200337016

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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

U.I.L. 414.09-00

JUN 19 2003

T:EP:RA:T1

Attn.:

LEGEND:

State A =

Employer M =

Plan X =

Act D =

Board C =

Group B Employees =

Statute T =

Resolution O =

Resolution P =

Form P =

Dear :

This is in response to a ruling request submitted by your authorized representative dated July 10, 2002, as supplemented by correspondence dated August 16, 2002, November 13, 2002, December 19, 2002, December 23, 2002, February 19, 2003, and March 11, 2003, with respect to the federal income tax treatment of certain contributions to Plan X under section 414(h)(2) of the Internal Revenue Code (the"Code").

The following facts and representations have been submitted on your behalf:

Plan X was established by State A statutes and is codified at Statute T, as promulgated by State A's legislature. Plan X was established for the benefit of Group B Employees as defined in section 5/13-204 of Plan X. You represent that Plan X is qualified under section 401(a) of the Code.

Employer M is a unit of local government organized pursuant to the provisions of Act D. Section 5/13-701 of Plan X provides that Board C, a five-member board, is responsible for the administration of Plan X. Board C is also an employer of employees who participate in Plan X.

Group B Employees are required to contribute a specified percentage of their salary to Plan X pursuant to the provisions of Section 5/13-502 of Plan X. Under that section, the contributions made by the Group B Employees may be picked up by the employer under section 414(h)(2) of the Code. Employer M and Board C, as an employer of employees that participate in Plan X, propose to extend its pick up program to certain permissive contributions. Prior to January 1, 2002, Group B Employees were permitted to make additional optional contributions to Plan X in order to obtain an enhanced benefit formula at retirement. Contributions under this program have been treated as after-tax contributions. You represent that this program terminated December 31, 2002.

Plan X was amended by Section 5/13.1, effective January 1, 2003.

Section 5/13-304.1 of Plan X, as added by State A's legislature, provides that while this plan is in effect, a Group B Employee may establish optional additional credit toward additional benefits for eligible service by making an irrevocable written election to make additional contributions as authorized by this section. A Group B Employee may begin to make additional contributions under this section, via payroll deduction, no later than the first pay period of the calendar year in which the employee fulfills the 10-year service requirement as herein described. The additional contributions of 4 percent of salary shall be paid to Plan X on the same basis and under the same conditions as contributions required under Plan X. This section pertaining to additional benefits and

contributions expires on December 31, 2007. No additional contributions may be made after that date, and no additional benefits will accrue after that date.

A Group B Employee can make a lump sum contribution to Plan X to purchase service credits for additional benefits. In the event a Group B Employee elects to make such a lump sum contribution to Plan X to purchase service credits for additional benefits, those contributions will be after-tax contributions and therefore, ineligible for pick up treatment.

To implement the pick up of contributions, via payroll deduction, as provided for in Section 5/13-304.1 of Plan X, the President of the Board of Commissioners of Employer M and the Vice President and Secretary of Board C approved resolutions on December 19, 2002, and December 23, 2002, respectively, authorizing the pick up of Optional Plan contributions. Resolution O and Resolution P provide that beginning in 2003, Optional Plan contributions made via payroll deduction, although designated as employee contributions, are being paid by the employer (Employer M or Board C) to Plan X in lieu of contributions by Group B Employee. Resolution O and Resolution P further provide that upon such election, the Group B Employee will not have the option of choosing to receive the contributions directly instead of having them paid to Plan X.

You represent that in order to participate in the enhanced benefit program through the salary reduction plan, a Group B Employee must sign a form authorizing the irrevocable payroll deduction. Form P, a payroll deduction authorization form, will be used in conjunction with Resolution O and Resolution P to effect the pick up of the contributions as provided for in Section 5/13-304.1. Form P states that the Group B Employee elects to participate in the Optional Plan and directs the employer to deduct 4 percent of his/her gross salary and transfer such amount to Plan X. A Group B Employee may elect to participate in the Optional Plan up to a maximum of five years. You further represent that the Group B Employee will not be allowed to change the amount or length of time over which the irrevocable payroll deduction will occur. If the frequency of payroll is changed, the number and the amount of each payroll deduction will automatically be adjusted, without any action on the part of the Group B Employee. Contributions that are picked up pursuant to Section 5/13-304.1 of Plan X will cease upon the Group B Employee's death, retirement, separation from employment, disability or upon reaching the maximum benefit level permitted by state statute. Form P also provides that the Optional Plan is effective from 2003 through 2007.

Based upon the aforementioned facts and representations, you request the following rulings:

(1) That after a Group B Employee has executed the irrevocable payroll deduction authorization, contributions made to Plan X for the purpose of an employee's purchase of optional service credit will be treated as contributions picked up by

Employer M within the meaning of section 414(h)(2) of the Code and will be treated as employer contributions for federal income tax purposes.

(2) That the picked-up contributions for the Group B Employees pursuant to irrevocable payroll deduction elections, will not constitute wages under section 3401(a) of the Code from which federal income tax must be withheld in the tax year in which they are contributed.

(3) That the picked-up contributions 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) of the Code, established by a state government or 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 employee's 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 as Source on Wages; therefore, no withholding is required from employees' salaries with respect to such 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 C.B. 255. These revenue rulings established that the following two criteria must be met: (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 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 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 order to satisfy Revenue Rulings 81-35 and 81-36 with respect to particular contributions, Revenue Ruling 87-10, 1987-1 C.B. 136 provides that the required specification of designated employee contributions must be completed before the

period to which such contributions relate. If not, the designated employee contributions being paid by the employer are actually employee contributions paid by the employee and recharacterized as of a later date. Thus, the retroactive specification of designated employee contributions as paid by the employing unit, i.e., the retroactive "pick-up" of designated employee contributions by a governmental employer, is not permitted under section 414(h)(2) of the Code.

Resolution O and Resolution P satisfy the criteria set forth in Revenue Rulling 81-35 and Revenue Ruling 81-36 by providing that contributions, via payroll deduction, made pursuant to Section 5/13-304.1 of Plan X, although designated as employee contributions, are being paid by Employer M or Board C in lieu of contributions by the Group B Employees and that the Group B Employees do not have the option of choosing to receive the contributions directly instead of having them paid to Plan X.

With respect to your first and second ruling request, we conclude that after a Group B Employee has executed Form P, an irrevocable payroll deduction authorization form, contributions to Plan X to purchase optional service credit pursuant to section 5/13-304.1 of Plan X will be treated as contributions picked up by Employer M and/or Board C within the meaning of section 414(h)(2) of the Code and will be treated as employer contributions for federal income tax purposes. These amounts will not be included in the Group B 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 Group B Employees or their beneficiaries in the year in which they are distributed to the extent the amounts represent contributions made by Employer M or Board C. Because we have determined that the picked-up amounts are to be treated as employer contributions, they 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 or Board C will constitute wages for federal income tax withholding purposes in the taxable year in which they are contributed to Plan X.

With respect to your third ruling request, 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 annual additions described in section 415(c). However, employee contributions which 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, with respect to your third ruling request, we conclude that the picked up contributions will not be treated as "annual additions" for purposes of section 415(c).

In accordance with Revenue Ruling 87-10, the pick up treatment of designated employee contributions that are picked up pursuant to section 414(h)(2) of the Code will not become effective prior to the date of the last governmental action implementing the pick up. Further, this ruling does not apply to any contribution to the extent it relates to compensation earned before the date of the last governmental action implementing the pick up.

The effective date for the commencement of any pick up pursuant to Section 5/13-304.1 cannot be any earlier than the later of (1) the date Plan X, as amended by Section 5/13-304.1 is adopted; (2) the date Section 5/13-304.1 of Plan X becomes effective; (3) the date Resolution O and Resolution P are adopted and put into effect; or (4) the date Form P is signed and executed by the Group B Employees and Employer M or Board C and put into effect.

This ruling is based on the following conditions: (1) a Group B Employee who makes a one time irrevocable election to make additional contributions to purchase service credit for an additional benefit pursuant to Section 5/13-304.1 may not make more than one irrevocable election to make contributions to purchase service credit for the additional benefit; and (2) an election by a Group B Employee to make such additional contributions to purchase service credit for an additional benefit is irrevocable and may not be subsequently altered or amended. Further, this ruling expresses no opinion as to the pick up treatment of additional contributions made by a Group B Employee who elects to purchase service credit in accordance with Section 5/13-304.1 subsequent to December 31, 2007 (the expiration date of Section 5/13-304.1 of Plan X).

No opinion is expressed as to whether the pick up arrangement as described in Section 5/13-502 of Plan X satisfies the requirements of section 414(h)(2) 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 paid pursuant to a "salary Reduction agreement" within the meaning of Code section 3121(v)(1)(B).

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

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.

If you have any questions, please contact , I.D. # , T:EP:RA:T2, at .

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

Sincerely yours,

Joyce E. Floyd
Manager, Employees Plans
Technical Group 2
Tax Exempt and Government
Entities Division

Enclosures:
Deleted copy of letter ruling
Form 437