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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

NOV 2 2004

U.I.L. 414.09-00

SE:T:ER:RA:T2

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Attn: **********

LEGEND:

City D = **********

State A = **********

Resolution P = **********

Agreement F = **********

System S = **********

Group B Employees = **********

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

Statute E = **********

Statute F = **********

Form N = **********

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

This is in response to a ruling request dated May 21, 2004, and supplemented by correspondence dated October 25, 2004, submitted on your behalf by your authorized representative concerning the federal income tax treatment, under

section 414(h)(2) of the Internal Revenue Code (the "Code"), of certain contributions to Plan X.

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

City D, a municipality, is described as a body corporate and politic, duly organized and existing under the laws of State A. On [redacted], the Mayor and City Commissioners of City D signed Resolution P whereby its Group B Employees voted to participate in Plan X. It has been represented that Plan X is a defined benefit plan qualified under section 401(a) of the Code, and that Plan X is available to all State A and municipal employees, educators, judges, legislators, State A police, fire fighters, and law enforcement personnel. It has been further represented that before a municipal employee can participate in Plan X, his or her employer must first make an election to participate in Plan X. On [redacted], City D and System S signed Agreement F acknowledging City D's participation in Plan X, as set forth in Resolution P, and outlining City D's obligations as a participating governmental unit in Plan X.

Statute E of the Annotated Code of State A describes the contribution rate for participants that are subject to the contributory pension system and provides that the contribution rate of such participant is two percent of the participant's earnable compensation. You describe Plan X as a contributory pension system. Further, you represent that Statute F permits employers, such as City D, to "pick up" the contributions made by its Group B Employees to Plan X.

To implement and effectuate the pick up of the Group B Employees' contributions, the Mayor and City Commissioners of City D adopted Resolution P. Resolution P not only acknowledged the Group B Employees' vote to participate in Plan X, but also contains City D's authorization to pick up the Group B Employees' contributions to Plan X.

Resolution P provides that the Mayor and the City Commissioners of City D have elected to treat the mandatory Group B Employee contributions as being picked up by City D, the employer. Resolution P states that the Mayor and the City Commissioners of City D resolve that City D, the employer, shall pick up the two percent contribution required to be made by the Group B Employee and shall consider this amount to be an employer contribution for Federal tax purposes; that no Group B Employee will have access to these funds; that the Group B Employee contribution, although designated as an employee contribution, shall be paid (picked up) by City D and that the Group B Employee will not be given the option of choosing to receive the contributed amounts directly instead of having them paid by City D to Plan X. Resolution P was adopted by the Mayor and the City Commissioners of City D on [redacted] and was effective [redacted].

Prior to the effective date of Resolution P, City D provided its current Group B Employees an opportunity to elect in writing, on Form N, whether or not to participate in Plan X. In a letter dated October 25, 2004, you state that Group B Employees who elected to participate in Plan X before the effective date of Resolution P became participants in Plan X on [redacted]. You further represent that Group B Employees who did not elect to become participants in Plan X as of the effective date of Resolution P may elect to join Plan X at any time before [redacted]. You further state that all elections are irrevocable. Further, you state that if a Group B Employee fails to elect to participate in Plan X on or before [redacted], that Group B Employee may not subsequently elect to participate in Plan X. Group B Employees hired after [redacted] are required, as a condition of employment, to participate in Plan X.

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

1. That the mandatory contributions made by the Group B Employees and picked up by City D be treated as employer contributions for federal income tax purposes.

2. That the mandatory contributions made by the Group B Employees and picked up by City D will not be included in the current gross income of the Group B Employees for federal income tax purposes.

3. That the mandatory contributions of the Group B Employees picked up by City D will not constitute wages subject to federal income tax withholding.

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) of the Code, established by a state government or 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 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 C.B. 255. These revenue rulings established that the following two criteria must be met: (1) the employer must specify that 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 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 employee contributions paid by the employee and recharacterized at a later date. The retroactive specification of designated employee contributions as paid by the employing unit, i.e., the retroactive "pick-up" of designated employee contributions by a governmental employer, is not permitted under section 414(h)(2) of the Code. Thus, employees may not exclude from current gross income designated employee contributions to a qualified plan that relate to compensation earned for services rendered prior to the date of the last governmental action necessary to effect the pick up.

In this case, Resolution P satisfies the criteria set forth in Revenue Ruling 81-35 and Revenue Ruling 81-36 by specifically providing that City D will pick up the Group B Employee contributions made to Plan X, and although these contributions are designated as employee contributions, City D will pay such contributions in lieu of contributions by the Group B Employees. Resolution P further provides that Group B Employees participating in Plan X will not have the option of choosing to receive the contributions that are picked up directly instead of having them paid by City D to Plan X.

With respect to your first, second, and third ruling requests, we conclude, that the mandatory contributions made by the Group B Employees to Plan X and picked up by City D, as the employer, although designated as Group B Employee contributions, will be treated as employer contributions that are picked up by City D within the meaning of Code section 414(h)(2) and will not be includable in the

Group B Employees' gross income for federal income tax purposes in the year in which they are contributed to Plan X. These amounts will be includable in the gross income of the Group B Employees or their beneficiaries in the taxable year in which they are distributed, to the extent they represent amounts contributed by City D. 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 City D will constitute wages for federal income tax withholding purposes in the taxable year in which they are contributed to Plan X.

It has been represented that Group B Employees hired after [redacted], are required to participate in Plan X as a condition of their employment with City D and therefore, will not have the option to elect whether or not to participate in Plan X. Group B Employees hired before [redacted] were given an opportunity to elect whether or not to participate in Plan X. The following conditions apply to those Group B Employees hired before [redacted]:

1. A Group B Employee who made a one-time irrevocable election to participate in Plan X on [redacted] may not subsequently alter or amend that election to participate in Plan X.

2. A Group B Employee who made an affirmative written election before [redacted] to not participate in Plan X may not subsequently alter or amend that election to participate in Plan X. This election to not participate is considered this employee's one-time irrevocable election for purposes of Code section 414(h)(2) that cannot subsequently be altered or amended.

3. It has been represented that Group B Employees who did not make an affirmative written election to participate or to not participate in Plan X by [redacted], have until [redacted] to make an election as to his or her participation in Plan X. The following applies to elections made by these particular Group B Employees on or before [redacted]: (a) The Group B Employee who makes an affirmative written election to not participate on or before [redacted] may not subsequently elect to participate in Plan X. For purposes of Code section 414(h)(2), this election is this employee's one-time irrevocable election that cannot subsequently be altered or amended. (b) The Group B Employee who affirmatively elects to participate in Plan X on or before [redacted] may not subsequently alter or amend that election.

4. A Group B Employee who fails to make an affirmative written election is deemed to have elected to not participate in Plan X. For this Group B Employee this deemed election to not participate is treated as the one-time irrevocable election for such employee, and for purposes of Code section 414(h)(2), may not be subsequently altered or amended.

These rulings apply only if the effective date for the commencement of any pick up as described in Resolution P is not earlier than the later of the date Resolution P was adopted by the Mayor and the City Commissioners of City D or the date the pick up was put into effect. This ruling is based on Resolution P as submitted with your correspondence dated [redacted].

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).

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

This letter ruling 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 ruling is being sent to your authorized representative in accordance with a Power of Attorney (Form 2848) on file in this office.

If you have any questions, please contact ********** SE:T:EP:RA:T2.

Sincerely yours,

(signed) JOYCE E. FLOYD

Joyce E. Floyd, Manager
Employee Plans Technical Group 2

Enclosures:
Deleted copy of letter ruling
Form 437