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

Date: December 11,2003

Uniform Issue List: 414.09-00

T:EP:RA:T1

LEGEND:

State A = ***

Employer B = ***

Statute C = ***

Resolution R = ***

Plan X = ***

Dear ***:

This is in response to a ruling request dated February 5, 2003, as supplemented by additional information submitted April 2, 2003, concerning the pick up of employee contributions to Plan X under section 414(h)(2) of the Internal Revenue Code ("Code").

The following facts and representations have been submitted:

Participation in Plan X, a retirement system sponsored by State A, is mandatory by all employees of participating employers. All eligible employees of Employer B participate in Plan X. Plan X requires mandatory employee contributions equal to two per cent of compensation from all eligible employees. It has been represented that Plan X meets the qualification requirements of section 401(a) of the Code.

Employer B has adopted Resolution R which provides that Employer B will pick up the mandatory employee contributions to Plan X within the meaning of Code section 414(h)(2). Resolution R states that the contributions, although designated as employee

contributions, are being paid by the employer in lieu of contributions by the employee. In addition, the employees will not have the option of receiving the picked-up contributions in cash instead of having the contributions paid by Employer B to Plan X. Resolution R also provides that State A has enacted legislation, Statute C, which enables employers that participate in Plan X to pick up and pay the mandatory employee contributions to Plan X.

Statute C provides that a participating employer in Plan X that has received a favorable ruling from the Internal Revenue Service ("Service") for an employer pick-up program in accordance with Code section 414(h)(2) shall pick up the employee contributions required by Plan X. Under Statute C, the contributions, designated as employee contributions, to be picked up by the employing unit within the meaning of section 414(h)(2) shall be treated as employer contributions for federal income tax purposes; the employee's compensation must be reduced by the amount of the mandatory employee contribution; and the picked-up amounts shall not be included in gross income of the employee until such amounts are distributed.

Based on the aforementioned facts and representations you request the following ruling:

No part of the mandatory employee contributions to Plan X picked up by Employer B on behalf of eligible employees will constitute taxable income to such employees in the year of the pick up.

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 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)(l2)(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 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.

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

Accordingly, based on the above facts and representations, we conclude:

No part of the mandatory employee contributions to Plan X picked up by Employer B on behalf of eligible employees will constitute taxable income to such employees in the year of the pick up but such picked-up amounts shall be includable in the gross income of employees in the year of distribution.

Because we have determined that the picked-up amounts are to be treated as employer contributions, they are excepted from wages under Code section 3401(a)(12)(A). Therefore, no part of the amounts that are picked up by Employer B will constitute wages for federal income tax withholding purposes in the taxable year in which they are contributed to Plan X.

In accordance with Rev. Rut. 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 relevant statutes, the date Resolution R 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)(l)(B).

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

This ruling is directed only to the taxpayer that requested it. Code section **61**10(k) provides that it may not be used or cited by others as precedent.

Should you have any concerns with this letter, please contact ***, at ***.

Sincerely yours,

Madan Dua

Madan Dua, Acting Manager
Employee Plans Technical Group **1**