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Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply to:

OP:E:EP:T:4

Date:

OCT 20, 1999

Attn:

Legend:

State A =

Subdivision B =

Employer M =

Plan X =

Ladies and Gentlemen:

This letter is in reply to a request for a letter ruling dated July 14, 1998, as supplemented by a letter dated December 8, 1998, 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").

You have submitted the following facts and representations:

Employer M is a political subdivision of State A. Employer M and Subdivision B established Plan X effective July 1, 1973. Plan X provides retirement benefits to members, based on the member's length of service and compensation. Benefits which are provided under Plan X supplement those payable under the Retirement System of State A. Plan X is a qualified plan pursuant to section 401(a) of the Code and received its most recent determination letter on May 12, 1986.

253

Pursuant to Section 3.02(b) of Plan X, Employer M has since January 1, 1985 picked up mandatory employee contributions in accordance with Code section 414(h)(2). Plan X proposes to extend the application of Code section 414(h)(2) to certain contributions to purchase service credit.

Section 12.01 of Plan X provides that when a member terminates employment, the member may receive a refund of contributions previously made to Plan X and upon receipt of these refunded contributions, the member's contributory service credits are forfeited. Plan X also provides that if a former member recommences employment within five years of termination, such member may elect to either (1) redeposit an amount equal to any contributions that have previously been refunded plus interest, or (2) repurchase suspended service credit in accordance with the provisions of Article XI of Plan X. A member may therefore "buy back" prior service canceled upon the member's earlier termination of employment. Repayment may be made in either a lump sum or by means of payroll withholding.

Under conditions specified in Article XI of Plan X, members may elect to purchase additional service credit (1) for any years of service as an educational employee of Employer M that are not otherwise creditable; (2) for years of service as an educational employee in a public school system other than Employer M or in any private school system,and (3) for years of service in any other employment in a capacity which, pursuant to uniform and nondiscriminatory rules adopted by Plan X's Board of Trustees, is deemed to have favorably impacted on the employee's experience to teach in the Employer M school system. A member may pay for the permissive service credit either by a lump sum payment or by payroll withholding.

In order to permit the pick up of redeposit contributions or permissive service contributions, Employer M and Plan X have adopted a resolution to pick up such contributions made through payroll deduction. The Resolution requires Employer M to pick up the contributions made through irrevocable payroll deduction authorizations. Section 11.09, as proposed to be added to Plan X by the amendment set forth in the Resolution, provides that, member contributions to purchase prior service credit shall be picked up by Employer M, as described in section 414(h)(2) of the Code,and deducted from the pay of the contributing member as salary reduction contributions, and paid by Employer M to Plan X.

254

Section 11.01 of Plan X is proposed to be amended to require that any purchase of service through periodic installment payments by payroll deduction must be made pursuant to a binding irrevocable payroll deduction authorization between Employer M and the member participant which provides for the number of deductions and the dollar amount of each deduction.

The Resolution also provides that Employer M shall pick up the contributions used to purchase prior service through payroll deduction,and that no employee who elects to purchase prior service through such pick-up contributions will be permitted to receive the contributions directly instead of having the contributions contributed to Plan X.

The payroll authorization form will be used in conjunction with the above-referenced resolution to effect the pickup of the payroll deductions. This form is to be signed by the member participant and Employer M and is a binding irrevocable payroll deduction authorization between Employer M and the member participant who acknowledges the fact that Employer M will not accept direct payment from the member participant while the form is in effect. This precludes the member participant from revoking the pick-up election and making direct payments to Plan X. The payroll authorization form shall remain in effect until payroll payments are completed or termination of employment, whichever occurs earlier.

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

(1) That the periodic installment payments used to purchase service credit through payroll deductions under Plan X will be treated as employer contributions picked up by Employer M within the meaning of section 414(h)(2) of the Code for federal income tax purposes; and

(2) That such picked-up contributions will not constitute wages under section 3401(a) of the Code from which federal income 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 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.

255

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.

In this case, with respect to redeposit contributions or permissive service contributions, the Resolution adopted by Employer M and Plan X, in conjunction with the irrevocable payroll deduction authorization form and the aforesaid proposed amendments to Plan X, satisfy the criteria of Revenue Rulings 81-35, 81-36, and 87-10 by providing that the payroll deduction authorization form specifies that the contributions, although designated as employee contributions, are being paid by the employer in lieu of contributions by the employee; and an employee who has completed a payroll authorization form is not given the option of choosing to receive the contributed amounts directly in lieu of having them paid to Plan X; and further an employee must complete the payroll authorization form

2756

before the period to which the contributions relate. Also, Revenue Ruling 77-462 provides that picked-up contributions are exempt from federal income tax withholding.

Accordingly, assuming the proposed pick ups are implemented as proposed, we conclude that:

1. The periodic installment payments used to purchase service credit through payroll deductions (amounts deducted in order to redeposit previously refunded contributions or to purchase permissive service credit) will be treated as employer contributions picked up by Employer M within the meaning of section 414(h)(2) of the Code for federal income tax purposes; and

2. Such picked-up contributions will not constitute wages under section 3401(a) of the Code from which federal income taxes must be withheld.

These rulings apply only if the effective date for the commencement of any proposed pick up is not any earlier than the latest of: (a) the later of the date the Resolution is adopted by Employer M and Plan X or the date it is put into effect; (b) the later of the date Employer M adopts the proposed amendments to Plan X as set forth in the Resolution or the date the proposed amendments are put into effect; or (c) the later of the effective date of the appropriate irrevocable payroll deduction authorization form or the date the form has been signed by the parties.

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 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.

257

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

Sincerely yours,

John G. Riddle, Jr.

John G. Riddle, Jr.
Chief, Employee Plans
Technical Branch 4

Enclosures:

Deleted copy of the letter
Notice 437

cc:

258