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

200224034

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

U.I.L. 414.09-00

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T:EP:RA:T2

Attn: XXXXXXXXXXXXX

Legend

State A	= XXXXXXXXXXXXXXXX
Employer M	= XXXXXXXXXXXXXXXX
Group B Employees	= XXXXXXXXXXXXXXXX
	XXXXXXXXXXXXXXXX
	XXXXXXXXXXXXXXXX
	XXXXXXXXXXXXXXXX
Plan X	= XXXXXXXXXXXXXXXX
Statute A	= XXXXXXXXXXXXXXXX
Section B	= XXXXXXXXXXXXXXXX
Proposed Resolution A	= XXXXXXXXXXXXXXX X
	XXXXXXXXXXXXXXXX
	XXXXXXXXXXXXXXXX
	XXXXXXXXXXXXXXXX
	XXXXXXXXXXXXXXXX
Form P	= XXXXXXXXXXXXXXXX
	XXXXXXXXXXXXXXXX

Dear XXXXXXX:

This letter is in response to your request for a ruling dated September 28, 2000, as supplemented by correspondence dated February 9, 2001, March 26, 2001, and May 1, 2001, which was submitted on your behalf by your authorized representative, concerning the federal income tax treatment of certain contributions to Plan X under section 414(h)(2) of the Internal Revenue Code ("Code").

The following facts and representations have been submitted:

217

State A maintains Plan X, a statewide defined benefit plan. Employer M, a political subdivision of State A, is a contributing member of Plan X. Plan X was created under Statute A for the purpose of providing retirement and certain other benefits to public employees of State A and political subdivisions thereof, including county and local governments. All public employees of State A and its political subdivisions are covered under Plan X. Plan X is established as a separate trust. You represent that Plan X meets the qualification requirements under section 401(a) of the Code and that Employer M currently maintains a pickup program for purposes of section 414(h)(2) of the Code.

All Group B Employees of Employer M who are members of Plan X are required to contribute a specified percentage of their compensation to Plan X. Section B of Statute A permits Employer M to pick up the required employee contributions under its existing pick up program established under section 414(h)(2) of the Code. The rulings requested herein extends the application of section 414(h)(2) to include the purchase of permissive service credits.

Prior to February 1, 1997, Section B of Statute A permitted the purchase of permissive service credits by payroll deduction based only on after-tax employee contributions. Effective February 1, 1997, Section B of Statute A was amended to permit the purchase of such credits through a pick-up plan under Plan X. Permissive service credits generally include the following: the purchase of additional service credits, credit for prior service, credit while on leave of absence, credit for out-of-state service and redeposit of contributions to restore service credits.

As authorized by Section B of Statute A, Employer M proposes to establish a program that will allow Group B Employees to make contributions to purchase permissive service credits and have such contributions picked-up under section 414(h)(2) of the Code. To implement the program, Employer M has adopted Proposed Resolution A. Proposed Resolution A provides that Employer M shall withhold the required service credit amount from the gross pay of each Group B Employee who elects to purchase permissive service credits and shall pick up (assume and pay) such deduction to Plan X; that any pickup contributions made hereunder, although designated as employee contributions, shall be treated as having been made by Employer M in lieu of contributions made by the Group B Employee; that any Group B Employee electing the pickup deduction shall not have the option of choosing to receive the payroll deduction directly instead of having this amount picked up by Employer M, and Group B Employees who have elected to participate in the purchase of permissive service credits cannot increase, decrease, or terminate the amount of the pick up contribution.

In accordance with Proposed Resolution A, Group B Employees of Employer M who are contributing members of Plan X and who have "qualified service" may purchase permissive

service credits. Proposed Resolution A defines the term "qualified service" as any of the following types of service:

(i) service (including parental, medical, sabbatical, and similar leave) as an employee of the Government of the United States, any State or political subdivision thereof, or any agency or instrumentality of any of the foregoing (other than military service or service for credit which was obtained as a result of a repayment described in section 415(k)(3) of the Code),

(ii) service (including parental, medical, sabbatical, and similar leave) as an employee (other than as an employee described in clause (i)) of an educational organization described in section 170(b)(1)(A)(ii) of the Code which is a public, private, or sectarian school which provides elementary or secondary education (through grade 12), as determined under State law,

(iii) service as an employee of an association of employees who are described in clause (i), or

(iv) military service (other than qualified military service under Internal Revenue Code section 414(u)) recognized by such governmental plan.

In the case of service described in clause (i), (ii), or (iii), such service will not be "qualified service" if recognition of such service would cause a participant to receive a retirement benefit for the same service under more than one plan.

In general, a member of Plan X may purchase permissive service credits by payroll deduction pursuant to Section B of Statute A and the following sections 145.20, 145.201, 145.28, 145.29, 145.291, 145.293, 145.301, 145.302, 145.31, and 145.42 of Statute A.

Under a procedure that is in compliance with section 414(h)(2) of the Code , as provided in Section B of Statute A, a Group B member of Plan X may purchase any of the foregoing permissive service credits by payroll deduction with amounts designated by Employer M as picked-up contributions.

Form P, a payroll reduction form, will be used in conjunction with Proposed Resolution A to effectuate the pick up of the purchase of permissive service credits. A Group B Employee who wants to participate in the purchase of permissive service credits must complete Form P. Form P, which is signed by the Group B Employee and Employer M, is binding and irrevocable and authorizes Employer M to reduce the Group B Employee's salary by a designated dollar amount for a designated number of pay periods. Form P further provides that while this

agreement is in effect, Plan X will only accept payment for the purchase of permissive service credits from Employer M and not directly from the Group B Employee. Form P shall remain in effect until payments for the purchase of permissive service credits is completed or termination of the Group B Employee's employment with Employer M.

The Group B Employees must complete Form P by marking a plan of payment, signing the authorization for payroll reduction and returning the form to Plan X. A separate Form P must be completed for each separate type of service credit. After receipt of the Group B Employees' Form P, Plan X will notify Employer M that payroll deductions will begin within 60 days.

Pursuant to Section B of Statute A, the purchase of service credits, including permissive service credits, with amounts designated by Employer M as picked-up contributions under section 414(h)(2) of the Code, a Group B Employee will not be permitted to:

1. decrease or increase such payroll deduction unless the member has terminated employment or all of such service credit has been purchased by such payroll deduction; or

2. terminate such payroll deduction unless the member has terminated employment or all of such service credit has been purchased by payroll deduction; or

3. make a partial payment as defined in Section C of Statute A.

The election by a Group B Employee to have Employer M pick up such contributions will be irrevocable, and Employer M will not decrease, increase or terminate such payroll deduction unless the member has terminated employment or all of such service credit has been purchased.

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

(1) The payroll deduction used to purchase permissive service credits under Plan X, pursuant to Proposed Resolution A will be treated as employer contributions picked up by Employer M on behalf of the Group B Employees within the meaning of section 414(h)(2) of the Code for federal income tax purposes. As such, the amounts picked-up will not be included in the gross income of the Group B Employees in the year of contribution, but will instead be included in the Group B Employees gross income at the time such amounts are distributed to the Group B Employees.

2. The picked-up contributions referred to in ruling request number one, pursuant to Plan X, as amended, and Proposed Resolution A will not constitute wages under section 3401(a) of the Code for federal income tax withholding purposes.

3. The picked-up contributions referred to in ruling request number one, will not be treated as annual additions for purposes of section 415(c) of the Code.

4. The provisions of section 415(n)(3)(C) of the Code will not apply to the picked-up contributions referred to in ruling request number one.

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 Resolution A, if implemented as proposed, satisfies the criteria set forth in Rev. Rul. 81-35 and Rev. Rul. 81-36. It provides, in effect, that Employer M will make contributions to Plan X in lieu of contributions by the Group B Employees and that the Group B Employees may not elect to receive such contributions directly. Further, Form P which is signed by the Group B Employee and Employer M, is binding and irrevocable and authorizes Employer M to reduce the salary of the Group B Employee by a designated dollar amount for a designated number of pay periods. Form P also provides that while the agreement to purchase such credits is in effect, Plan X will only accept payments for the purchase of such credits from Employer M and not directly by the Group B Employee.

Accordingly, with respect to ruling request number one, we conclude that, the contributions made pursuant to the payroll reduction authorization (Form P) by Group B Employees to purchase permissive service credits under Plan X, pursuant to Proposed Resolution A will be treated as employer contributions picked up by Employer M within the meaning of section 414(h)(2) of the Code, and will not be included in the gross income of the Group B Employees in the year of contribution, but will instead be included in the Group B Employees gross income at the time such amounts are distributed to the Group B Employees, to the extent the contributions represent amounts contributed to Plan X by Employer M.

With respect to ruling request number two, 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, with respect to such picked-up amounts, no withholding of federal income tax is required in the taxable year in which they are contributed to Plan X.

With respect to the third ruling request, 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) of the regulations provides further 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, with respect to the third ruling request, we conclude that the picked-up contributions referred to in

ruling request number one, will not be treated as annual additions for purposes of section 415(c) of the Code.

With respect to your fourth ruling request, section 415(n)(3) of the Code defines "permissive service credit" as service credit (i) that is recognized by the governmental plan for purposes of calculating a participant's benefit under the plan, (ii) which such participant has not received under such governmental plan, and (iii) which such participant may receive only by making a voluntary additional contribution, in an amount necessary to fund the benefit attributable to such service credit.

Section 415(n)(3)(C) of the Code generally defines "nonqualified service" as service other than service as an employee of the federal government, state, political subdivision or agency or instrumentality thereof; service as an employee of certain educational organizations described in section 170(b)(1)(A)(ii) of the Code; military service or service as an employee of an association. Section 415(n)(3)(C) further provides that in the case of such service previously described in (i), (ii), and (iii), such service will be nonqualified service if recognition of such service would cause a participant to receive a retirement benefit for the same service under more than one plan. Because the service for which permissive service credit will be purchased under Plan X in accordance with Proposed Resolution A is the type of service described in section 415(n)(3)(C), we conclude that it does not constitute "nonqualified service" within the meaning of section 415(n)(3)(C) of the Code.

For purposes 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.

These rulings apply only if the effective date for the commencement of any proposed pick-up as specified in Proposed Resolution A is not earlier than the later of the date Proposed Resolution A is signed, the date it is put into effect, or the effective date of Form P.

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 Resolution A, as amended in your correspondence dated March 26, 2001, and Form P, as submitted with your correspondence dated September 28, 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.

Should you have any questions, please contact XXXXXXXXXXXXXXXXXXXXXXXXXXX, T:TP:RA:T2, at XXXXXXXXXXXXXX.

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

224