Internal Revenue Service

Department of the Treasury

Washington, DC 20224

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U.I.L. 414.09-00`

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Contact Person: **********

Telephone Number: **********

In Reference to:

Date: T:EP:RA:T2

OCT 30 2001

Attn: **********

Legend

State A = **********
Employer M = **********
Group B Employees = **********
Plan X = **********
Statute R = **********
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Ordinance A = **********
Agreement B = **********
Proposed Ordinance C = **********
Board S = **********

Dear **********

This letter is in response to a ruling request dated January 29, 2001, which was submitted on your behalf by your authorized representative, concerning the federal income tax treatment, under section 414(h)(2) of the Internal Revenue Code ("Code"), of certain contributions to Plan X.

The following facts and representations have been submitted:

Employer M is a municipality and political subdivision of State A. On May 3, 1994, the Board of Supervisors of Employer M adopted Ordinance A electing to enroll its municipal employees in Plan X pursuant to Article IV of Statute R. Membership in Plan X is mandatory for all permanent Group B Employees of Employer M. On that same day, Employer M and Board S, the administrator of Plan X, signed Agreement B.

Agreement B acknowledges Employer M's desire to establish a pension plan for its Group B Employees and that Employer M has negotiated an optional retirement plan contract with Board S. Further, Agreement B contains the retirement pension plan for the Group B Employees as agreed to by Employer M and Board S. You represent that Plan X is qualified under section 401(a) of the Code, and the associated trust is exempt from federal income tax under section 501(a). Group B Employees are required to contribute three per cent of their compensation to Plan X.

Employer M now proposes to pick-up the mandatory employee contributions made by its Group B Employees to Plan X. To implement the pick up of such contributions, Employer M has proposed to adopt Ordinance C, which will be enacted after receipt of a favorable letter ruling from the Internal Revenue Service. Proposed Ordinance C provides that Employer M agrees to pick up the mandatory member contributions to Plan X, in lieu of the Group B Employees paying such contributions. Proposed Ordinance C also provides that the proposed pick up is effective for service rendered on or after the effective date of the pick up. Proposed Ordinance C further provides that the total gross compensation of each Group B Employee will be reduced by the amount of the required mandatory member contribution, and that the Group B Employee, under no circumstances, shall have the option of choosing to receive directly the amounts picked up by Employer M instead of having such amounts paid by Employer M to Plan X.

Based on the aforementioned facts, you request the following rulings:

1. That no part of the mandatory employee contributions picked up by Employer M on behalf of the Group B Employees included in Plan X shall be includible in the gross income of the Group B Employees for federal income tax purposes in the year in which such amounts are contributed.

2. That the contributions picked up by Employer M, though picked up by salary reduction and designated as employee or member contributions, will be treated as employer contributions for federal income tax purposes.

3. That no part of the contributions picked up by Employer M will constitute wages for federal income tax withholding purposes in the taxable year in which they are contributed to Plan X.

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), established by a state government or a political subdivision thereof, 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 section 414(h)(2) of the Code 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. Revenue Ruling 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 section 3401(a)(12)(A) of the Code, 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 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 section 414(h)(2) of the Code 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. For purposes of the application of section 414(h)(2) of the Code, it is immaterial 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 request, Proposed Ordinance C, if adopted as proposed, would satisfy the criteria set forth in Rev. Rul. 81-35 and Rev. Rul. 81-36. It provides that Employer M will make contributions to Plan X in lieu of contributions by the Group B Employees and that the Group B Employees may not elect to receive such contributions directly.

Accordingly, we conclude that, with regard to ruling requests one, two, and three, the mandatory employee contributions picked up by Employer M pursuant to Proposed Ordinance C on behalf of the Group B Employees who participate in Plan X shall be treated as employer contributions and will not be includible in the gross income of the Group B Employees for federal income tax purposes in the year in which such amounts are contributed by Employer M to Plan X. These amounts will be includible in the gross income of the Group B Employees or their beneficiaries only in the taxable year in which they are distributed, to the extent the amounts represent contributions made by Employer M to Plan X. Because we have determined that the picked up amounts are to be treated as employer contributions, they are excepted from wages as defined in section 3401(a)(12)(A) of the Code for federal income tax withholding purposes. In addition, no part of the amounts picked up by Employer M will constitute wages for federal income tax withholding purposes in the taxable year in which they are contributed to Plan X.

These rulings apply only if the effective date for the commencement of any proposed pick up is not earlier than the later of the date Proposed Ordinance C is signed into law or the date it is put into effect.

These rulings are based on the assumption that Plan X will be qualified under section 401(a) of the Code at the time of the proposed contributions and distributions.

In addition, these rulings are contingent upon the adoption of Proposed Ordinance C as contained in your correspondence dated January 29, 2001.

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 section 3121(v)(1)(B).

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

A copy of this letter has been sent to your authorized representative in accordance with the power of attorney on file with this office.

Sincerely yours,

(signed) JOYCE E. FLOYD

Joyce E. Floyd, Manager
Employee Plans Technical Group 2
Tax Exempt and Government Entities Division

Enclosures:
Copy of this letter, Deleted copy, & Notice 437