Internal Revenue Service Department of the Treasury

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Person to Contact:
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Refer Reply to:
T:EP:RA:**

Date: FEB 10 2000

Attention: **********
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Legend:

State A = ****

Plan X = **********
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Plan Y = **********
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Statute Z = **********

Resolution B = **********

Employer M = **********

Dear **********

This is in response to a request for a ruling, dated July 7, 1999, submitted on your behalf by your authorized representative, with respect to the federal income tax treatment of certain contributions to Plan X and Plan Y under section 414(h)(2) of the Internal Revenue Code.

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

Employer M is an instrumentality of State A providing public educational services. Most of Employer M's staff employees are participants in Plan X, a governmental plan within the meaning of section 414(d) of the Code. Plan X is a contributory defined benefit plan intended to meet the requirements of section 401(a) of the Code as applicable to governmental plans as defined in section 414(d). Plan X has received a favorable determination letter.

377

All staff members except those involved in law enforcement are required to contribute 8.5 percent and Employer M contributes 13.31 percent of their compensation to Plan X. Law enforcement staff members contribute 9 percent and Employer M contributes 16.77 percent of their compensation to Plan X. The current mandatory employee contributions to Plan X are "picked up" under section 414(h)(2) of the Code based on a ruling effective January 1, 1983. The contributions are separately accounted for and are held in individual member accounts.

Pursuant to terms set forth in Chapter 145 of Statute Z, Plan X also permits the purchase of prior or additional service credit by its employee members for service previously performed when the employee was not a contributing member of Plan X (e.g., military service, out-of-state public service, federal civilian service, exempted service (student), or unpaid leave of absence) or service for which the employee has previously received a refund of Plan X contributions.

To purchase additional service credit, an employee must pay into Plan X. The amount depends upon the type of credit being purchased. In some cases it is equal to the contributions the employee would have made had the employee been a contributing member for the years of credit being purchased plus interest. In other situations, the employee may purchase an additional benefit by paying the actuarial cost of that benefit to Plan X. Purchase of additional service credit under Plan X may be done by payroll deduction.

Currently, all purchases of additional retirement service credit by Employer M's employees are being made on an after-tax basis. Employer M proposes to pick up the additional employee contributions made through payroll deduction installment payments. Employer M adopted Resolution B approving a Plan X pick up plan providing that prior or additional service credit may be purchased under the installment method on a pre-tax basis only after the completion of a binding, irrevocable payroll authorization form by the employee and Employer M. For employees in the Plan X pick up plan, employee contributions made through payroll deduction will be picked up and paid by Employer M with the employee having no option of receiving the picked-up amounts directly. The employee will waive all rights to terminate the election.

The pick up arrangement is scheduled to start September 1, 1999 or as soon as possible thereafter. The irrevocable agreement between each participating employee and Employer M

will be signed by both parties prior to any contributions. Amounts deducted from the employee's compensation and used to purchase additional retirement service credit will not be available for withdrawal from Plan X until the employee's termination of employment.

Employees electing not to participant in the Plan X pick up plan may make after-tax purchases of additional service credits by payroll deduction, partial payment or lump sum payment. They will do so as in the past by making a revocable election to purchase additional service credits.

Most of Employer M's faculty employees are participants in Plan Y, a governmental plan within the meaning of section 414(d) of the Code. Plan Y is a contributory defined benefit plan intended to meet the requirements of section 401(a) of the Code as applicable to governmental plans as defined in section 414(d). The related trust forming part of Plan Y is intended to be exempt from taxation under section 501(a) of the Code. Plan Y has received a favorable determination letter.

All members of Plan Y are required to contribute 9.3 percent, and Employer M contributes 14 percent, of compensation to Plan Y. The current mandatory employee contributions to Plan Y are picked up under section 414(h)(2) of the Code based on a ruling effective January 1, 1983. The contributions are separately accounted for and are held in individual member accounts.

Pursuant to the terms set forth in Chapter 3307 of Statute Z, Plan Y also permits the purchase of prior or additional service credit by employee members for service previously performed when the employee was not a contributing member of Plan Y (e.g., military service, out-of-state public service, exempted service (student), or service as a teacher at a private educational institution) or service for which the employee has previously received a refund of Plan Y contributions.

To purchase additional service credit, an employee must pay into Plan Y. The amount depends upon the type of credit being purchased. In some cases it is equal to the contributions the employee would have made had the employee been a contributing member for the years of credit being purchased, plus interest. In other situations the employee may purchase an additional benefit by paying the actuarial cost of that benefit to Plan Y. Purchase of additional service credit may be done by payroll deduction.

Currently, all purchases of additional retirement service credit by Employer M's employees are being made on an after-tax basis. Employer M proposes to pick up the additional employee contributions made through payroll deduction installment payments. Employer M adopted Resolution B approving a Plan Y pick up plan providing that prior or additional service credit may be purchased under the installment method on a pre-tax basis only after the completion of a binding irrevocable payroll authorization form by the employee and Employer M. For employees in the Plan Y pick up plan, employee contributions made through payroll deduction will be picked up and paid by Employer M with the employee having no option of receiving the picked-up amounts directly. The employee will waive all rights to terminate the election.

The pick up arrangement is scheduled to start September 1, 1999 or as soon as possible thereafter. The irrevocable agreement between the employee and Employer M must be signed by both parties prior to the pick up of any contributions. Amounts deducted from the employee's compensation and used to purchase additional retirement service credit will not be available for withdrawal from Plan Y until the employee's termination of employment.

Employees electing not to participate in the Plan Y pick up plan may make after-tax purchases of additional service credit by payroll deduction, partial payment or lump sum payment. They will do so as in the past by making a revocable election to purchase additional service credits.

Based on the foregoing facts and representations, your authorized representative has requested rulings that:

(1) No part of the contributions picked up by Employer M as the employer of the employees included in Plan X or Plan Y be considered as gross income to the employees for federal tax treatment;
(2) The contributions, whether picked up by salary reduction, offset against future salary increases, or both and though designated as employee contributions, will be treated as Employer M contributions for federal income tax purposes; and,
(3) The contributions picked up by Employer M will not constitute wages from which taxes must be withheld.

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 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 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 order to satisfy Revenue Rulings 81-35 and 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. Thus, 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.

Resolution B, adopted by Employer M, satisfies the criteria set forth in Revenue Rulings 81-35 and 81-36 inasmuch as: (1) the contributions, although designated as employee contributions, are to be made by Employer M in lieu of contributions by the employees; and, (2) the employees may not elect to receive such contributions directly.

Accordingly, we conclude that no part of the contributions picked up by Employer M as the employer of the employees included in Plan X or Plan Y is gross income to the employees for federal tax treatment; the contributions, whether picked up by salary reduction, offset against future salary increases, or both, and though designated as employee contributions, will be treated as employer contributions for federal income tax purposes; and, such contributions will not constitute wages from which federal income taxes must be withheld.

These rulings apply only if the effective date for the commencement of any proposed pick up of prior or additional service credit as specified in Resolution B is no earlier than the later of the date the resolution and payroll authorization form are signed or the date they are put into effect.

State A has not requested a ruling and the Internal Revenue Service reaches no conclusion in this letter as to the status of Plan X or Plan Y as a governmental plan within the meaning of section 414(d) of the code.

These rulings are based on the assumption that Plan X and Plan Y will be qualified 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 being paid pursuant to a "salary reduction agreement" within the meaning of section 3121(v)(1)(B).

These rulings are directed only to the taxpayer who requested them. Section 6110(k)(3) of the Code provides that they may not be used or cited by others as precedent.

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

Sincerely yours,

(signed) JOYCE E. FLOYD
Joyce E. Floyd, Manager
Employee Plans Technical Group 2
Tax Exempt and Government Entities
Division

Enclosures:
Deleted copy of this letter
Notice 437