TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

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T:EP:RA:T2

APR 14 2006

Uniform Issue List: 414.09-00

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Attn: *****

Legend:

Employer M = *****

State A = *****

Plan X = *****

Statute P = *****

Statute Q = *****

Statute R = *****

Statute S = *****

Group N Employees = *****

Proposed Ordinance O = *****

Dear *****:

This is in response to a letter dated January 25, 2006, as supplemented by correspondence dated April 3, 2006, submitted on your behalf by your authorized representative, concerning the federal income tax treatment under Internal Revenue Code (Code) section 414(h)(2) of certain contributions to Plan X.

The following facts and representations have been submitted by your authorized representative:

Employer M is a governmental employer in State A. Statute P provides that in each municipality, as defined in Statute Q, with a population of between 5,000 and 50,000 inhabitants, the city council or board of trustees shall establish and administer a pension plan for the benefit of its employees and their beneficiaries. Employer M is described as a municipality in State A and established Plan X for the benefit of its Group N Employees and their beneficiaries. You represent that Plan X is qualified under section 401(a) of the Code and is a governmental plan as described in section 414(d) of the Code.

Statute R provides, in general, that each Group N Employee shall contribute a certain percentage of his or her salary to Plan X. You represent that the basic contribution rate is percent of each Group N Employee's salary, which amount is to be withheld from the Group N Employee's salary and contributed to Plan X.

Statute S provides, in general, that a municipality, such as Employer A, may pick up the Group N Employees contributions' required by Statute R. If a municipality decides not 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 Code; however, the 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. Statute S also states that the municipality shall pay these contributions from the same source of funds which is used to pay the salaries of the Group N Employees and that the municipality 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 a reduction in the salary and offset against a future salary increase. If contributions are picked up they shall be considered for all purposes of this statute as Group N Employee contributions made prior to the time that contributions were picked up.

To effectuate and implement the pickup as provided for in Statute S, Employer M intends to adopt Proposed Ordinance O. Proposed Ordinance O provides that Employer M will pick up the contributions the Group N Employees are required to make to Plan X pursuant to Statute R, as permitted by Statute S. Proposed Ordinance O further provides that such contributions, although designated as employee contributions, shall be made by Employer M in lieu of employee contributions, and the cash salary of each Group N Employee shall be reduced by the amount so contributed. In addition, Proposed Ordinance O states that the Group N Employees shall not be given the option of receiving the contributions directly rather than having such contributions paid by Employer M to Plan X.

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

1. That the mandatory contributions made by the Group N Employees and picked up by Employer M pursuant to section 414(h)(2) of the Code will not be included in the current gross income of the Group N Employees for federal income tax purposes.

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

3. That the mandatory contributions of the Group N Employees picked up by Employer M will not constitute wages from which taxes must be withheld under Code section 3401(a)(12)(A) in the taxable year in which they are contributed to Plan X.

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) of the Code, 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 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 order to in 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, Proposed Ordinance O satisfies the criteria set forth in Rev. Rul. 81-35 and Rev. Rul. 81-36 by specifically providing that Employer M shall pick up the contributions the Group N Employees are required to make to Plan X; that such contributions, although designated as employee contributions, shall be paid (picked up) by Employer M in lieu of contributions by the Group N Employees; 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 M to Plan X.

With respect to ruling requests one, two, and three, we conclude that the mandatory contributions made by the Group N Employees to Plan X and picked up by Employer M shall be treated as employer contributions and will not be included in the current gross income of the Group N Employees for federal income tax purposes in the year in which contributions are made to Plan X, 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 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.

This ruling applies only if the effective date for the commencement of the pick up is not earlier than the later of the date Proposed Ordinance O is signed and adopted by Employer M, or the date the pick-up is put into effect. This ruling is based on Proposed Ordinance O as submitted with your correspondence dated April 3, 2006 and conditioned on Employer A adopting Proposed Ordinance O as so submitted.

This ruling is based on the assumption that Plan X meets the requirements of Code section 401(a) at all times relevant to this proposed transaction.

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 who 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 letter has been sent to your authorized representative in accordance with a Power of Attorney on file with this office.

If you have any questions, you may contact ********** SE:T:EP:RA:T:2.

Sincerely yours,

Joyce E. Floyd, Manager,
Employee Plans Technical Group 2

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