Internal Revenue Service Department of the Treasury

Uniform Issue List: 414.09-00 Washington, DC 20224 200126042
415.00-00

Person to Contact:

Telephone Number:

Refer Reply to:

Date: T:EP:RA:T2

APR 6 200

Attn:
Executive Director

Legend:

State A =

System S =

Participating
Employer/Employers=

Plan X =

Resolution R =

Form P =

Statute T =

360

This letter is in reply to a request for a letter ruling dated November 16, 1998, as supplemented by submissions of May 19, 1999, September 16, 1999, November 9, 1999, March 14, 2000, April 27,2000, November 2, 2000, and April 4, 2001, made on your behalf, concerning the federal tax treatment of certain contributions made to Plan X under section 414(h)(2) of the Internal Revenue Code ("Code").

The following facts and representations have been submitted:

System S is a retirement and benefit system created by the laws of State A for the purpose of providing retirement annuities and other benefits for employees of Participating Employers.

System S maintains Plan X, a defined benefit plan, qualified under section 401(a) of the Code. Plan X received its recent determination letter on March 28, 2001. System S is also an employer of employees who are participants in Plan X. Plan X is administered by the Board of Trustees of System S in accordance with the provisions of Statute T.

Effective in 1998, as an alternative to participating in Plan X, eligible employees may elect to participate in a defined contribution plan to be maintained by System S.

All participants in Plan X are required to contribute a specified percentage of their compensation to Plan X. Under the provisions of Statute T, required employee contributions under Plan X shall be made as an "employer pick-up" under section 414(h)(2) of the Code. System S proposes to extend its pick-up program to certain contributions which include the contributions that employees may make for the purpose of purchasing additional service credit or redepositing contributions previously refunded to an employee.

Under the provisions of Statute T, employees of Participating Employers may make contributions to Plan X for the purpose of obtaining additional service credit under two circumstances: (1) for the purpose of restoring prior service with a Participating Employer that was forfeited due to a refund of contributions ("Past Service"); and (2) for the purpose of obtaining additional service credit for periods of service not previously credited by Plan X, such as prior service before becoming a participant, service with other State A public agencies, military service, or service for leaves of absence ("Permissive Service").

Provisions of Statute T permit an employee leaving the service of a Participating Employer the opportunity to obtain a refund of contributions made during the course of that employee's employment. The refund includes interest on the employee contributions and, based upon elections that may have been made by the employee, may include employer contributions with interest. Upon obtaining a refund of prior contributions, the employee forfeits all service credits and any rights to future benefits. If the employee returns to work for a Participating Employer that entitles the employee to again become a member of System S, then that employee has the option, after remaining in eligible service for a 2-year period, of reinstating the Past Service credit that was forfeited upon obtaining the refund. To reinstate the Past Service credit the employee must repay the full amount that was refunded, plus interest from the refund date to the date of repayment, calculated using Plan X's effective rate of interest. The election to reinstate Past Service credits must be made at a time prior to the date of the employee's retirement. Under present procedures the contributions must be paid directly to System S and must be paid in a lump sum. As with the election to purchase Past Service credits, an employee who elects to purchase Permissive Service credits must currently make payment directly to System S on a lump sum basis. The service credit may be purchased in increments of one year, if more than one year of service is available to purchase.

Statute T was amended in 1997 to permit Participating Employers to pick up the contributions required to be made by employees who wish to purchase service credit. Under Statute T an employee may elect to have a Participating

Employer pick up the contributions required to purchase service credits and the election to have these contributions picked up is irrevocable.

System S proposes to implement a program under which an employee will have several options concerning the method under which contributions could be made when the employee elects to purchase service credits, whether by repaying the amount of a prior refund, plus interest, in order to reinstate Past Service credits, or by making the contributions required to purchase Permissive Service credits.

Under the proposed program, an employee will have the option to elect: (1) to make the contributions on a lump sum after-tax basis, (2) to make the contributions as a lump sum pre-tax contribution from an eligible rollover contribution, or (3) to irrevocably make the contributions on an installment basis by pre-tax payroll deductions. If the employee elects to make the contributions by payroll deduction, the repayment period must be for a period of one, two, three, four, or five years, and the payments will also have to be scheduled so that the contributions for purchase of service credits will be completed prior to the employee's retirement. If the employee elects to make the contributions for the purchase of service credits by irrevocable pre-tax payroll deduction, the contributions will be withheld by the employer and forwarded to Plan X as picked-up contributions under section 414(h)(2) of the Code.

By your authorized representative's letter of March 14, 2000, it was clarified that in an effort to provide a full description of the program for purchasing service credit, System S has described the three methods above (including rollover contributions) that may be used for such purposes. However, it has been represented that System S is not requesting a ruling that a rollover contribution is eligible for "pick up" treatment under section 414(h)(2) of the Code when used to reinstate Past Service credit or purchase Permissive Service credit.

If the employee elects the irrevocable payroll deduction program, then Plan X will refuse any direct payments from the employee for the purchase of the service credits that were being paid for by irrevocable payroll deduction. Also, the employee could not change the amount

or length of time over which the irrevocable payroll deduction will occur. However, because Plan X's effective rate of interest changes at the beginning of each fiscal year, the amount of an employee's payroll deduction will be subject to automatic adjustment, without any action on the employee's part, if the effective rate of interest changes during the scheduled repayment period. Also, if the employer changes the employee's payroll frequency, the number and amount of each payroll deduction will automatically be adjusted, without any action on the employee's part, for the balance of the elected repayment period. Under Plan X, participant benefits may be determined based on contributions made by the participant to the Plan along with earnings attributable to such contributions. The amount of attributable earnings is calculated using the effective rate of interest which is established under Statute T.

Under Plan X a participant can purchase service credit relating to prior refunds from the Plan by paying back into the Plan the amount of the refund received and an additional amount as interest for the period of time from the date of refund to the date of repayment. The interest that the participant must pay into the Plan is calculated so as to equal the relative benefit increase that the participant would have enjoyed had the amounts remained in the Plan.

The effective rate of interest under Plan X is subject to change on an annual basis if, due to the relative performance of the underlying assets of the Plan, and other additional factors, it is warranted to adjust the rate that is used to calculate the benefits payable to annuitants under the Plan. Consequently, if the contribution to be paid into the Plan to repay a prior refund is to be made over a period of months, rather than in a single payment, it is necessary to take into account the impact of a change in the effective rate of interest used by the Plan to calculate Plan benefits. Any changes to the effective rate of interest, while a participant is making contributions under the irrevocable payroll deduction program, would automatically change the contributions picked up by the employer. That is, if the effective rate of interest is increased, the contribution amount required from the participant must be adjusted upward. This change in the payment amount is not volitional nor is it subject to adjustment by the participant.

200126042

In the case of the death of an employee, payments for the purchase of service credits will stop and partial service credit will be granted, rounded down to the next quarter-year increment, based upon the contributions made to the date of death. Contributions in excess of the amount needed to provide a quarter-year of service credit will be paid to the employee's beneficiary or estate.

If irrevocable payroll deductions cease due to termination of employment or the disability of the employee, the employee will have a 60-day period in which to make an after-tax lump sum payment to pay for the balance of the contributions required to obtain the service credits which the employee intended to purchase or, if no after-tax lump sum payment is made by the employee, then partial service credit will be granted, rounded down to the next quarter-year increment, based upon the contributions made to the date payments ceased, with any excess contributions refunded to the employee.

Employees will be permitted to make separate payroll deduction authorizations to purchase service credit relating to different types of service or different periods of time. However, any subsequent irrevocable payroll deduction authorizations will not alter, amend or revoke the amount of picked up contributions to be made to Plan X under any irrevocable elections then in effect.

A Participating Employer will be required to adopt Resolution R authorizing the employer to participate in the pick-up program. This resolution shall designate such payroll deductions (as are made pursuant to a binding irrevocable payroll deduction authorization between an employee and respective employer to have such amounts picked up) as being picked up by such employer and paid by such employer with the employee having no option of receiving such picked up amounts contributed to Plan X.

The payroll deduction authorization form (Form P) will state the type of service and the period of service which the employee intends to purchase, the dollar amount and the period of time over which payroll deductions will take place, that the employee understands that the payroll deduction authorization is binding and irrevocable, that the employee has no option to subsequently choose to receive those amounts directly instead of having them paid

to Plan X, that payments are to be made by the employer only and that Plan X will not accept payments from the employee with respect to the purchase of the service credit to which the election relates, and that the agreement shall remain in effect until either the payroll deductions are completed or the payroll deductions can no longer be made due to the employee's death, disability, or termination of employment.

Based on the above facts and representations, your authorized representative has requested the following rulings:

1. That after a Participating Employer has adopted Resolution R and the employee has executed the irrevocable payroll deduction authorization (Form P), contributions made to Plan X for the purpose of an employee's purchase of service credit (regardless of whether such service credit is for Past Service or Permissive Service) will be treated as contributions picked up by the Participating Employer within the meaning of section 414(h)(2) of the Code and will be treated as employer contributions for federal income tax purposes.

2. That changes to the amount or number of payments under an irrevocable payroll deduction authorization (Form P), due to changes in Plan X's effective rate of interest, or to changes in the employer's payroll frequency, will not cause the contributions to cease to qualify as contributions picked up by a Participating Employer within the meaning of section 414(h)(2) of the Code nor cease to qualify as employer contributions for federal income tax purposes.

3. That for purposes of the application of section 414(h)(2) of the Code, death, disability, or termination of employment are permissible reasons for the termination of the irrevocable election to make the contributions by payroll deduction.

4. That for purposes of employees of System S, who are participants in Plan X, the picked-up contributions, pursuant to such irrevocable elections, will not constitute wages under section 3401(a) of the Code from which federal income taxes must be withheld in the tax year in which they are contributed.

5.(a) Pursuant to Code section 415(n), the picked-up contributions relating to the purchase of permissive service credit are not annual additions for purposes of Code section 415(c), and after-tax employee contributions used to purchase permissive service credit may also, at Plan X's election, be treated as not subject to section 415(c) of the Code; and

(b)(i) The contributions relating to the reinstatement of Past Service (whether after-tax or picked-up) are not subject to Code section 415(c) when made to Plan X pursuant to Code section 415(k)(3); and (ii) benefits attributable to after-tax employee contributions used to reinstate Past Service (and interest thereon) are not subject to Code section 415(b) when distributed from Plan X pursuant to Income Tax Reg. Sec.1.415-3(d).

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, 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 must be completed before the period to which such contributions relate.

In this case, Plan X is a governmental plan as described in section 414(d) of the Code. In accordance with the provisions of Statute T and Resolution R, a Participating Employer will pick up certain employee contributions and pay them to Plan X. If an employee of a Participating Employer elects to reinstate Past Service credit or purchase Permissive Service credit and agrees to do so by payroll deduction, the Participating Employer will pick up (i.e., assume and pay) the contributions that the employee is required to pay for the purchase of service credit. Further, in accordance with the provisions of Form P, the election of the employee to purchase service credit by payroll deduction under the pick-up arrangement with such Participating Employer is irrevocable and cannot be changed by the employee prior to termination of employment, disability, or purchase of all of the service credit set forth on Form P.

The provisions of Resolution R in conjunction with Statute T meet the requirements of Rev. Rul. 81-35 and Rev. Rul. 81-36. Thus, the amounts deducted by a Participating Employer from employees' compensation and contributed to Plan X for the purchase of service credit will qualify as picked-up contributions within the meaning of section 414(h)(2) of the Code.

Accordingly, with respect to Ruling Request # 1, we conclude that after a Participating Employer has adopted Resolution R and the employee has executed the irrevocable payroll deduction authorization form (Form P), contributions made to Plan X for the purpose of an employee's purchase of service credit (regardless of whether such service credit is for Past Service or Permissive Service) will be treated as contributions picked up by the Participating Employer within the meaning of section 414(h)(2)of the Code and will be treated as employer contributions for federal income tax purposes.

With regard to Ruling Requests #2 and #3, under Plan X, in general, the amount of a participant's retirement benefit is determined by the greater of a retirement annuity based on (i) a fixed percentage of compensation and years of service formula, or (ii) a formula based on a participant's required contributions to Plan X, together with earnings thereon at the Plan's effective rate of interest for the respective years.

To reinstate Past Service credit under Plan X, a participant must repay the full amount that was previously refunded, plus interest from the refund date to the date of repayment, calculated using the Plan's effective rate of interest. The interest that the participant must pay into the Plan is calculated so as to equal the relative benefit increase the participant would have received had the amounts remained in the Plan. By applying the same effective rate of interest to the repayment amount as is used for the benefit determination, Plan X maintains a balance, such that the amounts that are to be returned to the Plan approximate the amount that the Plan may be obligated to later pay back out as a benefit to the participant.

If the repayment amount is to be made over a period of months or years, rather than in a single payment, it is necessary to take into account the impact of a change in the effective rate of interest used by Plan X to calculate Plan benefits. Thus, any changes to the effective rate of interest, while a participant is making contributions under the irrevocable payroll deduction program, would automatically change the contributions picked up by the employer. This change in the payment amount is not volitional nor is it subject to adjustment by the participant.

Therefore, with regard to Ruling Requests #2 and #3, we conclude that changes to the amount or number of payments under an irrevocable payroll deduction authorization (Form P), due to changes in Plan X's effective rate of interest, or to changes in the employer's payroll frequency, will not cause the contributions to cease to qualify as contributions picked up by a Participating Employer within the meaning of section 414(h)(2) of the Code nor cease to qualify as employer contributions for federal income tax purposes; and that for purposes of the application of section 414(h)(2) of the Code, death, disability, or termination of employment are permissible reasons for the termination of the irrevocable election to make the contributions by payroll deduction.

It has been represented that System S is also an employer of employees who are participants in Plan X. Therefore, we conclude, with respect to Ruling Request # 4, that for purposes of employees of System S, who are participants in Plan X, the picked-up contributions, pursuant to such irrevocable elections, will not constitute wages under section 3401(a) of the Code from which federal income taxes must be withheld in the tax year in which they are contributed.

As to your Ruling Request # 5, we notified your authorized representative in our letter dated October 13, 2000, that the Service was proposing to rule favorably with respect to Part (a) of Ruling Request #5 but unfavorably with respect to Part (b) of Ruling Request #5. Your authorized representative, in his letter dated November 2, 2000, requested that Ruling Request # 5, Parts (a) and (b), be issued as we had proposed.

Section 415(b)(2) of the Code provides, in general, that a participant's benefit, expressed as an annual benefit, cannot exceed the lesser of : (A) $90,000(as adjusted for cost-of-living increases), or (B) 100 percent of the participant's average compensation for the high three years. The 100 percent of compensation limit under section 415(b)(2)(B) does not apply to governmental plans.

Section 415(c)(1) of the Code provides, in general, that contributions and other annual additions for a participant may not exceed the lesser of: (A) $30,000 (as

adjusted for cost-of-living increases), or (B) 25 percent of the participant's compensation.

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. However, 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).

Section 415(n)(1) of the Code provides that if an employee makes one or more contributions to a defined benefit governmental plan to purchase permissive service credit under such plan, then the requirements of this section shall be treated as met only if: (A) the requirements of section 415(b) are met, determined by treating the accrued benefit derived from all such contributions as an annual benefit or (B) the requirements of section 415(c) are met, determined by treating all such contributions as annual additions.

Section 415(n)(3) of the Code defines "permissive service credit" as service credit (i) that is recognized by the governmental plan for purposes of calculating a participant's benefit under the plan, (ii) which such participant has not received under such governmental plan, and (iii) which such participant may receive only by making a voluntary additional contribution, in an amount determined which does not exceed the amount necessary to fund the benefit attributable to such service credit.

Section 415(n) was added to the Code by section 1526(a) of the Taxpayer Relief Act of 1997 (TRA '97), Pub.L.105-34, effective with respect to contributions to purchase permissive service credits made in plan years beginning after December 31, 1997. The legislative history to section 1526 of TRA '97 states that Code section 415(n) is not intended to affect the application of "pick up"

271

contributions to purchase permissive service credit or the treatment of pick up contributions under section 415. (H.R. Rep. No. 105-220, 105th Cong., 1st Sess. 742 (1997)). That is, as provided in section 1.415-3(d)(1) of the regulations set forth above, employee contributions made to a defined benefit plan are treated as annual additions subject to the limitations of Code section 415(c). However, employee contributions that are picked up by the employer pursuant to Code section 414(h)(2) are treated as employer contributions and, as such, are not annual additions subject to the limitations of Code section 415(c). Instead, benefits attributable to such contributions are subject to the limitations of section 415(b).

Under section 415(n) of the Code, contributions by a participant in a governmental defined benefit plan to purchase permissive service credits are subject to one of two limits: (1) the benefit derived from all contributions used to purchase permissive service credit must be taken into account in determining whether the limit under Code section 415(b) is satisfied, or (2) all such contributions must be taken into account in determining whether the limit on annual additions under Code section 415(c) is met(taking into account any other annual additions of the participant).

Thus, we conclude that after-tax employee contributions made to a governmental defined benefit plan for the purchase of permissive service credit may, in accordance with Code section 415(n)(1), be treated as not subject to section 415(c), but instead the benefits attributable to such contributions would be subject to the limitations of section 415(b).

With respect to Part (a) of Ruling Request #5, it has been represented that Plan X meets the requirements of Code section 415(n)(3) for the purchase of permissive service credit: (i) the permissive service credit that may be purchased with additional employee contributions is recognized under Plan X for purposes of calculating the participant's benefit under the Plan; (ii) the credit is for service for which the participant has not previously received credit under Plan X; and (iii) under Statute T, the participant may receive such additional service credit only by making such voluntary contribution, and such contribution does not exceed the amount necessary to fund the benefit attributable to such service credit. In

addition, it has been represented that Plan X meets the limitations on "nonqualified service" that may be taken into account under Code section 415(n) and that the purchase of permissive service credit under Plan X will not cause the participant to receive a retirement benefit for the same service under more than one plan.

Accordingly, based on the above representations, we conclude, with respect to Part (a) of Ruling Request #5, that pursuant to Code section 415(n), the picked-up contributions relating to the purchase of permissive service credit within the meaning of section 415(n)(3) are not annual additions for purposes of Code section 415(c), and after-tax employee contributions used to purchase such permissive service credit may also, in accordance with section 415(n)(1), be treated as not subject to section 415(c) of the Code.

Section 415(k)(3) of the Code provides that in the case of any repayment of contributions (including interest thereon) to the governmental plan with respect to an amount previously refunded upon a forfeiture of service credit under the plan or under another governmental plan maintained by a State or a local government employer within the same State, any such repayment shall not be taken into account for purposes of this section.

Section 415(k)(3) was added to the Code by section 1526(b) of TRA '97, effective with respect to contributions made in plan years beginning after December 31, 1997. The legislative history to section 1526 of TRA '97 states that in the case of any repayment of contributions and earnings to a governmental plan with respect to an amount previously refunded upon a forfeiture of service credit under a plan (or another plan maintained by a State or local government employer within the same State), any such repayment shall not be taken into account for purposes of Code section 415 and service credit obtained as a result of the repayment shall not be considered permissive service credit. (H.R. Rep. No. 105-220, 105th Cong., 1st Sess. 742 (1997)). Thus, we conclude that the special rule under section 415(k)(3) of the Code only applies to after-tax employee contributions that are paid into a state or local governmental plan to reinstate previously forfeited service credit.

Accordingly, with respect to Part(b) of Ruling Request # 5, we conclude that (i) the after-tax employee contributions made to reinstate Past Service (not "picked-up" contributions) are not subject to Code section 415(c) when made to Plan X within the meaning of Code section 415(k)(3); and (ii) benefits attributable to after-tax employee contributions made to reinstate Past Service (and interest thereon) are not subject to Code section 415(b) when distributed from Plan X pursuant to Income Tax Reg. Sec. 1.415-3(d), provided the total benefit under Plan X attributable to employer contributions (inclusive of any benefit attributable to "picked-up" contributions made to reinstate Past Service) is subject to Code section 415(b).

The effective date for the commencement of any proposed pick up cannot be any earlier than the later of (i) the adoption date of Resolution R, (ii) the effective date of Resolution R, or (iii) the date the irrevocable payroll authorization form (Form P) is signed by both parties.

These rulings are based on the assumption that Plan X meets the requirements for qualification under section 401(a) of the Code at the time of the proposed contributions and distributions.

These rulings do not address the option under the proposed pick-up program that allows a participant to reinstate Past Service credit or purchase Permissive Service credit by using the funds from an eligible rollover contribution.

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

274

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 ruling has been sent to your authorized representative in accordance with a power of attorney on file in this office.

Sincerely yours,

Joyce E. Floyd

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

cc: