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Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply to: OP:E:EP:T:3

Date:

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LEGEND:

State A =

Participating
Employer/Employers =

Plan X =

Group C
Employees =

Resolution N =

Payroll Authorization
Form P =

This is in response to a ruling request dated June 1, 1998, as amended and supplemented by submissions of July 16, 1998, August 4, 1998, September 4, 8, 9, 11, 17 and 18, 1998, October

28, 1998, December 4 and 18, 1998, January 15, 1999, and February 1 and 5, 1999, concerning Plan X and the pick up under section 414(h)(2) of the Internal Revenue Code of certain employee contributions to redeposit previously refunded contributions, to purchase certain additional service credit and to purchase additional retirement benefits attributable to termination pay.

The following facts and representations have been submitted:

Plan X is a defined benefit program intended to qualify under section 401(a) of the Code. It was established by State A for the benefit of Group C Employees. Group C Employees primarily include employees of all public schools and certain employees of colleges and universities in State A.

Plan X provides that employee mandatory contributions are required to be picked up by the Participating Employer. In a prior private letter ruling the Internal Revenue Service concluded that the mandatory employee contributions picked up by Participating Employers for Group C Employees satisfied the requirements of section 414(h)(2) of the Code. The current ruling request seeks to extend the application of section 414(h)(2) to the elective contributions described below.

Plan X provides that certain inactive and terminated participants may withdraw their contributions and related earnings from Plan X. Plan X also provides that former participants who resume active participation may redeposit their withdrawn contributions plus interest. Subject to approval by the plan administrator, a participant may make the redeposit in a single payment or by an increased rate of contribution. It is now proposed to amend Plan X to provide Group C Employees with the option of electing to have Participating Employers pick up these redeposit contributions under section 414(h)(2) of the Code when the contributions are being made through payroll deduction.

Under conditions specified in Plan X, participants may elect to purchase additional service credit. For example, a member may elect to purchase credit for time spent in out-of-state public and federal employment, time spent on certain qualifying leave, time spent in active service in the military, red cross or merchant marine, time spent in private school employment, time spent in State A's public employees' retirement system, and extension service employment and time spent on workers' compensation leave. A member may pay for the additional service credit in a lump-sum payment or in installments as agreed between the participant and the plan administrator. It is now proposed to amend Plan X to provide Group C Employees with the option of electing to have Participating Employers pick up these additional service credit contributions under section 414(h)(2) of the Code when the contributions are being made through payroll deduction.

In order to permit the pick up of the above-referenced redeposit contributions and additional service credit contributions that are being made through payroll deduction, a Participating Employer will be required to adopt Resolution N (attached). This resolution designates such payroll deductions (as are made pursuant to a binding irrevocable payroll deduction authorization between a Plan X participant and a Participating Employer to have such amounts picked up) as being picked up by the Participating Employer with the employee having no option of receiving such picked up amounts directly instead of having such amounts contributed to Plan X.

Payroll Authorization Form P (attached) will be used in conjunction with Resolution N to effect the pick up of the above-referenced payroll deductions. This form, which is to be signed by the electing Plan X participant and the Participating Employer, subsequent to adoption of Resolution N, states that the employee authorizes the deduction from salary for pick up purposes and understands that this authorization is binding and irrevocable. The number of months during which the deductions will be made and the dollar amount of the deductions are designated on this form. The employee will agree in Payroll Authorization Form P that, with respect to the redeposit or the specific type of additional service credit being funded by the picked-up contributions designated therein, Plan X will only accept payment from the Participating Employer and not directly from the employee. Similarly, Plan X will preclude prepayment of any amounts designated under Payroll Authorization Form P. The employee is thus precluded from revoking the pick-up election by making payments directly to Plan X. Payroll Authorization Form P also provides that the contributions are being picked up by the Participating Employer and paid directly to Plan X and that the employee does not have the option of receiving the amounts directly. Further, as proposed to be amended, Plan X specifically envisions that the proposed pick up will be implemented through Resolution N and Payroll Authorization Form P, or substantially similar documents.

The effective date of the pick-up arrangement with respect to the redeposit of previously refunded contributions or the purchase of additional service credit is the later of the date Resolution N is adopted by the Participating Employer, or the date Payroll Authorization Form P has been signed by both parties. The pick up does not apply to any contribution made before the effective date or to any contribution that relates to compensation earned for services before the effective date.

Under Plan X, termination pay may be taken into consideration in determining the average final compensation on which benefits are based. Plan X provides three options with respect to termination pay:

(1) The employee may use total termination pay in determining the average final compensation. Under this option, the retiree and the employer shall pay such contributions to Plan X as are determined by the plan administrator to adequately compensate Plan X for the additional retirement benefit. The contribution must be made by the 15th of the month following the month of termination.

(2) The employee may use a yearly amount of termination pay added to each of the three consecutive years salary used in the calculation of the member's average final compensation. To determine the amount of termination pay used in the calculation of average final compensation, termination pay must be divided by the total mumber of years of creditable service to determine a yearly amount. To compensate Plan X for the additional benefit under this option, the member and employer pay contributions on the termination pay according to the regular employee and employer contribution rates specified in Plan X with respect to compensation.

(3) The employee may exclude termination pay from the final average compensation.

It is now proposed that State A will amend the provisions of Plan X dealing with termination pay so that the employee contribution necessary to compensate Plan X for any additional benefits attributable to inclusion of termination pay in average final compensation may be picked up by the Participating Employer. As amended, Plan X will provide for a binding irrevocable written election of one of the above termination pay options. The election must be executed by both the employee and the employer. The employee's election must precede the employee's termination date by at least three months. Termination pay is restricted to payments available upon termination. It does not include pretermination payments. Provided the election is timely made and the contribution required to pay for the additional benefit does not exceed the termination pay, Plan X as proposed to be amended, will require that the contribution be deducted from the termination pay and picked up by the Participating Employer. If the election is not timely made or the contribution required to pay for the additional benefit exceeds the amount of the termination pay, Plan X will provide that the contribution cannot be picked up by the Participating Employer. The pick up does not apply to a contribution made before the effective date of the pick up. Termination pay includes commuted sick pay, commuted vacation pay and other termination payments which would be reportable on Form W-2 as taxable wages but for the pick up.

The election will further provide as follows:

(1) that the contributions being picked up, although designated

as employee contributions, are being paid by the employer directly to Plan X in lieu of contributions by the employee and that the picked-up contributions are paid from the same source as compensation is paid;

(2) that the employee may not choose to directly receive the amounts deducted from the employee's termination pay instead of having them paid by the employer to Plan X;

(3) that the employee may not prepay any portion of the picked-up contributions; and

(4) that the effective date of the pick up is the date of execution of the binding irrevocable election by both the employee and employer. The pick up does not apply to a contribution made before the effective date of the pick up.

Based on the facts and representations above, you request the following rulings:

1. The amounts deducted by a Participating Employer from an employee's compensation and paid to Plan X in order to (a) redeposit previously withdrawn contributions, (b) purchase additional service credit or (c) reimburse Plan X for the cost of the additional retirement benefits attributable to including termination pay in average final compensation, qualify as contributions that are picked up by the Participating Employer under section 414(h)(2) of the Code.

2. 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), 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. 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.

Revenue Ruling 87-10, 1987-1 C.B. 136, provides that in order to satisfy Revenue Rulings 81-35 and 81-36, the required specification of designated employee contributions must be completed before the period to which such contributions relate. Thus, 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.

With respect to the pick up of employee redeposit contributions and employee additional service credit contributions, Resolution N, which will be adopted by electing Participating Employers, satisfies the criteria set forth in Revenue Rulings 81-35 and Revenue Ruling 81-36 by providing that the Participating Employers will make the contributions on behalf of the employees in lieu of contributions by the employees and that no employee will have the option of receiving the contribution directly instead of having it contributed to Plan X. Further, the proposed pick-up election agreement of employees (Payroll Authorization Form P) is irrevocable and also provides that the contributions are being picked up by the Participating Employer and paid directly to Plan X and that the employee does not have the option of receiving the amounts directly. The effective date of the pick-up arrangement is the later of the date Resolution N is adopted by the Participating Employer or the date Payroll Authorization Form P has been signed by both parties. The pick up does not apply to any contribution before the effective date or to any contribution that relates to compensation earned for services before the effective date.

With respect to the pick up of employee contributions to compensate Plan X for the additional benefits attributable to the

inclusion of termination pay in average final compensation, the following is applicable. Plan X, as proposed to be amended, will require a binding irrevocable election at least three months before the employee's termination date to have the necessary contributions deducted from termination pay. Under the binding irrevocable election the Participating Employer will pick up and pay the contributions directly to Plan X and the employee will not have the option of choosing to receive the contributed amounts directly instead of having them paid by the Participating Employer to Plan X. The effective date of the pick up is the execution of the binding irrevocable election by both the employer and the employee. The pick up does not apply to any contribution made before the effective date or to any contribution that relates to compensation earned for services before the effective date.

Accordingly, assuming the proposed pick ups are implemented as proposed, it is concluded, with respect to the first ruling request, that the amounts deducted by a Participating Employer from an employee's compensation and paid to Plan X in order to (a) redeposit previously withdrawn contributions, (b) purchase additional service credit or (c) reimburse Plan X for the cost of the additional retirement benefits attributable to including termination pay in average final compensation, qualify as contributions that are picked up by the Participating Employer under section 414(h)(2) of the Code.

With respect to the second ruling request, section 1.415-3(d)(1) of the Income Tax Regulation 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 415(b) of the Code. Section 1.415-3(d)(1) 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) of the Code. Employee contributions that are picked-up by the employer pursuant to 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 the second ruling request, it is concluded that the picked-up contributions will not be treated as "annual additions" for purposes of section 415(c) of the Code.

In accordance with Revenue Ruling 87-10, this ruling does not apply to any contribution to the extent it relates to compensation earned before the later of the effective date of the relevant statutes, the date the pick-up election is executed or the date it is put into effect.

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.

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 being paid pursuant to a "salary reduction agreement" within the meaning of section 3121(v)(1)(B) of the Code.

Further, this ruling is not a ruling with respect to the tax effects of the pick-up on employees of Participating Employers. 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.

A copy of this letter has been sent to your authorized representative in accordance with the power of attorney submitted with the ruling request.

Sincerely yours,

/s/ Frances V. Sloan

Frances V. Sloan
Chief, Employee Plans
Technical Branch 3

Attachments:
Resolution N
Payroll Authorization Form P

Enclosures:
Deleted copy of letter ruling
Form 437

PAYROLL AUTHORIZATION FORM P

Employee Social Security Number _____ Employee Name (First, ML, Last) _____

Employer _____ Employer Identification Number _____

A member, pursuant to is permitted to redeposit member contributions previously withdrawn and/or elect to purchase additional service credit through additional contributions to the retirement system. Any additional amounts due may generally be paid by the member directly to the retirement system, or the member may request, and the employer may permit, deductions through payroll.

I understand that pursuant to my employer has adopted a resolution under the "pickup" tax deferral provisions of the Internal Revenue Code Section 414(h)(2) and that tax deferral of my additional contributions due to the retirement system requires this irrevocable payroll deduction authorization.

I hereby direct my Employer to make the following deductions from my salary per pay period for the purpose of purchasing _____ years of service as provided under or redepositing withdrawn amounts and interest in an amount equal to $_____ as provided under

$_____ per pay period, beginning on _____ for _____ months.

With respect to this payroll deduction I understand the following:

- This is an irrevocable deduction authorization.
- The minimum duration of the authorization is three (3) months; the maximum duration is five (5) years.
- After the execution of this irrevocable deduction authorization, I do not have the option of receiving the deduction amounts directly instead of having them paid by my Employer to
- These contributions are being picked up by my Employer; and, as a result, although designated as employee contributions, they are being paid directly to in lieu of contributions by me.
- I may make more than one irrevocable, binding payroll deduction authorization so long as a subsequent deduction authorization does not amend this binding, irrevocable authorization.

- While this agreement is in effect, I understand that (with respect to the redeposit or the specific type of additional service credit being purchased by the contributions designated herein) will only accept payment from my Employer and not directly from me.

- If I terminate employment with my Employer or die prior to completion of the installment payments, this binding, irrevocable payroll deduction authorization shall expire and shall pro-rate the service purchase, subject to the following:

  - In the case of termination, I may make a lump-sum contribution for the balance of the service subject to the limitations of Section 415 of the Internal Revenue Code of 1986.

  - In the case of a death, the payment of the balance may be made by my spouse or from my estate subject to the limitations of Code Section 415.

- The payroll deduction authorization is not effective until signed by me and an authorized representative of my Employer. The pick up is only applicable to contributions to the extent the contribution is deducted from compensation earned for services after the effective date of the pick up.

Signatures

Date	Employee's Signature
Date	Signature of Authorized Representative or Employer
	Name and Title of Authorized Representative

RESOLUTION N

Resolution _____ of the _____

of _____

Whereas, _____ is an employer whose employees participate in _____ pursuant to _____ (hereinafter referred to as the "Employer"),

Whereas, the _____ of the employer (hereinafter referred to as the "Governing Body") has determined that it would be in the best interest of its employees to provide a pick-up of employee contributions under Section 414(h)(2) of the Internal Revenue Code of 1986 for contributions that are made for the purpose of purchasing service credit under _____ and/or redepositing amounts withdrawn under _____ ;

Whereas, under _____, in order to effectuate this pick-up, the Governing Body must adopt a resolution to pick up the member's contributions made pursuant to a binding, irrevocable payroll deduction authorization; and

Whereas, the contributions picked up by the Employer must be payable from the same source as is used to pay compensation to the employee;

Now, therefore, be it resolved by the Governing Body of the Employer as follows:

Section 1. That employee contributions made (pursuant to a binding irrevocable payroll deduction authorization to have such contributions picked up) for the purpose of purchasing service under _____ and/or redepositing amounts withdrawn under _____, even though designated as employee contributions for state law purposes, are being paid by the Employer to _____ in lieu of the contributions by the employee.

Section 2. That, if the employee desiring to have contributions picked up executes an irrevocable, binding payroll deduction with respect to these contributions, the employee shall not be entitled to any option of choosing to receive the contributed amounts directly instead of having them paid by the Employer to _____.

Section 3. That, with respect to any employee's contributions, the effective date of the pick-up by the Employer is the later of:

(a) the adoption of this resolution; or

(b) the execution of the payroll deduction authorization form.

This pick up does not apply to any contributions made before the effective date or to any contribution

that relates to compensation earned for services before the effective date.

Section 4. That any payroll deduction authorizations in effect as of the effective date of this resolution are void and that an employee who wishes to have payroll deductions made for the purpose of purchasing service or redepositing withdrawn amounts must follow the procedures specified in Section 5 of this resolution.

Section 5. That an employee who wishes to redeposit amounts withdrawn under or to purchase service credit under shall make the following series of elections with regard to these actions:

(a) The employee may elect a lump sum payment, a series of installments, or a combination of lump sum payments and installments.

(b) If a series of installment payments is elected by the employee, he/she may elect to pay the installments directly to or to have the installments payable by payroll deduction; or the employee may select a combination of both.

(c) With respect to installments payable by payroll deduction, the employee may elect to execute a binding irrevocable payroll deduction authorization to have these installment contributions picked up by the participating employer.

Section 6. That contributions made pursuant to Section 5(c) of this resolution are designated as being picked up by the employer and paid from the same source as the payment of salary to these employees.

Section 7. That this resolution takes effect _____.

Adopted this ___ day of _____, _____ by the Governing Body of the Employer.

_____

Signature of Authorized Representative or Employer

_____

Name and Title of Authorized Representative