Uniform Issue List No: 414.09-00

200317034

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

OCT 10 2002

T:EP:RA:T1

Legend:

System A

State B

Statute D

Administrative Regulations E

Plan X

Plan Y

Plan Z

This is in response to a ruling request dated July 17, 2002, from your authorized representative, concerning the pick up of certain employee contributions to Plans X, Y and Z (collectively, the "Plans") under section 414(h)(2) of the Internal Revenue Code (the "Code").

The following facts and representations have been submitted:

System A is established pursuant to Statute D, to administer Plans X, Y and Z, which cover certain employees. Plans X, Y and Z are defined benefit pension plans that meet the qualification requirements of Code section 401(a), and are governmental plans

under section 414(d) of the Code. The Internal Revenue Service (the "Service") last issued favorable determination letters with respect to Plans X, Y and Z on December 9, 1974.

Pursuant to Statute D, membership in Plan X consists of all full-time officers of the State B Police; membership in Plan Y consists of employees of participating departments of the Commonwealth of State B; and membership in Plan Z consists of employees of counties, school boards, and units of local government in State B.

Contributions to System A include amounts from employers and employees. Employers' contributions are actuarially determined. Employee contributions are required at a rate of 8% of creditable compensation for members of Plan X, 5% of creditable compensation for members of Plan Y and 5% of creditable compensation for members of Plan Z. Members of Plans Y and Z that are employed in hazardous duty positions contribute 8% of creditable compensation. State B employers are required to treat the employee contributions as being picked up under Section 414(h)(2) of the Code, and Plan members do not have an option to receive the employee contributions in cash.

In addition to the creditable service received as a result of mandatory contributions as an active member of System A, members may purchase credit for various types of service. Pursuant to Statute D, if a member has received a refund of the member's accumulated contributions, the member may re-establish creditable service upon repaying the refund plus interest. Employees may also purchase permissive service credits based on prior employment with an area development district or a state university, State B Peace Corps or a regional community health services program, and certain other specified types of employment.

Statute D allows members to purchase and reinstate credit under any of the provisions that provide for additional purchases in the Plans. Statute D grants System A's Board of Trustees authority to promulgate rules to implement the provisions of Statute D pursuant to Code section 414(h)(2). Accordingly, the Board has proposed an amendment to Administrative Regulations E (the "Amendment") for the purpose of providing a pick-up of employee contributions under section 414(h)(2) of the Code, for contributions that are made for the purpose of purchasing credit or re-establishing withdrawn service.

Pursuant to the Amendment, a participant in one of the Plans may elect to have contributions made to purchase or reinstate credit paid by the employer as picked-up contributions in lieu of contributions by the employer. The election to purchase or reinstate credit through installments is made through a binding, one time irrevocable payroll reduction authorization.

An employee who has signed an authorization will not be able to receive the amounts being contributed directly instead of having the contributions contributed to the retirement system. Employees may not make more than one irrevocable reduction authorization. The pick-up is only applicable to contributions to the extent that the compensation that is reduced from the contributions is limited to compensation earned for services after the effective date of the pick-up.

The employee must complete an irrevocable, binding payroll reduction authorization on the form prescribed by System A. The employer shall pick-up the contributions by a corresponding reduction in the cash salary of the employee, by an offset against future salary increase, or a combination of both.

Notwithstanding the foregoing, the reductions covered by such authorization shall cease only after the authorization has expired by its terms or upon the employee's death, or termination of employment for any reason. Payroll reductions shall last no longer than five years, and employees may not make more than one irrevocable reduction authorization.

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

1. That amounts by which an employer reduces an employee's compensation and pays to System A in order to (a) redeposit previously withdrawn contributions or (b) purchase additional credit, qualify as contributions that are picked up by the employer under Code section 414(h)(2).

2. That the picked up contributions will not be treated as "annual additions" for purposes of section 415(c) of the Code.

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

With respect to ruling request 1, Code section 414(h)(2) provides that contributions, otherwise designated as employee contributions, shall be treated as employer contributions if such contributions are made to a plan described in Code section 401(a), established by a state government or a political subdivision thereof, or any agency or instrumentality of any one of the foregoing, 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 Code section 414(h)(2) 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 amount employees were required by state law to contribute to a state pension plan. Rev. Rul. 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 Code 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 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 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 Code 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.

Statute D and the Amendment satisfy the criteria set forth in Code section 414(h)(2), Revenue Ruling 81-35, and Revenue Ruling 81-36 by providing that the employer will pick up and make contributions to System A to redeposit previously withdrawn contributions or purchase additional credit in lieu of contributions by eligible employees, and that no employee will have the option of receiving such amount directly in cash instead of having it contributed to System A. Accordingly, we conclude that the amounts by which an employer reduces an employee's compensation and pays to System A in order to redeposit previously withdrawn contributions or purchase additional credit qualify as contributions picked up by the employer under section 414(h)(2) of the Code.

With respect to ruling request 2, section 415(b)(2) of the Code provides, in general, that a participant's benefit, expressed as an annual benefit, cannot exceed the lesser of: (A) $160,000 (as adjusted for cost-of-living increases), or (B) 100 percent of the participant's average compensation for the high three years. The 100 percent of compensation limit under section 415(b)(2)(B) does not apply to governmental plans.

Section 415(c)(1) of the Code provides, in general, that contributions and other annual additions for a participant may not exceed the lesser of: (A) $40,000 (as adjusted for cost-of-living increases), or (B) 100 percent of the participant's compensation.

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 Code section 415(b). This regulation 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 additions described in Code section 415(c). However, employee contributions that are picked up by the employer pursuant to Code section 414(h)(2) 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, we conclude with respect to ruling request 2, that the picked up contributions will not be treated as "annual additions" for purposes of Code section 415(c).

With respect to ruling request 3, because we have determined that the picked up amounts are to be treated as employer contributions, they are excepted from wages as defined in Code section 3401(a)(12)(A) for Federal income tax withholding purposes.

These rulings are based on the assumption that the Plans will be qualified under section 401(a) of the Code at all relevant times. Further, this ruling is not a ruling with respect to the tax effects of the picked-up contributions for employees participating in System A. 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.

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 that requested it. Section 6110(k) of the Code provides that it may not be used or cited by others as precedent.

A copy of this ruling is being sent to your authorized representative pursuant to a power of attorney on file in this office. Should you have any questions pertaining to this ruling, you may contact of this office at

Sincerely yours,

Andrew E. Zuckerman
Manager, Employee Plans
Technical Group 1