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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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UIL 414.09-00

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Attn:

Legend

State A =

Employer M =

Bill H =

Group B Employees =

Plan X =

Plan Y =

Resolution R =

Resolution S =

Dear

This is in response to a ruling request dated June 9, 2003, as supplemented by correspondence dated July 1, 2003, and September 4, 2003, submitted on your behalf by your authorized representative, concerning the federal income tax treatment, under section 414(h)(2) of the Internal Revenue Code ("Code"), of certain contributions to Plan X.

The following facts and representations have been submitted in support of your ruling request.

Employer M is a tax–exempt public body corporate and politic of State A which was established as a regional planning and development agency to facilitate regional planning and development. Employer M is exempt from tax under section 501(a) of the Code as an organization described in section 501(c)(3).

In 1988, the General Assembly of State A enacted legislation that permits employers to "pick up" mandatory employee contributions paid to Plan X so that these contributions may be exempt from federal taxation under section 414(h)(2) of the Code. Bill H, passed by the State A General Assembly and signed into law by the governor of State A in 1999, opened participation in the contributory pension system to all governmental units that offer state retirement and pension system benefits to their employees. You state that the contributory pension system is not a new plan but rather a modification of the Plan X and Plan Y, both of which you represent as meeting the requirements for qualification under Code section 401(a) and their respective trusts tax exempt under Code section 501(a). You further state that Bill H amended and restated both plans setting forth the Code section 414(h) arrangement. In your communication dated September 4, 2003, you describe Plan X as a contributory plan and Plan Y as a defined benefit plan.

Resolution R, as signed by the Chairman of Employer M on May 21, 2003, acknowledges that Employer M was established through State A legislation and is therefore eligible to participate in Plan X and has determined that it is advisable to participate in such plan and shall participate in Plan X effective July 1, 2003.

Resolution S, as signed by the chairman of Employer M, acknowledges that State A statutes permit employers who participate in Plan X to "pick-up" employee contributions, thus exempting those contributions from Federal taxation; that Employer M has elected to treat the mandatory employee contributions of two percent of Group B Employees' annual salary as paid (picked-up) by Employer M; and further resolved that Employer M shall pick-up the retirement contribution required to be made by the Group B Employee and will consider this amount as an employer contribution for Federal tax purposes only and therefore no Group B Employee will have access to these funds. Resolution S further provides that Group B Employee contributions will be paid by Employer M in lieu of contributions being paid by Group B Employee and the Group B Employee will not have

the option of receiving the pick-up contribution in cash instead of having the contribution paid to Plan X.

You describe the contributory pension system as a salary reduction plan that requires a mandatory two percent employee contribution. In letters dated July 1, 2003 and September 4, 2003, you stated that you are only asking for a ruling for the pick-up treatment of the mandatory employee contribution of two percent of compensation as authorized under Bill H, and that you are not asking for a ruling pertaining to Plan Y, the defined benefit plan.

Based on the above facts and representations, the following rulings are requested, as restated in your correspondence dated September 4, 2003:

1. That the amounts picked up by Employer M, as the employer on behalf of contributing Group B Employees shall not be included in the gross income of the Group B Employee on whose behalf the "pick-up" is made.

2. That the mandatory Group B Employee contributions picked up by Employer M, as employer, will be treated as employer contributions for purposes of section 414(h)(2) of the Code and will not constitute wages for federal income tax withholding purposes.

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 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 order to satisfy Revenue Ruling 81-35 and Revenue Ruling 81-36 with respect to particular contributions, Revenue Ruling 87-10, 1987-1 C.B. 136, provides that the required specification of designated employee contributions must be completed before the period to which such contributions relate. If not, the designated employee contributions being paid by the employer are actually contributions paid by the employee and recharacterized at a later date. 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.

In this case, Resolution S satisfies the criteria set forth in Rev. Rul. 81-35 and Rev. Rul. 81-36, by specifically providing that Employer M has elected to treat the mandatory Group B Employee contribution of two percent of their annual salary as paid (picked-up) by Employer M; that Employer M shall pick up the retirement contribution required to be paid by the Group B Employee and will consider this amount as an employer contribution for Federal Tax purposes only and that no Group B Employee will have access to these funds. Resolution S further provides that Group B Employee contributions will be paid by Employer M in lieu of contributions being paid by the Group B Employee and the Group Employee will not have the option of receiving the pick-up contribution in cash instead of having the contribution paid to Plan X.

Accordingly, with respect to ruling requests one and two, we conclude that the amounts picked up by Employer M, as the employer, on behalf of Group B Employees will not be included in the gross income of Group B Employees on whose behalf the "pick –up" is made and the mandatory Group B Employee contributions picked up by Employer M, as employer, will be treated as employer contributions for purposes of section 414(h)(2) of the Code and will not constitute wages for federal income tax withholding purposes. These amounts will be includible in the gross income of Group B Employees or their beneficiaries only 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 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.

The effective date for the commencement of any pick up of employee contributions in Plan X cannot be any earlier than the later of the date Resolution S is adopted or the date the pick- up is put into effect. This ruling is based on Resolution S as submitted with your correspondence dated June 9, 2003.

This ruling is based on the assumption that Plan X will be qualified under section 401(a) of the Code at the time of the proposed contributions and distributions. This ruling is further limited to the pick up treatment under Code section 414(h)(2) of the two percent mandatory employee contribution made pursuant to the provisions of Bill H and Resolution S. The conclusions reached in this ruling do not apply or address the federal income tax treatment under Code section 414(h)(2) of any other pick up feature in Plan X or Plan Y as those provisions may relate to Employer M and the Group B Employees described herein by virtue of Employer M's eligibility to participate in those retirement systems or any other State A sponsored retirement system.

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 directed only to the taxpayer who 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 ruling letter has been sent to your authorized representative in accordance with the power of attorney on file with this office.

If you have any questions, please contact , at

Sincerely yours,

(signed) JOYCE E. FLOYD
Joyce E. Floyd, Manager
Employee Plans Technical Group 2

Enclosures:

Deleted copy of ruling letter
Notice 437

cc: