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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

OCTOBER 31, 2002
T:EP:RA:T2

U.I.L. 414.09-00

XXXXXXXXXXX
XXXXXXXXXXX
XXXXXXXXXXX

Attn: XXXXXX

Legend

State A = ***

Group B Employees = ***

Plan X = ***

Employer M = ***

Resolution N = ***

Statute P = ***

Statute Q = ***

Statute R = ***

Dear

This is in response to a ruling request dated ***, as supplemented by correspondence dated *** and ***, 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 in support of your ruling request.

Employer M, a political subdivision of State A, established and created Plan X in accordance with Statute P and Statute Q for the benefit of Group B Employees. You represent that Plan X meets the qualification requirements set forth under section 401(a) of the Code.

The foregoing Statutes permit government employers, such as Employer M, to reduce the current salaries paid to Group B Employees and pay the mandatory employee contributions directly to Plan X in lieu of contributions by Group B Employees. Statute R provides that 8.45 percent of Group B Employees' salaries shall be withheld and paid to Plan X.

Statute R also provides that when mandatory employee contributions are picked up by Employer M, the contributions shall be considered as employee contributions. Statute R states that picked up contributions shall be treated as employer contributions in determining tax treatment under the Code. Statute R further provides that Employer M shall continue to withhold Federal and State income taxes based upon these contributions until the Internal Revenue Service or the Federal Courts rule that pursuant to section 414(h) of the Code, these contributions shall not be included in gross income of Group B Employees until such time as they are distributed or made available.

Resolution N provides that Employer M will pick up and pay the mandatory Group B Employees' contributions to Plan X in accordance with Statute R. The Group B Employees' salaries will be reduced by an amount equal to the amount picked up by Employer M. Employer M will cease to withhold Federal and State income taxes on the picked-up contributions; the contributions, although designated as employee contributions, will be paid by Employer M in lieu of contributions by Group B Employees; and Group B Employees participating in Plan X will not be given the option to receive cash directly in lieu of having such contributions paid by Employer M to Plan X.

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

1. The mandatory employee contributions "picked up" by Employer M shall be excluded from the current gross income of Group B Employees until distributed.

2. The "picked up" contributions paid by Employer M are not wages for Federal income tax withholding purposes and Federal income taxes need not be withheld on the "picked up" contributions.

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, 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 the 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.

Revenue Ruling 87-10, 1987-1 C.B. 136, provides that in order to satisfy Revenue Rulings 81-35 and 81-36, the required specification of designated employee contributions must be completed before the period to which such contributions relate. Thus, employees may not exclude from current gross income designated employee contributions to a qualified plan that relate to compensation earned for services prior to the date of the last governmental action necessary to effect the pick up.

In this request, Resolution N satisfies the criteria set forth in Rev. Rul. 81-35 and Rev. Rul. 81-36, by providing, in effect, that Employer M will make contributions to Plan X in lieu of contributions by Group B Employees, and Group B Employees participating in Plan X will have no option to receive such contributions directly instead of having such contributions paid by Employer M to Plan X.

Accordingly, we conclude, with respect to ruling requests numbers 1 and 2, that the amounts picked up by Employer M on behalf of Group B Employees who participate in Plan X shall be treated as employer contributions and will not be includible in Group B Employees' gross income in the year in which such amounts are contributed to Plan X. These amounts will be includible in the gross income of Group B Employees or their beneficiaries only in the taxable year in which they are distributed, to the extent that the amounts represent contributions made by Employer M. 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 the pick-up is no earlier than the later of the date Resolution N is signed or the date the pick-up is put into effect.

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.

This ruling is 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.

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.

If you have any questions, please contact ***, T:EP:RA:T2, at ***.

Sincerely yours,

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

Enclosures:
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