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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

200407022

Index No. 414.09-00

NOV 18 2003

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ATTN: ***

LEGEND:

Employer M	=	***
State A	=	***
City E	=	***
Group B Employees	=	***
Agreement C	=	***
Resolution N	=	***
Plan X	=	***
Board Y	=	***
Union Z	=	***

Dear ***:

This is in response to a letter dated ***, submitted by your authorized representative, supplemented by correspondence dated, ***, ***, ***, and facsimiles dated *** and *** for a ruling concerning the federal income tax treatment under Internal Revenue Code (the "Code") section 414(h)(2) of certain contributions to Plan X.

Your authorized representative submitted the following facts and representations:

Employer M is a governmental agency established under the laws of State A to provide schools and other educational services to the residents of City E.

In the course of collective bargaining in ***, Employer M proposed to the unions representing its employees that the two defined contribution plans it maintains for its employees be amended to provide, among other things, that Employer M would no longer make contributions of *** percent of each participant's compensation to either plan, the employees would be required to make mandatory contributions to those plans in that amount, and Employer M would treat those amounts as pick up contributions. Employer M's and Union Z's agreement to the above changes are set forth in Agreement C, which you represent has been finalized. Agreement C provides that if the existing plans maintained by Employer M were not amended to reflect the proposed changes, Employer M would establish another plan that provides for the employer pick up of the employees' mandatory contributions. The new plan established by Employer M is Plan X.

Employer M adopted Plan X, effective as of ***. Plan X is a money purchase pension plan qualified under Code section 401(a). Plan X contributions are invested, at the direction of each Group B Employee, in one or more annuity contracts as described in section *** of Plan X. Plan X's most recent favorable determination letter is dated ***.

Agreement C provides that all Group B Employees must elect whether to participate in Plan X. In a letter dated ***, Employer M represented that it would adhere to the following procedure with respect to Group B Employees' election to participate in Plan X: (1) Each eligible Group B Employee will have until the second anniversary of his or her date of hire (or date of Plan X eligibility, if later) to elect to participate in Plan X. Failure to make an election before that date will be deemed an election not to participate in Plan X. A Group B Employee's election with respect to Plan X participation will be irrevocable; and (2) Group B Employees who became eligible to participate in Plan X before ***, but have not elected to do so will have until the later of *** or the date described in (1) to elect to participate in Plan X. The election to participate is a one time irrevocable election.

Section *** of Plan X provides, in pertinent part, that each active Group B Employee is required to make a mandatory contribution of a specified percentage of his or her compensation to Plan X. For Group B Employees who are covered by a collective bargaining agreement, the contribution percentage shall be specified in the current agreement. For all other Group B Employees, the contribution percentage shall be established by Employer M. Employer M shall pay each Group B Employee's contribution to Plan X as a "pick-up" contribution under Code section 414(h)(2) and shall reduce its payment of compensation to the Group B Employee by an equal amount. Section *** further provides that under no circumstances may a Group B Employee elect to receive his or her contribution amount as a cash payment of compensation.

To implement the pick up of the Group B Employee's mandatory contributions, the President of Board Y, on behalf of Employer M, enacted Resolution N on ***. Resolution N acknowledges that Employer M and Union Z have agreed, that effective ***, contributions to Plan X will be designated as Group B Employee contributions and will be paid by Employer M as salary reduction pick-up contributions pursuant to Code section 414(h)(2). Section *** of Resolution N provides, that with respect to compensation earned on or after ***, Employer M shall pick up

under the provisions of section 414(h)(2) of the Code and pay the contributions which each Group B Employee is required to make to Plan X and that each Group B Employee's compensation paid by Employer M shall be reduced by an equal amount. Resolution N further provides that although the contributions so picked up are designated as Group B Employee contributions, such contributions shall be treated as contributions paid by Employer M in lieu of contributions by the Group B Employee in determining the tax treatment under the Code and such picked up contributions shall not be includable in the gross income of the Group B Employee until such amounts are distributed or made available to the Group B Employee or his or her beneficiary. Group B Employees participating in Plan X do not have any option to choose to receive the contributions so picked up directly.

Based on the foregoing facts and representations, your authorized representative has requested the following rulings:

1) The mandatory contributions that are assumed and paid by Employer M through a reduction in employees' compensation, although designated as employee contributions pursuant to the Plan X, will be treated as employer contributions and will qualify as picked-up contributions under section 414(h)(2) of the Code.

2) Picked-up mandatory contributions to Plan X made through a reduction of an employee's salary will not be included in the employee's gross income until paid or distributed.

3) Picked-up mandatory contributions to Plan X will be excepted from wages under section 3401(a)(12)(A) of the Code and will therefore not be subject to federal income tax withholding in the taxable year in which they are contributed to Plan X.

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' 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.

In this request, Resolution N satisfies the criteria set forth in Rev. Rul. 81-35 and Rev. Rul. 81-36, by specifically providing that contributions to Plan X will be designated as Group B Employee contributions and will be paid by Employer M as salary reduction pick up contributions; that although the contributions so picked up are designated as Group B Employee contributions, such contributions shall be treated as paid by Employer M in lieu of contributions by the Group B Employee in determining the tax treatment under the Code and that the Group B Employee participating in Plan X does not have any option to choose to receive the contributions so picked up directly.

Accordingly, we conclude with respect to the ruling requests that the amounts picked up by Employer M on behalf of Group B Employees who participate in Plan X shall be treated as employer contributions and will not be includible in the Group B 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 Group B 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 purposes. In addition, no part of the amounts picked up by Employer M will constitute wages for federal income tax purposes in the taxable year in which they are contributed to Plan X.

This ruling is based on the condition that a Group B Employee who makes a one-time irrevocable election to participate in Plan X within Employer M's prescribed election period may not subsequently alter or amend this election to participate in Plan X. This ruling is also based on the condition that a Group B Employee who makes a one-time irrevocable election not to participate in Plan X within Employer M's prescribed election period may not subsequently alter or amend this election to not participate in Plan X. Further, a Group B Employee who fails to make an affirmative election to participate in Plan X within Employer M's prescribed election period is deemed to have elected to not participate in Plan X. This deemed election to not participate in Plan X is treated as the one time irrevocable election for such Group B Employee and, for purposes of this ruling and the conclusions reached under Code section 414(h)(2), may not be subsequently altered or amended.

This ruling is based on Resolution N as submitted with your correspondence dated *** and Employer M's election to participate procedures as set forth in your correspondence dated ***.

These rulings apply only if the effective date for the commencement of the pick up is not earlier than the later of the date Resolution N was signed by Employer M, or the date the pick up 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 Code section 3121(v)(1)(B).

This letter is directed only to the taxpayer that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Pursuant to a power of attorney on file with this office, a copy of this ruling letter is being sent to your authorized representative.

If you have any questions regarding this ruling, please contact ***, T:EP:RA:T2, at ***.

Sincerely,

(signed) JOYCE E. FLOYD

Joyce E. Floyd, Manager
Employee Plans Technical Group 2
Tax Exempt and Government
Entities Division

Enclosures:
Deleted copy of ruling letter
Notice of Intention to Disclose Form 437