Internal Revenue Service

Department of the Treasury

Washington, DC 20224

199914054

U.I.L. 414.09-00

Contact Person:

Telephone Number:

In Reference to:

Date:

OP:E:EP:T:2

JAN 13 1999

Attn:

Legend

State A =
Employer M =
Group B Employees =
Plan X =
Proposed Ordinance R=

Dear

This is in response to a ruling request dated September 15, 1998, submitted on your behalf by your authorized representative, concerning the federal income tax treatment, under section 414(h)(2) of the Internal Revenue Code ("Code"), of certain contributions to Plan X including contributions to purchase additional service credit.

The following facts and representations have been submitted:

Employer M, a political subdivision of State A, has been a participating employer in Plan X, a qualified pension plan under section 401(a) of the Code. Plan X is also a governmental plan as defined in Code section 414(d). All participants are required to contribute a specified percentage of their compensation to Plan X. In a prior ruling request, the Service concluded that such contributions meet the requirements of section 414(h)(2) of the Code.

Employer M's employees are mandatory participants in Plan X unless they are covered by another retirement system or qualify for certain exemptions provided to certain types of employees (e.g. temporary employees). Participation in Plan X is in lieu of Social Security and provides the covered employee with retirement, disability and survivor benefits through a funded plan. Funding for Plan X is provided by both employee and employer contributions.

Pursuant to the terms set forth in State A's statute, employees may purchase additional service credit by payroll deduction. In accordance with the foregoing statute Employer M has proposed to enact Ordinance R, which will become effective upon a favorable ruling from the Internal Revenue Service. Section 1 of Proposed Ordinance R provides that any election by the employee to have his or her payroll deductions purchase service credit under Plan X must comply with State A's statute governing pickup contributions and must be irrevocable. Sections 2 and 3 of the Proposed Ordinance R provide that Employer M shall pay the pick-up amount directly to Plan X, in lieu of such payment being made by the employee. In addition, Section 5 of Proposed Ordinance R provides that the pickup shall be mandatory for the covered employee until the earlier of termination of employment or the completion of all required payments for the service credit. Further, Section 5 of Proposed Ordinance R states that no covered employee shall have the option of choosing to receive the picked up amounts directly instead of having them paid by Employer M to Plan X. For purposes of the Internal Revenue Code, such picked-up contributions shall be treated as employer contributions within the meaning of section 414(h)(2) of the Code.

Based on the aforementioned facts, you request the following rulings:

1. That amounts picked up by Employer M on behalf of the Group B Employees pursuant to Proposed Ordinance R although designated as employee contributions will be treated as employer contributions for federal income tax purposes.

2. That amounts picked up by Employer M pursuant to Proposed Ordinance R are excluded from the gross income of the Group B Employees for federal income tax purposes.

3. That amounts picked up by Employer M will not constitute wages 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 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.

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 pension plan.

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, Proposed Ordinance R, if adopted as proposed, would satisfy 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 Group B Employees and that the Employees may not elect to receive such contributions directly.

Accordingly, we conclude with respect to ruling requests numbers 1, 2, and 3 that the amounts picked up by Employer M on behalf of the Group B employees who participate in Plan 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 which they are distributed, to the extent that the amounts represent contributions made by Employer M. 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 will constitute wages for federal income tax withholding purposes in the taxable year in which they are contributed to Plan X.

These rulings apply only if the effective date for the commencement of any proposed pick up as specified in Proposed Ordinance R cannot be any earlier than the later of the date Proposed Ordinance R is signed into law or the date it is put into effect.

In addition, these rulings are contingent upon the adoption of Proposed Ordinance R as contained in your correspondence dated October 26, 1998.

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.

These rulings are 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.

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).

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

Sincerely yours,

(signed) JOYCE E. FLOYD

Joyce E. Floyd
Chief, Employee Plans
Technical Branch 2

Enclosures:
Copy of this letter
Deleted copy
Notice 437