DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

200221060

U.I.L. 414.09-00

FEB 27 2002

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Attn: XXXXXXXXXXXX

Legend

State A =
System S =
Participating Employer/ Employer =
Group B Employees =
Plan X =
Statute A =
Statute B =
Statute C =
Statute D =
Resolution N =
Form P =
Contracts O =

Dear

This letter in response to a ruling request dated September 12, 2000, as supplemented by correspondence dated December 7, 2000, December 14, 2000, May 16, 2001, and November 26, 2001, 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:

System S, an agency or instrumentality of State A, administers Plan X, a defined benefit pension plan that was established for the benefit of Group B Employees. Pursuant to Statute A, System S's membership consists primarily of certified teachers, non-certified staff, and administrators employed by school districts in State A. You represent that Plan X meets the qualification requirements set forth in section 401(a) of the Internal Revenue Code.

Statute B sets forth the contribution rates for Group B Employees. In general, all new Group B Employees must contribute percent of their salary to Plan X. For Group B Employees who are members of Plan X as of , Plan X offers two benefit accrual rates depending upon whether a member makes an irrevocable election, on or before , , to make additional contributions to Plan X. In order to obtain the higher rates, the Group B Employee must make mandatory contributions to Plan X. Once the election is made, it cannot be changed by the Group B Employee.

Statute B also provides that in addition to the regular member contributions made to Plan X, a Group B Employee may redeposit in Plan X, by a single sum or by an increased rate of contribution the amounts he or she may have received from Plan X and not repaid to Plan X, together with interest from the date of withdrawal to the date of repayment. In no case shall a Group B Employee be given credit for service rendered prior to the date he or she received payments until he or she returns to Plan X all amounts due from him or her.

Statute B was amended by Statute C. Statute C provides that each Participating Employer shall pay the Group B Employee contributions required by Statute B from the salary earned by the Group B Employee after , and those contributions shall then be treated as employer contributions in determining the tax treatment under the Internal Revenue Code. Statute C further provides that if the Group B Employee elects to purchase past service credits under Statute D through payroll deductions, the Participating Employer shall pay the amount required to purchase such past service credits from the Group B Employee's salary earned after the Group B Employee signs Form P, and those purchases shall then be treated as employer contributions in determining tax treatment under the Internal Revenue Code.

Statute C also provides that each Participating Employer shall continue to withhold federal and state income taxes on those contributions until the Internal Revenue Service or federal court rules that pursuant to section 414(h) of the Code, the contributions shall not be includible in the gross income of the Group B Employee until they are distributed or made available to the Group B Employee. Each Participating Employer shall pay these Group B

Employees' contributions from the same source of funds used in paying the Group B Employee's salary. The Participating Employer may pay these contributions by a reduction in the cash salary of the Group B Employee, or by a setoff against future salary increases, or by a combination of a reduction in salary and a setoff against future salary increases. Statute C also provides that whenever Group B Employees' contributions are required to be paid by a Participating Employer under this subsection, the Group B Employee shall not have the option of choosing to receive the contributed amounts directly instead of having them paid by the Participating Employer.

Statute D allows certain Group B Employees who have been out of Plan X to purchase past service credits when they re-enter Plan X. This option is available to Group B Employees entering the armed forces, service out of State A that would have been covered if rendered in State A, certain service overseas, service in the State A General Assembly, members taking a leave of absence to obtain an advanced degree, and service in a private school. Contracts O have been developed by System S to facilitate the purchase of past service credits for all of the above service except for military service and service in the State A General Assembly. Statute D as it pertains to military service and service in the State A General Assembly does not require the Group B Employee to complete written contracts to purchase past service credits.

On , the Board of Trustees of System S adopted Resolution N. Resolution N provides that all Participating Employers are required to pay the Group B Employee's contributions required by Statute B (including the amendment to that statute by Statute C); that all new Group B Employees hired after , are required to make member contributions to Plan X; that active members as of , may elect on or before to make member contributions to Plan X, and that once made, such an election is irrevocable; that the contributions made to Plan X, although designated as employee contributions, are being paid by the employer in lieu of contributions by the Group B Employee and the Group B 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.

In addition, Resolution N further provides that each employer shall pay the Group B Employee's contribution from the salary earned by the member after , and that those contributions shall then be treated as employer contributions in determining tax treatment under the Code. Resolution N further provides that if a Group B Employee elects to purchase past service credits through payroll deductions, the employer shall pay the amount required to purchase the past service credits from the salary earned after the Group B Employee signs Form P and those purchases shall be treated as employer contributions in determining tax treatment under the Code.

Form P is an irrevocable payroll authorization form, which will be used by the Group B Employee who elects to redeposit member contributions previously withdrawn and/or to purchase permissive service credits through payroll deductions. Form P is completed by the Group B Employee and approved by the employer.

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

1. That Plan X, specifically Statute C, satisfies the requirements of section 414(h)(2) of the Code.

2. That the regular mandatory contributions picked up by the employers participating in Plan X on behalf of the Group B Employees pursuant to Statutes B and C and Resolution N are not includible in the gross income of the Group B Employees until the amounts contributed are distributed from Plan X.

3. That the additional contributions for the purchase of past service credits picked up by the employers participating in Plan X on behalf of the Group B Employees pursuant to Statutes B and C and Resolution N are not includible in the gross income of the Group B Employees until the amounts contributed are distributed from Plan X.

4. That the redeposit of Group B Employees' contributions previously withdrawn, and picked up by the employers participating in Plan X on behalf of the Group B Employee pursuant to Statutes B and C and Resolution N are not includible in the gross income of the Group B Employees until the amounts contributed are distributed from Plan X.

5. That the contributions picked up by System S pursuant to Statutes B and C and Resolution N on behalf of its employees who are participants in Plan X will not constitute wages for purposes of section 3401(a) of the Code, and accordingly, the amounts picked up by System S on behalf of its employees are not subject to federal income tax withholding.

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 order to satisfy Revenue Ruling 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.

Plan X is a plan described in section 401(a) of the Code that is maintained by System S, an agency or instrumentality of State A. Since member contributions are made to a plan described in section 401(a) and since these contributions are picked up by the employing unit, Plan X, specifically Statute C as it provides for the designation of employee contributions by the participating employers, meets the requirements of section 414(h)(2) by providing that contributions, otherwise designated as employee contributions, that are picked up by the employing unit shall be treated as employer contributions.

Statute B, as amended by Statute C, and Resolution N satisfy the requirements set forth in Rev. Rul. 81-35 and Rev. Rul. 81-36. Statute B, as amended by Statute C, and Resolution N provide that the Group B Employees' contributions, although designated as employee contributions, shall be treated as employer contributions. They provide that the employer will make contributions on behalf of the Group B Employees participating in Plan X in lieu of contributions by the Group B Employees and that no Group B Employee will have the option of receiving the contributions directly instead of having them paid by the employers to Plan X.

With respect to the mandatory Group B Employee contributions, contributions made by a Group B Employee to redeposit previously withdrawn member contributions, and contributions to purchase past service credits, Resolution N specifically provides that member contributions required by Statutes B and C, although designated as employee contributions, are being paid by the employer in lieu of contributions by the Group B Employee and the Group B Employee does not have the option of choosing to receive the contributed amounts directly instead of having them paid by the employer to Plan X. In addition, Form P is irrevocable and is signed by the Group B Employee and the employer and acknowledges Resolution N adopting the pick-up tax deferral provisions of section 414(h)(2) of the Code. Form P remains in effect until the payroll payments are completed or the Group B Employee terminates employment. Statute C also provides that the employer may pay these contributions by a reduction in the cash salary of the Group B Employee, a setoff against future salary increases, or a combination of both.

Therefore, with respect to ruling requests one, two, three and four, we conclude that Plan X, specifically Statute C as it contains the statutory designation of employee contributions by the participating employers, meets the requirements of section 414(h)(2) of the Code; that the regular mandatory contributions picked up by a Participating Employer on behalf of a Group B Employee pursuant to Statute B, as amended by Statute C, and Resolution N; that the redeposit of a Group B Employee's contributions previously withdrawn that are pick up by a Participating Employer on behalf of a Group B Employee pursuant to Statute B, as amended by Statute C, and Resolution N; and contributions picked up by a Participating Employer on behalf of a Group B Employee to purchase past service credits pursuant to Statute B, as amended by Statute C, and Resolution N meet the requirements of section 414(h)(2) of the Code. In addition, with respect to Group B Employees of System S who participate in Plan X, such amounts picked up by System S will not be includible in the gross income of such employees. These amounts will be includible in the gross income of such Group B Employees (or their beneficiaries) of System S in the year in which such

amounts are distributed to the extent that they represent amounts contributed by System S.

It has been represented that System S is also an employer of employees who are participants in Plan X. Therefore, with respect to ruling request number five as it relates only to the employees of System S who participate in Plan X, since we have determined that the picked up contributions pursuant to Statute B, as amended by Statute C and Resolution N are to be treated as employer contributions, we conclude that these contributions 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 is not earlier than the later of the date Resolution N is adopted or the date it is put into effect.

These ruling are based upon Statute B, Statute C, Resolution N and Form P as set forth in your letters dated September 12, 2000, December 7, 2000, May 16, 2001, and November 27, 2001.

In accordance with Rev. Rul. 87-10, this ruling does not apply to any contribution to the extent that it relates to compensation earned before the later of the effective date of the relevant statutes, the date the pick-up election is executed, or the date it is put into effect.

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.

These rulings express no opinion as to the impact of these proposed transactions upon the qualified, nor the continuing qualified status of Plan X. These rulings are based on the assumption that Plan X will be qualified under section 401(a) of the Code at all relevant times.

Further, this ruling is not a ruling with respect to the tax effects of the pick up on employees of Participating Employers, other than System S. In order for the tax effects that follow from this ruling to apply to those employees of a particular Participating

Employer, other than System S, the pick up arrangement must be adopted and implemented by that Participating Employer in the manner herein described.

These rulings are 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. If you have any questions regarding this letter, you may contact XXXXXXXXXXXXXX, T:EP:RA:T:2 at XXXXXXXXXXXX.

Sincerely yours,

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

Enclosures:
Copy of this letter, Deleted copy, & Notice 437

cc: