Internal Revenue Service

Department of the Treasury

Washington, DC 20224

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Index No.: 414.01-00

Contact Person:

Telephone Number:

In Reference to:

OP:E:EP:T:1

Date:

NOV 1 5 1999

Attn:

In re:

EIN:

LEGEND:

State A =
Employer M =

Plan X =

Gentlemen:

This is in response to a request submitted on your behalf by your authorized representative on December 31, 1998, for a private ruling letter concerning the federal income tax treatment of certain contributions to Plan X under section 414(h)(2) of the Internal Revenue Code ("Code").

In support of the ruling request the following facts and representations have been submitted:

Prior to July 1, 1998, police and fire employees of Employer M, a city in State A, participated in two State A retirement systems. Effective July 1, 1998, Employer M withdrew certain of its full-time career police and fire employees from those systems. Effective July 1, 1998, Employer M adopted Plan X, a defined benefit plan, to cover full-time police and fire employees. Plan X states that it is intended to qualify under section 401(a) of the Code.

Generally, an eligible employee is required as a condition of employment with Employer M to participate in Plan X. Under the plan, effective for the pay period

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beginning July 5, 1998, each participant must make contributions equal to 7% of compensation ("City Pick-up Contributions"). Participants do not have the option of choosing to receive City Pick-up Contributions in cash instead of having them paid directly by Employer M to Plan X. Plan X provides that City Pick-up Contributions are deducted from the pay of the contributing participants as salary reduction contributions, must be made pursuant to a binding, irrevocable payroll deduction authorization between Employer M and the participant, and are intended to be pick-up contributions, as described in section 414(h)(2) of the Code. Contributions picked up by previous government employers may also be transferred to Plan X.

Participants may also purchase credit for prior service performed for another governmental employer in the form of salary reduction contributions ("Periodic Installment Payments") which are picked up by Employer M. Plan X provides that the purchase of prior service credit shall be made pursuant to a binding, irrevocable salary reduction authorization between the participant and Employer M. Thus, the participant does not have the option to receive the payments directly instead of having them contributed to Plan X once the agreement is authorized.

Based on the facts described above, Employer M requests the following rulings under section 414(h) of the Code:

1. That the mandatory contributions made by participants and picked up by Employer M under Plan X will be treated as employer contributions for federal income tax purposes.

2. That the mandatory contributions made by participants and picked up by Employer M under Plan X will not be included in the current gross income of the employees for federal income tax purposes.

3. That the mandatory contributions of participants picked up by Employer M under Plan X will not constitute wages subject to federal income tax withholding.

4. That the periodic installment payments for purchase of service credit made by participants and picked up by Employer M under Plan X will be treated as employer contributions for federal income tax purposes.

5. That the periodic installment payments for purchase of service credit made by participants and picked up by Employer M under Plan X will not be included in the gross income of the employees for federal income tax purposes.

6. That the periodic installment contributions for purchase of service credit made by participants and picked up by Employer M will not constitute wages subject to federal income tax withholding.

7. That the periodic installment contributions for purchase of service credit made by participants and picked up by Employer M 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) 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 revenue ruling held further that under the provisions of

section 3401(a)(12)(A), 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 amounts directly instead of having them paid by the employer to the pension plan. Furthermore, 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.

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.

Section 415(c)(1) of the Code provides generally that contributions and other additions with respect to a defined contribution plan, when expressed as an annual addition to a participant's account, may not exceed the lesser of $30,000 or 25% of the participant's compensation. Section 415(c)(2) defines annual additions as employer contributions, employee contributions and forfeitures.

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 415(b) of the Code.

Section 1.415-3(d)(1) of the regulations 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.

The City Pick-up Contributions and Periodic Installment Pick-up Contributions satisfy the criteria set forth in Revenue Rulings 81-35 and 81-36 because Plan X provides that the contributions, although designated as employee contributions, are to be made by Employer M in lieu of contributions by the employees; and the employees may not elect to receive such contribution amounts directly.

Accordingly, with respect to the first six ruling requests, we conclude that both the City Pick-up Contributions and the Periodic Installment Payments for purchase-of-service credit made by participants and picked up by Employer M are treated as employer contributions and are not includible in the gross income of employees in the taxable year of the contributions under section 414(h)(2) of the Code. In addition, they do not constitute wages subject to federal income tax withholding under section 3401(a)(12)(A).

With respect to the seventh ruling request, employee contributions that are picked-up by the employer pursuant to section 414(h)(2) of the Code are treated as employer contributions and, as such, are not annual additions to a separate defined contribution plan for purposes of section 415(c).

Accordingly, with respect to the seventh ruling request, it is concluded that the that the periodic installment contributions for purchase of service credit made by participants and picked up by Employer M will not be treated as "annual additions" for purposes of section 415(c) of the Code.

The ruling applies only to the contributions described above. The effective date for the commencement of the pick-up of the contributions cannot be earlier than effective date of Plan X.

The Internal Revenue Service reaches no conclusion in this letter as to the status of Plan X as a governmental

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plan within the meaning of section 414(d) of the Code. 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).

This ruling is based on the assumption that Plan X is qualified under section 401(a) of the Code at the time of the contributions.

This ruling is directed only to the taxpayer who requested it. Section 6110(c)(3) of the Internal Revenue Code provides that it may not be used or cited as precedent.

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

Sincerely yours,

John Swieca
Chief, Employee Plans
Technical Branch 1

Enclosures:
Deleted copy
Notice of Intention to Disclose

cc:

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