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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

SIN 414.09-00

MAY 20 2003

T:EP:RA:UR

ATTN: ...
Director, Employee Services

LEGEND:

Employer M =

State A =

Plan X =

Group B Employees =

Group C Employees =

City D =

Amendment O =

Dear :

This letter is in response to a request for a private letter ruling dated March 27, 2002, supplemented by additional correspondence dated January 31, 2003 and March 20, 2003, submitted on your behalf by your authorized representative, regarding the federal income tax treatment

of certain contributions to Plan X under section 414(h) of the Internal Revenue Code (the "Code").

The following facts and representations have been submitted:

Employer M is a political subdivision of State A. Employer M has two classes of employees, Group B Employees and Group C Employees. Group B Employees are management staff employees who are exempt from the civil service system, are not covered by collective bargaining agreements and serve under Employer M's Board of Directors or the managing director and chief executive officer. Both Group B and Group C Employees are covered by a defined benefit plan co-sponsored by City D. Effective January 1, 2002, Employer M established Plan X to provide a supplemental benefit to Group B Employees and Plan X currently covers only Group B Employees. Plan X is intended to be qualified under section 401(a) of the Code.

Plan X is a defined contribution plan that provides for employer and employee contributions. Section 2.2, as amended effective April 1, 2003, provides that an eligible Group B Employee, upon satisfying the conditions set forth in this Section 2.2 shall become a participant immediately and shall be eligible to receive contributions made by Employer M pursuant to section 4.1(a) of Plan X, and shall be eligible to make the election described in section 3.1

Section 4.1 of Plan X provides that Employer M shall make a contribution to Plan X on behalf of each Group B Employee equal to ten percent of the Group B Employee's One-Time Performance Pay incentive amount.

Section 15.5 of Plan X provides that the Board of Directors of Employer M may modify or amend in whole or part any or all of the provisions of Plan X. Pursuant to this authority, Employer M has proposed the following amendment, Amendment O, to section 3.1 of Plan X. Amendment O is effective April 1, 2003.

Amendment O provides that upon meeting the eligibility requirements of Article II, a Group B Employee may make a one-time irrevocable election to have mandatory contributions made to Plan X by electing salary reduction in the amount of 0%, 2%, 5%, 10% or 20% of salary or wages to be paid by Employer M into Plan X. Upon meeting the eligibility requirements of Article II, a Group B Employee may make a one-time irrevocable election to have mandatory contributions made to Plan X by electing a reduction in the

amount of 0%, 10%, 25%, 50%, or 100% of the Group B Employee's One-Time Performance Pay incentive to be paid by Employer M into Plan X. The Group B Employee's contribution elections under this Section 3.1 shall be irrevocable and shall remain in force until the Group B Employee ceases to be an eligible Group B Employee under Article II or terminates employment with Employer M. Group B Employee contributions, although designated as employee contributions under this Section 3.1, are being paid by Employer M in lieu of contributions by the Group B Employees. Such Group B Employee contributions shall be designated as employer pick up contributions pursuant to Code section 414(h). A Group B Employee shall not have the option of receiving cash in lieu of the contributions that are elected by such Group B Employee pursuant to this Section 3.1, designated as employer contributions, and picked up pursuant to Code section 414(h).

A Group B Employee's election to have mandatory contributions made to Plan X pursuant to this Section 3.1 shall be made no longer that 24 months following the date they become first eligible to participate pursuant to Section 2.1. For a Group B Employee who met the eligibility requirements of Section 2.1 as of Plan X's effective date, the 24-month election period to have mandatory contributions made to Plan X shall commence as of Plan X's effective date. All Group B Employee contribution elections pursuant to this Section 3.1 shall be made at the same time.

A Group B Employee is permitted only one irrevocable election to make mandatory contribution during the 24-month election period pursuant to this Section 3.1. A Group B Employee's election to contribute 0% of salary, wages or annual One-Time Performance Pay incentive may not be subsequently altered or amended.

A Group B Employee who fails to make an election to contribute a percentage of salary, wages or annual One-Time Performance Pay incentive during the 24-month election period shall be deemed to have elected to contribute 0% of salary, wages, or annual One-Time Performance Pay, and may not subsequently elect to make a contribution to Plan X.

Section 3.2 of Plan X provides that Group B Employee contributions may be paid into Plan X only by means of employer pick up, which each Group B Employee shall authorize through a salary reduction agreement. Section 3.3 of Plan X provides that salary deductions shall begin no later than the first payday of the first month which begins at least 10 days after receipt by Employer M of the approved

salary reduction agreement from Employer M's Administrative Committee.

On March 20, 2003, Employer M's Director of Employee Services made the following representations concerning the pick up of the above-mentioned contributions:

(1) Group B Employees will have a period of no longer than 24 months after the day they become first eligible to participate in Plan X to make the elections under Section 3.1 of Plan X;

(2) Both the election to contribute a percentage of salary and wages and the election to contribute a percentage of annual One-Time Performance Pay incentive will be made at the same time;

(3) A Group B Employee may not make more than one irrevocable election to make contributions to Plan X during the 24-month election period;

(4) A one-time irrevocable election to contribute 0% of salary, wages, or the annual One-Time Performance Pay incentive may not be subsequently altered or amended; and

(5) A Group B Employee who fails to make an election to contribute a percentage of salary, wages, or annual One-Time Performance Pay incentive during the specified 24-month period cannot subsequently elect to make a contribution to Plan X.

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

(1) That the picked up contributions will be treated as employer contributions for federal income tax purposes in accordance with the requirements of section 414(h)(2) of the Code and Revenue Rulings 81-35 and 81-36.

(2) That such contributions to be made to Plan X by Employer M will be excludible from the participating employees' wages for purpose of

federal income tax withholding under section 3401(a)(12)(A) of the Code in the taxable year in which they are contributed to Plan X.

(3) That the picked-up contributions to be made under Plan X by Employer M will not constitute gross income for federal income tax purposes until such time as they are distributed and made available to the participating employees or their beneficiaries to the extent that the picked-up amounts represent contributions made by Employer M.

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 described in section 401(a), established by a state government or a political subdivision thereof, and are picked up by that 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. 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.

Revenue Ruling 87-10, 1987-1 C.B. 136, provides that in order to satisfy Revenue Rulings 81-35 and 81-36, the required specification of designated employee contributions must be completed before the period to which such contributions relate. Thus, employees may not exclude from current gross income designated employee contributions to a qualified plan that relate to compensation earned for services prior to the date of the last governmental action necessary to effect the pick up.

Plan X, as amended by Amendment O, satisfies the criteria set forth in Revenue Ruling 81-35 and Revenue Ruling 81-36 by providing that mandatory contributions made pursuant to Amendment O, although designated as employee contributions, are being made by Employer M in lieu of contributions by the Group B Employees and that the Group B Employees shall not have the option of receiving cash in lieu of the contributions that are elected by Group B Employees, designated as Employer M contributions, and picked up pursuant to section 414(h)of the Code.

Accordingly, assuming Amendment O is adopted and implemented as proposed, we conclude, with respect to rulings number one, two, and three, that the picked up contributions will be treated as employer contributions for federal income tax purposes in accordance with the requirements of section 414(h)(2) of the Code and Revenue Rulings 81-35 and 81-36; that, because we have determined that the picked-up amounts are to be treated as employer contributions, such contributions to be made to Plan X by Employer M will be excludible from the Group B Employees' wages for purposes of federal income tax withholding under section 3401(a)(12)(A) of the Code in the taxable year in which they are contributed to Plan X; and that the picked-up contributions to be made under Plan X by Employer M will not constitute gross income for federal income tax purposes until such time as they are distributed to the Group B Employees or their beneficiaries to the extent the picked-up amounts represent contributions made by Employer M.

For purposes of the application of section 414(h)(2) of the Code, it is immaterial whether Employer M picks up contributions through a reduction in salary, an offset against future salary increase, or a combination of both.

In accordance with Revenue Ruling 87-10, the pick up treatment of designated employee contributions that are picked up pursuant to section 414(h)(2) of the Code will not become effective prior to the date of the last governmental action implementing the pick up. Thus, this ruling does not apply to any contributions to the extent it relates to compensation or the annual One-Time Performance Pay incentive earned by a Group B Employee prior to the date the last governmental action has taken place to implement the pick up arrangement as described in Amendment O.

These rulings apply only if the effective date for the commencement of any proposed pick up as described in Amendment O is not any earlier than the later of the date proposed Amendment O is adopted by Employer M, the date proposed Amendment O becomes effective, or the date of the execution of the salary reduction election form by the Group B Employee and Employer M.

This ruling is based on the assumption that a Group B Employee who elects to make contributions to Plan X pursuant to the terms of Amendment O, as proposed, may not make more that one irrevocable election to make such contributions to Plan X. A one-time irrevocable election to contribute zero percent of salary or wages as defined in Section 1.1(r) of Plan X, and a one-time irrevocable election to contribute zero percent of the One-Time Performance Pay incentive as defined in section 1.1(q) of Plan X are elections that may not subsequently be altered or amended. This ruling is also conditioned on the Group B Employee making the elections described in Amendment O within the appropriate 24-month election period.

These rulings are based on the assumption that Plan X, as amended, meets the requirements for qualification 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 section 3121(v)(1)(B) of the Code.

This ruling is based on Plan X, submitted with your correspondence dated March 27, 2002, and proposed Amendment O, submitted with your letter dated March 20, 2003.

This ruling only addresses the proposed amendment to Plan X that relates to the pick up of contributions pursuant to section 414(h) of the Code. This ruling does not express an opinion as to the status of Plan X under section 401(a) of the Code. The determination as to whether Plan X is qualified under section 401(a) is within the jurisdiction of the Employee Plans Determinations Office of the Internal Revenue Service.

This letter is directed only to the taxpayer that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited by others as precedent.

A copy of this letter is being sent to your authorized representative in accordance with a power of attorney on file in this office.

If you have any questions, please contact T:EP:RA:T2, by telephone at or by fax at ( ) .

Sincerely yours,

Joyce E. Floyd
Manager, Employee Plans
Technical Group 2
Tax Exempt and Government
Entities Division

Enclosures:
Deleted copy of letter ruling
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