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TAX EXEMPT AND GOVERNMENT ENTITIES DIVISION

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

MAY 0 2 2005

T:EP:RA:T2

U.I.L. 414.09-00

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

Legend:

Employer M	= ********************
State A	= ********************
Group N Employees	= ********************
Statute P	= ********************
Statute Q	= ********************
Statute R	= ********************
Statute S	= ********************
Plan X	= ********************
Resolution N	= ********************
Village K	= ********************

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

This is in response to a ruling request dated December 3, 2004 (under a cover letter dated December 14, 2004), as supplemented by correspondence dated March 16, 2005, March 28, 2005, and April 14, 2005, 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 on your behalf:

The Board of Trustees of Employer M, a governmental employer in State A, established Plan X, pursuant to the statutory authority granted to municipalities in State A by Statute P. Statute P provides that in each municipality, such as Employer M, as defined in Statute Q, the city council or the board of trustees shall establish and administer a pension fund for the benefit of its Group N Employees and their beneficiaries. You represent that Plan X is qualified under Code section 401(a) and is exempt from federal income tax under Code section 501(a).

Statute R provides that each Group N Employee shall contribute a certain percentage of his or her salary to Plan X. The mandatory employee contribution rate is 9.91 percent of salary as defined in Statute R.

Statute S provides that a municipality, such as Employer M, may pick up the Group N Employees' contributions required by Statute R. If a municipality decides not to pick up the contributions, the required contributions shall continue to be deducted from salary. Statute S further provides that if contributions are picked up, they shall be treated as employer contributions in determining the tax treatment under the Internal Revenue Code. Statute S also provides that a municipality shall continue to withhold Federal and State income taxes based on these contributions until the Internal Revenue Service or the Federal Courts rule that pursuant to section 414(h) of the Code, these contributions shall not be included as gross income of the Group N Employees until such time as they are distributed or made available. The municipality shall pay these contributions from the same source of funds which is used to pay the salaries of the Group N Employees. Employer M may pick up these contributions by a reduction in the cash salary of the Group N Employees or by an offset against a future salary increase or by a combination of both. On March 15, 2005, Employer M adopted Resolution N to effectuate the pick up of contributions as provided for in Statute S.

Resolution N, in pertinent part, recognizes that Employer M has established Plan X pursuant to Statute P; that Statute R provides that a statutory percentage shall be withheld from the Group N Employees' salaries and paid to Plan X; that mandatory Group N Employee contributions are taxable as current gross income;

and that a municipality, such as Employer M, may pick up the Group N Employees' contributions pursuant to Statute S. Resolution N further provides that the Board of Trustees of Employer M has resolved to pick up the Group N Employees' contributions to Plan X in accordance with Statute S; that the contributions, although designated as Group N Employee contributions, are being paid by Employer M in lieu of contributions by the Group N Employees; and that the employee contribution is a mandatory contribution whereby the Group N Employee shall not have the option of choosing to receive the contributed amounts directly instead of having them paid by Employer M to Plan X.

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

1. That no part of the mandatory contributions picked up by Employer M, as the employer of the Group N Employees, will be included in the gross income of Group N Employees for federal income tax purposes pursuant to Code section 414(h)(2).

2. That the contributions picked up by Employer M will not constitute wages from which taxes must be withheld.

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 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 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.

In this request, Resolution N satisfies the criteria set forth in Rev. Rul. 81-35 and Rev. Rul. 81-36, by specifically providing that Employer M will pick up the Group N Employees' contributions now being paid by the Group N Employees to Plan X; that the contributions, although designated as employee contributions, are in lieu of contributions by the Group N Employees; and that the Group N Employee shall not have the option of choosing to receive the contributed amounts directly instead of having them paid by Employer M to Plan X.

Accordingly, we conclude with respect to ruling requests number 1 and 2, that the amounts picked up by Employer M on behalf of the Group N Employees who participate in Plan X shall be treated as employer contributions and will not be includible in the Group N Employees' gross income in the year in which such amounts are contributed for federal income tax treatment. These amounts will be includible in gross income of the Group N Employees or their beneficiaries 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.

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

These rulings apply only if the effective date for the commencement of the pick-up is no earlier than the later of March 15, 2005, the date that Resolution N, as submitted with your correspondence dated March 16, 2005, was adopted,

approved and signed by the President of Village K, or the date the pick up is put into effect.

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 limited to the tax treatment of the proposed contributions under Code section 414(h)(2). No opinion is expressed as to the tax treatment of the transactions described herein under the provisions of any other section of either the Code or regulations, which may be applicable thereto.

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).

These rulings are directed only to the taxpayer who requested them. Section 6110(k)(3) of the Code provides that they may not be used or cited by others as precedent.

A copy of this letter has been sent to your authorized representative in accordance with the power of attorney on file with this office.

If you have questions regarding this ruling, you may contact
*********************************SE:T:EP:RA:T:2.

Sincerely yours,

(signed) JOYCE E. FLOYD

Joyce E. Floyd, Manager
Employee Plans Technical Group 2

Enclosures:
Deleted copy of this letter ruling
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