-up rules expressed in Revenue Ruling 81-35 and Revenue Ruling 81-36 apply even if the employer picks up contributions through a reduction in salary or through an offset against future salary increases.

Revenue Ruling 67-213, 1967-2 C.B. 149, involves the transfer of funds attributable to employer contributions directly from the trust forming a part of a qualified pension plan to the trust forming part of a qualified stock bonus plan. The revenue ruling provides, in part, that if funds are transferred from one qualified plan to another, without being made available to the participants, no taxable income will be recognized by the participants by reason of such a transfer. The revenue ruling further provides that since the funds are not considered as having been made available to the participants, they continue to be funds derived from employer contributions and do not constitute employee contributions even though they are fully vested.

With respect to ruling request one, similar to the holding of Revenue Ruling 67-213, we conclude that the direct transfer of assets from Plan Z to Plan Y for the purchase of service credit and the funding of the Plan Y benefit will not be deemed to be an actual distribution to the participant of the amounts transferred. Accordingly, such amounts shall not be subject to taxation at the time of transfer under section 402(a) of the Code. Furthermore, as the amounts transferred will not be includible in the employees' gross income at the time of transfer, such transfer will not result in the imposition of an early distribution penalty under section 72(t) of the Code.

With respect to ruling request two, we conclude that a member's transfer of participation from Plan Z to Plan Y, and the concurrent transfer of assets, does not constitute a cash or deferred election within the meaning of section 401(k) of the Code. Employees of State X's public higher education institutions who are eligible for Plan Z coverage must elect the retirement plan under which their benefits will accrue. Providing employees with such a choice, of whether to be covered under Plan Z or Plan Y, by itself, is not a CODA. Plan Z has the identical mandatory employee contribution rate as Plan Y. Regardless of an employee's election to participate in Plan Z or Plan Y, the employee must necessarily have the same percentage of his or her compensation contributed by State X on the employee's behalf to such plan. Under no circumstances does the employee have, as a result of such an election or a corresponding trustee-to-trustee transfer of assets, a greater opportunity to receive cash (or some other taxable benefit) that is not currently available, in lieu of a tax-deferred contribution to a qualified pension plan.

With respect to ruling request three, we conclude that the right to transfer participation from Plan Z to Plan Y, and the concurrent transfer of assets, does not affect the treatment of accrued and future employee contributions as being picked-up by an employer under section 414(h)(2) of the Code, and does not impair the compliance of Plan Z or Plan Y with section 401(a) of the Code, and, specifically, does not adversely impact the qualification status of Plan Z or Plan Y. The represented facts state that under Plan Z and Plan Y, the mandatory employee contributions are picked-up by the employer in accordance with section 414(h)(2) of the Code and treated as employer contributions. The pick-up of employee contributions under Plan Z and Plan Y is authorized by statute under State X law. Furthermore, under State X law, once a choice of plans is made by eligible employees, it cannot be changed. For the reasons stated earlier, the election provided to participants to participate in Plan Y or Plan Z, by itself, is not a cash or deferred election right within the meaning of section 1.401(k)-1(a)(3) of the Regulations with respect to designated employee contributions. In this case, no participating employee is given the right to opt out of the pick-up arrangement, or to receive the contributed amounts directly instead of having them paid by the employing unit to the appropriate plan.

No opinion is expressed as to the federal tax consequences of the transaction described above under any other provisions of the Code.

This ruling is based on the assumption that Plan Y and Plan Z satisfy the qualification requirements set forth in section 401(a) of the Code, and constitute governmental plans within the meaning of section 414(d) of the Code, at all relevant times.

This ruling is directed only to the specific taxpayers that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited by others as precedent.

Pursuant to a power of attorney on file with this office, a copy of this letter ruling is being sent to your authorized representative.

Should you have any questions or concerns regarding this ruling, please contact xxxxxxxxxxxx (I.D. Number xxxxxxxxx), SE:T:EP:RA:T3 at (xxx) xxx-xxxx.

Sincerely yours,

Laura B. Warshawsky, Manager
Employee Plans Technical Group 3

Enclosures:
Deleted copy of this letter
Notice of Intention to Disclose

cc: xxxxxxxxxxxxxxxxx
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