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

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Uniform Issue List: 414.08-00

T:EP:RA:T4

Legend:

City A =

State B =

Plan X =

State B Statute =

Resolution N =

Resolution O =

Payroll Authorization Form P =

Dear :

This is in response to a ruling request submitted by your authorized representative dated , as supplemented by your letter of , with respect to 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 on your behalf:

Plan X was created by the State B Legislature to provide retirement benefits for certain employees of City A and the employees of Plan X who are government employees pursuant to State B. Statute. Plan X is a contributory retirement system established for employees of City A and Plan X. Plan X is administered by a board of trustees ("Pension Board") created by the State B legislature. You represent that Plan X is qualified under section 401(a) of the Code and that Plan X received its most recent favorable determination letter on

Plan X contains three separate benefit formulas, depending on how a participant is classified. A participant is classified as either a Group A, Group B, or Group C Member. An employee may not receive service as a Group A Member, Group B Member, or Group C Member for any period in which he or she is also receiving service as a member of any other group or as a member of any other pension plan maintained by City A. However, as described below, a Member of one Group may sometimes move to another Group and transfer service earned as a Member of the former Group to the new Group.

A Group B Member may make an irrevocable election to change membership from Group B to Group A for future service only, or for both past and future service. If the Member changes to Group A for future service purposes only, the Member may later elect to convert all the prior Group B service to Group A service. However, a Member who elects to convert Group B service to Group A service must pay the contributions that would have been paid if the Member had been a Group A Member for the period of service, plus interest thereon.

A Group A Member may obtain service to which he or she would be entitled except that no contributions were made by the Member for the service. Again, the Member must pay the contributions that would otherwise have been required to receive the service, plus interest thereon. Similarly, a Group C member who has not received all the Group C service to which he or she was entitled merely because required Member contributions were not made may obtain the Group C service by paying the required contributions and interest.

If a Member's employment is terminated for other than a service disability before the Member completes five years of service, the Member is not eligible to receive a pension but is entitled to a refund of an amount equal to any picked-up contributions or other authorized contributions, without interest. If that Member returns to employment with an employer that contributes to Plan X, service for the pre-termination employment may be repurchased by repaying the refunded contributions, with interest as described above.

A Member who terminated employment and received a lump sum payment of the actuarial present value of the Member's benefit may, if the Member is reemployed and has at least two years of continuous credited service after reemployment, reinstate the service for which the Member received the lump sum payment by repaying the amount of the lump sum payment, with interest.

A Member who has reemployment rights under the Uniformed Services Employment and Reemployment Act ("Act") is entitled to obtain service in accordance with the requirements of the Act by making the Member contributions, if any, that would have been required by the Act. A Member who has active military service for a period for which there are no rights under the Act may still, subject to limitations, obtain service under Plan X for at least a part of the period of military service by paying to Plan X the actuarially determined cost, including the employer contributions, of the service plus administrative costs.

Plan X has passed Resolution N to pick-up certain contributions that its employees have been required to make in order to receive additional benefits. In addition, City A has passed Resolution O to pick up certain contributions that its employees have been required to make in order to receive additional benefits from Plan X.

Prior to the adoption of Resolution N and Resolution O, both City A and Plan X allowed Members to purchase service they were entitled to purchase under the provisions of the State B Statute through payment of a lump sum to Plan X or by after-tax installment payments made pursuant to a written agreement.

Plan X adopted Resolution N on , to pick-up the contributions otherwise required by employees to purchase service they are entitled to purchase by reason of their Membership in Group A or Group C, including the repayment of refunded contributions, and military service. Under Resolution N, an employee who wishes to redeposit amounts withdrawn under the State B Statute, or a predecessor statute, or to purchase service credit he or she is entitled to purchase under the State B Statute, or a predecessor statute, makes the purchases with either a lump sum payment or a series of installments. If a series of installment payments is to be made, the employee must agree to have the installments payable by payroll deduction, and execute a binding irrevocable payroll deduction authorization form, Payroll Authorization Form P, that will result in these installment contributions being picked up by the employer. All contributions made pursuant to Payroll Authorization Form P to have such contributions paid in installments shall be picked up by the employer for the purpose of purchasing service under the State B Statute, or a predecessor statute, and/or redepositing amounts withdrawn under the State B Statute, or a predecessor statute, even though such contributions may be treated differently for state law purposes, and shall be paid by the employer to Plan X in lieu of the contributions by the employee.

Also, under Resolution N, the employer shall pay the picked-up contribution to the Pension System from the same source of funds that is used in paying earnings to the employees and such payments shall be in lieu of contributions by the employees. The pick-up may be made by a corresponding reduction in the cash salary of the employees, by an offset against future salary increases, or by any combination of salary reduction and offset against future salary increases and the employees who enter into the

irrevocable agreement shall not have the option of choosing to receive the contributed amounts directly instead of having them paid by the employer to Plan X.

Resolution N further provides that any payroll deduction authorizations executed prior to , that are in effect as of the effective date of Resolution N may be converted at the option of the employee after the effective date of Resolution N to authorize the service purchase or redeposit of withdrawn amounts on an installment basis in accordance with the irrevocable procedures specified in Resolution N.
Under Resolution N, the effective date of the pick-up of the employee's contributions by the employer is the first day of the employee's first pay period beginning after the latest of the following:

(a) The date of the adoption of Resolution N
(b) . or
(c) The date of the execution of Payroll Authorization Form P

The pick up under Resolution N does not apply to any contributions made before the effective date and shall not be made from compensation earned for services performed before the effective date.

City A has approved Resolution O to pick-up the contributions otherwise required by its employees to purchase service they are entitled to purchase by reason of their Membership in Group A or Group C, including the repayment of refunded contributions, and military service. Under Resolution O, an employee who wishes to redeposit amounts withdrawn under the State B Statute, or a predecessor statute, or to purchase service credit he or she is entitled to purchase under the State B Statute, or a predecessor statute, may make the purchases with either a lump sum payment or a series of installments. If a series of installments is to be made, the employee must agree to have the installments paid by the employer, and execute a binding irrevocable authorization form that will result in these installment contributions being picked up the employer. All employee contributions made pursuant to such a binding irrevocable agreement to have such contributions paid in installments shall be picked up by the employer for the purpose of purchasing service under the State B Statute, or a predecessor statute, even though such contributions may be treated differently for state law purposes, and shall be paid by the employer to Plan X in lieu of the contributions by the employee.

Also, under Resolution O, the employer shall pay the picked-up contributions to Plan X from the same source of funds that is used in paying earnings to the employees and such payments shall be lieu of contributions by the employees. The pick-up may be made by a corresponding reduction in the cash salary of the employees, by an offset against future salary increases, or by any combination of salary reduction and offset against future salary increases and the employees who enter into the irrevocable agreement shall not have the option to choosing to receive the contributed amounts directly instead of having them paid by the employer to Plan X.

Resolution O further provides that any payroll deduction authorizations executed prior to , that are in effect as of the effective date of Resolution O may be converted at the option of the employee after the effective date of Resolution O to authorize the service purchase or redeposit withdrawn amounts on an installment basis in accordance with the irrevocable agreement procedures specified in Resolution O.

Under Resolution O, the effective date of the pick-up of the employee's contributions by the employer is the later of the following:

(a) The date of the adoption of Resolution O;
(b) The execution of Payroll Authorization Form P

The pick up under Resolution O does not apply to any contributions made before the effective date of Resolution O and shall not be made from compensation earned for services performed before the effective date.

After the effective date of Resolution N and Resolution O, whichever is applicable, the only way Members may provide for the installment purchase of service is pursuant to Payroll Authorization Form P. Under the irrevocable agreement, the Member agrees to have the employer make the contributions the Member would otherwise have made to purchase or restore service. Once the Member enters into this agreement, it may not be changed or revoked. Payments will stop only when all payments subject to the agreement have been made or the Member has terminated employment.

Based on the above facts and representations, Plan X requests the following rulings:

1. The installment contributions made by Plan X, after the effective date of Resolution N and pursuant to Payroll Authorization Form P, on behalf of its employees to restore service which the employees are entitled to restore under the terms of the State B Statute will be treated as picked up in accordance with section 414(h)(2) of the Code and are not taxable to the employee at the time such contributions are picked up.

2. The installment contributions made by City A, after the effective date of Resolution O and pursuant to Payroll Authorization Form P, on behalf of its employees to restore service which its employees are entitled to restore under the terms of the State B Statute will be treated as picked up in accordance with section 414(h)(2) of the Code and are not taxable to the employee at the time such contributions are picked up.

3. The installment contributions made by Plan X, after the effective date of Resolution N and pursuant to Payroll Authorization Form P, on behalf of its employees to purchase service which the employees are entitled to purchase under the terms of the State B Statute will be treated as picked up in accordance with section 414(h)(2) of the Code and are not taxable to the employee at the time such contributions are picked up.

4. The installment contributions made by City A, after the effective date of Resolution O and pursuant to Payroll Authorization Form P, on behalf of its employees to purchase service which the employees are entitled to purchase under the terms of the State B Statute will be treated as picked up in accordance with section 414(h)(2) of the Code and are not taxable to the employee at the time such contributions are picked up.

5. Contributions made pursuant to the irrevocable agreements described in ruling requests 1 through 4 above are not wages for purposes of the collection of Income Tax at Source on Wages.

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) of the Code, established by a state government or political subdivision thereof, and are picked up by the employing unit.

The federal income tax treatment to be accorded contributions that 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 and that, 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. Furthermore, it is immaterial, for purposes of the applicability of 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.

Revenue Ruling 87-10, 1987-1 C.B. 136, provides that in order to satisfy Revenue Rulings 81-35 and 81-36, the required specification of designated employee contributions must be completed before the period to which such contributions relate. Thus, employees may not exclude from current gross income designated employee

contributions to a qualified plan that relate to compensation earned for services prior to the date of the last governmental action necessary to effect the employer pick up.

In this case, with respect to the contributions to Plan X on behalf of employees who have made elections pursuant to Payroll Authorization Form P, Resolution N and Resolution O, adopted by the employers, satisfy the criteria of Revenue Rulings 81-35, 81-36, and 87-10. The binding irrevocable payroll deduction authorization form, Payroll Authorization Form P, specifies that the contributions, although designated as employee contributions, are being paid by the employer in lieu of contributions by the employee. In addition, an employee who has completed Payroll Authorization Form P is not given the option of choosing to receive the contributed amounts directly in lieu of having them paid to Plan X. Furthermore, an employee must complete Payroll Authorization Form P before the period to which the contributions relate. Also, Revenue Ruling 77-462 provides that picked-up contributions are exempt from federal income tax withholding.

Accordingly, assuming the proposed pick ups are implemented as proposed, we conclude that:

1. The installment contributions made by Plan X, after the effective date of Resolution N and pursuant to Payroll Authorization Form P, on behalf of its employees to restore service which the employees are entitled to restore under the terms of the State B Statute will be treated as picked up in accordance with section 414(h)(2) of the Code and are not taxable to the employee at the time such contributions are picked up.

2. The installment contributions made by City A, after the effective date of Resolution O and pursuant to Payroll Authorization Form P, on behalf of its employees to restore service which its employees are entitled to restore under the terms of the State B Statute will be treated as picked up in accordance with section 414(h)(2) of the Code and are not taxable to the employee at the time such contributions are picked up.

3. The installment contributions made by Plan X after the effective date of Resolution N and pursuant to Payroll Authorization Form P, on behalf of its employees to purchase service which the employees are entitled to purchase under the terms of the State B Statute will be treated as picked up in accordance with section 414(h)(2) of the Code and are not taxable to the employee at the time such contributions are picked up.

4. The installment contributions made by City A after the effective date of Resolution O and pursuant to Payroll Authorization Form P, on behalf of its employees to purchase service which the employees are entitled to purchase under the terms of the State B Statute will be treated as picked up in accordance with section 414(h)(2) of the Code and are not taxable to the employee at the time such contributions are picked up.

5. Contributions made pursuant to the irrevocable agreements described in ruling requests 1 through 4 above are not wages for purposes of the collection of Income Tax at Source on Wages.

No opinion is expressed as to the tax treatment of the transaction described herein under the provisions of any other section of either the Code or regulations that may be applicable thereto.

These rulings are based on the assumption that Plan X is qualified under section 401(a) of the Code at the time of the proposed contributions and distributions.

This letter 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 as precedent.

Pursuant to the power of attorney on file with this office, you are receiving a copy of this letter ruling and your representative is receiving the original letter ruling.

If you wish to inquire about this ruling, please contact

Sincerely yours,

Alan C. Pipkin
Manager, Technical Group 4
Employee Plans

Enclosures:
Deleted copy of ruling letter
Notice of Intention to Disclose

cc: Internal Revenue Service
EP Area Manager

cc: