MEMORANDUM OF LAW

DATE: November 3, 1992

TO: Larry Gardner, Labor Relations Manager

FROM: City Attorney

SUBJECT: Internal Revenue Code Section 414(h)(2); Impact of the City's "Pick-up" of a Portion of the Employee's Contribution to the Retirement System

Recently you asked for clarification of Internal Revenue Code ("IRC") section 414(h)(2) and its impact on general and safety member employees of the City Employees' Retirement System ("CERS"). Our analysis of IRC section 414(h)(2), including tax considerations and wage-base considerations for other employee contributions involving 401(k), the various Supplemental Pension and Savings Plans (SPSP and SPSP-M) and CERS, follows:

BACKGROUND

Currently, The City of San Diego ("City") and its employees who are members of CERS contribute to CERS. The amount of the contribution for the employee is based on actuarial considerations and is determined by the age of the employee upon enrollment into CERS. The City matches this amount. In addition, pursuant to the Salary Ordinance adopted each year, the City pays a portion of the employee's contribution. The specific percentage of the employee's contribution paid by the City varies according to the employee's membership classification and bargaining unit.

The Salary Ordinance for fiscal year 1992-1993, O-17781, adopted on May 26, 1992, sets forth the percentages to be paid by the City on behalf of its officers and employees as additional employer contributions for Retirement System contributory purposes. Section 14 provides in pertinent part:

Section 14. RETIREMENT CONTRIBUTION

> In accordance with the following schedule, the City shall pay into the Retirement System an actuarial equivalent of employee base compensation as additional employer contribution for Retirement System contributory purposes for those

officers and employees who are members of the System.

1. All Legislative Officers 6.9%
2. All Unclassified Officers and Employees and all unrepresented classified employees with the exception of such personnel in the Police and Fire classifications. 6.0%
3. All represented classified employees with the exception of those listed in 4. below including civilian Fire Inspectors. 5.0%
4. All employees in the Police and Fire Bargaining Units who are members of the safety retirement system and all unclassified and unrepresented officers and employees in the safety retirement system and all Lifeguard classifications which are in the safety retirement system. 6.5%* Upon acceptance of the reduced compensation schedule set forth in section 4 of this ordinance, safety employees in the Police and Firefighters bargaining unit shall be entitled to an additional .5 percent increase in City retirement contributions. *As a result of this provision, safety employees in the Police bargaining unit now receive a 7.0% contribution.

The City's total contribution to CERS, i.e., both its contribution and that portion of the employee's contribution paid by the City pursuant to the Salary Ordinance, is made on a pre-tax basis. The employee's contribution to CERS is made on an after tax basis. For example, an employee's contribution rate is 8%. Under the CERS plan, both the City and the employee are required to pay into the Retirement System 8% of the employee's base compensation.

Pursuant to the Salary Ordinance, however, the City pays a portion of the employee's contribution. If the employee is unclassified, the City pays 6% of the employee's contribution. As such, the City pays 14% of the total contribution required by CERS. The employee pays only 2%. The City's total contribution, 14% in our example, is paid on a pre-tax basis. It is separately

accounted for. It is placed in the employer's account and designated as an employer contribution. The remaining 2% paid by the employee is paid on an after tax basis. It is placed in the employee's account and is designated an employee contribution.

In the event that the employee does not vest in the Retirement System, the money in the employee's account will be refunded. Any money placed in the employer's account, including any money paid by the City on behalf of its employee pursuant to the Salary Ordinance, will remain with the Retirement System.

The City is now considering the implementation of a "pick-up" of the remaining portion of the employee's contribution (2% in the example described above). The "pick-up" contemplated by the City is authorized by IRC section 414(h)(2). The balance of this Memorandum of Law addresses the substance and impact of IRC section 414(h)(2).

IRC Section 414(h)(2)

IRC section 414(h)(1) provides that amounts contributed to a plan qualified under IRC section 401(a) (such as CERS) may not, for tax purposes, be treated as employer contributions if they are designated as employee contributions. IRC section 414(h)(2), however, provides an exception to this rule by allowing contributions (otherwise designated as employee contributions) to government plans to be treated as employer contributions if the employers "pick-up" the contributions. Rev. Rul. 81-35, 1981-1 C.B. 255.

Rev. Rul. 77-462, 1977-2 C.B. 358, specifies the federal income tax treatment to be given to contributions "picked-up," i.e., paid by the employer for the employee into a plan qualified under IRC section 401(a) such as CERS within the meaning of IRC section 414(h)(2). It concludes that the contributions "picked-up" in this manner are not includible in the employee's gross income until these amounts are distributed or made available to the employees.

Contributions are considered "picked-up" by the employer, for purposes of IRC section 414(h)(2) only when two criteria are satisfied. 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. Rul. 81-35, 1981-1 C.B. 255; Rev. Rul. 81-36, 1981-1 C.B. 255.

Assuming these criteria are met, an employee may, pursuant to IRC section 414(h)(2) exclude from his or her gross income, for federal income tax purposes, those contributions made by the employer in this fashion to its qualified pension plan.

Additionally, in order to satisfy the requirements set forth in Rev. Ruls. 81-35 and 81-36, 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.

In short, retroactive "pick-up" of designated employee contributions by a governmental employer is not permitted under IRC section 414(h)(2). As such, under IRC section 414(h)(2), government employees may only exclude from current gross income designated employee contributions to a qualified plan that relate to compensation earned for services after the date of the last governmental action necessary to effect the employer pick-up. Rev. Rul. 87-10, 1987-1 C.B. 136.

IMPLEMENTATION OF IRC SECTION 414(h)(2)

1. Procedural Considerations

As mentioned earlier, the City must comply with two requirements to ensure that any "pick-up" program implemented pursuant to IRC section 414(h)(2) remains qualified for favorable tax treatment. Simply stated, they are:

1. The City must specify that the contributions are being paid by the employer, not by the employee, and are in lieu of contributions paid by the employee.
2. The employee cannot be given the option to receive the contributions directly instead of having them paid by the employer. This means that there can be no option to contribute or not. In addition, it also means that there can be no option to make contributions on an after tax basis instead of a pre-tax basis.

Recognizing that pick-ups cannot be retroactive, we remind you that contributions can be picked-up only to the extent that they are from compensation earned after the date that the City takes final action needed to effect the pick-ups. In this regard, we recommend that the implementation of any pick-up pursuant to IRC section 414(h)(2) be specifically described in the Salary Ordinance adopted each year. The mandatory requirements for the pick-up, the relationship between the pick-up and the current offset, the tax considerations and the accounting procedures involved could easily be addressed in this manner.

As you are no doubt aware, the Salary Ordinance for fiscal year 1992-1993 is already in effect. It was adopted on May 26, 1992. As such, if you desire to implement a pick-up before the end of the fiscal year, we recommend that the current Salary Ordinance O-17781, be amended to identify the participants in and describe the implementation of a pick-up of the employee's remaining contribution to the Retirement System. For your information, an amendment of this nature is permissible under Section 70 of the Charter for The City of San Diego because the implementation of a pick-up pursuant to IRC section 414(h)(2) does not change the base compensation paid to City employees. Importantly, the amendment to the Salary Ordinance must set forth the mandatory requirements for the pick-up authorized by IRC section 414(h)(2) outlined in this Memorandum of Law.

2. Impact of IRC section 414(h)(2) on employee contributions to SPSP, SPSP-M, and the City's 401(k) Plan.

After reviewing the plan documents for SPSP, SPSP-M and the City's 401(k) plan, we conclude that there should not be any adverse effect on the amount of contributions made to a member's account under SPSP, SPSP-M or the 401(k) plans because of a pick-up. As such, the implementation of a pick-up pursuant to IRC section 414(h)(2) would not affect the wage-base currently used to calculate the member's contributions to any of these contributory plans.

The term "compensation" is uniformly defined in these plan documents as "regular bi-weekly salary" and other items. Pick-ups under IRC section 414(h)(2) do not change the stated salary of any member. As such, there would not be any change to the "regular bi-weekly salary" used to determine contributions to these plans. This result, in turn, should mean no change in the amount that is contributed to these plans for individual members.

In addition, as more fully discussed in the next section, there are no adverse tax consequences under IRC section 415 with the implementation of an IRC section 414(h)(2) pick-up.

3. IRC section 415 limitations

IRC section 415 has three basic elements: a defined benefit limit, a defined contribution limit and a combination limit. Each will be discussed separately.

DEFINED BENEFIT LIMIT

The defined benefit annual limit is the smaller of (1) a dollar amount of benefit (currently $112,221 per year paid beginning at age 65, reduced for early payment) or (2) 100% of W-2 compensation. If member contributions to CERS that now are made on an after-tax basis are picked-up, within the meaning of IRC section 414(h)(2), the effect is to reduce W-2 compensation

for the member. Therefore, the 100% of compensation limit is reduced for the member. The dollar limit is not affected. To the extent that a member is at, or close to, the 100% of compensation limit now, pick-up could create an IRC section 415 limitations problem for him or her. The 100% of compensation limit, however, is the subject of pending federal legislation ("HR 11"). It is anticipated that this requirement will be eliminated in the future.

The defined benefit limit applies to benefits provided by pre-tax contributions, not by after-tax member contributions and interest on them (the "member's account"). In testing the defined benefit limits, total CERS benefits are reduced by the annuitized value of the member's account. Pick-ups are not added to this account for tax purposes so the amount of this reduction will be fixed (with some changes due to interest) at current levels if pickup is established. Over time, more of the total CERS benefits will be subject to both the 100% of compensation and dollar limits of the defined benefit test. Although this change should not be a large amount, it will differ with the age of the individual who is being tested. It will have the least effect on the older members.

According to the actuary's calculations, there are very few CERS members who may have, or be close to, a 100% of compensation problem. HR 11, however, would eliminate the 100% of compensation limit for public sector retirement systems. Even if HR 11 is not signed into law this year, it is anticipated that similar legislation will be passed within the next 12-18 months.

DEFINED CONTRIBUTION LIMIT

SPSP, SPSP-M and the City's 401(k) plan are tax qualified defined contribution plans subject to different limitations under IRC section 415. Here, the annual limit is an account addition, per year, of no more than $30,000 or 25% of W-2 compensation, if smaller.

Pickup of a member's contributions to CERS will also reduce W-2 compensation and therefore affect the IRC section 415 limitation that is based on W-2 compensation. However, the net effect of pick-up may be to ease any defined contribution limit problem because of the way that the 25% limit is calculated.

The 25% limit is, of course, tested with a fraction. The numerator includes contributions and forfeitures added to a member's account under SPSP or SPSP-M, contributions to his or her account under the 401(k) plan, and the annual amount of after-tax member contributions to CERS. For your information, the numerator does not include any additions to the 457 plan or any investment earnings.

When CERS member contributions become pickups, the

numerator is reduced by the amount of the pickup. This occurs because pickups are not treated as additions to a defined contribution plan under IRC section 415. Therefore, with pickups, both the numerator of the defined contribution fraction and the denominator of the fraction are changed. The net effect is a reduction in the overall fraction. The reason for the reduction is that the denominator is reduced by 25 cents for every one dollar reduction in the numerator, making the fraction smaller with every such reduction.

Consider the following example. Assume that the pre-pickup numbers are as follows:

3,000	Employee's salary per month
225	SPSP contribution
225	Employer match
30	401(k) (1%)
150	After tax contribution to CERS

The W-2 wages = $2970 (3000-30(401(k))

The Defined Contribution Fraction = 630* = 21.21%

2,970

(*The 630 is the sum of all of the employee's contributions to SPSP, 401(k) and after tax contributions to CERS.)

Now, assume that the employer implements a 5% pickup to cover the $150 contribution to CERS currently paid by the employee on an after tax basis.

3,000	Employee's salary per month
225	SPSP contribution
225	Employer match
30	401(k)
0	No after tax contributions to CERS because this is now picked up by employer under IRC section 414(h)(2)

The W-2 wages = $2,820 (3,000-150(pick-up) - 30(401(k))

The Defined Contribution Fraction = 480* = 17.02%

2,820

(*The 480 is the sum of all of the employee's contributions to SPSP and 401(k).)

Obviously, the fraction has been reduced from 21.21% to 17.02%. If the defined contribution limit is 25%, the IRC section 415 limit has been eased for this member.

COMBINATION LIMIT

IRC section 415 also has a limit on the amount of benefits from the combination of defined benefit and defined contributions plans. The limit is very complex, but for this analysis can be set out relatively simply.

Under the combination limit, generally, most members of CERS can have 100% of one type of benefit and 40% of the other type of benefit (or any other mix of percentages that do not total more than 140%). Higher paid members have a 125% limit. However, under the precise way of computing the combination limit, long service members effectively can have the full defined benefit limit from CERS and the full defined contribution limit as well, yielding a "200%" limit, not a 140% or 125% limit.

On the CERS side, pickups will reduce W-2 compensation and reduce reductions for the annuitized value of the member's after tax account, and therefore push this fraction higher. This could cause IRC section 415 combination limit problems. But on the SPSP, SPSP-M and 401(k) side, pickups will reduce the fraction (for the reasons described above), easing any combination limit problem. It is difficult to know the net results without doing calculations for individual members, but it is not unreasonable to believe there could be a balancing out of the two effects.

4. Accounting Considerations

We know of no report that must be provided to the Internal Revenue Service ("IRS") or any other federal agency if the City picks up member contributions to CERS. When a member of CERS receives benefits, the member and the IRS must be informed with IRS form 1099R. That form has boxes for reporting, among other things, total distributions, taxable distributions, and after-tax employee contributions. Pickup will not change the total distributions. It will change taxable distributions, because these will increase. It will also reduce after-tax employee contributions. However, there is no requirement of any special notification that these changes are due to an employer's pickup.

CONCLUSION

We hope this Memorandum of Law has provided the clarification of IRC section 414(h)(2) requested. If you decide to implement an IRC section 414(h)(2) pickup program before the end of the fiscal year, I will draft an amendment to the current Salary Ordinance that meets the requirements outlined in this Memorandum of Law. Please contact me if you need any additional information.

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