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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

SEP 30 2002

T:EP:RA:T1

Uniform Issue List: 414.09-00

Attn:

Legend:

Employer A =

State B =

Plan X =

Form N =

Dear :

This is in response to a ruling request dated March 2, 2001, as supplemented by additional correspondence dated July 17, 2002, July 22, 2002, and July 23, 2002, and September 26, 2002, concerning the pick up of certain employee contributions to Plan X under section 414(h)(2) of the Internal Revenue Code ("Code").

The following facts and representations have been submitted:

Employer A is a governmental entity created under the laws of State B. Employer A proposes to adopt Plan X , a defined contribution plan, and represents that it is a governmental plan under Code section 414 (d) and is qualified under Code section 401(a). The qualified status of Plan X is currently under review through a determination letter request to the Internal Revenue Service.

All employees of Employer A who are actively employed in at least a 75% full-time equivalence position with an appointment duration of at least six months are eligible to participate in Plan X. All eligible employees may make an irrevocable election to direct Employer A to make contributions directly to Plan X by deducting from the employee's compensation for the plan year the amount elected by the employee on Form N, an irrevocable salary reduction agreement binding on both Employer A and the employee.

Under Section 2.1 of Plan X, a new employee shall participate in Plan X on the six-month entry date following a three-month period of employment beginning on the employee's initial date of employment. For eligible employees with at least three months of employment on the date of adoption of Plan X by Employer A, participation shall commence immediately.

Employer A has proposed the following amendments to Plan X: 1) in section 3.1(a), Employer A will add: "A Participant's election of a contribution rate must be stated as a fixed percentage of Compensation, as a fixed dollar amount, or a combination of both"; 2) section 3.1(b), in part, will now read: "The election period for a Participant to elect to make employee contributions shall be a twenty-four (24) month period beginning on the first day the person becomes eligible to participate as described in Article 2.1"; and 3) section 3.1(c) will now read: "A Participant's election authorizing employee contributions will remain in effect for the duration of that Participant's employment with the Employer as an Eligible Employee. A Participant may not decrease or increase the contribution rate designated under paragraph (a) of this Section for the duration of the Participant's employment with the Employer as an Eligible Employee."

Section 3.1(e) of Plan X provides that "[t]he Employer may elect to pay the employee contributions under this Section on behalf of each Participant. The amount paid by the Employer shall be paid in lieu of the contributions made by the employee under this Section in a manner and as permitted under Code section 414(h)(2). Employee contributions paid by the Employer under this

Section shall be treated as Employer contributions under the Code and state tax law." The Employer represents that once an employee elects to make employee contributions, the employee may no longer choose to receive the contributed amounts directly instead of having them paid to Plan X.

Employer A proposes to adopt a resolution ("proposed resolution") authorizing Employer A to pick up the employee contributions made to Plan X. The proposed resolution also provides that the employee contributions will be paid by Employer A in lieu of such contributions being paid by the employee and that the employee will not have the option of receiving the pick-up contributions in cash instead of having the contributions paid to Plan X.

Employer A may also choose to make profit sharing contributions to Plan X on behalf of all eligible employees. Employer A's profit sharing contribution is made without regard to whether the employee elects to make employee contributions. The Plan X trust will be separate and apart from the other qualified plans maintained by Employer A.

Based on the foregoing facts and representations, you have requested the following rulings:

1) The proposed provisions of section 3.1 of Plan X satisfy the requirements of Code section 414(h)(2) for employer pick up of employee contributions made pursuant to an irrevocable election.

2) The contributions of employees picked up by Employer A pursuant to an irrevocable salary reduction agreement, though designated as employee contributions, will be treated as employer contributions for federal income tax purposes.

3) That no part of the Plan X contribution amounts picked up by Employer A will be includable as gross income for federal income tax purposes in the year of contribution with respect to employees.

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 Code section 401(a), established by a state government or a political subdivision thereof, or any agency or instrumentality of any one of the foregoing, 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. Rev. Rul. 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 Code 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 for federal income tax purposes 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 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 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 Code 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 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.

Section 3.1 of Plan X, as proposed to be amended above, and the proposed resolution, satisfy the criteria set forth in Revenue Ruling 81-35 and Revenue Ruling 81-36 by providing that Employer A will pick up and make contributions to Plan X in lieu of contributions by electing employees. In addition, no such employee will have the option of receiving the contribution in cash instead of having such contribution paid to Plan X. Under section 3.1 of Plan X, and Form N, an eligible employee may make a one-time irrevocable election to have Employer A pick up and make employee contributions to Plan X on behalf

of such participant through the use of a reduction in compensation. A participant's election of a contribution rate must be a stated percentage of compensation, a fixed dollar amount, or a combination of both; the election must be made within 24 months of the date an employee becomes a participant in Plan X and the election will remain in effect for the duration of the participant's employment with Employer A; and the participant may not change or modify the designated contribution rate during this period of time. Therefore, although the employee voluntarily elects to make employee contributions to Plan X, the election is irrevocable and, once made, the employee no longer has the option of receiving the employee contributions directly instead of having them paid by Employer A to Plan X.

Accordingly, we conclude that:

1) The proposed provisions of section 3.1 of Plan X satisfy the requirements of Code section 414(h)(2) for employer pick up of employee contributions made pursuant to an irrevocable election.

2) The contributions of employees picked up by Employer A pursuant to an irrevocable salary reduction agreement, though designated as employee contributions, will be treated as employer contributions for federal income tax purposes.

3) That no part of the Plan X contribution amounts picked up by Employer A will be includable in gross income for federal income tax purposes in the year of contribution with respect to employees.

The effective date for the commencement of any proposed pick up as specified in the proposed resolution cannot be any earlier than the latest of: (1) the date Plan X is adopted or put into effect; (2) the date the proposed resolution is adopted or put into effect; or (3) the date Form N is signed by both parties to the agreement.

This ruling is conditioned on Employer A's adoption of the above-described proposed amendments to section 3.1 of Plan X. Failure to adopt the amendments exactly as specified in this ruling means that the ruling is null and void.

This ruling is based on the assumption that Plan X is qualified under Code section 401(a) at all relevant times.

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

This ruling is directed only to the taxpayer that requested it. Code section 6110(k) provides that it may not be used or cited by others as precedent.

A copy of this ruling has been sent to your authorized representative pursuant to a power of attorney on file in this office. If you have any questions, please call , T:EP:RA:T1 at

Sincerely yours,

(Signed)

Manager, Employee Plans
Technical Group 1

Enclosures:
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Notice 437