Uniform Issue List: 414.09-00

200325007

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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Mar 25, 2003
T:EP:RA:T1

Attn:

Legend:

State A =

Statute B =

Statute C =

Statute D =

Statute E =

Statute F =

Statute G =

Form H =

Form I =

Plan X =

Plan Y =

Dear :

This is in response to a ruling request dated June 27, 2001, as supplemented by additional correspondence dated October 2, 2001, February 5, 2002, April 5, 2002, July 29, 2002, September 10, 2002, November 6, 2002, November 8, 2002, December 13, 2002, January 31, 2003, February 26, 2003, and March 12, 2003, from your authorized representative concerning the pick up of certain employee contributions to Plan Y under section 414(h)(2) of the Internal Revenue Code.

The following facts and representations have been submitted:

State A established Plan X for the benefit of eligible employees of participating employers. Plan X requires mandatory employee contributions and is qualified under Code section 401(a). In addition, Plan X is a governmental plan as described in section 414(d).

In 1985, the Legislature of State A adopted the predecessor to Statute B directing all employers of Plan X participants to pick up the mandatory employee contributions as provided by Code section 414(h)(2). In 1986, the Internal Revenue Service ruled that amounts picked up by the employers participating in Plan X satisfy the requirements of section 414(h)(2). In 1997, the Legislature of State A amended Statute C allowing Plan X participants who purchase credited service pursuant to State A Statutes to either make payments directly to Plan X, or elect to have the employers pick up the payments through a salary reduction program. In 1997, the Internal Revenue Service ruled that amounts picked up by the employers in Plan X pursuant to Statute C satisfy the requirements of section 414(h)(2).

In 2001, the Legislature of State A enacted Statute D which authorized the creation of Plan Y. The Governing Board which established and administers Plan X also established and administers Plan Y. While Plan Y will be filed with the Internal Revenue Service for a determination letter, it is represented that Plan Y is qualified under Code section 401(a).

Plan Y is a governmental plan of State A, as described in Code section 414(d). Plan Y is also a defined contribution plan described in Code section 414(i) since it provides for an individual account for each member and for benefits based solely on amounts contributed to the member's account, together with any income, expenses, gains and losses, and any forfeitures of account of other members which may be allocated to the member's account.

Under Statute D and Plan Y, the term "employer" means any agency or department of State A, or any agency or department of a political subdivision of

State A, that has employees participating in Plan X and that adopts Plan Y. If an employer adopts Plan Y, any employee member of the employer may elect to participate in Plan Y. Under the provisions of Plan Y, an eligible employee who desires to enroll in Plan Y shall do so by completing Form I. If an employee does not enroll when first eligible to do so, the employee may enroll as of any subsequent Enrollment Date by completing Form I.

Statute F and Plan Y provide that if an employee elects to participate in a plan pursuant to this subsection, the employee shall contribute an amount equal to at least one per cent of the employee's gross salary. An election to participate in a plan is irrevocable and shall be for a period of at least one year. An employee may annually increase or decrease the employee contributions in increments of one per cent up to the maximum allowed by law.

Statute E and Plan Y provide that although designated as employee contributions, all employee contributions made to a plan shall be picked up and paid by the employer in lieu of contributions by the employee. The contributions picked up by an employer may be made through reduction in the employee's salary or an offset against future salary increases, or a combination of both. An employee participating in a plan does not have the option of choosing to receive the contributed amounts directly instead of the employer paying the amounts to the plan. It is intended that all employee contributions that are picked up by the employer as provided in this subsection shall be treated as employer contributions under Code section 414(h)(2), shall be excluded from employees' gross income for federal and state income tax purposes, and includible in the gross income of the employees or their beneficiaries only in the taxable year in which they are distributed. The specified effective date of the pick up pursuant to this subsection shall not be before the date the Plan receives notification from the Internal Revenue Service that pursuant to section 414(h)(2) the employee contributions picked up shall not be included in gross income for income tax purposes until the time that the picked up contributions are distributed by pension payments. Until notification is received, any contributions made under this subsection are made with after-tax contributions.

Also, in 2001, State A enacted Statute G authorizing the creation of a deferred retirement option plan ("DROP") program under Plan Y. Under the DROP Program, an employer may enter into an agreement with a member who is participating in Plan X and who has attained normal retirement age under Plan X, whereby the member may work for up to an additional 36 months. Upon conclusion of such additional service after attaining normal retirement age, the member shall then be entitled to receive credited service under Plan X for two times the year(s) worked. The costs for the additional credited service shall be at the same rate as for any public service purchase determined pursuant to State A Statutes. Once the cost for purchasing the additional years of service is

determined, the member and employer, pursuant to Statute G, agree to the allocation between them for payment of the purchase costs, and they shall make contributions as so agreed to be paid during the term of the agreement.

During the period of additional employment after attaining normal retirement age, the employer's and member's contributions are credited to the "employer" and "employee" DROP accounts maintained on behalf of each DROP member under Plan Y. Any member contributions are irrevocable and subject to the same pick up provisions contained in Statute E discussed above. Upon successful conclusion of the additional service, the amount credited to Plan Y is then transferred to Plan X to purchase the credited service earned by the member under the DROP Program. If the amount allocated to the member's DROP accounts exceeds the cost for purchasing the years of credited service, such excess is distributed to the member. If the amount held in the DROP accounts is less than the amount necessary to purchase the additional years of service, then the member will be required to make an extra contribution to Plan X to pay for the difference. If the member does not complete the additional service pursuant to the agreement between the member and his or her employer, then the member is not entitled to the additional credited service under Plan X, but rather will receive a distribution from Plan Y equal to the amount allocated to the member's "employer" and "employee" DROP accounts.

In order to ensure pick-up treatment for any member contributions credited to an employee DROP account, the following amendments to the eligibility provisions of the DROP Program under Plan Y are proposed. First, each employee in recognized employment who has been offered a termination option as provided in Statute G shall become a participant on the date the employee enrolls in the DROP Program. And, second, each employee who is or will become eligible to become a participant, as provided in the first proposed amendment, shall enroll for earnings reduction by completing Form H. Such Form H shall be delivered to the Director and shall become effective on the date the employee enrolls in the DROP Program.

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

1) The supplemental contributions made by a member to Plan Y under Statute F, which are picked up by the member's employer pursuant to Statute E, satisfy the requirements of Code section 414(h)(2).

2) The contribution amounts made by a member under the DROP Program, which are picked up by the member's employer pursuant to Statute E, satisfy the requirements of Code section 414(h)(2).

Regarding Ruling Requests One and Two, 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, or any agency or instrumentality of any one of the foregoing, 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 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.

Statute E, and Plan Y established thereunder, provide that although designated as employee contributions, all employee contributions made to the plan shall be picked up and paid by the employer in lieu of contributions by the employee. The

contributions picked up by an employer may be made through reduction in the employee's salary or an offset against future salary increases, or a combination of both. An employee participating in the plan does not have the option of choosing to receive the contributed amounts directly instead of the employer paying the amounts to the plan.

However, Statute F and Plan Y also state that if an employee elects to participate in the plan pursuant to this subsection, the employee shall contribute an amount equal to at least one per cent of the employee's gross salary. An election to participate in the plan is irrevocable and shall be for a period of at least one year. An employee may annually increase or decrease the employee contributions in increments of one per cent up to the maximum allowed by law. These employee elections are inconsistent with criterion (2) set forth in Revenue Rulings 81-35 and 81-36 for pick-up plan treatment. Criterion (2) provides that 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 plan.

Under Statute F, the participant can elect to contribute to Plan Y at any time and may change the amount of contribution after one year. To satisfy criterion (2) of Revenue Rulings 81-35 and 81-36, however, the employee must have a one-time election to contribute a selected percentage of pay and that election must carry forward during the employee's entire period of employment. In addition, the election must be made within the later of 24 months of the date of hire or 24 months of the date that the employee is first eligible to participate. Since Statute F does not satisfy criterion (2) of the Revenue Rulings, we conclude, with respect to Ruling Request One, that the supplemental contributions made by a member to Plan Y under Statute F, which are picked up by the member's employer pursuant to Statute E, do not satisfy the requirements of Code section 414(h)(2).

Participation in the DROP Program, as specified in the proposed plan amendments, satisfies the requirements of the above referenced Revenue Rulings because members shall elect to participate upon first becoming eligible, such election is irrevocable for the remainder of their employment, and their rate of contribution shall remain fixed. Therefore, with respect to Ruling Request Two, we conclude that the contribution amounts made by a member under the DROP Program, which are picked up by the member's employer pursuant to Statute E, satisfy the requirements of Code section 414(h)(2).

With respect to the DROP Program, the effective date for the commencement of the proposed pick up as specified in Statutes E and G cannot be any earlier than the later of the date the statutes are signed or put into effect, the date the participating employer adopts Plan Y, or the date the employee signs Form H to participate in the DROP Program.

This ruling is conditioned on adoption by the Governing Board of Plan Y of the above-described proposed amendments to the eligibility provisions of the DROP Program.

For purposes of the application of Code section 414(h)(2), 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.

This ruling is based on the assumption that Plan X and Plan Y will be qualified under Code section 401(a) at all relevant times.

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).

This ruling is directed only to the taxpayer that requested it. Code section 6110(k) provides that it may not be used or cited by others as precedent.

A copy of this ruling has been sent to your authorized representative pursuant to a power of attorney on file in this office. If you have any questions, please call

Sincerely yours,

Andrew E. Zuckerman

Andrew E. Zuckerman Manager
Employee Plans Technical Group 1

Enclosures:
Deleted Copy of the Ruling
Notice 437

cc: