Internal Revenue Service

Significant Index No. 414.15-00

Department of the Treasury

Washington, DC 20224

Person to Contact:

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Telephone Number:

Refer Reply to: OP:E:EP:T:3

Date:

DEC 14 1998

LEGEND:

State A =

Employer M =

Plan X =

Plan Y =

Ladies and Gentlemen:

This is in response to correspondence dated September 23, 1998, as supplemented by letters of October 27, 1998 and November 5, 1998, in which your authorized representative requested a private letter ruling concerning the federal income tax treatment under section 414(h)(2) of the Internal Revenue Code of certain contributions to Plan X.

The following facts and representations have been submitted. Employer M is a political subdivision of State A. As of July 1, 1968, Employer M established Plan X for the benefit of certain "Participants". Plan X was amended and restated effective July 1, 1987. A Participant is defined in section 2 of Plan X to include any employee who becomes covered under Plan X. Generally, any individual in the employ of Employer M whose customary employment is for 25 hours or more per week and for at least 1,250 hours per calendar year is eligible to participate in Plan X. Participants generally include employees and elected officials of Employer M. However, neither employees of the Employer M Board of Education nor participants in Plan Y, another plan sponsored Employer M for certain employees, are permitted to participate in Plan X. Plan X is intended to qualify under section 401(a) of the Code.

Effective January 1, 1992, Plan X was amended to allow Employer M to pick up the Participant's contributions and to provide that the amount picked up by Employer M on behalf of the Participants would be excluded from the Participant's gross income for federal tax purposes. Employer M began treating the Participants' contributions as "pick-up" contributions on the first payroll period after January 1, 1992.

Section 7.4 of Plan X provides that Participants are required to make mandatory contributions of four percent of earnings to Plan X. Section 7.4 of Plan X also provides that Employer M will pick up and pay the mandatory contributions of Participants to Plan X. Participants do not have the option of receiving the contributed amounts directly instead of having them contributed to Plan X. The contributions will be deducted from the earnings of the Participant as a salary reduction contribution.

Based on the aforementioned facts and representations, you have asked for rulings:

1. That the mandatory contributions made by Participants and picked up by Employer M under section 7.4 of Plan X will be treated as employer contributions for federal income tax purposes.

2. That the mandatory contributions made by Participants and picked up by Employer M under section 7.4 of Plan X will not be included in the current gross income of the employees for federal income tax purposes.

3. That the mandatory contributions of Participants picked up by Employer M will not constitute wages subject to federal income tax withholding.

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), 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. 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.

Revenue Ruling 87-10, 1987-1 C.B. 136, provides that in order to satisfy Revenue Rulings 81-35 and 81-36, the required specification of designated employee contributions must be completed before the period to which such contributions relate. Thus, employees may not exclude from current gross income designated employee contributions to a qualified plan that relate to compensation earned for services prior to the date of the last governmental action necessary to effect the employer pick up.

It has been represented that under Plan X as amended, Employer M will make contributions in lieu of contributions by the Participants and that the Participants may not elect to receive such contributions directly. Therefore, Plan X satisfies the criteria set forth in Revenue Ruling 81-35 and Revenue Ruling 81-36. Accordingly, with respect to ruling requests one and two, we conclude:

1. That the mandatory contributions made by Participants and picked up by Employer M under section 7.4 of Plan X will be treated as employer contributions for federal income tax purposes.

2. That the mandatory contributions made by Participants and picked up by Employer M under section 7.4 of Plan X will not be included in the current gross income of the employees for federal income tax purposes.

We have determined that the employee contributions paid to Plan X by Employer M on behalf of Participants will be treated as picked-up contributions in accordance with Revenue Ruling 81-35 and Revenue Ruling 81-36. Pursuant to Revenue Ruling 77-462, picked-up contributions are excluded from the employees' gross income until such time as they are distributed to the employees. Accordingly, with respect to ruling request three, we conclude:

3. That the mandatory contributions of Participants picked up by Employer M will not constitute wages subject to federal income tax withholding.

These rulings are based on the assumption that Plan X will be qualified under section 401(a) of the Code at the time of the proposed contributions.

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) of the Code.

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

Sincerely yours,

/s/ Frances V. Sloan

Frances V. Sloan
Chief, Employee Plans
Technical Branch 3

Enclosures:

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Form 437