Uniform Issue List: 414.09-00

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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEC 19 2002

T:GP:RA:T1

Attn:

Legend:

Employer A =

State B =

Plan X =

Retirement System Y =

Dear :

This is in response to a ruling request dated May 7, 2001, as supplemented by additional information submitted May 24, 2001, May 29, 2002, July 18, 2002, September 5, 2002, September 16, 2002, October 15, 2002, November 19, 2002, and November 22, 2002, from your authorized representative, concerning the pick up of employee contributions to Plan X under section 414(h)(2) of the Internal Revenue Code ("Code").

The following facts and representations have been submitted:

Retirement System Y (or "System") was established by applicable State B statutes to provide a system of retirement benefits for the employees of municipalities or municipal authorities of State B that elect to join the System. State B law defines an "active member" in Retirement System Y to include a municipal employee who is earning credited service in a System pension plan as a result of employment with a municipality that has enrolled in the System.

Employer A, a municipal authority located in State B, joined Retirement System Y, and pursuant to a pension plan agreement entered into between Employer A and the Retirement Board (or "Board") that administers the System, dated February 21, 1996, Plan X was established by Employer A to cover all permanent municipal employees of Employer A who are enrolled in the System. Plan X is administered by Retirement System Y and, pursuant to the above agreement, embodies the benefits agreed to be provided to the municipal employees of Employer A by Retirement System Y.

It is represented that Retirement System Y meets the requirements of section 401(a) of the Code, and that Plan X is intended to qualify under section 401(a). Plan X requires mandatory employee contributions to be made to Retirement System Y.

State B law provides that member contributions shall be paid into Retirement System Y by the municipality through payroll deductions in such manner and at such time as the Board may by rule or regulation determine. Retirement System Y has adopted a regulation which states that "contributions required to be made by a Member may not be paid by the Municipality under any circumstances other than the provisions of the federal Internal Revenue Code, section 414(h)(2)." In accordance with such regulation and a collective bargaining agreement reached with the union representing its employees, Employer A intends to pick up the mandatory employee contributions for its municipal employees. Pursuant to said collective bargaining agreement, Employer A has proposed a resolution which provides that Employer A will pick up the mandatory employee contributions within the meaning of Code section 414(h)(2). The resolution states that the contributions, although designated as employee contributions, are being paid by the employer in lieu of contributions by the employee. In addition, the employees will not have the option of receiving the picked-up contributions in cash instead of having the contributions paid by Employer A to Plan X, as a System Y administered pension plan.

Based on the foregoing facts and representations, you have requested the following rulings:

1) No part of the mandatory employee contributions to Plan X picked up by Employer A as the employer of its employees be considered as gross income to the employees for federal income tax treatment in the taxable year in which the pick up is made, but will only be taxable to the employee upon distribution to the employee in accordance with the Plan.

2) That the contributions picked up by Employer A, though designated as employee contributions, be treated as employer contributions for federal income tax purposes.

3) That the contributions picked up by Employer A will not constitute wages from which taxes must be withheld for federal income tax purposes when contributed to Plan X.

Code section 414(h)(2) provides that contributions, otherwise designated as employee contributions, shall be treated as employer contributions if such contributions are made to a plan described in Code section 401(a), established by a state government or a 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 Code section 414(h)(2) 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. Rev. Rul. 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 Code section 3401(a)(12)(A), 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 for federal income tax purposes 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 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.

A regulation adopted by Retirement System Y authorizes participating employers to pick up mandatory employee contributions pursuant to Code section 414(h)(2). The proposed resolution of Employer A's Governing Board satisfies the criteria set forth in Revenue Ruling 81-35 and Revenue Ruling 81-36 by providing that Employer A will pick up and make contributions to Plan X in lieu of contributions by participating employees. It also states that no employee will have the option of receiving the contribution in cash instead of having such contribution paid to Plan X.

Accordingly, based on the above facts and representations, we conclude that: 1) No part of the mandatory employee contributions to Plan X picked up by Employer A as the employer of its employees will be considered as gross income to the employees for federal income tax treatment in the taxable year in which the pick up is made, but will only be taxable to the employee upon distribution to the employee in accordance with the Plan; 2) The contributions picked up by Employer A, though designated as employee contributions, will be treated as employer contributions for federal income tax purposes; and 3) The contributions picked up by Employer A will not constitute wages from which taxes must be withheld for federal income tax purposes when contributed to Plan X.

The effective date for the commencement of any proposed pick up as specified in the final resolution cannot be any earlier than the later of the date the final resolution is signed or put into effect.

This ruling is based on the assumption that Retirement System Y and Plan X are qualified under Code section 401(a) at all relevant times.

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 directed only to the taxpayer that requested it. Code section 6110(k) provides that it may not be used or cited by others as precedent.

If you have any questions, please call , T:EP:RA:T1 at .

Sincerely yours,

Andrew E. Zuckerman
Manager, Employee Plans
Technical Group 1

Enclosures:
Deleted Copy of the Ruling
Notice 437

cc