Uniform Issue List No: 414.09-00

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

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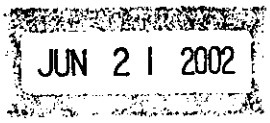

Legend:

Employer A

State B

Group C employees

Plan X

Statute D

This is in response to a ruling request dated October 16, 2001, as supplemented by additional correspondence dated December 6, 2001, from your authorized representative, concerning the pick up of certain employee contributions to Plan X under section 414(h)(2) of the Internal Revenue Code (the "Code").

The following facts and representations have been submitted:

Pursuant to Statute D, State B created Plan X in as a defined benefit pension plan and retirement system for the benefit of Group C employees. Plan X meets the qualification requirements of Code section 401(a), and is a governmental plan within the meaning of section 414(d) of the Code. Participation in Plan X is mandatory on the part of Group C employees.

Under Statute D, section 22.25.011, employee contributions to Plan X are mandatory, and all participants are required to contribute a certain percentage of their base annual salary. This contribution is made in the form of a deduction from compensation. Employer A is allowed to reduce the current salary of Plan X

participants and pay the mandatory employee contribution directly to Plan X in lieu of contributions by the individual participants. Group C employees do not have the option of receiving such contributions directly instead of having them paid to Plan X.

Statute D, section 22.25.022 also allows State B to pick up and pay the mandatory contributions to Plan X pursuant to section 414(h) of the Code. If contributions are picked up, Statute D provides that they shall be treated as employer contributions for Federal income tax purposes.

Pursuant to Statute D, State B proposes that effective the first payroll period following receipt of a favorable ruling by the Internal Revenue Service, contributions shall be deducted from the compensation of Group C employees before the computation of applicable federal taxes, and shall be treated as employer contributions under section 414(h)(2) of the Code.

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

1. That amounts deducted and withheld from the salary of Group C employees pursuant to section 22.25.011 of Statute D, qualify as employee contributions that are picked up by State B under Code section 414(h)(2) and, as such, are not included in Group C employees' gross income for Federal income tax purposes.

2. That amounts deducted and withheld from the salary of Group C employees pursuant to section 22.25.011 of Statute D, qualify as employee contributions that are picked up by State B under Code section 414(h)(2) and, as such, do not constitute wages for Federal income tax withholding purposes.

3. That the picked-up contributions will not be treated as "annual additions" for purposes of Code section 415(c).

With respect to ruling requests 1 and 2, 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 that 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 amount 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 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.

Employer A satisfies the criteria set forth in Code section 414(h)(2), Revenue Ruling 81-35, and Revenue Ruling 81-36 by providing that it will pick up, and make contributions to Plan X in lieu of contributions by eligible employees, and that no employee will have the option of receiving such amount directly in cash instead of having it contributed to Plan X.

Accordingly, we conclude that amounts picked up by Employer A for Group C employees shall be treated as employer contributions and will not be includable in Group C employees' gross income for the taxable year in which such amounts are contributed.

Because we have determined that the picked up amounts are to be treated as employer contributions, they are excepted from wages as defined in Code section 3401(a)(12)(A) for Federal income tax withholding purposes. Therefore, no withholding of Federal income tax is required from employees' salaries with respect to such picked up amounts.

Regarding ruling request 3, section 415(b)(2) of the Code provides, in general, that a participant's benefit, expressed as an annual benefit, cannot exceed the lesser of: (A) $160,000 (as adjusted for cost-of-living increases), or (B) 100 percent of the participant's average compensation for the high three years. The 100 percent of compensation limit under section 415(b)(2)(B) does not apply to governmental plans.

Section 415(c)(1) of the Code provides, in general, that contributions and other annual additions for a participant may not exceed the lesser of: (A) $40,000 (as adjusted for cost-of-living increases), or (B) 100 percent of the participant's compensation.

Section 1.415-3(d)(1) of the Income Tax Regulations provides, in part, that where a defined benefit plan provides for mandatory employee contributions, the annual benefit attributable to such contributions is not taken into account for purposes of determining the maximum limitations under Code section 415(b). This regulation further provides that the mandatory employee contributions are considered a separate defined contribution plan maintained by the employer that is subject to the limitations on contributions and other additions described in Code section 415(c). However, employee contributions that are picked up by the employer pursuant to Code section 414(h)(2) are treated as employer contributions and, as such, are not annual additions to a separate defined contribution plan for purposes of section 415(c). Accordingly, we conclude that the picked up contributions will not be treated as "annual additions" for purposes of Code section 415(c).

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.

The effective date for the commencement of the proposed pick-up of the mandatory contributions cannot be earlier than the date of this letter ruling.

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) of the Code.

This ruling is directed only to the taxpayer that 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 ruling is being sent to your authorized representative pursuant to a power of attorney on file in this office. Should you have any questions pertaining to this ruling, you may contact of this office at

Sincerely yours,

Andrew E. Zuckerman
Acting Manager, Employee Plans
Technical Branch 1