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Internal Revenue Service

Department of the Treasury

Significant Index No. 414.08-00

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply to: T:EP:RA:T3

Date:

LEGEND:

State A =

Plan X =

Board B =

Group C
Employees =

Payroll Authorization
Form P =

This is in response to a ruling request dated October 1, 1999, concerning Plan X and the pick up under section 414(h)(2) of the Internal Revenue Code of certain employee contributions to purchase optional service credit, including service credit attributable to amounts previously withdrawn from Plan X.

The following facts and representations have been submitted:

Plan X is a multiple employer, cost-sharing defined benefit plan qualified under section 401(a) of the Code. Plan X is administered by Board B for the benefit of Group C Employees. The members of Board B are appointed by the governor of State A and serve staggered five-year terms. The governing provisions of Board B and Plan X are statutorily promulgated by the State A

legislature. The plan documents that relate to Plan X are the relevant sections of the State A Code Annotated and the relevant provisions of the Administrative Rules of State A.

Group C Employees include certain police officers of first and second class cities. The State A legislature intends to allow two separate and distinct retirement systems to exist: (1) a system of local police retirement funds, which apply to cities other than those of the first and second class and those that adopt Plan X and (2) Plan X, which applies to first and second class cities, those cities that wish to adopt Plan X and any city that has adopted the statewide police reserve fund, all as further delineated under applicable provisions of the State A Code Annotated and the relevant provisions of the Administrative Rules of State A. An employee is regarded as a participant as long as the employee is employed in a Plan X covered job or has contributions or service on account under Plan X.

Under conditions specified in Plan X, a participant may elect to purchase certain optional service credit, including service credit attributable to amounts previously withdrawn from Plan X. For example, a member may elect to purchase credit for time spent in the military and other State A public service. Plan X has been amended (per section 19-2-704 of the State A Code Annotated) to provide Group C Employees with the option of electing to have their respective employers pick up these optional service credit contributions under section 414(h)(2) of the Code when the contributions are being made through payroll deduction.

Payroll Authorization Form P (attached) will be used to effect the pick up of the above-referenced payroll deduction contributions. This form, which is to be signed by the Plan X participant and his employer states that the employee authorizes the deduction from salary for pick-up purposes and understands that this authorization is binding and irrevocable. The number of months during which the deductions will be made, the dollar amount of the deductions and the specific kind of service being purchased are designated on this form. The employee will agree in Payroll Authorization Form P that, with respect to the specified type of service credit being funded, Plan X will only accept payment from the employer and not directly from the employee. The employee is thus precluded from revoking the pick-up election by making payments directly to Plan X. Payroll Authorization Form P and Plan X also provide that the contributions are being picked up by the employer and paid directly to Plan X and that the employee does not have the option of receiving the amounts directly. Plan X provides that the contributions are paid from the same source as is used to pay compensation to the employee.

No employer resolution is required to implement the pick up. If the employee elects an irrevocable payroll deduction, the employer must pick up.

The effective date of the employer pick up is the date on which the employee contribution is first deducted from the employee's compensation but in no event earlier than after completion of all steps required to be taken by the employer and employee with respect to Payroll Authorization Form P. The pick up does not apply to any contribution made before the effective date or to any contribution that relates to compensation earned for services before the effective date.

It is represented that the picked-up contributions described herein are exclusively for the purpose of purchasing service credit attributable to amounts previously withdrawn from Plan X, as well as other optional service credit available under Plan X. The picked-up contributions are made only on behalf of current employees who are active participants in Plan X and for whom Plan X is being maintained by the employer making the contributions.

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

1. The above-described employee contributions, which are to be picked up pursuant to Plan X (section 19-2-704 of the State A Code Annotated) and paid to Plan X by the employers of Group C Employees on their behalf, although designated as employee contributions under state law, will be treated as employer contributions for federal income tax purposes under section 414(h)(2) of the Code.

2. The picked-up contributions will not be treated as "annual additions" for purposes of section 415(c) of the Code.

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, 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, 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 prior to the date of the last governmental action necessary to effect the employer pick up.

With respect to the pick up of the employee contributions to purchase the optional service credit described herein and further specified in Plan X, Plan X satisfies the criteria set forth in Revenue Ruling 81-35 and Revenue Ruling 81-36 by providing that the employers will make the contributions on behalf of the employees in lieu of contributions by the employees and that no employee will have the option of receiving the contributions directly instead of having them contributed to Plan X. Payroll Authorization Form P is irrevocable and also provides that the contributions are being picked up by the employer and paid directly to Plan X and that the employee does not have the option of receiving the amounts directly. The effective date of the pick up is the date on which the employee contribution is first deducted from the employee's compensation but in no event earlier than after completion of all steps required to be taken by the employer and the employee with respect to Payroll Authorization Form P. The pick up does not apply to any contribution made before the effective date.

Accordingly, assuming the proposed pick ups are implemented as proposed, it is concluded, with respect to the first ruling request, that the above described optional employee contributions, which are to be picked up pursuant to Plan X (section 19-2-704 of the State A Code Annotated) and paid to Plan X by the employers of Group C Employees on their behalf, although designated as employee contributions under state law, will be treated as employer contributions for federal income tax purposes under section 414(h)(2) of the Code.

With respect to the second ruling request, section 1.415-3(d)(1) of the Income Tax Regulations provides that, where a defined benefit plan provides for mandatory employee contributions, the annual benefit attributable to such contributions is not taken into account for purposes of section 415(b) of the Code. Section 1.415-3(d)(1) further provides that the mandatory employee contributions are considered a separate defined contribution plan maintained by the employer that is subject to the limitations on contributions and other annual additions described in section 415(c) of the Code. Employee contributions that are picked up by the employer pursuant to section 414(h)(2) are treated as employer contributions and, as such, are not annual additions to a separate defined contribution plan for purposes of section 415(c). Accordingly, with respect to the second ruling request, it is concluded that the picked-up contributions will not be treated as "annual additions" for purposes of section 415(c) of the Code.

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 statute, 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 Group C Employees. However, in order for the tax effects that follow from this ruling to apply to the employees of a particular employer, the pick-up arrangement must be implemented in the manner described herein.

This ruling is directed only 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 submitted with the ruling request.

Sincerely yours,

Frances V. Sloan

Frances V. Sloan, Manager
Employee Plans Technical Group 3
Tax Exempt and Government Entities
Division

Attachment:
Payroll Authorization Form P

Enclosures:
Deleted copy of letter ruling
Form 437