Internal Revenue Service

Department of the Treasury

Washington, DC 20224

Uniform Issue List No. 414.09-00

Contact Person:

Telephone Number:

In Reference to: T:EP:RA:T4

Date: JUL - 6 2000

Legend:

State A =

Employer M =

Plan X =

Plan Y =

Group B Employees =

Group C Employees =

Statute T =

Ladies and Gentlemen:

This letter is in reply to a request for a letter ruling dated July 7, 1998, as supplemented by submissions of December 3, 1998, November 16, 1999, and June 22, 2000, made on behalf of Employer M, concerning the federal tax treatment of certain contributions made to Plan X and Plan Y under section 414(h)(2) of the Internal Revenue Code ("Code").

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You have submitted the following facts and representations:

Employer M is an instrumentality of State A providing public educational services. Employer M's Group B Employees are participants in Plan X. Plan X was established in accordance with the provisions of Statute T and is a governmental plan within the meaning of section 414(d) of the Code. Plan X is a contributory defined benefit plan intended to meet the requirements of section 401(a) of the Code and the related trust forming part of Plan X is intended to be exempt from taxation under section 501(a) of the Code. Plan X has a favorable determination letter.

Group B Employees are required to contribute a certain percentage of their compensation to Plan X. The current mandatory employee contributions to Plan X are "picked up" under section 414(h)(2) of the Code based on a private letter ruling dated April 11, 1983. The contributions are separately accounted for and are held in individual member accounts.

Pursuant to terms set forth in Statute T, Plan X also permits the purchase of additional service credit by its employee members for service previously performed when the employee was not a contributing member of Plan X (e.g., military service, out-of-state public service, exempted service(student), or service as a teacher at a private educational institution) or service for which the employee has previously received a refund of Plan X contributions.

In order to purchase additional service credit, an employee must pay into Plan X. The amount depends upon the type of credit being purchased. In some cases it is equal to the contributions the employee would have made had the employee been a contributing member for the years of credit being purchased, plus interest. Purchase of additional service credit may be done by payroll deduction.

All purchases of additional retirement service credit under Plan X made prior to September 1, 1998, were made on an after-tax basis. Employer M proposes to pick up the additional employee contributions made through payroll deduction installment payments. Employer M passed a resolution on June 18, 1998, adopting a Plan X tax-deferred payroll deduction plan providing that additional service credit may be purchased under the installment method on a pre-tax basis only after the completion of a binding irrevocable payroll deduction authorization form by the employee and Employer M. Employee contributions made pursuant to an irrevocable payroll deduction authorization will be picked up and paid by Employer M and the employee will have no option of receiving the picked-up contributions directly. Further, the employee will waive all rights to terminate the election.

Also, Employer M's Group C Employees are participants in Plan Y. Plan Y was established pursuant to the provisions of Statute T and is a governmental plan within the meaning of section 414(d) of the Code. Plan Y is a contributory defined benefit plan intended to meet the requirements of section 401(a) of the Code and the related trust of Plan Y is intended to be exempt from taxation under section 501(a) of the Code. Plan Y has received a favorable determination letter.

All Group C Employees are required to contribute a certain percentage of their compensation to Plan Y. The current mandatory employee contributions to Plan Y are "picked up" by Employer M based on private letter rulings dated July 26, 1983 and February 29, 1984. The contributions are separately accounted for and held in individual member accounts.

Pursuant to the terms set forth in Statute T, Plan Y also permits the purchase of additional service credit by its employee members for service previously performed when the employee was not a contributing member of Plan Y (e.g., military service, out-of-state public service, federal civilian service, exempted service (student), or unpaid leave of absence) or service for which the employee has previously received a refund of Plan Y contributions.

In order to purchase additional service credit, an employee must pay into Plan Y. The amount depends upon the type of credit being purchased. In some cases it is equal to the contributions the employee would have made had the employee been a contributing member for the years of credit being purchased, plus interest.

Currently, all purchases of additional retirement service credit under Plan Y are being made on an after-tax basis. Employer M proposes to pick up the additional employee contributions made through payroll deduction installment payments. Employer M passed a resolution on June 18, 1998, adopting a Plan Y tax-deferred payroll deduction plan providing that additional service credit may be purchased under the installment method on a pre-tax basis only after the completion of a binding irrevocable payroll deduction authorization form by Group C Employees. Employee contributions made pursuant to an irrevocable payroll deduction authorization will be picked up and paid by Employer M and the employee will have no option of receiving the picked-up contributions directly. The employee will waive all rights to terminate the election.

Amounts deducted from employees' compensation and used to purchase additional retirement service credit will not be available for withdrawal from either Plan X or Plan Y until the employees' termination of employment. Also, employees who do not elect to purchase additional service credits on a pre-tax payroll deduction "pick up" basis may make after-tax purchases of additional service credits by payroll deduction, partial payment or lump sum payment. They can do so as in the past by making a revocable election to purchase additional service credits.

Based on the aforementioned facts and representations, you have requested the following rulings with respect to the purchase of additional service credit under Plan X or Plan Y:

1. That no part of the contributions picked up by Employer M as the employer of the employees included in Plan X or Plan Y be considered as gross income to the employees for federal income tax treatment until such time as they are distributed to the employees.

2. That the contributions picked up by the salary reduction by means of the irrevocable payroll deduction authorization form though designated as employee contributions will be treated as employer contributions for federal income tax purposes.

3. That the contributions picked up by Employer M will not 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 described in section 401(a) or 403(a) of the Code, established by a state government or political subdivision thereof, or by any agency or instrumentality of any of the foregoing, where the contributions of employing units are designated as employee contributions but where any employing unit picks up the contributions, the contributions so picked up shall be treated as employer contributions.

Revenue Ruling 77-462, 1977-2 C.B. 358, addresses the federal income tax treatment of contributions picked up by the employer within the meaning of section 414(h)(2) of the Code. In Rev. Rul. 77-462, the employer school district agreed to pick up the required contributions of the eligible employees under the plan. The revenue ruling held that under the provisions of section 3401(a)(12)(A) of the Code, the school district's picked-up contributions to the plan are excluded from wages for purposes of the Collection of Income Tax at Source on Wages, and no federal income tax withholding is required from employees' salaries with respect to the said picked-up contributions. The revenue ruling further held that the school district's picked-up contributions are excluded from the gross income of employees until such time as they are distributed to the employees.

Revenue Ruling 81-35, 1981-1 C.B. 255, and Revenue Ruling 81-36, 1981-1 C.B. 255, provide guidance as to whether contributions will be considered as "picked up" by the employer. Both revenue rulings establish that the following two criteria must be satisfied: (1) the employer must specify that 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 have an option of choosing to receive the contributed amounts directly or to have them paid by the employer to the plan.

In Revenue Ruling 87-10, 1987-1 C.B. 136, the 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 case, the amounts deducted by Employer M from Group B and Group C Employees' compensation and contributed to Plan X and Plan Y, respectively, for the purchase of additional retirement service credit in accordance with the irrevocable payroll deduction authorization form described above will qualify as picked-up contributions within the meaning of section 414(h)(2) of the Code. The provisions of the above resolution adopted by Employer M on June 18, 1998 meet the requirements of Rev. Rul. 81-35 and Rev. Rul. 81-36 by providing that (1) the amounts withheld through payroll deduction are designated as being picked up by Employer M and paid on behalf of the employees and in lieu of contributions by the employees and that (2) no employee will have the option of receiving the contribution directly instead of having it contributed to Plan X or Plan Y. Pursuant to the terms of the irrevocable payroll deduction authorization form, a Group B or Group C Employee can not terminate the deduction unless all of the service credit has been purchased by payroll deduction or employment terminates. Further, the irrevocable payroll deduction authorization form will be implemented so as to specify the designated pick up contributions, as such, before the period to which such contributions relate.

Accordingly, with respect to the purchase of additional service credit under Plan X or Plan Y, we conclude that:

1. No part of the contributions picked up by Employer M as the employer of the employees included in Plan X or Plan Y will be considered as gross income to the employees for federal income tax treatment until such time as they are distributed to the employees.

2. The contributions picked up by the salary reduction by means of the irrevocable payroll deduction authorization form though designated as employee contributions will be treated as employer contributions for federal income tax purposes.

3. The contributions picked up by Employer M will not constitute wages from which federal income tax must be withheld.

These rulings apply only if the effective date for the commencement of any proposed pick up is not any earlier than the latest of (a) the later of the date of adoption of the above resolution by Employer M or the date it is put into effect; or (b) the later of the effective date of the appropriate irrevocable payroll deduction authorization form or the date the form has been signed by the parties.

These rulings are based on the assumption that Plan X and Plan Y meet the requirements for qualification 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 paid pursuant to a "salary reduction agreement" within the meaning of section 3121(v)(1)(B) of the Code.

This letter ruling is directed only to the taxpayer that 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 ruling has been sent to your authorized representative in accordance with a power of attorney on file in this office.

Sincerely yours,

John G. Riddle, Jr.

John G. Riddle, Jr.
Manager, Employee Plans
Technical Group 4
Tax Exempt and Government
Entities Division

Enclosures:

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Notice 437

cc: