

Part I

Section 414.—Definitions and Special Rules.

(Also, §7805; 26 CFR 301.7805-1.)

Rev. Rul. 2006-43

ISSUES

What actions are required in order for a State or political subdivision thereof, or an agency or instrumentality of any of the foregoing, to “pick up” employee contributions to a plan qualified under § 401(a) of the Internal Revenue Code so that the contributions are treated as employer contributions pursuant to § 414(h)(2)?

FACTS

Employer M is a political subdivision of State N. Employer M participates in Plan A, a defined benefit pension plan qualified under § 401(a) and established by State N to provide retirement benefits to eligible employees of State N and any political subdivision of State N. Plan A requires each participating employee to make employee contributions to Plan A equal to a specified percentage of the participant’s salary. These amounts, designated as employee contributions under § 414(h)(1), are deducted from the participant’s salary. State N statutes governing Plan A permit any political subdivision to provide that the employee contributions will be paid by the employer in order to be picked up and treated as employer contributions under § 414(h)(2). On March 1, 2006, Employer M amends its governing laws to provide that the amounts

designated as employee contributions under Plan A will be paid by Employer M for all of Employer M's employees in order to be treated as employer contributions under § 414(h)(2), as permitted under the statutes governing Plan A. The amendment is in writing, was adopted by persons authorized to amend Employer M's governing laws, and is effective for periods on or after April 1, 2006. Employer M, thereafter, treats the amounts as employer contributions, instead of as being employee contributions, for federal income tax purposes and does not include these amounts in the participating employees' gross income.

LAW AND ANALYSIS

Section 414(h)(1) provides that any amount contributed to a qualified plan is not treated as having been made by the employer if it is designated as an employee contribution.

Section 414(h)(2) provides a special rule for qualified plans established by a State government or political subdivision thereof, or by any agency or instrumentality of the foregoing. Under this rule, contributions, although designated as employee contributions, are nevertheless treated as employer contributions if the contributions are picked up by the employing unit.

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

Section 1.401(k)-1(a)(3) 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 (i) provide an amount that is not currently available to the employee in the form of cash or some other taxable benefit, or (ii) contribute an amount to a trust or provide an accrual for a plan deferring the receipt of compensation.

Rev. Rul. 77-462, 1977-2 C.B. 358, addresses the income tax treatment of contributions picked up by the employer within the meaning of § 414(h)(2). In Rev. Rul. 77-462, the employer school district agreed to “pick up” and pay the required contributions of the eligible employees under the plan. The revenue ruling holds that the contributions picked up by the school district are excluded from the gross income of employees until such time as they are distributed to the employees.

Rev. Rul. 81-35, 1981-1 C.B. 255, and Rev. Rul. 81-36, 1981-1 C.B. 255, address certain requirements for contributions to be picked up by an employer within the meaning of § 414(h)(2). These revenue rulings establish that the following criteria must be satisfied: (i) 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 (ii) 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 plan. Rev. Rul. 81-35 and Rev. Rul. 81-36 apply even if the employer picks up the contributions through either a reduction in salary or an offset against future salary increases.

Rev. Rul. 87-10, 1987-1 C.B. 136, addresses when contributions designated as employee contributions (designated employee contributions) under § 414(h)(1) to a qualified plan established by a State government (including a political subdivision

thereof, or any agency or instrumentality of the foregoing) are excludable from the gross income of the employee. The ruling concludes that, to satisfy the criteria set forth in Rev. Rul. 81-35 and Rev. Rul. 81-36, the governmental action necessary to effectuate the “pick-up” must be completed before the period to which such contributions relate. Thus, designated employee contributions to a qualified plan established by a State government are excluded from gross income as “pick-up” contributions that are treated as employer contributions only to the extent the contributions relate to compensation for services rendered after the date of the last governmental action necessary to effectuate the “pick-up.”

Based on the foregoing, a contribution to a qualified plan established by a State government will not be treated as picked up by the employing unit under §414(h)(2) unless the employing unit:

(1) Specifies 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 an ordinance).

(2) Does 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, participating employees must not be permitted to opt out of the “pick-up”, or to receive the

contributed amounts directly instead of having them paid by the employing unit to the plan.

Employer M has taken formal action which was memorialized in a contemporaneous writing that provides that it will “pick up” all prospective contributions for the Employer M employees who are required to contribute to Plan A. Further, employees are required to participate in Plan A, do not have the option of choosing to receive the contributed amounts directly, and may not make a cash or deferred election with respect to such amounts. Employer M has met the requirements to have the designated employee contributions under Plan A picked up and treated as employer contributions pursuant to § 414(h)(2). Thus, contributions made to Plan A are not includible in a participant’s gross income until distributed under § 402.

This revenue ruling applies only for federal income tax purposes. See §§ 3121(a)(5)(A) and 3121(v)(1)(B) of the Federal Insurance Contributions Act (FICA) for the treatment of amounts treated as an employer contributions under § 414(h)(2).

HOLDING

Because an authorized person has taken formal action in writing prospectively to have the employing unit pay previously designated employee contributions to a § 401(a) qualified plan, appropriate actions have been taken for the contributions to be picked up by the employing unit and treated as employer contributions pursuant to § 414(h)(2).

TRANSITION RELIEF FOR PRE-EXISTING “PICK- UPS”

Under the authority of § 7805(b)(8), the Service will not treat any plan that on or before August 28, 2006, includes designated employee contributions that were intended to be picked up as employer contributions pursuant to § 414(h)(2) as failing to meet the

requirements of such section prior to January 1, 2009, solely on account of the failure to satisfy the requirement that the “pick-up” be pursuant to a formal action, by a person duly authorized to take such action with respect to the employing unit, that is evidenced by contemporaneous writing, but only if the following conditions are satisfied: (1) the employing unit has taken contemporaneous action evidencing an intent to establish a “pick-up” (e.g., provided information to employees relating to the establishment of the “pick-up”) and has operated the plan accordingly; and (2) the employing unit takes formal action in writing prior to January 1, 2009, with respect to future contributions to meet the requirements set forth above in paragraph (1) of Law and Analysis in this revenue ruling.

The relief provided above for “pick-ups” implemented prior to August 28, 2006, applies only if the actions taken otherwise complied with Rev. Rul. 81-35, Rev. Rul. 81-36, and Rev. Rul. 87-10, and only if the employing unit has not reported the contributions as wages subject to federal income tax withholding from and after the date of implementation of the intended “pick-up”.

In addition, under the authority of § 7805(b)(8), this revenue ruling does not modify or revoke any private letter ruling issued to any taxpayer prior to August 28, 2006. See § 601.201(l)(4).

EFFECT ON OTHER GUIDANCE

Rev. Rul. 81-35, Rev. Rul. 81-36, and Rev. Rul. 87-10 are amplified and modified.

DRAFTING INFORMATION

The principal drafter of this revenue ruling is Kathleen Herrmann of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding

this revenue ruling, please contact the Employee Plans' taxpayer assistance telephone service at 1-877-829-5500 (a toll-free number) between the hours of 8:30 a.m. and 4:30 p.m. Eastern Time, Monday through Friday. Ms. Herrmann may be reached at (202) 283-9888 (not a toll-free number).