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Plan X = **********
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Dear M**********

This is in response to a ruling request submitted by your authorized representative dated September 8, 2000, as supplemented by correspondence dated November 28, 2000, January 25, March 26, and April 30, 2001 with respect to the federal income tax treatment of certain contributions

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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 for employees of City A, and its auxiliary agencies, Agencies A, B, C and D. Plan X is administered by Board M. Board M is comprised of five members: the city auditor (ex officio), a second member appointed by the mayor of City A, two members elected by the members of Plan X in or retired from service, and a member chosen by the other four who is not an employee, retiree, or official of the governmental unit. Board M administers Plan X, a defined benefit program which includes a mandatory employee contribution feature and certain elective contribution features, and 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. The Plan X documents are the relevant sections of the State A General Laws and the relevant portions of the Code of State A Regulations, as promulgated by Commission C, an agency of State A which has general oversight over numerous retirement board functions.

Plan X provides retirement, disability and survivor benefits to all employees of City A and its auxiliary agencies, including, but not limited to, all city employees, public safety employees, emergency medical service employees, clerical and administrative employees, city attorneys and staff, highway employees, all employees of Agencies A, B, C and D, and the approximately 5,000 teachers in the public schools of City A.

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 for members who joined Plan X after January 1, 1979.

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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.

The calculation of benefits is based upon a formula that includes a creditable service, age at retirement, and average annual rate of regular compensation for a member's highest compensated three consecutive years of service. "Creditable service" is defined as time that an individual has worked as an employee of City A or its auxiliary agencies, or employment which included membership of any public State A retirement system, and for which the individual has paid or transferred retirement contributions to Plan X, and also includes certain military service. Creditable service is earned by employees who are employed on at least a half-time basis and who are contributing members of Plan X. Employees automatically receive credit for regular employment for City A or its auxiliary agencies, authorized leave of absence, and active military service during membership.

In addition to creditable service received as a result of mandatory contributions to Plan X, teachers in City A may also purchase credit for prior substitute teaching, teaching in an out-of-state public school, and certain non-public teaching, while all employees (including teachers) of City A or its auxiliary agencies may purchase credit for other State A public service, and active military service. If a member withdrew retirement account amounts from Plan X, 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 a member would have paid in contributions during that period (plus interest to date) or what the member actually paid

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and withdrew (plus interest to date). All forms of creditable service must be purchased prior to the member's date of retirement. Types of service eligible for purchase by members are: (1) out-of-state public school teaching; (2) overseas dependent school teaching service; (3) non-public school teaching service (in State A or out-of-state); (4) State A public school substitute, temporary or part-time teaching or tutoring service; (5) State A public service; (6) active military service; (7) maternity; and, (8) superannuation retirement.

Recently enacted State A legislation provides generally, with respect to maternity leave, that a teacher who is a member of Plan X who was on maternity leave prior to 1975, and who has completed ten or more years of membership service, may purchase service credit for the period of maternity leave, up to four years.

The legislation further establishes an alternative superannuation retirement benefit program ("program") for teachers who are members of Plan X. This provides an enhanced retirement benefit for qualified members. Participation in the program is mandatory for teachers hired on or after July 1, 2001, and such members will be required to make contributions equal to 11 percent of regular compensation. Any teacher, who is a member of Plan X before July 1, 2001, may elect to participate in the program on or after January 1, 2001 and before July 1, 2001. Further, any member of a contributory retirement system who transfers into Plan X as a teacher may elect to participate in the program within 180 days of establishing membership in Plan X. Any election to participate in the program is irrevocable. A member who elects to participate shall be required to make a minimum of five years of retirement contributions at the rate of 11 percent of regular compensation. As a separate matter, if a member elects to participate in the program, the member may also elect to accelerate payment of the five year minimum of the 11 percent contributions. These payments could be made from all actual salary or compensation.

Pursuant to State A statutes, Board M has authority to propose rules governing the employer pick-up of employee contributions. In this regard, (final) Regulations N and 0 were adopted by Board M on September 14, 2000 for the purpose of providing a pick-up of employee contributions

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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 employee contributions for up to five years of accelerated contributions ("Regulation O") that are made pursuant to the alternative superannuation retirement benefit program of section 114 of chapter 32 of State A statutes.

Under Regulation N, members in service who elect to purchase or buy back service through installments, in accordance with a schedule established by Board M, may elect to do so through executing Proposed Form P, a binding, irrevocable payroll reduction authorization. A member in service, having executed an authorization, with respect to any such "picked-up" contributions, shall not be entitled to any option of choosing to receive the contributed amounts directly instead of having them paid by the employer to Board M. Such contributions shall be remitted to Board M pursuant to State A statutes 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 receipt of a favorable ruling by the Internal Revenue Service ("Service").

Further, under Regulation N, members in service may elect to pay all or part of any service purchase or buyback through such payroll reduction. The amounts of the payroll reduction and the duration of the reduction shall be specified on Proposed Form P and the amounts and duration shall be irrevocable and binding once made. Prepayment of amounts covered by the authorization is not permitted. However, a member may pay amounts not covered by the authorization with after-tax dollars. No such payroll reduction shall begin unless and until the member in service executes Proposed Form P. Board M will send Proposed Form P to the treasurer or other disbursing officer of the employer. After receiving the authorization, the treasurer or other disbursing officer of

each employer shall add such contributions to the contributions deducted from the member's regular compensation each payday. The employer shall continue to make such reductions for the number of weeks or months specified on Proposed Form P and shall treat these reductions as picked-up contributions. All such payroll reductions, including the amounts and the duration specified, shall be binding and irrevocable upon the member's execution of Proposed Form P. Notwithstanding the above provisions of Regulation N, Regulation N provides that such reductions will cease only after the authorization has expired by its terms or upon the member's death or the termination of the member's employment.

In the event of the member's death, an eligible beneficiary or spouse having a right to a member-survivor allowance may pay the remaining amount owed in one lump sum using after-tax dollars. If the entire remaining amount is not paid, the beneficiary or spouse eligible for a member-survivor allowance shall be entitled to credit for that proportion of the additional contribution made prior to the member's death.

In the event of the termination of the member's employment, the member shall have the right to pay the remaining amount owed in one lump sum (using after-tax dollars) during the same calendar year and within six months of the date of termination or before the date of retirement, whichever occurs earlier. If the member does not pay the entire remaining amount and the member retires, the member shall be entitled to credit for that proportion of the additional contributions actually made. After-tax contributions (in the case of the member's death or termination of employment) shall only be received to the extent allowed by section 415 of the Code. The payroll reductions and installment agreements of Regulation N shall last no longer than five years.

Proposed Form P relates to the irrevocable payroll reduction authorization for the purpose of purchasing service credits or service buybacks through the deposit of additional contributions. Pursuant to Proposed Form P, a member directs his/her employer to make reductions from salary per pay period (for the purpose of purchasing or buying back additional creditable service) and to remit the reduction amounts to Board M together with other

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statutorily authorized contributions of specific amounts per pay period beginning with the pay period immediately after the employer receives Proposed Form P and continuing for a specific number of weeks or months. By signing Proposed Form P, the member acknowledges that: the payroll reduction authorization is irrevocable; the maximum duration of the authorization is five years; after the execution of the authorization the member has no option of receiving the reduction amounts directly instead of having them paid by the employer to Board M; 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; the member may make more than one irrevocable binding payroll reduction authorization so long as a subsequent reduction authorization does not amend the binding, irrevocable authorization; while the agreement is in effect, that with respect to the buyback or service being purchased by the contributions designated therein, Board M will only accept payment from the employer and not directly from the member; if the member terminates employment with the employer or dies prior to completion of the installment payments, the binding, irrevocable payroll reduction authorization shall expire and that the right (or survivor's right) to finish the payment, or whether Board M will pro-rate, is governed by Regulation N; and, the payroll reduction authorization is not effective until signed by the member and by an authorized representative of the employer, and the pick-up is only applicable to contributions to the extent the contribution is a reduction from compensation earned for services after the effective date of the pick-up.

The purpose of Regulation 0 is to provide a pick-up of employee contributions under section 414(h) (2) of the Code for accelerated contributions that are made pursuant to the alternative supernannuation retirement benefits program of State A statutes, and applies only to teachers who are active members of Plan X who elect to participate in the enhanced benefit program. Such electing teachers may also elect to accelerate their contributions under Regulation 0. Unless paid directly to the Plan X, these accelerated contributions must be made in accordance with a schedule established by Board M through a binding, irrevocable payroll reduction authorization (Proposed Form R, described in detail below).

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Under Regulation 0, teachers who are members in service of Plan X, having executed Proposed Form R, 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 in stead 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 by the Service.

Regulation 0 also provides that teachers who are members in service of Plan X may elect to pay all or part of the accelerated contributions through such payroll reduction. The amounts of the payroll reduction and the duration of the reduction shall be specified on Proposed Form R, the authorization form 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 within Regulation 0 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 on Proposed Form R as prescribed by Board M. Board M will send Proposed Form R to the treasurer or other disbursing officer of the employer. After receiving Proposed Form R, the binding irrevocable payroll reduction authorization, the treasurer or other disbursing officer of each employer shall add such contributions to the contributions deducted from the member's regular compensation each pay day pursuant to State A statute. The employer shall continue to make such reductions for the period specified on Proposed Form R and shall treat these reductions as picked-up contributions. All such payroll reductions, including the amounts and the duration specified, shall be binding and irrevocable upon the member's execution of the prescribed Proposed Form R.

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Notwithstanding the above, Regulation N provides that such reductions will cease only after the authorization has expired by its terms or upon the member's death or termination of employment. Upon the member's death, an eligible beneficiary or spouse having a right to a member-survivor allowance shall pay the remaining amount owed in one lump sum (using after-tax dollars). If the entire remaining amount cannot be paid due to Code section 415 limitations, the beneficiary or spouse eligible for a member-survivor allowance shall be entitled to the benefit available under Regulation 0 in proportion to the accelerated contributions actually made. In no event shall the member receive a return of the payroll reductions from compensation made hereunder, except as specifically provided, as a refund together with all other contributions as provided in State A statutes, or as provided in Regulation 0 for the benefit of a member who retires or terminates without completing thirty years of creditable service.

Proposed Form R relates to the irrevocable payroll reduction authorization for the teachers alternative retirement program accelerated contributions and provides that the member is entitled to participate in the alternative superannuation retirement program by paying contributions at the rate of 11 per cent on all regular compensation and that he/she has elected to do so. Further, it provides that the member is entitled to elect to pay accelerated contributions and that the member desires to do so through accelerated contributions through payroll reductions. The member directs the employer to make specified reductions from salary per pay period for the purpose of receiving the alternative superannuation retirement benefit and to remit them to Board M together with other statutorily specified contributions, beginning with the pay period immediately after the employer receives Proposed Form R and continuing for a specified number of weeks or months for a stated total dollar amount. By signing Proposed Form R, the member acknowledges that: the payroll reduction authorization is irrevocable; the maximum duration of the authorization is five years; after the execution of the authorization the member has no option of receiving the reduction amounts directly instead of having them paid by the employer to Board M; 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; the member may make more than one irrevocable binding payroll reduction authorization so long as a subsequent reduction authorization does not amend the binding, irrevocable authorization; while the agreement is in effect, that with respect to the accelerated contributions designated therein, Board M will only accept payment from the employer and not directly from the member; if the member terminates employment with the employer or dies prior to completion of the installment payments, the binding, irrevocable payroll reduction authorization shall expire and that the right (or survivor's right) to finish the payment, or whether Board M will pro-rate, is governed by Regulation 0; and, the payroll reduction authorization is not effective until singed by the member and by an authorized representative of the employer, and 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 superannuation retirement benefit program, qualify as contributions that are picked-up by the employer under section 414(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 request 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.

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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 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

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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, Proposed 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 Proposed 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 accelerated contributions that are made pursuant to the alternative superannuation retirement benefit provisions, Regulation 0 satisfies the criteria set 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, Proposed 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. Proposed 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

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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).

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 regulations can not be any earlier than the later of the date the final regulations are signed or the date they are put into effect.

These rulings are based upon Regulation N and Regulation 0 as adopted by Board M on September 14, 2000 and submitted to us under a letter dated December 13, 2000, and Proposed Form P (as revised) and Proposed Form R (as

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revised) as set forth in your letter dated April 30, 2001.

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 28, 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. In addition, our conclusions with respect to the pick up of contributions to redeposit amounts previously withdrawn, purchase additional service credit, and pay the regular cost and the accelerated cost of the alternative superannuation retirement benefit program do not apply to the purchase with after-tax dollars of these benefits by a member or a beneficiary upon the death of the member in the event the member terminates employment or dies before paying the remaining amount owed to purchase the additional service credit or the alternative superannuation benefit.

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 times.

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

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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

cc: