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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

SEP 20 2002

Uniform Issue List: 414.08-00

T:EP:RA:T4

Legend:

City A =

State B =

Plan X =

Resolution N =

Payroll Authorization Form P =

Dear

This is in response to a ruling request dated October 4, 2001, as amended by correspondence dated September 16, 2002, submitted by your authorized representative, concerning mandatory and voluntary contributions to Plan X based upon the value of an employee's termination pay.

You submitted the following facts and representations in support of your request:

Plan X is a governmental plan as defined in section 414(d) of the Code. The plan covers all fire fighters employed by City A. City A is a governmental agency and is a political subdivision of State B.

As part of their compensation, City A fire fighters can earn vacation, sick leave, sick leave bonus, compensatory time, and/or floating holidays. Some of these earnings can be accumulated and paid out in cash upon a fire fighter's retirement from City A (hereafter referred to as "Termination Pay"). As provided by Plan X, Termination Pay can be contributed to Plan X either as a mandatory contribution or as a voluntary

contribution.

Section 3.02 of Plan X provides that City A will contribute to Plan X an amount that is all or part of the commuted value of an employee's accumulated Termination Pay upon the employee's retirement (hereafter referred to as "Mandatory Contributions"). The portion that will be contributed under this provision will be determined pursuant to collective bargaining for union members or pursuant to a determination by City A for unrepresented fire fighters. Conversion and contribution of Termination Pay under this provision is mandatory and automatic. No employee for whom there is a contribution of commuted Termination Pay under this provision may elect to receive such part of his or her Termination Pay in cash.

Section 3.02(d) of Plan X provides that if the limits of section 415 of the Code could materially reduce the amount of Mandatory Contributions otherwise made to a participant under Plan X then, upon the participant's retirement and as provided by the applicable collective bargaining agreement, City A shall automatically contribute an amount equal to the amount that would otherwise be contributed under section 3.02 of Plan X in the Plan Year prior to a participant's anticipated retirement. If such contribution is made, there shall be a commensurate reduction in the participant's unused Termination Pay.

Under section 3.03 of Plan X, no later than three months prior to retirement, fire fighters may choose to have a portion of their Termination Pay contributed to Plan X as a pick up under section 414(h)(2) of the Code (hereafter referred to as "Voluntary Contributions"). This provision applies to "Termination Pay" that is not contributed to Plan X as a Mandatory Contribution under section 3.02 of Plan X. Under this provision, pursuant to a binding irrevocable election, City A will pick up and pay the Voluntary Contributions directly to Plan X and, after executing such election, the employee will not have the option of choosing to receive the contributed amounts directly instead of having them paid by City A to Plan X. Under the election, the employee must agree that Plan X will only accept payment from City A and not directly from the employee. The effective date of the pick up will be the later of the date the City Council adopts the authorizing resolution and the date of execution of the binding irrevocable election by both City A and the employee. The pick up does not apply to a contribution made before the effective date of the pick up.

In order to permit the pick up of the above-referenced Termination Pay, the City A City Council is required to adopt the authorizing resolution, Resolution N. This resolution designates that Mandatory Contributions and Voluntary Contributions of Termination Pay are picked up by City A with an employee having no option of receiving such picked up amounts directly instead of having such amounts contributed to Plan X.

Payroll Authorization Form P will be used to effectuate the binding irrevocable election to pick up Voluntary Contributions pursuant to Resolution N. This form states that the employee authorizes the deduction from Termination Pay for pick up purposes and

understands that this authorization is binding and irrevocable. The dollar amount of the deduction is designated on the form. The pick-up election to have the contributions deducted from Termination Pay must be made no less than three months before the employee's termination date. Payroll Authorization Form P provides that Plan X will only accept payment from City A and not directly from the employee. The employee is thus precluded from revoking the pick-up election by making payments directly to Plan X. Payroll Authorization Form P also provides that the contributions are being picked up by City A and paid directly to Plan X and that, after executing the authorization, the employee does not have the option of receiving such amounts directly.

Based on the above facts and representations, City A requests the following rulings:

With respect to Mandatory Contributions to Plan X of Termination Pay, (1) such contributions to Plan X satisfy the requirements of section 414(h)(2) of the Code and are not includible in employees' income until such time as they are distributed from Plan X, (2) such contributions to Plan X will be treated as employer contributions for federal income tax purposes, and (3) such contributions will not constitute wages from which taxes must be withheld under section 3401(a)(12)(A) of the Code in the taxable year in which they are contributed to Plan X.

With respect to Voluntary Contributions to Plan X of Termination Pay, (1) such contributions to Plan X satisfy the requirements of section 414(h)(2) of the Code and are not includible in employees' income until such time as they are distributed from Plan X, (2) such contributions to Plan X will be treated as employer contributions for federal income tax purposes, and (3) such contributions will not constitute wages from which taxes must be withheld under section 3401(a)(12)(A) of the Code 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 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 that 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 and that, 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.

Revenue Ruling 87-10, 1987-1 C.B. 136, provides that in order to satisfy Revenue Rulings 81-35 and 81-36, the required specification of designated employee contributions must be completed before the period to which such contributions relate. Thus, employees may not exclude from current gross income designated employee contributions to a qualified plan that relate to compensation earned for services prior to the date of the last governmental action necessary to effect the employer pick up.

With respect to the pick up of Mandatory Contributions, Resolution N, which will be adopted by City A, satisfies the criteria set forth in Revenue Ruling 81-35 and Revenue Ruling 81-36 by providing that City A will make the contributions on behalf of the employees in lieu of contributions by the employees and that no employee will have the option of receiving Mandatory Contributions directly instead of having them contributed to Plan X. The effective date of the pick-up arrangement is the later of the date Resolution N is adopted by City A and the date of contribution as set forth in the applicable memorandum of understanding for employees covered by a collective bargaining agreement or the date designated by City A for employees not covered by a collective bargaining unit. The pick up does not apply to any contribution before the effective date or to any contribution that relates to compensation earned for services before the effective date.

With respect to the pick up of Voluntary Contributions, Resolution N, which will be adopted by City A, satisfies the criteria set forth in Revenue Ruling 81-35 and Revenue Ruling 81-36 by providing that City A will make the contributions on behalf of the employees in lieu of contributions by the employees and that no employee will have the option of receiving the contribution directly instead of having it contributed to Plan X. Further, the proposed pick-up election agreement of employees (Payroll Authorization Form P) is irrevocable and also provides that the contributions are being picked up by City A and paid directly to Plan X and that the employee does not have the option of receiving amounts directly. The effective date of the pick-up arrangement is the later of the date Resolution N is adopted by City A and the date Payroll Authorization P has been signed by both parties. The pick up does not apply to any contribution before the effective date or to any contribution that relates to compensation earned for services before the effective date.

Accordingly, assuming that the proposed pick ups are implemented as proposed and that contributions of Termination Pay are made within a reasonable period after an employee's retirement from City A employment, it is concluded, with respect to Mandatory Contributions to Plan X of Termination Pay, that (1) such contributions to Plan X satisfy the requirements of section 414(h)(2) of the Code and are not includible in employees' income until such time as they are distributed from Plan X, (2) such contributions to Plan X will be treated as employer contributions for federal income tax purposes, and (3) such contributions will not constitute wages from which taxes must be withheld under section 3401(a)(12)(A) of the Code in the taxable year in which they are contributed to Plan X. For purposes of these rulings, it is assumed that the Mandatory Contributions provided for in any collective bargaining agreement or city ordinance will state a set amount or percentage of Termination Pay to be contributed to Plan X as a Mandatory Contribution without any allowance for participant or employer discretion in determining the amount. Additionally, it is assumed that neither the employer nor the participant will retain any discretion to request or decline (1) the determination of whether the section 415 limits could materially reduce the amount of a Mandatory Contribution in the year of termination of employment, or (2) the contribution of Termination Pay to Plan X as a Mandatory Contribution in the year preceding the year of the participant's anticipated retirement date due to such determination.

Assuming that the proposed pick ups are implemented as proposed and that contributions of Termination Pay are made within a reasonable period after an employee's retirement from City A employment, it is concluded, with respect to Voluntary Contributions to Plan X of Termination Pay, that (1) such contributions to Plan X satisfy the requirements of section 414(h)(2) of the Code and are not includible in employees' income until such time as they are distributed from Plan X, provided that such contributions are made within a reasonable period after an employee's retirement from City A employment, (2) such contributions to Plan X will be treated as employer contributions for federal income tax purposes, and (3) such contributions will not constitute wages from which taxes must be withheld under section 3401(a)(12)(A) of the Code in the taxable year in which they are contributed to Plan X.

No opinion is expressed as to the tax treatment of the transaction described herein under the provisions of any other section of either the Code or regulations that may be applicable thereto.

These rulings are based on the assumption that Plan X is qualified under section 401(a) of the Code at the time of the proposed contributions and distributions, and that such contributions meet the applicable limitations under the Code, including the relevant section 415(c) limitations.

This letter 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 the power of attorney on file with this office, you are receiving a copy of this letter ruling and your representative is receiving the original letter ruling.

If you wish to inquire about this ruling, please contact T:EP:RA:T4, at .

Sincerely yours,

Alan C. Pipkin
Manager, Technical Group 4
Employee Plans

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