Internal Revenue Service

Significant Index No. 414.15-00

Department of the Treasury

Washington, DC 20224

Person to Contact: 199905036

Telephone Number:

Refer Reply to: CP:E:EP:T:3

Date:

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LEGEND:

State A =

Employer M =

Plan X =

Group B
Employees =

Ordinance O =

This is in response to correspondence dated June 25, 1998, in which you request a private letter ruling concerning the federal income tax treatment under section 414(h)(2) of the Internal Revenue Code of certain contributions to Plan X.

The following facts and representations have been submitted. Employer M is a political subdivision of State A. Employer M adopted Plan X for the benefit of Group B Employees. Plan X is qualified under section 401(a) of the Code. Under Plan X, Group B Employees are required to make mandatory contributions of 8.25 percent of salary to Plan X.

Ordinance O was adopted by Employer M on May 19, 1998. In accordance with Ordinance O, Employer M will pick up and pay the employee contributions under Plan X. Group B Employees do not have the option of receiving the contributed amounts directly instead of having them contributed to Plan X. The contributions will be made by Employer M through a reduction in the cash

salary payable to the employee. Ordinance O provides that it is not effective until the issuance of this letter ruling by the Internal Revenue Service.

Based on the aforementioned facts and representations, you have asked for rulings:

1. That the mandatory employee contributions picked up by Employer M will be excluded from the current gross income of Group B Employees until distributed or otherwise made available.

2. That 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 described in 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. Furthermore, it is immaterial, for

purposes of the applicability of 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.

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 employer pick up.

It has been represented that under Ordianace O, Employer M will make contributions in lieu of contributions by Group B Employees and that the Employees may not elect to receive such contributions directly. Therefore, Ordinance O satisfies the criteria set forth in Revenue Ruling 81-35 and Revenue Ruling 81-36. Accordingly, with respect to ruling request one, we conclude:

1. That the mandatory employee contributions picked up by Employer M will be excluded from the current gross income of Group B Employees until distributed or otherwise made available.

We have determined that the employee contributions paid to Plan X by Employer M on behalf of Group B Employees will be treated as picked up contributions in accordance with Revenue Ruling 81-35 and Revenue Ruling 81-36. Pursuant to Revenue Ruling 77-462, picked-up contributions are excluded from the employees' gross income until such time as they are distributed to the employees. Accordingly, with respect to ruling request two, we conclude:

2. That 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.

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.

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.

Sincerely yours,

/s/ Frances V. Sloan

Frances V. Sloan
Chief, Employee Plans
Technical Branch 3

Enclosures:

Deleted copy of letter ruling
Form 437