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National Conference on Public Employee Retirement Systems

NCPERS: Who We ARE

The National Conference on Public Employee Retirement Systems (NCPERS) is the largest trade association for public-sector pension funds, representing more than 550 funds throughout the United States and Canada. We are a unique network of public trustees, administrators, public officials, and investment professionals who collectively manage approximately $3.7 trillion in pension assets. Our core missions are federal Advocacy, conducting Research vital to the public pension community, and Educating pension trustees and officials—it’s who we ARE.

Who do we benefit? The approximately $3.7 trillion in public pension assets in the United States is managed on behalf of 7.3 million public retirees and 14.5 million active public servants who provide vital services, such as law enforcement, fire and rescue, education, health care, and more, to our communities. Currently, NCPERS member pension funds provide a modest retirement benefit—an average of approximately $25,000 per year—that helps afford a secure retirement for our public servants and heroes.

Public pensions are financially sound and good for the economy. On average, the nation’s public pension plans are well-funded. Almost all public plans require employee contributions, and all public plans invest their assets in growth vehicles that earn additional income. According to a recent National Institute on Retirement Security study, state and local pension plans had a total economic impact of more than $358 billion, supported more than 2.5 million American jobs, and provided more than $57 billion in annual federal, state, and local tax revenue in a single year. Each taxpayer dollar invested in state and local pensions supported $11.45 in total economic activity, while each dollar paid out in benefits supported $2.36 in economic activity.

Public pensions are regulated by state and federal laws. All public plans are governed by federal and state laws that regulate how those plans are established and the level of benefits they can provide. Public plans are also governed by comprehensive financial reporting standards established by the Governmental Accounting Standards Board (GASB). These standards provide the framework for the annual financial audits that most governments contract to independent accounting firms. Because credit rating agencies pay close attention to the auditor’s report in assessing a government’s credit quality, there is significant incentive to adhere to GASB’s standards. Although public plans are not subject to many of the provisions of the federal Employee Retirement Income Security Act (ERISA) of 1974, state fiduciary laws governing public plans often reflect ERISA’s language.
The Secure Annuities for Employee (SAFE) Retirement Act

In the 113th Congress, Senator Orrin Hatch (R-UT) introduced S. 1270, the Secure Annuities for Employees (SAFE) Retirement Act. Title I of the SAFE Act would allow states and municipalities to prospectively replace their public pensions by purchasing private insurance annuities for public employees. Once annuities replace the public plans, most experts believe that the traditional public pensions would be closed.

Claiming that unfunded pension liabilities of state and local governments are undermining the fiscal health of states and municipalities, Senator Hatch, who will chair the Senate Finance Committee in the 114th Congress, is proposing a new state-regulated, privatized, fixed-annuity product for public employees. The group annuity contracts would be bid out every year. So, theoretically, a public employee could have a different annuity insurance company for each and every year he or she works for the state or local government. At the end of his or her career, the individual’s yearly annuity contracts would be aggregated to provide retirement income. The annuity premiums would be paid by the employer only.

Important issues have been raised by NCPERS and the public pension plan community:

- **Replacement Income** – The threshold question for our nation’s firefighters, police officers, teachers, and other state and local governmental employees is whether distributions from the aggregation of annually negotiated, single-year, fixed-rate, individual annuity contracts would provide a comparable level of replacement income during retirement to that of a prefunded defined benefit (DB) plan. In considering this question, it is important to note that, under the legislation, the plan sponsor would not be required to enter into any annuity contracts for its employees. This purely voluntary system could – and most likely will – change each year, depending on the plan sponsor’s financial and political situation.

- **Disallowance of Employee Contributions** – Another factor in the replacement income discussion is that the vast majority of current DB plans for state and local governmental employees are contributory plans – in other words, the plans are funded by contributions from both employers and employees – and the number of contributory plans continues to grow. The proposed annuity accumulation scheme would not allow employees to contribute to their own retirement plans. It is unlikely that employer-only funded annuities would be able to provide an adequate level of replacement income for retirees.

- **Survivor and Disability Benefits** – The legislation does not contemplate any provisions for survivor or disability benefits, which are essential for people engaged in public safety, such as those who provide firefighting services, police protection, or emergency medical services. If plan sponsors add survivor or disability benefits, premium costs for the annuities will rise significantly.

- **Aggregation Costs** – The systematic aggregation of the annual annuity contracts will be necessary if plan participants are to be confident that they will receive their full retirement income. It is not reasonable
The Secure Annuities for Employee (SAFE) Retirement Act (continued)

to place the burden of tracking each annuity contract on retirees. Private-sector aggregation services will charge fees, which are a hidden cost to the plan participants. Or, if a governmental entity is created to aggregate the annuity contracts, then taxpayers will bear the cost for this service.

- **Transition Costs** – In the past, after careful review, many jurisdictions that were considering a change from DB to defined-contribution (DC) plans chose not to proceed because of the high transition costs. Costs associated with a transition to the annuity-accumulation model are likely to be significant as well.

- **Financial Backstop** – There are questions related to the ability of state guaranty funds to provide a dollar-for-dollar backstop for annuity accumulation plan participants if a single life insurance company – or more than one company – should collapse. Although the legislation is designed to shift risk from plan sponsors to insurance companies, in reality, the plan participants and retirees will always bear the risk of having their benefits reduced under the proposed system.

- **Question of Law** – There are also questions related to which state law will apply in the event of a collapse: The state in which the annuity contract was purchased? The state in which the plan participant resides? The state in which the plan sponsor resides? The state in which the insurance company has its headquarters or primary place of business?

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*NCPERS opposes Title I of the SAFE Act.*
The Public Employee Pension Transparency Act

In the 113th Congress, Representative Devin Nunes (R-CA) and Senator Richard Burr (R-NC) introduced H.R. 1628 and S. 779, respectively. Entitled the Public Employee Pension Transparency Act, this legislation would, for the first time, impose a federal reporting requirement on the funding status of state and local pension plans.

Fulfilling the reporting requirement would be the responsibility of the plan sponsor – that is, the state or municipal government. Failure to comply with the reporting requirement would result in the loss of the plan sponsor’s ability to issue bonds that are exempt from federal tax.

Reporting would be done using two distinct methods. First, pension liabilities would be reported based on the economic assumptions and rates of return that each plan currently uses as its expected (long-term) return. Second, all plans that are not fully funded would be required to report their pension liabilities on a rate of return based on a U.S. Treasury obligation yield curve. This second method would result in outcomes that would show a dramatically lower funded status for public plans.

NCPERS opposes the Public Employee Pension Transparency Act.
State-Based Survivor Benefits

In the 113th Congress, Senator Kelly Ayotte (R-NH) introduced S. 2912, which would clarify that state-based survivor benefits for public safety officers are exempt from federal tax, provided the benefit was earned in the line of duty. The Senate approved S. 2912 in 2014. As of this writing, the House has not yet taken action on the bill.

NCPERS supports passage of S. 2912.

Expansion of Exemption from Early Withdrawal Tax Penalty

In the 113th Congress, Representative Dave Reichert (R-WA) introduced H.R. 4634, which would expand the exemption in Internal Revenue Code (IRC) Section 72(t)(10) for qualified public safety employees (QPSEs) who reach age 50, separate from service, and receive a distribution from a DB plan. The current exemption covers QPSEs who work for a state or local government or political subdivision thereof. Representative Reichert’s legislation would expand the exemption to also cover federal QPSEs and distributions from DC plans.

NCPERS supports passage of H.R. 4634.
Tax Reform and Retirement Savings

Tax expenditures will be under the microscope as the 114th Congress considers comprehensive tax reform. One area that has been raised as a potential source of income to help lower tax rates is tax-preferred contributions to both DB and DC plans, which combined would result in a tax deferral of almost $650 billion over a five-year period, according to the Joint Committee on Taxation. The tax deferral is computed as the income taxes foregone on current tax-excluded pension contributions and earnings, less the income taxes paid on current pension distributions. The expenditure of $650 billion over five years, or $1.3 trillion over 10 years, will be difficult to ignore for purposes of revenue generation during the tax reform debate. Although eliminating the tax-preferred treatment of pension contributions is neither politically attainable nor sound long-term economics, reductions to the annual contribution limits could certainly be on the table.

NCPERS supports maintaining the current tax treatment of pension contributions and does not support reductions in the annual contribution limits.
Excise Tax on High-Cost Health Insurance

The Affordable Care Act (ACA) contains a provision to impose a 40 percent excise tax on healthcare plans that exceed certain annual cost thresholds. The excise tax is effective in 2018, and the Treasury Department and the Internal Revenue Service (IRS) are expected to issue guidance on the tax in 2015 or early 2016.

The annual thresholds are set at $10,200 for individual and $27,500 for family coverage. The thresholds are set higher for certain high-risk professions, such as firefighters and police officers; those rates are $11,850 for individual and $30,950 for family coverage. The excise tax will be imposed on issuers of insured plans and plan administrators (usually plan sponsors) of self-funded plans. Estimates show that over 60 percent of public- and private-sector employers with more than 500 employees will trigger the excise tax.

This is one of the most controversial provisions in the ACA. As we get closer to the 2018 effective date, we will hear more and more about the excise tax from our community.

NCPERS will continue to provide input to the Treasury Department, the IRS, and Congress on this important topic.
Normal Retirement Age

In May 2007, the Department of the Treasury and the IRS promulgated regulations that would define the term normal retirement age for pension plans. Specifically, the regulations provide that pension plans must have an age-based criterion for normal retirement.

Most pension plans for public employees provide eligibility for nondisability retirement based on years of service, rather than on attainment of a certain age. Therefore, to comply with the 2007 regulations, many public plans may be forced to devote considerable resources to pursuing changes in governing state laws.

Public plans protested the new regulations in formal comments to the Treasury and IRS and in subsequent meetings attended by NCPERS and other national groups. As a result, the effective date of the regulations has been pushed back multiple times. In early 2012, the Treasury and IRS issued Notice 2012-29, which announced the intention to issue revisions to the 2007 regulations in order to clarify their scope. In particular, the notice stated that the revised regulations would clarify that governmental plans that do not provide for in-service distributions before age 62 do not need to have a definition of normal retirement age. In addition, the notice stated that the revised regulations would modify the age-50 safe harbor provision for public safety employees to ensure its application when public safety employees are only a subset of a plan that includes other public-sector employees.

Treasury Notice 2012-29 also resets the effective date of the 2007 regulations as it applies to state and local governmental plans. The notice states that the regulations will be effective to annuity starting dates that occur in plan years beginning on or after the later of (1) January 1, 2015, or (2) the close of the first regular session of the legislative body that has the authority to amend the plan that begins on or after the date that is three months after the final regulations are published in the Federal Register. Please be aware that the proposed regulations on the issues raised in the notice have not yet been published.

NCPERS supports the direction of Treasury Notice 2012-29 and will continue to work with the Treasury Department and the IRS on the revised regulations.
In November 2011, the IRS issued an Advance Notice of Proposed Rulemaking (ANPRM), announcing that the Department of the Treasury and the IRS plan to issue regulations defining the term governmental plan under IRC Section 414(d). The ANPRM also included a draft notice of proposed rulemaking and invited public comment.

NCPERS joined with a number of other national groups in submitting comments. Our joint letter focused on the creation of safe harbors, grandfather treatment, transition-related issues, and certain practical administrative concerns.

The basic structure of the ANPRM, which is the initial step in creating the first set of federal regulations under IRC Section 414(d), is a facts-and-circumstances test. Of particular interest is a test that would determine whether an entity is an “agency or instrumentality of a state or a political subdivision of a state.” The ANPRM’s test for this definition is based on five major factors and eight other factors. The factors include most of the areas of inquiry that logically would be investigated in determining whether an entity is a governmental plan, such as state or political subdivision control of the entity, state responsibility for the general debts and liabilities of the entity, delegation of sovereign powers, treatment as a governmental entity for federal tax purposes, and whether the entity is determined by state law to be an agency or instrumentality. However, there is no certainty that meeting four or five or even six factors would be sufficient for an entity to satisfy the new federal regulatory test outlined in the ANPRM. More clarity is needed.

At a public hearing held by the IRS in the summer of 2012, 14 witnesses testified on the ANPRM. Five witnesses focused on the controversy surrounding whether charter schools would be eligible for governmental plan status under the ANPRM’s factor-based test. In the question-and-answer portion of the hearing, the IRS seemed to give serious consideration to adding an example to the next iteration of the ANPRM that would describe the relevant factors of charter schools – open enrollment, free tuition, and state regulation and funding – and conclude that this type of entity would meet the definition of governmental plan.

NCPERS will continue to work with the Treasury Department and the IRS as they develop proposed regulations on the definition of a government plan.
Employer Pickups

Under IRC Section 414(h)(2), governmental entities may “pick up” their employees’ pension contributions and, in effect, transform the employee contributions into employer contributions, provided certain conditions are met. Employee contributions that are picked up by the employer are not includible in the employees’ gross income until distributed and are considered pretax employer contributions.

Revenue Ruling 2006-43 provides the rules for a pickup. These rules do not permit participating employees to have a right to a cash-or-deferred election with respect to designated employee contributions as of the date of the pickup. Therefore, participating employees must not be allowed to opt out of the pickup treatment or receive the contributed amounts directly, instead of having them paid by the employing unit to the plan. This issue is a current focus of the Department of the Treasury, the IRS, and Congress. The issue was triggered by a private letter ruling (PLR) request. Federal legislation, H.R. 205 (113th Congress), was also introduced.

The PLR sought to approve the use of the pickup in a situation where a new, reduced DB tier was created and the new tier would be available by election to existing employees. The employer would continue to pick up the contributions of existing employees, but the employee contribution rate in the new tier would be less than the rate in the existing tier. Existing employees who elect into the new plan would see their salaries increased by virtue of the lower contribution rate. Hence, by being able to choose between the current and newly created plans (or tiers), existing employees would have a right to a cash-or-deferred election.

In early 2014, the IRS issued a PLR that allowed pickup treatment in a case where the election for existing employees was between two tiers that had the same employee contribution rate. Use of the pickup in instances where the election would be between tiers with different employee contribution rates remains disallowed.

NCPERS will continue to provide input to the Treasury Department, the IRS, and Congress on this important topic.