200021058

Internal Revenue Service

U.I.L. 414.09-00

Department of the Treasury

Washington, DC 20224

Contact Person:

Telephone Number:

In Reference to:

T:EP:RA:T:2/5002313

Date:

FEB 28 2000

Attn:

Legend

Statute P =
Statute Q =
Statute R =
Statute S =
State A =
Plan X =
Employer M =
Resolution N =
Group N Employees =

Dear

This is in response to a ruling request dated November 18, 1999, as supplemented by correspondence dated February 11, 2000, 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:

The Board of Trustees of Employer M established and created Plan X in accordance with Statute P and Statute Q for the benefit of the Group N Employees. You represent that Plan X meets the qualification requirements set forth under section 401(a) of the Code.

The foregoing statutes permit government employers, such as Employer M, to reduce the current salaries paid to Group N Employees and pay these mandatory employee contributions directly to Plan X in lieu of such contributions by the Group N Employees. Pursuant to Statute R, the Group N Employees are required to contribute nine percent of their respective salaries to Plan X.

Statute S provides that a municipality, such as Employer M, may pick up the Group N Employees' contributions required by Statute R. Statute S further provides that if a municipality decides to pick up the contributions, they shall be treated as employer

281

contributions in determining tax treatment under the Code. Statute S also provides that a 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. Employer M 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 both. To effectuate the pickup as provided for in Statute S, Employer M, on September 22, 1999, passed Resolution N.

Resolution N provides that Employer M will pick up the Group N Employees contributions to Plan X in accordance with Statute R and Statute S. The Group N Employees salaries will be reduced by an amount equal to the amount picked up by Employer M. Employer M will cease to withhold federal and State income taxes on the picked-up contributions; and the Group N Employees participating in Plan X will not be given the option to receive cash directly in lieu of having such contributions paid to Plan X.

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

1. That the mandatory employee contributions picked up by Employer M shall be excluded from the current gross income of the Group N Employees until distributed or otherwise made available.

2. That the picked up contributions paid by Employer M, are not wages for federal income tax withholding purposes and federal income taxes need not be withheld on the picked up contributions.

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' 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, Resolution N satisfies the criteria set forth in Rev. Rul. 81-35 and Rev. Rul. 81-36, by providing, in effect, that Employer M will make contributions to Plan X in lieu of contributions by Group N Employees. Under Resolution N, 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 and 2 that the amounts picked up by Employer M on behalf of the 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 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.

These rulings apply only if the effective date for the commencement of the pick-up is no earlier than the later of the date Resolution N 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, Manager,
Employee Plans Technical Group 2
Tax Exempt and Government Entities Division

Enclosures:
Deleted copy of this letter and Notice 437

284