



New PLR Calls “Air Time” into Question Technical Corrections must be Retained in Pension Conference

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Summary

While Congress enacted section 415(n) of the Internal Revenue Code (IRC) -- which governs the purchase of permissive service credits -- to specifically address a number of existing policies under State or local law, the IRS has indicated that many practices specifically intended to be covered may not fit within their reading of this section. The most recent example is Private Letter Ruling 200550042 (a summary prepared by Paul Zorn, Gabriel, Roeder & Smith, is attached) expressing IRS staff’s view that to qualify as “permissive service credit” the purchased service must correspond to a period of employment that was not previously credited under the plan. Presumably, this would disallow service credit purchases that do not correspond to a period of prior employment (sometimes referred to as “air time”).

Furthermore, this linkage with actual employment compounds problems posed by past PLRs and could be read to prohibit increasing the multiplier under a benefit formula, sometimes referred to as “buying-up” the multiplier. The rulings do not appear to be an exact science – often hinging more on how the purchase is defined rather than the underlying policy itself. Even within PLR 200550042, there appears to be an inherent inconsistency, since it permits school employees to purchase credit for service that is indirectly tied to employment, yet implying actual service is required for service purchased by others.

Thus, a few technical but critical changes, which are included in the Senate version of pending pension reform legislation, are imperative to further clarify the ability of public employees to purchase various types of service credit in their State or local defined benefit plans in order to build for their retirement security.

Background

When IRC section 415(n) was originally adopted by the Congress as part of the Taxpayer Relief Act of 1997, NASRA and NCTR, as well as public plan representatives and public employer and employee organizations, were closely involved in its drafting. The aim of establishing the new subsection was to permit public plan participants to purchase permissive service credit in their defined benefit plans at or close to retirement without running afoul of federal tax limits.

It was recognized that service credit is an important component in eligibility and calculation of payments under defined benefit plans and the ability to purchase service credit provides added portability and benefit adequacy for workers in such plans. This is particularly true for public employees who leave the workforce to raise a family, return later in life to their career, and wish to be able to make up for lost service within the DB context, similar to the catch-up provisions allowed for DC plan participants.



Furthermore, it was also understood that the purchase of service credit provided a solution to problems that arose in connection with different tiers or plans within a system. For example, the purchase of service credits would permit a dispatcher who is reclassified as a public safety employee rather than a general employee to convert service credited under the general plan to service under the public safety plan, which has higher contribution rates. Other uses involve employees who wish to buy into a new tier that has been created that has higher benefits, but also higher contribution rates, or when individuals that elect participation in an alternative defined contribution plan subsequently have the opportunity to participate in the defined benefit plan.

The use of the term “permissible service credit” in this regard was chosen because it reflected the terminology recognized by governmental plans for purposes of calculating a participant's benefit, and not because it was intended to suggest that some form of actual “service” was required.

Recent Private Letter Ruling

While a PLR interprets the tax laws as they apply to the requester’s specific set of facts, and are not to be used or cited as precedent, they nevertheless provide a record of interpretation by the IRS. Furthermore, they are typically accorded a high degree of deference given that the IRS is less likely to reverse itself once it has established a written position on a given issue.

The new PLR can be read as rejecting the practice of some governmental plans not to require a period of actual employment in order for a member to purchase up to 5 years of nonqualified service credit. This reading of the law is contrary to specific discussions with Treasury officials regarding the need to accommodate “air time” when 415(n) was being drafted. Many public plan provisions were subsequently modified to permit up to 5 years of “airtime” to be purchased following the enactment of 415(n).

However, it appears the Service does not feel the statute or legislative history is clear enough on this issue. Some deferred compensation administrators have reportedly been urged to keep these issues in mind when permitting transfers to purchase service credit. Some have barred transfers for airtime until definitive guidance is received in this area. That said, PLR 200550042 also makes what appears to be a clear exception in the case of school employees by permitting them to purchase up to three additional months of service that do not represent a period of actual employment, so long as these months are part of a 12-month period (school year or term) during which the member does perform actual service for the educational institution.

This inconsistency of treatment does not seem to be linked to any exception in the law itself. While it may reflect a valid recognition of the employment realities of certain educational employees, there are other sympathetic situations that exist. The need to make such an exception also serves to underscore the inherent weakness in the IRS’ otherwise intractable insistence on actual employment of some nature. Furthermore, it makes abundantly clear that the clarification of IRC section 415(n) contained in S. 1783, currently pending in conference with the House of Representatives, needs to be adopted.



S. 1783 Addresses Numerous Issues

While IRC §415(n) was initially written primarily to deal with after-tax contributions to public sector DB plans to purchase service credits, the enactment of numerous portability provisions as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 permitted additional sources of pre-tax income to be used to make such purchases. Rollovers and transfers can now be made between qualified and many nonqualified plans (including governmental 403(b) and 457(b) plans). In addition, in-service transfers can be made specifically from 457 and 403(b) plans to purchase permissive service credits in public DB plans.

Treasury was responsive to the concerns of public sector pension advocates and final 457 regulations favorably addressed a number of issues raised in proposed regulations on purchases of service credit. However, new issues have since arisen. To address the many extremely restrictive interpretations of 415(n) being taken or discussed by the IRS, the Senate-passed Pension Security and Transparency Act (S. 1783) makes the following clarifications:

- Service credit may be purchased for periods for which there is no performance of service (e.g. airtime);
- Credit may be purchased in order to qualify for an increased benefit (e.g. a higher tier/formula in the same plan);
- A trustee-to-trustee transfer of 403(b) and 457 funds into a governmental defined benefit plan to purchase service credit does not need to be tested under the 415(n) limits on after-tax contributions to the plan;
- Once 403(b)/457 funds are transferred to a governmental defined benefit plan, they take on the distribution rules of such a plan (i.e. must be tested under 415(b), etc); and
- Transfers need not be made between plans maintained by same employer.

Since these clarifications address numerous problematic issues and have been scored as having a negligible impact on federal tax revenues, we urge they be retained in the final House-Senate conference agreement on pension reform.

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From: Paul Zorn, Director of Governmental Research

Subject: IRS PLR 200550042 on Purchasing Service Credit

On September 20, 2005, the IRS issued a private letter ruling (PLR 200550042) regarding service credit purchases provided by a governmental plan. The IRS was asked to rule on two issues: (1) whether the plan's definitions of "other service" and "summer months service" constitute "permissive service credit" under the Internal Revenue Code and (2) whether the service could be purchased with direct trustee-to-trustee transfers from 403(b) and 457(b) plans on a pre-tax basis. Readers should note that private letter rulings are only directed to the taxpayer requesting them and may not be used or cited as precedent.

The ruling was requested by a governmental retirement system that administers several contributory defined benefit plans for state employees (Plan X), state police officers (Plan Y), county employees, school boards, and local governments (Plan Z). Plan X provides that any employee participating in one of more of the plans administered by the system prior to July 15, 2002, who has accrued at least 48 months of service at age 65 (or at least 60 months of service if under 65) and who has at least 180 months of total service may purchase up to five years of "other service" credit that is not otherwise purchasable under the plans.

Plan X also provides that employees of schools, school boards, or institutions of higher education who participate in Plans X or Z and who receive credit for less than 12 months of service each year, may purchase additional "summer months service" credit (up to 3 months) needed to total one year. Moreover, for employees who have credit for service prior to July 1, 1992, half of the cost of the purchased service may be paid by the employer.

Code § 415(n)(3)(A) provides that "permissive service credit" means service credit recognized by a governmental plan for calculating a participant's benefit, which the participant has not received under the plan, and which the participant may only receive by making a voluntary additional contribution to the plan which does not exceed the amount necessary to fund the benefit attributable to the purchased service.

After discussion with the IRS, the system revised its provision for purchasing "other service" – allowing it only if the purchased service corresponds to a period of employment (in the public or private sector) that was not previously credited under the system. After this change, the IRS agreed that the plan's definition of "other service" constituted permissive service credit under the Code, since it relates to an actual period of employment for which the member has not received credit under the plan and which the member could receive by making an additional voluntary contribution. The IRS also ruled that "summer months service" constituted permissive service credit, since the member would not otherwise have received credit for the additional months of

service under the plan and which the member could only receive by making an additional voluntary contribution.

Regarding purchasing service credit through direct trustee-to-trustee transfers, the IRS found that since "other service" and "summer months service" are permissive service within the meaning of Code § 415(n)(3)(A), the service could be paid for by direct trustee-to-trustee transfers from a 403(b) arrangement or a governmental 457(b) plan. Moreover, such transfers are not includible in a member's gross income at the time of transfer to the extent the transferred amounts are used to pay the member's cost associated with purchasing the service credit.

Note: The Pension Security and Transparency Act of 2005 (S. 1783), approved by the Senate in November 2005 by a vote of 97-2, includes a provision related to governmental service purchases. Section 1001 of the Act amends the definition of "permissive service" in Code § 415(n)(3)(A) to include "service credit for periods for which there is no performance of service, and ... may include service credited in order to provide an increased benefit for service credit which a participant is receiving under the plan." However, before this becomes law, it must first survive the House/Senate Conference Committee and be signed by the President.