DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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OFFICE OF
CHIEF COUNSEL

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MEMORANDUM FOR DIRECTOR, EMPLOYEE PLANS DIVISION
OP:E:EP

FROM: Chief, Branch 2
CC:EBEO

SUBJECT: Our memorandum of August 19, 1999

This is in connection with the attached memo, which we sent to you on August 19, 1999, on the issue of whether a retirement plan is a “retirement system” within the meaning of section 3121(b)(7)(F) of the Internal Revenue Code. We understand that our advice was requested in order for the advice in turn to be provided to a field office. Our memo therefore constitutes Chief Counsel Advice within the meaning of section 6110 and will be disclosed under the applicable 6110 procedures.

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August 19, 1999
Jerry E. Holmes

MEMORANDUM FOR DIRECTOR, EMPLOYEE PLANS DIVISION
OP:E:EP

FROM: Chief, Branch 2
CC:EBEO

SUBJECT:

State X =

You have requested assistance on the question of whether the State X is a "retirement system" within the meaning of section 3121(b)(7)(F) of the Internal Revenue Code (Code).

FACTS

State X sponsors the , a retirement plan available to all employees not covered by the Teachers' Retirement System of State X. Members of this plan hold service jobs such as cafeteria workers, maintenance workers, and bus drivers. Participation in the plan is required as a condition of employment.

The terms of the are outlined in a plan document entitled

According to this document, members are required to contribute $ per month during the school year. The employer also makes contributions in an unspecified amount. The contributions are deposited into a trust under the PSERS plan. The trust is examined each year by an independent actuarial firm to determine its ability to make the payments for which it is obligated, as well as by an accounting firm.

Benefits are calculated on the basis of the "Retirement Benefit Formula," according to which a monthly "benefit rate" in effect at the time is multiplied by a factor representing years and months of service. The benefit rate in effect in 1996 was $. Monthly benefits are calculated as follows:

10 yrs x $ = $
12 yrs x =
15 yrs x =

The monthly benefit is reduced if the member chooses one of several options, among them different forms of joint and several annuity and a guaranteed benefit amount. Benefits are reduced for early retirement before age 65 by ½ of one percent for each month under the age of 65. Vesting occurs after years of service. Prior to vesting, an employee who leaves is entitled to a refund of his or her contributions plus interest. The plan makes no specific reference to part-time employees, who appear to be covered on the same terms as full-time employees. The document states that substitute employees who work less than 60 percent of the time during a monthly period do not participate in the plan.

Typical yearly compensation of employees covered by the plan is as follows: $ for a bus driver working 20 hours per week, $ for a lunchroom employee working 30 hours per week, and $ for a custodian working 40 hours per week.

Some State X school districts withhold and pay taxes under the Federal Insurance Contributions Act (FICA) for employees who participate in , but some do not.

QUESTIONS

1. Do the minimum benefit requirements have to be met on an individual-by-individual basis? Section 31.3121(b)(7)-2(e)(2)

2. Does the meet the minimum benefit requirement and the specifications found in Revenue Procedure 91-40 and Treasury Regulation section 31.3121(b)(7)-2(e)(2)?

3. Do the part-time workers meet the “nonforfeitable” exception under Treasury Regulation section 31.3121(b)(7)-2(d)(2)(i)?

4. Does the qualify for the exception to the definition of “employment” for purposes of FICA withholding?

LAW

Sections 3101 and 3111 of the Code impose FICA taxes on the wages paid by employers to employees with respect to employment. Sections 3101(a) and 3111(a) impose Old-Age, Survivors, and Disability Insurance (OASDI) taxes on the wages of employees. Sections 3101(b) and 3111(b) impose Medicare taxes on the wages of employees. 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) 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 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.

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.

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 meets the minimum benefit requirement. Section 31.3121(b)(7)-2(d)(1)(i).

Specific 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 5 months in a year. A temporary employee is any employee performing services under a contractual arrangement with the employer of 2 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. Section 31.3121(b)(7)-2(d)(2)(ii) and (e)(2)(iii)(C).

Code section 414(i) states that a "defined contribution plan" means 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 losses, and any forfeitures of accounts of other participants which may be allocated to the participant's account.

Code section 414(j) states that a "defined benefit plan" means any plan which is not a defined contribution plan.

Rev. Proc. 91-40, 1991-2 C.B. 694, section 3, provides safe-harbor formulas for defined benefit retirement systems: benefits calculated under these formulas are deemed to meet the minimum retirement benefit requirement of section 31.3121(b)(7)-2(e) for defined benefit plans. Section 3.01 provides that a plan meets the minimum retirement benefit requirement with respect to an employee if it satisfies the following conditions: 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 3 or fewer calendar or plan years of service.

ANALYSIS

Whether an employee's services are excepted from employment under section 3121(b)(7) turns on whether the individual employee is a qualified

participant in a retirement system at the time the services are performed. Although the concept of retirement system is very broad, the system must provide a minimum benefit to an employee in order for the employee's services to be excepted from employment. Thus the minimum benefit requirement must be met on an employee-by-employee basis. However, it is possible to conclude that the benefits provided under a particular system are so low that the minimum benefit requirement will never be met.

The plan falls within the section 414(j) definition of a defined benefit plan, i.e., any plan which is not a defined contribution plan. Under section 31.3121(b)(7)-2(e)(2)(ii), a defined benefit retirement system must provide a benefit which is at least equal to the annual PIA that an employee would have under social security. As an initial matter, it is apparent that the benefits calculated under the are very much less than the social security PIA.[1] For example, an employee who worked 30 years at a salary of $9,000 a year would have average monthly earnings of $750, but a benefit of only $.

Rev. Proc. 91-40, section 3.01(1), provides a safe harbor for a defined benefit plan which provides a single life annuity payable beginning no later than age 65 that is at least 1.5 percent of average compensation for each year, or fraction thereof, of credited service. For this purpose, average compensation may be defined as the average of the employee's compensation over the last 36 or fewer months. The benefit is not based upon average compensation. The benefit formula includes a factor for years of service but entirely omits the factor for amount of compensation. Consequently, the benefit formula does not satisfy the safe harbor standards of Rev. Proc. 91-40.

The plan does not satisfy the definition of retirement system under section 31.3121(b)(7)-2(e).

Since the plan does not satisfy the definition of a retirement system, it is not, strictly speaking, necessary to reach the question of whether individuals, including part-time employees, are qualified participants in a retirement system within the statutory definition. You have asked us to discuss part-time employees, and such a discussion is helpful to call attention to the fact that the plan is deficient in more than one respect.

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[1]Calculation of the PIA is based upon Average Indexed Monthly Earnings (AIME). For 1996, the formula was 90 percent of the first $437 of AIME, 32 percent of any AIME between $437 and $2,635, 15 percent of any AIME above $2,635. 1996 Social Security Benefits Including Medicare, CCH (1995).

The regulation contains a specific requirement applicable to part-time seasonal or temporary employees: these employees are not qualified participants on any day unless their benefits are 100-percent nonforfeitable on that day. Section 31.3121(b)(7)-2(d)(2)(i). Under the , benefits are not 100-percent nonforfeitable within the meaning of section 411(a)(11) until the employee completes 10 years of service. Alternatively, under section 31.3121(b)(7)-2(d)(2)(ii), the employee must be 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, plus interest at a reasonable rate. In other words, when a retirement system does not provide for immediate vesting, the regulation contains more stringent requirements for part-time, seasonal, and temporary employees than for full-time, long-term employees. The plan does not comply with these requirements. A non-vested employee who leaves the plan receives only his or her own contribution, $ per month, with interest. Some temporary employees do not participate in the plan at all.

Therefore, even if the plan did qualify as a retirement system, its members who are part-time, seasonal, or temporary employees would not be qualified members of the plan until fully vested in a minimum benefit.

CONCLUSIONS

1. The minimum benefit requirements must generally be met on an individual-by-individual basis.

2. The does not meet the minimum benefit requirement under section 31.3121(b)(7)-2(e)(2) or Rev. Proc. 91-40 for any employee.

3. Part-time workers do not meet the nonforfeitability requirement under section 31.3121(b)(7)-2(d)(2) until they have completed 10 years of credited service.

4. Services performed by an employee who is a member of are not excepted from employment under section 3121(b)(7).