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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

200616047

JAN 27 2006

T:EP:RA:T2

U.I.L. 414.09-00

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Attn.: **********
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Legend:

Employer A	= **********
State B	= **********
Plan X	= **********
Group N Employees	= **********
Statute T	= **********
System M	= **********
Board F	= **********
Ordinance O	= **********
Resolution R	= **********

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

This is in response to a ruling request submitted by your authorized representative dated September 19, 2005, as supplemented by correspondence dated November 4, 2005, and January 17, 2006, concerning the federal income

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

The following facts and representation have been submitted on your behalf:

Employer A, a municipality of State B, is a body corporate and politic, duly organized and existing under the laws of State B.

Plan X is a multiple employer, defined benefit pension plan qualified under section 401(a) of the Code. Membership in Plan X is made available to employees and elected officials of State B's participating governmental units under section 23-201 of Statute T. However, before a municipal employee can participate in Plan X, the employer of such employee must first make an election to participate in Plan X.

On , Board F on behalf of Employer A, signed Resolution R that acknowledges that its enrollment in Plan X was approved effective as of , and further noting that one hundred percent of the Group N Employees employed by Employer A at that time voted to participate in Plan X. (Participation in Plan X is required for all employees hired after the effective date of Employer A's election to participate in Plan X).

Section 23-201(a)(3) of Statute T provides for the participation in Plan X of employees and electing officials of governmental units who elect to participate in Plan X by entering into a participation agreement. A revised participation agreement was entered into by and between System M and Employer A on . The revised participation agreement, among other things, acknowledged that pursuant to Resolution R dated , Board F, on behalf of Employer A, approved participation of the Group N Employees in Plan X. Section 4 of the participation agreement provides, in relevant part, that Employer A shall remit to Plan X, the contributions payable by a Group N Employee who is a member of Plan X and who is subject to the contributory pension benefit under Title 23, Subtitle 2 Part II of Statute T. Section 23-212(b) of Statute T provides that the contribution rate of a member who is subject to the contributory pension benefit under this section is two percent of the member's earnable compensation. You represent that section 21-313 of Statute T provides for the pick up of member contributions to Plan X.

To effectuate and implement the pick up of its Group N Employees' contributions to Plan X, Board F, on behalf of Employer A, adopted Ordinance O on . Ordinance O provides that Employer A shall pick up the two percent contribution required to be made by the Group N Employees and shall consider this amount to be an employer contribution for Federal tax purposes, and that no participant will have access to these funds. Ordinance O further provides that the Group N Employee contribution, although designated as such, shall be paid (picked up) by Employer A pursuant to section 414(h)(2) of the Code and the

Group N Employee will not be given the option of choosing to receive the contributed amounts directly instead of having they paid by Employer A to Plan X.

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

1. That the mandatory contributions made by the Group N Employees and picked up by Employer A be treated as employer contributions for federal income tax purposes.

2. That the mandatory contributions made by the Group N Employees and picked by Employer A will not be included in the current gross income of the Group N Employees for federal income tax purposes.

3. That the mandatory contributions of the Group N Employees picked up by Employer A 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, 1981-1 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, Ordinance O satisfies the criteria set forth in Revenue Ruling 81-35 and Revenue Ruling 81-36 by specifically providing that Board F, on behalf of Employer A, shall pick up the two percent contribution required to be made by the Group N Employees to Plan X and shall consider such amount to be an employer contribution, and by further providing that the Group N Employees' contributions, although designated as employee contributions, shall be paid (picked up) by Employer A and that the Group N Employees will not be given the option of choosing to receive the contributed amounts directly instead of having them paid by Employer A to Plan X.

With respect to your ruling requests one, two and three, we conclude that the mandatory contributions made by the Group N Employees that are picked up by Employer A will be treated as employer contributions under Code section 414(h)(2); will not be included in the current gross income of the Group N Employees for federal income tax purposes in the year in which such contributions are made to Plan X; and will not constitute wages for federal income tax withholding purposes. These amounts will be includible in the gross income of the Group N Employees or their beneficiaries only in the taxable year in which they are distributed, to the extent they represent contributions made by Employer A. 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 A 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 the Group N Employees' contributions in Plan X cannot be any earlier than the later of the date Ordinance O was adopted by Employer A, the effective date of Ordinance O, or the date the pick up is put into effect. This ruling is based on Ordinance O as submitted with your correspondence dated September 19, 2005.

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 only addresses the income tax treatment of the pick up of the Group N Employee contributions by Employer A under Code section 414(h)(2) subsequent to Employer A's election to participate in Plan X and the implementation of the pick up arrangement as described in Ordinance O. No opinion is expressed as to the income tax consequences, if any, that may apply as a result of the other provisions of Ordinance O and the revised participation agreement dated , that pertain to the termination of Employer A's prior plan and the transfer of assets from Employer A's prior plan to Plan X.

This ruling assumes that Plan X is qualified under Code section 401(a) at times relevant to this transaction.

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 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