INTERNAL REVENUE SERVICE

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[redacted]

Dear [redacted]:

This relates to your letter dated August 17, 2000, regarding the treatment of part-time employees of a State or local government entity as qualified participants in a retirement system for purposes of the Federal Insurance Contributions Act (FICA). Specifically, you asked the following questions:

1. Whether a retirement system maintained by a State or local government entity may be completely funded through employee contributions;

2. Whether a retirement system maintained by a State or local government entity must provide earnings at an interest rate that equals or exceeds the Applicable Federal Rate; and

3. Whether a retirement system maintained by a State or local government entity may immediately distribute an employee's benefit upon the employee's separation from service without the consent of the employee.

The rules for determining whether part-time employees of a State or local government entity constitute qualified participants in a retirement system for purposes of FICA are discussed below. This discussion is generic in nature and does not attempt to apply the general rules to your specific facts. Pursuant to these rules a defined contribution retirement system maintained by a State or local government entity may be completely funded through employee contributions equal to 7.5% of the employee's compensation. Additionally, a defined contribution retirement system maintained by a State or local government entity is not required to provide earnings at an interest rate that equals or exceeds the Applicable Federal Rate. Finally, a retirement system maintained by a State or local government entity may immediately distribute an employee's benefit upon the employee's separation from service if the present value of the benefit does not exceed $5,000.

Legislative Background

Prior to the enactment of the Omnibus Budget Reconciliation Act of 1990 (OBRA 1990) service as an employee for a State or local government entity was generally not treated as employment for FICA tax purposes. Wages paid to such an employee were not subject to FICA tax unless there was an agreement under section 218 of the Social Security Act in effect between the State and the Secretary of Health and Human Services covering the employee's service. OBRA 1990 amended prior law by adding a new section 3121(b)(7)(F) to the Internal Revenue Code. Section 3121(b)(7)(F) expanded the definition of employment for FICA tax purposes to include service performed after July 1, 1991, as an employee for a State or local government entity unless the employee is a member of a retirement system of such entity.[1] Consequently, with the enactment of section 3121(b)(7)(F) and the corresponding provisions of the Social Security Act, the Congress ensured that service by employees of State and local government entities would be covered either under social security or under a public retirement system providing meaningful benefits.

An employee of a State or local government entity is generally treated as a member of a retirement system of that entity if he or she participates in a system providing retirement benefits that are comparable to the benefits he or she would have received under social security. In the case of part-time, seasonal, and temporary employees this minimum retirement benefit is required to be nonforfeitable. As discussed below an employee is not a member of a retirement system at the time service is performed unless he or she is a "qualified participant" in a "retirement system" as those terms are defined in section 31.3121(b)(7)-2 of the Employment Tax Regulations.

Definition of Retirement System

For service in the employ of a State or local government entity to qualify for the exception from employment under section 3121(b)(7) the employee must be a member of a retirement system that provides at least a minimum level of retirement benefits to that employee. To meet this minimum retirement benefit requirement a pension, annuity, retirement, or similar fund or system must provide a retirement benefit to the employee that is comparable to the benefit provided under the Old-Age portion of the Old-Age, Survivor, and Disability Insurance program of social security. Whether a retirement system meets this requirement is generally determined under the facts and circumstances of each case and on an individual-by-individual basis.

While the definition of retirement system is limited in order to carry out the purposes of section 3121(b)(7)(F) and of the corresponding provisions of the Social Security Act, the legal form of the system is generally not determinative. Thus, the fact that a retirement system is not a qualified plan under the Code is not relevant.

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[1] OBRA 1990 made a similar change to corresponding provisions of the Social Security Act.

Additionally, benefits provided through employee contributions are taken into account to the same extent as benefits provided through employer contributions. Consequently, a plan may be treated as a retirement system even if it is completely funded through employee contributions.

A defined contribution retirement system maintained by a State or local government entity meets the minimum retirement benefit requirement of section 3121(b)(7)(F) if allocations to an employee's account (not including earnings) for a period are at least 7.5 percent of the employee's compensation for service during that period. The period used to determine whether the defined contribution retirement system meets the minimum retirement benefit requirement need not remain the same from day to day as long as the period begins on or after the beginning of the plan year and ends on the date with respect to which the determination is being made.

A defined contribution retirement system does not satisfy the minimum retirement benefit requirement unless the employee's account is credited with earnings at a rate that is reasonable under all the facts and circumstances or the employees' accounts are held in a separate trust that is subject to general fiduciary standards and are credited with actual earnings on the trust fund. Whether the interest rate with which an employee's account is credited is reasonable is determined after reducing the rate to adjust for the payment of any administrative expenses.

Pursuant to section 5.06 of the [redacted] the [redacted] must establish a trust or custodial account for the exclusive benefit of participants and their beneficiaries. Additionally, all amounts of compensation deferred pursuant to the plan, all property and rights purchased with such amounts, and all income attributable to such amounts, property, or rights must be held in the trust or custodial account. Finally, the custodian of any custodian account created pursuant to the plan must be a bank or a nonbank trustee in accordance with applicable provisions of the Internal Revenue Code. As discussed above, if employees' accounts are held in a separate trust that is subject to general fiduciary standards and are credited with the actual earnings on the trust fund, the applicable interest rate requirements will be satisfied regardless of the actual rate of earnings on the account.

Definition of Qualified Participant

An employee is treated as a member of a retirement system only if he or she actually participates in the system and actually receives an allocation sufficient to satisfy the minimum retirement benefit requirement (7.5 percent of the employee's compensation). Allocations that are conditioned on the satisfaction of service, employee election, or other requirements are not taken into account for this purpose unless and until the employee has satisfied those requirements.

Whether an employee is a qualified participant in a defined contribution retirement system is determined as services are performed. An employee is a qualified participant in a defined contribution retirement system with respect to services

performed on a given day if, on that day, he or she has satisfied all conditions for receiving an allocation to an account that meets the minimum retirement benefit requirement during any period ending on that day and beginning on or after the beginning of the plan year. Thus, the period used to determine whether an employee is a qualified participant on a given day may begin on any day after the beginning of the plan year and may end on any subsequent day within the same plan year. Consequently, if the level of contributions during a specified period within the plan year meets the minimum retirement benefit requirement with respect to compensation during that period, the employee is treated as a qualified participant during that period notwithstanding the fact that the employee may not be treated as a qualified participant during other periods within the same plan year.

A part-time, seasonal, or temporary employee is generally not a qualified participant on a given day unless any benefit relied upon to meet the minimum retirement benefit requirement is 100-percent nonforfeitable on that day. 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 under the retirement system 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 taken into account in determining whether the employee's benefit under the retirement system meets the minimum retirement benefit requirement. Additionally, the participant must be entitled to interest on the distributable amount through the date of distribution at a rate satisfying the reasonable interest rate requirements.

A distribution is considered available on account of separation from service if it is available when an employee retires or reaches normal retirement age after separation from service. Thus, there is no requirement that the distribution occur at the time the employee separates from service. A benefit does not fail to be nonforfeitable, however, solely because it can be immediately distributed upon separation of service without the consent of the employee if the present value of the benefit does not exceed $5,000. Thus, a system may retain the right to cash-out the benefit of a part-time, seasonal, or temporary employee in certain circumstances without the consent of the employee and may still meet the nonforfeitable benefit requirement.

Transition Rules

A defined contribution retirement system maintained by a State, political subdivision or instrumentality thereof on November 5, 1990, met the minimum retirement benefit requirement for any plan year beginning before January 1, 1993, if mandatory allocations to an employee's account (not including earnings) for a period were at least 6 percent (rather than 7.5 percent) of the employee's compensation for service during that period. This transition rule was only available with respect to an employee who was actually covered under the system on November 5, 1990, and to an employee who became a participant after November 5, 1990, if he or she was employed in a position that had been covered under the retirement system on November 5, 1990, without regard to whether such coverage was mandatory or

elective. Additionally, this transition rule was not available with respect to a part-time, seasonal, or temporary employee unless the mandatory allocation was 100-percent nonforfeitable.

Under a special transition rule an employee could have been treated as a qualified participant in a retirement system on a given day during the period July 1 through December 31, 1991, if it would have been reasonable on that day to believe that he or she would be a qualified participant by January 1, 1992 (taking into account only service and compensation on or after such date). In making this determination it would have been reasonable to assume that the terms of a plan would be changed or that a new retirement system would be established by the end of calendar year 1991, as long as affirmative steps had been taken to accomplish this result.

We hope this discussion of the rules for determining whether part-time employees of a State or local government entity constitute qualified participants in a retirement system for purposes of FICA is helpful to you. Please telephone me at (202) 622-6040 with any additional questions you may have or if I may be of further assistance to you in any way.

Sincerely,

JERRY E. HOLMES
Chief, Employment Tax Branch 2
Office of Assistant Chief Counsel
(Exempt Organizations/Employment
Tax/Governmental Entities)