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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Uniform Issue List No. 414.09-00

SEP 10 2002

OP:E:EP:T4

Legend:

State A =
Employer M =
Plan X =

Group B Employees =

Proposed Ordinance O =

Form F =

Ladies and Gentlemen:

This letter is in reply to a request for a letter ruling dated September 5, 1997, as supplemented by letters dated March 24, 1998 and July 22, 1998 (hereafter the "Original Request"), made on behalf of Employer M, concerning the federal tax treatment of certain contributions made to Plan X under section 414(h)(2) of the Internal Revenue Code ("Code"). The Original Request has been revised, amended and replaced by your request for a letter ruling dated July 29, 1999, as supplemented and amended by letters dated October 18, 1999, August 29, 2000, November 6, 2000, November 14, 2000, August 8, 2001, July 25, 2002, and September 4, 2002.

You have submitted the following facts and representations:

Employer M is a political subdivision of State A. Employer M maintains Plan X, a defined benefit plan that provides pension, disability, survivorship and death benefits for Group B Employees. Plan X is a qualified plan under section 401(a) of the Code and its most recent favorable determination letter was issued on September 7, 1988.

Plan X receives mandatory contributions from employees which are picked up by Employer M pursuant to section 414(h)(2) of the Code. Plan X provides a defined benefit at normal retirement date which, for Group B Employees, is the attainment of age 52 or, if earlier, the completion of 23 years of credited service.

Employer M grants to Group B Employees paid time off for absences from work due to illness (known as "sick leave"), vacations (known as "annual leave"), as a substitute for working on holidays (known as "holiday leave") and as compensation for working overtime (known as "compensatory time"). Such paid time off is accrued by each Group B Employee as it is earned subject to a maximum cap. The total number of hours of the various types of unused paid time off accrued by a Group B Employee is known as that employee's accrued unused leave. Upon retirement or other termination of employment, Employer M pays a Group B Employee his or her "termination pay" which is the value of the employee's accrued unused leave as of his or her retirement or termination date at the employee's hourly rate in effect at the time of retirement or termination.

Employer M proposes to permit Group B Employees who have served in the military or engaged in other law enforcement activities prior to being employed by Employer M to purchase credited service under Plan X for that military service or other law enforcement service up to a maximum of four years. The proposed transaction would permit Group B Employees purchasing such credited service to elect to pay for such purchase by having Employer M pick up these additional service credit contributions under section 414(h)(2) of the Code when these contributions are made through payroll deduction. A participant is required, at the time of choosing to purchase credited service, to elect whether to make additional contributions by a single lump sum payment, pay in installments, or pay a single payment for part of the purchase price with the balance paid in installments. A participant electing installment payments could elect to have those payments made through payroll deduction and picked up by Employer M.

In order to permit the pick up of the above referenced contributions, Employer M proposes to adopt Proposed Ordinance O to pick up such contributions through payroll deduction. Proposed Ordinance O requires Employer M to pick up the contributions made pursuant to an irrevocable payroll deduction authorization form. This form, Form F, which is signed by both the Group B Employee and Employer M, states that the Group B Employee authorizes the deduction from salary for pick up purposes and understands that this authorization is binding and irrevocable. Form F includes the number of months during which the deductions will be made and the dollar amount of the deductions.

Further, the Group B Employee agrees in Form F that, with respect to the additional service credit being purchased by the picked-up contributions designated therein, Plan X will only accept payment from Employer M and not directly from the Group B Employee. Plan X precludes prepayment by the Group B Employee of any amounts designated in Form F. The Group B Employees are thus precluded from revoking the pick-up election by making payments directly to Plan X. Form F also provides that the contributions are being picked up by Employer M and paid directly to Plan X and the Group B Employee does not have the option of receiving the amounts directly.

In case the Group B Employee retires or such employee's employment is otherwise terminated before all the contributions which are due to Plan X for additional service credit are made, Proposed Ordinance O and Form F authorize Employer M to deduct and pick up the balance due from the payment for accrued unused leave (termination pay) which is paid by Employer M to the Group B Employee upon termination. These termination payments for accrued unused leave, which are paid at the Group B Employee's hourly wage rate in effect at the time of termination, would be reportable on Form W-2 as taxable wages but for the pick up. Should the amount of termination pay be more than the balance due to Plan X, then Plan X will first be paid the full balance due by employer pickup and then the remaining termination pay will be paid to the Group B Employee as taxable wages reportable on Form W-2. Should the amount of termination pay not be enough to pay the full balance due to Plan X, then the entire termination payment would be picked up and paid to Plan X. Then the amount of additional service credit to be purchased would either be pro-rated or the Group B Employee could elect to make a lump sum payment of the balance due from his or her own after-tax funds, payable prior to the payment of the employee's first pension benefit check. You represent that a Group B employee is paid termination payment within two pay periods after termination of employment. Further, you represent that the "pay period" is weekly, Thursday through Wednesday and the employees are paid each week, so a retiring employee receives payment for all sums due within 2 weeks of retirement.

Proposed Ordinance O and Form F provide that, with respect to the pick up by Employer M from payments for accrued unused leave (termination pay), such pick ups from termination pay can only be made if Form F is signed by both Employer M and the Group B Employee at least three months before such employee's termination date. The election made by the Group B Employee will further provide that the contributions being picked up, although designated as employee contributions, are being paid by Employer M directly to Plan X in lieu of contributions by the Group B Employee and that the Group B Employee may not choose to directly receive the amounts deducted from the employee's termination pay instead of having them paid by Employer M to Plan X.

With respect to irrevocable elections, you represent that (i) a Group B Employee who elects to purchase a particular type of past service credit may not make more than one irrevocable election to purchase that type of service credit; (ii) a Group B Employee may make more than one irrevocable election to purchase past service credit provided any subsequent election is for the purchase of a

different type of the past service credit, is irrevocable, and does not alter or amend the terms and conditions of any prior election to purchase past service credit; and (iii) a Group B Employee may not make more than one irrevocable election to use termination pay as herein described.

The effective date of this pick-up arrangement is the later of (1) or (2) as follows: (1) the later of the date that Proposed Ordinance O is adopted by Employer M or the date it is put into effect, or (2) the later of the date that Form F has been signed by both parties or the date it is put into effect. The pick up from both regular payroll and termination pay does not apply to any contribution made before the effective date or to any contribution that relates to compensation earned for services before the effective date, except with respect to termination pay, for which the pick up may apply to accrued unused leave which was earned but had not yet been paid as of the effective date of the employer pick up.

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

That the amounts deducted by Employer M from Group B Employees' regular compensation or termination pay and paid to Plan X for the purchase of additional service credit (i) qualify as contributions that are picked up by Employer M under section 414(h)(2) of the Code; (ii) are excluded from the Group B Employees' gross income until such time as they are distributed to the employees; (iii) under the provisions of section 3401(a)(12)(A) of the Code are excluded from wages for purposes of the Collection of Income Tax at Source on Wages so that no withholding is required from the Group B Employees' wages with respect to such picked-up contributions; and (iv) that the picked-up contributions will not be treated as "annual additions" for purposes of section 415 (c) of the Code.

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 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 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 of designated employee contributions must be completed before the period to which such contributions relate.

Under the proposed transaction, Group B Employees owing money for the purchase of additional service credit can elect, through a binding irrevocable election, to have Employer M pick up the contributions due from the Group B Employee. For Group B Employees so electing, Employer M will make the contributions on behalf of the Group B Employee in lieu of contributions made by the employee. No Group B Employee electing employer pick up will have the option of receiving the contribution directly instead of having said amount contributed to Plan X. The proposed pick-up election agreement (Form F) provides that the contributions are being picked up by Employer M and paid directly to Plan X and the Group B Employee does not have the option of receiving the amounts directly.

The pick up from both regular payroll and termination pay does not apply to any contribution made before the effective date of the pick-up arrangement or to any contribution that relates to compensation earned for services before the effective date, except with respect to termination pay, for which the pick up may apply to accrued unused leave which was earned but had not yet been paid as of the effective date of the employer pick up.

With respect to the pick up from payments for accrued unused leave (termination pay) to pay for any balance due to Plan X upon the employee's retirement or termination, said pick up will be made pursuant to the binding irrevocable election made at the time the Group B Employee elected to purchase such service, provided Form F was signed by both Employer M and the Group B Employee at least three months before the employee's termination date. Under the binding irrevocable election, Employer M will pick up and pay directly to Plan X any balance which remains due from the Group B Employee to Plan X at the time of retirement or termination. The Group B Employee will not have the option of choosing to receive the contributed amounts directly instead of having them paid by Employer M to Plan X. The binding irrevocable election (Form F) signed at the time the Group B Employee agrees to purchase the additional service credit through employer pick up will serve to authorize both the deduction from regular payroll and the deduction from termination pay. The pick up from both regular payroll and termination pay does not apply to any contribution made before the effective date of the pick-up arrangement or to any contribution that

relates to compensation earned for services before the effective date, except with respect to termination pay, for which the pick up may apply to accrued unused leave which was earned but had not yet been paid as of the effective date of the employer pick up.

In this case, the amounts deducted by Employer M from Group B Employees' regular compensation and termination pay and contributed to Plan X for the purchase of additional service credit, in accordance with Form F described above and the provisions of Proposed Ordinance O, meet the requirements of Rev. Rul. 81-35 and Rev. Rul. 81-36 by providing that Employer M will make contributions on behalf of the Group B Employees and in lieu of the contributions by such employees and that no Group B Employee will have the option of receiving the contribution directly instead of having said amount contributed to Plan X . Further, Form F will be implemented so as to specify the designated pick up contributions, as such, before the period to which such contributions relate.

Accordingly, we conclude that:

The amounts deducted by Employer M from Group B Employees' regular compensation or termination pay and paid to Plan X for the purchase of additional service credit (i) qualify as contributions that are picked up by Employer M under section 414(h)(2) of the Code; (ii) are excluded from the Group B Employees' gross income until such time as they are distributed to the employees; (iii) are excluded from wages for purposes of the Collection of Income Tax at Source on Wages under section 3401(a)(12)(A) of the Code so that no withholding is required from Group B Employees' wages with respect to such picked-up contributions.

With respect to ruling request number (iv), 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. Employee contributions to a defined benefit plan, however, 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) and that the benefits attributable to employer contributions, including benefits attributable to "picked up contributions" are subject to the limits of section 415 (b) of the Code.

Accordingly, with respect to ruling request number (iv), we conclude that the picked-up contributions will not be treated as "annual additions" for purposes of section 415(c) of the Code.

These rulings apply only if the effective date for the commencement of any proposed pick up as specified in Proposed Ordinance O cannot be any earlier than the later of (1) or (2) as follows: (1) the later of the date Employer M adopts Proposed Ordinance O or puts it into effect or (2) the later of the date Form F is signed by both Employer M and the Group B Employee or the date it is put into effect.

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.

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 limited to the pick up of contributions to purchase credited service for prior military or law enforcement services pursuant to section 3.04(e) of Plan X. This ruling expresses no opinion as to the validity of the pick-up arrangement pertaining to the mandatory employee contributions under Plan X.

This ruling is based on the conditions that (a) a Group B Employee who elects to purchase a particular type of past service credit may not make more than one irrevocable election to purchase that type of service credit; (b) a Group B Employee may make more than one irrevocable election to purchase past service credit provided any subsequent election is for the purchase of a different type of the past service credit, is irrevocable, and does not alter or amend the terms and conditions of any prior election to purchase past service credit; and (c) a Group B Employee may not make more than one irrevocable election to use termination pay as herein described.

Further, this ruling is based on Form F and Proposed Ordinance O as set forth in your letters dated November 6, and November 14, 2000, respectively.

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.

The original of this letter ruling is being sent to your authorized representative in accordance with a power of attorney on file in this office. If you have any questions, please contact

Sincerely yours,

(signed) JOYCE E. FLOYD

Joyce E. Floyd, Manager
Employee Plans Technical Group 2

Enclosures:

Deleted copy of the letter
Notice 437