



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

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Significant index no. 414.09-00

T:EP:RA:T3

Legend:

State A =

State Statute C =

Group B Employees =

Plan X =

Joinder Agreement Form J =

Payroll Authorization Form P =

Dear

In a letter dated August 10, 2001, as supplemented by correspondence dated August 19, 2002, January 30, 2003, March 13, 2003, April 24, 2003, May 14, 2003, and June 12, 2003, you requested a ruling concerning the federal income tax treatment of certain contributions to Plan X under section 414(h)(2) of the Internal Revenue Code.

The following facts and representations have been submitted:

Plan X is a defined contribution plan sponsored by State A that is intended to meet the requirements of section 401(a) of the Code. Plan X is authorized by State Statute C, which became effective August 9, 2001.

Plan X is a governmental plan as specified in section 414(d) of the Code. It was created to provide tax-deferred retirement benefits to Group B Employees, who are State A employees of eligible groups specified in Plan X. The employers of Group B Employees are instrumentalities of State A, within the meaning of section 414(d). Upon execution of Joinder Agreement Form J, these employers of Group B Employees become participating employers in Plan X.

Participation in Plan X is elective, but once such election is made, it is irrevocable. The election to participate must be made within two years of the date of eligibility. All participants in Plan X are required to make mandatory employee contributions of at least one percent of the employee's gross salary or as required by the employer. The participating employers of Group B Employees have the right to designate the amount to be contributed. If the employer designates no amount, then no contribution may be made. The participating employers of Group B Employees may elect to make a contribution for each participant to be determined by the employer.

You have represented that section 38-952(D) of State Statute C has been amended but will not officially become law until 90 days after the legislative session of State A ends. As amended, section 38-952(D) includes a Code section 414(h) "pick up" provision, as follows:

Although designated as employee contributions, all employee contributions made to a plan shall be picked up and paid by the employer in lieu of contributions by the employee. The contributions picked up by an employer may be made through a reduction in the employee's compensation or an offset against future compensation increases, or a combination of both. An employee participating in a plan does not have the option of choosing to receive the contributed amounts directly instead of the employer paying the amounts to the plan. It is intended that all employee contributions that are picked up by the employer as provided in this subsection shall be treated as employer contributions under section 414(h) of the Internal Revenue Code, shall be excluded from employees' gross income for federal and state income tax purposes and are includable in the gross income of the employees or their beneficiaries only in the taxable year in which they are distributed. The specified effective date shall not be before the date the plan receives notification from the Internal Revenue Service that pursuant to section 414(h) of the Internal Revenue Code all employee contributions that are picked up by the employer as provided in this subsection shall be treated as employer contributions. Until notification is received, any contributions made under [State Statute C] are made with after-tax contributions.

Pursuant to the terms of Plan X and the authority vested in the Plan Administrator, Plan X is authorized to treat all participant contributions to Plan X as having been picked up under section 414(h) (2) of the Code, providing each participating employer has adopted Joinder Agreement Form J to this effect covering participant contributions. This Joinder Agreement Form J provides that participating employers will make contributions in lieu of the employees' contributions and that the employees may not receive such contributions directly. In addition, each participant will be required to complete Payroll Authorization Form P, which provides that the employer will pay amounts due

directly to the Plan and an election to participate must be made within two years of the date of eligibility and is irrevocable.

In addition, you expressly represent that pursuant to State Statute C, the fund manager may delegate authority to implement the Plan to the administrator employed, and the board or fund manager may perform all acts, whether or not expressly authorized, that it deems necessary and proper for the operation and protection of the Plan. Further, you represent that you have the authority to make any necessary changes to Plan X documents in order to establish, administer, manage and operate a supplemental defined contribution plan. In addition, you represent that the changes to the Plan X documents submitted in the above-referenced letters were made pursuant to this authority.

Based on the facts and representations above, a ruling is requested that the employee contributions to Plan X picked up by the participating employers on behalf of Group B Employees in accordance with State Statute C, Payroll Authorization Form P, and Joinder Agreement Form J, will qualify as being picked up under section 414(h)(2) of the Code and will be considered to be employer contributions, provided such contributions are made in accordance with State Statute C, Payroll Authorization Form P, and Joinder Agreement Form J.

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 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 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.

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.

Pursuant to State Statute C, criteria set forth in Revenue Ruling 81-35 and Revenue Ruling 81-36 are satisfied by providing, in effect, that State A and the participating employers of Group B Employers will make contributions in lieu of Group B Employees' contributions and by providing that Group B Employees shall not be given the option to receive such contributions directly.

Assuming the proposed pick ups are implemented as stated herein, with respect to your ruling request, it is concluded that the employee contributions to Plan X picked up by the participating employers on behalf of Group B Employees in accordance with State Statute C, Payroll Authorization Form P, and Joinder Agreement Form J, will qualify as being picked up under section 414(h)(2) of the Code and will be considered to be employer contributions, provided such contributions are made in accordance with State Statute C, Payroll Authorization Form P, and Joinder Agreement Form J.

This ruling is based on the assumption that section 38-952(D) of State Statute C will become law in the timeframe mentioned herein.

In accordance with Rev. Rul. 87-10, this ruling does not apply to any contribution to the extent it relates to compensation earned before the later of the effective date of the relevant statutes, the date the pick-up election is executed or the date it is put into effect.

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.

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.

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.

Further, this ruling is not a ruling with respect to the tax effects of the pickup on employees of participating employers. However, in order for the tax effects that follow from this ruling to apply to those employees of a particular participating employer described in the preceding sentence, the pick-up arrangement must be implemented by that participating employer in the manner described herein.

A copy of this letter has been sent to your authorized representative in accordance with a Power of Attorney on file in this office. If you have any questions, please contact

Sincerely yours,

/s/ Frances V. Sloan

Frances V. Sloan, Manager
Employee Plans Technical Group 3
Tax Exempt and Government
Entities Division

Enclosures:

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Notice 437 •