200420033

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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

FEB 18 2004

Uniform Issue List: 414.00-00

Legend:

City A =

Group B Employees =

Proposed Ordinance M =

Plan X =

Dear Mr.

In a letter dated May 19, 2003, as supplemented by correspondence dated November 6, 2003, you requested a ruling concerning the federal income tax treatment of certain contributions to Plan X under section 414(h)(2) of the Internal Revenue Code.

The following facts and representations have been submitted:

Plan X, a defined benefit plan, was established by City A for the benefit of Group B Employees and is intended to meet the requirements of section (401)(a) of the Code. You also represent that Plan X is a governmental plan as specified in section 414(d) of the Code.

Participation in Plan X is mandatory for Group B Employees. Group B Employees must contribute eight percent of their salary to Plan X. Under Proposed Ordinance M, City A shall pickup their mandatory employee contributions.

Proposed Ordinance M provides as follows:

(f) The city shall pick up the member contribution required by subsection (b) of this section for all compensation earned

after the effective date of this subsection. The contributions so picked up shall be treated as employer contributions in determining tax treatment under the United States Internal Revenue Code. The city shall pick up the member contributions from funds established and available in the salaries account, which funds would otherwise have been designated as member contributions and paid to the pension fund. Member contributions picked up by the city pursuant to this subsection shall be treated for all other purposes of this and other laws of the city in the same manner and to the same extent as member contributions made prior to the effective date of this subsection.

Member contributions to the pension fund shall be paid by the city on behalf of all members. Payment of the member's contribution picked up by the city shall be made by reducing the amount of the compensation payable to such members and making payment of such amount directly to the pension fund. Contributions, although designated as member contributions, are being paid by the city in lieu of contributions by the members. Members do not have the option of choosing to receive the contributed amounts directly instead of having them paid by the city to the pension fund.

The effective date of this subsection shall be the first day of the first pay period after the city has received notification of approval from the Internal Revenue Service that, pursuant to Section 414(h) of the United States Internal Revenue Code, the member contributions so picked up shall not be included in gross income for tax purposes until such time as they are distributed by refund or benefit payment, but the effective date shall not be prior to December 15, 2003.

Pursuant to the terms of the Plan and the authority vested in the Plan Administrator, the Plan is authorized to treat all participant contributions to the Plan as having been picked up under Section 414(h)(2) of the Code.

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

1. That no part of the member contributions proposed to be picked-up by City A pursuant to Proposed Ordinance M is includible in the gross income of the affected employees for purposes of the Internal Revenue Code.

2. That a distribution of the amount picked-up on behalf of Group B Employees, either through a retirement pension or lump sum payment, will be considered a distribution of employer contributions taxable at time of receipt by the employee under Section 402 of the Code.

3. Proposed Ordinance M satisfies the requirements of Section 414(h)(2) of the Internal Revenue Code.

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 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 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 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.

Pursuant to Proposed Ordinance M, the criteria set forth in Revenue Ruling 81-35 and Revenue Ruling 81-36 is satisfied by providing, in effect, that Employer B will make contributions in lieu of Group B Employees' contributions and by providing that Group B Employees shall not be given the option to receive such contributions directly.

Accordingly, with respect to ruling requests 1 and 2, we conclude that the mandatory employee contributions picked up by City A on behalf of Group B Employees who are participants in Plan X will be treated as employer contributions for purposes of federal income taxation, and will

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not be included in the Group B Employees' gross income for the year in which such amounts are contributed. These amounts will be includible in the gross income of the Group B Employees or their beneficiaries only in the taxable year in which they are distributed from Plan X.

With respect to ruling request 3, we conclude that contributions under Proposed Ordinance M will have been picked up by an employer within the meaning of Code section 414(h)(2).

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 and, as such, no withholding of federal income tax is required from Group B Employees' salaries with respect to such picked-up contributions.

In accordance with Rev. Rul. 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 the pick-up election 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 section 3121(v)(1)(B) of the Code.

These rulings are 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 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.

If you wish to inquire about this ruling, please contact , I.D. , at . Please address all correspondence to SE:T:EP:RA:T3.

Sincerely yours,

Frances V. Sloan

Frances V. Sloan, Manager
Employee Plans Technical Group 3

Enclosures:
Deleted copy of ruling letter
Notice of Intention to Disclose