

## Public Pension Plan Reforms and IRS Pick-Up Requirements

By: Susan Lenczewski

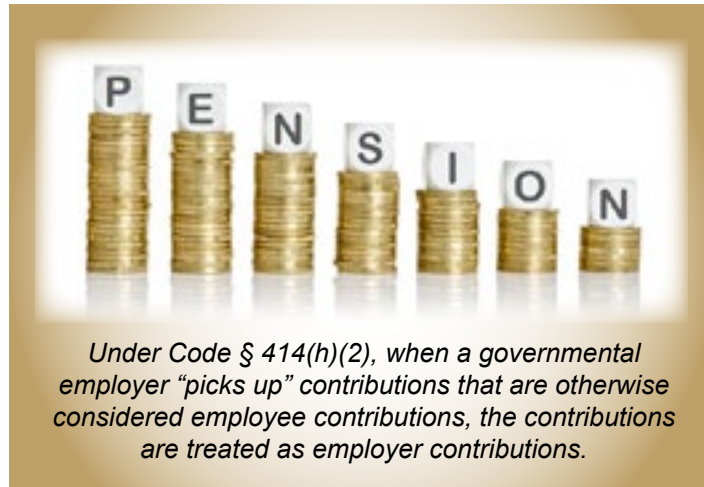
Under the Internal Revenue Code, employee contributions made to a qualified retirement plan are included in income and considered “after-tax” contributions, unless they are made pursuant to a cash or deferred arrangement (CODA), such as under Section 401(k) of the Code. A governmental employer is not permitted to offer a CODA as part of a tax-qualified, or Section 401(a), plan, unless the plan is a “grandfathered 401(k) plan.”<sup>1</sup> But what about employee contributions that are not elective, that is, employee contributions that are required as a condition of employment?

Enter “pick-up” contributions: Under Code § 414(h)(2), when a governmental employer “picks up” contributions that are otherwise considered employee contributions, the contributions are treated as employer contributions. Employer contributions are not taxed to the employee until the benefit is distributed. For governmental defined benefit pension plans, it is important, from a funding perspective, to receive the contributions “pre-tax” to maximize plan assets. Thus, from both a plan qualification perspective and a funding perspective, ensuring compliance with the pick-up rules is critically important.

Section 414(h)(2) states, simply, that “... in the case of any [governmental] plan..., 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 contributions.” It would appear that all the employer needs to do to “pick up” an employee contribution is to include a statement to that effect in the plan document. For governmental plans, the plan document is typically the governing state statutes or city ordinances.

Not one to miss an opportunity to complicate a simple statutory provision, the IRS has expanded and supplemented the law in a number of revenue rulings and private letter rulings since 1980. Note that the IRS has not chosen to go through the rule-making process in its fine-tuning of the requirements of Section 414(h)(2), a process that would have provided opportunity for public pension plans and governmental entities to provide input on draft regulations. Under the IRS’ current criteria, published in a 2006 revenue ruling, to satisfy the pick-up requirements, a governmental employer must do the following:

1. Specify that the contributions, although designated as employee contributions, are being paid by the employer. For this purpose, the employing unit must take formal action to provide that the contributions on behalf of a specific class of employees of the employing unit, although designated as employee contributions, will be paid by the employing unit in lieu of employee contributions. A person duly authorized to take such action with respect to the employing unit must take such action. The action must apply only prospectively and be evidenced by a contemporaneous written document (e.g., minutes of a meeting, a resolution, or an ordinance); and
2. Not permit a participating employee from and after the date of the “pick-up” to have a cash or deferred election right (within the meaning of Section 1.401(k)-1(a)(3)) with respect to designated employee contributions. Thus, for example, participating employees must not be permitted to opt out of the “pick-up”, or to receive the contributed amounts directly instead of having them paid by the employing unit to the plan.<sup>2</sup>



The IRS’ second requirement, which has little to do with Section 414(h)(2), slips into a parenthetical the requirements of a detailed regulation under Section 401(k) regarding what does and does not constitute a cash or deferred election. This 401(k) regulation:

- Defines a “cash or deferred election” to include “*any direct or indirect*” election;
- States that the cash alternative includes “some other taxable benefit;”
- Specifies timing rules, that is, the election must precede the date on which the pay is “currently available,” the services for which pay would have been received must precede the date of the contribution, and the election must precede the date of the contribution; and
- Defines a “one-time irrevocable election” to mean an election made “no later than the employee’s first becoming eligible under the plan *or any other plan or arrangement of the employer.*” (Emphasis added.)

## Public Pension Plan Reforms and IRS Pick-Up Requirements *(continued)*

As borne out by subsequent private letter rulings, the IRS apparently intends to rigorously apply this 401(k) regulation in its analysis of governmental pick-up contributions.

Additional funding for public pension plans is, for many states, counties, cities, and school districts, either not financially possible or politically not feasible. Therefore, to address the problem of insufficient assets to cover benefit liabilities, many public pension plans are having to consider benefit reforms in order to reduce benefit liabilities. Public pension plans, however, will want to ensure that pension benefit reforms or plan design changes do not cause the plan to fail to comply with the pick-up requirements. To fail to comply means risking, at a minimum, the tax-deferred status of employee contributions, causing current taxation of those contributions and requiring plans to separately account for not yet taxed and already taxed contributions. Having to withhold taxes from an employee contribution before it can be paid to the pension plan will reduce the net contribution and worsen the plan's funded status.

Private letter rulings<sup>3</sup> (PLRs) issued since 2006 indicate a predilection on the part of the IRS to interfere with governmental entities' ability to enact benefit reforms. A slightly modified real life example and the application of two PLRs illustrate this potential:

The state sponsors a hybrid plan that requires employees to participate in a defined contribution plan but allows employees to elect to transfer their account to the state's pension plan at any time during the first ten years of employment and be covered under the pension plan. The percentage of salary contributed by employees and employers is identical for both the defined contribution plan and the pension plan, at 5.5% for employee contributions and 6% for employer contributions.

The pension plan is seriously underfunded and is looking at benefit reforms as well as increased contributions. The plan's governing board is proposing an increase of a half percent in the employee contribution rate under the pension plan. The result is that the rate of employee contribution to the pension plan would be 6% of pay, while the rate of employee contribution to the defined

contribution plan would remain at 5.5%. After this change takes effect, an employee electing to transfer to the pension plan from the defined contribution plan would, in effect, be electing to change the rate of employee contribution from 5.5% to 6%.

PLR 201351030 (September 25, 2013) analyzes the impact of being able to transfer from a defined contribution plan to a defined benefit plan, both of which are governmental plans with pick-up contributions. The issue was whether the ability to transfer was a cash or deferred election that would cause the arrangement to violate the pick-up rules. The IRS determined that the transfer did not interfere with the pick-up rules under either plan. The IRS noted that the plans had identical mandatory employee contribution rates and "the employee must necessarily have the same percentage

of his or her compensation contributed by State X on the employee's behalf to [the elected] plan." The PLR does not address whether its conclusion would have been different had the election to transfer from one plan to another also meant a change in the level of employee contribution.

PLR 201532036 (August 7, 2015) analyzes, among several issues, whether plan members' ability to make a one-time irrevocable election to increase their employee contributions from 4% to 5% in year 1 and from 5% to 6% in year 2 and increase their pension multiplier from 1.75% to 1.85% was a cash or deferred arrangement. If the IRS determined that the election was an impermissible CODA, the state statute at issue provided that the employee contribution increases would be automatic and there would be no member election. The IRS reiterated applicable law, which is that a defined benefit plan, such as the plan in this case, could not include a CODA and, even if the plan were a defined contribution plan, it could only include a CODA if the CODA had been adopted prior to May 6, 1986. The IRS held that the election to increase employee contributions was an election to defer receipt of compensation that would otherwise be paid currently, i.e., a CODA. Since that was the IRS ruling, the state statute required employee contribution and multiplier increases,



*Having to withhold taxes from an employee contribution before it can be paid to the pension plan will reduce the net contribution and worsen the plan's funded status.*

## Public Pension Plan Reforms and IRS Pick-Up Requirements *(continued)*

which the IRS found to be permissible under the pick-up rules because there was no longer any employee election.

Since the pension plan's proposed changes in this example fall somewhere between the facts in the two private letter rulings, it would be risky for the governmental entity to proceed with the proposed changes in the absence of its own private letter ruling. Under the rationale in these PLRs, being able to elect a transfer to a pension plan that results in an increase in the employee contribution rate may be considered by the IRS to be an impermissible CODA and a violation of the pick-up requirements.

Like the state in the example, many states and other governmental units are looking at proposals to install a defined contribution plan to which current employees would be given the opportunity to transfer from their current pension plans. The need for "cost-sharing," that is, requiring employees to contribute, as well as employers, is an omnipresent feature of such proposals. As noted above, however, in order to have pre-tax employee contributions, governmental plans must avoid having the new arrangement look like a CODA and otherwise comply with the pick-up requirements. Other benefit reform proposals, such as permitting employees to elect a lower employee contribution rate, in exchange for a lower multiple in their pension formula, would appear to run afoul of the CODA prohibition and would likely be considered an employee election that violates the pick-up requirements.

If a governmental entity or plan wishes to go forward with benefit reforms that are not clearly compliant with the pick-up rules, it would be wise to delay the effective date of the change until a private letter ruling can be obtained from the IRS that the proposed changes do not impact the qualification of the plan or the treatment of the employee contributions as pick-up contributions.

Alternatively, or additionally, it might be time to raise concerns with associations such as NAPPA, NASRA, or NCSL, and advocate for federal legislation that forces the IRS to actually engage in rule-making with regard to the requirements of Section 414(h)(2). The statutory language provides no specifics on what is meant by an employing unit "picking up" employee

contributions. The IRS has filled the void with revenue rulings and private letter rulings, without the benefit of public input and the other procedural protections of rule-making. Legislation could simply amend Section 414(h)(2) to require the IRS to issue final regulations pursuant to that section by a date certain, such as December 31, 2018. That would jumpstart the process of issuing proposed regulations, allowing a period of public comment and testimony, increased transparency, and development of final regulations informed by governmental plan experts.

Other options for federal legislation, such as allowing all governmental entities to sponsor CODAs, would provide much needed flexibility to legislatures and other governing bodies in reforming their pension systems, but such legislation has little chance of success if it is a revenue loser at the federal level.

As noted by Bloomberg BNA, the PLRs issued over the last few years on pick-up contributions suggest that there may be more going on behind the scenes at the IRS with regard to further restrictions on employee elections among plans or tiers of benefits.<sup>4</sup> It may be helpful for association representatives to engage

IRS representatives in discussion regarding their concerns and what abuses the IRS has detected that indicate a more restrictive approach to the CODA requirement is needed. Public pension attorneys and other experts may be able to craft other solutions to help the IRS end whatever abuse it is concerned with, but still give needed flexibility to states in enacting benefit reforms.

*Susan Lenczewski is the Executive Director of the Legislative Commission on Pensions and Retirement for the State of Minnesota.*

### ENDNOTES:

<sup>1</sup>Under Treas. Reg. § 1.401(k)-1(e)(4), a cash or deferred arrangement adopted by a governmental employer before May 7, 1986, is grandfathered.

<sup>2</sup>Rev. Rul. 2006-43, 2006-35 I.R.B. 329 (August 28, 2006).

<sup>3</sup>Private letter rulings are effective only with respect to the specific parties who requested the ruling and may not be relied on or used as precedent by anybody else. Still, PLRs are helpful in interpreting generally applicable guidance, such as a revenue ruling, and as an indication of the IRS' view on a particular issue.

<sup>4</sup>Compensation Planning Portfolio 372-4th Part III. F. (Bloomberg BNA).



*If a governmental entity or plan wishes to go forward with benefit reforms that are not clearly compliant with the pick-up rules, it would be wise to delay the effective date of the change until a private letter ruling can be obtained from the IRS that the proposed changes do not impact the qualification of the plan or the treatment of the employee contributions as pick-up contributions.*