MEMORANDUM OF LAW

DATE: January 25, 1990

TO: Lawrence B. Grissom, Retirement Administrator
FROM: City Attorney
SUBJECT: Internal Revenue Code Section 415 and its Affect on Retirement "Buy Back" Options

INTRODUCTION

You have indicated that the San Diego City Employees' Retirement System (CERS) is currently offering a variety of "buy back" programs to City employees. Your question, expressed in a November 21, 1989 memorandum, is whether or not these "buy back" programs impact the annual limit on benefits set forth in Internal Revenue Code (IRC) section 415(e).

As a point of initial clarification, the term "buy back" as used in your memorandum refers to the purchase by an unclassified employee of previous years of creditable service in CERS during which the employee was not a member of CERS but was eligible for membership. It also refers to an eligible employee's opportunity to upgrade years of creditable service in the 1981 Pension Plan to the higher benefit level of CERS. For the purpose of this memorandum, unless otherwise expressly indicated, the term "buy back" does not refer to repayments of withdrawn contributions by a reemployed individual who returns to City employment and reinvests withdrawn contributions in CERS to repurchase years of creditable service pursuant to San Diego Municipal Code sections 24.0208 and 24.0310 or to an employee who repurchases years of creditable service covering a period of approved leave of absence pursuant to San Diego Municipal Code section 24.0313.

Employees who elect to participate in the "buy back" program have several alternate methods of payment available. They may pay in a lump sum; by installment payments which may, depending upon the amount, range from a few months to several years in duration; or they may defer payment until retirement and pay a lump sum, possibly by utilizing Supplemental Pension Savings Plans (SPSP/SPSP-M) funds. In addition, an eligible unclassified employee may designate a portion of the employee's Management Benefits Plan (MBP) allocation for "buy back" payments.

BACKGROUND

The City of San Diego currently offers eligible employees a variety of tax qualified pension and retirement plans (pension plans) in addition to an unqualified IRC section 457 deferred

compensation plan. Prior to 1982 CERS was the City's sole qualified pension plan. CERS, a defined benefit plan, sets forth different benefit systems for Legislative, Safety and General members. Contribution rates under CERS vary according to the employees' age, entry level and system. When The City of San Diego withdrew from the Social Security System on December 31, 1981, it replaced that program, in part, with a qualified defined contribution plan called the Supplemental Pension Savings Plan (SPSP). This Plan was offered only to employees in those classifications previously covered by the Social Security System. Safety employees in the Police and Fire Departments are not eligible for participation in SPSP because those classifications were never covered by the Social Security System. They do, however, receive a higher benefit level in CERS.

On July 1, 1985, The City of San Diego adopted an IRC section 401(k) Plan. The City's 401(k) Plan, a qualified defined contribution plan, was adopted primarily to permit City employees to make tax deferred elections to a qualified pension plan from the City's two IRC section 125 plans, the Flexible Benefits Plan (FBP) and the Management Benefits Plan (MBP). Contributions to the IRC section 401(k) Plan can also be made by payroll deduction (i.e., salary reduction). After May 6, 1986, state and local government agencies are no longer authorized to establish IRC section 401(k) plans; however, existing plans of local agencies, such as The City of San Diego, may continue in effect under a special transition rule. IRC section 401(k)(4)(A); 26 C.F.R. 1.401(k)-1(h)(4).

In 1986 The City of San Diego adopted the Supplemental Pension Savings Plan-Medicare (SPSP-M) plan covering eligible employees hired after June 30, 1986, who were required to pay the medicare surcharge tax by section 13205 of the Budget and Reconciliation Act. (Public Law 99-272, 100 Stats. 313 (1986).) SPSP-M, a qualified defined contribution plan, is similar to SPSP except for a lower voluntary employee/employer contribution rate.

The City of San Diego now finds itself in the unique situation of having three tax qualified pension plans (CERS, SPSP/SPSP-M and the 401(k)) and one unqualified IRC section 457 deferred compensation plan. As previously indicated, the SPSP/SPSP-M and 401(k) are all defined contribution plans. CERS is a defined benefit plan. The term defined contribution plan is defined in IRC section 414(i) as a "plan which provides for an individual account for each participant and for benefits based solely on the amount contributed to the participant's account, and any income, expenses, gains and loses, and any forfeitures of

accounts of other participants which may be allocated to such participant's account." IRC section 414(j) states simply that a defined benefit plan is any plan which is not a defined contribution plan.

All qualified pension plans are subject to the maximum limit on benefits rules found in IRC section 415. These limits are commonly referred to as safe harbor limitations. Generally speaking, a defined benefit plan cannot offer benefits based solely on employer contributions which will result in an annual benefit upon retirement of more than $90,000 or one hundred percent (100%) of the employee's average compensation for his or her highest three years, whichever is less. Annual contributions to a defined contribution plan are set at the lesser of $30,000 or 25% of compensation as defined in IRC section 414(s). There is a special rule in IRC section 415(e) for employers who offer both defined benefit and defined contribution plans to their employees. That rule, discussed more freely below, sets forth a complicated formula for determining the combined limit. The City's unqualified IRC section 457 deferred compensation plan does not directly affect the maximum limit on benefits set forth in IRC section 415 but current contributions to that plan may not be included in the annual compensation figure used as a basis for the plan formulas. IRC section 457(c) does place a $7,500 combined contribution limit on an employee who participates in both a IRC section 401(k) plan and a section 457 deferred compensation plan. ╒During a participant's last three taxable years ending before the participant attains normal retirement age, the plan ceiling is raised to $15,000.σ

The Wyatt Company, the City's consultant for the SPSP/SPSP-M and 401(k) plans devised safe harbor limitations for the City's qualified pension plans based on the formula for combined plans found in IRC section 415(e). These safe harbor limitations take into effect the employee's after tax contributions and the City's tax deferred contributions to the employee's various accounts. They do not reflect the voluntary contributions from MBP for retirement "buy back" or "retirement offset" or an employee's voluntary after tax contributions for retirement "buy back."

A summary of the safe harbor contribution limits according to the employee's participation in CERS and SPSP/SPSP-M is as follows:

	Plan Coverage Status		Remaining 415(e) Limit Available For 401(k)	
Employee Group	CERS	SPSP/SPSP-M	SPSP	SPSP-M

Legislative Ret. Members	X	X	2.0%	4.0%
General CERS Members	X	X	3.0%	5.0%
Safety Members	X	N/A	12.0%	12.0%
Unclassified/Unrepresented	X	X	1.5%	3.5%
Employees not in CERS	N/A	X	8.0%	10.0%

The above limits are based on a maximum participation level of 7.% of compensation for SPSP and 6.05% of compensation for SPSP-M where applicable. Any reduction of the employee's voluntary contributions to the mandatory minimum level of 3% for SPSP and SPSP-M will automatically increase the employee's safe harbor limitations. Additionally, actual individual limits may be slightly greater than these safe harbor limitations, depending upon each employees' age, salary and plan coverage.

ANALYSIS

Pension plans which violate the limit on benefits rules found in IRC section 415 risk plan disqualification. As in the case of The City of San Diego, if an employer maintains more than one plan, the Treasury Regulations set forth at 26 C.F.R. 1.415-9(b)(3) prescribe the order in which pension plans will be disqualified. Plan disqualification will cause the City's Plans to lose the following advantages of qualified plans:

1. Participant is not taxed on the earnings on his/her contributions while they remain on the plan.
2. Participant is not taxed on his/her share of contributions made by the employer and the earnings on those contributions while they remain on the plan.
3. Participant or his/her beneficiary is entitled to special taxed treatment on distributions in certain circumstances.
4. In accordance with IRC section 414(h) employee contributions may be "picked up" by the employer.

Plan qualification is therefore of critical importance to The City of San Diego and its employees.

The IRC describes certain specific conditions under which a rehired employee may "buy back" years of participation when the employee is attempting to restore retirement benefits previously lost upon termination of employment. Those conditions are set forth in IRC section 411 and at 29 C.F.R. 1.411(a)-7. They relate to the minimum vesting standards imposed upon private sector pension plans by the Employment Retirement Income Security Act of 1974 (ERISA). These "buy back" payments are exempt from

the current year IRC section 415 limits but do count towards the limit for the repurchased year. As a governmental plan, CERS is exempt from the application of the mandatory vesting standards pursuant to IRC section 411(e)(1)(A). We do believe, however, that this exemption does not prohibit The City of San Diego from voluntarily offering rehired employees the benefits of IRC section 411. In other words, rehired City employee may restore previous years of service in CERS through a "buy back" program to the extent that the repurchase is authorized by IRC sections 411 and 415. These rules also apply to employees returning from approved leave of absence.

IRC section 415(b) states that the annual retirement benefit based solely on employer tax deferred contributions cannot exceed the statutory limit of $90,000 or one hundred percent (100%) of the employee's average compensation for his/her highest three years whichever is less. Of course, any "offset," "buy back" or "repurchase" by an employee through an allocation of funds from the employee's MBP account affects this maximum annual benefit limit for CERS because it is in fact an employer tax deferred contribution. The combined defined benefit plan and defined contribution plan formula of IRC section 415(e) specifically incorporates this annual benefit level formula. Therefore, there can be no doubt that any "buy back" or "offset" contributions allocated from an employee's MBP account directly impacts the IRC section 415(e) combined formula and therefore affects the employee's safe harbor limitations.

Unfortunately, the IRC does not provide special treatment for the type of "buy backs" described in your memorandum. We are seriously concerned over the impact IRC section 415 has on voluntary additional employee after tax contributions under such a program. Both the consultant for CERS, (Buck Consultants, Inc.) and the consultant for the SPSP, SPSP-M and 401(k) plans (The Wyatt Company) have expressed concerns that these voluntary employee after tax contributions may be required to be calculated into the IRC section 415(e) combined formula for the year in which the contribution is made. In other words, they believe that the amounts contributed voluntarily by an employee with after tax contributions become annual additions for the current year.

IRC section 415(e) states, in part, as follows:

> (e) Limitation in case of defined benefit plan and defined contribution plan for same employee.
>
> (1) In general. -In any case in

which an individual is a participant in both a defined benefit plan and a defined contribution plan maintained by the same employer, the sum of the defined benefit plan fraction and the defined contribution plan fraction for any year may not exceed 1.0.

(2) Defined benefit plan fraction. -For purposes of this subsection, the defined benefit plan fraction for any year is a

fraction-(A) the numerator of which is the projected annual benefit of the participant under the plan (determined as of the close of the year), and

(B) the denominator of which is the lesser

of-(i) the product of 1.25, multiplied by the dollar limitation in effect under subsection (b)(1)(A) for such year, or

(ii) the product

of-(I) 1.4, multiplied by

(II) the amount which may be taken into account under subsection (b)(1)(B) with respect to such individual under the plan for such year.

(3) Defined contribution plan fraction. -For purposes of this subsection, the defined contribution plan fraction for any year is a

fraction-(A) the numerator of which is the sum of the annual additions to the participant's account as of the close of the year, and

(B) the denominator of which is the sum of the lesser of the following amounts determined for such year and for each prior year of service with the employer:

(i) the product of 1.25 multiplied by the dollar limitation in effect under subsection (c)(1)(A) for such year (determined without regard to subsection (c)(6)), or

(ii) the product

of-(I) 1.4, multiplied

by-(II) the amount which may be taken into account under subsection (c)(1)(B)

> (or subsection (c)(7), if applicable) with respect to such individual under such plan for such year (emphasis added).
>
> . . . .

A key factor that complicates our analysis is the requirement in the proposed "buy back" program that a prorated portion of the employee contributions allocated to the "buy back" program be treated as City (employer) contributions to the retirement fund and not as an addition to the employee's separate account. CERS maintains a separate account for each participant which reflects the employee's after tax contributions and this amount is reflected on each employee's bi-weekly pay stub. It is envisioned that employee voluntary contributions to the current "buy back" program representing amounts which would have been the City's contributions had the employee been a member of the system will not be allocated to that account. This procedure is

contrary to the usual method of allocating employee after tax contributions to a defined benefit plan. The IRC contemplates that the defined benefit plan will provide a separate account for all of the employee's after tax contributions in order to take advantage of the separate contract rule found in IRC section 72(d). This rule enables the employee to withdraw his or her contributions plus interest earned on those contributions upon termination prior to retirement regardless of vesting status. The employer's tax deferred contributions to the retirement fund on behalf of the terminated employee under these circumstances remain in the fund to be used for future retirement fund trust purposes. When the employee receives benefits upon retirement, the distribution consisting of the employee's after tax contributions are not subject to taxation (interest earned is taxable) but distributions allocated to the employer's tax deferred contributions are subject to taxation in the year of distribution. IRC section 414(h) authorizes the employer to "pick up" any part of the employee's contributions but such contributions are then treated as employer contributions. The employee enjoys no right to these employer contributions under the separate contract rule and receives no benefit from such contributions until the employee receives a distribution upon retirement in accordance with the plan. The IRC does not limit the annual amount that the employer may contribute to a defined benefit plan. It does, however, as we have previously discussed, place a limit on the annual distribution received upon retirement by the employee that is based solely on employer contributions to a defined benefit plan. For the purpose of the IRC section 415

limit employee after tax contributions (voluntary or mandatory) to a defined benefit plan such as CERS are treated as contributions to a defined contribution plan pursuant to IRC section 414(k). This is a result of the separate contract rule discussed above and the fact that they are after tax contributions. (We are specifically not addressing the pre-January 1, 1987, special rule for limited tax deductible qualified voluntary employee contributions.) The formula found in IRC section 415(e) is also based upon operation of the separate contract rule. Simply stated, under IRC section 415(e) employer contributions to a defined benefit plan are restricted by the annual benefit limit and employee contributions are restricted by the annual addition limit.

If employee after tax contributions to a "buy back" can be legally converted into "employer contributions," such contributions should logically affect only the annual benefit limit. However, there is no authority for such procedure in the IRC. Perhaps the drafters of the IRC did not envision anyone placing after tax contributions into an account that will result

in the contributions being taxed again upon distribution during retirement. The IRC does recognize the benefit for an employee to voluntarily increase after tax contributions to a defined benefit account under the separate contract rule where the contributions are placed in the employee's account. We fear that the manner which the present program is structured may have disastrous results. The Internal Revenue Service (IRS) may take the position that any attempt to place employee after tax contributions into a defined benefit plan retirement fund as an "employer" contribution is nothing more than an attempt to avoid the annual addition limit set forth in the rules for employee contributions. If such is the case, the IRS could have it both ways. The contributions could count against the annual addition limit for defined contribution accounts and then be considered as part of the employer's account upon distribution thereby resulting in both double taxation and possible plan disqualification for exceeding the annual addition limit.

If on the other hand the "buy back" contributions are treated as employee contributions, IRC section 414(k)(2) requires that they be treated as a contributions to a defined contribution plan. As can be seen by the express language of IRC sections 415(e)(3) and 414(k)(2), employee after tax contributions to CERS to "buy back" previous years of service will count against the annual addition limit for defined contribution plans set forth in the formula. We must therefore agree with the consultants that,

except for the repurchase of previous years of participation in CERS as described in IRC section 411(e)(1)(A), after tax voluntary contributions by an employee to CERS must be calculated into the IRC section 415(e) formula for the year in which the contribution is made as a contribution to a defined contribution plan. Contributions from MBP to CERS for "buy back" or "offset" must also be calculated into the IRC section 415(e) formula as employer contributions.

CONCLUSION

Participants in the described "buy back" program are affected by IRC section 415(e) limits on annual additions. We recommend that employees who desire to "buy back" years of participation in CERS or upgrade years of participation in the 1981 Pension Plan to the CERS level of benefit, be made aware of the fact that any amount contributed to CERS through an employee after tax contribution or through a MBP allocation directly impacts the employee's IRC section 415(e) safe harbor limits. An employee may still "buy back" years of creditable service in CERS but only to the extent that the amount contributed annually to "buy back" does not cause the employee to violate the IRC section 415(e)

safe harbor limits. The employee has the option of increasing his or her safe harbor limit by reducing voluntary contributions to SPSP/SPSP-M and the 401(k) Plans. While the option of voluntarily reducing once SPSP/SPSP-M contribution rate account has the adverse consequence of forfeiting the City's matching contributions, in some cases the ability to "buy back" creditable years in CERS may be of more significant benefit to the affected employee. In addition, we recommend that the Retirement Board of Administration revisit those aspects of the "buy back" program addressed in this Memorandum of Law which appear to be inconsistent with the approach contained in the IRC and the Treasury Regulations. We also recommend that a program be developed by The City of San Diego to ensure that employees do

not exceed the maximum limits set forth in IRC section 415(e) and thereby jeopardize the tax qualification status of the City's qualified plans.

JOHN W. WITT, City Attorney
By
John M. Kaheny
Chief Deputy City Attorney

JMK:mrh:352(x043.2)
ML-90-16