TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

200684084

T:EP:RA:T2

APR 25 2006

Uniform Issue List: 414.09-00

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Attn: *****

Legend:

Employer M	= *****
State A	= *****
System S	= *****
Plan X	= *****
Statute T	= *****
Statute U	= *****
Group N Employees	= *****
Board F	= *****
Bill H	= *****
Resolution R	= *****
Resolution S	= *****

Dear *****

This is in response to a ruling request submitted by your authorized representative dated January 2, 2006, as supplemented by correspondence dated March 27, 2006,

concerning 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:

In 1988, the State A General Assembly enacted legislation that permits employers to pick up mandatory employee contributions paid to System S so that these contributions may be exempt from Federal taxation under section 414(h)(2) of the Code. Bill H, which was passed by the State A General Assembly and signed into law by the State A Governor in 1999, opened participation in Plan X to all governmental units that offer State A retirement and pension system benefits to their personnel. You represent that Plan X is not a new plan, but a modification of System S. You describe Plan X as a contributory salary reduction plan and that it requires a mandatory two percent employee contribution rate. You further represent that Plan X meets the requirements for qualification under section 401(a) of the Code, that its related trust is tax exempt under section 501(a) of the Code, and that it is a governmental plan as described in section 414(d) of the Code.

Employer M is a political subdivision of State A. On June 20, 2005, Board F, on behalf of Employer M, signed Resolution R which authorizes Employer M to begin participating in Plan X in accordance with Statute T and Statute U for the benefit of its Group N Employees. You represent that Statute T permits employers who participate in System S to pick up employee contributions, thus excluding those contributions from Federal tax. Statute U provides that the contribution rate for a member who is subject to a pension benefit under Plan X is two percent of the member's earnable compensation.

To effectuate and implement the pick up of its Group N Employees' contributions to Plan X, Employer M adopted Resolution S on September 12, 2005. Resolution S recognizes that Statute T permits employers who participate in System S to pick up the employee contributions and that Board F, on behalf of Employer M, has elected to treat the mandatory employee contribution of two percent of the Group N Employees' annual salary as paid (picked up) by Employer M. Resolution S provides that Employer M shall pick-up the two percent contribution required to be made by the Group N Employees and will consider this amount as an employer contribution for Federal tax purposes and therefore no Group N Employee will have access to these funds. Resolution S further provides that the Group N Employee contributions will be paid by Employer M in lieu of such contributions being paid by the Group N Employee. Additionally, Resolution S provides that the Group N Employee will not have the option of receiving the pick-up contribution in cash instead of having the contribution paid to Plan X.

Based on the aforementioned facts, you request the following rulings:

1. That the mandatory contributions made by the Group N Employees and picked up by Employer M will not be included in the current gross income of the Group N Employees on whose behalf the pick up is made for federal income tax purposes.

2. That the mandatory contributions (two percent of earnable salary) made by the Group N Employees and picked up by Employer M will be treated as employer contributions for federal income tax purposes; and 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 determined to be qualified under section 401(a) of the Code, 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 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.

In order to satisfy Revenue Ruling 81-35, and Revenue Ruling 81-36, with respect to particular contributions, Revenue Ruling 87-10, 1987-1 C.B. 136 provides that the required specification of designated employee contributions must be completed before the period to which such contributions relate. If not, the designated employee contributions being paid by the employer are actually employee contributions paid by the employee and recharacterized at a later date. The retroactive specification of designated employee contributions as paid by the employing unit, i.e., the retroactive "pick up" of designated employee contributions by a governmental employer, is not permitted under section 414(h)(2) of the Code. Thus, employees may not exclude from current gross income designated employee contributions to a qualified plan that

relate to compensation earned for services rendered prior to the date of the last governmental action necessary to effect the pick up.

In this case, Resolution S satisfies the criteria set forth in Revenue Ruling 81-35 and Revenue Ruling 81-36 by specifically providing that Employer M shall pick up the two percent contribution required to be made by the Group N Employees to Plan X and shall consider such amount to be an employer contribution, and by further providing that the Group N Employees' contributions, although designated as employee contributions, shall be paid (picked up) by Employer M in lieu of such contributions being paid by the Group N Employee and that the Group N Employees will not have the option of receiving the pick up contribution in cash instead of having the contribution paid to Plan X.

With respect to ruling requests one and two, we conclude that the mandatory contributions made by the Group N Employees and picked up by Employer M will not be included in the current gross income of the Group N Employees for federal income tax purposes in the year in which such contributions are made to Plan X; will be treated as employer contributions for federal income tax purposes; and will not constitute wages for federal income tax withholding purposes. These amounts will be includible in the gross income of the Group N Employees or their beneficiaries only in the taxable year in which they are distributed, to the extent they represent contributions made by Employer M. Because we have determined that the picked-up amounts are to be treated as employer contributions, they are excepted from wages as defined in section 3401(a)(12)(A) of the Code for federal income tax withholding purposes. In addition, no part of the 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.

This ruling applies only if the effective date for the commencement of the pick up is not earlier than the later of the date Resolution S is signed by Employer M, or the date the pick-up is put into effect. This ruling is based on Resolution S as submitted with your correspondence on January 2, 2006.

This ruling is based on the assumption that Plan X meets the requirements of Code section 401(a) at all times relevant to this proposed transaction.

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 who requested it. Section 6110(k)(3) of the Code 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 with this office.

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If you have any questions, you may contact **********
SE:T:EP:RA:T:2.

Sincerely yours,

(signed) JOYCE E. FLOYD

Joyce E. Floyd, Manager,
Employee Plans Technical Group 2

Enclosures:
Deleted copy of this ruling letter
Notice of Intention to Disclose - Notice 437