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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Uniform Issue No.: 414.07-00

MAY 9 2003

T:EP:RA:T2

Legend:

State C =

Fund F =

Participating Employees =

Plan X =

Plan Y =

Group B Employees =

Statue R =

Statue S =

Statute T =

System B =

Resolution R =

Dear

This letter is in response to a request for a private letter ruling dated November 21, 2000, as supplemented by letters dated September 24, 2001, May 7, 2002, July 11, 2002, July 31, 2002, January 17, 2003, February 28, 2003, March 24, 2003, and March 27, 2003, made on your behalf by your authorized representatives concerning the treatment of certain contributions made to Plan X and Plan Y under section 414(h)(2) of the Internal Revenue Code, (the "Code").

The following facts and representations have been submitted:

Fund F is a retirement fund established in 1994, pursuant to Statute R of State C Revised Statutes, to provide retirement benefits to eligible Group B Employees of Participating Employers located in State C. Statute R provides that Fund F shall be managed by a board of directors, which you represent is a state agency under the State C Revised Statutes. The Board of Directors governs Fund F. County employees elect nine board members and the governor of State C appoints the other two members.

Prior to January 1, 2000, all retirement benefits were provided through Plan X defined benefit plan. Plan X is intended to be a tax-exempt retirement program under section 401(a) of the Code. In 1999, the State C legislature amended Statute R to create Plan Y, a defined contribution plan. Plan Y became effective January 1, 2000. Plan Y is intended to qualify as a tax-exempt retirement program under section 401(a). Plan X and Plan Y are statutorily promulgated by the State C legislature. The plan documents that relate to Plan X are the relevant sections of Statute S of the Code of State C Regulations. The plan documents that relate to Plan Y are the relevant sections of Statute T of the Code of State C Regulations.

Under Plan X, certain Group B Employees are required, as a condition of employment with the Participating Employer that employs them, to contribute two percent of their compensation to Plan X. Before January 1, 2000, certain Group B Employees were permitted to opt-out of Plan X and not make contributions to Plan X. These Group B Employees who had previously opted out of Plan X before the effective date of the pick up contributions were given a one-time opportunity for a three-month period to opt into Plan X after the pick up contributions went into effect. If the Group B Employee failed to opt into Plan X within the applicable three-month period, the Group B Employee became forever ineligible to participate in Plan X.

Effective January 1, 2000, Plan X and Plan Y were amended to provide for a pick up of employee contributions by the Participating Employers. Plan X provides that a participant who is not a member of System B is subject to a two percent monthly payroll deduction beginning with the first payroll deduction after the participant's entry date and

such contributions shall constitute the participant's required contributions and after January 1, 2002, shall be designed as an employer pick up contribution, as described in section 414(h) of the Code. Plan X further provides that a participant may not waive this contribution or terminate this contribution by waiving out of the plan.

Plan Y provides that each employee who is not a member of System B shall make a contribution of seven-tenths of one percent of his/her compensation to Plan Y. This contribution shall be made by payroll deduction and shall commence immediately upon the date the individual becomes an employee. Plan Y further provides that this contribution shall be designated as an employee pick up contribution as described in section 414(h) of the Code and that a participant may not waive this contribution requirement by waiving out of the plan.

In order to implement the pick up contributions provisions of Plan X and Plan Y, the Board of Directors of Fund F has proposed a resolution, Proposed Resolution M. Proposed Resolution M provides that each respective Participating Employer will assume and pay the mandatory contributions of Group B Employees who participate in Plan X and Plan Y. Such contributions, although designated as employee contributions, are being paid by each Participating Employer in lieu of contributions by the Group B Employee. No Group B Employee will have the option of choosing to receive such contributions directly instead of having them paid by the Participating Employer to Plan X and Plan Y.

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

1. The mandatory employee contributions "picked-up" by each participating employer in Plan X will be treated as employer contributions for the purposes of section 414(h)(2) of the Code.

2. The mandatory employee contributions "picked up" by each participating employer in Plan Y will be treated as employer contributions for the purposes of section 414(h)(2) of the Code.

Section 414(h)(2) of the Code provides that contributions, otherwise designated as employee contributions, shall be treated as employer contributions if (1) such contributions are made to a plan determined to be qualified under section 401(a), (2) the plan is established by a state government or political subdivision thereof, and (3) the contributions 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, 1997-2 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 pick-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 such pick-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 contribution 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.

Revenue Ruling 87-10, 1987-1 C.B. 136, provides that in order to satisfy Revenue Rulings 81-35 and 81-36, the required specification of designated employee contributions must be completed before the period to which such contributions relate. Thus, employees may not exclude from current gross income designated employee contributions to a qualified plan that relate to compensation earned for services prior to the date of the last governmental action necessary to effect the pick up.

In this case, Proposed Resolution M satisfies the criteria of Rev. Rul. 81-35 and Rev. Rul. 81-36 by providing that the respective Participating Employers will assume and pay the mandatory employee contributions of Group B Employees who participate in Plan X and Plan Y; that such contributions although designated as employee contributions, are being paid by each Participating Employer in lieu of contributions by the Group B Employees; and that no Group B Employee will have the option of choosing to receive such contributions directly instead of having them paid by the Participating Employer to Plan X and Plan Y.

Accordingly, with respect to ruling request one and two, we conclude that the mandatory Group B Employee contributions pick up by each Participating Employer in Plan X and Plan Y will be treated as employer contributions for purposes of section 414(h)(2) of the Code.

The effective date for the commencement of any pick up of employee contributions in Plan X and Plan Y cannot be earlier than the later of the date the Proposed Resolution M is adopted and put into effect by the Board of Directors of Fund F, or the date the pick up provisions of Plan X and Plan Y are put into effect.

This ruling is conditioned on the Board of Directors of Fund F adopting and implementing Proposed Resolution M as submitted with your correspondence dated March 24, 2003.

Revenue Ruling 87-10 provides that employees may not exclude from current gross income designated employee contributions that relate to compensation earned for services prior to the date of the last governmental action necessary to effect the pick up. Therefore, in accordance with Revenue Ruling 87-10, the conclusions reached herein do not apply to any picked up contributions in Plan X and Plan Y to the extent the picked up contributions in either plan relate to compensation earned prior to Board of Directors of Fund F adopting Proposed Resolution M, or prior to the date the last governmental action necessary to effect the pick up provisions in Plan X and Plan Y. This ruling is limited to employee contributions that are picked up subsequent to the adoption and implementation of Proposed Resolution M by the Board of Directors of Fund F and does not express an opinion as to the validity of the pick up of employee contributions prior to such adoption and implementation.

An election by a Group B Employee to not participate in the pick up provisions in Plan X is an irrevocable election that may not subsequently be altered or amended.

This ruling expresses no opinion as to the validity of the pick up employee contributions in Plan X and Plan Y as stated in your letter dated March 24, 2003, prior to the date the Board of Directors of Fund F adopts and puts the Proposed Resolution into effect.

This ruling is based on the assumption that Plan X and Plan Y meet the requirements for qualification 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) of the Code.

Further, this ruling is not a ruling with respect to the tax effects of the pick-up on employees of the Participating Employers in Plan X and/or Plan Y. However, in order for the tax effects that follow from this ruling to apply to those employees of a particular

Participating Employer described in the preceding sentence, the pick-up arrangement must be implemented by that Participating Employer in the manner described herein.

This ruling letter 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.

This letter is being sent to your authorized representative in accordance with a power of attorney on file in this office.

Sincerely yours,

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

Enclosures:
Deleted copy of letter ruling
Form 437