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Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

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

Date: SEP 2 1 1999

Attn: ****************
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Legend:

State A = ****
Employer M = **
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System X = ***
Statute Y = **

Dear M*****************

This is in response to your ruling request dated November 19, 1998, as supplemented by correspondence dated August 3, 1999, concerning the federal income tax treatment, under section 414(h)(2) of the Internal Revenue Code (Code), of certain contributions to System X.

The following facts and representations have been submitted:

The Plan sponsored by System X is a governmental plan within the meaning of section 414(d) of the Code. The Plan is a contributory defined benefit plan intended to meet the requirements of section 401(a) of the Code and has received a favorable determination letter. The related trust forming part of the Plan is intended to be exempt from taxation under section 501(a) of the Code. Employer M, a political subdivision of State A, is a participating employer in System X. Employer M's permanent full-time non-bargaining unit employees are participants in System X. Employees are required to contribute to the Plan.

The current mandatory employee contributions to the Plan are a pick-up under section 414(h)(2) of the Code based upon a private letter ruling effective January 1, 1983. The Plan also permits the purchase of prior or additional service credit by its employee members for service previously performed when the employee was not a contributing member to System X or service for which the employee has previously received a refund of System X contributions. To purchase additional service credit, an employee must pay into System X an amount dependent upon the type of credit being purchased. Such additional service credit must be purchased by payroll deduction. All such purchases are currently being made on an after-tax basis. Pursuant to Statute Y, Employer M proposes to pick up the additional

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employee contributions to purchase prior and additional service credit.

To effect the pick-up, Employer M proposes to adopt a resolution. Pursuant to the resolution, Employer M's pick-up shall apply to all persons who (1) are full-time employees and who are contributing members of System X (other than any such employees who are included in a collective bargaining unit unless such employees' participation in the pick-up has been approved in a collective bargaining agreement between Employer M and the authorized bargaining representatives of such collective bargaining unit); (b) are eligible to purchase additional service credits under Statute Y; and (c) have properly completed a payroll authorization form making a binding and irrevocable election to purchase service credits under the pick-up. Designated employee contributions will be picked up through a salary reduction. Further, no employees can purchase, through a lump-sum payment or otherwise, any additional service credit under System X that is being picked-up by Employer M under the Plan. System X shall accept contributions being picked-up by Employer M under the Plan only from Employer M. Employer M will pick up the contributions in lieu of such employees paying such contributions. In addition, employees will have no option to receive the picked-up contributions in cash instead of having such contributions paid to System X. An irrevocable payroll authorization agreement will be used in conjunction with the proposed resolution to effect the pick up.

Based on the aforementioned facts, you request rulings that:

1. No part of the contributions to purchase prior or additional service credit picked-up by Employer M as the employer of the affected employees included in System X be considered as gross income to said employees for federal tax treatment;

2. The contributions to purchase prior or additional service credit, whether picked-up by the salary reduction, offset against future salary increases, or both, and though designated as employee contributions will be treated as Employer M contributions for federal income tax purposes; and,

3. The contributions to purchase prior or additional service credit picked-up by Employer M will not constitute wages from which taxes 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 determined to be qualified under section 401(a), established by a state government or a political subdivision thereof, and are picked up by the employing unit.

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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. 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 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.

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.

In this request, Resolution A satisfies the criteria set forth in Rev. Rul. 81-35 and Rev. Rul. 81-36. It provides that Employer M will make contributions in lieu of contributions by employees and that employees may not elect to receive such contributions directly.

Accordingly, we conclude with respect to your ruling request number one that contributions to purchase prior additional service credit that are picked up by Employer M on behalf of employees who participate in System X shall be treated as employer contributions and will not be includible in the employees' gross income in the year in which such amounts are contributed for federal income tax treatment. These amounts will be includible in the gross income of the employees or their beneficiaries only in the taxable year in

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which they are distributed, to the extent that the amounts represent contributions made by Employer M. With respect to ruling request number two, we have determined that the picked-up amounts are to be treated as Employer M contributions for federal income tax purposes. With respect to ruling request number three, we conclude that contributions to purchase prior additional service credit that are picked up by Employer M are excepted from wages as defined in section 3401(a)(12)(A) of the Code for federal income tax withholding purposes. In addition, no part of the amounts picked up by Employer M will constitute wages for federal income tax withholding purposes in the taxable year in which they are contributed to System X.

This ruling applies only if the effective date for the commencement of the pick-up is no earlier than the later of the date the proposed resolution and payroll authorization form are signed or the date they are put into effect.

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.

This ruling is based on the assumption that the Plan sponsored by System X will be qualified under section 401(a) of the Code at the time of the proposed contributions and distributions.

In addition, these rulings are contingent upon the adoption of the proposed resolution as contained in your correspondence dated August 3, 1999.

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 directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited by others as precedent.

Sincerely yours,

(signed) JOYCE E. FLOYD

Joyce E. Floyd
Chief, Employee Plans
Technical Branch 2

Enclosures:
Deleted Copy of this Letter
Notice of Intention to Disclose

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