TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

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AUG 12 2005

SE:T:EP:RA:T2

U.I.L. 414.09-00

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Attn: **********
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LEGEND:

Employer A = **********

City C = **********

State B = **********

Plan X = **********

Group N Employees = **********

Resolution R = **********

Dear **********:

This is in response to a ruling request dated June 6, 2005, as supplemented by correspondence dated August 2, 2005, submitted on your behalf by your authorized representative, concerning the federal income tax treatment of certain contributions to Plan X under section 414(h)(2) of the Internal Revenue Code (the "Code").

The following facts and representations have been submitted on your behalf:

Employer A is a political subdivision of State B and the governmental employer of Group N Employees. Plan X, a defined benefit plan, was adopted by Employer A on April 14, 1969 for the benefit of its Group N Employees. Plan X has been amended and restated several times and received its last determination letter dated May 25, 2004, pertaining to certain amendments executed by Employer A on February 18, 2002. Plan X requires that, as a condition of employment, each Group N Employee shall contribute to Plan X by payroll deduction an amount equal to three and one-half percent of the participant's compensation subject to federal social security taxation under Code section 3101(a) and five percent of the participant's compensation that is in excess of the amount subject to federal social security taxation under Code section 3101(a). You represent that Plan X meets the qualification requirements set forth in section 401(a) of the Code.

In February 2005, Employer A decided to implement a pick up of the mandatory employee contributions that Group N Employees are required to make to Plan X. On February 21, 2005, Employer A approved Resolution R which authorizes the pick up of mandatory Group N Employees' contributions pursuant to Code section 414(h)(2).

Resolution R recognizes that Employer A maintains Plan X and desires to pick up the Group N Employees' mandatory contributions to Plan X pursuant to Code section 414(h)(2). Resolution R specifically provides that any such program to pick up the Group N Employee contributions shall provide that all mandatory employee contributions designated as such made on or after the effective date of Resolution R shall be paid or "picked up" by Employer A in lieu of contributions by the Group N Employees and thereafter treated as employer contributions for federal income taxation purposes within the meaning of Code section 414(h)(2). The contributions may be paid or picked up by a reduction in the cash salary, by an offset against future salary increases or a combination of both. Resolution N further provides that Group N Employees shall not have the option of choosing to receive the picked up contributions directly in lieu of having them paid by Employer A to Plan X. Resolution R also states that contributions made to Plan X prior to the effective date of Resolution R shall not be affected by the pick up.

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

1. That no part of the mandatory Group N Employees' contributions picked up by Employer A be included in the gross income of Group N Employees for federal income tax purposes.

2. That the Group N Employees' contributions picked up by Employer A will not constitute wages from which taxes must be withheld.

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 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.

In this request, Resolution R satisfies the criteria set forth in Rev. Rul. 81-35 and Rev. Rul. 81-36, by specifically providing that Employer A will pick up the Group N Employees' contributions now being paid by the Group N Employees to Plan X; that the contributions, although designated as employee contributions, are in lieu of contributions by the Group N Employees; and that the Group N Employees do not have the option of choosing to receive the contributed amounts directly instead of having them paid by Employer A to Plan X.

Accordingly, we conclude, with respect to ruling requests numbers one and two, that the amounts picked up by Employer A 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 A. 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.

For purposes of the application of Code section 414(h)(2), 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 apply only if the effective for the commencement of the pick up is no earlier than the later of February 21, 2005, the date that Resolution R, as submitted with your correspondence dated June 6, 2005, was adopted, approved and signed by the Mayor of City C (Employer A), or the date the pick up is put into effect.

These rulings are based on the assumption that Plan X meets the requirements for qualification under section 401(a) of the Code at the time of the proposed contributions and distributions.

This ruling is limited to the tax treatment of the proposed contributions under Code section 414(h)(2). No opinion is expressed a to the tax treatment of the transactions described herein under the provisions of any other section of either the Code or regulations, which may be applicable thereto.

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 it. Section 6110(k)(3) of the Code provides that they may not be used or cited by others as precedent.

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:T2.

Sincerely yours,

[redacted]

Joyce E. Floyd, Manager
Employee Plans Technical Group 2

Enclosures:
Deleted copy of this letter ruling
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