Internal Revenue Service
Uniform Issue List No. 414.09-00

Department of the Treasury

Washington, DC 20224

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Legend:
State = **********
Employer = **********
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Plan X = **********
Benefit Structure Y = **********
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Municipal Resolution Z = **********

Ladies and Gentlemen:

By letter dated April 21, 1998, as supplemented by additional correspondence dated December 30, 1998, your authorized representative requested, on your behalf, a private ruling concerning the federal income tax consequences of certain contributions to the Plan X under section 414(h) of the Internal Revenue Code ("Code").

In support of this ruling request you have submitted the following facts and made the following representations:

The Employer is a municipality located in the above-named State. The Employer's employees participate in Plan X, the pension fund administered by the State for state and municipal employees. Plan X is a qualified plan under section 401(a) of the Code. Membership in Plan X is, with certain exemptions, mandatory upon becoming employed by local governmental authorities such as the Employer.

Plan X is funded in part by mandatory employee contributions of *** or ** percent of compensation, depending upon a particular employee's job classification. In order to allow its employees to pay their mandatory employee contributions

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to Plan X on a pre-tax basis, the Employer previously agreed, by resolution, to pick up those contributions pursuant to a pick-up arrangement under section 414(h)(2) of the Code. The Internal Revenue Service previously ruled that the Employer has a valid pick-up arrangement regarding these mandatory contributions, under which the contributions are treated as Employer contributions that are not includible in the gross income of employees on whose behalf the contributions are made.

State statutes now also provide Benefit Structure Y, which allows State employees and employees of participating local governments to purchase additional retirement benefits, referred to as "permissive service credit," for various periods of service that have not been funded by the regular contributions described above. The statutes allow purchase of this permissive service credit: (1) by elective officials, (2) for prior service, (3) for a period of leave of absence, (4) for municipal out-of-state or federal service, (5) by eligible veterans, (6) by an eligible veteran re-employed by a prior public employer, (7) for restoration of membership in Plan X, and (8) upon reinstatement after a leave of absence to United States employment service. State statutes also authorize a municipality such as the Employer to establish a pick-up plan pursuant to section 414(h)(2) of the Code that allows employees to purchase the permissive service credits with pre-tax dollars.

Upon request, Plan X administrators provide a participating employee with a payroll deduction form, which describes the service credit to be purchased under Benefit Structure Y, the cost of the benefit, and various payment plans available to participants. An employee who has elected the pick-up deduction may not increase or decrease his or her payment allotment. A participant also is prohibited from terminating his payroll deduction election unless he or she has terminated employment, or all such service credit has been purchased with employer pick-up contributions.

To facilitate the purchase of permissive service credit under Benefit Structure Y, the Employer enacted (on **********, ****) Municipal Resolution Z, effective **********, ****. Municipal Resolution Z provides for the pick-up of permissive service credits elected by its employees. Municipal Resolution Z affirms Plan X rules regarding Benefit Structure Y, and provides that any person electing to have the Employer pick up, assume, and pay its employee contributions shall not thereafter have the option of choosing to receive the payroll deduction directly. Electing employees also are prohibited from increasing, decreasing, or terminating the amount of the pick-up deduction.

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Plan X will not accept Employer pick-up contributions for more than one type of permissive service credit at a time. A separate payroll deduction form is required for each type of service credit being purchased.

Based on the foregoing statements and representations, you have requested the following rulings:

1. Employee contributions made by payroll deduction for the purchase of permissive service credits under Benefit Structure Y in Plan X that are picked up by the Employer on or after January 29, 1998, pursuant to the rules of Plan X and Municipal Resolution Z are to be treated as Employer contributions for federal income tax purposes.

2. No part of the amount of the pick-up by the Employer shall be includible in the gross income of any employee of the Employer on whose behalf the pick-up is made, for the year in which such contribution is made.

3. Such contributions are excepted from the definition of wages as set forth in section 3401(a)(12)(A) of the Code, and no part of the amount of the pick-up constitutes wages for federal income tax withholding purposes in the taxable year in which contributed to Plan X.

Section 414(h)(2) of the Code provides that contributions, otherwise designated as employee contributions, shall be treated as employer contributions if: (1) such contributions are made to a plan determined to be qualified under section 401(a) of the Code; (2) the plan is established by a state government or a political subdivision thereof; and (3) the contributions are picked up by the governmental employer.

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 also held 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 the source of wages; therefore, no withholding is required from the employees' salaries with respect to such picked-up contributions.

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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 Rulings 81-35 and 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 into the retirement 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 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. Rev. Rul. 87-10 held that ". . . government employees may not exclude from current gross income designated employee contributions to a qualified plan that relate to compensation earned for services prior to the date of the last governmental action necessary to effect the employer pick up." If this last governmental action necessary to effect the pick up has not taken place, the designated employee contributions being paid by the employer are actually employee contributions paid by the employee and recharacterized at a later date. 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.

In this case, the rules of Plan X and the provisions of Municipal Resolution Z provide that the Employer will pick up and pay the employee contributions made to Plan X for the purchase of permissive service credit under Benefit Structure Y. The rules of Plan X and Municipal Resolution Z further provide that, once a pick-up election is made, an employee may not elect to receive the contributions directly in cash instead of having them paid into Plan X by the Employer. The Plan X rules and Municipal Resolution Z meet, therefore, the criteria established under Revenue Rulings 81-35 and 81-36 for a valid pick-up by an employer of employee contributions to a governmental plan.

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Accordingly it is ruled that:

1. Employee contributions for the purchase of permissive service credits under Benefit Structure Y in Plan X that are or have been picked up by the Employer on or after **********, ****, pursuant to the rules of Plan X and Municipal Resolution Z are to be treated as Employer contributions under section 414(h)(2) of the Code for federal income tax purposes.

2. No part of the amount of the pick-up by the employer shall be includible in the gross income of any employee of the Employer on whose behalf the pick-up is made, for the year in which such contributions are made.

3. Because we have ruled that the amounts picked up by the Employer are to be treated as Employer contributions, they are excepted from the definition of wages as set forth in section 3401(a)(12)(A) of the Code, and no part of the amount of the pick-up constitutes wages for federal income tax withholding purposes in the taxable year in which contributed to Plan X.

These rulings are based on the assumption that Plan X will continue to be qualified under section 401(a) of the Code at the time of the proposed contributions. Also, no opinion is expressed as to whether the amounts in question are subject to tax under the Federal Insurance Contributions Act, and 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) of the Code.

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

Sincerely,

John Swieca

John Swieca
Chief, Employee Plans
Technical Branch 1

Enclosures:
- Deleted Copy of this Letter
- Notice of Intention to Disclose, Notice 437
- Copy of Notification Letter (Form 1155) to Authorized Representative

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