Uniform Issue List No: 414.09-00

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

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

T:EP:RA:T1

AUG 28 2003

Attn:

Legend:

State =

Group C employees =

Plan X =

Plan Y =

Statute D =

Statute E =

Statute F =

Dear:

This is in response to a ruling request dated October 16, 2001, as supplemented by additional correspondence dated December 6, 2001, May 7, 2002, July 17, 2002, September 12, 2002, October 22, 2002, November 21, 2002, January 13, 2003, February 28, 2003 and March 31, 2003, from your authorized

representative, concerning the pick up of certain employee contributions to Plan X under §414(h)(2) of the Internal Revenue Code (the "Code"), and the federal income tax treatment of certain transfers of funds from Plan Y to Plan X.

The following facts and representations have been submitted:

Pursuant to Statute D, the State created Plan X in 1955 as a defined benefit pension plan and retirement system for the benefit of Group C employees. Plan X is intended to meet the qualification requirements of §401(a) of the Code, to the extent that section applies to a governmental plan under Code §414(d).

Under Statute D, employee contributions to Plan X are mandatory for Group C employees. Effective July 1, 1991, each participant has been required to contribute a certain percentage of their base annual salary to Plan X in the form of a deduction from compensation. The State is required to reduce the current salary of Group C employees, and pay the mandatory employee contribution directly to Plan X, in lieu of contributions by the individual participants. No option to receive the mandatory contributions in cash has ever been permitted; such an option is specifically precluded by Statute D. The State has treated the mandatory employee contributions in a manner consistent with §414(h)(2) of the Code. As such, they have been treated as employer contributions for federal income tax purposes.

Pursuant to State Statute, the State also established Plan Y, a defined contribution pension plan qualified under §401(a) of the Code. Plan Y covers employees of the State and employees of any political subdivision of the State that elects to participate in Plan Y.

Employees participating in Plan Y are required to contribute a percentage of their compensation to Plan Y. This amount is deducted by the employer each payroll period and paid over to the Plan's trust. Statute F requires the State or other adopting employer to pick up and pay the mandatory contributions to Plan Y pursuant to §414(h) of the Code.

Statute E, as submitted to the Internal Revenue Service (the "Service") in proposed form on February 28, 2003, provides for the purchase of credited service for employees participating in Plan X, such as credited service for employment with a political subdivision or agency of the State, for leave of absence, or military service. The State proposes to implement a program under which an employee will have several options for purchasing credited service or for the reinstatement of forfeited credited service due to a prior refund of contributions. Two of the available options include employee payments made through payroll deduction or a direct trustee-to-trustee transfer from a Code

§401(a) plan, including Plan Y. These provisions will become effective upon the receipt of a favorable letter ruling from the Service concerning their tax consequences.

A covered employee who is eligible to purchase credited service through payroll deduction is required to make an irrevocable election to purchase the credited service as permitted under Statute E. The irrevocable election must specify the number of payroll periods that deductions will be made from the employee's compensation, and the dollar amount of deductions for each payroll period during the specified number of payroll periods. The deductions will cease upon the earliest of the employee's termination of employment with the employer, the employee's death, or completion of the specified payroll deduction period. If an employee terminates employment before all payments are made, the employee's benefits shall be based only on the payments actually made with respect to the credited service purchased.

Under Statute E, the amounts paid under the payroll deduction program are paid by the employer in lieu of contributions by the employee making the election, and the employee does not have the option of choosing to receive the contributed amounts directly in cash.

The State also proposes to allow employees to use funds from Plan Y for the limited purpose of purchasing credited service on behalf of employees participating in Plan X, or for the reinstatement of forfeited credited service. Under Statute E, Plan X permits the acceptance of funds by reason of a direct trustee-to-trustee transfer from an account established for the benefit of an employee in Plan Y. The amounts transferred from Plan Y will be applied to reduce the employee's outstanding indebtedness at the time that the contributions are received by Plan X.

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

1. That amounts deducted and withheld from the salary of covered employees pursuant to Statute D qualify as employee contributions that are picked up by the State under Code §414(h)(2) and, as such, are not included in gross income for federal income tax purposes.

2. That amounts deducted and withheld from the salary of covered employees pursuant to Statute D qualify as employee contributions that are picked up by the State under Code §414(h)(2) and, as such, do not constitute wages for federal income tax withholding purposes.

3. That amounts deducted and withheld from the salary of covered employees for purposes of purchasing additional credited service pursuant to Statute E qualify as employee contributions that are picked up by the State under Code §414(h)(2) and, as such, are not included in the employee's gross income for federal income tax purposes.

4. That amounts deducted and withheld from the salary of covered employees for purposes of purchasing additional credited service pursuant to Statute E qualify as employee contributions that are picked up by the State under Code §414(h)(2) and, as such, do not constitute wages for federal income tax withholding purposes.

5. That the picked-up contributions permitted under Statutes D and E will not be treated as "annual additions" for purposes of Code §415(c).

6. That amounts transferred in a direct trustee-to-trustee transfer to the Plan X trust from an account established in an exempt trust for the benefit of the employee in Plan Y, which is a Code §401(a) qualified plan, to purchase additional credited service pursuant to Statute E, will not result in ordinary income to the employee under §72 of the Code.

With respect to ruling requests 1, 2, 3 and 4, Code §414(h)(2) provides that contributions, otherwise designated as employee contributions, shall be treated as employer contributions if such contributions are made to a plan described in Code §401(a), established by a state government or a political subdivision thereof, or any agency or instrumentality of any one of the foregoing, and are picked up by the employing unit.

The federal income tax treatment to be accorded contributions that are picked up by the employer within the meaning of Code §414(h)(2) 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 amount employees were required by state law to contribute to a state pension plan. Rev. Rul. 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 Code §3401(a)(12)(A), 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 for federal income tax purposes 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 Code §414(h)(2) 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 Code §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 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 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.

Plan X satisfies the criteria set forth in Code §414(h)(2), Revenue Ruling 81-35, and Revenue Ruling 81-36 by providing that the State will pick up and make contributions to Plan X in lieu of contributions by eligible employees, and that no employee will have the option of receiving such amount directly in cash instead of having it contributed to Plan X.

Accordingly, with respect to ruling requests 1 and 2, we conclude that the amounts deducted and withheld from the salary of covered employees to pay mandatory employee contributions, pursuant to Statute D, are picked up by the State within the meaning of §414(h)(2) of the Code, and that such amounts will be treated as employer contributions, and will not be includable in employees' gross income for the taxable year in which such amounts are contributed.

With respect to ruling requests 3 and 4, Statute E provides for the purchase of additional credited service for employees participating in Plan X. If a Group C employee elects to purchase additional credited service under one of the provisions of Statute E, and agrees to do so by payroll deduction, the employee and the State may further agree that the State will pick up the contributions that the employee is required to pay for the purchase of additional credited service.

Any election to have payroll deductions for the purchase of additional credited service picked up by the State is irrevocable. Statute E provides that the State will pay the picked-up amount directly to Plan X in lieu of such payment by the employee. The payroll deductions shall continue to be picked up until the earlier

of termination of employment or the completion of all the required payments for the additional credited service. Statute E further provides that the covered employee will not have the option of choosing to receive the picked-up amounts instead of having them paid by the State to Plan X.

Accordingly, we conclude that the amounts deducted and withheld from the salary of covered employees to purchase additional credited service, pursuant to Statute E, are picked up by the State within the meaning of §414(h)(2) of the Code, and that such amounts will be treated as employer contributions and will not be included in employees' gross income for the taxable year in which such amounts are contributed.

Because we have determined, with respect to mandatory employee contributions under Statute D and additional service credit contributions under Statute E, that the picked-up amounts are to be treated as employer contributions, they are excepted from wages as defined in Code §3401(a)(12)(A) for federal income tax withholding purposes. Therefore, no withholding of federal income tax is required from the salaries of Group C employees with respect to such picked-up amounts.

With respect to ruling request 5, §415(b)(2) of the Code provides, in general, that a participant's benefit, expressed as an annual benefit, cannot exceed the lesser of: (A) $160,000 (as adjusted for cost-of-living increases), or (B) 100 percent of the participant's average compensation for the high three years. The 100 percent of compensation limit under §415(b)(2)(B) does not apply to governmental plans.

Section 415(c)(1) of the Code provides, in general, that contributions and other annual additions for a participant may not exceed the lesser of: (A) $40,000 (as adjusted for cost-of-living increases), or (B) 100 percent of the participant's compensation.

Section 1.415-3(d)(1) of the Income Tax Regulations provides, in part, 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 determining the maximum limitations under Code §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 additions described in Code §415(c). However, employee contributions that are picked up by the employer pursuant to Code §414(h)(2) are treated as employer contributions and, as such, are not annual additions to a separate defined contribution plan for purposes of §415(c). Accordingly, we conclude that the picked-up contributions under Statutes D and E will not be treated as "annual additions" for purposes of Code §415(c).

With respect to ruling request 6, §402(a) of the Code provides, in pertinent part, that the amount actually distributed to any distributee by any employees' trust described in §401(a) which is exempt from tax under §501(a) shall be taxable to such distributee in the year in which so distributed, under §72 (relating to annuities).

Revenue Ruling 67-213, 1967-2 C.B. 149, holds that where a participant's interest is transferred from a trust forming part of one qualified employees' plan to a trust forming part of another qualified plan, no taxable income will be recognized to the participant by reason of such transfer.

Therefore, with respect to ruling request 6, we conclude that amounts transferred in a direct trustee-to-trustee transfer from an employee's account in the Plan Y trust to such employee's account in the Plan X trust, in order to purchase additional credited service pursuant to Statute E, will not result in ordinary income to the employee under §72 of the Code by reason of such transfer.

These rulings are based on the assumption that Plans X and Y will be qualified under §401(a) of the Code at the time of the proposed contributions and distributions.

This ruling is based on the conditions that (a) a Group C employee who elects to purchase a particular type of past service credit may not make more than one

irrevocable election to purchase that type of service credit, and (b) a Group C employee may make more than one irrevocable election to purchase past service credit provided any subsequent election is for the purchase of a different type of the past service credit, is irrevocable, and does not alter or amend the terms and conditions of any prior election to purchase past service credit.

Proposed pick-up contributions for the purchase of additional credited service under Plan X cannot commence prior to the later of the date Statute E (as submitted to the Service in proposed form on February 28, 2003) is signed or put into effect.

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 §3121(v)(1)(B) of the Code.

This ruling is directed only to the taxpayer that requested it. Section 6110(k) of the Code provides that it may not be used or cited by others as precedent.

A copy of this ruling is being sent to your authorized representative pursuant to a power of attorney on file in this office. Should you have any questions pertaining to this ruling, you may contact **** of this office at ****.

Sincerely yours,

Donzell Littlejohn

Donzell H. Littlejohn, Acting Manager
Employee Plans Technical Group 1

Enclosures:
Deleted Copy of the Ruling Letter
Notice of Intention to Disclose, Notice 437

cc: