Internal Revenue Service

Department of the Treasury

Washington, DC 20224

U.I.L. 414.09-00

Contact Person:

199915062

Telephone Number:

In Reference to:

OP:E:EP:T:2

Date:

JAN 21 1999

Attn:

Legend

State A =
Employer M =
Group B Employees =
Plan X =
Plan Y =
Resolution R =
Form P =
Contract C =

Dear

This is in response to a ruling request dated July 22, 1998, as supplemented by correspondence dated November 4, 1998, December 28, 1998, and January 12, 1999, 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 and Plan Y including contributions to purchase additional retirement credit.

The following facts and representations have been submitted:

State A has established various pension plans which are qualified under section 401(a) of the Code, including Plan X and Plan Y. Employer M, an instrumentality of State A, is a participating Employer in Plan X and Plan Y. Employer M contributes to Plan X for employees who qualify as teachers under the State A statute.

Employer M also contributes to Plan Y for nonteaching employees. State law requires that employees must participate in the plan for which they are eligible to participate unless they opt out of participation under the state statute allowing such an election as in the case of student employees at universities.

Plan X and Plan Y members may purchase certain types of additional eligible retirement credit, such as relating to out-of-state teaching and military service, by payroll deductions if their employer adopts a program to so allow. Employer M has adopted such a payroll deduction program for contributions from affected members' after-tax income.

Employer M's employees fall within nine collective bargaining units. After collective bargaining with a unit, Employer M proposes to offer the following to employees eligible to participate in either Plan X or Plan Y.

The Board of Education, governing board of Employer M, will pass a resolution offering to employees covered by the unit the opportunity to purchase allowable retirement credits on a pre-tax basis under the following terms and conditions:

a. Employer M agrees to deduct and remit the payments to the applicable state pension plan as employer contributions.

b. A participating employee must irrevocably agree to continue payroll deductions until the purchase is complete or employment is terminated; and

c. No direct payments to the plan may be made by the employee while the payroll deduction is in force.

d. No federal income taxes will be withheld from the picked-up contributions.

e. The pickup arrangement with respect to the purchase of permissive retirement credit will start only after the said resolution is duly adopted and the irrevocable agreement for payroll deductions for this purpose is fully executed by the taxpayer and the affected employee.

The resolution will also provide that Employer M will pick up the contributions to Plan X and Plan Y to purchase additional eligible retirement credit on a pre-tax basis.

The proposed resolution provides that, " in order to permit tax deferral for these additional amounts, any member of ... who wishes to purchase or restore Plan X and Plan Y credit by payroll deduction on a pre-tax basis must enter into a binding irrevocable payroll deduction authorization and such employee shall not have the option of choosing to receive the amounts directly instead of having them paid by Employer M to Plan X and Plan Y; be it further resolved that additional amounts herein specified, through payroll deduction from salary, are designated as being picked up by Employer M in accordance with the Internal Revenue Code requirements."

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

1. The amounts deducted by Employer M from affected employees' pre-tax incomes for purposes of purchasing additional retirement credits will qualify as picked-up contributions under Code section 414(h)(2).

2. Picked-up contributions made on a pre-tax basis will not be included in the affected employee's gross income until such time as they are distributed to the employee.

3. The fact that participating employees will have the option to choose between making such contributions through pre-tax and after-tax payroll deductions does not affect the treatment of such contributions as picked-up contributions within the meaning of Code section 414(h)(2).

4. No income tax withholding is required from the employees' salaries with respect to picked-up contributions made on a pre-tax basis.

5. No FICA tax is required to be withheld on pre-tax picked-up contributions.

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 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

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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.

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. If not, the designated employee contributions 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 are paid by the employing unit, i.e., the retroactive "pick-up" of designated employee contributions by a governmental employer, is not permitted under Code section 414(h)(2).

In this request, the proposed resolution if adopted by Employer M satisfies the criteria set forth in Rev. Rul. 81-35 and Rev. Rul. 81-36 by providing that the contributions, although designated as employee contributions, are to be made by Employer M in lieu of contributions by the employees and that the employees may not elect to receive such contributions directly.

Accordingly, we conclude that if Employer M and the unions adopt the resolution and Form P as proposed:

1. The amounts picked up by Employer M on behalf of employees who participate in Plan X and Plan Y for purposes of purchasing additional retirement credit will qualify as picked-up contributions under Code section 414(h)(2).

2. Picked-up contributions made on a pre-tax basis will not be treated as employer contributions and will not be includible in the Employees' gross income in the year in which such amounts are contributed.

3. The contributions, whether picked up by payroll deduction, offset against future salary increases, or both, and though designated as employee contributions, will be treated as employer contributions for federal income tax purposes.

4. Because the contributions will be treated as employer contributions, they will be excepted from wages for federal withholding purposes, in the taxable year in which they are contributed to Plan X and Plan Y. Therefore, no income tax withholding is required with respect to picked-up contributions made on a pre-tax basis.

5. As we previously advised you, your ruling on the FICA tax withholding was transferred to the Office of Chief Counsel, Employee Benefits and Exempt Organizations. That office will respond directly to you on this request.

The effective date for the commencement of any proposed pick-up as specified in the resolution, cannot be any earlier than the later of the date the resolution is signed or the date it is put into effect.

In addition, these rulings are contingent upon the adoption of Proposed Resolution R and Form P as contained in your correspondence dated July 22, 1998, November 4, 1998, and December 28, 1998.

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

A copy of this letter has been sent to your authorized representative in accordance with the power of attorney on file with this office.

Sincerely yours,

(signed) JOYCE E. FLOYD

Joyce E. Floyd
Chief, Employee Plans
Technical Branch 2

Enclosures:
Copy of this letter
Deleted copy
Notice 437