Office of Chief Counsel
Internal Revenue Service

memorandum

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to: , FSLG Specialist
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from: John Richards, Senior Counsel
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subject: Retirement System

This Chief Counsel Advice responds to your facsimile of April 10, 2002. We apologize for the delay in responding. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

State =

Retirement System =

Compensation =

v =

w =

x =

y =

z =

ISSUES

1. Whether Retirement System's definition of Compensation is "reasonable" within the meaning of section 31.3121(b)(7)-2(e)(2)(iii)(B) of the Employment Tax Regulations.

2. If Retirement System fails to meet the section 31.3121(b)(7)-2(e)(2)(iii)(B) standard, then whether Retirement System nevertheless meets the safe harbor minimum benefit standards provided under sections 3.01(1) and 3.03(1)(b) of Rev. Proc. 91-40, 1991-2 C.B. 694.

CONCLUSIONS

1. We need additional time to consider whether the Retirement System's definition of Compensation is reasonable within the meaning of section 31.3121(b)(7)-2(e)(iii)(B). We will respond separately on this issue.

2. If it were determined that the Retirement System's definition of Compensation was unreasonable, then whether the Retirement System meets the minimum benefit requirement of section 31.3121(b)(7)-2(e)(2)(ii) depends in part on application of the safe harbor minimum benefit standards provided under sections 3.01(1) and 3.03(1)(b). Based on the facts presented, Retirement System's rate of benefit accrual satisfies the safe harbor standards of sections 3.01(1) and 3.03(1)(b) of Rev. Proc. 91-40. The minimum benefit requirement would also be met for part-time employees, provided benefits under the Retirement System are 100 percent vested at the time the services are performed, and the Retirement System otherwise meets the requirements of section 3.03(4) of the Rev. Proc.

FACTS

Retirement System is a defined benefit retirement plan. Retirement System computes accrued benefits for State employees by multiplying years of service by v percent. The annual retirement benefit is then computed by multiplying this percentage by the average of the participant's Compensation for his or her three highest earnings years. Participants in Retirement System include full- and part-time employees.

Participant Compensation for purposes of computing Retirement System accrued benefits is in the range of $w to $x annually. Compensation excludes cash benefits paid in lieu of certain retirement and welfare benefits. The amount of "cash in lieu" benefits paid to a participant is as much as $y annually.

LAW

Sections 3101(a) and 3111(a) of the Internal Revenue Code (the Code) impose the Old-Age Survivors and Disability Insurance (OASDI) portion of the taxes under the Federal Insurance Contributions Act (FICA) upon the wages of employees paid by employers with respect to employment. Sections 3101(b) and 3111(b) impose the Medicare portion of the FICA tax. In general, all payments of remuneration by an employer for services performed

by an employee are subject to FICA taxes, unless the payments are specifically excepted from the term "wages" or the services are specifically excepted from the term "employment."

Section 3121(b)(7) of the Code generally excludes from "employment" services performed in the employ of any state, or any political subdivision thereof, or any wholly-owned instrumentality of any one or more of the foregoing. Section 3121(b)(7)(F), added to the Code by the Omnibus Budget Reconciliation Act of 1990 and effective for services performed after July 1, 1991, excludes from "employment" only the services of an employee of a state, political subdivision, or wholly-owned instrumentality who is a member of a retirement system.

Section 31.3121(b)(7)-2(c)(1) provides that an employee is not a member of a retirement system at the time service is performed unless at that time he or she is a "qualified participant," as defined in paragraph 2(d) of the regulation, in a retirement system that meets the requirements of paragraph 2(e) of the regulation with respect to that employee.

An employee is a qualified participant in a defined benefit retirement system with respect to service on a given day if the employee has a total accrued benefit that meets the minimum benefit requirement described under paragraph 2(e)(2). Section 31.3121(b)(7)-2(d)(1)(i).

A pension, annuity, retirement or similar fund or system is not a retirement system with respect to an employee on a given day unless it provides a retirement benefit under the system that is comparable to the benefit provided under the Old-Age portion of the OASDI program of social security. Section 31.3121(b)(7)-2(e)(2)(i). Section 31.3121(b)(7)-2(e)(2)(ii) provides that a defined benefit retirement system maintained by a state, political subdivision or instrumentality meets the requirements if and only if the employee has an accrued benefit under the system that entitles the employee to an annual benefit commencing on or before his or her social security retirement age that is at least equal to the annual Primary Insurance Amount (PIA) the employee would have under social security. For this purpose, the PIA is determined as if the employee had been covered under social security for all periods of service with the state, political subdivision or instrumentality, had never performed service for any other employer, and had been fully insured within the meaning of section 214(a) of the Social Security Act, except that all periods of service with the state, political subdivision or instrumentality must be taken into account, i.e., without reduction for low-earning years.

Additional requirements under the regulation apply to determine whether a part-time, seasonal or temporary employee is a qualified participant in the plan. A part-time employee is any employee who normally works 20 hours or less per week. A seasonal employee is any employee who normally works on a full-time basis less than five months in a year. A temporary employee is any employee performing services under a contractual

arrangement with the employer of two years or less duration. Section 31.3121(b)(7)-2(d)(2)(iii).

A part-time, seasonal, or temporary employee is not a qualified participant on a given day unless any benefit relied upon to meet the requirements of paragraph (d)(1) is 100 percent nonforfeitable on that day under rules similar to those under section 411(a)(11). Section 31.3121(b)(7)-2(d)(2)(i). A benefit does not fail to be nonforfeitable solely because it can be immediately distributed upon separation of service without the consent of the employee, provided that the present value of the benefit does not exceed $3,500.

A part-time, seasonal or temporary employee's benefit under a retirement system is considered nonforfeitable on a given day if on that day the employee is unconditionally entitled to a single-sum distribution on account of death or separation from service of an amount that is at least equal to 7.5 percent of the participant's compensation for all periods of credited service. The participant must be entitled to a reasonable rate of interest on the distributable amount. Sections 31.3121(b)(7)-2(d)(2)(ii) and (e)(2)(iii)(C).

Rev. Proc. 91-40, § 3.01, provides safe-harbor formulas for defined benefit retirement systems. Benefits calculated under these formulas meeting certain accrual rate requirements are deemed to meet the minimum retirement benefit requirement of section 31.3121(b)(7)-2(e). Section 3.01(1) provides that a plan meets the minimum retirement benefit requirement with respect to an employee if it makes available to the employee a single life annuity payable no later than age 65 that is at least 1.5 percent of average compensation for each year or fraction of a year of credited service. For this purpose, average compensation may be defined as (1) the average of the employee's compensation over the 36 or fewer consecutive or non-consecutive months that provides the highest such average, (2) the average of the employee's compensation for his or her last 36 or fewer months of service, or (3) the average of the employee's compensation for his or her high consecutive or non-consecutive or final three or fewer calendar or plan years of service.

Section 3.03(4) of the Rev. Proc. provides that in order to meet the requirements of any of the defined benefit safe harbor formulas with respect to a part-time, seasonal or temporary employee, a safe harbor formula may not permit double proration of the employee's benefits under the retirement system. Under this rule, the benefit under the retirement system may be prorated either on the basis of full-time service or on the basis of full-time compensation, but may not be prorated based upon both service and compensation. In addition, a safe harbor formula may not subject the crediting of service used in calculating the benefit of any part-time, seasonal or temporary employee to any conditions, such as a requirement that the employee attain a minimum age, perform a minimum period of service, be credited with a minimum number of hours of service, make an election in order to participate, or be present at the end of the plan year. The requirements of this section

are deemed met with respect to an employee if the requirements of section 31.3121(b)(7)-2(d)(2)(ii) are met.

In addition, and most relevant for purposes of this memorandum, the definition of compensation used to compute an employee's accrued benefit under a defined benefit plan must not be so narrow as to frustrate the minimum benefit requirement under the regulation. Section 3.03(1)(a) of the Rev. Proc. provides that "to meet the requirements of any of the defined benefit safe harbor formulas for plan years beginning after July 1, 1991, a retirement system must calculate benefits based on a definition of compensation that meets the requirements of section 31.3121(b)(7)-2(e)(2)(iii)(B). Section 31.3121(b)(7)-2(e)(2)(iii)(B) provides the definition of compensation

> must generally be no less inclusive than the definition of the employee's base pay as designated by the employer or the retirement system, provided such designation is reasonable under all the facts and circumstances. Thus, for example, a . . . retirement system will not fail to meet this requirement merely because it disregards for all purposes one or more of the following: overtime pay, bonuses, or single-sum amounts received on account of death or separation from service under a bona fide vacation, compensatory time or sick pay plan, or under severance pay plans.

Section 3.03(1)(b) of the Rev. Proc. provides that in the event that the definition of compensation under the retirement system is less inclusive than the definition otherwise permitted under section 31.3121(b)(7)-2(e)(2)(iii)(B), the applicable benefit percentage used in the safe harbor formula provided under section 3.01 must be increased to offset the effect of the lower compensation base. The benefit percentage for employees in a retirement system whose benefits are computed using this definition must be multiplied by the ratio of (i) aggregate compensation (defined as under section 3.03(1)(a) and assuming that compensation considered in determining retirement benefits is limited to the contribution base described in section 3121(x)(1)) of these employees to (ii) aggregate compensation (as defined under the plan) of these employees. This ratio may be determined based upon the compensation during the immediately preceding plan year. In the case of a retirement system sponsored by more than one employer, this ratio must be calculated separately with respect to the employees of each employer whose benefits are computed using this definition.

ANALYSIS

Because we need additional time to consider Issue 1, we will respond separately on that issue.

Regardless of whether Retirement System's definition of Compensation is reasonable within the meaning of section 31.3121(b)(7)-2(e)(2)(iii)(B), Retirement System may still meet the safe harbor standards under Rev. Proc. 91-40 if its benefit accrual rate is meets

the percentage requirements of sections 3.01(1) and 3.03(1)(b) of the Rev. Proc. Applying this rule to the present facts, it appears Retirement System meets the safe harbor minimum benefit accrual requirement. To illustrate, if State employee receives $w as Compensation, and a $y cash in lieu benefit, the safe harbor accrual percentage would be z percent (w + y / w times 1.5 = y). Because the v percent accrual rate under Retirement System exceeds z percent, the plan meets the safe harbor minimum benefit accrual requirement of Rev. Proc. 91-40. Therefore, Retirement System satisfies the minimum benefit requirement regardless of whether Retirement System's definition of Compensation is reasonable under the paragraph 2(e)(2)(iii)(B) standard. This formula is applied on an employee-by-employee basis, but, of course, any participant with compensation greater than $w would also meet the safe harbor standard (given that the cash in lieu of benefit is not greater than $y for any State employee).

Please call me at (202) 622-6040 if you have any further questions.