Internal Revenue Service

SIN # 414.07-00

Department of the Treasury

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply to:
OP:E:EP:T:2

Date:
JAN 19 1999

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Legend:

System A =

State B =

System C =

System D =

System E =

Section F =

Section G =

Section H =

Dear :

This is in response to a letter dated May 18, 1998 as supplemented by letters dated October 14, 1998, November 12, 1998, and January 8, 1999 submitted by your authorized representative for a ruling concerning the federal income tax treatment under Internal Revenue Code §414(h)(2) of certain contributions to plans administered by System A.

Your authorized representative submitted the following facts and representations:

System A is an independent state agency of State B that conducts the day to day administration of the plans maintained by Systems C, D and E. System C's plan covers the employees of State B, local school boards and participating political subdivisions. System D's plan covers State B's police officers, and System E's plan covers the justices and judges of State B. Each of the plans sponsored by Systems C, D, and E is a contributory defined benefit pension plan (collectively referred

to as the "Plan"). The Plan is qualified under section 401(a) of the Internal Revenue Code and its related trust is exempt from taxation under section 501(a) of the Code.

Membership in the Plan is mandatory for all full-time, permanent salaried employees of State B, local school boards and of participating local governments and political subdivisions. Contributions to the fund include amounts from participating employers and from members, with the members required to contribute an amount equal to 5% of "creditable compensation." Unless the participating employer elects to pick up employees' contributions, the 5% is deducted from the employee's salary each pay period. Upon accepting employment, an employee is deemed to consent and agree to the deduction from his or her compensation.

Pursuant to Section F of State B's Code, any employer may elect to pay the equivalent amount in lieu of all member contributions required of its employees. Alternatively, effective generally July 1, 1998, an employer may elect to phase in the pick up of member contributions over a period of three years. Under System A's procedures, the participating employer must adopt one of the resolutions offered by it to implement the pick up arrangement. The employer must adopt the model resolution in its entirety as written. The resolutions specify that all or a portion of the members' mandatory contributions are being assumed by the employer and states that the pick up may not commence on a date prior to the employer's adoption and implementation of the applicable resolution. The resolutions further specify that the contributions, even though designated as member contributions, are being paid by the employer in lieu of member contributions and that the members shall not be entitled to receive the contributed amounts directly, instead of having them paid by the employer to the Plan.

Pursuant to Sections G and H of State B's Code, the Plan also permits a member to purchase creditable service for prior service in various capacities with various employers (generally governmental service). The cost of such creditable service purchase varies depending on the type of service purchased. The cost is 5% or 15% of current annual compensation per year of credit purchased. Under System A's procedure, certain service may be purchased by making payroll deductions or by lump sum purchase. Other types of service may only be purchased through a lump sum payment.

Effective generally July 1, 1998, any employer may elect to pay the equivalent amount in lieu of member contributions required of its employees to purchase the prior service credit. Under System A's procedure, only service credit that may otherwise be purchased through payroll deduction can be picked up by the employer. Under System A's procedures, the participating employer must adopt a model resolution offered by

it to implement the pick up arrangement. The employer must adopt the model resolution in its entirety as written. The model resolution specifies that all or a portion of the members' contributions required to purchase prior service credit are being assumed by the Employer and states that the pick up may not commence on a date prior to the employer's adoption and implementation of the resolution. The resolution further specifies that the contribution is being paid by the employer in lieu of member contributions and that the members shall not be entitled to receive the contributed amounts directly. The resolution provides that a member may revoke his salary reduction election only in the event of an unforeseeable emergency as that phrase is used and defined in Internal Revenue Code Section 457 and §1.457-2(h)(4) of the Regulations. If such a revocation is made, the member may not make a new salary reduction election during his period of employment. In addition, the resolution precludes the member from purchasing the service credit that is the subject of the salary reduction election through a lump sum payment during the term of the salary reduction election.

In order for such purchase of past service credit to be picked up by the employer, the member must execute a binding salary reduction agreement stating the beginning and ending date of the election, the amount of money that will be paid each pay period and in total, and that the member may not receive the contributed amounts instead of having them paid by the employer into the Plan. The agreement provides that the election is binding and may not be revoked by the member except in the event of an unforeseeable emergency as that phrase is used and defined in Internal Revenue Code Section 457 and §1.457-2(h)(4) of the Regulations. If such a revocation is made, the election form provides that the member may not make a new salary reduction election during his employment with the employer. The salary reduction election also contains language precluding the member from purchasing service credit through a lump sum during the term of the salary reduction election.

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

(1) Amounts, deducted and withheld from a member's salary pursuant to a participating employer's implementing resolution and subsequently contributed by the employer in lieu of the employee's mandatory contribution to the Plan pursuant to Section F of State B's Code qualify as employee contributions that are picked up by the employer under Internal Revenue Section 414(h)(2).

(2) Amounts, deducted and withheld from a member's salary pursuant to (I) a participating employer's implementing resolution and (ii) a binding, irrevocable payroll deduction election between the employer and the member that are used to

purchase prior service credit pursuant to Section G and H of State B's Code, qualify as employee contributions that are picked up by the employer under Internal Revenue Section 414(h)(2).

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' income until such time as they are distributed to the employees.

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 amounts directly instead of having them paid by the employer to the pension plan.

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.

The proposed model resolutions for the pick up of mandatory employee contributions the model resolution and the accompanying Salary Reduction election form for the pick up of prior service credit satisfy the criteria set forth in Rev. Rul. 81-35 and Rev. Rul. 81-36 by providing that participating employers will make contributions in lieu of contributions by employees and that employees may not elect to receive such contributions directly.

Accordingly, we conclude as follows:

(1) Amounts, deducted and withheld from a member's salary pursuant to a participating employer's implementing resolution and subsequently contributed by the employer in lieu of the employee's mandatory contribution to the Plan pursuant to Section F of State B's Code, qualify as employee contributions that are picked up by the employer under Internal Revenue Code §414(h)(2).

(2) Amounts, deducted and withheld from a member's salary pursuant to (I) a participating employer's implementing resolution and (ii) a binding, irrevocable payroll deduction election between the employer and the member that are used to purchase prior service credit pursuant to Sections G and H of State B's Code, qualify as employee contributions that are picked up by the employer under Internal Revenue Code §414(h)(2).

These rulings apply only if the effective date for the commencement of any proposed pick up of mandatory contributions as specified in the appropriate participating employer's resolution is no earlier than the later of the date the resolution is signed or put into effect.

These rulings apply only if the effective date for the commencement of any proposed pick up of prior service credit as specified in the appropriate participating employer's resolution is no earlier than the later of the date the resolution and salary reduction Election form are signed or the date they are put into effect.

The above ruling is based on the assumption that the plan sponsored by System A will be qualified under section 401(a) of the Code and its related trusts will be tax-exempt under section 501(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 to whether the amounts in question are paid pursuant to a "salary reduction agreement" within the meaning of section 3121(v)(1)(B).

Further, this ruling is not a ruling with respect to the tax effects of the pick up on employees of participating employers. However, in order for the tax effects that follow from this ruling to apply to those employees of a particular participating employer described in the preceding sentence, the pick up arrangement must be implemented by that participating employer in the manner described herein.

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

Sincerely,

(signed) JOYCE E. FLOYD

Joyce E. Floyd
Chief, Employee Plans
Technical Branch 2