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Internal Revenue Service

Department of the Treasury

Washington, DC 20224

U.I.L. 414.09-00

Contact Person:

Telephone Number:

In R

Date: T:EP:RA:T2

FEB 10 2000

Attn:

Legend

State A =
Employer M =
Group B Employees =
Plan X =
Subsection E =

Proposed Ordinance R=

Proposed Resolution N=

Dear

This is in response to a ruling request dated October 1, 1999, as supplemented by correspondence dated January 4, 2000, which was submitted on your behalf by your authorized representative, concerning the federal income tax treatment, under section 414(h)(2) of the Internal Revenue Code ("Code"), of certain contributions to Plan X.

The following facts and representations have been submitted:

Plan X is funded through a combination of employer and mandatory employee contributions. Prior to 1991, mandatory contributions were contributed by employees on an after-tax basis. Effective in 1991, Plan X was amended by Subsection E to provide that employee mandatory contributions would be picked up under section 414(h)(2) of the Code. In a letter ruling dated November 21, 1991, the Service concluded that amounts picked up by Employer M on behalf of those employees who participate in Plan X shall be treated as employer contributions and will not be includible in the employee's gross income in the year in which such amounts are contributed.

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In 1998, Plan X was amended by adding Subsection 1.202(6) to permit covered employees to purchase up to 24 additional months of credited service on a pre-tax basis. There was no provision for the pick-up of the contributions for these special purchases. The current ruling request seeks to extend the application of Code section 414(h)(2) to the redeposit of contributions previously withdrawn plus interest and the purchase of military service or other permissive service credit.

Employer M proposes to adopt Proposed Ordinance R, which includes Proposed Resolution N. Pursuant to the terms set forth in Proposed Ordinance R, employees may purchase additional service credit and purchase service attributable to absences while on military service leave. Proposed Ordinance R, which will become effective upon receipt of a favorable ruling from the Internal Revenue Service, permits members to pay for additional service purchases in a lump sum in cash (after-tax) or by a combination of a payment in a lump sum in cash and the balance paid by payroll deduction over a period of five years or less. The deferred payments may be either picked-up under Code section 414(h)(2) or may be paid on an after-tax, payroll deduction method, as chosen by the member. Proposed Ordinance R prohibits the member from altering the form of payment, once made. Further, Proposed Ordinance R provides that if employment is terminated prior to completion of the original schedule of payments, an accelerated, after-tax payment or a reduction in the service which is the subject of the purchase will occur. The terms of the election to purchase service and the restrictions on the form of payment are described in the Service Purchase Election and Payroll Authorization Form. The special election and the payroll deduction authorization agreement is binding and irrevocable and is signed by the employee and Employer M.

Proposed Resolution N certifies approval of Proposed Ordinance R. Proposed Resolution N provides that members are permitted to redeposit contributions previously withdrawn plus interest and to purchase military service occurring during employment or other permissive credit. In order to permit tax deferral for these elective service purchases, Proposed Resolution N further provides that an employee may enter into a binding, irrevocable payroll deduction authorization and such employee will not have the option of choosing to receive the amounts directly instead of having them paid by Employer M directly into Plan X and that the amounts specified as picked up through payroll deductions from salary will be paid by Employer M to Plan X.

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

1. That contributions picked up by Employer M on behalf of the Group B Employees pursuant to Proposed Ordinance R, Proposed Resolution N, and Subsection E, satisfy the requirements of section 414(h)(2) of the Code.

2. That no part of the contributions picked up by Employer M pursuant to Proposed Ordinance R, Proposed Resolution N, and Subsection E will be includable in the gross income of the Group B Employees for federal income tax purposes.

3. That the contributions whether picked up by payroll deduction, offset against future salary increases, or both and though designated as employee contributions will be treated as employer contributions for federal income tax purposes.

4. That no part of the contributions picked up by Employer M pursuant to Proposed Ordinance R, Proposed Resolution N, and Subsection E will constitute wages from which federal income taxes must be withheld.

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, 1981-1 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 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 this request, Proposed Ordinance R, Proposed Resolution N, and Subsection E, if adopted as proposed, would satisfy the criteria set forth in Rev. Rul. 81-35 and Rev. Rul. 81-36. They provide that Employer M will make contributions in lieu of contributions by Group B Employees and that the Group B Employees may not elect to receive such contributions directly.

Accordingly, we conclude that, with regard to ruling request number one, Proposed Ordinance R, Proposed Resolution N, and Subsection E satisfy the requirements of section 414(h)(2) of the Code.

With regard to ruling request number two, we conclude that no part of the contributions picked up by Employer M on behalf of the Group B Employees will be includable as gross income for federal income tax purposes in the year of contribution with respect to such employees.

With regard to ruling request number three, we conclude that the contributions picked up by Employer M on behalf of the Group B Employees, whether by payroll deduction, an offset against future salary increases, or both and though designated as employee contributions will be treated as employer contributions for federal income tax purposes.

With regard to ruling request number four, since we have determined that the picked-up contributions are to be treated as employer contributions, they are excepted from wages as defined in section 3401(a)(12)(A) of the Code for federal income tax withholding purposes. Therefore, no withholding of federal income tax is required in the taxable year in which they are contributed to Plan X.

These rulings apply only if the effective date for the commencement of any proposed pick up is not earlier than the later of the date Proposed Ordinance R, Proposed Resolution N, and Subsection E are signed into law or the date they are put into effect.

These rulings are 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.

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In addition, these rulings are contingent upon the adoption of Proposed Ordinance R, Proposed Resolution N, and Subsection E, as contained in your correspondence dated October 1, 1999.

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).

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 on file with this office.

Sincerely yours,

(signed) JOYCE E. FLOYD

Joyce E. Floyd, Manager
Employee Plans Technical Group 2
Tax Exempt and Government Entities

Enclosures:
Copy of this letter, Deleted copy, & Notice 437