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Internal Revenue Service

Department of the Treasury

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Legend:

State A =

Department M =

Department N =

Plan X =

Plan X Board =

Group B Employees=

Group C Employees =

Resolution R =

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Form P =

Statute T =

Ladies and Gentlemen:

This is in response to your ruling request dated November 30, 1999, as supplemented by correspondence dated June 14, 2000, and September 22, 2000, made on your behalf by your authorized representative, concerning the pick up of employee contributions under Plan X pursuant to section 414(h)(2) of the Internal Revenue Code ("Code").

The following facts and representations have been submitted:

Plan X is a governmental defined benefit plan and provides pension benefits to participant/members who are employees of State A. With certain exceptions, Plan X covers all State A employees, comprised of the Group B Employees and Group C Employees. Plan X received its most recent favorable determination letter as to its qualified status under section 401(a) of the Code on September 4, 1997.

Plan X's basic benefit formula provides a retirement benefit of a percentage of final average compensation, multiplied by years of credited service. Prior to July 1, 1974, participants were required to make mandatory contributions to Plan X. Plan X provides that a participant who has made mandatory contributions and terminates employment prior to retirement may elect to receive a refund of any of these contributions. Upon receipt of these refunded contributions, a participant's service credit for the time period covered by these contributions is forfeited. Such refund is non-taxable, as the mandatory contributions were previously made to Plan X with post-tax dollars.

If the former participant is subsequently rehired by State A, the participant may elect to redeposit an amount equal to any such mandatory contributions that were previously refunded, plus interest (" repurchased service credit"). By making this repayment, the participant is able to "repurchase" the prior service that was canceled upon the participant's earlier termination of employment. Repayment may be made at any time prior to the date of the participant's later retirement, in either lump sum or in installments.

Plan X also provides that participants may voluntarily elect to purchase "additional service credits." The types of service for which credits may be purchased are specified in the relevant provisions of Statute T, some of which include State A university service, county social services agencies, state police/courts service, maternity/paternity/child rearing leave, municipal/county government service, federal and other state government service, and military service. The amounts payable to Plan X by a participant for these service credits differ. As with payment for "repurchased service credit," a participant may pay for "additional service credits" in either a lump sum or in installments.

Plan X participants have no access to the contributions made with respect to these "repurchased" and/or additional service credits (which are accounted for separately by Plan X) while employed, but they are returned to participants upon termination of employment or paid as a part of their benefit upon retirement. Up to this time, Plan X has treated all contributions made with respect to these "repurchased" and/or additional service credits as having been made on an after-tax basis.

Plan X now proposes to implement a tax-deferred payment system, pursuant to which all of the contributions made by participants with respect to these " repurchased" and/or additional service credits may be treated as "picked up" under section 414(h)(2) of the Code. The Plan X Board, having the power to promulgate rules for the implementation and administration of Plan X, will adopt a resolution whereby it is determined that contributions made to redeposit member contributions previously withdrawn (plus

interest), or to purchase additional service credits, may be picked up and paid by State A on behalf of any participants in Plan X in accordance with section 414(h)(2) of the Code, provided that resolutions to that effect are adopted by Departments M and N of State A. Departments M and N of State A are the appropriate State A departments to authorize these pick-up procedures.

Department M will adopt Resolution R with respect to the Group B Employees participating in Plan X, and Department N will adopt Resolution R with respect to the Group C Employees participating in Plan X. It has been represented that Departments M and N of State A are authorized to adopt Resolution R with respect to the Group B Employees and Group C Employees, respectively.

Resolution R will approve and permit the contributions made by participants with respect to both "repurchased" and additional service credit to be treated as "picked up". Under Resolution R, each participant who elects to make contributions with respect to "repurchased" or additional service credits, will execute Form P, a binding irrevocable payroll deduction authorization form which specifies the number and dollar amount of the withholding deductions, and prohibits the participants from thereafter making a prepayment of the specified amounts on an after-tax basis by paying to Plan X directly. The payroll deduction authorization shall only terminate upon the completion of the payroll deductions required for the purchase of service credits or the participant's termination of employment.

Resolution R specifically provides that (i) State A agrees to assume and pay the amounts that employees would be required to pay for "repurchased" or additional service credits, (ii) the contributions, although designated as employee contributions, will be paid by State A in lieu of contributions by the employees, and (iii) the employees will not be given the option of choosing to receive the contributed amounts directly instead of having them paid by State A to Plan X.

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

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1. That the contributions made pursuant to a participant's election with respect to either "repurchased"or additional service credits will be treated as employer contributions "picked up" by State A within the meaning of Code section 414(h)(2), provided that such contributions are made pursuant to Resolution R and Payroll Deduction Authorization Form P.

2. That the amounts "picked up" in connection with the contributions made with respect to "repurchased" or additional service credits, will not be treated as "annual additions" for purposes of section 415(c) 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 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 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 for "repurchased service credit" or "additional service credit," Resolution R which is to be adopted by Departments M and N, in conjunction with the irrevocable payroll deduction authorization (Form P), satisfy the criteria of Revenue Rulings 81-35, 81-36, and 87-10 by providing that (i) the contributions, although designated as employee contributions, are being paid by the employer in lieu of contributions by the employee, and (ii) an employee who has completed a payroll deduction authorization form is not given the option of choosing to receive the contributed amounts directly in lieu of having them paid to Plan X. Further, an employee must complete the payroll deduction authorization form before the period to which the contributions relate.

Accordingly, assuming the proposed pick-ups are implemented as proposed, we conclude with respect to ruling request # 1 that the contributions made pursuant to a participant's election with respect to either "repurchased service credit" or "additional service credits" will be treated as employer contributions "picked up" by State A within the meaning of Code section 414(h)(2), provided that such contributions are made pursuant to Resolution R and Payroll Deduction Authorization Form P.

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With respect to ruling request #2, section 1.415-3(d)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. Employee contributions that are picked up by the employer pursuant to section 414(h)(2) are treated as employer contributions and, as such, are not annual additions to a separate defined contribution plan for purposes of section 415(c).

Accordingly, we conclude with respect to ruling request #2 that the amounts "picked up" in connection with the contributions made with respect to "repurchased service credit" or "additional service credits" will not be treated as "annual additions" for purposes of section 415(c) of the Code.

The effective date for the commencement of any proposed pick up cannot be any earlier than the latest of the following: (i) the adoption date of Resolution R, (ii) the effective date of Resolution R, or (iii) the later of the execution date or the effective date of the participant's Payroll Deduction Authorization Form P.

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.

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 and
Government Entities
Division

Enclosures:

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