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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Uniform Issue List: 414.09-00

SEP 13 2004

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ATTN: ***

LEGEND:

Employer M	=	***
State A	=	***
Plan X	=	***
Statute P	=	***
Group N Employees	=	***
Ordinance O	=	***

Dear ***:

This is in response to a letter dated April 19, 2004 for a ruling concerning the federal income tax treatment under Internal Revenue Code (Code) section 414(h)(2) of certain contributions to Plan X.

You have submitted the following facts and representations:

Employer M, a governmental employer, is a special taxing district of State A. Employer M established and created Plan X in accordance with the applicable statutory authority of State A. You state that Plan X meets the qualification requirements of section 401(a) of the Code. The required Group N Employees' contributions to Plan X are currently being deducted from the Group N Employees' gross wages.

Statute P provides that a municipality, such as Employer M, may pick up the Group N Employees' contributions required by applicable State A statute. If a municipality decides not to pick up the contributions, the required contributions shall continue to be deducted from salary. Statute P further provides that if contributions are picked up, they

shall be treated as employer contributions in determining tax treatment under the Internal Revenue Code. Statute P 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 of 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 that 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 pick up as provided in Statute P, Employer M passed Ordinance O on . Section One of Ordinance O provides that, in accordance with Statute P, Employer M will pick up the Group N Employees' contributions to Plan X by a reduction in cash salary of the Group N Employees, an offset against future salary increases or a combination of both. Section Two of Ordinance O states that contributions picked up by Employer M, in accordance with Revenue Rulings 81-35, 1981-1 C.B. 255 and 81-36, 1981-1 C.B. 255, although designated as employee contributions, will be paid by Employer M in lieu of contributions by the employee and that the employee will not be given the option of choosing to receive the amounts directly instead of having them paid by Employer M to Plan X. Participation in Plan X is mandatory for all Group N Employees.

Based on the aforementioned facts and representations, 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.

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' 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.

This 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. 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, Ordinance O satisfies the criteria set forth in Rev. Rul. 81-35 and Rev. Rul. 81-36, by specifically providing that contributions to Plan X, although designated as Group N Employee contributions, will be paid by Employer M; that although the contributions so picked up are designated as Group N Employee contributions, such contributions shall be treated as paid by Employer M in lieu of contributions by the Group N Employee in determining the tax treatment under the Code; and that the Group N Employees participating in Plan X do not have any option to choose to receive the contributions so picked up directly in lieu of having them paid by Employer M to Plan X. For purposes of Code section 414(h)(2), it is immaterial whether Employer M picks up these contributions through a reduction in salary, an offset against future salary increases, or a combination of both.

Accordingly, we conclude with respect to ruling requests one and two 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 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.

This ruling is based on Ordinance O as submitted with your correspondence dated April 19, 2004.

This ruling applies only if the effective date for the commencement of the pick up is not earlier than the later of the date Ordinance O was signed by Employer M, or the date the pick up is put into effect.

The conclusions reached in this ruling are limited to the pick up treatment under Code section 414(h)(2) of Group N Employee contributions made to Plan X pursuant to Statute P and Ordinance O.

This ruling is based on the assumption that Plan X meets the requirements of Code section 401(a) at all times relevant to this transaction.

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).

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.

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

Sincerely,

(signed) JOYCE E. FLOYD

Joyce E. Floyd, Manager
Employee Plans Technical Group 2

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