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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEC 1 1 2003

T:EP:RA:T1

Uniform Issue List: 414.09-00

LEGEND:

State A = ***

System *S* = ***

Code C = ***

Payroll Authorization Form P = ***

Ladies and Gentlemen:

This is in response to your ruling request dated ***, as supplemented by correspondence dated ***, January 20, 2003, and ***, concerning the federal income tax treatment of certain contributions to System *S* under section 414(h)(2) of the Internal Revenue Code ("Code").

The following facts and representations have been submitted:

System S is a retirement and benefit system created by the laws of State A. System S maintains a defined benefit plan (the "Plan") qualified under section 401(a) of the Code. The Plan is administered by System S in accordance with the provisions of Code C. As the Plan is established and maintained for the benefit of employees of State A and the employees of any political subdivision thereof that elects to participate, the Plan is a governmental plan as defined in Code section 414(d).

Under Code C, all participants in the Plan are required to contribute a specified percentage of their compensation to the Plan. Code C permits each participating

employer to pick up and pay these "mandatory contributions" to the Plan pursuant to section 414(h) of the Code. If contributions are picked up, Code C provides that they shall be treated as employer contributions for federal income tax purposes. Furthermore, Code C states that the amount picked up by the employer must be made in lieu of contributions by the employee, and employees may not receive the picked-up contribution amounts directly once the employer has elected to pay the employee contributions.

Relevant sections of Code C provide that when a participant terminates employment, the participant may receive a refund of contributions previously made to the Plan. Upon receipt of these refunded contributions, the participant's contributory service credits are forfeited. If the former participant is subsequently rehired, such participant may elect to restore prior service that was forfeited upon a refund of contributions or to obtain "permissive service credit," as defined in section 415(n)(3) of the Code, for periods of service not previously credited by the Plan. Making the repayment allows the participant to "buy back" prior service that was canceled upon the participant's earlier termination of employment.

To date, participants in the Plan have been able to purchase such additional service credit with after-tax payments only. Recently, however, the Legislative Assembly of State A enacted legislation amending Code C to allow Plan participants to purchase service credit with either pre-tax or after-tax contributions, in accordance with rules adopted by the Board of Trustees of System S. Under Code C, as amended if a participant elects to purchase service credit with pre-tax contributions, the purchase must be made pursuant to an irrevocable purchase agreement, Payroll Authorization Form P.

Under the above legislative enactment, the pre-tax "pick-up" arrangement with respect to the redeposit of previously refunded contributions or the purchase of permissive service credit will commence only after the Board of Trustees of System S receives a letter ruling from the Internal Revenue Service on the issues described in this request. It has been represented that this constitutes a legislative delegation to the Board of Trustees of System S of the power to request the subject letter ruling on behalf of State A.

In addition, System S represents that, under the Plan, the term "employer" means State A or a political subdivision thereof. Thus the "employer" of all state employees is State A itself rather than the individual state agencies. Accordingly, it is further represented that the Legislative Assembly of State A is the only entity with the authority to make the election to pick up contributions for all state employees who elect to purchase service credit with pre-tax contributions, and that under the relevant provisions of Code C, State A has elected to do *so*.

Pursuant to Code C provisions, the Board of Trustees of System S has the authority to promulgate regulations and to establish terms and conditions for the purchase of prior service credit. Code C has been amended to require that if a participant elects to

purchase service credit using pre-tax contributions, the Board's rules may not be inconsistent with the requirements that the employee may not receive the contributed amount directly once the employer has elected to pay the employee contribution and the amount paid must be paid by the employer in lieu of contributions by the employee.

It has been represented that the rules adopted by the Board of Trustees must adhere to the following guidelines: The Board will require participants to enter into an irrevocable salary reduction agreement and participating employers may pick up the pre-tax contributions under Code section 414(h)(2). Once a participant enters into such irrevocable agreement, the participant will not be able to make any changes to the agreement, including changing the amount or length of time over which salary reduction is made, or have the option of receiving picked-up amounts contributed to the Plan for purchase of service. Also, the Plan will not accept any other type of payment for the purpose of purchasing the service for which the irrevocable agreement was entered into. The irrevocable salary reduction agreement may be terminated prior to completion of payment of the service purchase amount only upon the death, disability, or termination of employment of the participant.

Payroll Authorization Form P will be used to effect the pick up of the above-referenced payroll deductions. Form P will state the type of service and the period of service which the employee intends to purchase, the dollar amount and the period of time over which payroll deductions will take place, that the employee understands that the payroll deduction authorization is binding and irrevocable, that the employee has no option to subsequently choose to receive those amounts directly instead of having them paid to the Plan, that payments are to be made by the employer only, that the Plan will not accept payments from the employee with respect to the purchase of the service credit to which the election relates, and that the agreement shall remain in effect until either the payroll deductions are completed or the payroll deductions can no longer be made due to the employee's death, disability, or termination of employment.

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

1. That after a participant has executed an irrevocable salary reduction agreement, contributions made to the Plan by participating employers for the purpose of purchasing service credit (either forfeited prior service or permissive service) will be treated as contributions picked up by the participating employer within the meaning of Code section 414(h)(2) and will be treated as employer contributions for federal income tax purposes, whether picked up by a reduction in the participant's salary, by an offset against future salary increases or a combination of both.

2. That the contributions picked up by State A for State A employees who are participants in the Plan, pursuant to an irrevocable salary reduction agreement, will be excluded from the gross income of the participant until such time as they are distributed to the participant. Also, that the amounts picked up by State A

on behalf of its employees will not constitute wages within the meaning of section 3401(a) of the Code, and accordingly, the amounts picked up are not subject to federal income tax withholding in the tax year in which they are contributed.

3. That for purposes of the application of section 414(h)(2) of the Code, the participant's death, disability, and termination of employment are permissible reasons for termination of the irrevocable salary reduction agreement to make pre-tax contributions to the Plan, for the purpose of purchasing additional service credit, that are picked up by participating employers.

With respect to Ruling Requests 1 and 2, section 414(h)(2) of the Code provides that contributions, othetwise 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 to 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 plan. The revenue ruling held that such amounts 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)(l2)(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, for federal income tax purposes, 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 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.

In regard to Ruling Request 1, Code C satisfies the criteria set forth in Rev. Rul. 81-35 and Rev. Rul. 81-36, by providing, in effect, that the employer will make contributions to the Plan in lieu of contributions by the participating employees. Under Code C, the employees participating in the Plan have no option to receive any picked-up contributions in cash in lieu of having such contributions paid by the employer to the Plan.

Since the Plan provides that employee contributions are being paid by the employer in lieu of contributions by the employee and the employee does not have the option of receiving the picked-up contributions in cash, accordingly, we conclude that after a participant has executed Payroll Authorization Form P, contributions made to the Plan by participating employers for the purpose of purchasing service credit (either forfeited prior service or permissive service) will be treated as contributions picked up by the participating employer within the meaning of Code section 414(h)(2) and will be treated as employer contributions for federal income tax purposes, whether picked up by a reduction in the participant's salary, by an offset against future salary increases or a combination of both.

With respect to State A as a participating employer in the Plan, it has been represented that the "employer" of the state employees who are participants in the Plan is State A itself rather than the individual state agencies. Accordingly, we conclude, with respect to Ruling Request 2, that the contributions picked up by State A for State A employees who are participants in the Plan, pursuant to Payroll Authorization Form P, will be excluded from the gross income of the participant until such time as they are distributed to the participant. Also, that the amounts picked up by State A on behalf of its employees will not constitute wages within the meaning of section 3401(a)(l2)(A) of the Code, and accordingly, the amounts picked up are not subject to federal income tax withholding in the tax year in which they are contributed.

Furthermore, with respect to Ruling Request 3, for purposes of the application of section 414(h)(2) of the Code, the participant's death, disability, and termination of employment are permissible reasons for termination of the irrevocable salary reduction agreement to make pre-tax contributions to the Plan, for the purpose of purchasing additional service credit, that are picked up by participating employers.

These rulings are based on the assumption that the Plan will be qualified under section 401(a) of the Code at all relevant times.

The effective date for the commencement of the proposed pick up of the contributions cannot be earlier than the later of the date the amendments to Code C are signed or put into effect, or the date the Payroll Authorization Form P is signed by both parties.

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)(l)(B) of the Code.

Further, this ruling is not a ruling with respect to the tax effects of the pickup on employees of participating employers other than State *A* employees. However, in order for the tax effects that follow from this ruling to apply to those other employees of a particular participating employer, other than State A employees, the pick-up arrangement must be implemented by that participating employer in the manner described herein.

This ruling **is** based on conditions that (1) a participant who elects to purchase a particular type of service credit may not make more than one irrevocable election to purchase that type of service credit; and (2) a participant may make more that one irrevocable election to purchase service credit provided any subsequent election is for the purchase of a different type of service credit, is irrevocable, and does not alter or amend the terms and conditions of any prior election to purchase service credit.

This ruling is limited to the pick up of contributions to purchase additional service credit under the Plan. This ruling expresses no opinion as to the validity of the pick-up arrangement pertaining to the mandatory employee contributions under the Plan.

This ruling is directed only to the taxpayer that requested it. Section 611O(k) of the Code provides that it may not be used or cited by others as precedent.

Pursuant to the power of attorney on file with this office, a copy of this ruling letter is being sent to your authorized representative.

Should you have any concerns with this letter, please contact ***, at ***.

Sincerely yours,

Dua, Acting Manager
Employee Plans Technical Group 1