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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Index No. 414.09-00

OCT 9 2002

T:EP:RA:T2

Legend:

City A.....

State S.....

Plan X.....

Plan Y.....

Group B Employees.....

Statute A.....

Statute B.....

Dear

This is in response to a letter dated April 20, 2001, submitted on your behalf by your authorized representative in which you requested a ruling under section 414(h)(2) of the Internal Revenue Code ("Code"). The following facts and representations were submitted in connection with your request.

Pursuant to State S law, City A has been a participating local district in Plan X since 1943. Under State S law, membership in Plan X is compulsory for all

Group B Employees of City A, except certain elected and appointed officials. For Group B Employees of City A participating in Plan X, City A is required to make contributions on behalf of such employees to Plan X. Each Group B Employee of City A who participates in Plan X is required to contribute 6.5 percent of his or her compensation to Plan X. You represent that such contributions are required by State S statute to be picked up by City A, such that these contributions are treated as employer contributions under section 414(h)(2) of the Code. You further represent that Group B Employees of City A do not have the ability under State S statute to elect to receive the picked up contributions directly. Plan X is a defined benefit plan maintained by State S which is intended to be a plan as described in section 401(a) of the Code.

In addition to being a participating local district in Plan X, City A is the sponsor of Plan Y, a defined contribution money purchase plan. As originally adopted by order of the City Council of City A, Plan Y became effective on July 1, 1991. Plan Y was adopted in 1991 by City A because under a ruling by State S officials, participation in Plan X became optional for department heads and other appointed officials. Plan Y was amended and restated in 1991 by City A because of a change in State S law that allowed any City A employee who was not covered by a collective bargaining agreement to choose between participation in Plan X and participation in a qualified plan, such as Plan Y, sponsored by a participating local district, such as City A. Plan Y was further amended in 1998, based on a change in State S law, that permits all Group B Employees of City A, including those covered by a collective bargaining agreement to choose to participate in Plan X or Plan Y. Statute B provides the authority pursuant to which City A provides Plan Y for its employees. You represent that City A has never applied for a determination letter with respect to Plan Y. You further represent that Plan Y is and has intended to be a qualified plan under section 401(a) of the Code and its trust tax exempt under section 501(a).

As mentioned earlier, City A adopted Plan Y in 1991, and amended it in 1998 in order to provide an alternative to participation in Plan X for those of its Group B Employees for whom participation in Plan X became optional. Under the terms of Plan Y, City A has been obligated to make the same contribution to Plan Y as a percentage of compensation, as if the employee were covered under the Social Security Act. Further, Group B Employees of City A who participate in Plan Y are required to contribute 6.5 percent of his or her compensation to Pan Y, which is the same as the Group B Employee's required contribution rate in Plan X. Plan Y provides that City A elects to pick up the mandatory, required Group B Employee contributions.

Prior to 1998, State S law did not allow an employee of a participating local district who was required to participate in Plan X to opt out of Plan X in order to participate in an alternative plan offered by the participating local district. Under Statute A, an employee of a participating local district now has the ability to move

back and forth, within limits, between Plan X and an alternative plan offered by the participating local district employer. An employee of a participating local district must elect to participate in Plan X, or, as it specifically applies to Group B Employees, Plan Y. Group B Employees, for example, are not able to elect to not participate in either plan and thereby receive directly as additional compensation the participating local district's contributions.
In July, 1998, the City Council of City A also provided that any Group B Employee's choice to enter Plan Y shall be irrevocable.

A Group B Employee of City A desires to take advantage of the ability to move back and forth between Plan X and Plan Y as contemplated by Statute A. The current terms of Plan Y do not allow Group B Employees to revoke their decision to participate in Plan Y in order to participate in Plan X. City A wishes to amend Plan Y in order to provide its Group B Employees with the ability to take advantage of the flexibility that State S law now provides with respect to their decision to participate in either Plan X or Plan Y. In the event of such an election, all future Group B Employee contributions shall be made to the plan as elected by the employee. As proposed, the amendment provides that if a Group B Employee elects to opt out of Plan Y to participate in Plan X, Plan Y will make a direct plan-to-plan transfer of the employee's benefit under Plan Y to Plan X. Similarly, when a Group B Employee who participates in Plan X elects to participate in Plan Y, Plan X will make a direct plan-to-plan transfer of the Group B Employee's accumulated contributions in Plan X to Plan Y. At no time will a Group B Employee be able to elect out of the pick up arrangement in either Plan X or Plan Y. City A will continue to pick up the Group B Employee's contributions whether the Group B Employee elects to participate in Plan X or Plan Y.

Based on the above facts and representations, you request the following ruling:

That the Group B Employee mandatory contributions made to Plan Y (which are designated as pick-up contributions pursuant to section 414(h)(2) of the Code) shall continue to be treated as employer contributions for Federal income tax purposes in the event of an election by a Group B Employee in Plan Y to participate in Plan X in lieu of participation in Plan Y as permitted by the amendment to Plan Y, consistent with the requirements of State S law.

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 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 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. 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), 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 the 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 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 Ruling 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.

In the instant case, you have represented that mandatory Group B Employee contributions to both Plans X and Y are picked-up in accordance with the aforementioned authority. As such, the mere election by a Group B Employee to participate in Plan X rather than Plan Y, pursuant to Statute A, will not in and of itself cause the Plan Y pick-up arrangement to be other than an arrangement as described in section 414(h)(2) of the Code.

Therefore, as to your ruling request, we conclude that the Group B Employee mandatory contributions made to Plan Y (which are designated as pick-up contributions pursuant to section 414(h)(2) of the Code) shall continue to be treated as employer contributions for Federal income tax purposes in the event of an election by a Group B Employee in Plan Y to participate in Plan X in lieu of participation in Plan Y as permitted by the amendment to Plan Y, consistent with the requirements of State S law.

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" under Code section 3121(v)(1)(B).

These rulings are based on the assumption that Plans X and Y are qualified under section 401(a) at all times relevant to the proposed transaction. In addition, this ruling expresses no opinion as to be validity of the pick-up arrangements of Plan X and Plan Y under section 414(h)(2) of the Code.

This ruling is directed only to the taxpayer who requested it. Code section 6110(k)(3) provides that it may not be used or cited as precedent.

Should you have any questions, please contact **********, **-*****, *:**:**:**, at (***) ***-****.

Sincerely yours,

(signed) JOYCE E. FLOYD

Joyce E. Floyd, Manager
Employee Plans Technical Group 2
Tax Exempt and Government Entities Division

Enclosures:
Copy of ruling
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Notice 437

cc:

cc: