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Attn: **********
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Legend:

State A = **********
Plan X = **********
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Board M = **********
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Regulation N = **********
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Regulation O = **********
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Form P = **********
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Form R = **********
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Dear **********

This is in response to a ruling request submitted by your authorized representative dated September 16, 2000, as supplemented by correspondence dated December 22, 1999, July 26, 2000, July 27, 2000, August 21, 2000, August 30, 2000, September 13, 2000, November 21, 2000, December 8, 2000, and January 18, 2001, with respect to the federal income tax treatment of certain contributions to Plan X under section 414(h)(2) of the Internal Revenue Code.

The following facts and representations have been submitted on your behalf:

Plan X is a contributory retirement system established

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for teachers and administrators of public schools in State A, and is administered by Board M. Board M is comprised of five members: the commissioner of education (or his or her designee), who shall be a member ex officio and shall serve as chairman; a member appointed by the governor who shall be a retired former public school teacher within State A; two members who shall be elected by the members in or retired from the service in the system from among their number; and a fifth member chosen by the other four. Board M administers Plan X, a defined benefit program, which, for purposes of this ruling request is assumed to be qualified under section 401(a) of the Code.

The governing provisions for Plan X are statutorily promulgated by the State A legislature. In addition, Board M has established administrative rules in accord with the statutory requirements (i.e., relevant sections of State A general laws and regulations).

Plan X provides retirement, disability and survivor benefits to State A public school teachers, administrators and their families. Contributions to Plan X are mandatory for all members in service and are made by payroll deductions equal to a percentage of each member's regular compensation ranging from five percent to nine percent, depending upon the member's date of service. Payroll deductions equal to an additional two percent of each member's regular compensation over $30,000 are required.

Pursuant to chapter 32, section 22(10) of State A statutes, each employer shall pick up all of the members' contributions. That is, each governmental unit to which a system pertains shall assume and pay the contributions which would be payable by the employees as members. Such contributions, although designated as employee contributions, will be paid by the applicable government unit in lieu of contributions by the employee. Further, no employee will have the option of choosing to receive such contributed amounts directly instead of having them paid by the employing governmental unit. The contributions so assumed shall be treated as employer contributions in determining tax treatment under the Internal Revenue Code. "Creditable service" is defined as time that an individual has worked as a teacher, administrator or other State A public employee, and for which the individual has paid or transferred retirement contributions to Plan X, and also

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includes certain military service. Creditable service is earned by all teachers and administrators who are employed on at least a half-time basis and who are contributing members of Plan X. Employees automatically receive credit for regular State A public school teaching, authorized leave of absence, and active military service during membership. Governmental unit, as defined in State A statutes, is State A, or any political subdivision thereof, except that a teacher who is a member of, or eligible for membership in Plan X shall, for purposes of membership and the requirements in connection therewith, be deemed to be employed by the same governmental unit.

Additionally, employees may choose to pay an additional amount into the fund, either in one sum or installments, for the purpose of providing an additional annuity, subject to limitations and such terms and conditions as Board M may prescribe.

In addition to creditable service received as a result of mandatory contributions to Plan X, a member pursuant to State A statutes, may also purchase credit for prior substitute teaching, teaching in an out-of-state public school, certain non-public teaching, other State A public service, active military service and maternity leave. If a member withdrew retirement account amounts from Plan X or any other State A contributory retirement system, the member may also receive creditable service upon repaying the amount withdrawn plus interest prior to the date of retirement.

The cost of purchasing past service is based on what the member would have paid in contributions during that period (plus interest to date) or what the member actually paid and withdrew (plus interest to date). All forms of creditable service must be purchased prior to the member's date of retirement.

Pursuant to State A statutes, Board M has authority to promulgate regulations and to establish terms and conditions for the purchase of prior service credit. Board M has adopted Regulations N and 0 for the purpose of providing a pick-up of employee contributions under section 414(h) (2) of the Code for contributions that are made for the purpose of purchasing service credit or service buybacks ("Regulation N"), or to provide a pick-up of

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employee contributions for up to five years of accelerated contributions ("Regulation O") that are made pursuant to the alternative superannuation retirement benefit provisions of section 104 of chapter 32 of State A statutes.

The purpose of Regulation N is to provide a pick-up of employee contributions for contributions that are made for the purpose of purchasing service credit or service buybacks. Members in service who elect to purchase or buyback service under Regulation N through installments in accordance with a schedule established by Board M may elect to do so through a binding, irrevocable payroll reduction authorization (Form P). Under Regulation N, a member in service, having executed a binding irrevocable payroll reduction authorization with respect to any such contributions, shall not be entitled to any option of choosing to receive the contributed amounts directly instead of having them paid by that employer to Board M. Such contributions, although designated as employee contributions, will be paid by the employer in lieu of contributions by the employee. The contributions so assumed shall be paid by the employer in lieu of contributions by the employee, and shall be treated as tax-deferred employer "pick-up" contributions pursuant to section 414(h)(2) of the Code, subject to a favorable letter ruling by the Internal Revenue Service ("Service"). Members in service may elect to pay all or part of any service purchase or buyback through such payroll reduction. The amounts and the duration of the reduction shall be specified on Form P as prescribed by Board M and the amounts and duration shall be irrevocable and binding once made. No prepayment of amounts covered by the authorization is permitted. However, nothing in Regulation N shall prevent a member from paying any amounts not covered by the authorization with after-tax dollars. No such payroll reduction shall begin unless and until the member in service executes the payroll reduction authorization Form P as prescribed by Board M. The employer shall continue such reductions for the number of weeks or months specified on the form and shall treat these reductions as picked-up contributions. Such reductions will cease only after the authorization has expired by its terms or upon the member's death or termination of employment. Payroll reductions and installment agreements shall last no longer than five years.

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The purpose of Regulation 0 is to provide a pick-up of employee contributions for retirement plus accelerated contributions that are made pursuant to the alternative superannuation retirement benefits provisions of State A statutes. Members who have elected to participate in the alternative superannuation program may also elect to accelerate their contributions to this program. Unless paid directly to Plan X, these accelerated contributions must be made in accordance with a schedule established by Board M through a binding, irrevocable payroll reduction authorization (Form R). A member in service, having executed a binding, irrevocable payroll reduction authorization with respect to any such contributions, shall not be entitled to any option of choosing to receive the contribution amounts directly instead of having them paid by the employer to Board M. Such contributions shall be remitted to Board M in the same manner as all other contributions made thereunder and shall be credited to the member's annuity savings account. Such contributions, although designated as employee contributions, will be paid by the employer in lieu of contributions by the employee. The contributions so assumed shall be paid by the employer in lieu of contributions by the employee. The contributions so assumed shall be treated as tax-deferred employer pick-up contributions pursuant to section 414(h)(2) of the Code, subject to a favorable letter ruling the Service. Members in service may elect to pay all or part of the accelerated contributions through such payroll reduction. The amounts and the duration of the reduction shall be specified on Form R as prescribed by Board M and the amounts and duration shall be irrevocable and binding once made. Prepayment of amounts covered by the authorization is not permitted. However, nothing shall prevent a member from paying any amounts not covered by the authorization with after-tax dollars. No such payroll reduction shall begin unless and until the member in service executes the payroll reduction authorization described as Form R prescribed by Board M. The employer shall continue to make such reductions for the period specified on the form and shall treat these reductions as picked-up contributions. Such reductions shall cease only after the authorization has expired by its terms or upon the member's death or termination of employment. Payroll reductions and installment agreements shall last no longer than five years.

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Members in service may elect to purchase or buyback service through installments under an elective binding, irrevocable payroll reduction authorization. Form P, as used in conjunction with Regulation N provides, in pertinent part, that a member in service of Board M, who is entitled under State A statutes to buyback creditable service through the deposit of additional contributions, desires to make those contributions through payroll reductions, and directs the employer to make specific dollar-amount reductions from his/her salary each pay period for such purpose, beginning with the pay period immediately after the employer receives Form P and continuing for a specific length of time.

With respect to the reduction, Form P states that the member understands that the authorization is irrevocable and has a maximum duration of five years; that after the execution of the authorization, there is no option of receiving the reduction amounts directly instead of having them paid by the employer to Board M; that the contributions are being picked-up by the employer and, as a result, although designated as employee contributions, they are being paid directly to Board M in lieu of contributions by the **member**; that more than one irrevocable, binding payroll reduction authorization may be made so long as a subsequent reduction authorization does not amend the outstanding binding irrevocable authorization; that while the agreement is in effect, with respect to the buyback or service being purchased by the contribution designated on Form P, Board M will only accept payment from the employer and not directly from the member; that if the members terminates employment or dies prior to completion of the installment payments, the authorization shall expire and that the member or survivor's right to finish the payment, or whether Board M will pro-rate credit, is governed by State A statute; that the authorization Form P is not effective until signed by the member and an authorized representative of the member's employer; and, that 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.

Form R, as used in conjunction with Regulation 0, provides that a member in service with Board M may elect to participate in the alternative superanuation retirement

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program by paying contributions at a rate of 11 percent of all regular compensation. Form R also provides that a member may elect to pay accelerated contributions and that such accelerated contributions can be made through payroll reductions. Form R directs the employer to make specified reductions from the member's salary per pay period for the purpose of receiving the superannuation retirement benefit and to remit such contributions to Board M. The reductions will begin with the pay period immediately after the employer receives Form R and continuing for a specified period of time.

With respect to the reduction, Form R provides that the payroll reduction authorization is irrevocable; that the maximum duration of the authorization is five years; that after execution of Form R the member does not have the option of receiving the reduction amounts directly instead of having them paid by the employer to Board M; that the contributions are being picked up by the employer and, as a result, although designated as employee contributions, are being paid directly to Board M in lieu of contributions by the member; that the member can make more than one irrevocable, binding payroll reduction authorization so long as subsequent reduction authorizations do not amend the outstanding binding, irrevocable authorization; that while Form R is in effect with respect to the accelerated contributions, Board M will only accept payments from the employer and not directly from the member; that if a member terminated employment with the employer or dies before completion of the installment payments, the authorization shall expire; that Form R is not effective until signed by the member and an authorized representative of the employer; and that 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.

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

(1) that the amount deducted by employers 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) pay the regular cost and the accelerated cost of the alternative

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superannuation retirement benefit program, qualify as contributions that are picked-up by the employer under section 41(h)(2) of the Code, and,

(2) that the picked-up contributions will not be treated as "annual additions" for purposes of section 415(c) of the Code.

With respect to ruling requests one, 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-l C.B. 255 and Revenue Ruling 81-36, 1981-l 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

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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.

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. If not, the designated employee contributions being paid by the employer are actually employee contributions paid by the employee and recharacterized at a later date. Thus, 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.

With respect to the pick up of employee contributions for the purpose of purchasing service credit or service buybacks, Regulation N satisfies the criteria set forth in Revenue Ruling 81-35 and Revenue Ruling 81-36 by providing that the employer will make contributions on behalf of members participating in Plan X in lieu of contributions by the members and that no member will have the option of receiving the contributions directly instead of having them contributed to Plan X. Further, Form P is irrevocable and 'provides that the contributions are being picked up by the employer and paid directly by the employer to Board M, as administrator of Plan X, and that the member does not have the option of receiving the contributed amounts directly instead of having them paid to Plan X. The pick-up of employee contributions to purchase service credit or service buybacks is not effective until Form R is signed by the member and an authorized representative of the employer. The pick-up of employee contributions to purchase service credit or service buy backs 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.

With respect to the pick-up of employee contributions for retirement plus accelerated contributions that are made pursuant to the alternative superannuation retirement benefit provisions, Regulation 0 satisfies the criteria set

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forth in Revenue Ruling 81-35 and Revenue Ruling 81-36 by providing that the contributions, although designated as employee contributions, will be paid by the employer in lieu of contributions by the member and that the member shall not have any option of choosing to receive the contribution amounts directly instead of having them paid to Plan X. Further, Form R is irrevocable and provides that the contributions, although designated as employee contributions, are being paid directly to Board M, as administrator of Plan X, in lieu of contributions by the members and that the members do not have the option of receiving the amounts directly instead of having them paid to Plan X. Form R is not effective until it is signed by both the member and an authorized representative of the employer. Additionally, 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.

Accordingly, we conclude with respect to ruling request one that the amount deducted by employers 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) pay the regular cost and the accelerated cost of the alternative superannuation retirement benefit program, qualify as contributions that are picked-up by the employer under section 414(h) (2) of the Code.

With respect to ruling request two, section 1.415-3(d) (1) of the Income Tax Regulations 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 applying the limitations on benefits described in section 415 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 Code section 415(c). Employee contributions that are picked up by employers 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 Code section 415(c).

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Accordingly, with respect to ruling request two, we conclude that picked-up contributions under the facts proposed will not be treated as annual additions for purposes of section 415(c) of the Code.

Our conclusions with respect to ruling request one apply only if the effective date for the commencement of any proposed pick up as specified in the final resolutions can not be any earlier than the later of the date the final resolutions are signed or the date they are put into effect.

These rulings are based upon Regulation N and Regulation 0 and Form P and Form R as set forth in your letters dated August 21, 2000 and December 8, 2000.

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.

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.

By letter dated November 21, 2000, you, through your authorized representative, withdrew that part of the above ruling requests relating to the inclusion of accrued sick pay as compensation available for an employer pick-up. Therefore, our conclusions with respect to ruling requests one, and two do not apply with respect to the pick-up of accrued sick pay as compensation.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited by others as precedent.

These rulings express no opinion as to the impact of these proposed transactions upon the qualified, nor the continuing qualified status of the plan involved. These rulings are based on the assumption that Plan X will be qualified under section 401(a) of the Code at all relevant

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times.

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 adopted and 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 a power of attorney on file in this office.

Sincerely yours,

(signed) JOYCE E. FLOYD

Joyce E. Floyd, Manager
Employee Plans Technical Group 2
Tax Exempt and Government
Entities Division

Enclosures:
Deleted Copy of this Letter
Notice of Intention to Disclose