Internal Revenue Service
Department of the Treasury
Washington, DC 20224

SIN: 414.07-00

xxxxx
xxxxx
xxxxx

Contact Person:
xxxxx/xxxxx
Telephone Number:
xxxxx
In Reference to:
T:EP:RA:T2, Rm 4H
Date:
FEB 12 2001

Attn: xxxxx xxxxx

Legend:

State A = xxxxx

Employer M = xxxxx

Plan X = xxxxx

Group B employees = xxxxx

Prposed Resolution N = xxxxx

Proposed Payroll Authorization Form P
= xxxxx

Dear xxxxx:

This letter is in response to a request for a ruling, dated xxxxx, 2000, as supplemented by correspondence dated xxxxx, 2000, and xxxxx, 2001, submitted on your behalf by your authorized representative, with respect to the federal income tax treatment of certain contributions to Plan X pursuant to section 414(h)(2) of the Internal Revenue Code.

The following facts and representations have been submitted:

Pursuant to the statutes of State A, Plan X was established for the retirement benefit of the employees of State A and those of its political subdivisions and instrumentalities. Employer M, a political subdivision of State A, is a participating employer in Plan X. Plan X is a defined benefit plan intended to qualify under section 401(a) of the Code. Employee contributions to Plan X are mandatory.

Under the terms of Plan X, an employee, upon termination of employment, may withdraw his or her employee contributions and the earnings attributable to such contributions. Under conditions specified in Plan X, an employee, upon reemployment, may redeposit into Plan X the amount of the withdrawal plus interest and receive credit for past employment service. In general, any redeposit due may be paid in a lump sum or in installment payments through payroll deduction.

Employer M is a political subdivision of State A. Among the employees of Employer M is Group B. Group B is composed of certain management-level employees. In lieu of a reemployed member of Group B making contributions to Plan X for the purpose of restoring past service credit, Employer M proposes to pick up, pursuant to section 414(h) of the Code, any employee contributions that a Group B employee makes to Plan X through installment payments for the purpose of redepositing amounts previously withdrawn.

Proposed Resolution N has been drafted for adoption by the Board of Directors of Employer M to effectuate the pick-up. Proposed Resolution N authorizes the pick up of a redeposit, as described above, that a Group B employee makes to Plan X in order to restore service credit. Proposed Resolution N provides that the cash salaries of Group B employees will be reduced by an amount equal to the redeposit picked up by Employer M, that the contributions paid by Employer M pursuant to Proposed Resolution N, although designated as employee contributions will be paid by Employer M to Plan X in lieu of contributions by Group B employees, and that Group B employees will not have the option to receive directly the amounts picked up by Employer M instead of having such amounts paid into Plan X.

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Proposed Payroll Authorization Form P details the procedure for payroll deductions of picked-up amounts subsequent to the adoption of Proposed Resolution N by Employer M. Proposed Payroll Authorization Form P authorizes Employer M to make a deduction from the Group B employee's salary per pay period for the purpose of restoring past service credits. With respect to the payroll deduction, the Group B employee acknowledges that this is an irrevocable deduction authorization; that after execution of Proposed Payroll Authorization Form P, the Group B employee does not have the option of receiving the deduction amounts directly instead of having them paid by Employer M to Plan X; that these contributions are being picked up by Employer M, and, although designated as employee contributions, such contributions are being paid directly to Plan X in lieu of contributions by the Group B employee; that while this agreement is in effect, Plan X will only accept contributions from Employer M and not directly from the Group B employee; that the payroll deduction authorization will not become effective until signed by the Group B employee and an authorized representative of Employer M; and that the pick-up is only applicable to contributions to the extent the contributions are deducted from compensation earned for services rendered subsequent to the effective date of the pick-up.

Proposed Resolution N provides that the effective date of the pick-up is the later of the date Proposed Resolution N is signed or the date it is put into effect. Proposed Payroll Authorization Form P, which is completed subsequent to the adoption of Proposed Resolution N, provides that such form is not effective until signed by the Group B employee and an authorized representative of Employer M.

Based on the foregoing facts and representations, your authorized representative has requested rulings that:

(1) The amounts picked up and paid to Plan X in order to redeposit previously withdrawn contributions on behalf of a Group B employee qualify as contributions that are picked up by Employer M under section 414(h)(2) of the Code.

(2) No part of the redeposited contributions picked up Employer M on behalf of a Group B employee will constitute gross income to that employee for federal income tax treatment.

(3) The contributions picked up by Employer M will be treated as employer contributions for federal income tax purposes.

(4) The contributions picked up by Employer M will not constitute wages from which federal income tax 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 established by a state government or a political subdivision thereof, which is described in section 401(a), 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 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 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 school district's picked-up contributions to the plan are excluded from the employees' income until such time as they are distributed to the employees. The revenue ruling held further that under the provisions of section 3401(a)(12)(A) of the Code, 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 section 414(h)(2), whether an employer picks up contributions through a reduction in salary, an

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offset against future salary increases or a combination of both.

Revenue Ruling 87-10, 1987-1 C.B. 136, provides that in order to satisfy Revenue Rulings 81-35 and 81-36, the required specification of designated employee contributions must be completed before the period to which such contributions relate. Thus, employees may not exclude from current gross income designated employee contributions to a qualified plan that relate to compensation earned for services prior to the date of the last governmental action necessary to effect the employer pick-up.

Proposed Resolution N satisfies the criteria set forth in Revenue Ruling 81-35 and Revenue Ruling 81-36 by providing that contributions paid by Employer M under the pick-up, although designated as employee contributions, are being paid by Employer M in lieu of contributions by the Group B employees, and that Group B employees shall not be entitled to any option of receiving such contributions directly instead of having them paid by Employer M to Plan X.

Further, Proposed Payroll Authorization Form P is irrevocable and also provides that the contributions, although designated as employee contributions, are being picked up by Employer M, that they are being paid directly to Plan X in lieu of contributions by the Group B employee, and that after execution of Proposed Payroll Authorization Form P, the Group B employee does not have the option of receiving the contributed amounts directly instead of having them paid by Employer M to Plan X.

Proposed Resolution N provides that the effective date of the pick-up by Employer M is the later of the date Proposed Resolution N is signed or the date it is put into effect. Proposed Payroll Authorization Form P, which is completed subsequent to the adoption of Proposed Resolution N, by Employer M, provides that such form is not effective until signed by a Group B employee and an authorized representative of Employer M. The pick-up does not apply to any contribution before the effective date or to any contribution that relates to compensation earned for services before the effective date.

Accordingly, assuming Proposed Resolution N and Proposed Payroll Authorization Form P are adopted and

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implemented as proposed, we conclude, with respect to rulings one, two, three and four that amounts picked-up by Employer M and paid to Plan X on behalf of Group B employees in order to restore past service credit will be treated as employer contributions for federal income tax purposes in accordance with the requirements of section 414(h)(2) of the Code and Revenue Rulings 81-35 and 81-36; that, because we have determined that the picked-up amounts are to be treated as employer contributions, such contributions to be made to Plan X by Employer M will be excludable from Group B employees' wages for purposes of federal income tax withholding under section 3401(a)(12)(A) of the Code in the taxable year in which they are contributed to Plan X; and that the picked-up contributions to be made under Plan X by Employer M will not constitute gross income for federal income tax purposes until such time as they are distributed or made available to the Group B employees or their beneficiaries to the extent the picked-up amounts represent contributions made by Employer M.

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.

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).

These rulings apply only if the effective date for the commencement of any proposed pick up, as described in Proposed Resolution N, cannot be earlier than the later of the date Proposed Resolution N is signed and becomes effective or the date of execution of Proposed Payroll Authorization Form P. In addition, these rulings are contingent upon the adoption by Employer M of Proposed Resolution N as set forth in your supplemental submission dated December 4, 2000 and the adoption of Proposed Payroll Authorization Form P as set forth in your supplemental submission dated January 31, 2001.

These rulings are based on the assumption that Plan X will be qualified under section 401(a) of the Code at the time of the proposed contributions and distributions.

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

Sincerely yours,

(signed) JOYCE E. FLOYD

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

Enclosures:
Deleted copy of this letter
Notice 437

cc: EP Manager, xxxxx Area

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