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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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Uniform Issue List: 72.00-00, 402.01-00, 414.09-00

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Attn:

Legend:

City A =

State B =

Ordinance C =

Ordinance D =

Ordinance E =

Ordinance F =

Ordinance G =

Ordinance H =

Ordinance I =

Ordinance J =

Ordinance K =

Ordinance L =

System Y =

DC Plan =

DB Plan =

Dear :

This is in response to a ruling request dated December 31, 2001, as supplemented by additional correspondence dated September 18, 2002, April 21, 2003, May 1, 2003, May 12, 2003, and May 16, 2003, from your authorized representative, concerning certain employee elections regarding System Y and the pick up of certain employee contributions to System Y under section 414(h)(2) of the Internal Revenue Code ("Code").

The following facts and representations have been submitted:

City A, the sponsor of System Y, is a municipal government created under the laws of State B. System Y includes a defined benefit plan ("DB Plan") which is a governmental plan within the meaning of Code section 414(d). The DB Plan satisfies the qualification requirements of section 401(a). Effective July 1, 1998, System Y was amended to add an optional defined contribution retirement plan ("DC Plan"), to be put into effect on the date following approval by the City Council of City A and the Internal Revenue Service, when the DC Plan is open for participation by eligible members ("implementation date").

Following the implementation date, current members of System Y will be able to make an irrevocable election, during an election period, to transfer his or her benefit under the DB Plan to the DC Plan. Proposed amendments to Ordinance C provide the following: 1) such irrevocable election must be made within 24 months of the implementation date of the DC Plan; and 2) the annuity savings fund balance and the actuarial present value of credited benefits of an individual under the DB Plan who elects to make a transfer to the DC plan shall be transferred to the DC Plan on a date which shall in no event be later than one

hundred and twenty days after receipt of the individual's written election; provided, however, that such individual shall become a participant in the DC Plan as soon as administratively feasible following receipt of the individual's written election. Ordinance D provides an annual election period for current members to elect to transfer their benefits from the DB Plan to the DC Plan. A proposed amendment to Ordinance D states that such election must be made within 24 months of the implementation date of the DC Plan.

Ordinance E provides that former employees of City A who terminated employment between July 1, 1998 and the implementation date with vested pension rights under the DB Plan will have a one-time election, to be made within six months of notification of their election rights, to transfer their benefits under the DB Plan to the DC Plan. This election will be irrevocable. Ordinance F provides the same election to employees who separated from service on or after July 1, 1998, but prior to the implementation of the DC Plan, without vested pension rights under the DB Plan.

Employees hired on or after the implementation date will have a one-time election to participate in either the DB or DC Plan. A proposed amendment to Ordinance G provides that such election may be made at date of hire or during enrollment periods held during the participant's first two years of employment with City A. This election also will be irrevocable. Employees who fail to make an election to participate in the DC Plan will be deemed to have elected to participate in the DB Plan.

Pursuant to Ordinance C, the actuarial present value of the participant's credited benefits under the DB Plan will be transferred to the participant's employer contribution account under the DC Plan and the participant's annuity savings fund balance (participant's after-tax contributions) under the DB Plan will be transferred to the participant's annuity savings account under the DC Plan.

The DC Plan provides that amounts attributable to employer contributions will be fully vested after four years of service (a four-year graded vesting schedule). The DB Plan generally provides a ten-year cliff vesting schedule. The amounts transferred from the DB Plan to the DC Plan will vest under the vesting schedule set forth in the DC Plan.

A proposed amendment to Ordinance H provides that at the time a member elects to participate in/transfer to the DC Plan pursuant to Ordinances C or G, a participant may elect to make a basic employee contribution of zero, one, two, or three percent (0%, 1%, 2%, or 3%) of compensation which will be matched by City A. Such election shall be irrevocable and the basic employee contribution

shall be made each year to such participant's employee contribution account under the DC Plan. A proposed amendment to Ordinance I provides at the time the participant elects to participate in/transfer to the DC Plan pursuant to Ordinances C or G, a participant may elect to make an additional voluntary employee contribution of zero, one, two, or three percent (0%, 1%, 2%, or 3%) of compensation which will be contributed on his or her behalf to the DC Plan which will not be matched by City A. Such election shall be irrevocable and the additional voluntary employee contribution shall be made each year to such participant's employee contribution account under the DC Plan. Such contributions under Ordinances H and I will be made by City A through payroll reductions, effective after City A and the employee sign an irrevocable participation agreement. Such agreement continues for the duration of the employee's employment with City A.

Ordinance J provides effective as of the adoption and approval of the DC Plan by City A or the implementation date, if later, no participant may elect to receive such participant's basic employee contributions or additional voluntary employee contributions directly instead of having them "picked up" and paid by the employer to the participant's employee contribution account under the DC Plan. If a participant irrevocably elects to have such participant's basic employee contributions and additional voluntary employee contributions "picked up" by the employer, such employee contributions shall be paid by the employer to the DC Plan and not the participant.

Ordinance K defines employee contributions picked up by the employer. It states that employee contributions are picked up by the employer if: 1) the employer specifies 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 cannot be given the option of choosing to receive the contributed amounts directly instead of having them paid by the employer to the plan.

By resolution, City A proposes to pick up employee contributions to the DC Plan under Code section 414(h)(2). The proposed resolution provides 1) that in order to permit tax deferral for employee contributions, an employee shall enter into a binding irrevocable payroll deduction authorization and such employee shall not have the option of choosing to receive the amounts directly instead of having them paid by City A to the DC Plan; and 2) that employee contributions, through payroll deduction from compensation, are designated as being picked up by City A and paid by City A in accordance with the DC Plan requirements. The irrevocable payroll deduction authorization agreement between City A and the employee provides that employee contributions made under Ordinances H and I shall be picked up by City A.

A proposed amendment to Ordinance L provides that a participant who does not utilize the maximum participant's contributions that are "picked up" by the employer, as detailed in Ordinances H and I, may elect to make employee contributions on an after-tax basis and change the employee's after-tax contribution percentage in accordance with procedures established by the Board of Trustees, provided utilizing Ordinances H, I, and L does not exceed the three percent (3%) maximums of Ordinances H and I.

Based on the foregoing facts and representations, you have requested the following rulings:

1) The initial election of eligible members to participate in the DC Plan and any transfer of amounts from the DB Plan to the DC Plan if participation in the DC Plan is initially elected will not result in currently taxable income to the member under Code sections 72 or 402, and will not result in the imposition of the early distribution tax under section 72(t).

2) The additional one-time opportunity for an eligible member to elect to transfer to the DC Plan, and the subsequent transfer of amounts from the DB Plan to the DC Plan upon such an election, will not result in current taxable income to the member under Code sections 72 or 402, and will not result in the imposition of the early distribution tax under section 72(t).

3) Amounts transferred directly from the DB Plan to the DC Plan at the election of the member are not annual additions to the DC Plan within the meaning of Code section 415(c).

4) The DC Plan contained in System Y qualifies as a Code section 414(h)(2) pick-up plan.

5) The contributions picked up by City A as the employer will not constitute gross income to the employees for federal income tax purposes until actually received.

6) The employee salary reduction contributions will be treated as employer contributions for federal income tax purposes.

7) The contributions picked up by City A will not constitute wages from which taxes must be withheld.

Regarding ruling requests one and two, Code section 402(a) provides that the amount actually distributed from an employee's trust described in section 401(a) which is exempt from tax under section 501(a), shall be taxable to the distributee under section 72 in the year in which distributed. Section 72(t) provides for a 10-percent additional tax on distributions from qualified retirement plans. However, this rule shall not apply to distributions contained in section 72(t)(2)(A).

Revenue Ruling 67-213, 1967-2 C.B. 149, provides that if an employee's interest in a trust forming part of a qualified plan is transferred to the trust forming part of another qualified plan without being made available to the employee, no taxable income will be recognized on account of the transfer.

The elections by participants in System Y to transfer their accrued benefits in the DB Plan to the DC Plan are not amounts distributed to the participants. Therefore, with respect to ruling requests one and two, we conclude that the initial election of eligible members to participate in the DC Plan and any transfer of amounts from the DB Plan to the DC Plan if participation in the DC Plan is initially elected will not result in currently taxable income to the member under Code sections 72 or 402, and will not result in the imposition of the early distribution tax under section 72(t); and the additional one-time opportunity for an eligible member to elect to transfer to the DC Plan, and the subsequent transfer of amounts from the DB Plan to the DC Plan upon such an election, will not result in current taxable income to the member under Code sections 72 or 402, and will not result in the imposition of the early distribution tax under section 72(t).

Regarding ruling request three, Code section 415(a) provides that a trust which is part of a pension, profit-sharing, or stock bonus plan shall not constitute a qualified trust under section 401(a) if: (A) in the case of a defined benefit plan, the plan provides for the payment of benefits with respect to a participant which exceed the limitations of subsection (b); or (B) in the case of a defined contribution plan, contributions and other additions under the plan with respect to any participant for any taxable year exceed the limitation of subsection (c).

Section 1.415-3(b)(1)(iv) of the Income Tax Regulations ("Regulations") states that for purposes of limitations for defined benefit plans, when there is a transfer of assets or liabilities from one qualified plan to another, the annual benefit attributable to the assets transferred does not have to be taken into account by the transferee plan in applying the limitations of section 415. Section 1.415-3(d)(2) of the Regulations provides that voluntary contributions to a defined benefit plan are considered a separate defined contribution plan that is subject to the limitations on contributions and other additions described in Regulation section 1.415-6. Section 1.415-6(b)(2)(iv) of the Regulations provides that the transfer of funds from one qualified plan to another will not be considered an

annual addition for the limitation year in which the transfer occurs. Section 1.415-6(b)(3) of the Regulations provides that the direct transfer of employee contributions from one qualified plan to another also will not be considered an annual addition.

In the case of a transfer of funds from the DB Plan to the DC Plan, the amounts are being transferred from one qualified plan to another and are not considered annual additions under sections 1.415-6(b)(2)(iv) and 1.415-6(b)(3) of the Regulations. Therefore, with respect to ruling request three, we conclude that amounts transferred directly from the DB Plan to the DC Plan at the election of the member are not annual additions to the DC Plan within the meaning of Code section 415(c).

Regarding ruling requests four through seven, Code section 414(h)(2) provides that contributions, otherwise designated as employee contributions, shall be treated as employer contributions if such contributions are made to a plan described in Code section 401(a), 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 accorded contributions which are picked up by the employer within the meaning of Code section 414(h)(2) is specified in Revenue Ruling 77-462, 1977-2 C.B. 358. In that revenue ruling, the employer school district agreed to assume and pay the amounts employees were required by state law to contribute to a state pension plan. Rev. Rul. 77-462 concluded that the school district's picked-up contributions to the plan are excluded from the employees' gross income until such time as they are distributed to the employees. The revenue ruling held further that under the provisions of Code section 3401(a)(12)(A), the school district's contributions to the plan are excluded from wages for purposes of the Collection of Income Tax at Source on Wages; therefore, no withholding for federal income tax purposes is required from the employees' salaries with respect to such picked-up contributions.

The issue of whether contributions have been picked up by an employer within the meaning of Code section 414(h)(2) is addressed in Revenue Ruling 81-35, 1981-1 C.B. 255 and Revenue Ruling 81-36, 1981-1 C.B. 255. These revenue rulings 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. Furthermore, it is immaterial, for purposes of the applicability of Code section 414(h)(2), whether an employer picks up

contributions through a reduction in salary, an offset against future salary increases, or a combination of both.

In Revenue Ruling 87-10, 1987-1 C.B. 136, the Internal Revenue Service considered whether contributions designated as employee contributions to a governmental plan are excludable from the gross income of the employee. The Service concluded that to satisfy the criteria set forth in Revenue Rulings 81-35 and 81-36 with respect to particular contributions, the required specification of designated employee contributions must be completed before the period to which such contributions relate.

In this case, the one-time irrevocable election by employees who wish to participate in the pick up of employee contributions under the DC Plan does not violate Revenue Rulings 81-35 and 81-36 because it does not result in such employees having sufficient control of the contributed amounts to preclude such amounts from being treated as employer contributions.

City A's proposed resolution provides 1) that in order to permit tax deferral for employee contributions, an employee shall enter into a binding irrevocable payroll deduction authorization and such employee shall not have the option of choosing to receive the amounts directly instead of having them paid by City A to the DC Plan; and 2) that employee contributions, through payroll deduction from compensation, are designated as being picked up by City A and paid by City A in accordance with the DC Plan requirements. This satisfies both criteria set forth in Revenue Rulings 81-35 and 81-36 which require that the contributions, although designated as employee contributions, be paid by the employer in lieu of contributions by the employee, and 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. The irrevocable payroll deduction authorization agreement between City A and the employee provides that basic employee contributions and additional voluntary employee contributions made under Ordinances H and I, respectively, shall be picked up by City A and the pick up is irrevocable for the duration of the employee's employment with City A. This agreement is consistent with authority for Code section 414(h)(2).

For new, current, and terminated employees who return to service, the various participation elections to participate in/transfer to the DC Plan and make employee contributions are consistent with the criteria set forth in Revenue Rulings 81-35 and 81-36. Current employees must irrevocably elect to participate within 24 months of the implementation date of the DC Plan. For new and terminated employees who return to service, such irrevocable election may be made at date of hire or during enrollment periods held during the

participant's first two years of employment with City A. Elections regarding making voluntary employee contributions to the DC Plan are made at the time a member elects to participate in/transfer to the DC Plan. These employee elections regarding participation in/transfer to the DC Plan and making voluntary basic and additional employee contributions to the DC Plan are consistent with authority for Code section 414(h)(2) which requires that employee participation elections must be made within the later of 24 months of the date of hire or 24 months of the date that the employee is first eligible to participate.

Ordinance K states that employee contributions are "picked up" by the employer if: 1) the employer specifies 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 cannot be given the option of choosing to receive the contributed amounts directly instead of having them paid by the employer to the Plan. City A's proposed resolution to pick up voluntary basic employee contributions and additional employee contributions made to the DC Plan satisfies both criteria in Revenue Rulings 81-35 and 81-36.

Accordingly, with respect to ruling requests four through seven, we conclude that the voluntary basic employee contributions and additional employee contributions picked up by City A and paid to the DC Plan qualify as picked-up contributions under Code section 414(h)(2); that the contributions picked up by City A as the employer will not constitute gross income to the employees for federal income tax purposes until actually distributed and received; that the employee salary reduction contributions will be treated as employer contributions for federal income tax purposes; and that the contributions picked up by City A will not constitute wages from which federal income taxes must be withheld.

The effective date for the commencement of any proposed pick up as specified in the proposed resolution and amendments (Ordinances C, G, H, and I) to the DC Plan cannot be any earlier than the latest of: 1) the later of the date the proposed resolution is signed or put into effect, 2) the later of the date the proposed amendments are signed or put into effect, or 3) the later of the date the irrevocable payroll deduction authorization agreement is signed or put into effect.

This ruling is based on the assumption that the DB Plan and the DC Plan of System Y are qualified under Code section 401(a) at all relevant times.

No opinion is expressed as to whether the amounts in question are subject to tax under the Federal Insurance Contributions Act. No opinion is expressed as to whether the amounts in question are paid pursuant to a "salary reduction agreement" within the meaning of Code section 3121(v)(1)(B).

This ruling is directed only to the taxpayer that requested it. Code section 6110(k) provides that it may not be used or cited by others as precedent.

A copy of this ruling has been sent to your authorized representative pursuant to a power of attorney on file in this office. If you have any questions, please call , T:EP:RA:T1 at .

Sincerely yours,

Donzel H. Littlejohn

Acting Manager
Employee Plans Technical Group 1

Enclosures:
Deleted Copy of the Ruling
Notice 437

cc: