Internal Revenue Service

Department of the Treasury

200116055

Uniform Issue List NO. 414.09-00

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply to: T:EP:RA:T4

Date: JAN 2 5 2001

Legend:

State A =

Employer M =

Plan X =

Plan X Board =

Plan Y =

Plan Y Board =

Group B Employees =

Group C Employees =

Resolution R =

Resolution S =

Statute T

Rule U =

Rule V =

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Ladies and Gentlemen:

This letter is in reply to a request for a letter ruling dated December 29, 1998, as supplemented by submissions of September 24, 1999, and July 28, 2000, made on behalf of Employer M, concerning the federal tax treatment of certain contributions made to Plan X and Plan Y under section 414(h)(2) of the Internal Revenue Code ("Code")

The following facts and representations have been submitted:

Employer M is a political subdivision of State A. Plan X and Plan Y are qualified plans under section 401(a) of the Code and are tax exempt under section 501(a) of the Code. Both Plan X and Plan Y are governmental plans under section 414(d) of the Code.

Plan X is administered by the Plan X Board. The Plan X Board has authority to adopt rules for the administration of the retirement system.

Group B Employees are mandatory participants in Plan X. Funding for Plan X is provided by both employee (i.e. member) contributions and employer contributions. Contributions are defined as a stated percentage of the "compensation" of the member. Member contributions and interest thereon are considered the "accumulated contributions" of the-member.

If a member ceases to be an employee covered by Plan X for any reason other than death, retirement, receipt of a disability benefit, or election of an alternative retirement plan, the member can elect to receive a refund of his or her accumulated contributions. In addition, if the member has made payments to purchase additional service credit under Statute T, the amounts paid are credited to his or her accumulated account and are also refundable pursuant to Statute T. If the member elects a refund of accumulated contributions, all of his or her service credit under Plan X is cancelled.

Statute T has a variety of provisions which permit a member of Plan X to purchase additional service credit for certain types of services performed, some of which include

restoration of prior service credit cancelled, military service, and like-kind public service in another state or the United States government.

Statute T provides that the Plan X Board may establish by rule a payroll deduction plan for payment of the cost of purchasing service credit. Accordingly, the Plan X Board has adopted Rule U regarding the purchase of service credit by payroll deduction.

Payroll deduction is made by the employer and transmitted by the employer to Plan X. Payroll deduction for a service credit purchase is not available to purchase more than one type of service credit at a time; nor is it available for a purchase of service credit that is to be made by a lump sum payment. If service credit is to be purchased by payroll deduction, the member must sign a payroll deduction authorization form for each type of service credit to be purchased.

Rule U further provides that payroll deduction purchases may be made with amounts which are designated by the member's employer as picked-up contributions under Code section 414(h)(2). If a member is purchasing service credit with amounts that are designated by the employer as picked-up contributions under Code section 414(h)(2), the member may not terminate or alter the payroll deduction until the credit is fully purchased or the member has terminated employment.

Employer M has adopted Resolution R which will permit its employees who are Plan X members to elect to have payroll deduction contributions for purchases of service credit picked up by Employer M in accordance with section 414(h)(2) of the Code. Resolution R is to be effective prospectively from the date of its adoption.

Under Resolution R, any election by the employee to have his or her payroll deductions for the purchase of service credit picked up by Employer M must comply with the requirements of Rule U and must be irrevocable. Resolution R provides that Employer M will pay the pick up amount directly to Plan X, in lieu of such payment being made by the employee. In addition, Resolution R states that the pick up shall be mandatory for the employee until the earlier of termination of employment or the completion of all the required payments for the service credit. Also,

Resolution R specifies that no employee shall have the option of choosing to receive the picked up amounts directly instead of having them paid by Employer M to Plan X.

Plan Y is administered by the Plan Y Board. The Plan Y Board has authority to adopt rules for the administration of the retirement system.

Group C Employees are mandatory participants in Plan Y. Funding for Plan Y is provided by both employee (i.e. member) contributions and employer contributions. Contributions are defined as a stated percentage of the "compensation" of the member. Member contributions and interest thereon are considered the "accumulated contributions" of the member.

If a member ceases to be an employee covered by Plan Y for any reason other than death, retirement, receipt of a disability benefit, or election of an alternative retirement plan, the member can elect to receive a refund of his or her accumulated contributions. In addition, if the member has made payments to purchase additional service credit under Statute T, the amounts paid are credited to his or her accumulated account and are also refundable pursuant to Statute T. If the member elects a refund of accumulated contributions, all of his or her service credit under Plan Y is cancelled.

Statute T has a variety of provisions which permit a member of Plan Y to purchase additional service credit for certain types of services performed, some of which include restoration of prior service credit cancelled, military service, and like-kind public service in another state or the United States government.

Statute T provides that the Plan Y Board may establish by rule a payroll deduction plan for payment of the cost of purchasing service credit. Accordingly, the Plan Y Board has adopted Rule V regarding the purchase of service credit by payroll deduction with amounts which are designated by the member's employer as picked-up contributions under Code section 414(h)(2).

Once payroll deduction for a service credit purchase is begun, a member cannot purchase the service credit by a lump sum payment. If service credit is to be purchased by

payroll deduction, the member must sign a payroll deduction authorization form for the type of service credit to be purchased. The member may not terminate or alter the. payroll deduction until the credit is fully purchased or the member has terminated employment.

Employer M will be adopting Resolution S which will permit its employees who are Plan Y members to elect to have payroll deduction contributions for purchases of service credit picked up by Employer M in accordance with Code section 414(h) (2). Resolution S is to be effective prospectively from the date of its adoption.

Under Resolution S, any election by the employee to have his or her payroll deductions for the purchase of service credit picked up by Employer M must comply with the requirements of Rule V and must be irrevocable. Resolution S provides that Employer M will pay the pick up amount directly to Plan Y, in lieu of such payment being made by the employee. In addition, Resolution S states that the pick up shall be mandatory for the employee until the earlier of termination of employment or the completion of all the required payments for the service credit. Also, Resolution S specifies that no employee shall have the option of choosing to receive the picked up amounts directly instead of having them paid by Employer M to Plan Y.

Based on the aforementioned facts and representations, you have requested the following rulings with respect to the purchase of additional service credit under Plan X and Plan Y:

1. Pursuant to section 414(h) (2) of the Code, amounts "picked up" by Employer M under the provisions of Rule U and Resolution R, even though designated as employee contributions for state law purposes, will be treated as employer contributions for federal income tax purposes.

2. Pursuant to section 414(h) (2) of the Code, amounts "picked up" by Employer M under the provisions of Rule V and Resolution S, even though designated as employee contributions for state law purposes, will be treated as employer contributions for federal income tax purposes.

3. Pursuant to sections 414(h) (2) and 402(a) of the Code, amounts "picked up" by Employer M under the

provisions of Rule U and Resolution R are excluded from the gross income of Group B Employees at the time they are paid to Plan X by Employer M and will be included in gross income in accordance with the provisions of section 402 of the Code.

4. Pursuant to sections 414(h)(2) and 402(a) of the Code, amounts "picked up" by Employer M under the provisions of Rule V and Resolution S are excluded from the gross income of Group C Employees at the time they are paid to Plan Y by Employer M and will be included in gross income in accordance with the provisions of section 402 of the Code.

5. Pursuant to section 3401(a)(12)(A) of the Code, amounts "picked up" by Employer M under the provisions of Rule U and Resolution R will not constitute wages for federal income tax withholding purposes.

6. Pursuant to section 3401(a)(12)(A) of the Code, amounts "picked up" by Employer M under the provisions of Rule V and Resolution S will not constitute wages for federal income tax withholding purposes.

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) or 403(a) of the Code, established by a state government or political subdivision thereof, or by any agency or instrumentality of any of the foregoing, where the contributions of employing units are designated as employee contributions but where any employing unit picks up the contributions, the contributions so picked up shall be treated as employer contributions.

Revenue Ruling 77-462, 1977-2 C.B. 358, addresses the federal income tax treatment of contributions picked up by the employer within the meaning of section 414(h)(2) of the Code. In Rev. Rul. 77-462, the employer school district agreed to pick up the required contributions of the eligible employees under the plan. The revenue ruling held that under the provisions of section 3401(a)(12)(A) of the Code, the school district's picked-up contributions to the plan are excluded from wages for purposes of the Collection of Income Tax at Source on Wages, and no federal income tax

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withholding is required from employees' salaries with respect to the said picked-up contributions. The revenue ruling further held that the school district's picked-up contributions are excluded from the gross income of employees until such time as they are distributed to the employees.

Revenue Ruling 81-35, 1981-l C.B. 255, and Revenue Ruling 81-36, 1981-l C.B. 255, provide guidance as to whether contributions will be considered as "picked up" by the employer. Both revenue rulings establish that the following two criteria must be satisfied: (1) the employer must specify that 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 have an option of choosing to receive the contributed amounts directly or to have them paid by the employer to the plan.

In Revenue Ruling 87-10, 1987-l C.B. 136, the 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 case, in accordance with Rule U and Resolution R, if a Group B Employee of Employer M elects to purchase additional service credit under one of the Statute T provisions identified in Rule U, and agrees to do so by payroll deduction, the employee and Employer M may further agree that Employer M will pick up (i.e. assume and pay) the contributions that the employee is required to pay for the purchase of service credit. Further, in accordance with Rule U and Resolution R, the election of the employee to purchase service credit by payroll deduction under the pick up arrangement with Employer M is irrevocable and cannot be changed by the employee prior to termination of employment or purchase of all of the service credit set forth on the payroll deduction authorization form.

The provisions of Rule U and Resolution R meet the requirements of Rev. Rul. 81-35 and Rev. Rul. 81-36. Thus, the amounts deducted by Employer M from Group B Employees'

compensation and contributed to Plan X for the purchase of service credit will qualify as picked-up contributions within the meaning of section 414(h)(2) of the Code.

In accordance with Rule V and Resolution S, if a Group C Employee of Employer M elects to purchase additional service credit under one of the Statute T provisions identified in Rule V, and agrees to do so by payroll deduction, the employee and Employer M may further agree that Employer M will pick up (i.e. assume and pay) the contributions that the employee is required to pay for the purchase of service credit. Further, in accordance with Rule V and Resolution S, the election of the employee to purchase service credit by payroll deduction under the pick up arrangement with Employer M is irrevocable and cannot be changed by the employee prior to termination of employment or purchase of all of the service credit set forth on the payroll deduction authorization form.

The provisions of Rule V and Resolution S meet the requirements of Rev. Rul. 81-35 and Rev. Rul. 81-36. Thus, the amounts deducted by Employer M from Group C Employees' compensation and contributed to Plan Y for the purchase of service credit will qualify as picked-up contributions within the meaning of section 414(h)(2) of the Code.

Accordingly, we conclude that:

1. Pursuant to section 414(h)(2) of the Code, amounts "picked up" by Employer M under the provisions of Rule U and Resolution R and paid to Plan X, even though designated as employee contributions for state law purposes, will be treated as employer contributions for federal income tax purposes.

2. Pursuant to section 414(h)(2) of the Code, amounts "picked up" by Employer M under the provisions of Rule V and Resolution S and paid to Plan Y, even though designated as employee contributions for state law purposes, will be treated as employer contributions for federal income tax purposes.

3. Pursuant to sections 414(h)(2) and 402(a) of the Code, amounts "picked up" by Employer M under the provisions of Rule U and Resolution R are excluded from the gross income of Group B Employees at the time they are paid

to Plan X by Employer M and will be included in gross income in the year they are distributed in accordance with the provisions of section 402 of the Code.

4. Pursuant to sections 414(h)(2) and 402(a) of the Code, amounts "picked up" by Employer M under the provisions of Rule V and Resolution S are excluded from the gross income of Group C Employees at the time they are paid to Plan Y by Employer M and will be included in gross income in the year they are distributed in accordance with the provisions of section 402 of the Code.

5. Pursuant to section 3401(a)(12)(A) of the Code, amounts "picked up" by Employer M under the provisions of Rule U and Resolution R will not constitute wages for federal income tax withholding purposes.

6. Pursuant to section 3401(a)(12)(A) of the Code, amounts "picked up" by Employer M under the provisions of Rule V and Resolution S will not constitute wages for federal income tax withholding purposes.

In the case of Plan X, rulings 1, 3, and 5, above, apply only if the effective date for the commencement of any proposed pick up is not any earlier than the later of (a) the date of adoption of Resolution R by Employer M or (b) the later of the effective date of the irrevocable payroll deduction authorization form or the date the form has been signed by the parties.

In the case of Plan Y, rulings 2, 4, and 6, above, apply only if the effective date for the commencement of any proposed pick up is not any earlier than the later of (a) the date of adoption of Resolution S by Employer M or (b) the later of the effective date of the irrevocable payroll deduction authorization form or the date the form has been signed by the parties.

These rulings are based on the assumption that Plan X and Plan Y meet the requirements for qualification 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 paid pursuant to a "salary reduction agreement" within the meaning of section 3121(v)(1)(B) of the Code.

This letter ruling is directed only to the taxpayer that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited by others as precedent.

The original of this letter ruling has been sent to your authorized representative in accordance with a power of attorney on file in this office.

Sincerely yours,

John G. Riddle, Jr.

John G. Riddle, Jr.
Manager, Employee Plans
Technical Group 4
Tax Exempt and Government
Entities Division

Enclosures:
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