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TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

MAY 12 2005

T:EP:RA:T4

Uniform Issue List 414.07-00

Attn:

Legend:

Employer A =

State B =

Plan X =

Statute M =

Dear:

This is in response to a ruling request dated November 16, 2004, as supplemented by correspondence, dated February 4, 2005 and March 8, 2005, from your authorized representative, concerning the pick up of certain employee contributions to Plan X under section 414(h)(2) of the Internal Revenue Code (the "Code").

The following facts and representations have been submitted:

Employer A, a political subdivision of State B, sponsors Plan X for the benefit of certain of its public transportation employees. Plan X meets the qualification requirements of Code section 401(a).

Statute M enabled Employer A to establish and maintain Plan X. Under Plan X, Employer A is required to withhold a certain percentage of each employee's salary who participates in Plan X and pay the amount withheld directly to Plan X.

Plan X provides that Employer A may elect to reduce the current salary of Plan X participants and pay the mandatory employee contribution directly to Plan X in lieu of contributions by the individual participants.

The Retirement Allowance Committee adopted an amendment (sec. 7.6) to Plan X on [redacted] which provided for the pick-up of mandatory employee contributions by Employer A. The plan amendment provides, in part, that: Employer A shall pick up the mandatory contribution to Plan X; Employer A shall reduce eligible employees' current salary by the amount picked up by Employer A; and employees of Plan X shall not be given the option to receive cash directly in lieu of contributions. The pick-up of contributions was implemented under Plan X by Employer A in [redacted].

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

1. That the mandatory employee contributions "picked up" by Employer A shall be excluded from the gross income of eligible participants in the taxable year in which they are contributed.

2. The "picked up" contributions paid by Employer A will be treated as employer contributions for federal income tax purposes.

3. That the "picked up" contributions paid by Employer A are not wages from which tax must be withheld under section 3401(a)(12)(A) of the Code for the taxable year in which contributed to Plan X.

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 Code 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 Code 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.

The issue of whether contributions have been picked up by an employer within the meaning of Code section 414(h)(2) is addressed in Rev. Rul. 81-35, 1981-1 C.B. 255 and Rev. Rul. 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 Rev. Rul. 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 Rev. Ruls. 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.

The amendment to Plan X satisfies the criteria set forth in Code section 414(h)(2) and Rev. Ruls. 81-35, and 81-36 by providing that Employer A will make contributions in lieu of contributions by eligible employees and that no employee will have the option of receiving the contribution instead of having it contributed to Plan X.

Accordingly, we conclude the amounts picked up by Employer A for employees shall be treated as employer contributions and will not be includable in employees' gross income for the taxable year in which such amounts are contributed.

Because we have determined that the picked up amounts are to be treated as employer contributions, they are excepted from wages as defined in Code section 3401(a)(12)(A) for Federal income tax withholding purposes. Therefore, no withholding of Federal income tax is required from employees' salaries with respect to such picked up amounts.

This ruling is based on the assumption that Plan X will be qualified under Code section 401(a) at the time of the proposed transactions.

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 amendment, 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 Code section 3121(v)(1)(B).

This ruling is directed only to the taxpayer who requested it. Code section 6110(k) provides that it may not be used or cited by others as precedent.

For any questions regarding this ruling, please contact.....

A copy of this ruling is being sent to your authorized representative pursuant to a power of attorney on file in this office.

Sincerely yours,

/s/ Ada Perry

for Donzell Littlejohn, Manager
Employee Plans
Technical Branch 4