Uniform Issue List: 414.09-00

200328043

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

APR 17 2003

T:EP:RA:T1

Attn:

Legend:

State A =

Plan X =

Statute D =

Statute E =

Resolution F =

Regulation G =

Dear :

This is in response to a ruling request dated August 3, 2000, as supplemented by additional correspondence dated September 15, 2000, April 11, 2001, September 23, 2002, December 13, 2002, December 16, 2002, and February 26, 2003, from your authorized representative, concerning the pick up of certain employee contributions to Plan X under section 414(h)(2) of the Internal Revenue Code ("Code").

The following facts and representations have been submitted:

Plan X is a fund established to pay benefits to teachers and to supervisors of teachers in the public schools of State A and its political subdivisions. Plan X is a defined benefit plan which satisfies the requirements of Code section 401(a) and is governed by State A Statutes. In addition, Plan X is a governmental plan within the meaning of Code section 414(d). Plan X maintains two types of accounts: an annuity savings account and a retirement allowance account.

Under State A Statutes, Plan X is further segregated into the pre-1996 account and the 1996 account. Member contributions made after June 30, 1995 are credited to the annuity savings accounts within the 1996 account with respect to (1) a member who was hired after June 30, 1995 by an institution covered by Plan X, or (2) a member who, before July 1, 1995, served in a position covered by Plan X and after June 30, 1995 was hired by another institution covered by Plan X or rehired by a prior employer. All other member contributions are credited to the annuity savings accounts within the pre-1996 account. Employer contributions made after June 30, 1995, with respect to members described in (1) and (2) above, are credited to the retirement allowance account within the 1996 account, and employer contributions made after June 30, 1995 with respect to all other members are credited to the retirement allowance account within the pre-1996 account.

Under Plan X, employer contributions are paid to the retirement allowance account, from which a defined benefit is paid at retirement. The retirement allowance account of the pre-1996 account consists of the pre-1996 account exclusive of the annuity savings account, and the retirement allowance account of the 1996 account consists of the 1996 account exclusive of the annuity savings account. For the 1996 account, separate accounts within the retirement allowance account are maintained for contributions made by State A, by each school corporation, and by each institution.

Members' contributions are paid to each member's separate annuity savings account, which at distribution may be paid out as a lump sum or an annuity. The Board of Trustees of Plan X maintains a guaranteed program and an alternative

investment program for the investment of the members' contributions. In the guaranteed program, a stated interest rate is credited on each member's account; on the other hand, in the alternative investment program, the gain or loss in market value on the member's account is attributed to the member's account. The member may direct the allocation of the member's annuity savings account among the guaranteed fund and any available alternative investment funds in 10% increments.

Contributions to Plan X include amounts from employers and employees. Under Statute D, each member is required to contribute to Plan X a percentage of compensation as a condition of employment. Pursuant to Statute E, the member's employer may pick up and pay the mandatory contribution for the member within the meaning of Code section 414(h)(2).

In 2000, the State A General Assembly amended Statute D to allow a member of Plan X to make an "additional employee contribution" to the member's annuity savings account. This contribution is in addition to the mandatory employee contribution. The total amount of additional employee contributions that may be made to a member's annuity savings account with respect to a payroll period may not exceed ten percent (10%) of the member's compensation for that payroll period. In addition, Statute D provides that, in compliance with the rules adopted by the Board of Trustees of Plan X, a member's employer may pick up and pay the additional employee contributions under Code section 414(h)(2). The employer shall reduce the member's compensation by an amount equal to the amount of the member's additional employee contributions that are picked up by the employer.

Employers may elect to participate in the pick up of the additional employee contributions by adopting Resolution F. The Resolution states that the additional employee contributions, even though designated as employee contributions for state law purposes, are being paid by the employer in lieu of contributions by the employee. The Resolution also states that a participating employer shall pick up all of the additional employee contributions made by employees through a binding irrevocable payroll deduction authorization and shall comply with all the terms and conditions of Regulation G and applicable provisions of the Code. Members electing to make additional employee contributions to the member's annuity savings account in Plan X do so by completing a binding payroll deduction authorization form. The form states that the authorization is irrevocable and that (1) the contributions are being picked up by the employer, and (2) the employee does not have the option of receiving the deducted amounts directly instead of having them paid by the employer to Plan X.

The irrevocable payroll deduction authorization may only be made during an election period. That period will begin on the September 1 following the plan year in which the employee completes five years of creditable service under Plan X and ends two years later, on August 31 of the second calendar year following the opening of the election period. The authorization provides that a dollar amount (but not more than 10% of compensation) shall be deducted per pay period, beginning with the pay period immediately after the employer receives the authorization and continuing until the employee's termination of employment or death.

Proposed Regulation G under Statute D provides that if a member terminates and then returns to covered employment with a different employer, when the member has five or more years of creditable service credited or recredited under State A Statutes, the member shall be entitled to execute a new binding irrevocable payroll deduction authorization within a two year election period, beginning on the September 1 following the plan year in which the employee completes or is recredited with five years of creditable service and ending on the August 31 of the second calendar year following the opening of the election period. If a member terminates and then returns to covered employment with the same employer, the member's binding irrevocable payroll deduction authorization (if any) shall be immediately effective upon rehire.

The following is a summarization of the provisions of Proposed Regulation G that deal with a member's election to make additional employee contributions through irrevocable payroll deductions.

Once a member in active covered employment has executed a binding irrevocable payroll deduction authorization with respect to any additional employee contributions, he or she shall not be entitled to any option of choosing to receive the contributed amounts directly instead of having them paid by the employer to Plan X. The contributions shall be remitted to Plan X in the same manner as all other contributions made by the employee and shall be credited to the member's annuity savings account. The salary the employer shall use to calculate such contributions is the same as the salary the employer reports to the Board of Trustees of Plan X for purposes of determining a member's mandatory contributions and benefit calculation. The additional employee contributions, although designated as employee contributions, will be paid by the employer in lieu of contributions by the employee.

Members in active covered employment may elect to pay all or part of any additional employee contributions through payroll deduction. The amounts to be deducted and the duration of the deduction shall be specified on the authorization form, and such amounts and duration shall be irrevocable and binding once the authorization is made. Prepayment of amounts covered by the

authorization is not permitted; however, a member may pay any amounts not covered by the authorization with after-tax dollars, up to the statutory maximum.

The payroll deduction shall not begin unless and until the member in service executes the payroll deduction authorization. After the treasurer or other disbursing officer of the employer receives the binding irrevocable payroll deduction authorization from the employee, he or she shall add such contributions to the contributions deducted from the member's regular compensation each pay day. The employer shall continue to make the deductions for the duration specified on the form and shall treat these deductions as picked-up contributions.

All payroll deductions covered by the binding irrevocable payroll deduction authorization, including the amounts and the duration specified therein, shall be binding and irrevocable upon the member's execution of the authorization form.

The deductions covered by such authorization shall cease only upon either (1) the member's death, or (2) the termination of the member's employment.

Distribution of the additional employee contributions shall be made in the same manner as distribution from the member's annuity savings account. In no event shall the member receive a return of the payroll deductions made under the above rules, except pursuant to the normal disbursement procedures under Plan X.

Members with at least five years of creditable service as of June 30, 2003 may elect to make additional employee contributions to their annuity savings accounts through payroll deduction by executing the irrevocable payroll deduction authorization form between September 1, 2003 and August 31, 2005.

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

1) That the amounts deducted by employers from an employee's compensation and paid to an employee's annuity savings account in order to pay the additional employee contributions as provided by Statute D qualify as contributions that are picked up by the employer under Code section 414(h)(2).

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

Regarding Ruling Request One, 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 for federal income tax purposes 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.

In this case, the one-time irrevocable election by employees who wish to make additional employee contributions to Plan X does not violate Revenue Rulings 81-35 and 81-36 because the election does not result in such employees having

sufficient control of the contributed amounts to preclude such amounts from being treated as employer contributions.

Resolution F states that additional employee contributions, even though designated as employee contributions for state law purposes, are being paid by the employer in lieu of contributions by the employee. This satisfies the first criterion set forth in Revenue Ruling 81-35 and Revenue Ruling 81-36 which requires that the contributions, although designated as employee contributions, be paid by the employer in lieu of contributions by the employee. The irrevocable payroll deduction authorization provides (1) the additional employee contributions are being picked up by the employer, and (2) the employee does not have the option of receiving the deducted amounts directly instead of having them paid by the employer to Plan X, which satisfy both criteria of Revenue Ruling 81-35 and Revenue Ruling 81-36. Proposed Regulation G, as discussed above, also satisfies the criteria of the Revenue Rulings.

For new, current, and terminated employees who return to service, the various participation elections to make additional employee contributions to Plan X are consistent with the criteria set forth in Revenue Rulings 81-35 and 81-36. The election period for new and current employees of participating employers opens on the September 1 following the plan year in which the employee completes five years of creditable service under Plan X and closes on the August 31 that is 24 months after that September 1. However, current employees with at least five years of creditable service as of June 30, 2003 may elect to make additional employee contributions to their annuity savings accounts under Plan X by executing the irrevocable payroll deduction authorization during the 24-month period beginning September 1, 2003 and ending August 31, 2005. For terminated employees who return to covered employment with a different employer, when the member has five or more years of creditable service credited or recredited under State A Statutes, the member shall be entitled to execute a new binding irrevocable payroll deduction authorization within a two year election period, beginning on the September 1 following the plan year in which the employee completes or is recredited with five years of creditable service and ending on the August 31 that is 24 months after that September 1. These employee elections regarding the making of additional employee contributions to Plan X are consistent with authority for Code section 414(h)(2) which requires that employee participation elections must be made within the later of 24 months of the date of hire or 24 months of the date that the employee is first eligible to participate. Therefore, with respect to Ruling Request One, we conclude that the amounts deducted by employers from an employee's compensation and paid to an employee's annuity savings account under Plan X in order to pay the additional employee contributions as provided by Statute D qualify as contributions that are picked up by the employer under Code section 414(h)(2).

Regarding Ruling Request Two, section 1.415-3(d)(1) of the Income Tax Regulations states 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 applying the limitations on benefits described in Code section 415(b). 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 Code section 415(c). Employee contributions, however, that are picked up by participating employers 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 Code section 415(c). Accordingly, with respect to the pick up of additional employee contributions paid to Plan X, we conclude that these picked-up contributions will not be treated as annual additions for purposes of Code section 415(c).

The effective date for the commencement of any proposed pick up as specified in the Resolution F cannot be any earlier than the later of the date the Resolution is signed or put into effect, or the date the irrevocable payroll deduction authorization is signed by both parties.

This ruling is conditioned on the adoption of Proposed Regulation G which governs the pick up of additional employee contributions to Plan X, as set forth in your authorized representative's correspondence dated December 16, 2002, and further modified by correspondence dated February 26, 2003.

This ruling is based on the assumption that Plan X is qualified under Code section 401(a) at all relevant times.

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 Code section 3121(v)(1)(B).

This ruling is directed only to the taxpayer that 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. If you have any questions, please call , T: EP: RA: T1 (ID # 50-00751), at .

Sincerely yours,

Andrew E. Zuckerman

Manager
Employee Plans Technical Group 1

Enclosures:
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Notice 437

cc: