TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

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MAR 9

Uniform Issue List: 414.09-00

T:EP:RA:T2

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ATTN: ***

LEGEND:

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

Dear ***:

This is in response to a letter dated June 10, 2003 submitted by your authorized representative, supplemented by correspondence dated, August 26, 2003, September

8, 2003, January 28, 2004, and February 19, 2004 for a ruling concerning the federal income tax treatment under Internal Revenue Code (the "Code") section 414(h)(2) of certain contributions to Plan X.

Your authorized representative submitted the following facts and representations:

Employer M, a governmental employer in State A, established and created Plan X in accordance with the statutory authority granted to municipalities in State A by Statute P. Statute P provides that in each municipality, as defined in Statute Q, such as Employer M, the city council or the board of trustees shall establish and administer a pension fund for the benefit of Group N Employees, as defined in Statute T, and their beneficiaries. Statute T provides, in pertinent part, that a Group N Employee is any person who is appointed to the police force of a police department and sworn and commissioned to perform duties and who, within three months after receiving his or her first appointment, has made an irrevocable election to participate in Plan X. Your authorized representative has stated that the election to participate or not to participate in Plan X is a one-time irrevocable election and that in the event a Group N Employee elects not to file an application to participate in Plan X within the prescribed three month period, that employee is precluded from participating in Plan X at a later date.

Statute R provides that each Group N Employee shall contribute, beginning January 1, percent of his/her salary to Plan X.

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 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 that 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 future salary increase or by a combination of both.

To effectuate the pick up as provided in Statute S, Employer M passed Resolution N on March Section One of Resolution N provides that, in accordance with Statute S, Employer M will pick up the Group N Employees' contributions to Plan X, and although being designated as employee contributions, Employer M will pay those contributions in lieu of employee contributions. Section Two of Resolution N states that Group N Employees' current cash salaries shall be reduced by an amount equal to the amount picked up by Employer M. Resolution N further provides that Employer M will not withhold Federal and State income taxes on the picked up contributions and Group

N Employees will not have the option to receive those contributions directly in lieu of having them paid by Employer M to Plan X.

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

1. The mandatory employee contributions "picked up" by Employer M shall be excluded from the current gross income of the Group N Employees until distributed or otherwise made available.

2. The "picked up" contributions paid by the Employer M are not wages for Federal income tax withholding purposes and Federal income taxes need not be withheld on the "picked up" contributions.

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' 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.

This 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 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 contributions to Plan X, although designated as Group N Employee contributions, will be paid by Employer M as salary reduction pick up contributions; that although the contributions so picked up are designated as Group N Employee contributions, such contributions shall be treated as paid by Employer M in lieu of contributions by the Group N Employee in determining the tax treatment under the Code; and that the Group N Employees participating in Plan X do not have any option to choose to receive the contributions so picked up directly in lieu of having them paid by Employer M to Plan X.

Accordingly, we conclude with respect to ruling requests one and two 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 the 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 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.

This ruling is based on the condition that a Group N Employee who makes a one-time irrevocable election to participate in Plan X within Employer M's prescribed election period may not subsequently alter or amend this election to participate in Plan X. This ruling is also based on the condition that a Group N Employee who makes a one-time irrevocable election not to participate in Plan X within Employer M's prescribed election period may not subsequently alter or amend this election to not participate in Plan X. Further, a Group N Employee who fails to make an affirmative election to participate in Plan X within Employer M's prescribed election period is deemed to have made an election not to participate in Plan X. This deemed election is treated as the one-time irrevocable election for such Group N Employee and, for purposes of this ruling and the conclusions reached under Code section 414(h)(2), may not be subsequently altered or amended.

This ruling is based on Resolution N as submitted with your correspondence dated June 10, 2003.

This ruling applies only if the effective date for the commencement of the pick up is not earlier than the later of the date Resolution N was signed by Employer M, or the date the pick up is put into effect.

The conclusions reached in this ruling are limited to the pick up treatment under Code section 414(h)(2) of Group N Employee contributions made to Plan X pursuant to Statute S. No opinion is expressed as to the validity of the pick-up treatment under Code section 414(h)(2) of employee contributions made to the self-managed plan as described in Statute W.

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).

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 as precedent.

Pursuant to a power of attorney on file with this office, a copy of this ruling letter is being sent to your authorized representative.

If you have any questions regarding this ruling, you may contact ***, SE:T:EP:RA:T2, at ***.

Sincerely,

(signed) JOYCE E. FLOYD

Joyce E. Floyd, Manager
Employee Plans Technical Group 2

Enclosures:
Deleted copy of ruling letter
Notice of Intention to Disclose Form 437

cc:
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