Significant Index Number: 414-0900

T:EP:RA:T1
4/25/00

Attn:

Legend:

Employer A =

State B =

Plan X =

Dear :

This is in response to a ruling request dated February 9, 2000, 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 received a determination letter from the Internal Revenue Service dated August 26, 1999.

Prior to January 1, 1999, all participant contributions were on an after-tax basis. Section 9.02(f) of Plan X, adopted on December 17, 1998, provides that participant contributions required as a condition of employment are picked up under Code section 414(h)(2). In a letter ruling dated October 30, 1998, the Service concluded that

mandatory employee contributions picked up by Employer A satisfy the requirements of Code section 414(h)(2) and thus are treated as employer contributions excluded from employees' gross income in the year they are made.

Plan X has included certain provisions permitting members to add additional credited service for periods of military service. Under the Plan, members may purchase these periods of military service but there is no provision for the pick up of these contributions. Employer A is now in the process of securing agreements with collective bargaining representatives to amend the Plan as necessary to permit the pick up of member contributions for purchases of military service.

Proposed section 9.02(g) of Plan X provides that members may purchase credited service for periods of military service in a lump sum or in installments or in a combination of an initial lump sum and subsequent installments in a manner approved by the pension board. Contributions that are made as a percentage of periodic pay may be made on an after-tax basis or pre-tax basis which will be picked up by Employer A.

If a member elects to purchase additional service credit on a pre-tax, pick up basis, the election to do so may not be amended or revoked. The proposed election form, Military Service Purchase Election and Payroll Deduction Authorization (Pre-tax, Pick – Up Payment), provides that the election is binding and irrevocable and will remain in effect until the earlier of the date the payments are completed or termination of employment. This form further provides that Employer A will make the contributions, in lieu of contributions by members.

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

1) That the provisions of proposed section 9.02(g) of Plan X satisfy the requirements of Code section 414(h)(2).

2) That no part of the Plan X contribution amounts picked up by Employer A on behalf of members of the Plan will be includable as gross income for federal income tax purposes in the year of contribution with respect to such employees.

3) That cotributions of members whether picked up by payroll deduction, offset against future salary increases or both and though designated as employee contributions will be treated as employer contributions for Federal income tax purposes.

4) That no part of the contributions of Employer A that are pick up contributions made by the Employer on behalf of its employees pursuant to proposed section 9.02(g)

will constitute wages for federal income tax withholding purposes in the taxable year in which contributed to Plan X.

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 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.

Pursuant to proposed section 9.02(g) of Plan X and the election form described above, a member may purchase additional credit for military service 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.

Regarding ruling requests (1) through (3), we conclude that the contributions picked up by Employer A pursuant to proposed section 9.02(g) and proposed payroll reduction agreement satisfy the requirements of Code section 414(h)(2). The amounts picked up by Employer A ,whether through pre-tax payroll deduction (as described above) or an offset against future salary increases, or both, will be treated as employer contributions and will not be includable in the employees' gross income for the taxable year in which such amounts are contributed.

Regarding ruling request (4), because we have determined that the picked up amounts are to be treated as employer contributions, they are excepted from wages for federal income tax withholding purposes under section 3401(a)(12)(A). 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 pick up as specified in proposed section 9.02(g) cannot be any earlier than the later of the date the proposed amendment is signed or put into effect.

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

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

Enclosures:
Deleted Copy of the Ruling
Notice 437

cc: