TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

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AUG 10 2004

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Legend:

State B =

Employer A =

Group B Employees =

Plan X =

Resolution R =

Dear

In letters dated February 27, 2004, and May 7, 2004, your authorized representative requested a letter ruling on your behalf concerning the federal income tax treatment of certain contributions to Plan X under section 414(h)(2) of the Internal Revenue Code.

The following facts and representations have been submitted:

Employer A is a political subdivision of State B. Employer A established Plan X for the benefit of Group B Employees. Plan X requires mandatory employee contributions and is intended to qualify under Code section 401(a).

Pursuant to Resolution R, dated January 27, 2004, Employer A has agreed to pick up, i.e., assume and pay, the mandatory employee contributions to Plan X in lieu of Plan X participants paying such contributions. These contributions

although designated as employee contributions, will be deemed to have been paid by Employer A in lieu of contributions by Plan X participants. Also, Plan X participants will have no option to receive the picked-up contributions in cash in lieu of having such contributions paid to Plan X.

Based on the aforementioned facts and representations, you have requested rulings that:

1. No part of the mandatory contributions picked up by Employer A as the employer of Group B Employees be constituted as gross income to the Plan X participants for federal income tax treatment in the taxable year in which the pick-up is made, but will only be taxable to the recipient upon distribution to the participant in accordance with Plan X.

2. The contributions picked up by payroll deductions though designated as employee contributions will be treated as employer contributions for federal income tax purposes.

3. The contributions picked up by Employer A will not constitute wages from which federal income taxes must be withheld when contributed to Plan X.

Section 414(h)(2) of the Code provides in relevant part 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), 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 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 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.

Resolution R, adopted by Employer A on January 27, 2004, satisfies the criteria set forth in Rev. Rul. 81-35 and Rev. Rul. 81-36 by providing that Employer A will make contributions to Plan X in lieu of contributions by Plan X participants and that Plan X participants may not elect to receive such contributions directly. Thus, Employer A's pick-up arrangement first satisfies the criteria of Rev. Rul. 81-35 and Rev. Rul. 81-36 on January 27, , the date of Employer A's adoption of Resolution R.

Accordingly, we conclude that:

Amounts picked up by Employer A for Group B Employees who are Plan X participants shall be treated as employer contributions and will not be includible in the Plan X participants' gross income for the taxable year in which such amounts are contributed. These amounts will be includible in the gross income of the Plan X participants or their beneficiaries only in the taxable year in which they are distributed, to the extent that the amounts 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 provided in section 3401(a)(12)(A) of the Code for federal income tax withholding purposes. Therefore, no withholding of federal income tax is required from Plan X participants' salaries with respect to such picked-up amounts.

For purposes of the application of section 414(h)(2) of the Code, 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.

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)(I)(B) of the Code.

These rulings apply only if the effective date for the commencement of any proposed pick-up contributions as specified in Resolution R cannot be any earlier than the later of the date the resolution is signed or the date it is put into effect. Therefore, the effective date for the commencement of the pick-up contributions cannot be any earlier than January 27,

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.

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

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 by others as precedent.

If you wish to inquire about this ruling, please contact , I.D. # ., at . Please address all correspondence to SE:T:EP:RA:T3.

Sincerely yours,

/s/

Frances V. Sloan, Manager
Employee Plans Technical Group 3

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