

MEMORANDUM OF LAW

DATE: June 27, 1988

TO: D. Cruz Gonzalez, Risk Management Director

FROM: City Attorney

SUBJECT: Tax Consequences of Retirement Buy Back

In a memorandum dated June 2, 1988, you asked if the amounts designated by eligible employees in the Management Benefit Plan to purchase past creditable years in The City of San Diego's retirement system are tax exempt to the same extent as amounts set aside to offset employee contributions in the current year.

Section 414(h) of the Internal Revenue Code provides as follows:

(h) Tax treatment of certain contributions.- (1) In general.- Effective with respect to taxable years beginning after December 31, 1973, for purposes of this title, any amount contributed-(A) to an employees' trust described in section 401(a), or (B) under a plan described in section 403(a), shall not be treated as having been made by the employer if it is designated as an employee contribution. (2) Designation by units of government.- For purposes of paragraph (1), in the case of any plan established by the government of any State or political subdivision thereof, or by an agency or instrumentality of any of the foregoing, where the contributions of employing units are designated as employee contributions but where any employing unit picks up the contributions, the contributions so picked up shall be treated as employer contribution.

The City of San Diego's retirement system is a trust described in section 401(a). Section 414(h) permits the City to treat contributions made on behalf of an employee to the system as the City's contributions and therefore not subject to income tax until receipt by the employee after retirement. *Howell v. United States*, 775 F.2d 887 (7th Cir. 1985). Section 414(h) makes no distinction between contributions for the current year and contributions for past years as long as the amount set aside

is treated as the employer's contribution. The key factor is that the amount used to either buy back creditable years in the retirement system or to provide for an offset in the current year must be treated as City contributions and not credited to the employee's account as employee contributions. Amounts designated by an eligible employee in the Management Benefit Plan used to purchase prior years of creditable service in The City of San Diego's retirement system will then receive the same tax treatment as amounts designated to offset the employee's contributions in the current year.

JOHN W. WITT, City Attorney

By

John M. Kaheny

Deputy City Attorney

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ML-88-63