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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

MAR 01 2005

Uniform Issue List: 414.09-00

Attn:

Legend:

Employer A =

State B =

Ordinance C =

Statute D =

Plan X =

Dear :

This is in response to a ruling request dated July 1, 2004, as supplemented by additional information submitted on July 29, 2004, August 9, 2004, and February 2, 2005, from your authorized representative, concerning the pick up of employee contributions to Plan X under section 414(h)(2) of the Internal Revenue Code ("Code").

The following facts and representations have been submitted:

Employer A established Plan X pursuant to Ordinance C on November 26, 2002. Authority for the adoption of Ordinance C came from Statute D which governs all police pension funds in State B.

Under the terms of Plan X, all police officers employed by Employer A, and not otherwise excluded, must participate in Plan X. Plan X requires mandatory employee contributions equal to a stated percentage of compensation and is qualified under Code section 401(a).

Statute D permits Employer A to pick up the mandatory employee contributions required by Plan X pursuant to Code section 414(h)(2). Statute D also states that the employee contributions which are picked up are treated as employer contributions under the federal income tax laws, but Employer A is required to continue to withhold federal income taxes based upon these contributions until the Internal Revenue Service ("Service") rules, pursuant to Code section 414(h)(2), that these contributions are not to be included in gross income of the participants until such time as they are distributed.

Employer A's governing authority has proposed a resolution, as submitted in your correspondence of February 2, 2005, which provides that Employer A will pick up the mandatory employee contributions within the meaning of Code section 414(h)(2). The resolution states that the contributions, although designated as employee contributions, are being paid by the employer in lieu of contributions by the employee. In addition, the employees will not have the option of receiving the picked-up contributions in cash instead of having the contributions paid by Employer A to Plan X.

The proposed resolution also provides that State B has enacted legislation, Statute D, which enables Employer A to pick up and pay the mandatory employee contributions to Plan X. It further states that upon Employer A's receipt of a favorable ruling from the Service in regard to Code section 414(h)(2), Employer A will as soon as practicable: 1) commence the pick up of mandatory employee pension contributions; 2) exclude all picked-up pension contributions from the gross pay of the policemen involved; and 3) withhold federal and state income taxes on the gross pay less the said picked-up contributions.

Based on the foregoing facts and representations, you have requested the following ruling:

1) That contributions which are picked up by Employer A on behalf of participants in Plan X satisfy all the requirements necessary for such contributions to be considered "picked up" pursuant to Code section 414(h)(2), and that, therefore, they will not be includable in the participants' gross income in the year in which such amounts are contributed, and will be taxable to the respective participants only in the taxable year in which they are distributed, either as a retirement benefit or a lump sum payment.

2) That such "picked-up" contributions, whether "picked-up" by salary reduction, offset against future salary increases, or both, although designated as "employee contributions" for State law purposes, will be treated as "employer contributions" for federal income tax purposes.

3) That such "picked-up" employee contributions are excepted from the definition of "wages" set forth in Code section 3401(a)(12)(A) and, therefore, are not subject to federal income tax withholding when contributed to Plan X.

4) That any distribution of the amount of the "picked-up" contributions, whether distributed as a retirement pension or as a lump sum payment by Plan X, will be taxable under Code section 402(a).

Code section 414(h)(2) provides that contributions, otherwise designated as employee contributions, shall be treated as employer contributions if such contributions are made to a plan described in Code section 401(a), 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 Code section 414(h)(2) 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 Code section 3401(a)(12)(A), 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 for federal income tax purposes 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 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.

The proposed resolution of Employer A's governing authority satisfies the criteria set forth in Revenue Ruling 81-35 and Revenue Ruling 81-36 by providing that Employer A will pick up and make contributions to Plan X in lieu of contributions by participating employees and that no employee will have the option of receiving the contribution in cash instead of having such contribution paid to Plan X.

Accordingly, based on the above facts and representations, we conclude:

1) That contributions which are picked up by Employer A on behalf of participants in Plan X satisfy all the requirements necessary for such contributions to be considered "picked up" pursuant to Code section 414(h)(2), and that, therefore, they will not be includable in the participants' gross income in the year in which such amounts are contributed, and will be taxable to the respective participants only in the taxable year in which they are distributed, either as a retirement benefit or a lump sum payment.

2) That such "picked-up" contributions, whether "picked-up" by salary reduction, offset against future salary increases, or both, although designated as "employee contributions" for State law purposes, will be treated as "employer contributions" for federal income tax purposes.

3) That such "picked-up" employee contributions are excepted from the definition of "wages" set forth in Code section 3401(a)(12)(A) and, therefore, are not subject to federal income tax withholding when contributed to Plan X.

4) That any distribution of the amount of the "picked-up" contributions, whether distributed as a retirement pension or as a lump sum payment by Plan X, will be taxable under Code section 402(a).

The effective date for the commencement of any proposed pick up as specified in the final resolution cannot be any earlier than the later of the date the final resolution is signed or put into effect. Specifically, the resolution shall become effective as of the later of : 1) the date on which the resolution is passed and approved by Employer A, or 2) the date on which the Service rules that pursuant to Code section 414(h)(2) the employees' mandatory contributions to Plan X are not includable in the employees' gross income until they are distributed.

This ruling assumes that the final resolution described above contains all the provisions of the proposed resolution submitted to the Service on February 2, 2005.

This ruling is based on the assumption that Plan X is qualified under Code section 401(a) at all relevant times.

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 that requested it. Code section 6110(k) provides that it may not be used or cited by others as precedent.

If you have any questions, please call , SE:T:EP:RA:T1 [redacted] at [redacted]

Sincerely yours,

Carlton A. Watkins

Manager
Employee Plans Technical Group 1

Enclosures:
Deleted Copy of the Ruling
Notice 437

cc: