TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

200402027

Uniform Issue List: 414.09-00

Attn:

Legend:

System S =

State A =

Statute B =

Statute C =

Statute D =

Form I =

Plan X =

Plan Y =

Dear :

This is in response to a ruling request dated May 29, 2003, as supplemented by additional correspondence dated July 1, 2003, July 24, 2003, and August 12, 2003, from your authorized representative concerning the pick up of certain employee contributions to Plan Y under section 414(h)(2) of the Internal Revenue Code ("Code").

The following facts and representations have been submitted:

State A established Plan X for the benefit of eligible employees of participating employers. Plan X requires mandatory employee contributions and is qualified under Code section 401(a). In addition, Plan X is a governmental plan as described in section 414(d).

In 1985, the Legislature of State A adopted the predecessor to Statute B directing all employers of Plan X participants to pick up the mandatory employee contributions as provided by Code section 414(h)(2). In 1986, the Internal Revenue Service ("Service") ruled that amounts picked up by the employers participating in Plan X satisfy the requirements of section 414(h)(2). In 1997, the Legislature of State A amended Statute C allowing Plan X participants who purchase credited service pursuant to State A Statutes to either make payments directly to Plan X, or elect to have the employers pick up the payments through a salary reduction program. In 1997, the Service ruled that amounts picked up by the employers in Plan X pursuant to Statute C satisfy the requirements of section 414(h)(2).

In 2001, the Legislature of State A enacted Statute D which authorized the creation of Plan Y. The Governing Board of System S, which established and administers Plan X, also established and administers Plan Y. Plan Y, as adopted by System S on January 31, 2002, has been filed with the Service for a determination letter that the Plan is qualified under section 401(a) of the Code.

Plan Y is a governmental plan of State A, as described in Code section 414(d). Plan Y is also a defined contribution plan described in Code section 414(i) since it provides for an individual account for each member and for benefits based solely on amounts contributed to the member's account, together with any income, expenses, gains and losses, and any forfeitures of account of other members which may be allocated to the member's account.

Under Plan Y, the term "employer" includes System S, any agency or department of State A, or any agency or department of a political subdivision of State A, that has employees participating in Plan X and that adopts Plan Y. If an employer adopts Plan Y, any employee member of the employer may elect to participate in

Plan Y by completing Form I.

Plan Y, as adopted by System S in 2002, provided that (1) an employee must contribute an amount equal to at least one percent of the employee's gross salary, (2) an employee can elect to participate in Plan Y at any time and must elect to participate for a period of at least one year, and (3) an employee may annually increase or decrease the employee contributions in increments of one percent up to the maximum allowed by law. A ruling request had been filed by System S with the Service in 2001 requesting, among other things, that the Service issue a ruling that employee contributions to Play Y would be treated as picked-up contributions under Code section 414(h)(2).

On March 25, 2003, the Service issued a private letter ruling which stated, among other things, that employee contributions to Plan Y picked up by participating employers pursuant to the provisions of Plan Y failed to satisfy the requirements of Code section 414(h)(2). The Service based its adverse ruling on the second criterion of Revenue Rulings 81-35, 1981-1 C.B. 255 and 81-36, 1981-1 C.B. 255, which states that 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 the adverse ruling, the Service stated the following: to satisfy criterion (2) of Revenue Rulings 81-35 and 81-36, the employee must have a one-time election to contribute a selected percentage of pay and that election must carry forward during the employee's entire period of employment. In addition, the election must be made within the later of 24 months of the date of hire or 24 months of the date that the employee is first eligible to participate.

In 2003, the Legislature of State A amended Statute D to bring the pertinent provisions of the statute governing Plan Y into compliance with the requirements for pick-up treatment under section 414(h)(2) of the Code. In accordance with changes to Statute D, System S proposes to amend section 2.1.3 of Plan Y to provide that an employee shall only be eligible to elect to participate in Plan Y, by executing Form I, within two years following the employee's eligibility for participation in the Plan.

System S also proposes to amend section 2.1.4 of Plan Y to provide that an employee who executes Form I shall specify an amount to contribute to Plan Y at least equal to one percent of the employee's gross compensation. The employee's rate of contribution specified on Form I shall be irrevocable for the remainder of the employee's employment with the participating employer for whom the employee is employed on the date the employee executes Form I.

In addition, section 2.1.4 of Plan Y provides that although designated as employee contributions, all employee contributions made to the 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 salary or an offset against future salary increases, or a combination of both. An employee participating in the 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 Plan shall be treated as employer contributions under Code section 414(h)(2), shall be excluded from employees' gross income for federal and state income tax purposes, and shall be included in the gross income of the employees or their beneficiaries only in the taxable year in which they are distributed. The specified effective date of the pick up pursuant to this Plan shall not be before the date the Plan receives notification from the Service that employee contributions that are picked up by the employer as provided in this Plan shall be treated as employer contributions pursuant to Code section 414(h)(2). Until such notification is received, any employee contributions made under this Plan are made with after-tax contributions.

Based on the foregoing facts and representations, you have requested the following ruling:

Sections 2.1.3 and 2.1.4 of Plan Y, as proposed to be amended, satisfy the requirements of section 414(h)(2) of the Code and employee contributions to Plan Y picked up by participating employers under these provisions will be treated as employer contributions pursuant to Code section 414(h)(2) .

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 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 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 Code section 414(h)(2) 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 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), 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 for federal income tax purposes.

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 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.

Section 2.1.4 of Plan Y provides that although designated as employee contributions, all employee contributions made to the 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 salary or an offset against future salary increases, or a combination of both. An employee participating in the Plan does not have the option of choosing to receive the contributed amounts directly instead of the employer paying the amounts to the Plan.

A proposed amendment to section 2.1.3 of Plan Y provides that an employee shall make an election to participate in the Plan within two years following the employee's eligibility for participation in the Plan. An election to participate in the Plan is irrevocable and continues for the remainder of the employee's employment with the employer. A proposed amendment to section 2.1.4 of Plan Y provides that if an employee elects to participate in the Plan, the employee shall contribute an amount equal to at least one per cent of the employee's gross compensation. The employee may make a one-time irrevocable election of the employee's rate of contribution. Since the employee's elections are irrevocable and continue throughout the remainder of the employee's employment with the employer, these elections are consistent with criterion (2) set forth in Revenue

Rulings 81-35 and 81-36 for pick-up plan treatment. Criterion (2) provides that 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 plan.

Accordingly, with respect to your ruling request, we conclude that sections 2.1.3 and 2.1.4 of Plan Y, as proposed to be amended, satisfy the requirements of section 414(h)(2) of the Code and employee contributions to Plan Y picked up by participating employers under these provisions will be treated as employer contributions pursuant to Code section 414(h)(2).

The effective date for the commencement of the proposed pick up as specified in sections 2.1.3 and 2.1.4 of Plan Y cannot be any earlier than the later of the date the above proposed amendments are signed or put into effect, the date the participating employer adopts Plan Y, or the date the employee signs Form I to participate in Plan Y.

This ruling is conditioned on adoption by System S of the above-described proposed amendments to sections 2.1.3 and 2.1.4 of Plan Y.

For purposes of the application of Code section 414(h)(2), 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.

This ruling is based on the assumption that Plan X and Plan Y will be qualified under Code section 401(a) at all relevant times. This letter expresses no opinion as to whether Plan X or Plan Y satisfies the requirements for qualification under Code section 401(a). The determination as to whether a plan is qualified under section 401(a) is within the jurisdiction of the appropriate Employee Plans Area Manager.

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 has been sent to your authorized representative pursuant to a power of attorney on file in this office. If you have any questions, please call , SE:T:EP:RA:T1 , at .

Sincerely yours,

Madan Dua

Acting Manager
Employee Plans Technical Group 1

Enclosures:
Deleted Copy of the Ruling
Notice 437

cc: