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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

JUN 3 2005

Uniform Issue List: 414.09-00

Attn:

Legend:

Employer A =

State B =

Plan X =

Statute C =

Dear [redacted] :

This is in response to a ruling request dated October 26, 2004, as supplemented by additional correspondence dated December 28, 2004, January 19, 2005, and May 9, 2005, concerning the pick up of certain employee contributions to Plan X under section 414(h)(2) of the Internal Revenue Code ("Code").

The following facts and representations have been submitted:

Statute C of State B requires Employer A, a municipality of State B, to establish and maintain a pension plan for the benefit of certain of its employees which complies with the provisions set forth in Statute C. Pursuant to Statute C, Employer A adopted Plan X, a pension plan as prescribed in Statute C, for the benefit of certain of its employees. Plan X requires mandatory employee contributions and is qualified under Code section 401(a).

Statute C provides that a municipality may pick up the mandatory employee contributions within the meaning of Code section 414(h)(2). If contributions are picked up, Statute C provides that they shall be treated as employer contributions for federal income tax purposes.

Under Statute C and pursuant to a proposed resolution, Employer A has agreed to pick up, i.e., assume and pay, the mandatory employee contributions for Plan X participants. This resolution provides that the contributions, although designated as employee contributions, will be paid by the employer in lieu of contributions by the employee and the employee will not be given the option of choosing to receive the contributed amounts directly instead of having them paid by the employer to Plan X.

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

1) No part of the mandatory contributions picked up by Employer A on behalf of the employees participating in Plan X will be includable in the gross income of the employees for purposes of federal income tax treatment until distributed.

2) The contributions, whether picked up by salary reduction, offset against future salary increases, or both, and though designated as employee contributions, will be treated as employer contributions.

3) The contributions picked up by Employer A will not constitute wages from which federal income tax must be withheld.

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 for federal income tax purposes 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 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.

Employer A's proposed resolution satisfies the criteria set forth in Revenue Ruling 81-35 and Revenue Ruling 81-36 by providing that Employer A will pick up and make contributions to Plan X in lieu of contributions by participating employees and that no such employee will have the option of receiving the contribution in cash instead of having such contribution paid to Plan X.

Accordingly, we conclude that:

1) No part of the mandatory contributions picked up by Employer A on behalf of the employees participating in Plan X will be includable in the gross income of the employees for purposes of federal income tax treatment until distributed.

2) The contributions, whether picked up by salary reduction, offset against future salary increases, or both, and though designated as employee contributions, will be treated as employer contributions.

3) The contributions picked up by Employer A will not constitute wages from which federal income tax must be withheld.

The effective date for the commencement of any proposed pick up as specified in the final resolution cannot be any earlier than the later of the date the final resolution is signed or put into effect.

This ruling is based on the assumption that Plan X is qualified under Code section 401(a) at all relevant times.

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.

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[redacted]

Sincerely yours,

Carlton A. Watkins

Manager
Employee Plans Technical Group 1

Enclosures:
Deleted Copy of the Ruling
Notice 437

cc: