TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

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T:EP:RA:T1

EIN:

LEGEND:

State A =
City A =
Corporation A =

Plan X =

Plan Y =

Ladies and Gentlemen:

This is in response to a request submitted on your behalf by your authorized representative on February 9, 2000, supplemented by correspondence dated April 24, 2001, August 17, 2001, August 27, 2001, August 31, 2001, September 27, 2001, and January 11, 2002, for a private ruling letter concerning the federal income tax treatment of certain contributions to Plans X and Y under section 414(h)(2) of the Internal Revenue Code ("Code").

In support of the ruling request the following facts and representations have been submitted:

Corporation A was created by a statute enacted in 1998 under the law of State A, which provides in part as follows:

> The Corporation is a body politic and corporate and is constituted as a public instrumentality of [State A] and an independent unit in the Executive Branch of the State government.

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> The exercise by the Corporation of the powers conferred by this subtitle is deemed to be the performance of an essential public function.
>
> . . . .
>
> The purpose of the Corporation is to plan, develop, and manage a [State A] museum of . . . history and culture in [City A], in cooperation with and with the active support of the Mayor and City Council of [City A], affected State agencies, and other public and private institutions.

. of the members of the Board of Directors of Corporation A are appointed by the Governor for a term of years. The one member who is not so appointed is the Mayor of City A. Each appointee is required to take the oath of office as set forth in the State constitution. Under the law of State A, the Board members appointed by the Governor consist of certain State government officials, are representatives of certain historical or cultural institutions in the State, have expertise in certain history, culture, museums, or fund-raising, or represent the diversity of communities throughout the State that can benefit from the activities of Corporation A. Any of the directors appointed by the Governor at any time can be removed by the Governor for misconduct or incompetence.

The members of the Board of Directors, as specified by the law of State A, control the management and affairs of Corporation A. Upon dissolution of Corporation A, all of its assets are required to be distributed to State A. Corporation A is required to report annually to the Governor and to the General Assembly as to its activities. There are no private interests involved in the ownership or operations of Corporation A. Corporation A has received a determination letter from the Service stating that it is an organization described in section 501(c)(3) of the Code.

All but $ . of the approximately $ total costs of constructing the museum has been funded by State A. The site on which the museum will be constructed will be leased to Corporation A by City A for a total rent of $ pursuant to the terms of a long-term lease.

Under State A statute, the operating costs of Corporation A are to be funded from annual grants from the State A budget or other income of Corporation A. State A funds have been appropriated to support percent of the museum's annual operating costs, and, after the museum opens to the public, State A funds will be used to support percent of the museum's annual operating costs.

There are many provisions of State A personnel statutory law that apply to the employees of Corporation A to the same extent as all other State A employees, including:

- Employee Rights on Transfer between Units of State Government. A Corporation A employee who transfers to another State unit does not lose leave or credit earned while employed by Corporation A. Likewise, an employee of another State unit who transfers to Corporation A does not lose leave or credit earned while employed by the other State unit.

- Employee Rights on Return to State Service. Corporation A must restore all unused sick leave for reinstated Corporation A employees and must grant reinstated employees all the benefits allowed under Corporation A's personnel system which are the same protections afforded to other State employees.

- Employee Payment through State's Central Payroll Bureau. Corporation A must pay all employees through the State's Central Payroll Bureau when those employees are paid from funds appropriated by the General Assembly through the State budget and the Central Payroll Bureau must maintain all supporting payroll records. Because all of Corporation A's funds to date, and for the foreseeable future, have been derived from the General Assembly, all employees of Corporation A receive paychecks just like the ones received by State administrators and other employees of the State.

- No Employee Loss of Health Insurance Benefits, Seniority, or Leave Accruals while on Leave with Pay. Corporation A employees are entitled to subsidized State health insurance benefits, seniority and leave accruals, and pay at the employee's regular hourly rate (except during sick leave) while on paid leave.

- State Health and Welfare Benefits. Corporation A employees, retirees, and their survivors may participate in the State Employee and Retiree Health and Welfare Benefits Program, including any State subsidies for the Program to the same extent as other eligible State employees.

- Pensions. The Executive Director and all regular full-time employees of Corporation A may participate in Plan X or Plan Y, including any State subsidies for the Program.

- Employee Death Benefits. Survivors of Corporation A employees are entitled to a death benefit paid by the State (except when death is caused by the employee's negligence).

- Social Security Benefits. Corporation A employees, their dependents and survivors are entitled to the same federal social security benefits as other State employees and officers.

In addition, State A law expressly provides that employees and officials of Corporation A enjoy the State's sovereign immunity from suit for tort liability to the same extent as personnel of other State units. Also, the Attorney General of State A must provide legal counsel to Corporation A and legal services to the museum established by Corporation A.

Plan Y requires that employees contribute a certain percentage of salary over the social security wage base. Employee contributions to Plan X are required for certain employees who were members of that Plan on December 31, and did not transfer or terminate their membership.

The law of State A permits employers who participate in Plans X and Y to pick up contributions to the plans, provided that the employer has received a favorable ruling from the Service that it has an employer pick-up program within the meaning of section 414(h)(2) of the Code. According to representations made with the ruling request, Plans X and Y are qualified plans under section 401(a) of the Code, and the trust funds of Plans X and Y are exempt from federal income tax under section 501(a).

On , the Board of Directors of Corporation A adopted a resolution authorizing Corporation A, subject to the Service's issuance of a favorable ruling, to pick up the mandatory employee contributions of those employees who participate in Plans X and Y. In accordance with State A law, although designated as employee contributions, the contributions will be paid by the employer through a reduction in current salary, an offset against future salary, or both. As employer pick-up contributions, these contributions will not be included in an employee's salary reported for federal income tax purposes and will be treated as employer contributions in determining the federal income tax treatment of distributions from Plans X and Y. For all other purposes, the pick-up contributions will be treated the same as the employee contributions received prior to the adoption of the pick-up program. In no circumstances would any employee of Corporation A be permitted to receive the picked-up contributions directly. Under the statute, the employer shall pick up the mandatory employee contribution, and the employee's compensation must be reduced by the amount of the picked-up contribution. Corporation A represents that it will pay the picked-up contributions directly to Plans X and Y without ever allowing the employees direct access to such funds.

Based on the facts and representations as stated above, Corporation A requests the following rulings:

Contributions made by Corporation A on behalf of its employees to Plans X and Y will be governed by section 414(h) of the Code and, more specifically, that:

(1) no part of the mandatory contributions picked up by Corporation A as an employer of employees included in Plans X and Y will be considered as gross income of such employees for the taxable year in which the pick-up is made;

(2) the contributions, whether picked up by salary reduction, off-set against future salary increases, or both, and although designated as employee contributions, will be treated as employer contributions for federal income tax purposes; and

(3) the contributions picked up by Corporation A will not constitute wages for federal income tax withholding purposes in the taxable year in which contributed.

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 or by any agency or instrumentality 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' 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), 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 for federal income tax purposes 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 amounts directly instead of having them paid by the employer to the pension plan. Furthermore, 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.

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.

In determining whether an organization is an agency or instrumentality of the United States or any state or political subdivision thereof, the Service, in Revenue Ruling 89-49, 1989-1 C.B. 117, considered a number of different factors. The Revenue Ruling stated that one of the most important factors to be considered in determining whether an organization is an agency or instrumentality of the United States or of any state or political subdivision is the degree of control that the federal or state government has over the organization's everyday operations. Other factors include: (1) whether there is specific legislation creating the organization; (2) the source of funds for the organization; (3) the manner in which the organization's trustees or operating board are selected; (4) whether the applicable governmental unit considers the employees of the organization to be employees of the applicable governmental unit. Although all of the above factors are considered in determining

whether an organization is an agency of a government, the mere satisfaction of one or all of the factors is not necessarily determinative.

Corporation A's sole purpose for being created is the establishment and maintenance of a cultural and historical museum. We conclude that such a purpose can be treated as a governmental purpose and the support activity as a governmental function. Secondly, all but one of the members of the Board of Directors of Corporation A are appointed by the Governor of State A, and they are chosen for their competence in the pursuit of the historical and cultural activity of the museum. Thirdly, State A has funded 90 percent of the museum construction costs, 75 percent of the museum's annual operating budget since 1999, and State A will fund 50 percent annually after the museum opens to the public. Fourth, Corporation A was created by statute pursuant to the authority of the State A General Assembly. Lastly, we conclude that, when considering the totality of the personnel-related rules covering the employees of State A that also apply to the employees of Corporation A, for purposes of Rev. Rul. 89-49, the applicable governmental unit considers the employees of Corporation A to be its employees. Accordingly, for these reasons, Corporation A is an instrumentality of State A, and thus constitutes an "employing unit" within the meaning of section 414(h)(2) of the Code.

The terms of Plan X, Plan Y, and the resolution adopted on by Corporation A satisfy the criteria set forth in Revenue Rulings 81-35 and 81-36 because the contributions, although otherwise designated as employee contributions, are to be made by Corporation A in lieu of contributions by the employees, and the employees may not elect to receive such contribution amounts directly.

Accordingly, we conclude that contributions made by Corporation A on behalf of its employees to Plans X and Y will be governed by section 414(h) of the Code and, more specifically, that:

(1) no part of the mandatory contributions picked up by Corporation A as an employer of employees included in Plans X and Y will be considered as gross income of such employees for the taxable year in which the pick-up is made;

(2) the contributions, whether picked up by salary reduction, off-set against future salary increases, or both, and although designated as employee contributions, will be treated as employer contributions for federal income tax purposes; and

(3) the contributions picked up by Corporation A will not constitute wages for federal income tax withholding purposes in the taxable year in which contributed.

This ruling applies only to contributions specified in the resolution adopted on . The effective date for the commencement of the proposed pick-up of the mandatory contributions cannot be earlier than the later of the date the resolution is put into effect, or 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 being paid pursuant to a "salary reduction agreement" within the meaning of section 3121(v)(1)(B).

This ruling is based on the assumption that Plans X and Y are qualified under section 401(a) of the Code, and their related trusts tax exempt under section 501(a), at all relevant times.

This letter only addresses the federal income tax treatment of certain contributions to be picked up by the taxpayer within the meaning of section 414(h)(2) of the Code. The taxpayer does not request a ruling as to whether Plan X or Plan Y is a governmental plan within the meaning of section 414(d) of the Code, and this letter cannot be relied on for such purposes.

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 as precedent.

A copy of this ruling is being sent to your authorized representative in accordance with a power of attorney on file in this office. Should you have any concerns regarding this ruling, please contact , at .

Sincerely yours,

John Swieca

John Swieca
Manager, Employee Plans
Technical Group 1
Tax Exempt and Government
Entities Division

Enclosures:
Deleted copy
Notice of Intention to Disclose