Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

U.I.L. 414.09-00

Contact Person:

Telephone Number:

In Reference to:

Date: OP:E:EP:T:2/5002313

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Attn:

Legend
Statute P =
Statute Q =
Statute R =
State A =
Board M =
System Y =
Plan X =

Employer W =
Group N Employees =

Dear

This is in response to a ruling request dated April 9, 1999, as supplemented by correspondence dated August 24, 1999, submitted on your behalf by your authorized representative, concerning the federal income tax treatment, under section 414(h)(2) of the Internal Revenue Code ("Code"), of certain contributions to Plan X.

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

System Y was created by Statute P, which became effective July 1, 1998. System Y offers Plan X, which has been determined to be qualified under section 401(a) of the Code and its related trusts exempt under section 501(a) of the Code. Board M was created pursuant to Statute R and began administration of certain public retirement plans in State A, effective July 1, 1991. Board M administers Plan X.

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Pursuant to Statute P, Group N Employees who are participants in Plan X are required to contribute a specified percentage of their compensation to Plan X as a condition of employment. Statute Q, as amended, specifically provides that Employer W shall pick up employee contributions paid to Plan X. Contributions picked up by Employer W are employer contributions and are paid in lieu of employee contributions. In addition, Group N Employees participating in Plan X will have no option to receive the picked-up contributions in cash instead of having such contributions paid to Plan X.

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

1. That no part of the amount of the contributions picked up by Employer W will be included in the gross income of Group N Employees participating in Plan X for federal income tax purposes.

2. That the contributions picked up by Employer W, whether picked up by salary reduction, offset against future salary increases, or both, and though designated as employee contributions, will be treated as employer contributions for federal income tax purposes.

3. That distribution of the picked up contributions by Employer W on behalf of Group N Employees participating in Plan X, either through a retirement pension, a lump sum or otherwise will be considered a distribution taxable under section 402 of the Code.

4. That under the provisions of section 3401(a)(12)(A) of the Code, the picked-up contributions to Plan X will be treated as employer contributions with respect to plans qualified under section 401(a) of the Code and will be excluded from wages for purposes of the collection of income tax at source on wages.

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'

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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.

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, Statute Q satisfies the criteria set forth in Rev. Rul. 81-35 and Rev. Rul. 81-36, by providing, in effect, that Employer W will make contributions to Plan X in lieu of contributions by Group N Employees. Under Statute Q, Group N Employees participating in Plan X have no option to receive any picked up contributions in cash in lieu of having such contributions paid to Plan X.

Accordingly, we conclude with respect to ruling requests numbers 1, 2, 3, and 4 that the amounts picked up by Employer W on behalf of 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 only in the taxable year in which they are distributed, to the extent that the amounts represent contributions made by Employer W. 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 W will constitute wages for federal income tax withholding purposes in the taxable year in which they are contributed to Plan X.

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These rulings apply only if the effective date for the commencement of the pick-up is no earlier than the later of the date Statute Q, as amended, was signed or the date the pick-up is put into effect.

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.

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.

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).

These rulings are directed only to the taxpayer who requested them. Section 6110(k)(3) of the Code provides that they 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 the power of attorney on file with this office.

Sincerely yours,

(signed) JOYCE E. FLOYD

Joyce E. Floyd
Chief, Employee Plans
Technical Branch 2

Enclosures:
Deleted copy of this letter
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