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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

MAY 28 2003

T:EP:RA:T2

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

Legend
Employer M = **********
State A = **********
Group N Employees = **********
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Statute P = **********
Statute Q = **********
Statute R = **********
Statute S = **********
Plan X = **********
Proposed Resolution N = **********
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Form O = **********
Ordinance O = **********
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City C = **********

Dear **********

This is in response to a ruling request dated November 25, 2002, which was received in our office on March 6, 2003, as supplemented by correspondence dated April 11, May 1, and May 22, 2003, 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.

Your authorized representative has submitted the following facts and representations:

Employer M is a municipal corporation duly organized and existing under the laws of State A. Ordinance O, signed by the Mayor of City C and dated December 11, 2001, created and established Plan X in accordance with Statute P for the benefit of its Group N Employees. Statute P provides that in each municipality, as defined in Statute Q, the city council or the board of trustees shall establish and administer a plan for the benefit of its Group N

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Employees, their surviving spouses, children and certain other dependents. You represent that Plan X meets the qualification requirements set forth under section 401(a) of the Code.

Statute R provides that, each Group N Employee shall contribute 9.91 percent of his/her salary to Plan X.

Statute S provides that a municipality, such as Employer M, may pick up the Group N Employees' contributions required by Statute R. If a municipality decides not to pick up the contributions, the required contributions shall continue to be deducted from salary. Statute S further provides that if contributions are picked up, they shall be treated as employer contributions in determining tax treatment under the Internal Revenue Code. Statute S also provides that a municipality shall continue to withhold Federal and State income taxes based on 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 as gross income of the Group N Employees until such time as they are distributed or made available. The municipality shall pay these contributions from the same source of funds which is used to pay the salaries of the Group N Employees. Employer M may pick up these contributions by a reduction in the cash salary of the Group N Employees or by an offset against a future salary increase or by a combination of both.

Prior to the inception of the pick up program, Employer M will give present Group N Employees an opportunity to elect, on Form O, whether to participate in the pickup program. New employees hired subsequent to the inception of the pick up program will also be given an opportunity to elect whether or not to participate in the pick up program. To effectuate the pickup as provided for in Statute S, Employer M intends to adopt Proposed Resolution N and Form O.

Section 1 of Proposed Resolution N provides that, in accordance with the provisions of Statute S, Employer M shall pick up the Group N Employees' contributions to Plan X. Section 2 of Proposed Resolution N, as amended in your correspondence dated May 1, 2003, provides, in pertinent part, that Employer M's pick up of the Group N Employees' pension contributions shall be treated as employer contributions in determining tax treatment under the Code, provided however, that Employer M shall continue to withhold Federal and state income taxes on these amounts until it is ruled that these contributions shall not be included as gross income of the Group N Employees until such time as they are distributed or made available. Proposed Resolution N further provides that a Group N Employee is not given the option to receive the contributed amounts directly.

Employer M proposes to give current and future employees an opportunity to make a one time irrevocable election to participate in the proposed pick up arrangement or to continue to make after tax employee contributions to Plan X. To facilitate this election, each Group N Employee, whether newly hired or presently employed by Employer M, shall be provided an election document, Form O, which requests the employee to identify whether he or she elects to continue making after-tax contributions to Plan X or to participate in the pick up program. The election to participate in the pick up program is irrevocable. Further, the election to not participate in the pick up program and to continue to make after-tax employee contributions to Plan X is also irrevocable. For currently instated employees, the one-time irrevocable election shall be exercised, in writing, no later than 60 days from the effective date of the pick up

arrangement. For employees hired subsequent to the effective date of the pick up arrangement, the one-time irrevocable election must be filed, in writing, no later than 60 days from the date he or she was accepted as a member of Plan X. The election period shall be extended for an additional thirty days in the event the subject Group N Employee has been unable to acknowledge his or her election for reasons other than fault of his or her own. Employer M represents in the letter it intends to give to all Group N Employees that the election to accept or reject the pension pick up is irrevocable, that the Group N Employee may not subsequently change or amend the election and that failure to make a written election within the prescribed election period shall be interpreted as an acceptance of the pick up program.

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

1. The mandatory employee contributions to Plan X, which are picked up for the Group N Employees who so elect in an irrevocable written election, are picked-up within the meaning of section 414(h)(2) of the Code; thereby rendering the picked-up contributions excludible from the current gross income of the Group N Employees on whose behalf the pickup is made.

2. The picked up contributions to Plan X are not considered wages of the Group N Employees for federal income tax withholding purposes and, as such, 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), 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.

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 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 the Group N Employees. Under Proposed Resolution N, Group N Employees participating in Plan X are not given the option to receive the contributed amounts directly in lieu 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 the Group N Employees who participate in Plan X shall be treated as employer contributions and will not be includible in the Group N Employees' gross income in the year in which such amounts are contributed for federal income tax treatment. These amounts will be includible in the gross income of the Group N Employees or their beneficiaries 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 Proposed Resolution N is signed or the date the pick-up is put into effect. This ruling is based on Proposed Resolution N as set forth in your letter dated November 25, 2002, and the amendment to Proposed Resolution N submitted with your correspondence dated May 1, 2003, and Form O as submitted with your correspondence dated May 22, 2003.

This ruling is based on the condition that a Group N Employee who makes a one-time irrevocable election to participate in the pick up provisions of Plan X within Employer M's prescribed election period may not subsequently alter or amend this election to participate in the pick up provisions of Plan X. Further, this ruling is also based on the condition that a Group N Employee who makes a one-time irrevocable election not to participate in the pick up provisions of Plan X within Employer M's prescribed election period may not subsequently alter or amend this election to not participate in the pick up provisions of Plan X.

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.

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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.

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).

These rulings are directed only to the taxpayer who requested them. Section 6110(k)(3) of the Code provides that they 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 questions regarding this ruling, you may contact T:EP:RA:T:2, at

Sincerely yours,

Joyce E. Floyd, Manager,
Employee Plans Technical Group 2

Enclosures:
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