

ARE YOU QUALIFIED?

A GUIDE TO TAX QUALIFICATION AND FEDERAL LAW ISSUES

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Pension Protection Act Update

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IRC § 401(a)(36) – Working in Retirement

- ❑ In-Service distributions allowed by PPA for DB plans and certain DC plans
- ❑ "Bright Line" at age 62 even though the employee has not separated from service
- ❑ Does not apply to 401(k), 457(b), or 403(b) plans

IRC § 401(a)(36) – Working in Retirement *(cont'd)*

- ❑ IRS Final Regulations issued May 2007 –
Defining Normal Retirement Age
 - o Maintains the Age 62 as "Safe Harbor" for all employees and permits a Normal Retirement Age as low as 55 based upon certain findings.

IRC § 401(a)(36) – Working in Retirement *(cont'd)*

- o Establishes Age 50 as "Safe Harbor" for public safety employees
 - Definition: "Any employee of a State or political subdivision of a State who provides police protection, firefighting services, or emergency medical services for any area within the jurisdiction of such State or political subdivision."

IRC § 401(a)(36) – Working in Retirement *(cont'd)*

❑ Important Issues to Consider

- o Effective Date: For governmental plans, plan years beginning in 2009. For collectively bargained plans in effect on 5/22/2007, the earlier of the end of the agreement or 5/22/2010.
- o Impact on plans that cover both public safety and general employees
- o Impact on HELPS

IRC § 401(a)(36) – Working in Retirement *(cont'd)*

- o Definition of Normal Retirement Age by reference to years of service.
 - Notice 2007-69: "The 2007 regulations do not provide a safe harbor or other guidance with respect to normal retirement age that is conditioned (directly or indirectly) on the completion of a stated number of years of service."

IRC § 401(a)(36) – Working in Retirement *(cont'd)*

- Comments filed
 - Need to recognize "Years of Service" as NRA where years of service represents a career
 - Need to allow multiple NRAs in a single plan
- IRS Response
 - Work Program

IRC § 402 – HELPS

- ❑ PPA created \$3,000 exclusion for direct deductions for health and long-term care insurance from distributions from DB and DC plans
- ❑ "Eligible Retired Public Safety Officers" - - Under 42 USC 3796b(9)(A) the Public Safety Officers Benefit Act ("PSOBA"):
 - o an individual involved in crime and juvenile delinquency control or reduction, or enforcement of the criminal laws (including juvenile delinquency), including, but not limited to police, corrections, probation, parole, and judicial officers;

IRC § 402 – HELPS *(cont'd)*

- o professional firefighters;
- o officially recognized or designated public employee members of a rescue squad or ambulance crew;
- o officially recognized or designated members of a legally organized volunteer fire department; and
- o officially recognized or designated chaplains of volunteer fire departments, fire departments, and police departments

IRC § 402 – HELPS *(cont'd)*

❑ IRS Notice 2007-7

- o Separated from service by reason of disability or attainment of Normal Retirement Age
- o One \$3,000 exclusion per year from all plans
- o Health Reimbursement Accounts are not covered
- o Only Employee and Spouse and Dependents covered and only while employee is living

IRC § 402 – HELPS *(cont'd)*

- o The IRS in Notice 2007-7 attempted to limit this provision to deductions for "insurance issued by an insurance company regulated by a State (including a managed care organization that is treated as issuing insurance)"
- o In response to letter from four caucuses, Treasury and IRS changed position so that both insured and self-insured products are covered. Notice 2007-99
- o Corrective language in PPA corrections bill to address this.

IRC § 402 – HELPS *(cont'd)*

❑ Most Recent IRS Actions

- 1099-R Reporting for 2008
 - No special reporting is required on Form 1099-R
 - It is permissible to include information as to amount of deductions
- Retirees will have to claim the exclusion on their 1040s

Other Health Care Deductions

❑ Proposed Regulations Issued

- o Only HELPS deductions can be made on non-taxable basis from pension distributions.
- o Only 401(h) accounts can provide for non-taxable distributions from a pension plan.
- o 401(h) accounts must be separate accounts that are separately funded. If pension assets are used for the distributions, they will be taxable.
- o IRS is closely monitoring this.

IRC § 72(t) – Waiver of 10 Percent Early Withdrawal Penalty

- ❑ A PPA provision that affects certain distributions of DB Plans – lump sums, cash-outs, DROPs
- ❑ "Qualified Public Safety Employee"
- ❑ Separates from service after age 50 (rather than age 55)

IRC § 72(t) – Waiver of 10 Percent Early Withdrawal Penalty *(cont'd)*

- ❑ IRS interpretations – Rollovers to IRA and DC plans not covered - this is a concern because of DROP rollovers.

Rollovers

- ❑ Non-Spouse Beneficiary Rollovers
 - Under PPA, optional provision for 2007 – 2008
 - Rollovers only to "inherited IRA"
 - Under PPA Technical Correction, mandatory provision for 2009

Rollovers *(cont'd)*

❑ Rollover to Roth IRA

- o Under PPA and Notice 2008-30, mandatory provision for 2008 and thereafter
- o Rollover is generally taxable
- o Need to be concerned about 1099-R reporting

HEART Act

HEART Act

- ❑ Heroes Earnings Assistance and Relief Tax (HEART) Act of 2008 (HR 6081)
 - Signed by President June 17, 2008
- ❑ Required Provisions
 - If a plan participant dies while performing USERRA service, 401(a), 403(b), and 457(b) plan must treat him/her as having died during covered employment.
 - Retroactively effective 1/1/2007

HEART Act *(cont'd)*

❑ Optional Provisions

- A retirement plan may treat an individual who died or who was disabled during USERRA service as though the individual had returned to employment and received credit for the intervening time.
 - May be retroactively effective to 1/1/2007

HEART Act *(cont'd)*

❑ Differential Pay

- An individual receiving differential pay must be treated as the employee of the employer.
- The payment is also treated as compensation for purposes of contributions and benefits.
 - Effective 2009
 - Consider impact on benefit calculation

HEART Act *(cont'd)*

❑ Distributions

- o During USERRA covered service, distributions can be received.
 - Effective 2009
- o Qualified Reservist Distributions made permanent

Important IRS Guidance Projects

DROPs

- ❑ Age Discrimination under ADEA § 4(i) (part of PPA provisions dealing with "cash balance plans")
 - Hybrid plan provisions in ADEA will apply to governmental plans
 - IRS and Treasury say "Market Rate of Return" applies to governmental plans
 - IRS has issued proposed regulations

DROPs *(cont'd)*

- ❑ Very important issue for certain governmental plans with cash balance component such as annuity savings accounts and DROPs.
- ❑ PPA technical correction bill contains exception from market rate of return for governmental plans.

❑ DROP Design

- IRS is closely scrutinizing DROP plans
- IRS wants to know how the DROP feature should be treated.
 - An accrual in the DB plan
 - Not a separate DC account
 - Must be analyzed under all IRC requirements – minimum distributions (401(a)(9)), 415(b) benefit limits, "definitely determinable benefits"

Pick-ups

- ❑ IRS issued Revenue Ruling 2006-43, August 2006.
 - Requires employers to take official action in order to have a pick-up of mandatory employee contribution, so that these contributions would be pre-tax.
 - Prohibits employees from having the right to change the amount of contributions.
 - Plans/employers with a private letter ruling are permanently grandfathered
 - Other plans/employers have until 1/1/09 to take official action

Pick-ups *(cont'd)*

- ❑ What's the problem?
 - IRS takes the position that there can be no "service-purchase pick-ups" on a pre-tax basis.
 - Those with PLRs are protected. Those without a PLR do not have protection.

Pick-ups *(cont'd)*

- o IRS takes the position that elective participation in 401(a) plans (both DB and DC) is restricted to a one-time irrevocable election at the commencement of employment.
 - The IRS position can cause a problem when a new benefit tier is instituted and employer wishes to offer an election to existing employees.

Leave Conversion Programs

- ❑ IRS has taken a very restrictive view on leave conversion programs, if there is any elective feature.
 - IRS is auditing these programs at the employer level.
 - Elective leave conversion programs are being treated as taxable elections, which can affect many programs – retirement and health.
- ❑ The status of "Special Pay Plans" is very unclear.

415 Regulations

- ❑ Final 415 Regulations were issued in April 4, 2007
 - Governmental plans compliance required:
 - "Limitation years that begin more than 90 days after the close of the first regular legislative session of the legislative body with authority to amend the plan that begins on or after July 1, 2007."
 - For a local governmental plan, this may mean that the effective date will begin in 2008.
 - For a state governmental plan where the legislature meets in 2008, this may mean that the effective date will begin in 2009.

415 Regulations *(cont'd)*

❑ DC Plan limits

- For a "pure" DC plan, the limit applies to the combined total of employer and employee contributions – the lesser of 100% of compensation or \$46,000 (adjusted each year)
- For a DB plan, the limit still applies to the employee after-tax contributions.
 - The limit does not apply to the picked-up contributions.
- The definition of compensation is changed.

415 Regulations *(cont'd)*

❑ DB Plans

- o The basic annual limit is \$185,000 (2008 and adjusted thereafter).
- o For general employees, that limit is reduced if the member's age is lower than 62. However, that reduction is not applicable to employees who have 15 years of service as public safety employees or 15 years of military service.

415 Regulations *(cont'd)*

- ❑ Special Issues for Defined Benefit Plans
 - o A DROP benefit must be taken into account for benefit testing purposes.
 - o Post-retirement adjustments (COLAs) will have to be examined.

Definition of a Governmental Plan

- ❑ IRS, Department of Labor, and PBGC are working on a definition of "governmental plan" – IRC § 414(d)
 - DOL allows *de minimis* number of non-governmental employees
 - IRS has not accepted that position
- ❑ This project is years from conclusion, per IRS.

IRS Compliance Efforts

IRS Initiative on Qualification Compliance

❑ IRS Roundtable – April 22, 2008

○ IRS Topics

- Compliance efforts
- Getting a determination letter
- Correction Procedures

IRS Compliance Efforts

- ❑ Survey
 - o Focus Group
 - o Data Collection
- ❑ Develop web site – [www.irs.gov/retirement -
"governmental plans"](http://www.irs.gov/retirement-governmental-plans)
- ❑ Develop compliance tools
 - o Compliance checklist
- ❑ Audits of governmental plans are going on now

Determination Letters

- ❑ Determination letter is an "insurance policy"
 - While the IRS is developing its compliance program, governmental plans have the opportunity to protect themselves
 - IRS has established a filing cycle for governmental plans to seek a favorable determination letter
 - Cycle C – February 1, 2008 through January 31, 2009
 - The next Cycle will be 2013 - 2014

Determination Letters *(cont'd)*

- ❑ What does a determination letter mean?
 - The "plan document" (statutes, regulations, ordinances, MOUs) complies with the Internal Revenue Code and IRS regulations.
 - All "required amendments" have been made
 - The plan does not have any provisions that are impermissible
 - Once a plan has a letter, the IRS is bound by its determination – so any future compliance efforts would be prospective.

Advantages of Having a Determination Letter

- ❑ Simplified compliance
 - Adopt interim amendments
 - Only file every 5 years
- ❑ Greater flexibility on self-correction
 - More types of problems can be fixed without going to IRS

Advantages of Having a Determination Letter *(cont'd)*

- ❑ Practical day-to-day advantages
 - o Foreign tax recapture or exemption
 - o Member bankruptcies

Determination Letter - Process

- ❑ How does a governmental plan get a letter?
 - Complete IRS Form 5300
 - Compile the "plan document"
 - Make sure plan language is in compliance
 - If plan has a "current" letter, explain amendments made since that letter
 - Pay filing fee - \$1000
 - Submit to IRS on or before January 31, 2009

Determination Letter - Process *(cont'd)*

- ❑ How does a governmental plan know if plan language is in compliance?
 - o Is plan language up to date? Is document consistent with how plan is administered?
 - o IRS "Cumulative list" – Notice 2007-94

Updating the Plan Document

- ❑ General Requirement – A qualified plan must be administered in accordance with its terms.
 - Review plan document to make sure it contains current benefit provisions, correct interpretations
- ❑ Does plan contain required IRS language?
 - Incorporation by reference is permissible in certain cases, but
 - IRS is increasingly requiring specific language
 - Have to look at date of amendments – were required amendments made on time?

Plan Amendments

- ❑ IRS issues annually a list of required amendments in order for plan document to remain in compliance.
 - In general, governmental plans must be amended by the last day of the next regular legislative session beginning after the amendment's effective date in which the government body with authority to amend the plan can consider a plan amendment under the laws and procedures applicable to the governing body's deliberations. (Rev. Proc. 2007-44)
- ❑ PPA Amendments must be made by the last day of the 2011 plan for governmental plans.
 - This is a technical amendment requirement. PPA provisions will have to be implemented (in many cases) before this date.

Plan Amendments *(cont'd)*

- ❑ HEART Act amendments must be made by the last day of the 2012 plan year for governmental plans.
 - o Some provisions effective 1/1/07.

Correcting Problems

- ❑ What should a governmental plan do if problems are uncovered?
 - Correct them!
 - IRS has a correction procedure
 - For a "late amender," there is a separate filing with a separate fee
 - For operational "failures", some problems can be self-corrected with no IRS filing or fee
 - Some operational corrections should be taken to IRS.

IRS List of Common Compliance Problems

- ❑ Failure to make required minimum distributions under Code Section 401(a)(9) in a timely manner.
- ❑ Impermissible cash or deferred elections.

IRS List of Common Compliance Problems *(cont'd)*

- ❑ Failure to comply with the requirements of Code Section 401(a)(31) - Rollovers.
- ❑ Some plans provided benefits to individuals based upon service and compensation that was not associated with the plan sponsor or any participating employer (non-governmental employers).

IRS List of Common Compliance Problems *(cont'd)*

- ❑ Computing benefits and required employee contributions using participant compensation that exceeded the limits imposed by Code Section 401(a)(17).
- ❑ Failure to limit plan benefits as required by Code Section 415(b).

IRS List of Common Compliance Problems *(cont'd)*

- ❑ Plan assets were used to fund retiree health insurance in a manner that did not comply with Code Sections 401(a)(2) and 401(h).
- ❑ Eligibility provisions were not followed and some ineligible employees were allowed to participate while eligible employees were improperly excluded.

IRS List of Common Compliance Problems *(cont'd)*

- ❑ Benefits were not determined in accordance with the written terms of the Plan.
- ❑ Premature distributions were made to plan participants who had not satisfied the plan's conditions for receiving a distribution (in-service distributions).
- ❑ In some DC plans, the allocation formulas were not definitely determinable.

FAQs About the Determination Letter and Correction Process

- ❑ "Our plan has never had a determination letter. How can we possibly get a letter?"
 - If your plan has been updated over the years for federal law changes, your filing will not be very difficult once you compile the documents and do the research on plan amendments and dates
 - If your plan has missed one or more amendments, you can use the correction procedure and then file for determination letter

FAQs About the Determination Letter and Correction Process *(cont'd)*

- o If your document review also reveals operational compliance issues, then that will need to be corrected as well
- Variations on the question – "Our plan's last letter was from the 70's, the 80's, the 90's"

FAQs About the Determination Letter and Correction Process *(cont'd)*

- ❑ Why would a governmental plan voluntarily go to the IRS?
 - IRS reads the newspapers
 - IRS is embarking on a compliance initiative for governmental plans
 - IRS is auditing governmental plans now
- ❑ Really Important Reasons
 - Protect members, retirees, and beneficiaries
 - Deferred taxation
 - Pick-ups
 - Rollovers

Thank You

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