Internal Revenue Service

Department of the Treasury

199951041

Washington, DC 20224

Significant Index Number: 414.09-00

Contact Person:

Telephone Number:

In Reference to:
OP:E:EP:T:1

Date:

Attn:

Legend:

State A =

Plan X =

Plan Z =

Resolution Y =

Employer M =

Dear :

This is in response to your ruling request dated February 10, 1999, as supplemented by a letter dated July 2, 1999, 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.

The following facts and representations have been submitted:

Employer M, a political subdivision of State A, established Plan X, a defined contribution plan, for the benefit of certain employees. The Plan requires mandatory employee contributions and is qualified under section 401(a) of the Code.

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Pursuant to section 4.1 of Plan X, Employer M agreed to pick up, i.e., assume and pay, the mandatory employee contributions to Plan X, in lieu of employees paying such contributions, effective September 30, 1997. Eligible employees do not have the option to receive the picked up contributions in cash in lieu of having such contributions paid to Plan X. Under section 3.2, an eligible employee has 30 days to elect to participate in Plan X. If an employee fails to make such an election, he or she may not participate in Plan X and automatically becomes a member of Plan Z, a retirement plan established under State A and qualified under Code section 401(a). An employee who elects participation in Plan X may later elect not to participate by irrevocably electing to participate in Plan Z. An eligible employee cannot elect to choose not to participate in either Plan X or Plan Z.

Based on the aforementioned facts and representations, your authorized representative has requested the following rulings:

1) No part of the contributions to Plan X picked up by Employer M on behalf of eligible employees will constitute taxable income to such employees until such contributions are actually received by these employees from Plan X; and

2) Employer M will not be required to withhold any amount of Federal income taxes with respect to the picked up contributions.

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. 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) 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 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.

Plan X satisfies the criteria set forth in Revenue Ruling 81-35 and Revenue Ruling 81-36 by providing that Employer M will make contributions in lieu of contributions by eligible employees. Although employees who participate in Plan X may later irrevocably elect to participate in

Plan Z, they do not have the option of receiving the picked up amounts directly. In addition, an election not to participate in Plan X is irrevocable. We believe that Plan X does not vest in the employee enough control of the picked up contributions to taint the contributions, and therefore, the picked up contributions are in substance employer contributions.

Accordingly, we conclude that:

The provisions of Plan X, as adopted by Employer M, satisfy the requirements of Code section 414(h)(2). Amounts picked up by Employer M for employees shall be treated as employer contributions and will not be includible in the employees' gross income for the taxable year in which such amounts are contributed.

Because we have determined that the 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. Therefore, no withholding of Federal income tax is required from the employees' salaries with respect to such picked up amounts.

This ruling is 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).

The effective date for the commencement of any proposed pick up as specified in the final resolution cannot be any earlier than the date the final resolution is signed or put into effect.

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

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

Sincerely yours,

John Swieca

John Swieca
Chief, Employee Plans
Technical Branch 1

Enclosures:
Deleted Copy of this Ruling
Notice 437

cc: