Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply to:

Date:

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Attn:

AUG 30 2000

Legend:

State A =

Participating Employer/Employers =

Plan X =

Pension Group B =

Pension Group C =

Pension Group D =

Board =

Act =

Form P =

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Ladies and Gentlemen:

This letter is in reply to a request for a letter ruling dated March 6, 1999, as supplemented by letters dated July 14,1999, April 14,2000, April 26, 2000, May 22, 2000 and June 29, 2000, made on behalf of Plan X, concerning the pick up of certain employee contributions under its qualified retirement plan pursuant to section 414(h)(2) of the Internal Revenue Code ("Code").

The following facts and representations have been submitted:

Plan X is a body corporate and an instrumentality of State A. Plan X is a single plan consisting of three statewide pension groups of employees (Group B, Group C and Group D) and is governed and administered by the Board. Plan X is qualified under section 401(a) of the Code and its most recent determination letter is dated October 14,1999. Plan X is a defined benefit plan that includes a mandatory employee contribution feature and certain elective contribution features.

As stated, Plan X includes employees of the three pension groups. With regard to Group B, membership in Plan X is mandatory for all employees of Participating Employers (except elected officials and specified state officers and employees who may make an irrevocable election to participate), both current and future, whose employment is not seasonal or temporary and requires at least one thousand (1,000) hours of work per year. School employees become eligible immediately after employment and non-school employees become eligible after one (1) continuous year of service.

For Group C, any policeman or fireman employed by a Participating Employer whose employment for police or fireman purposes is not seasonal or temporary and requires at least one thousand (1,000) hours of work per year is required to participate.

As to Group D, any duly elected or appointed justice of the Supreme Court, judge of the court of appeals or judge of any district court of State A, or district magistrate appointed on or after July 1, 1993 is required to participate automatically upon appointment.

Plan X previously received a private letter ruling dated February 2, 1984, with respect to the favorable "pick up" treatment under section 414(h)(2) of the Code for its members' mandatory employee contributions.

The relevant sections of the Act provide that members of the three pension groups(Groups B, C and D) are permitted through payroll reduction to purchase former or additional service credit or to make additional contributions for enhanced benefits.

Participants covered under Plan X may elect to purchase various types of service credit by making voluntary additional contributions to Plan X. Originally, only lump sum payments were allowed. Now most of these voluntary contributions may be made by lump sum payment or by payroll deduction. Types of service purchases available include military service, out-of-state public teaching service, in-state public service not covered by Plan X and out-of-state non-federal public service.

Plan X provides that when a participant terminates employment, the participant may receive a refund of contributions previously made to Plan X. Upon receipt of these refunded contributions, the participant's contributory service credits are forfeited. If the former participant is subsequently rehired by a Participating Employer, such participant may elect to redeposit an amount equal to any contributions that have previously been refunded plus interest. Repayment may be made at any time prior to the date of participant's retirement. The electing participant may make the redeposit in either lump sum or installments by executing an irrevocable payroll reduction authorization form (Form P).

Under the relevant provisions of the Act, Participating Employers are required to pick up and pay voluntary additional employee contributions made through Form P for the purchase or restoration of service credit. The Board interprets these provisions of the Act as

requiring that all such contributions be picked up by Participating Employers in accordance with Code requirements, without the need for separate employer pick-up resolutions.

The Act specifies that such picked-up contributions, although designated as employee contributions, are being paid by the employer in lieu of contributions by the employee and 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 Plan X, and that the pick up is not effective prior to the last action required to be taken by the employer and/or the employee. The pick up is not applicable to contributions attributable to service performed before the effective date. Also, Form P provides that member contributions to purchase prior service credit shall be picked up by Participating Employers, as described in section 414(h)(2) of the Code, deducted from the pay of the contributing member as salary reduction contributions, and paid by Participating Employers to Plan X. Members will have no option to receive the picked-up amounts directly because of the irrevocable binding election made by the members in Form P.

Based on the above facts and representations, you have requested the following rulings:

1. That voluntary additional employee contributions made to redeposit previously refunded contributions or to purchase additional service credit, which are to be picked up and paid to Plan X by a Participating Employer on behalf of its Member-Participants, although designated as employee contributions under state law, will be treated as employer contributions under Code section 414(h)(2).

2. That the picked-up contributions will not be treated as annual additions for purposes of Code section 415(c).

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) or 403(a) of the Code, established by a State government or political subdivision thereof, or by any agency or instrumentality of the foregoing, where the contributions of employing units are designated as employee contributions but where any employing unit picks up the contributions, the contributions so picked up shall be treated as employer contributions.

Revenue Ruling 77-462, 1977-2 C.B. 358, addresses the federal income tax treatment of contributions picked up by the employer within the meaning of section 414(h)(2) of the Code. In Rev. Rul. 77-462, the employer school district agreed to pick up the required contributions of the eligible employees under the plan. The revenue ruling held that under the provisions of section 3401(a)(12)(A) of the Code, the school district's picked-up contributions to the plan are excluded from wages for purposes of the Collection of Income Tax at Source on Wages, and no federal income tax withholding is required from employees' salaries with respect to the said picked-up contributions. The revenue ruling further held that the school district's picked-up contributions are excluded from the gross income of employees until such time as they are distributed to the employees.

Revenue Ruling 81-35, 1981-1 C.B. 255, and Revenue Ruling 81-36, 1981-1 C.B. 255, provide guidance as to whether contributions will be considered as "picked up" by the employer. Both revenue rulings establish that the following two criteria must be satisfied: (1) the employer must specify that 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 have an option of choosing to receive the contributed amounts directly or to have them paid by the employer to the plan.

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

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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 case, with respect to contributions made to purchase various types of prior service credit, the relevant provisions of the Act, in conjunction with the irrevocable payroll reduction authorization form (Form P), satisfy the criteria of Revenue Rulings 81-35, 81-36, and 87-10 by providing that the contributions, although designated as employee contributions, are being paid by the employer in lieu of contributions by the employee, and that an employee who has completed Form P is not given the option of choosing to receive the contributed amounts directly in lieu of having them paid to Plan X. The employee is not permitted to revoke the election to make the payroll reduction except in the case of death or termination of employment. Further, an employee must complete the payroll reduction authorization form before the period to which the contributions relate, and the payroll reduction authorization form is not effective until signed by both the employee and the employer.

Accordingly, assuming the proposed pick-ups are implemented as proposed, we conclude that:

1. The voluntary additional employee contributions made to redeposit previously refunded contributions or to purchase additional service credit, which are to be picked up and paid to Plan X by a Participating Employer on behalf of its Member-Participants, although designated as employee contributions under state law, will be treated as employer contributions under Code section 414(h)(2), and

2. With respect to ruling request no. 2, section 1.415-3(d)(1) of the Income Tax Regulations provides that where a defined benefit plan provides for mandatory employee contributions, the annual benefit attributable to such contributions is not taken into account for purposes of applying the limitations on benefits described in section 415(b) of the Code. Section 1.415-3(d)(1) further provides that the mandatory employee contributions are considered a separate defined contribution plan maintained by the employer that is subject to the limitations on

contributions and other annual additions described in section 415(c) of the Code. Section 1.415-3(d)(3) of the regulations provides that these same limitations would also apply if, instead of providing for mandatory employee contributions, the plan permitted voluntary employee contributions, since both voluntary and mandatory employee contributions are treated as separate defined contribution plans maintained by the employer. Employee contributions, however, that are picked up by the employer pursuant to section 414(h)(2) of the Code are treated as employer contributions and, as such, are not annual additions to a separate defined contribution plan for purposes of section 415(c). The benefit attributable to these picked-up contributions, however, would be taken into account under Code section 415(b). Accordingly, we conclude, with respect to ruling request no. 2, that contributions to be picked up under the facts as proposed will not be treated as annual additions for purposes of Code section 415(c).

The effective date for the commencement of any proposed pick-up cannot be any earlier than the later of the dates the Form P is signed by the employee and the employer.

These rulings are based on the assumption that Plan X meets the requirements for qualification under section 401(a) of the Code at the time of the proposed contributions and distributions.

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 Participating Employers. 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 letter ruling 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.

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

Sincerely yours,

John G. Riddle, Jr.

John G. Riddle, Jr.
Manager, Employee Plans
Technical Group 4
Tax Exempt & Government
Entities Division

Enclosures:

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cc: