Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: 200622043

Release Date: 6/2/2006
CC:TEGE:EOEG:ET2:DMParkinson
POSTF-139677-05

UILC: 3121.02-05

date: February 15, 2006

to: Deputy Area Counsel

from: Marie Cashman
Special Counsel, Exempt Organizations/Employment Tax/Government Entities
(Tax Exempt & Government Entities)
(CC:TEGE:EOEG)

---

subject: Police Pension Plan

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Employer X -
Plan Y -
Plan History -

ISSUE

Whether Plan Y satisfies the requirements of Internal Revenue Code (Code) section 3121(b)(7)(F) as they relate to a retirement system maintained by Employer X, an instrumentality of a political subdivision?[1]

[1] Whether Employer X is liable for the Hospital Insurance Tax portion of the FICA taxes imposed by Code sections 3101(b) and 3311(b) is not a part of this analysis. Such determination is made pursuant to the

CONCLUSION

Our evaluation of the terms of Plan Y indicates that the Plan satisfies the requirements of Code section 3121(b)(7)(F) as a retirement system. However, an evaluation must also be made to determine whether Employees are qualified participants in Plan Y. The exclusion from employment under section 3121(b)(7) does not apply unless the Employee is a qualified participant of Plan Y at the time services are performed. If an Employee of Employer X is not a member of Plan Y, Employer X will have a Federal Insurance Contributions Act (FICA) tax obligation with respect to that Employee, regardless of the Plan Y's status as a retirement system.

FACTS

Plan Y is a defined benefit plan maintained by Employer X, an instrumentality under Code section 3121(b)(7)(F). In the year , Plan Y was composed of a plan document and a series of amendments. See, Plan History. These items constitute Plan Y for purposes of our evaluation.

Plan Y section provides than an Employee is a Participant in the Plan if the Employee agrees to make mandatory Employee Contributions.

Plan Y section defines Employee as any person who is employed by the Employer, but excludes any person who is employed as an independent contractor.

Plan Y section provides that the retirement benefit for a Participant who retires on his Normal Retirement Date is equal to 50% of Final Pay at retirement multiplied by a fraction, the numerator of which equals the Years of Service completed by the participant on his Normal Retirement Date and the denominator of which is 20. Thus, a participant accrues a benefit equal to 50% of Final Pay at his Normal Retirement Date on a fractional rule basis, accruing $1/20^{th}$ of his retirement benefit for each year of service with the employer for an effective accrual rate of 2.50% for each year of service.

Plan Y section defines "Plan Year of Service" to mean a Plan Year during which an Employee is a Participant and completes 1,000 Hours of Service. Thus, under the terms of the Plan, a Participant will not be entitled to an annual accrual under the Plan's benefit formula unless and until that Participant has earned 1,000 Hours of Service.

Plan Y section provides that Final Pay means the average Compensation of the highest 12 continuous months out of the last three years of employment. Plan section provides that Compensation means a Participant's regular salary and wages paid by the Employer for a Plan Year, "excluding overtime, comp time, commissions, and discretionary bonuses."

---

rules of Code section 3121(u). See, Revenue Ruling 2003-46, 2003-1 C.B. 878.

It has been represented that the employer does not have any part-time or seasonal employees.

LAW AND ANALYSIS

Code sections 3101(a) and 3111(a) impose the Old-Age Survivors and Disability Insurance (OASDI) portion of the taxes under the 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 expected from the term "wages" or the services are specifically excepted from the term "employment".

Code section 3121(b)(7) 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. However, 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) of the Employment Tax Regulations 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 (d) of the regulation, in a "retirement system" that meets the requirements of paragraph (e) of the regulation with respect to that employee.

The exception from employment under section 3121(b) is applied on an employee by employee basis. Therefore, the determination of whether services performed by a state or local government employee are excepted from employment is a two part inquiry. First, whether the retirement plan at issue is a "retirement system" within the meaning of the regulations under Code section 3121(b)(7)(F), and second, whether the employee is a "qualified participant" of the retirement system. An employer that operates a retirement plan, which by its terms is a retirement system, will generally have a FICA obligation with respect to employees who are not members of the retirement system.

Employment Tax Regulation section 31.3121(b)(7)-2(d)(1)(i) provides that an employee is a qualified participant in a defined benefit retirement system with respect to services performed on a given day if the employee has a total accrued benefit that satisfies the minimum benefit requirement. Employment Tax Regulation section 31.3121(b)(7)-2(e)(2)(ii) provides that a defined benefit retirement system satisfies the minimum benefit requirement with respect to an employee on a given day "if and only if, on that day, the employee has an accrued benefit under the system that entitles the employee to an annual benefit commencing on or before his … Social Security retirement age that is at least equal to the annual Primary Insurance Amount the employee would have under Social Security." Revenue Procedure 90-40, 1991-2 C.B.

694, provides rules relating to the minimum benefit requirements of section 3121(b)(7)(F) for a defined benefit retirement system.

Section 3.02 of Revenue Procedure 90-40 provides guidance for plans using a fractional accrual rule and provides that such plans may meet the minimum benefit requirement for retirement plans using the rules in section 3.01(1) provided that the projected normal retirement benefit under the plan formula is greater to or equal to the benefit described in such section. Section 3.01(1) provides that where a defined benefit plan averages an employee's compensation over 36 (or fewer) consecutive months, the plan should provide a benefit that is at least equal to 1.5% of average compensation for each year of service with the employer until age 65.

Section 3.03(2)(b) provides that a plan formula may limit the maximum period of service that is credited for accrual purposes, but if the limit is less than the 30 years in the case of a formula described in section 3.01(1), the benefit formula must be increased by the ratio of 30 years to such lower limit.

Section 3.03(1)(a) provides that a defined benefit plan must define compensation in a manner that meets the requirements of regulation section 31.3121(b)(7)-2(e)(2)(iii)(B) which requires that the definition of compensation "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." Plan Y's definition of Compensation which includes "regular salary and wages" satisfies the requirement of regulation section 31.3121(b)(7)-2(e)(2)(iii)(B).

Plan Y complies with the applicable requirements of Revenue Procedure 90-40. Section 3.01 of the revenue procedure provides that a plan that averages compensation over a twelve-month period must provide a minimum benefit that is at least equal to 1.5% of average compensation for each year of service with the employer. Because Plan Y limits the maximum period of service credited for benefit accrual purposes to twenty years, section 3.02(b) of the revenue procedure provides that the 1.5% accrual rate must be increased by the ratio of 30 years to 20 years, which increases the minimum accrual rate for this Plan to 2.25%. Plan Y's rate of accrual is 2.50% per year of service. Thus, Plan Y provides the minimum benefit required under Revenue Procedure 90-40 and also satisfies the requirements for a defined benefit retirement system as required by Employment Tax Regulation section 31.3121(b)(7)-2(e)(2).

As indicated above, whether an employee is eligible for the employment exception in section 3121(b)(7)(F) also depends upon whether the employee is a qualified participant in the retirement system. Employment Tax Regulation section 31.3121(b)(7)-2(d)(1)(i) provides that an employee may not be treated as having an accrued benefit for purposes of determining whether the employee is a qualified participant in a defined benefit retirement system to the extent that such participation or benefit is subject to any conditions (other than vesting), such as the requirement that the employee attain a minimum age, perform a minimum period of service, make an

election to participate, or be present at the end of a plan year in order to be credited with an accrual, that have not been satisfied.

Play Y contains two conditions that employees must satisfy. Section of Plan Y requires Employees to elect to make mandatory Employee Contributions as a condition of Plan participation, and Section , which accrues benefits on a fractional accrual rule, requires an Employee to complete a year of service in order to receive an annual benefit accrual. Section defines a Plan Year of Service as a year in which a Participant is credited with 1,000 Hours of Service. Thus, under the terms of the Plan, a Participant will not be entitled to an annual accrual unless and until the Participant is credited with 1,000 Hours of Service.

Employees of Employer X will not be qualified participants in Plan Y for any period of employment prior to making an election to make mandatory Employee Contributions. During that time period they will not be eligible for the exception from employment provided by section 3121(b)(7)(F). See Regulation section 31.3121(b)(7)-2(d)(1)(i).

Under the general rule of Employment Tax Regulation section 31.3121(b)(7)-2(d)(1)(i), benefits that accrue only upon satisfaction of this 1,000 hour requirement may not be taken into account in determining whether an employee is a qualified participant in the Plan before the 1,000 hour requirement is satisfied. The effect of use of a 1,000 rule in a retirement system is illustrated by *Example (2)*, following regulation section 31.3121(b)(7)-2(d)(1)(i):

> A political subdivision maintains a defined benefit plan that is a retirement system within the meaning of paragraph (e)(1) of this section. Under the terms of the plan, service during a plan year is not credited unless a participant has at least 1,000 hours of service during the year. Benefits that accrue only upon satisfaction of this 1,000 requirement may not be taken into account in determining whether an employee is a qualified participant in the plan before the 1,000-hour requirement is satisfied.

Thus, under the general rule, an employee is not a qualified participant in the retirement system for the calendar year until the 1,000-hour requirement is satisfied.

However, Employment Tax Regulation section 31.3121(b)(7)-2(d)(3) provides for the operational use of an “alternative lookback rule.” In general, the alternative lookback rule provides that an employee may be treated as a qualified participant in a retirement system throughout the calendar year if he was a qualified participant at the end of the plan year of the system ending in the previous calendar year. The regulation provides for the use of a lookback rule in the first year of participation, in subsequent years of participation, and the last year of participation. For example, under the general rule an employee is not treated as a member of a retirement system that conditions participation or benefit accrual on the performance of 1,000 hours of service until the 1,000 hours have actually been performed. Under the alternative lookback method,

however, if the employee performed 1,000 hours of service in the plan year ending in the prior calendar year, and the retirement system satisfied the minimum retirement benefit requirement for the year as a result, the employee may be treated as a member of the retirement system throughout the calendar year even if no benefit accrual or allocation occurs during that year. If the alternative lookback rule is used, it must be used consistently from year to year with respect to all employees who are covered under the retirement system. If an Employee is not credited with 1,000 Hours of Service in any year under the terms of Plan Y, the alternative lookback rule may not be used for that Employee in the next year.

In the first year of participation, regulation section 31.3121(b)(7)-2(d)(3)(ii) provides in part that if the alternative lookback rule is used, an employee who participates in the retirement system may be treated as a qualified participant on any given day during his first plan year of participation in a retirement system "If and only if it is reasonable on such day to believe that the employee will be a qualified participant … on the last day of such plan year." For example, if it is unreasonable for Employer X to believe that the newly hired Employee will have 1,000 Hours of Service on the last day of the Plan Year, the newly hired Employee will not be a member of the retirement system in that year. Similarly, in the final year of participation, regulation section 31.3121(b)(7)-2(d)(3)(iii) provides in part that if the alternative lookback rule is used, an employee may be treated as a qualified participant on any given day during his last year of participation "if and only if it is reasonable to believe on such day that the employee will be a qualified participant on his … last day of participation." For example, if it is unreasonable to believe that an Employee will have 1,000 Hours of Service by the last day of participation under the terms of Plan Y, Employee will not be a member of the retirement system in that year.

We do not have the facts necessary to evaluate whether Plan Y satisfies these rules during the period under examination.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

As indicated, Plan Y requires Employees to elect to participate and to complete 1,000 Hours of Service during a Plan Year for benefit accrual purposes. While these conditions do not affect the status of the Plan as a retirement system, they can effect whether an Employee is a qualified participant in Plan Y. If an Employee is not a qualified participant he or she is not eligible for the exception from employment provided by section 3121(b)(7)(F), and their remuneration for employment is subject to FICA, unless another Code or regulatory provision provides an exclusion. The information provided for our review focused primarily on whether Plan Y was a retirement system [redacted]

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call Don Parkinson of my staff at (202) 622-7578 if you have any further questions.