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

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JUN 17 2005

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SE:T:EP:RA:T4

Attn: **********
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Legend

State A = ********

System S = **********

Plan X = **********

Participating Employers = **********
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Members = **********
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Statute A = **********

Statute B = **********

Statute C = **********

Statute D = **********

Statute E = **********

Statute F = **********

Statute G = **********

Statute H = **********

Resolution P = **********
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Resolution Q = **********
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Form O = **********

Dear ********:

This letter replaces the ruling letter issued on May 20, 2005, in response to a ruling request dated August 3, 2004, as supplemented by correspondence dated September 13, 2004, October 25, 2004, January 28, 2005, and April 8, 2005, which was submitted on your behalf by your authorized representative, concerning the federal income tax consequences of "pick-up" contributions to Plan X by the Participating Employers on behalf of their Members pursuant to section 414(h)(2) of the Internal Revenue Code ("Code"). The Service previously issued a favorable letter ruling to Plan X; subsequently, the legislature of State A amended the statute to allow noncontributory Members to elect to become contributory effective July 1 of each year beginning in 2005 and require any active Member whose job status changes from non-teacher to teacher to become a contributory Member in Plan X, as described below.

The following facts and representations have been submitted:

System S, an agency or instrumentality of State A, administers Plan X, a defined benefit pension plan that was established for the benefit of Members. Pursuant to Statute A, Plan X's membership consists primarily of certified teachers, non-certified staff, the administrators employed by school districts in State A, and the System S staff. It is represented that Plan X meets the qualification requirements set forth in section 401(a) of the Code.

Statute A outlines Membership in System S. Additional guidance to determine membership in Plan X is provided in another section of the State A Code by defining "employer" and "employment with a school."

Statute B sets forth the contribution rates for the Members. In general, all new Members must contribute ***** percent of their salary to Plan X. For Members who are members of Plan X as of July 1, ****, Plan X offers two benefit accrual rates depending upon whether a member makes an irrevocable election, on or before July 1, *****, to make additional contributions to Plan X. In order to obtain the higher

rates, the Members must make mandatory contributions to Plan X. Once the election is made, it cannot be changed by the Members.

Statute B also provides that Members may make contributions due on service rendered in a covered position but for which contributions were not withheld by a Participating Employer. Generally, these contributions are called "additional contributions" by Plan X. Statute B provides that a Member who has contributed only on his or her first $****** of annual salary can elect to contribute on all salary by paying to Plan X the Member contributions that would have been required had the Member been contributing on all of his or her salary, plus interest. If such election is made July 1, **** or later, the Member must also contribute the additional employer contributions that would have been made plus interest. Statute B provides that a Member may not make regular contributions until his or her additional contributions are paid in full.

Members may make contributions for service rendered in a covered position on which no applicable contributions have been paid and on which no service has been credited. Generally, these contributions are called "back contributions" by Plan X. Statute B provides that should an employer fail to report the salary of a Member and remit the contribution to Plan X, the System has the right to collect from the Member and the employer the contributions due from each, together with interest. Statute C provides that a Member may obtain credit for prior service upon payment of the Member contributions and employer contributions that would have been made plus interest on both. Statute D allows a covered employee who has excluded himself or herself from membership to rescind the exclusion. If the rescission is retroactive, the Member must pay the Member contributions and the employer contributions that would have been made plus interest on both.

A Member may convert credited service from noncontributory to contributory. Generally, these contributions are called "conversion contributions" by Plan X. Statute E provides that an active Member who has previously been a noncontributory member can elect to become a contributory Member by paying to Plan X the Member contributions that would have been required had the Member been contributory, plus interest.

Statute F also provides that a Member may repay to Plan X, by a single sum or by an increased rate of contribution, the amounts he or she previously received from Plan X, together with interest from the date of withdrawal to the date of repayment. Generally, these contributions are called "repayment contributions" by Plan X. A Member will receive credit for prior service on the date all amounts previously received, plus interest, are repaid to Plan X.

Members may purchase service credits for the following types of service: military service (Statutes G and C); out-of-state service (Statute G); overseas service (Statute G); State A General Assembly service (Statute G); sabbatical leave service (Statute G); private school service (Statute G); National Guard Service (Statute G), and domestic federal service (Statute G). Generally, these contributions are called "purchased service contributions" by Plan X.

Statute H provides that if the Member elects to purchase service credits through payroll deductions, the participating employer will pick-up the amount required to purchase such past service credits from the Member's salary earned after the Member signs Form O and those reductions will be picked-up and treated as employer contributions.

Each Participating Employer picks-up Member contributions from the same source of funds used in paying the Member's salary. The Participating Employer picks-up contributions by a reduction in the cash salary or by a setoff against future salary increases. Under Statute H the Member does not have the option of choosing to receive the contributed amounts directly instead of having them paid to Plan X by the Participating Employer.

Subsequent to the issuance of a prior letter ruling by the Service, the State A General Assembly amended Statute B to (i) allow noncontributory Members to elect to become contributory effective July 1 of each year beginning in 2005, and (ii) require any active member whose job status changes from non-teacher to teacher to become a contributory Member in Plan X.

Resolution P has been prepared for the Board of Trustees of Plan X and revises a prior resolution to provide that each Participating Employer shall pick up Member contributions from salary earned after June 30, 2005. If a Member elects to make additional contributions, back contributions, conversion contributions, repayment contributions or purchased service contributions through payroll reductions, the Participating Employer shall pick up the amount required to make such contributions from the employee's salary earned after the Member signs an irrevocable payroll authorization form prescribed by the Board of Trustees, and those contributions shall then be treated as employer contributions.

Resolution Q was prepared for use by the Participating Employers and provides that contributions from salaries earned after June 30, 2005, shall be treated as employer contributions if Members elect to make additional contributions, back contributions, conversion contributions, repayment contributions or purchased service contributions through payroll reductions. It also provides that the Participating Employer shall pick up the amount required to make such contributions from the employee's salary earned after the Member signs Form O.

Form O revises a prior payroll authorization form that will be used by a Member who elects to redeposit member contributions previously withdrawn and/or to purchase permissive service credits through payroll deductions. Form O is completed by the Member and approved by a Participating Employer.

On February 27, 2002, this office issued **** favorable rulings with respect to pick-up amounts made by Participating Employers on behalf of the Members to Plan X under the provisions of the above-described State A Statutes.

Based on the above described facts and representations, rulings are requested for Members contributions from salaries earned after June 30, 2005, as follows:

That the amounts deducted by a Participating Employer from a Member's salary and credited to the Member's account in Plan X in accordance with Form O authorization to purchase regular member contributions, additional contributions, back contributions, conversion contributions, repayment contributions and purchase service credits qualify as amounts that are picked up by the Participating Employers under section 414(h)(2) of the Code.

That the contributions picked up by the Participating Employers pursuant to Statute B on behalf of Members who are participants in Plan X will not constitute wages for purposes of section 3401(a) of the Code, and accordingly, the amounts picked up by Plan X on behalf of Members are not subject to federal income tax withholding.

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 determined to be qualified under 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, 1981-1 C.B. 255 and Revenue Ruling 81-36, 1981-36, 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. For purposes of the application of section 414(h)(2) of the Code, 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 order to satisfy Revenue Ruling 81-35 and Revenue Ruling 81-36 with respect to particular contributions Revenue Ruling 87-10, 1987-1 C.B. 136, provides that the required specification of designated employee contributions must be completed before the period to which such contributions relate. If not, the designated employee contributions being 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 as paid by the employing unit, i.e., the retroactive "pick up" of designated employee contributions by a governmental employer is not permitted under section 414(h)(2) of the Code.

Plan X is a plan described in section 401(a) of the Code that is maintained by an agency or instrumentality of State A. Since member contributions are made to a plan described in section 401(a) and since these contributions are picked up by the employing unit, Plan X, specifically Statute B as it provides for the designation of employee contributions by the participating employers, meets the requirements of section 414(h)(2) by providing that contributions, otherwise designated as employee contributions, that are picked up by the employing unit shall be treated as employer contributions.

Statute B and Resolution Q satisfy the requirements set forth in Rev. Rul. 81-35 and Rev. Rul. 81-36. Statute B and Resolutions P and Q provide that the Members' contributions, although designated as employee contributions, shall be treated as employer contributions. They provide that the employer will make contributions on behalf of the Members participating in Plan X in lieu of contributions by the Members and that no Member will have the option of receiving the contributions directly instead of having them paid by the employers to Plan X.

Subsequent to the issuance of a prior ruling by the Service, the State A General Assembly amended Statute B to allow noncontributory employees of a Participating

Employer to elect to become contributory effective July 1 of each year beginning in 2005, and require any active Member whose job status changes from non-teacher to teacher to become a contributory Member.

As provided in the prior ruling contributions made by a Member to redeposit previously withdrawn member contributions, and contributions to purchase past service credits and member contributions required by Statute B, although designated as employee contributions, are being paid by the Participating Employer in lieu of contributions by the Member and the Member does not have the option of choosing to receive the contributed amounts directly instead of having them paid by the employer to Plan X. In addition, the form is irrevocable and is signed by the Member and the Participating Employer and acknowledges the resolution adopting the pick-up tax deferral provisions of section 414(h)(2) of the Code.

In this case, Resolution P was prepared for use by Plan X and Resolution Q was prepared for use by the Participating Employers. The resolutions are effective for salaries earned by Members after June 30, 2005, if a Member uses Form O to elect to make additional contributions, back contributions, conversion contributions, repayment contributions or purchased service contributions through payroll reductions. In this case, the Participating Employer shall pick up the amount required to make such contributions from the employee's salary earned after the Member signs Form O, and those contributions shall then be treated as employer contributions.

Based on the aforementioned facts, we conclude that the amounts deducted by a Participating Employer from a Member's salary and credited to the Member's account in Plan X in accordance with Form O authorizes the purchase of regular member contributions, additional contributions, back contributions, conversion contributions, repayment contributions and purchase service credits qualify as amounts that are picked up by the Participating Employers under section 414(h)(2) of the Code.

Furthermore, we conclude that the contributions picked up by the Participating Employers pursuant to Statute B on behalf of Members who are participants in Plan X will not constitute wages for purposes of section 3401(a) of the Code, and accordingly, the amounts picked up by Plan X on behalf of Members are not subject to federal income tax withholding.

These rulings apply only with respect to salaries earned by Members after June 30, 2005, and after proposed Resolution P and proposed Resolution Q are adopted and only with respect to salaries earned by Members who use Form O and their Participating Employer picks up such contributions under Plan X.

No opinion is expressed in this letter as to whether the pick-up 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.

These rulings express no opinion as to the impact of these proposed transactions upon the qualified, or the continuing qualified status of Plan X. These rulings are based on the assumption that Plan X will be qualified under section 401(a) of the Code at all relevant times.

These rulings are directed to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited by others as precedent.

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

If you have any questions please contact ********** I.D. # ********, at **********.

Sincerely yours,

Donzell Littlejohn, Manager
Employee Plans Technical Group 4

Enclosures:
Deleted copy of this letter
Notice of Intention to Disclose, Notice 437