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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

U.I.L. 414.09-00

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MAY 21 2003

Attn: ********

T:EP:RA:T2

LEGEND:
Employer A: ********

State B: ********

Group C Employees: ********

Plan X: ********

Board M: ********

City E: ********

Statute D: ********

Ordinance Y: ********

Ordinance Z: ********

Dear ********

This is in response to a ruling request dated April 19, 2001, as supplemented by additional correspondence dated July 23, 2001, and December 12, 2002, and as amended by correspondence dated September 23, 2002, from your authorized representative, concerning the income tax treatment of certain employee contributions to Plan X under section 414(h)(2) of the Internal Revenue Code (the "Code").

The ruling request is based on the following facts and representations:

Employer A is a political subdivision of State B. Employer A is a city, which pursuant to its Home Rule Charter, created Plan X in l964, to provide pension benefits to all eligible persons in its permanent employ ("Group C Employees").

In general, all permanent Group C Employees of Employer A must participate in Plan X. Exceptions to participation in Plan X include the Director of Finance, the Director of Public Works and police and fire personnel who are participants in pension systems separate and distinct from Plan X. An additional exception to participation are those permanent employees who were eligible as of a certain date to participate in Plan X but who made a one-time irrevocable election prior to November 1, 1986, not to participate in Plan X. All Group C Employees who did not elect non-participation must make mandatory contributions to Plan X.

Statute D of City E sets forth the plan documentation for the specific terms and provisions of Plan X. Plan X is a defined benefit pension plan. Plan X is intended to meet the qualification requirements of section 401(a) of the Code and its trust is exempt from federal income taxation under section 501(a).

On December 29, 1997, Board M adopted Ordinance Y. The purpose of Ordinance Y was to amend Section 6.0209 of Statute D. Section 6.0209 of Statute D provides the contribution rate for contributions to Plan X and also provides that Group C Employees' contributions shall be picked up by Employer A. Section 6.0209 B, as amended by Ordinance Y, provides, in pertinent part, that Group C Employees' contributions shall be mandatory and that such reductions from a Group C Employee's base pay, although designated as employee contributions, shall be deducted by Employer A and paid by Employer A as pick up contributions in lieu of contributions by the employee. Board M's first reading of Ordinance Y was on December 15, 1997. Board M's second reading of Ordinance Y was on December 29, 1997, followed by final passage on that same date. Ordinance Y became effective January 1, 1998.

On July 22, 2002, Board M adopted Ordinance Z. Ordinance Z amends Section 6.0209 of Statute D and provides, in pertinent part, that a Group C Employee's contributions shall be mandatory and equal to, beginning with the first payroll period in 2002, four percent of a Group C Employee's pay and longevity as those terms are defined in Plan X. Such reductions, although designated as Group C Employee contributions, are being paid by Employer A as pick up contributions in lieu of contributions by the Group C Employees. Ordinance Z further provides that in no event shall a Group C Employee have the option of receiving the amount of the picked up employee contribution in cash in lieu of the picked contribution to Plan X. Board M's first reading of Ordinance Z was on July 8, 2002. Board M's second reading of Ordinance Z was on July 22, 2002, followed by final passage on that same date. Ordinance Z became effective July 22, 2002.

In a letter dated September 23, 2002, ruling request number one as set forth in the initial submission dated April 19, 2001, was withdrawn by Employer A. In a letter dated January 29, 2003, you requested that this ruling only pertain to the pick up of employee contributions on and after July 22, 2002.

Based on the foregoing facts and representations, the following rulings, as renumbered, have been requested:

1. That amounts deducted and withheld from the salary of Group C Employees (covered employees) qualify as employee contributions that are picked up by Employer A under Code section 414(h)(2) and, as such, are not included in gross income for federal income tax purposes.

2. That amounts deducted and withheld from the salary of Group C Employees (covered employees) qualify as employee contributions that are picked up by Employer A 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).

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 by the employing unit.

The federal income tax treatment to be accorded contributions that 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. Rev. Rul. 77-462 concluded that the school district's picked up contributions to the plan were 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 is salary, an offset against future salary increases, or a combination of both.

In Revenue Ruling 87-10, 1987-1 C.B. 136, the 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. Thus, employees may not exclude from current gross income designated employee contributions to a qualified plan that relate to compensation earned for services rendered prior to the date of the last governmental action necessary to effect the pick up.

Ordinance Z adopted by Board M on July 22, 2002 satisfies the criteria set forth in Revenue Ruling 81-35 and Revenue Ruling 81-36 by providing that Group C Employees' contributions, although designated as employee contributions, are paid by Employer A in lieu of contributions by the Group C Employees; and that in no event shall a Group C Employee have the option of receiving the amount of the pick up contribution in cash in lieu of the pick up contributions to Plan X.

Accordingly, we conclude, with respect to ruling requests one and two, that the amounts withheld from the salary of the Group C Employees who participate in Plan X qualify as employee contributions that are picked by Employer A under Code section 414(h)(2) and, as such, are not included in gross income for federal income tax purposes. These amounts will be includible in the gross income of the Group C Employees or their beneficiaries only in the taxable year in which they are distributed, to the extent they represent amounts contributed by Employer A. 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 A will constitute wages for federal income tax withholding purposes in the taxable year in which they are contributed to Plan X.

Revenue Ruling 87-10 provides that employees may not exclude from current gross income designated employee contributions that relate to compensation earned for services prior to the date of the last governmental action necessary to effect the pick up. In a letter dated January 29, 2003, you, through your authorized representative, requested that this ruling only pertain to the pick up of employee contributions on and after July 22, 2002. Therefore, in accordance with Rev. Rul. 87-10, the conclusions reached herein do not apply to any pick up contributions in Plan X to the extent the pick up contributions relate to compensation earned prior to July 22, 2002, the date Board M adopted Ordinance Z on behalf of Employer A, or prior to the date of the last

governmental action necessary to effect the pick up provisions in Plan X, whichever is the latest. This ruling is limited to employee contributions that are picked up subsequent to the adoption and implementation of Ordinance Z by Employer A and does not express an opinion as to the validity of the pick up of employee contributions prior to such adoption and implementation.

With respect to ruling request three, section 1.415-3(d)(1) of the Income Tax Regulations provides 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 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 annual additions described in Code section 415(c). However, employee contributions, which 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 Code section 415(c). Accordingly, with respect to ruling request three, we conclude that the picked up contributions under the facts as presented will not be treated as "annual additions" for purposes of Code section 415(c).

This ruling is based on the assumption that Plan X will be qualified under Code section 401(a) 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 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 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 ******** T:EP:RA:T2 of this office at ********

Sincerely yours,

Joyce E. Floyd
Manager, Employee Plans
Technical Group 2

Enclosures:
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