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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

200445037

U.I.L. 414.09-00

AUG 12 2004

SE:T:EP:RA:T3

Attn.:

LEGEND:

College A =

State B =

Plan X =

Group N Employees =

Proposed Resolution D =

Statute T =

Board F =

System M =

This is in response to a ruling request submitted on your behalf by your authorized representative dated June 14, 2004, as supplemented by correspondence dated July 30, 2004, and August 11, 2004, concerning the federal income tax treatment of certain contributions to Plan X under section 414(h)(2) of the Internal Revenue Code (the "Code").

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

College A is a governmental instrumentality and educational institution located in State B. Statute T of the State B Revised Statutes provides that boards, such as Board F, may establish an optional retirement program for its employees under which contracts providing retirement and death benefits are provided. Statute T further provides that an optional retirement plan established pursuant to Statute T shall qualify as a governmental plan under section 401(a) of the Code and section 414(d), and shall provide for the pick up of contributions under section 414(h)(2).

Board F, on behalf of College A, proposes to establish an optional retirement program, Plan X, for its Group N Employees. Pursuant to Proposed Resolution D, Board F proposes to adopt Plan X and will permit Group N Employees meeting the eligibility requirements for participation in System M, the retirement plan maintained by State B for state employees, the option to participate in Plan X, a defined contribution plan, at the same contribution rate as provided in System M, except as specifically stated in Proposed Resolution D.

College A proposes to give its current and future Group N Employees an opportunity to elect to participate in Plan X. Plan X, as proposed, will provide that current employees will be given an enrollment period of 90-days beginning on the effective date of Plan X to elect participation in Plan X in lieu of continued participation in System M. Current Group N Employees who do not elect to participate in Plan X within the 90-day election period will continue to participate in System M and will not be eligible to subsequently elect to participate in Plan X after the expiration of the 90-day election period. Group N Employees hired after the effective date of Plan X must elect within 30 days of the employee's effective date of employment to participate in Plan X, or the Group N Employee will be deemed as having elected to continue participation in System M. No subsequent election can be made after the expiration of the 30-day election period.

Section 1.18 of Plan X, as proposed, provides, in pertinent part, that participant plan contributions (Group N Employees' contributions) are designated as being picked up by the institution (College A) in lieu of contributions by the participant, and the picked up amounts cannot be received directly by the participant and are required to be made.

To implement and effectuate the pick-up authority as provided under Statute T, College A intends to adopt Proposed Resolution D.

Proposed Resolution D provides that although designated as employee contributions, all Group N Employee contributions made to Plan X shall be picked up and paid by College A in lieu of contributions by the eligible Group N Employees and the eligible Group N Employees participating in Plan X do not have the option of choosing to receive the contributed amounts directly instead of College A paying such amounts to Plan X.

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

1. That the required eligible employee contributions to Plan X that are "picked up" by College A will be excluded from Group N Employees' gross income.

2. That the "picked up" contributions to Plan X will not be considered wages for federal income tax withholding purposes, and therefore federal income taxes need not be withheld from 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) of the Code, established by a state government or 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 C.B. 255. These revenue rulings established that the following two criteria must be met: (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 be given the option of choosing to received 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 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, Proposed Resolution D satisfies the criteria set forth in Revenue Ruling 81-35 and Revenue Ruling 81-36 by specifically providing that College A will pick up the Group N Employee contributions made to Plan X, and although these contributions are designated as employee contributions, College A will pay such contributions in lieu of contributions by the Group N Employees. Proposed Resolution D further provides that Group N Employees participating in Plan X will not have the option of choosing to receive the contributions that are picked up directly in lieu of having them paid by College A to Plan X.

With respect to your first and second ruling requests, we conclude, assuming that Proposed Resolution D is adopted and implemented by Board F as proposed, that the Group N Employee contributions to Plan X, that are picked up by College A, although designated as employee contributions, will be treated as employer contributions that are picked up by College A within the meaning of Code section 414(h)(2) and will not be includable in the Group N Employees' gross income for federal income tax purposes in the year in which they are contributed to Plan X. These amounts will be includable in the gross income of the Group N Employees or their beneficiaries in the taxable year in which they are distributed, to the extent they represent amounts contributed by College A. 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 College A 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 any proposed pick up as described in Proposed Resolution D is not earlier than the later of the date Proposed Resolution D is adopted by College A, the date Proposed Resolution D become effective, or the date the pick up is put into effect. This ruling is contingent on College A adopting Proposed Resolution D as submitted with your correspondence dated July 30, 2004.

This ruling is based on the condition that a Group N Employee who makes a one-time irrevocable election to participate in the pick up arrangement of Plan X within College A's prescribed election period may not subsequently alter or amend this election to participate in the pick up arrangement. This ruling is also based on the condition that a Group N Employee who makes a one-time irrevocable election to not participate in the pick up arrangement of Plan X within College A's prescribed election period may not subsequently alter or amend this election to not participate in the pick up arrangement. Further, a Group N Employee who fails to elect to make an affirmation election to participate in the pick up arrangement of Plan X within College A's prescribed election period is deemed to have elected to not participate in that arrangement. This deemed election to not participate in the pick up arrangement is treated as the one-time irrevocable election for such Group N Employee and, for purposes of this ruling and the conclusions reached under Code section 414(h)(2), may not be subsequently altered or amended.

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 only addresses the income tax treatment of Group N Employee contributions under Code section 414(h)(2) subsequent to the adoption of Plan X and the implementation of the pick up arrangement described in Proposed Resolution D. No opinion is expressed as to the income tax consequences, if any, that may apply to other provisions of the Proposed Resolution D that relate to a transfer of contributions from System M to Plan X.

This ruling does not express an opinion as to the qualified status of Plan X under Code section 401(a), or Code section 414(d). The determination as to whether a plan is qualified under section 401(a) is within the jurisdiction of the Manager, Employee Plans Determinations Program.

This letter ruling is directed only to the taxpayer that 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 ruling is being sent to your authorized representative in accordance with a Power of Attorney (Form 2848) on file in this office.

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

Sincerely yours,

(signed) JOYCE E. FLOYD

Joyce E. Floyd, Manager
Employee Plans Technical Group 2

Enclsoures:

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Form 437