Internal Revenue Service

Department of the Treasury

Washington, DC 20224

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UIL: 414.00-00
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Contact Person:

Telephone Number:

In Reference to:

T:EP:RA:T3

Date:

JUN - 7 2000

Legend:

State A =
State Statute C =

Group B Employees =

Plan X =

Dear Mr.

In a letter dated October 15, 1999, as supplemented by correspondence dated November 29, 1999 and February 21, 2000, you requested a ruling concerning the federal income tax treatment of certain contributions to Plan X under section 414(h)(2) of the Internal Revenue Code.

The following facts and representations have been submitted:

Plan X was created by State Statute C. The enabling legislation for Plan X became effective August 13, 1986, retroactive to July 1, 1986.

Plan X is a defined benefit, multi-employer government pension plan as specified in section 414(d) of the Code. It was created to provide retirement, disability, survivor and death benefits to designated Group B Employees, who are designated corrections personnel employed by State A and its counties. Plan X currently has 12 participating employers, which include State A and each county in State A which employs corrections personnel (prison/jail guards etc.). Plan X is funded by employer and employee contributions, as well as investment income derived therefrom. The money accumulated by Plan X, the Fund, is managed

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by a separate agency of State A called the Fund Manager, which serves as the Fund's trustee. The Fund is used exclusively to pay benefits to and on behalf of Group B Employees and their beneficiaries in accordance with the Plan's enabling legislation, as well as to pay the administrative, operation and investment expenses of Plan X and the Fund. Various statutes prohibit any portion of the Fund from reverting or otherwise being paid to an employer participating in Plan X.

Plan X is a qualified pension plan under section 401(a) of the Code. Further, Plan X's Fund or trust is exempt from federal income tax under section 501(a) of the Code.

All employees in positions designated by Plan X's enabling legislation, and employed by an employer participating in Plan X, are required to participate in Plan X. Each Group B Employee participating in Plan X is required to contribute 8.5 percent of his salary to the Plan pursuant to payroll deduction. As determined by regularly determined actuarial valuations, each employer participating in Plan X is required to make level percentage of compensation contributions for its Group B Employees sufficient under the actuarial valuations to meet both the normal cost of funding Plan X plus the actuarially determined amount required to amortize the unfunded accrued liability of Plan X over a rolling 20-year period commencing July 1, 1997.

An employer may pay a higher level percentage of compensation, thereby reducing its unfunded past service liability for its participating employees. All employer contributions to Plan X are irrevocable and must be used to pay benefits under Plan X or to pay expenses of Plan X and the Fund. Forfeitures arising because of severance of employment before a participating Group B Employee becomes eligible for a pension or for any other reason are applied to reduce the cost to the respective employer, and not to increase the benefits otherwise payable to Group B Employees.

In August 1986, Plan X's enabling legislation, State Statute C, was amended to include a Code section 414(h) "pick up" provision, as follows:

> Each participating employer shall pick up the contributions required of members on account of compensation paid after the effective date specified in the resolution of the fund

> manager activating the provisions of this section. The picked-up contributions shall be treated as participating employer contributions for the purpose of tax treatment under the Code. The specified effective date shall not be before the date Plan X receives notification from the Internal Revenue Service that pursuant to section 414(h) of the Code, the member contributions picked up shall not be included in gross income for income tax purposes until the time that the picked-up contributions are distributed by refund or pension payments. The participating employers shall pick up the member's contributions from funds established and available in a retirement deduction account, which funds would otherwise have been designated as member contributions and paid to Plan X. Member contributions picked up pursuant to this section shall be treated for all other purposes, in the same manner and to the same extent, as member contributions made before the effective date.

You have represented that State Statute C provides that (1) the mandatory employee contributions are being paid by the participating Plan X employers in lieu of contributions by the Group B Employees, and (2) the Group B Employee does not have the option of choosing to receive the contributed amounts directly instead of having them paid by the participating Plan X employer to Plan X.

To date, no employer participating in Plan X has picked up contributions for its employees pursuant to State Statute C since to date, Plan X has not received notification from the Service that any employee contributions picked up pursuant to State Statute C will not be included in gross income for federal income tax purposes until the time that the picked-up contributions are distributed.

Based upon the aforementioned facts, you request a ruling that:

1. Amounts picked up by Plan X employers in accordance with State Statute C on behalf of their employees participating in Plan X shall not be considered to be included in such employees'

gross income for income tax purposes until the time that the picked-up contributions are distributed;

2. Amounts picked up by Plan X employers pursuant to State Statute C, although designated as employee contributions, shall be treated as employer contributions for purposes of federal income taxation; and

3. Contributions to Plan X picked up by Plan X employers in accordance with State Statute C will be treated by the Service as employer contributions and thus, excepted from wages under section 3401(a)(12)(A) of the Code for purposes of 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 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 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 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 Internal Revenue 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.

Pursuant to State Statute C, criteria set forth in Revenue Ruling 81-35 and Revenue Ruling 81-36 is satisfied by providing, in effect, that participating Plan X employers will make contributions in lieu of Group B Employees' contributions and by providing that Group B Employees shall not be given the option to receive such contributions directly.

Accordingly, with respect to ruling requests 1 and 2, we conclude that the mandatory employee contributions picked up by participating Plan X employers on behalf of Group B Employees who are participants in Plan X will be treated as employer contributions for purposes of federal income taxation and will not be included in the Group B Employees' gross income for the year in which such amounts are contributed. These amounts will be includible in the gross income of the Group B Employees or their beneficiaries only in the taxable year in which they are distributed from Plan X.

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. Therefore, with respect to ruling request 3, we conclude that no withholding of federal income tax is required from Group B Employees' salaries with respect to such picked-up contributions.

In accordance with Rev. Rul. 87-10, this ruling does not apply to any contribution to the extent it relates to compensation earned before the later of the effective date of the relevant statutes, the date the pick-up election is executed or the date it is put into effect.

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.

These rulings are based on the assumption that Plan X will be qualified under section 401(a) of the Code at the time of the proposed contributions and distributions.

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.

Sincerely yours,

Frances V. Sloan

Frances V. Sloan, Manager
Employee Plans Technical Group 3
Tax Exempt and Government
Entities Division

Enclosures:
Deleted copy of this ruling
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