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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

JUN 26 2003

UIL: 414.09-00

T:EP:RA:T2

Attn.:

Legend:

Employer M =

State S =

Plan X =

City Y =

Group B Employees =

Proposed Amendment O =

Proposed Resolution R =

Dear :

This is in response to a ruling request submitted on your behalf by your authorized representative dated June 28, 2002, as supplemented by correspondence dated November 14, 2002, March 26, 2003 and June 12, 2003, with respect to the federal

income tax treatment of certain contributions to Plan X under section 414(h)(2) of the Internal Revenue Code ("Code").

The following facts and representations have been submitted on your behalf:

Employer M is an instrumentality of City Y created under a charter granted to City Y by the State S Legislature in 1923. Employer M is a public utility that provides water and electric services to City Y.

Effective January 1, 1998, City Y established Plan X to provide retirement benefits for its Group B Employees. Plan X is qualified under Code section 401(a) and its trust is tax exempt under Code section 501(a). Plan X 's most recent favorable determination letter is dated March 22, 2000.

Plan X is funded in part by mandatory Group B Employee contributions equal to four percent of compensation. The mandatory Group B Employee contributions are designated by Employer M as contributions that are picked up by Employer M in accordance with Code section 414(h)(2).

Section 12.1 of Plan X provides that Employer M reserves the authority through a resolution or similar action to amend Plan X. Any such amendment shall be filed with the Trustee. Pursuant to this authority, Employer M proposes to amend Plan X to provide a new section 4.5, Proposed Amendment O (existing Plan X sections 4.5 through 4.10 would be accordingly renumbered Plan X sections 4.6 through 4.11). Proposed Amendment O reads as follows:

> Section 4.5 <u>Employee Supplemental Contributions</u>
>
> In accordance with rules and procedures established by Employer M, each active Group B Employee may make a one-time election to contribute to Plan X on his behalf an additional amount equal to not less than one percent and not more than two percent (expressed in whole percentages) of such active Group B Employee's compensation paid during the contribution period as described in section 4.2. Employee Supplemental Contributions shall be made by payroll deduction on a pre-tax basis. Employee Supplemental Contributions shall be picked up by Employer M and will be treated as employer contributions in accordance with Code section 414(h)(2). A Group B Employee who elects the Employee Supplemental Contributions shall not have the option thereafter of choosing to receive the payroll deductions directly or increasing or decreasing the amount of the Employee Supplemental Contributions. Any Group B Employee electing an Employee Supplemental Contribution is prohibited from terminating the payroll deduction pertaining thereto unless he has terminated employment.

Employer M also intends to adopt Proposed Resolution R to implement the provisions of Proposed Amendment O. Proposed Resolution R provides, in pertinent part, that Employer M will assume and pay the Employee Supplemental Contributions described in Proposed Amendment O of all Group B Employees who elect to make contributions pursuant to Proposed Amendment O. Such contributions, although designated as employee contributions, will be paid by Employer M in lieu of contributions by the Group B Employees. Proposed Resolution R further provides that no Group B Employee will have the option of choosing to receive such contributions directly instead of having them paid by Employer M to Plan X.

Based upon the aforementioned facts and representations, you request the following rulings:

(1) That the proposed additional Group B Employee contributions of up to two percent of compensation that are picked up by Employer M are to be treated as employer contributions under section 414(h)(2) of the Code for federal income tax purposes.

(2) No part of the amount of the additional Group B Employee contributions pick-up by Employer M shall be includible in the gross income of any Group B Employee of Employer M on whose behalf the pick-up is made, for the year in which such contributions are made.

(3) The amount of the additional Group B Employee contributions pick-up by Employer M is to be excepted from the definition of wages as set forth in section 3401(a)(12)(A) of the Code, and no part of the amount of the pick-up constitutes wages for federal income tax withholding purposes in the taxable year in which contributed to Plan X.

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 described in section 401(a) or 403(a) of the Code that was established by a state government or political subdivision thereof, and are picked up by the governing unit.

Revenue Ruling 77-462, 1977-2 C.B. 358, addresses the federal income tax treatment of contributions picked up by the employer within the meaning of section 414(h)(2) of the Code. In Revenue Ruling 77-462, the employer school district agreed to pick up the required contributions of the eligible employees under the plan. The revenue ruling concluded that the school district's picked-up contributions to the plan are excluded from the gross income of employees until such time as they are distributed to the employees. The revenue ruling further held that under the provisions of section 3401(a)(12)(A), the school district's picked-up contributions to the plan are excluded

from wages for purposes of the Collection of Income Tax at Source on Wages, and no federal income tax withholding is required from employees' salaries with respect to said picked-up contributions.

Revenue Ruling 81-35, 1981-1 C.B. 255 and Revenue Ruling 81-36, 1981 C.B. 255, provide guidance as to whether contributions will be considered as "picked-up" by the employer. These revenue rulings established that the following two criteria must be satisfied: (1) the employer must specify that 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 have an 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.

Proposed Amendment O satisfies the criteria set forth in Rev. Rul. 81-35 and Rev. Rul. 81-36 by providing that Group B Employee Supplemental Contributions will be treated as employer contributions and a Group B Employee who elects to make such Employee Supplemental Contributions shall not have the option of choosing to receive the payroll deductions directly or increasing or decreasing the amount of the Employee Supplemental Contributions. Further, Proposed Resolution R also satisfies the criteria of Rev. Rul. 81-35 and Rev. Rul. 81-36 by specifically providing that: (1) Employer M will assume and pay the Employee Supplemental Contributions described in Proposed Amendment O of all Group B Employees who elect to make such contributions; (2) such contributions, although designated as employee contributions, will be paid by Employer M in lieu of contributions by the Group B Employees; and (3) that no Group B Employee will have the option to receive such contributions directly instead of having them paid by Employer M to Plan X.

Accordingly, we conclude with respect to ruling requests numbers 1, 2, and 3 that the amounts picked up by Employer M pursuant to Proposed Amendment O and Proposed Resolution R are treated as employer contributions under Code section 414(h)(2) and will not be includible in the Group B Employees' gross income in the year such amounts are contributed for federal income tax purposes. These amounts will be includible in the gross income of the Group B Employees or their beneficiaries 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 proposed picked-up amounts are to be treated as employer contributions, they are excepted from wages as defined in Code section 3401(a)(12)(A) for federal income tax withholding purposes. In

addition, no part of the proposed 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 proposed pick up of Employee Supplemental Contributions is no earlier than the later of the date Proposed Amendment O is adopted, the date Proposed Amendment O is put into effect, the date Proposed Resolution R is adopted, or the date Proposed Resolution R is put into effect.

This ruling is based on the condition that a Group B Employee who elects to make Employee Supplemental Contributions pursuant to terms of Proposed Amendment O may not make more than one, binding irrevocable election to make such contributions. Further, a one-time election made by a Group B Employee to make contributions pursuant to the terms of Proposed Amendment O is a binding and irrevocable election that may not be subsequently altered or amended.

This ruling is based on Employer M adopting and implementing Proposed Amendment O that was submitted with your correspondence dated March 26, 2003, and Proposed Resolution R that was submitted with your correspondence dated June 12, 2003.

These rulings express no opinion as to whether the pick up of the Group B Employees' mandatory contributions as set forth in section 4.4 of Plan X meets the requirements of section 414(h) of the Code.

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 contributions in question are paid pursuant to a "salary reduction agreement" within the meaning of section 3121(v)(i)(B) of the Code.

For purposes of the application of Code section 414(h)(2), it is immaterial whether an employer picks up the contributions through a reduction in salary, an offset against future salary increases, or a combination of both.

This ruling is based on the assumption that Plan X will be qualified under Code section 401(a) at the time of the proposed contributions and distributions.

This ruling is directed only to the taxpayer that requested it. Code section 6110(k)(3) provides that it may not be used or cited by others as precedent.

A copy of this ruling letter has been sent to your authorized representative in accordance with a power of attorney on file in this office.

If you have any questions regarding this ruling, you may contact , ID No. , T:EP:RA:T:2, at .

Sincerely yours,

Joyce E. Floyd
Manager, Employee Plans
Technical Group 2

Enclosures:
Deleted copy of letter ruling
Form 437