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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: MAY 2 2000

FIN:

LEGEND:

State A =
Employer M =
Plan A =
Plan B =
Plan C =

Gentlemen:

This is in response to your ruling request dated February 17, 1999, concerning the federal income tax treatment, under section 414(h)(2) of the Internal Revenue Code (Code), of certain contributions to Plans A, B, and C.

The following facts and representations have been submitted:

Employer M is a political subdivision of State A. Plans A and B, both of which are statewide defined benefit plans maintained by State A, and Plan C, a defined benefit plan maintained by Employer M, were created under the law of State A for the purpose of providing retirement and certain other benefits to public employees. All employees of Employer M are covered members of Plan A, other than employees who are members of Plan B or Plan C. Plan B provides retirement and other benefits to members of police and fire departments of State A and its instrumentalities, municipal corporations, and political subdivisions. All members of

the police department and fire department of Employer M are covered under Plan B. The taxpayer represents that each of Plans A, B, and C is established as a separate trust and is qualified under section 401(a) of the Code.

Plan C provides retirement and other benefits to specified employees of Employer M. Plan C covers all individuals who are employed by Employer M other than those specifically excluded from coverage under Plan C pursuant to Employer M's municipal code.

All employees of Employer M who are members of Plans A, B, and C are required to contribute a specified percentage of their compensation to their respective plans. Under the law of State A, Employer M picks up the required employee contributions as described in section 414(h)(2) of the Code.

As authorized by the law of State A, Employer M proposes to allow certain employees participating in Plans A, B, or C to make contributions, by a lump sum, or in certain cases, by payroll reduction, to purchase permissive service credits under the Plans. Employer M has adopted ordinances with respect to Plan A, Plan B and Plan C providing for the purchase of permissive service credits that will become effective upon the issuance of a favorable ruling by the Internal Revenue Service ("Service") or some other date specified by the Service. In accordance with the ordinances, employees of Employer M who are contributing members of Plan A, Plan B or Plan C and who have "qualified service" may purchase permissive service credits. The ordinances define the term "qualified service" to include certain periods of service as an employee of the government of the United States, any State or political subdivision thereof, or any agency or instrumentality of any of the foregoing, service as an employee of an educational organization described in

section 170(b)(1)(A)(ii), and certain types of military service.

The ordinances provide that employer pick-up contributions will be made by Employer M in lieu of contributions by the employee; that an employee electing to purchase permissive service credits through such pickup contributions will not have the option to receive the contributions directly instead of having the contributions picked up by Employer M and contributed to Plan A, Plan B or Plan C; and that the election by an employee to have Employer M pick up such contributions will be irrevocable.

Based on the above facts and representations, Employer M requests the following rulings:

1. Payroll reductions used to purchase permissive service credits under Plan A, Plan B and Plan C will be treated as employer contributions picked up by the Employer within the meaning of section 414(h)(2) of the Code for federal income tax purposes. As such, the amounts picked up will not be included in the employee's gross income in the year of contribution, but will instead be included in the employee's gross income at the time such amounts are distributed to the employee.

2. Picked-up contributions referred to in ruling request (1) will not constitute wages under section 3401(a)(12)(A) of the Code for federal income tax withholding purposes.

3. Picked-up contributions referred to in ruling request (1) will not be treated as "annual additions" for purposes of section 415(c) of the Code.

4. The provisions of section 415(n)(3)(C) of the Code will not apply to the picked-up contributions referred to in ruling request (1).

Section 414(h)(2) of the Code provides that, in the case of any plan established by the government of any State 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 will be treated as employer contributions.

The federal income tax treatment to be accorded contributions that 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 "pick up" (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 contributions to the plan picked-up by the school district are excludable from the employees' gross income until such time as the contributions are distributed or made available to the employees. The revenue ruling further concludes that under 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; and, therefore, no withholding is required from the employees' salaries with respect to such picked-up contributions.

The issue of whether or not contributions have been picked up by an employer within the meaning of section 414(h)(2) of the Code is addressed in Revenue Rulings 81-35, 1981-1 C.B. 255, and 81-36, 1981-1 C.B. 255. Pursuant to these revenue rulings, 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 have the option of choosing to receive the contributions directly instead of having them paid by the employer to the plan. Furthermore, it is immaterial for purposes of 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.

With respect to ruling request (1), the ordinances provide that Employer M will make contributions to Plan A, Plan B, and Plan C in lieu of contributions by eligible employees, and that such employees can not elect to receive such contributions directly. Furthermore, the ordinances provide that the payroll reduction authorization by employees is irrevocable and will remain in effect until the payments to purchase the prior service credits are completed or the employee has terminated employment with Employer M. Thus, the ordinances satisfy the criteria set forth in Revenue Rulings 81-35 and 81-36.

Accordingly, with respect to ruling request (1), we conclude that the contributions made pursuant to the ordinances and binding irrevocable payroll reduction authorizations by eligible employees to purchase permissive service credit under Plan A, Plan B, and Plan C will qualify as employer contributions picked up by Employer M under section 414(h)(2) of the Code, and are not included in employees' gross income for federal income tax purposes in the year of the contributions.

With respect to ruling request (2), since picked-up contributions are to be treated as employer contributions, such contributions 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 from eligible employees' salaries with respect to such picked-up amounts.

With respect to ruling request (3), benefits paid from a defined benefit plan are generally subject to section 415(b) of the Code. Notwithstanding this general rule, 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 applying the limitations on benefits described in section 415(b). Section 1.415-3(d)(1) of the regulations instead 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). Employee contributions that are picked up by Employer M 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). Accordingly, the picked-up contributions referred to in ruling request (1) will not be treated as annual additions for purposes of section 415(c).

With respect to ruling request (4), section 415(n)(3)(C) of the Code generally defines "nonqualified service" as service other than service as an employee of the federal government, state, political subdivision or agency or instrumentality thereof; service as an employee of certain educational organizations under section 170(b)(1)(A)(ii); military service; or service as an employee of an association. Because the service for which permissive service credit will be purchased is the type of service described in section 415(n)(3)(C), we conclude that it does not constitute "nonqualified service" within the meaning of this section.

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 accordance with Revenue Ruling 87-10, this ruling does not apply to any contribution before the later of the effective date of the ordinances or the effective date of the payroll reduction authorization.

This ruling is based on the assumption that Plans A, B, and C will be qualified under section 401(a) of the Code 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 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 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.

Sincerely yours,

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

Enclosures:
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Notice of Intention to Disclose