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Internal Revenue Service

Department of the Treasury

Washington, DC 20224

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Contact Person:

Telephone Number:

In Reference to:
T:EP:RA:T1

Date:
March 1, 2000

Attn:

Legend:

Employer A =

State B =

Plan X =

Dear :

This is in response to a ruling request dated September 24, 1999, concerning the pick up of certain employee contributions to Plan X under section 414(h)(2) of the Internal Revenue Code.

The following facts and representations have been submitted:

Employer A, a political subdivision of State B, sponsors Plan X, a governmental plan under Code section 414(d), for the benefit of its employees. Plan X requires mandatory employee contributions and is qualified under Code section 401(a).

Plan X provides that when a participant terminates employment, the participant may receive a refund of contributions previously made to Plan X. Upon receipt of these refunded contributions, the participant's contributory service credits are forfeited. If the former participant is subsequently rehired within two years, such participant may elect to redeposit an amount equal to any contributions that have been previously been refunded

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plus interest. In addition, a member can purchase additional credited service if the participant was previously employed as a policeman or fireman, was covered under another retirement system, transfers to the Plan X employees' savings fund the amount that he or she previously contributed to the other retirement system, and the interest credited thereon, and is not entitled to a benefit under that other system.

Under conditions specified in State B statutes, Plan X, and Policy 11.35, as proposed to be revised, (" Proposed Policy 11.35"), participants may elect to purchase additional service credit. For example, a participant may purchase credit for time spent on leave for a period of up to five years of military service provided that (1) the member is reemployed by Employer A within one year of the termination of such military service, and (2) he or she repays to the employees' savings fund any accumulated contributions he or she previously withdrew, plus interest thereon. In addition, participants may purchase additional service credit if, prior to January 1, 1982, the participant had been a full-time temporary employee or in certain positions of employment that were excluded from Plan X because they were less that full-time; if the participant has made contributions to or been a non-contributory member of another public retirement system, and is not receiving or eligible to receive a retirement benefit from another public retirement system for the same credited service; and, if the participant began employment prior to December 24, 1969, and waived participation in Plan X for the first six months of employment pursuant to the provisions of Plan X then in effect. Statutes in State B also provide that a contributing member of a state retirement system may elect to transfer service credits to Plan X if (1) the Retirement Boards for the Plans agree to transfer, and (2) neither system incurs unfunded liabilities as a result of the transfer. Under the Uniformed Services Employment and Reemployment Rights Act of 1994, certain employees of Employer A who are reemployed after a period of uniformed service may be entitled to credited service under Plan X for the period of their absence. Under 38 U.S.C. 4318, Employer A can require that any such individual pay to Plan X an amount equal to the employee contributions that the individual would have had to make during the period of absence (based on projected pay).

Proposed Policy 11.35 further provides that if a member elects to purchase additional service credit, the member's decision to purchase the credited service, and the decision to do so by payroll reduction, is irrevocable. Payroll deduction will only be ended when all the required payments have been made or the member either terminates employment or becomes totally and permanently disabled. In addition, if a member's compensation is reduced to an amount that is insufficient to provide for the agreed amount of payroll reduction, the obligation to purchase the credited service continues and the Plan X Retirement Board will adjust the amount of the payroll reduction. The member must sign a payroll reduction authorization form for the credited service to be purchased.

Based on the foregoing facts and representations, you have requested the following rulings:

1) Pursuant to Code section 414(h)(2), amounts picked up by Employer A under the provisions of Plan X Proposed Policy 11.35 and the employee's agreement relating thereto, even though designated as member contributions will be treated as employer contributions.

2) Pursuant to Code sections 414(h)(2) and 402, amounts picked up by Employer A under the provisions of Plan X Proposed Policy 11.35 and the employee's agreement relating thereto, are excluded from the gross income of the employee at the time they are paid to Plan X by Employer A and will be included in gross income in accordance with Code section 402.

3) Pursuant to Code section 3401(a)(12)(A), amounts picked up by Employer A under the provisions of Plan X Proposed Policy 11.35 and the employee's agreement relating thereto, will not constitute wages for federal income taxwithholding purposes.

Code section 414(h)(2) provides that contributions, otherwise designated as employee contributions, shall be treated as employer contributions if such contributions are made to a plan described in Code section 401(a), established by a state government or a political subdivision thereof, or any agency or instrumentality of any one of the foregoing, 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 Code section 414(h)(2) 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. Rev. Rul. 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 Code section 3401(a)(12)(A), 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 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, for

purposes of the applicability of Code 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.

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.

Proposed Policy 11.35 provides the following: that a member may purchase additional service credit under Plan X pursuant to a binding, irrevocable payroll reduction agreement. These contributions will be picked up by Employer A, although they are designated as employee contributions. Members will not have the option to receive the amounts under the agreement directly instead of having them contributed to Plan X.

Accordingly, we conclude that the contributions picked up by Employer A pursuant to Proposed Policy 11.35 and the payroll reduction agreements satisfy the requirements of Code section 414(h)(2). These amounts picked up by Employer A for employees shall be treated as employer contributions and will not be includable in employees' gross income for the taxable year in which such amounts are contributed.

Because we have determined that the picked up amounts are to be treated as employer contributions, they are excepted from wages as defined in Code section 3401(a)(12)(A) for Federal income tax withholding purposes. Therefore, no withholding of Federal income tax is required from employees' salaries with respect to such picked up amounts.

The effective date for the commencement of the proposed pick up as specified in Proposed Policy 11.35 cannot be any earlier than the later of the date the proposed policy is signed or put into effect.

For purposes of the application of Code section 414(h)(2), 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.

This ruling is based on the assumption that Plan X will be qualified under Code section 401(a) at the time of the proposed contributions.

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 the whether the amounts in question are paid pursuant to a "salary reduction agreement" within the meaning of Code section 3121(v)(1)(B).

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

A copy of this ruling has been sent to your authorized representative pursuant to a power of attorney on file in this office.

Sincerely yours,

John Swieca

John Swieca,
Manager, Employee Plans
Technical Group 1
Tax Exempt and Government
Entities Division

Enclosures:
Deleted Copy of the Ruling
Notice 437

cc: