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

200419033

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

U.I.L. 414.09-00

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FEB 11 2004

SE:T:EP:RA:T2

Attn: **********

Legend
Employer M = **********
State A = **********
Group N Employees = **********
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Statute P = **********
Statute Q = **********
Statute R = **********
Statute S = **********
Plan X = **********
Proposed Resolution N = **********
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Dear Mr. **********

This is in response to a ruling request dated October 2, 2003, as supplemented by correspondence dated December 11, 2003, and December 17, 2003, submitted on your behalf by your authorized representative, concerning the federal income tax treatment, under section 414(h)(2) of the Internal Revenue Code ("Code"), of certain contributions to Plan X.

The following facts and representations have been submitted by your authorized representative:

Employer M, a government employer in State A, established Plan X, pursuant to the statutory authority granted to municipalities in State A by Statute P. Statute P provides that in each municipality, such as Employer M, as defined in Statute Q, the city council or the board of trustees shall establish and administer a pension fund for the benefit of its Group N Employees and their beneficiaries. You represent that Plan X meets the requirements for qualification set forth in Code section 401(a).

Statute R provides that each Group N Employee shall contribute to Plan X, beginning January 1, 2001, 9.91 percent of his or her salary to Plan X.

Statute S provides that a municipality, such as Employer M, may pick up the Group N Employees' contributions required by Statute R. If a municipality decides not to pick up the contributions, the required contributions shall continue to be deducted from salary. Statute S further provides that if contributions are picked up, they shall be treated as employer contributions in determining the tax treatment under the Internal Revenue Code. Statute S

also provides that a municipality shall continue to withhold Federal and State income taxes based on these contributions until the Internal Revenue Service or the Federal courts rule that pursuant to section 414(h) of the Code, these contributions shall not be included as gross income to the Group N Employees until such time as they are distributed or made available. The municipality shall pay these contributions from the same source of funds which is used to pay the salaries of the Group N Employees. Employer M may pick up these contributions by a reduction in the cash salary of the Group N Employees or by an offset against a future salary increase or by a combination of both. To effectuate the pickup as provided for in Statute S, Employer M, in correspondence to the Service dated December 17, 2003, submitted Proposed Resolution N, which Employer M represents will be adopted as soon as possible.

Proposed Resolution N, in pertinent part, provides that Employer M shall pick up the Group N Employees' contributions to Plan X in accordance with Statute S; that the contributions, although designated as Group N Employee contributions, are being paid by Employer M in lieu of contributions by the Group N Employees; that the Group N Employees' current cash salaries will be reduced by an amount equal to the amount picked up by Employer M; and that the Group N Employees will not be given the option to receive cash directly in lieu of the contributions.

Based on the aforementioned facts, you request the following rulings:

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

2. 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 determined to be qualified under 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.

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, Proposed Resolution N satisfies the criteria set forth in Rev. Rul. 81-35 and Rev. Rul. 81-36, by providing that Employer M will make contributions to Plan X in lieu of contributions by the Group N Employees. In addition, Proposed Resolution N provides that the Group N Employees participating in Plan X will not be given the option to receive the contributed amounts directly in lieu of having such contributions paid by Employer M to Plan X.

Accordingly, we conclude with respect to ruling requests numbers 1 and 2 that the amounts picked up by Employer M on behalf of the Group N Employees who participate in Plan X shall be treated as employer contributions and will not be includible in the Group N 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 the Group N 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 withholding purposes. In addition, no part of the amounts picked up by Employer M will constitute wages for federal income tax withholding purposes in the taxable year in which they are contributed to Plan X.

These rulings apply only if the effective date for the commencement of the pick-up is no earlier than the later of the date Proposed Resolution N is signed or the date the pick-up is put into effect. This ruling is based on Proposed Resolution N as set forth in your letter dated December 17, 2003, and is contingent upon Employer M adopting Proposed Resolution N.

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

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 and distributions.

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).

These rulings are directed only to the taxpayer who requested them. Section 6110(k)(3) of the Code provides that they may not be used or cited by others as precedent.

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A copy of this letter has been sent to your authorized representative in accordance with the power of attorney on file with this office.

If you have questions regarding this ruling, you may contact **********, SE:T:EP:RA:T:2, at **********.

Sincerely yours,

(signed) JOYCE E. FLOYD
Joyce E. Floyd, Manager
Employee Plans Technical Group 2

Enclosures:
Deleted copy of this letter and Notice 437