Internal Revenue Service

U.I.L. 414.09-00

Department of the Treasury

Washington, DC 20224

200044042

Contact Person:

Telephone Number:

In Reference to:

T:EP:RA:T2/5002313

Date:

AUG 7 2000

Attn:

Legend

State A =
Employer M =
Group B Employees =

Plan X =
Proposed Ordinance R=

Proposed Form N =

Dear

This is in response to a ruling request dated March 28, 2000, as supplemented by correspondence dated June 6, and June 7, 2000, which was submitted on your behalf by your authorized representative, concerning the federal income tax treatment, under section 414(h)(2) of the Internal Revenue Code ("Code"), of certain contributions to Plan X.

The following facts and representations have been submitted:

The Board of Trustees of Employer M sponsors Plan X, a defined benefit plan. It is represented that Plan X is qualified under section 401(a) of the Code. Membership in Plan X is granted to all full-time, permanent employees and officers of Employer M. Employer M wishes to implement a program in which prior service credit may be purchased. The business reason for this proposed arrangement is to permit contributions required to be made to obtain benefits under Plan X to be made on a pre-tax basis as permitted under section 414(h)(2) of the Code.

Effective, as of the later of July 1, 2000, or upon adoption of Proposed Ordinance R and Proposed Form N by the City Council of Employer M, Plan X will be

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amended to permit a covered employee to purchase creditable service for prior service in various capacities with various employers (generally governmental service) as described in Proposed Ordinance R.

In order to implement the foregoing, Employer M proposes to adopt Proposed Ordinance R and Proposed Form N. Proposed Ordinance R provides that upon an election by a member to purchase service pursuant to Proposed Ordinance R, and the receipt by Employer M of a binding and irrevocable salary reduction agreement executed by the member on a form (Proposed Form N) provided by Employer M for this purpose, Employer M shall pay to Plan X an equivalent amount in lieu of the employee's contribution required to purchase creditable service. The cost of such creditable service purchase is to be set at an actuarially determined percentage of earnable compensation intended to pay for the full cost of the benefit to be provided.

Proposed Ordinance R further provides that the employee shall not be given the option of choosing to receive the contributed amounts directly instead of having them paid by Employer M to Plan X. Such election shall not be effective prior to the effective date of Proposed Ordinance R or prior to the receipt of the signed Proposed Form N. Contributions made by Employer M pursuant to Proposed Ordinance R shall be considered earnable compensation for purposes of Chapter 22 of the City Code. Such contributions shall be paid to the trust fund by Employer M from the same source of funds as used in paying wages to affected employees.

Proposed Form N is a salary reduction election form to be used for the pick-up of prior service credit. Proposed Form N permits an employee to enter into a binding, irrevocable payroll deduction authorization which states the beginning and ending dates of the election, the percentage of earnable compensation that will be paid each pay period by Employer M and indicates the dates of the service being purchased. Proposed Form N also provides that such employee will not have the option of choosing to receive the amounts directly instead of having them paid by Employer M directly into Plan X.

Based on the aforementioned facts, you request the following rulings:

1. That amounts deducted and withheld from a Group B Employee's salary pursuant to Proposed Ordinance R and Proposed Form N that are used to purchase prior service credit pursuant to Proposed Ordinance R and Proposed Form N qualify as employee contributions that are picked up by Employer M under section 414(h)(2) of the Code and as such are not included in gross income for federal income tax purposes.

2. That amounts deducted and withheld from a Group B Employee's salary pursuant to Proposed Ordinance R and Proposed Form N that are used to purchase prior service credit pursuant to Proposed Ordinance R and Proposed Form N qualify as employee contributions that are picked up by Employer M under section 414(h)(2) of the Code and as such do not constitute wages for federal income tax withholding purposes.

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 determined to be qualified under 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. For purposes of the application of section 414(h)(2) of the Code, it is immaterial 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.

In this request, Proposed Ordinance R and Proposed Form N, if adopted as proposed, would satisfy the criteria set forth in Rev. Rul. 81-35 and Rev. Rul. 81-36. Proposed Ordinance R and Proposed Form N provide that Employer M will make contributions to Plan X in lieu of contributions by Group B Employees and that the Group B Employees may not elect to receive such contributions directly.

Accordingly, we conclude with respect to ruling request number one, that amounts deducted and withheld from a Group B Employee's salary pursuant to Proposed Ordinance R and Proposed Form N that are used to purchase prior service credit pursuant to Proposed Ordinance R and Proposed Form N qualify as employee contributions that are picked up by Employer M under section 414(h)(2) of the Code and as such are not included in gross income for federal income tax purposes in the year in which such amounts are contributed to Plan X. These amounts will be included in the gross income of the Group B Employees or their beneficiaries in the year in which they are distributed, to the extent that the amounts represent contributions made by Employer M.

With regard to ruling request number two, we conclude that amounts deducted and withheld from a Group B Employee's salary pursuant to Proposed Ordinance R and Proposed Form N that are used to purchase prior service credit pursuant to Proposed Ordinance R and Proposed Form N qualify as employee contributions that are picked up by Employer M and as such do not constitute wages for federal income tax withholding purposes. The contributions picked up by Employer M on behalf of the Group B Employees, whether by payroll deduction, an offset against future salary increases, or both and though designated as employee contributions will be treated as employer contributions for federal income tax purposes. Since we have determined that the picked-up contributions 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, no withholding of federal income tax is required in the taxable year in which they are contributed to Plan X.

These rulings apply only if the effective date for the commencement of any proposed pick up of prior service credit is not earlier than the later of the date Proposed Ordinance R and Proposed Form N are finalized and signed into law or the date they are put into effect.

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.

In addition, these rulings are contingent upon the adoption of Proposed Ordinance R and Proposed Form N, as contained in your correspondence dated June 7, 2000.

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).

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.

A copy of this letter has been sent to your authorized representative in accordance with the power of attorney on file with this office.

Sincerely yours,

(signed) JOYCE E. FLOYD

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

Enclosures:
Copy of this Letter, Deleted Copy, & Notice 437