MEMORANDUM OF LAW

DATE: March 19, 1991

TO: D. Cruz Gonzalez, Risk Management Director

FROM: City Attorney

SUBJECT: Permissibility of Employee Contributions to City Employees' Retirement System from an Employee's Flexible Benefit Plan or Management Benefit Plan Account

In a memorandum dated January 2, 1991, you attached a memorandum dated February 8, 1990, prepared by Chief Deputy City Attorney John M. Kaheny in which he concluded that after tax employee contributions to the Supplemental Pension Savings Plan (SPSP) from an employee's Flexible Benefit Plan ("FBP") or Management Benefit Plan ("MBP") accounts were permissible. Taking this one step further, you now ask whether employee contributions to City Employees' Retirement System ("CERS") from an employee's FBP or MBP account are permissible. You also ask if such contributions can be made on a pre-tax basis. Finally, you ask if these contributions would affect the Internal Revenue Code (IRC) section 415 limits.

BACKGROUND

The memorandum dated February 8, 1990, prepared by Chief Deputy City Attorney John M. Kaheny focused on proposed Treasury Regulation section 1.125-2 and addressed the permissibility of an employee's contributions to the SPSP plans directly from the employee's FBP or MBP account. Subdivision (c) of this proposed regulation states that "elective contributions to a qualified cash or deferred arrangement (section 401(k)) are permitted under a cafeteria plan." The proposed regulation further provides that "after-tax employee contributions under a qualified plan subject to section 401(m) are permitted under a cafeteria plan."

Noting that SPSP plans are qualified defined contribution plans subject to the nondiscrimination test found in IRC section 401(m), Chief Deputy City Attorney John M. Kaheny indicated that the proposed regulation did allow an employee to make after-tax (post-tax) contributions to a qualified defined contribution plan from a cafeteria plan such as FBP or MBP even if the defined contribution plan provides for employer matching contributions. Mr. Kaheny further stated these contributions were employee contributions which could not be tax deferred employer contributions. In short, these contributions were subject to the same federal and state withholding requirements as the current

cash option provision.

Your question, however, addresses the permissibility of employee contributions from the employee's FBP or MBP Plans directly into CERS, a defined benefit plan. This distinction is critical. Different rules and regulations apply to defined benefit plans.

ANALYSIS

CERS is a trust described in IRC section 401(a). Section 414(h), subdivision (1) of the IRC provides that any amount contributed to an employee's trust described in section 401(a) shall not be treated as having been made by the employer if it is designated as an employee contribution. Subdivision (h)(2) provides further, however, that "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." According to the Internal Revenue Service (IRS) contributions "picked-up" within the meaning of IRC section 414(h)(2) by a governmental unit and paid to a plan qualified under section 401(a) are not includable in the gross income of the employee until these amounts are distributed or made available to the employee. Rev. Ruling 77-462. In addition, two criteria must be satisfied before contributions are "picked-up" by the employer for purposes of IRC section 414(h)(2).

> First, 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. Second, the employee must not have the option of choosing to receive the contributed amounts directly instead of having them paid by the employer to the pension plan.

Rev. Ruling 81-35; Rev. Ruling 81-36.

These criteria are not met in the situation posed by your memorandum. First, the FBP and MBP plan document for 1990-1991 does not provide an option for the use of these accounts to buy back or offset contributions to CERS. As you know, prior to 1990-1991 the Plan Document for MBP and FBP included an option for retirement "buy back" or "offset" for MBP accounts only. This option was never available for FBP accounts. Second, even if the plan document were amended to provide for either of these options, the City could not meet the second criteria. Utilization of an employee's FBP or MBP accounts for the purpose

of a buy back or offset in CERS is purely voluntary. The employee has the option of receiving the money directly, on a post-tax basis, or choosing to have the contributions made to the plan. Thus, in response to your question, contributions made on a pre-tax basis to CERS directly from the employee's MBP account are not permissible. Because we conclude that pre-tax contributions from an employee's FBP or MBP accounts are not permissible, the effect of IRC section 415 on such contributions is moot.

Please be advised, however, that any "buy back" or "offset" contributions allocated from an employee's MBP account on a post-tax basis directly impacts the IRC section 415(e) combined formula and therefore affects the employee's safe harbor limits. 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 additional limit.

We are concerned over the impact IRC section 415 has on voluntary additional employee after tax contributions to CERS from an employee's MBP account. 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. For your information, these concerns have been addressed in greater detail in our Memorandum of Law dated January 25, 1990.

CONCLUSION

Employee contributions to CERS from the employee's FBP or MBP Plan Account, on a pre-tax basis, are not permitted under the authority of IRC section 414(h)(2). Preferential tax treatment under IRC section 414(h)(2) is only available in those situations where the employee does not retain the option to either receive the money directly or direct its distribution into the qualified pension plan. Since the use of FBP or MBP money (if the Plan document were so amended) to buy back or offset CERS contributions is strictly voluntary, the contributions to CERS made from these accounts would not be "picked-up" within the meaning of IRC section 414(h)(2). In addition, post-tax contributions to CERS from an employee's MBP account also impact IRC section 415. We recommend that this issue be reevaluated if you decide to amend the Plan Document for FBP and MBP to include an option for CERS contributions.

JOHN W. WITT, City Attorney

By

Loraine L. Etherington
Deputy City Attorney

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cc Larry Grissom
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