Internal Revenue Service | Department of the Treasury

Washington, DC 20224 199916044

Uniform Issue List: 414.09-00

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Attn: ***************
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Contact Person: ******

Telephone Number: ************

In Reference to: OP:E:EP:T:4

Date: NOV 18 1998

Legend:

State A = **********

Employer M = **********************************
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Plan X = ******************************
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Ordinance O = ***************************
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Ordinance P = *******************************
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Code C = **********************************

Program R = ****************

Program S = *********************

Program T = ************************

Form F = ******************************

Ladies and Gentlemen:

This letter is in response to a request for a letter ruling dated ***************, as supplemented by letters dated ***********, and *****************, submitted on

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your behalf by your authorized representative, concerning the federal tax treatment of certain contributions made to Plan X under section 414(h)(2) of the Internal Revenue Code ("Code").

The following facts and representations have been submitted:

Employer M is a political subdivision of State A. Employer M established, maintains and administers Plan X, a defined benefit retirement plan. Plan X is intended to qualify under section 401(a) of the Code.

All participants in Plan X are required to contribute a specified percentage of their compensation to Plan X, and Employer M is required, pursuant to the provisions of Ordinance O, incorporated in Code C, to pick up these required contributions and pay them to Plan X.

Plan X provides that when a participant terminates employment, the participant may, under certain circumstances, receive a refund of employee contributions previously made to Plan X, and, upon receipt of these refunded contributions, the employee's benefits for service credits are forfeited. Such refunds are taxable or nontaxable, depending upon whether or not the refunded amounts were previously paid to Plan X on a "pick up" basis or otherwise. Plan X also provides that if the former employee is subsequently rehired by Employer M, the employee may elect to redeposit an amount equal to any contributions that have previously been refunded plus interest ("Program R"). Electing to make a redeposit allows an employee to "buy back" prior service canceled upon the employee's earlier termination of employment. A redeposit must be made within a three year period and the repayment must be completed prior to retirement. Repayment may be made in a lump sum payment or by installment payments. An employee's installment payments are made through monthly payroll deductions on an after-tax basis.

Pursuant to Plan X, employees may also elect to purchase certain permissive service credit ("Program S"), such as time spent on certain active military service, certain prior service or public service, and representative service as a labor organization representative, by paying the employee contribution that would have been due for that period if the employee had been an active employee of Employer M, plus interest.

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In addition, in the past employees were permitted to make their mandatory contributions to Plan X at a reduced rate. They were allowed to make up the difference ("Program T") between the contributions at the full rate and contributions at the reduced rate before the date of retirement. Now the employees are no longer permitted to contribute at a reduced rate. All employees are required to make mandatory contributions at the full rate. However, those employees who elected to contribute at a reduced rate in the past may elect to make up any shortage in their account by either making a lump sum payment to Plan X or through monthly payroll deductions.

In order to permit the pick up of the above-described Programs R, S, or T Contributions made through payroll deductions, Employer M proposes to enact Ordinance P. This ordinance designates such payroll deduction contributions (as are made pursuant to a binding irrevocable payroll deduction authorization between the employee and Employer M to have such amounts picked up) as being picked up by Employer M and paid by Employer M with the employee having no option of receiving such picked-up amounts directly instead of having such amounts contributed to Plan X. The contributions so picked up shall be treated as employer contributions in the same manner as the mandatory employee contributions picked up under Ordinance O.

Employer M will use Form F in conjunction with proposed Ordinance P to effect the pick up of the Programs R, S, and T Contributions. This form, which is to be signed by the electing employee and Employer M, states that the employee authorizes the deduction from salary for pick up purposes and understands that this authorization is binding and irrevocable. The employee acknowledges in the form that Plan X will not accept direct payment from the employee while the authorization is in effect. This precludes the employee from revoking the pick up election by making direct payments to Plan X. The number of months during which the payroll deductions will be made and the dollar amount of the deductions are designated on this form.

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Based on the aforementioned facts and representations, you have requested the following rulings:

1. That mandatory annual employee contributions which are picked up and paid by Employer M satisfy the requirements of section 414(h)(2) of the Code and thus constitute employer contributions which are excludable from the gross income of the employees until paid or distributed;

2. That contributions by payroll deductions pursuant to Form F under Programs R, S, and T qualify as picked up contributions under section 414(h)(2) of the Code and will be treated as employer contributions;

3. That pick-up contributions under Programs R, S, and T are made on a pre-tax basis and do not constitute gross income of the electing employees for the year in which the pick up is made or until such time as they are distributed to the employees or their beneficiaries;

4. That the pick-up contributions under Programs R, S, and T are excludable from the employees' "wages" for purposes of federal income tax withholding in the taxable year in which they are contributed.

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) or 403(a) of the Code, established by a state government or political subdivision thereof, or by any agency or instrumentality of the foregoing, where the employing unit picks up the contributions.

Revenue Ruling 77-462, 1977-2 C.B. 358, addresses the federal income tax treatment of contributions picked up by the employer within the meaning of section 414(h)(2) of the Code. In Rev. Rul. 77-462, the employer school district agreed to pick up and pay the required contributions of the eligible employees under the plan. The revenue ruling held that under the provisions of section 3401(a)(12)(A) of the Code, the school district's picked-up contributions to the plan are excluded from wages for purposes of the Collection of Income Tax at Source on Wages, and no federal income tax withholding is required from employees' salaries with respect to such picked-up contributions. The revenue ruling

further held that the school district's picked-up contributions are excluded from the gross income of employees until such time as they are distributed to the employees.

Revenue Ruling 81-35, 1981-1 C.B. 255, and Revenue Ruling 81-36, 1981-1 C.B. 255, provide guidance as to whether contributions will be considered as "picked up" by the employer. Both revenue rulings establish that the following two criteria must be satisfied: (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 have the option of choosing to receive the contributed amounts directly or to have them paid by the employer to the plan.

In Revenue Ruling 87-10, 1987-1 C.B. 136, the Service considered whether contributions designated as employee contributions to a governmental plan are excludable from 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 the present case, Ordinance O satisfies the criteria set forth in Revenue Ruling 81-35 and Revenue Ruling 81-36 by providing that Employer M will pick up and pay the mandatory contributions to Plan X on behalf of the employees and in lieu of contributions by the employees and that no employee will have the option of receiving the amounts in cash instead of having them contributed to Plan X.

Also, in the case at hand, with respect to contributions under Programs R, S, and T, the provisions of proposed Ordinance P, in conjunction with provisions of Form F, satisfy the criteria set forth in Revenue Ruling 81-35 and Revenue Ruling 81-36 by providing that Employer M will make the contributions to Plan X on behalf of the employees and in lieu of contributions by the employees and that no employee will have the option of receiving the amounts in cash instead of having them contributed to Plan X.

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Further, the proposed pick-up election agreements of employees by means of Form F will be implemented so as to specify the designated pick up contributions, as such, before the period to which such contributions relate.

In order to exercise any of the above elections under Programs R, S, and T, employees must sign Form F authorizing a payroll deduction in a specific amount for a certain number of pay periods. As a condition to making such an election, the employee is required to execute an agreement making such an election irrevocable.

Accordingly, based on the above facts and representations, we conclude that:

1. The mandatory annual employee contributions which are picked up and paid by Employer M to Plan X satisfy the requirements of section 414(h)(2) of the Code and thus constitute employer contributions which are excludable from the gross income of the employees until paid or distributed.

2. The contributions by payroll deductions pursuant to Form F under Programs R, S, and T qualify as picked up contributions under section 414(h)(2) of the Code and will be treated as employer contributions.

3. The pick-up contributions under Programs R, S, and T are made on a pre-tax basis and do not constitute gross income of the electing employees for the year in which the pick up is made or until such time as they are distributed to the employees or their beneficiaries.

4. The mandatory annual employee contributions picked up by Employer M and the pick-up contributions under Programs R, S, and T are excludable from the employees' "wages" for purposes of federal income tax withholding in the taxable year in which they are contributed.

With respect to the pick up of mandatory employee contributions, rulings 1 and 4 are effective from the date Ordinance O was implemented. With respect to the elective contribution pick up programs (Programs R, S, and T), rulings 2, 3, and 4 apply only if the effective date for the commencement of any proposed pick up as specified in proposed Ordinance P cannot be any earlier than the later of the date Ordinance P is signed or the date Ordinance P is put into effect.

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These rulings are based on the assumption that Plan X meets the requirements for qualification 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) of the Code.

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

Sincerely yours,

John G. Riddle, Jr.

John G. Riddle, Jr.
Chief, Employee Plans
Technical Branch 4

Enclosures:

Deleted copy of the letter
Notice 437

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