Internal Revenue Service

Index No. 414.09-00

Department of the Treasury

Washington, DC 20224

200130051

Contact Person:

Telephone Number T:EP:RA:T1

In Reference to:

Date:

MAY - 2, 2001

Legend:

Plan A.....

Category B.....

State M.....

Statute P.....

Dear :

This is in response to a letter dated January 1, 2001, as supplemented by correspondence dated February 1, 2001, in which you requested rulings under section 414(h)(2) of the Internal Revenue Code ("Code"). You submitted the following facts and representations in connection with your request.

Plan A is a defined contribution plan offered only to certain elected officials, employees of State M, and "exempt" staff. " The exempt staff includes Category B employees. Plan A is a governmental plan described in Code section 414(d). State M has submitted an application for determination that Plan A is qualified under section 401(a) and its trust exempt under section 501(a).

Plan A is funded by both employer and employee contributions. All eligible employees are required to make mandatory employee contributions in an amount equal to a specified percentage of gross salary. State M is required to make a like contribution for each participant.

State M passed Statute P, effective December 1, 2000, requiring that all employee contributions to Plan A be picked up and paid by the employer in lieu of contributions by the employees. Statute P provides that employees do not have the option of choosing to receive the pick up amounts directly instead of the employer paying these amounts to Plan A. Statute P also provides that the contributions picked up by the employer may be

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made by a reduction in the employee's salary or an offset against future salary increases, or a combination of both. The specified effective date of the pick up shall not be before the date Plan A receives notification from the Internal Revenue Service (the "Service") that the pick up contributions are not includible in the gross income of employees for the taxable year contributed.

Based on the above facts and representations, you request the following rulings:

(1) that amounts picked up by State M in accordance with Statute P on behalf of its employees participating in the plan are not considered includible in such employees' gross income for income tax purposes until the contributions are distributed;
(2) that the amounts picked up by State M pursuant to Statute P, although designated as employee contributions, are considered employer contributions for purposes of federal income tax; and
(3) that the employee contributions picked up by State M pursuant to Statute P are not treated as wages under Code section 3401(a)(12)(A) for purposes of income tax withholding.

Code section 414(h)(2) 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 which are picked up by the employer within the meaning of Code section 414(h)(2) 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), 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 the picked up contributions.

The issue of whether contributions have been picked up by an employer within the meaning of Code section 414(h)(2) 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 me: (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 Ruling 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 case, State M adopted Statute P which specifically provides that the contributions shall be picked up and paid by the employer in lieu of contributions by the participant. Statute P further provides that employees do not have the option to choose to receive the amounts directly rather than have them paid by the employer to Plan A. Accordingly, we conclude, with respect to ruling request (1), that amounts picked by State M in accordance with Statute P on behalf of participants will not be considered includible in the participants' gross income until the contributions are distributed. Regarding ruling request (2), we conclude that the amounts picked up by the employer, although designated as employee contributions, are treated as employer contributions for federal income tax purposes under Code section 414(h)(2). Finally, we conclude with regard to ruling (3) that the employee contributions to Plan A picked up by State M will be excepted from wages under Code section 3401(a)(12)(A) for purposes of income tax withholding.

This ruling does not apply to any contribution to the extent it relates to compensation earned before the last governmental action necessary to implement the pick up.

Further, ruling (1) does not apply to Category B employees. In order for ruling (1) to apply to those employees of a particular employer (such as an agency or instrumentality of State M) of Category B employees, the employer may request a ruling on this issue.

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" under Code section 3121(v)(1)(B).

These rulings are based on the assumption that Plan A will be qualified under section 401(a) at all times relevant to the proposed transaction.

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This ruling is directed only tot he taxpayer who requested it. Code section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely yours,

John Swieca, Manager
Employee Plans Technical Group 1
Tax Exempt and Government Entities Division

cc:

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