Internal Revenue Service

Department of the Treasury

Significant Index No. 414.08-00

Washington, DC 20224

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Telephone Number:

Refer Reply to: OP:E:EP:T:3

Date:

DEC 12 1998

LEGEND:

State A =

Employer M =

Plan X =

Group B Employees =

Ordinance O =

This is in response to a letter dated September 15, 1998, as supplemented by a letter of November 9, 1998, in which your authorized representative requested a private letter ruling on your behalf concerning the federal income tax treatment under section 414(h)(2) of the Internal Revenue Code of certain contributions to Plan X.

The following facts and representations have been submitted:

Employer M is a political subdivision of State A. Under the Code of State A, Employer M and Group B Employees are required to participate in Plan X. Generally, Group B Employees include all the employees of Employer M except those excluded because they are covered under another State A retirement system and those excluded under certain other provisions of the State A Code, i.e., primarily employees who are of a temporary nature. Under the law of State A, Group B Employees are required to contribute 8.5 percent of earnable salary and Employer M is required to contribute 13.55 percent of earnable salary to Plan X. It is

270

represented that Plan X is qualified under section 401(a) of the Code.

There are a variety of provisions under Plan X which permit participants to purchase additional service credit or restore previously forfeited service credit. The State A Administrative Code provides that credit may be purchased by a participant's direct payment to Plan X or in certain circumstances by payroll deduction. If service credit is to be purchased by payroll deduction, the participant must sign a payroll deduction authorization form for each type of service credit to be purchased.

Rule 145-9-08 of the State A Administrative Code further provides that payroll deduction purchases may be made with amounts which are designated by the participant's employer as picked-up contributions under section 414(h)(2) of the Code. If a participant is purchasing service credit with amounts that are designated by a participating employer as picked-up contributions under section 414(h)(2) of the Code, the following rules apply:

1. the member cannot decrease or increase the payroll deduction,

2. the member cannot terminate the payroll deduction unless the member has terminated employment or all of the service credit has been purchased by payroll deduction,

3. the member cannot make a direct payment to Plan X for the purchase of service credit that is being purchased by the picked-up payroll deduction amounts, as would otherwise be permissible, and

4. the employer is prohibited from decreasing, increasing or terminating the payroll deduction unless the member has terminated employment, or all of the service credit has been purchased.

Pursuant to the applicable provisions of the State A Revised Code and the State A Administrative Code, including Rule 145-9-08, Employer M adopted Ordinance O which permits employees who are participants in Plan X to have payroll deduction contributions for purchases of the aforementioned service credits picked up by Employer M in accordance with section 414(h)(2) of the Code. The effective date of the Ordinance was June 12, 1998.

Under Ordinance O, any election by the employee to have his or her payroll deductions for the purchase of service credit picked up by Employer M must comply with the requirements of Rule 145-9-08 of the State A Administrative Code and must be irrevocable. Ordinance O provides that Employer M will pay the

pick-up amount directly to Plan X in lieu of such payment being made by the employee. Ordinance O states that the pick up shall be mandatory for the covered employee until the earlier of termination of employment or the completion of all the required payments for the service credit. In addition, Ordinance O specifies that no covered employee shall have the option of choosing to receive the picked-up amounts directly instead of having them paid by Employer M to Plan X.

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

1. Pursuant to section 414(h)(2) of the Code, amounts picked up by Employer M under the provisions of Rule 145-9-08 of the State A Administrative Code and Ordinance O, even though designated as member contributions for state law purposes, will be treated as employer contributions.

2. Pursuant to sections 414(h)(2) and 402(a) of the Code, amounts picked up by Employer M under the provisions of Rule 145-9-08 of the State A Administrative Code and Ordinance O are excluded from the gross income of the employees at the time they are paid by Employer M and will be included in gross income when distributed.

3. Pursuant to section 3401(a)(12)(A) of the Code, ammounts picked up by Employer M under the provisions of Rule 145-9-08 of the State A Administrative Code and Ordinance O will not constitute wages for federal income tax withholding purposes.

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), established by a state government or a political subdivision thereof, 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' gross income until such time as they are distributed to the employees. (See section 402 of the Code.) 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 section 414(h)(2) of the Code 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 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.

In this request, any election to have payroll deductions for the purchase of service credit picked up by Employer M is irrevocable. Ordinance O provides that Employer M will pay the picked-up amount directly to Plan X in lieu of such payment by the employee. The pick up is mandatory until the earlier of termination of employment or the completion of all the required payments for the service credit. Ordinance O further provides the covered employee will not have the option of choosing to receive the picked-up amounts instead of having them paid by Employer M to Plan X.

Accordingly, with respect to ruling request 1, it is concluded that:

1. Pursuant to section 414(h)(2) of the Code, amounts picked up by Employer M under the provisions of Rule 145-9-08 of the State A Administrative Code and Ordinance O, even though designated as member contributions for state law purposes, will be treated as employer contributions.

Revenue Ruling 77-462 provides, in part, that picked-up contributions are excluded from the employees' gross income until such time as they are distributed. Since it has been determined that the subject contributions meet the requirements of section

414(h)(2) of the Code, it is concluded with respect to ruling request 2 that:

2. Pursuant to sections 414(h)(2) and 402(a) of the Code, amounts picked up by Employer M under the provisions of Rule 145-9-08 of the State A Administrative Code and Ordinance O are excluded from the gross income of the employees at the time they are paid by Employer M and will be included in gross income when distributed.

Because we have determined that the picked-up contributions are to be treated as employer contributions, in accordance with Revenue Ruling 77-462, such contributions are excepted from wages as defined in section 3401(a)(12)(A) of the Code for federal income tax purposes. Therefore, it is concluded with respect to ruling request 3 that:

3. Pursuant to section 3401(a)(12)(A) of the Code, ammounts picked up by Employer M under the provisions of Rule 145-9-08 of the State A Administratve Code and Ordinance O will not constitute wages for federal income tax withholding purposes.

In accordance with Revenue Ruling 87-10, this ruling does not apply to any contribution to the extent it relates to compensation earned before the later of the effective date of the relevant statutes, the date the pick-up election is executed or the date it is put into effect.

This ruling is 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.

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 being paid pursuant to a "salary reduction agreement" within the meaning of section 3121(v)(1)(B) of the Code.

Pursuant to a power of attorney on file in this office, this ruling is being sent to your authorized representative and a copy is being sent to you.

Sincerely yours,

/s/ Frances V. Sloan

Frances V. Sloan
Chief, Employee Plans
Technical Branch 3

Enclosures:

Deleted copy of letter ruling
Form 437