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

200221063

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

U.I.L. 414.09-00

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ATTN: XXXXXXXXXXXXXXXXXX
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Legend

State A = XXXXXXXXXXXXXX
Employer M = XXXXXXXXXXXXXX
Group B Employees = XXXXXXXXXXXXXX
XXXXXX XXXXXXX
Plan X = XXXXXXXXXXXXXX
Plan Y = XXXXXXXXXXXXXX
Proposed Ordinance B = XXXXXXXXXXXXXX
XXXXXXXXXXXXXX
XXXXXXXXXXXXXX
XXXXXXXXXXXXXX
Proposed Ordinance C = XXXXXXXXXXXXXX
XXXXXXXXXXXXXX
XXXXXXXXXXXXXX
XXXXXXXXXXXXXX
Arrangement D = XXXXXXXXXXXXXX
XXXXXXXXXXXXXX
XXXXXXXXXXXXXX

Dear XXXXXXXXXXXX:

This letter is in response to a ruling request dated August 2, 2000, as supplemented by correspondence dated December 27, 2000, June 21, 2001, July 23, 2001, July 23, 2001, October 21, 2001, and February 13, 2002, which was 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 and Plan Y.

The following facts and representations have been submitted:

Employer M is a municipal corporation organized and operated in accordance with Title 31 of State A's Revised Statutes. Employer M established Plan X and Plan Y for the benefit of the Group B Employees. You represent that Plan X and Plan Y are defined benefit plans and are qualified under section 401(a) of the Code.

Plan X and Plan Y have achieved full actuarial funding as certified by an independent actuary for both plans. Employer M and Group B Employees' contributions to both Plan X and Plan Y ceased upon achieving actuarial full funding. Group B Employee contributions to Plan X and Plan Y were mandatory pre-tax contributions pursuant to section 414(h) of the Code. The only continuing employee contributions to Plan X and Plan Y are made by Group B Employees who participate in Arrangement D.

Plan X and Plan Y were amended in 1996 to add Arrangement D provisions. You represent that the Internal Revenue Service has issued favorable determination letters for both Plan X and Plan Y, as amended by the Arrangement D provisions. To participate in Arrangement D, a Group B Employee must sign an irrevocable election, which remains in effect until the Group B Employee terminates employment covered under either Plan X or Plan Y. Participation in the Arrangement D feature of both plans allows an eligible Group B Employee to elect, in lieu of immediate termination of employment and receipt of a retirement benefit,

to continue employment for a specified period of time, and have the Group B Employee's contributions and benefits from either Plan X or Plan Y paid into an Arrangement D account, which is a part of both plans. Although both Plan X and Plan Y have stopped accepting employee contributions due to their fully funded status, Plan X and Plan Y require current Arrangement D participants to continue making such employee contributions.

Employer M now proposes to permit Group B Employees who enter Arrangement D in the future to elect whether they will make pre-tax contributions to Plan X or Plan Y. Employer M intends to amend section 102-237(G) of Plan X and section 102-182(G) of Plan Y to allow a Group B Employee who elects to enter Arrangement D after a specified date, an opportunity to also make a one-time irrevocable election (at the time the Group B Employee elects to participate in Arrangement D) to make no contributions pursuant to the Arrangement D provisions, or to make pre-tax contributions pursuant to the Arrangement D provisions at the Group B Employee contribution rate each Plan X and Plan Y required before those plans became fully funded. A Group B Employee who elects to not make employee contributions pursuant to the Arrangement D provisions would, upon becoming a participant in such arrangement, still have Plan X or Plan Y benefits paid into the Arrangement D account.

Proposed Ordinance B, as it relates to Plan X and Proposed Ordinance C, as it relates to Plan Y, in pertinent part, provide that notwithstanding the termination of Employer M and Group B Employee contributions to Plan X and Plan Y, Group B Employee contributions to the Arrangement D accounts shall continue in accordance with the Arrangement D provisions as added to Plan X and Plan Y in 1996 for Group B Employees who enter Arrangement D before the later of October 1, 2001, or the effective date of Proposed Ordinance B or Proposed Ordinance C. Group B Employees who enter Arrangement D on or after the later of October 1, 2001 or the effective date of Proposed Ordinance B or Proposed Ordinance C shall be subject to the following rules:

(1) A Group B Employee who elects to participate in Arrangement D may elect not to make Group B Employee contributions to Arrangement D.

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(2) A Group B Employee's election not to make member contributions to Arrangement D must be irrevocable and must be made before the Group B Employee begins participation in Arrangement D.

(3) Group B Employee contributions shall be picked up by Employer M and deducted from the pay of the contributing Group B Employee as salary reduction contributions, and paid by Employer M to Plan X or Plan Y. Although designated as employee contributions, these member contributions to Arrangement D are being paid by Employer M in lieu of contributions by the Group B Employee, and once the contributions begin the Group B employee is not given the option of choosing to receive the contributed amounts directly instead of having them paid by Employer M to either Plan X or Plan Y.

Based on the aforementioned facts, the following rulings are requested:

1. That Group B Employee contributions made through payroll deductions pursuant to either Proposed Ordinance B and Proposed Ordinance C will be treated as employer contributions picked up by Employer M within the meaning of section 414(h)(2) of the Code for federal income tax purposes.

2. That such picked up contributions will not constitute wages under section 3401(a) of the Code from which federal income taxes must be withheld. .

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. 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.

In order to satisfy Revenue Ruling 81-35 and 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. Thus, 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.

In this case, Proposed Ordinance B as it relates to Plan X and Proposed Ordinance C as it relates to Plan Y satisfy the criteria set forth in Revenue Rulings 81-35 and 81-36 by providing that Group B Employee contributions that are picked up by Employer M and deducted from the pay of a contributing Group B Employee as

a salary reduction contribution, although designated as employee contributions, such contributions made pursuant to Arrangement D are being paid by Employer M in lieu of the Group B Employee. Proposed Ordinance B and Proposed Ordinance C further provide that once the contributions begin, the Group B Employee does not have the option of choosing to receive the contributed amounts directly instead of having such contributions paid by Employer M to the Arrangement D account in either Plan X or Plan Y.

Therefore, with respect to ruling request one, we conclude that Group B Employee contributions made in accordance with Proposed Ordinance B and Proposed Ordinance C will be treated as employer contributions picked up by Employer M within the meaning of section 414(h)(2) for federal income tax purposes. These contributions pick up in accordance with the abovementioned proposed ordinances will not be includible in the gross income of the Group B Employee until such time as the amounts contributed are distributed from either Plan X or Plan Y to the extent that these amounts represent contributions made by Employer M. These amounts will be includible in the gross income of the Group B Employees (or their beneficiaries) in the year in which such amounts are distributed to the extent that they represent amounts contributed by Employer M.

With respect to ruling request two, since we have determined that the picked up contributions made pursuant to Proposed Ordinance B and Proposed Ordinance C are to be treated as employer contributions, we conclude that these contributions are excepted from wages as defined in section 3401(a)(12)(A) of the Code for federal income tax withholding purposes. Therefore, no withholding of federal income tax is required in the taxable year in which they are contributed either Plan X or Plan Y.

These rulings apply only if the effective date for the commencement of any proposed pick up is not earlier than the later of the date Proposed Ordinance B and Proposed Ordinance C are adopted, or the date they are put into effect.

These ruling are based upon Proposed Ordinance B and Proposed Ordinance C as submitted with your letter dated October 17, 2001.

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In accordance with Rev. Rul. 87-10, this ruling does not apply to any contribution to the extent that it relates to compensation earned before the later of the effective date of the relevant proposed ordinances, or the date the proposed ordinances are put into effect.

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 it. Section 6110(k)(3) of the Code provides that it may not be used or cited by others as precedent.

These rulings express no opinion as to the impact of these proposed transactions upon the qualified, nor the continuing qualified status of Plan X and Plan Y. These rulings are based on the assumption that Plan X and Plan Y will be qualified under section 401(a) of the Code at all relevant times.

A copy of this letter has been sent to your authorized representative in accordance with the power of attorney on file with this office. If you have any questions regarding this letter, you may contact XXXXXX, XXXXXXXXX XXXXXXXX, T:EP:RA:T:2 at XXXXXXXXXXXXXXX.

Sincerely yours,

(signed) JOYCE E. FLOYD

Joyce E. Floyd
Manager, Employee Plans Technical Group 2
Tax Exempt and Government Entities Division

Enclosures:
Copy of this letter, Deleted copy, & Notice 437