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Recent IRS Rulings Illustrate the Dangers of Creating Impermissible Cash or Deferred Arrangements in Governmental Plans

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The Internal Revenue Code and regulations provide that a governmental 401(a) plan is generally prohibited from creating a "cash or deferred arrangement" similar to a 401(k) plan. Past IRS guidance also provides that the creation of such a cash or deferred arrangement invalidates a governmental "pick-up" under which employee contributions may be treated as pre-tax contributions under Code section 414(h)(2). And IRS Rev. Rul. 2006-43 has generally applied the definitions of the 401(k) regulation to allow -- as the only exception to that rule - a one-time, irrevocable election to participate or not at the time an employee is first able to participate in any retirement plan of the employer. Over the years, this position has been a significant impediment to public plans in structuring changes that depend on employee elections, such as a choice of a new "tier" of benefits, other than for new hires.

Two recent private letter rulings (PLRs) illustrate, once again, that the IRS interprets the rules for pick-up contributions, as they were elaborated on in Rev. Rul. 2006-43, very narrowly, so that any election between participation in two governmental 401(a) plans or tiers after initial hire that results in different picked-up contributions can be an impermissible cash-or-deferred arrangement.

PLRs 202020019 and 202020006 involve different plans and facts, but both involve adding a new tier of benefits in the form of a hybrid cash balance plan. In both cases, the State legislature enacted a law giving certain participants a one-time irrevocable election to participate in the new hybrid cash balance plan tier instead of receiving the benefits they were currently eligible to receive under their respective traditional defined benefit plan formulas. Under the legislation, the mandatory picked-up employee contribution amount for some, but not all, members would remain the

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same before and after the election. Certain employees making the election, though, would be required to contribute an additional percentage of compensation to a section 401(h) retiree medical account if the member elected to join the hybrid cash balance plan. In both rulings, the election would not be available until the taxpayer received a favorable private letter ruling from the IRS.

As expected, the IRS ruled that there would be a valid pick-up under section 414(h)(2) where the mandatory, pre-tax employee contributions to the new hybrid cash balance plan would be exactly the same as the employee contributions to the prior defined benefit tiers, but that the election was an impermissible cash or deferred arrangement as to those participants where there was a difference in total contributions between the two options due to the additional percentage contribution to the section 401(h) account. Though the ruling does not discuss it, the contributions that would be an impermissible cash or deferred arrangement could instead be made as after-tax contributions, subject to the section 415 limits for defined contribution amounts (although 401(h) accounts would not be able hold such contributions).

All of this is to reinforce the importance of properly designing any employee elections as to benefits under governmental 401(a) plans, as well as that the IRS is willing to rule in the area, if greater clarity on a specific design is desired.

If you have any questions about pick-ups and the impact of these rulings, please call David W. Powell or your regular Groom lawyer.