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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

JUN 09 2003

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Legend:

Plan A.....

State B.....

Statute C.....

Employer M.....

Resolution N.....

Dear :

This is in response to a letter received on February 20, 2003, as supplemented by correspondence dated April 21, 2003, and May 9, 2003, requesting rulings under section 414(h)(2) of the Internal Revenue Code (the "Code"). You submitted the following facts and representations in connection with this request.

State B established Plan A for employees of certain municipalities, including Employer M. Pursuant to Statute C, police officers are required to contribute 9.91 percent of their salary to Plan A. Plan A is qualified under Code section 401(a) and its trust is exempt under section 501(a). Plan A is also a governmental plan under section 414(d).

Statute C permits municipalities to pick up police officers' mandatory contributions by a reduction in salary or by an offset against a future salary increase. Statute C provides that if contributions are picked up, they shall be treated as contributions made by the employer. On February 10, 2003, Employer M passed Resolution N which provides that it will pick up the mandatory employee contributions in lieu of contributions made by the employee, and that employees do not have the option to receive the amounts picked up in cash. Resolution N further provides that Employer M will not treat the contributions as employer contributions until the receipt of a favorable ruling from the Internal Revenue Service.

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

(1) that no part of the mandatory contributions picked up by Employer M as employer of the police officers and contributed to Plan A constitutes gross income to employees for

federal tax treatment;

(2) that the contributions, whether picked up by salary reduction, offset against future salary increases, or both and though designated as employee contributions, will be treated as employer contributions for federal income tax purposes; and

(3) that the contributions picked up by Employer M will not constitute wages from which taxes must be withheld.

Regarding these ruling requests, 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, 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 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' salary 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 ("Rev. Rul. 81-35") and Revenue Ruling 81-36, 1981-1 C.B. 255 ("Rev. Rul. 81-36"). 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 Service considered whether contributions designated as employee contributions to a governmental plan are exlcudable from the gross income of the employee. The Service concluded that to satisfy the criteria set forth in Rev. Rul. 81-35 and Rev. Rul. 81-36 with respect to particular contributions, the required specification of designated employee contributions must be completed before the period to which the contributions relate.

Under Plan A and Statute C, a municipality may pick up mandatory employee

contributions to the plan and that if picked up, the contributions will be treated as contributions made by the employer. Resolution N provides that Employer M will pick up these contributions through a reduction in salary or an offset against future salary increases in lieu of contributions by the employee. Employees participating in Plan A do not have the option of choosing to receive the contributed amounts directly instead of the employer paying the amounts to the plan. Thus, the contributions satisfy the two criteria of Rev. Rul. 81-35 and Rev. Rul. 81-36. Accordingly, we rule that:

(1) no part of the mandatory contributions picked up by Employer M and contributed to Plan A constitutes gross income to employees for federal income tax treatment;

(2) the contributions, whether picked up by salary reduction, offset against future salary increases, or both and though designated as employee contributions will be treated as employer contributions for federal income tax purposes; and

(3) the contributions picked up by Employer M will not constitute wages from which taxes must be withheld pursuant to Code section 3401(a)(12)(A).

These rulings are based on the assumption that Plan A will be 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. Should you have any concerns regarding this ruling, please contact .

Sincerely yours,

Andrew E. Zuckerman, Manager
Employee Plans Technical Branch 1

Enclosures:
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