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Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply to: OP:E:EP:T:3

Date:

MAY 25 1999

Attn:

LEGEND:

State A =

Participating
Employer/Employers =

Plan X =

Group C
Employees =

Contributory
Provision P =

Resolution A =

Resolution B =

Resolution C =

Payroll Authorization
Form P =

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This is in response to a ruling request dated December 8, 1998, as amended and supplemented by submissions of February 1 and 3, 1999, March 11, 1999, April 1, 7, 8, 13, 19 and 26, 1999, concerning Plan X and the pick up under section 414(h)(2) of the Internal Revenue Code of certain employee contributions including "buy-back" contributions designed to fund the actuarial cost of the enhanced benefits that accrue to certain participants who are covered retroactively under the portion of Plan X that requires employee contributions.

The following facts and representations have been submitted:

Plan X is a governmental defined benefit plan that is qualified under section 401(a) of the Code. It was established by State A for the benefit of Group C Employees. Group C Employees include traditional public school employees along with intermediate school district employees and certain public school academy, district library, community or junior college and State A university employees, with numerous exceptions. The employer of a Group C Employee is considered to be a Participating Employer.

Beginning in 1987, Plan X participants and later hires were given a one-time option to participate in an enhanced retirement benefits program by irrevocably electing to make employee contributions under Contributory Provision P (CPP). The basic Plan X noncontributory benefit formula is: 1.5 percent times years of service times final average compensation (5 high year average). CPP uses the same basic formula, but enhances it by providing that final average compensation will be averaged over only a high 3 year period, which usually gives participants a slightly higher benefit. CPP also provides for a 3 percent annual cost-of-living increase on participants' retirement benefits once they actually retire. In addition, CPP has lower age or service requirements for unreduced benefits.

Effective in January 1990, Plan X was amended to require that all new participants (and most rehired participants) participate in CPP. Employees who elected to participate before January 1990, currently make standard contributions of 3.9 percent of their compensation (the contribution rate was 4 percent prior to 1990). Those beginning participation on a mandatory basis under CPP at any time after January 1990, currently make standard contributions according to the following scale: 3 percent of the first $5,000 of pay, plus 3.6 percent of the next $10,000 of pay, plus 4.3 percent of any pay in excess of $15,000. The term "standard contributions", as used herein, refers to the contributions a CPP participant is required to make in connection with current service.

Pursuant to the terms of Plan X and authority vested in the plan administrator (note Resolution C discussed later), Plan X is authorized to treat all participant contributions to CPP as having been picked up under section 414(h)(2) of the Code provided each Participating Employer has adopted a resolution covering the contribution. All Participating Employers have adopted Resolution A to this effect covering the above-described standard contributions. In private letter rulings dated September 30, 1985 and August 26, 1991, the Internal Revenue Service approved pick-up treatment under section 414(h)(2) of the Code of the above-described standard contributions in the case of employees who elected to participate before 1990 and those beginning participation on a mandatory basis under CPP on January 1, 1990, or thereafter.

Under the above-referenced 1985 and 1991 private letter rulings, it was concluded that Resolution A satisfies the criteria set forth in Revenue Ruling 81-35, 1981-1 C.B. 255, and Revenue Ruling 81-36, 1981-1 C.B. 255, by providing that Participating Employers will make contributions in lieu of the employees' contributions and that the employees may not elect to receive such contributions directly.

The State A legislature has on two occasions provided an opportunity for Plan X participants who were originally employed before 1990 (and thus not subject to the mandatory CPP participation requirement) to make an irrevocable election to participate in CPP. The two opportunities are referred to as the 1991 Window and the 1999 Window. Under the 1991 Window, employees who first became Plan X participants before January 1990 were given a one-time chance to irrevocably elect CPP coverage during an election period ending December 31, 1992. Under the 1999 Window, participation in CPP is available to rehired individuals who were not eligible for the 1991 Window, and who are also not subject to the general provision requiring mandatory CPP participation by rehired participants (because they first participated in Plan X between January 1, 1987 and December 31, 1989). The 1999 Window will be implemented as soon as practicable after notification of this ruling and will expire 180 days after receipt of this ruling. The participant's election under the 1999 Window is irrevocable.

The standard contribution a participant is required to make under either of these Windows is 3.9 percent of pay. In the above-referenced private letter ruling dated August 26, 1991, the Service also dealt with the pick-up treatment under section 414(h)(2) of the Code of the standard 3.9 percent of pay mandatory contribution required of all participants making the irrevocable election to participate in CPP under the 1991 Window. Pursuant to Resolution A, the private letter ruling confirmed pick-up treatment under section 414(h)(2) of the Code of the 3.9

percent contribution. This ruling now considers pick up of the standard 3.9 percent contribution required under the 1999 Window and the pick up of certain "buy-back" contributions required under the 1991 Window and the 1999 Window which are discussed below.

Under CPP and Plan X provisions, the enhanced benefit provisions of CPP are required to be based on total years of credited service regardless of the fact that employees electing to participate under the 1991 and 1999 Windows do not start to make the standard contribution until after their election. Thus, there may be substantial prior service during which no contributions were made. Accordingly, an additional "buy-back" amount is due to defray the actuarial cost of the participant's past service which becomes eligible to be counted under the CPP program (and for which the individual did not make the standard CPP contributions in earlier years). That is, 4 percent of pay received commencing January 1, 1987, (when CPP began) through December 31, 1989, plus 3.9 percent of pay received during the period January 1, 1990 to the date of election, plus compounded interest on those amounts as determined by Plan X.

In addition, Plan X permits participants to repurchase service lost as a result of previous withdrawals and also to purchase additional service credits (e.g., for sabbatical leave, maternity/paternity leave, out-of-system public education service, etc.). Since these years of service are included under the enhanced CPP formula, buy-back contributions are required to be further augmented to the extent of the net actuarial cost (as determined by Plan X) of including the service under CPP.

Up to this time, Plan X has (pursuant to the August 26, 1991, private letter ruling) treated the standard 3.9 percent contribution made with respect to current pay for those participants who elected CPP coverage under the 1991 Window, as being picked up by the Participating Employer in accordance with Resolution A referred to above and the participant's irrevocable election. However, all CPP buy-back contributions, as described in the preceding paragraph, for the 1991 Window have been treated as employee after-tax contributions. Participants have been permitted to make these after-tax buy-back contributions through various payment means (including lump sums, periodic payroll withholding, separate structured payments over a period of years, etc.), as long as all payments are completed by the time of retirement.

Plan X now proposes to treat the standard 3.9 percent CPP contributions under the 1999 Window as being picked up in accordance with the participant's irrevocable election under the 1999 Window and Resolution A as adopted by all Participating Employers. In addition, Plan X proposes that all of the buy-back

amounts contributed by participants under both the 1991 and the 1999 Windows should be treated as picked up under section 414(h)(2) of the Code. In order, to implement the pick up of buy-back contributions, Plan X proposes that: (i) Participating Employers will adopt Resolution B approving the pick up of these buy-back amounts and (ii) each participant who is currently participating in CPP by virtue of an election made during the 1991 Window, or who elects to participate in CPP under the 1999 Window, will execute Payroll Authorization Form P, an irrevocable payroll authorization form requesting the pick up of these buy-back amounts. Plan X will permit participants to pay (via payroll withholding) for the buy-back amounts in either a lump sum or installments, as irrevocably elected.

Resolution B provides that buy-back payments specified under Payroll Authorization Form P are designated as being picked up and paid by the Participating Employer adopting the Resolution. Resolution B further provides that the employee making an election to have buy-back contributons picked up does not have the option of choosing to receive the buy-back payments directly instead of having them paid by the Participating Employer to Plan X. Under Payroll Authorization Form P, participants make an irrevocable election to have specified buy-back payments picked up by the Participating Employer. Payroll Authorization Form P precludes revocation of the election by prepayment because it states that for the duration of the agreement, Plan X will only accept payment from the Participating Employer and not directly from the participant.

The pick-up of the standard contributions made pursuant to a participant's election under the 1999 Window will be effective upon the later of (i) the issuance of this ruling, or (ii) the effective date of the participant's election to participate in CPP pursuant to the 1999 Window. The pick up of buy-back contributions made pursuant to a participant's election under either the 1991 Window or the 1999 Window will be effective upon the latest of (i) the issuance of this ruling, (ii) the effective date of Payroll Authorization Form P, (iii) the adoption by the participant's employer of Resolution B authorizing the pick up of such buy-back contributions, or (iv) in the case of participants making the election under the 1999 Window, the effective date of the participant's election to participate in CPP.

Plan X is administered by the Plan X Board. In Resolution C (attached) passed by the Board on April 16, 1999, the Board cited its general power to administer Plan X and its extensive permissive statutory power. To the extent State A law on Plan X is inadequate to fully implement pick up of the above-noted buy-back contributions, Resolution C provides the authority by integrating and expanding the relevant provisions.

Based on the facts and representations above, the following ruling is requested:

Standard contributions made pursuant to a participant's election under the 1999 Window and buy-back contributions made pursuant to a participant's election under the 1991 Window and the 1999 Window will qualify as being picked up under section 414(h)(2) of the Code, provided such standard contributions are made pursuant to Resolution A and such buy-back contributions are made pursuant to Resolution B and Payroll Authorization Form P.

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), 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 and Revenue Ruling 81-36. 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.

With respect to the standard contributions made pursuant to a participant's irrevocable election under the 1999 Window, Resolution A was previously considered in the letter ruling dated August 26, 1991, noted above. The August 26, 1991 letter ruling confirmed pick-up treatment under section 414(h)(2) of the Code of the standard contributions made pursuant to Resolution A and the participant's irrevocable election under the 1991 Window. With respect to Resolution A, the letter ruling concluded that it satisfies the criteria set forth in Revenue Ruling 81-35 and 81-36 by providing that the Participating Employer will make contributions in lieu of the employees' contributions and that the employees may not elect to receive such contributions directly. The pick-up of the participant's standard contribution under the 1999 Window will be implemented pursuant to Resolution A and the participant's irrevocable election under the 1999 Window.

With respect to the pick up of buy-back contributions under the 1991 Window and the 1999 Window, the following is applicable. The election to participate in CPP under both Windows is irrevocable. Resolution B meets the requirements of Revenue Ruling 81-35 and 81-36 because it provides that buy-back amounts specified under Payroll Authorization Form P are designated as being picked up by the employer and paid by the employer and that the employee does not have the option of choosing to receive the amounts directly instead of having them paid by the Participating Employer to Plan X. Payroll Authorization Form P is an irrevocable election by the employee to have the buy-back contribution designated therein picked up by the Participating Employer. Further, Payroll Authorization Form P precludes the employee from revoking the pick-up election by prepaying any of the required buy-back contributions directly to Plan X during the term of the agreement.

Accordingly, assuming the proposed pick ups are implemented as proposed, it is concluded that:

Standard contributions made pursuant to a participant's election under the 1999 Window and buy-back contributions made pursuant to a participant's election under the 1991 Window and the 1999 Window will qualify as being picked up under section 414(h)(2) of the Code, provided such standard contributions are made pursuant to Resolution A and such buy-back contributions are made pursuant to Resolution B and Payroll Authorization Form P.

In accordance with Revenue Ruling 87-10, this ruling does not apply to any contribution 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.

This ruling is 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.

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 being paid pursuant to a "salary reduction agreement" within the meaning of section 3121(v)(1)(B) of the Code.

Further, this ruling is not a ruling with respect to the tax effects of the pick-up on employees of Participating Employers. However, in order for the tax effects that follow from this ruling to apply to those employees of a particular Participating Employer described in the preceding sentence, the pick-up arrangement must be implemented by that Participating Employer in the manner described herein.

A copy of this letter has been sent to your authorized representative in accordance with the power of attorney submitted with the ruling request.

Sincerely yours,

/s/ Frances V. Sloan

Frances V. Sloan
Chief, Employee Plans
Technical Branch 3

Attachment:
Resolution C

Enclosures:
Deleted copy of letter ruling
Form 437

CERTIFICATION 199933049

The undersigned, Executive Secretary of the [ ] Employees Retirement Board (the "Board"), hereby certifies that the following resolution was considered and adopted at a meeting of the Board duly called and held on [ ], 1999, commencing at 10:30a.m., and that such resolution remains in full force and effect and has not been rescinded:

Whereas the Board was created pursuant to the [ ] Employees Retirement Act [ ] (the "Act"), and specifically [ ], and both (i) is granted the general power and duty to promulgate rules for the implementation and administration of that Act and the [ ] Employees Retirement System ([ ]ERS) created thereunder, and (ii) is granted specific, permissive statutory powers in various provisions of the Act, including the power to determine the method and timing of payments made by [ ]ERS participants who make special one-time elections to participate in the Member Investment Plan ("MIP"), pursuant to [ ]; and

Whereas (i) participants in [ ]ERS are permitted under [ ] to redeposit contributions previously withdrawn and when full repayment is made before termination of employment, the previously forfeited service is reinstated in full, and participants are also permitted under [ ] (and other provisions of the Act, including [ ]) to purchase permissive service credits, upon payment to [ ]ERS of the actuarial cost thereof, and (ii) the Board is granted the specific, permissive statutory power under such provisions and [ ] to determine and require payment of the actuarial cost of the benefits attributable to such service, which service is automatically counted (pursuant to [ ]) as a factor in determining the amount of a [ ]ERS participant's enhanced benefits under MIP;

It is hereby acknowledged that pursuant to exercise of the above-cited permissive statutory powers vested in the Board, the service purchased in accordance with the above-cited redeposit and permissive service credit provisions is being taken into account under [ ] ("buy back" payments under the "1991 Window" for MIP) and [ ] ("buy back" payments under the "1999 Window" for MIP), and in conjunction with such Windows, additional contributions are required of a [ ]ERS participant as are equal to the net actuarial cost (as determined by the Board) of the additional benefits attributable to including under [ ] the service credited under the above-cited redeposit and permissive service credit provisions; and

Whereas employers are permitted under Section 414(h)(2) of the Internal Revenue Code to "pick up" and pay employee contributions on behalf of their employees;

It is hereby determined that pursuant to exercise of the above-cited permissive statutory powers vested in the Board, all the contributions required under [ ] ("buy back" payments under the "1999 Window") may be picked up and paid by any employer having employees who participate in [ ]ERS in accordance with Section 414(h)(2) of the Internal Revenue Code, at any time after the pick up is authorized by resolution of the employer's governing body.

Dated: [ ], 1999

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[ ], Executive Secretary, [ ] Employees Retirement Board

Director, [ ] Retirement Services