Internal Revenue Service

Department of the Treasury 200129039

Washington, DC 20224

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Contact Person:

Telephone Number:

In Reference to: T:EP:RA:T1

Date: APR 24 2001

Attn:

Legend:

State A =

Participating Employers =

Plan X =

Resolution M =

Payroll Authorization Form N =

Regulation O =

Dear :

This is in response to a ruling request dated February 12, 2001, from your authorized representative, concerning the federal tax treatment under section 414(h)(2) of the Internal Revenue Code ("Code") of certain contributions to repay previously withdrawn contributions or to purchase additional service credit under Plan X.

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The following facts and representations have been submitted:

Plan X was established by State A for employees of Participating Employers. Plan X is a defined benefit plan that includes mandatory employee contributions. Participation in Plan X is either mandatory or optional depending on the employee's job classification. Plan X is qualified under Code section 401(a) and received a favorable determination letter from the Service on May 31, 1995. Plan X is a governmental plan within the meaning of Code section 414(d).

All participants in Plan X are required to contribute a specified percentage of their compensation. In addition, the Participating Employers contribute a similar amount on behalf of the employees. The current ruling request seeks to apply Code section 414(h)(2) to the elective contributions described below.

The calculation of benefits is based upon a formula that includes the member's age at retirement, the member's highest three-year average salary upon which member contributions were made, and years of creditable service. In addition to the creditable service received as a result of mandatory contributions as an active member of Plan X, participants may purchase credit for various types of past service. The cost of purchasing past service is based on the actuarial cost of the incremental projected benefit to be purchased.

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. Making the repayment allows the participant to "buy back" prior service canceled upon the participant's earlier termination of employment. Repayment may be made at any time prior to the date of the participant's retirement. The electing participant may make the redeposit in either a lump sum or installments.

Under conditions specified by Plan X, participants may elect to purchase additional service credit. For example, a participant may elect to purchase credit for certain years of employment in the public schools of State A on which contributions were not made, for employment as a substitute teacher, for time spent on sabbatical leave, for employment covered by other retirement systems in State A, and leave for certain active military service. In addition, participants may purchase credit for the following: out-of-state service credit and adjunct service credit. As with the redeposit election, a member may pay for the additional service credit in a lump sum or installments.

Pursuant to State A Statutes, the Board of Trustees of Plan X (the "Board") has authority to promulgate regulations and to establish terms and conditions for the purchase of prior service credit. The Board has proposed a regulation ("Regulation O")

for the purpose of providing a pick-up of employee contributions under section 414(h)(2) of the Code for contributions that are made for the purpose of purchasing additional service credit or reinstating previously forfeited service credit. Regulation O permits an active member of Plan X who elects to purchase or reinstate service through installments to do so by payroll deductions.

In accordance with Regulation O, in order to permit the pick up of the above-referenced contributions made through payroll deduction, a Participating Employer will adopt Resolution M. This resolution provides that such payroll deductions (as are made pursuant to a binding irrevocable payroll deduction authorization between a Plan X participant and a Participating Employer to have such amounts picked up) even though designated as employee contributions are being paid by the Participating Employer in lieu of said contributions by the employee.

Payroll Authorization Form N will be used in conjunction with Resolution M to effect the pick up of the above-referenced payroll deductions. This form, which is to be signed by the electing Plan X participant and the Participating Employer, subsequent to adoption of Resolution M, states that the employee authorizes the deduction from salary for pick-up purposes and understands that this authorization is binding and irrevocable. The number of months during which the deductions will be made and the dollar amount of the deductions are designated on this form.

The authorization further states that it is irrevocable; that the maximum duration is sixty (60) months; that, after execution, the employee does not have the option of receiving the reduction amounts directly instead of having them paid by the employer to Plan X; that the contributions are being picked up by the employer; that the employee may make more than one authorization, so long as a subsequent authorization does not amend existing ones; that with respect to the contribution covered by the authorization, Plan X will only accept payment from the employer and not the employee; that amounts not covered by the authorization may be paid by the employee directly to Plan X, using after-tax dollars; that on termination of employment or death of the employee, the authorization expires; and that the authorization is not effective until executed and that the pick up is only applicable to contributions to the extent the compensation which is reduced for the contributions is limited to compensation earned for services after the effective date of the pick up.

Regulation O also states that a Plan X participant, having executed a binding irrevocable payroll deduction authorization with respect to the above-referenced contributions, shall not be entitled to any option of choosing to receive the contributed amounts directly instead of having them paid by the employer to Plan X. Such contributions, although designated as employee contributions, will be paid by the employer in lieu of contributions by the employee. Regulation O further provides that the contributions so assumed shall be treated as tax-deferred employer "pick-up" contributions pursuant to Code section 414(h)(2).

The pick-up arrangement with respect to the redeposit of previously refunded contributions or the purchase of additional service credit will start only after the resolution described above is adopted by the relevant Participating Employer, and only after the appropriate irrevocable agreement between the employee and employer has been signed by both parties.

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

1) The amounts by which a Participating Employer reduces an employee's compensation and pays to Plan X in order to (a) redeposit previously withdrawn contributions or (b) purchase additional service credit, as described herein, qualify as contributions that are picked up by the employer under Code section 414(h)(2).

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

Regarding ruling request 1, Code section 414(h)(2) 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 Code section 414(h)(2) 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. Rev. Rul. 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 Code section 3401(a)(12)(A), 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 Code 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.

Regulation O, Resolution M and Payroll Authorization Form N satisfy the criteria set forth in Code section 414(h)(2), Revenue Ruling 81-35, and Revenue Ruling 81-36 by providing that the Participating Employers will make contributions in lieu of contributions by eligible employees and that no employee will have the option of receiving the contribution instead of having it contributed to Plan X. In addition, Regulation O and the Payroll Authorization Form N provide that the employee is not permitted to prepay the amounts covered by the authorization while it is in effect, and the payroll deductions shall cease only after the authorization has expired by its terms or upon the employee's termination of employment or death.

Accordingly, with respect to ruling request 1, we conclude that the amounts by which a Participating Employer reduces an employee's compensation and pays to Plan X in order to (a) redeposit previously withdrawn contributions or (b) purchase additional service credit, as described herein, qualify as contributions that are picked up by the employer under Code section 414(h)(2).

Regarding ruling request 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 Code section 415(b). This regulation 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). However, employee contributions which are picked up by the employer pursuant to Code 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 the picked-up contributions 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 latest of (1) the later of the date Regulation O is adopted or put into effect, (2) the later of the date Resolution M is adopted or put into effect, or (3) the later

of the date Payroll Authorization Form N is signed by both parties or put into effect.

These rulings are based on the assumption that Plan X will be qualified under Code section 401(a) 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 Code section 3121(v)(1)(B).

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.

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

Sincerely yours,

John Swieca

John Swieca,
Manager, Employee Plans
Technical Group 1
Tax Exempt and Government
Entities Division

Enclosures:
Deleted Copy of the Ruling
Notice 437

cc: