



AN INTRODUCTION TO
QUALIFICATION AND TAXATION
ISSUES FOR GOVERNMENTAL
RETIREMENT PLANS:

A PRIMER FOR PLAN ADMINISTRATORS

NCPERS

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INTRODUCTION

The purpose of this Primer is to give an overview of the basic qualification requirements and general taxation issues under the Internal Revenue Code ("Code") as applicable to governmental plans. This Primer is not an exhaustive study of each requirement and is not intended to constitute legal advice on any particular issue. Instead, this is a brief summary of important topics for consideration by plan administrators.

Why is qualification under Code § 401(a) so important to a governmental plan?

The primary advantages in retaining "qualified" status are that:

- Employer contributions are not taxable to members as they are made (or even when vested); taxation only occurs when plan distributions are made;
- Employee contributions are not taxable to members as they are made (or even when vested); taxation only occurs when plan distributions are made;
- Earnings and income are not taxed to the trust or the members (until distribution);
- Certain favorable tax treatments may be available to members when they receive plan distributions, *e.g.*, ability to rollover eligible distributions; and
- Employers and members do not pay employment taxes (even if the positions are Social Security covered) when contributions are made or when benefits are paid.

These advantages generally do not apply to a non-qualified plan.

Why is qualification of a "governmental plan" so important?

There are also a number of special provisions and/or exemptions that are applicable solely to governmental plans. Chief among these is that governmental plans are exempt from Title I and Title IV of ERISA. As a result, governmental plans are exempt from many Code requirements that were imposed upon retirement plans by ERISA. Because this allows state and local government employers greater flexibility, it is important for these employers and policy makers to guard against their plans losing governmental plan status. Notable examples of the special provisions for governmental plans of state and local employers include:

- State and local government plans are exempt from many costly and cumbersome nondiscrimination testing requirements;
- State and local government employers may "pick up" employee contributions so that they are pre-tax when made;
- State and local government plans have favorable grandfathering and transitional rules under much IRS guidance;

- State and local government plans are under special limits on benefits under Code § 415 that are more favorable than private sector plans; and
- Certain service purchase opportunities apply only to governmental plans.

How does a qualified governmental plan preserve qualified status?

To preserve qualified status, a governmental plan must comply – in form and in operation – with certain requirements set forth in the Code and Treasury Regulations. The actions listed below must be followed:

- The plan(s) must be **amended** on a timely basis to conform with changes in federal law;
- The plan(s) must be **operated** in accordance with the written terms; and
- IRS correctional programs should be used to remedy any written or operational failures that occur.

Why do many governmental plans seek an IRS determination letter?

An IRS favorable determination letter contains the opinion of the IRS that a particular plan is qualified under Code § 401(a). The IRS refers to the determination letter as an "insurance policy" because it protects a plan from being challenged as not qualified on account of its terms. A determination letter is the only way to secure the IRS's opinion on qualified status.

A determination letter also means that:

- The "plan document" (statutes, regulations) complies with the Code, Treasury Regulations and other IRS guidance. In this regard,
 - all "required amendments" have been made; and
 - the plan does not have any provisions that are impermissible.
- Once a plan has a letter, the IRS is bound by its determination until the letter expires or the law is changed – so any future compliance efforts would be prospective.

The IRS Commissioner has established a 5-year cycle that applies to determination letter applications. Filing the plan for a determination letter within the appropriate cycle creates critically important remedial amendment protection for the plan and its members, as well as longer periods to consider changes in federal laws and possible plan provisions. *See* the discussion under Chapter XVIII, Code §401(b) Retroactive/Remedial Amendment Rules of this Primer.

Having a current favorable determination letter would provide the following advantages for plan administration:

- A qualified plan with a current determination letter may use an IRS voluntary correction program to make plan document changes to comply with federal law.
- In addition, a qualified plan with a current determination letter may use the IRS self-correction procedure for various errors. Following this self-correction process means that the plan will not have to make IRS filings and pay fees for those corrections. This process can be very efficient, streamlined and flexible.
- Having a favorable determination letter will measurably reduce the burden of an IRS audit with respect to the plan.
- With respect to any foreign investments, a current determination letter is helpful (and can be required) with respect to foreign tax recapture.

What are the advantages to individual members if their governmental plan has a determination letter?

Having a current determination letter can be advantageous for members in the following ways:

- All of the benefits of a tax qualified plan are confirmed for the member;
- A member's assets in a qualified plan are protected in bankruptcy. (If the member's plan has a determination letter, that makes it easier for the member to protect his/her assets in that case.);
- If a plan has a determination letter, a member can more easily respond to questions from financial institutions regarding rollovers; and
- Finally, if a member is audited by the IRS, a member can more easily respond to IRS questions if his/her plan has a determination letter.

This Primer addresses many (but not all) of the applicable Code provisions, focusing on those issues of greatest concern to plan administrators of defined benefit governmental plans. The Primer is organized in Code-cite order. Please note that this Primer does not discuss governmental defined contribution plans intended to be covered under Code §§ 403(b) or 457, though some of the concepts discussed herein also apply to those plans. Finally, to the extent that the plan has specific questions regarding its qualified status or its compliance requirements, it certainly should consult with its plan counsel.

DEFINITIONS

As used in this Resource, these terms are defined as follows:

CODA	Cash or Deferred Arrangement
Code	Internal Revenue Code of 1986, as amended
DOL	Department of Labor
DOMA	Federal Defense of Marriage Act of 1996
EGTRRA	Economic Growth and Tax Relief Reconciliation Act of 2001
ERISA	Employee Retirement Income Security Act of 1974
FICA	Federal Insurance Contributions Act
FUTA	Federal Unemployment Tax Act
HEART Act	Heroes Earnings Assistance and Relief Tax Act of 2008
IRA	Individual Retirement Account
IRS	Internal Revenue Service
PBGC	Pension Benefit Guaranty Corporation
PPA	Pension Protection Act of 2006
QDRO/DRO	Qualified Domestic Relations Order / Domestic Relations Order
QEBA	Qualified Governmental Excess Benefit Plan
TREAS. REG.	Treasury Regulation
USERRA	Uniformed Services Employment and Reemployment Rights Act of 1994, as amended
WRERA	Worker, Retiree and Employer Recovery Act of 2008

I. CODE § 72: TAXATION OF DISTRIBUTIONS

A. General Income Tax Rules and Basis Recovery

The principal advantage of maintaining a tax-qualified retirement plan that satisfies the requirements under Code § 401(a) involves the deferral of all income taxes on the amounts contributed by the employer to the plan. Code § 72 contains the principal provisions regarding the general income tax rules that apply to distributions from tax-qualified plans. Generally speaking, distributions from qualified retirement plans are taxed as ordinary income tax rates to the extent the distribution does not represent a return of the member's after-tax contributions (*i.e.*, contributions that were included in the member's taxable income at the time the contributions were made). These after-tax contributions are referred to as the member's "tax basis" or "investment in the contract."

NOTE: Basis recovery can be a complicated issue for the governmental plan, but is important for the accurate reporting of taxable distributions for the member on his/her Form 1099-R.¹ The plan is encouraged to consult with its plan counsel regarding these issues.

B. Premature Distribution Tax

Code § 72(t) imposes an additional 10% premature distribution tax on certain distributions that are paid to members from qualified plans.² This tax is in addition to the ordinary or other applicable income tax that applies to the distributed amount.

1. **Importance of Premature Distribution Tax for Form 1099-R.** The recipient of the premature distribution, not a qualified plan, is liable for this tax. The member reports the early distribution tax on IRS Form 5329, which is then filed in conjunction with the member's regular income tax return. See IRS Form 5329 and the instructions thereto. However, a qualified plan must properly code premature distributions when preparing IRS Form 1099-R.
2. **Exceptions to the Premature Distribution Tax**
 - a. The premature distribution tax does not apply to:
 - (i) distributions made after the date the member attains 59½;
 - (ii) distributions made after the member's death;
 - (iii) distributions attributable to the member's disability;³

¹ For employee contributions that have been picked up by the employer, basis recovery is not an issue.

² **NOTE:** this additional 10% premature tax does not apply to distributions made from Code § 457(b) plans (such plans are not "qualified" plans). However, if a distribution from a Code § 457(b) plan is rolled over to a qualified plan and a member subsequently receives that rollover amount as a distribution from the qualified plan before attaining age 59 ½, the distribution may be subject to the additional tax. Rev. Rul. 2004-12.

- (iv) substantially equal periodic payments commencing after the member separates from service and payable over the life (or life expectancy) of the member or the joint life (or joint life expectancy) of the member and member's designated beneficiary;
- (v) distributions made to a member who separates from service after attainment of age 55 (for a qualified public safety employee in a governmental defined benefit plan, age 50);
- (vi) distributions used by the member to pay significant medical expenses (medical expenses which exceed 7.5% of the member's adjusted gross income to qualify as a deduction) which do not exceed allowable amount of deduction under Code § 213 (Code § 72(t)(2)(B));
- (vii) distributions to an alternate payee pursuant to a qualified domestic relations order (Code § 72(t)(2)(C));
- (viii) distributions made on account of an IRS levy under Code § 6331 on the qualified retirement plan.⁴

b. Generally speaking, the exceptions above are self-explanatory. Our experience in this area, however, indicates that most questions relate to the exceptions applicable to substantially equal periodic payments, distributions payable after attaining age 50/55 and distributions under a federal tax levy. As a result, the remaining information in this subsection provides additional information regarding these three exceptions.

- (i) Separation from Service Concept. Two of the exceptions substantially equal periodic payment exception and the age 55 exception (age 50 for qualified public safety employees) – **require a separation from service.**

There is no exception for normal retirement age under Code § 72(t), so, in preparing 1099-Rs, the governmental plan payor must focus on age and separation from service in order to determine whether a retiree will be subject to a 10% taxation penalty.

³ **NOTE:** under the disability exclusion of Code § 72(t)(2)(A)(iii), a disability is defined by reference to Code § 72(m)(7). *See also* Form 1099-R Instructions (2014) which references Code § 72(m)(7) for use of Code 3 in Box 7. The definition of disability under Code § 72(m)(7) is similar to the Social Security definition and requires that the person be "unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration."

⁴ This exception to the 10% excise tax on premature distribution was inserted in Code § 72(t) by IRRA '98, § 3436(a). The amendment applies to distributions made after December 31, 1999.

The concept of separation from service for taxation purposes is viewed as a more stringent test than termination of employment for qualifications purposes. For instance, in the case *Ridenour v. U.S.*, 52 AFTR 2d 83-5584 (Cl. Ct. 1983), the Claims Court held that promotion from the status of common law employee to partner at the same firm was not a separation from service. The Claims Court drew a distinction between one who continues to provide services and one who discontinues providing services, rather than upon the particular status of the person rendering the service. The Claims Court concluded that one who continues to provide services has not separated from the service within the meaning of Code § 402(e)(4)(A)(iii).

If a reemployment policy allows a member to "retire" and take a distribution without a bona fide separation from service, and if that member is less than 59½ when he or she receives such benefit, the governmental plan must code the 1099-R with respect to those benefit payments such that the retiree will be subject to a 10% penalty on the taxable amount of the benefit.⁵

- (ii) Pre-Arranged Arrangement – Reemployment. The IRS specifically has provided guidance that a prearranged agreement for reemployment **with the same employer** will not be treated by the IRS as a termination from employment. Further, the IRS takes the position that the employment relationship must not continue post-retirement even if there is a substantial modification of the hours worked or the classification of the position. It is also important to realize that the IRS may not consider the employment relationship to have been severed if the member becomes a leased employee or independent contractor of the same employer. Finally, the IRS has stated repeatedly that the determination of whether there is or is not a severance from employment needs to be determined using a facts and circumstances test. In this regard, the IRS has not established a "safe harbor" period of time for severance from employment. Based upon the regulations under Code §§ 410 and 457, which are cited in PLR 201147038, it appears that a twelve (12) month period without performing service may qualify as a safe harbor.

⁵ **NOTE:** this in-service distribution is generally not permissible for a qualified pension plan, unless the member has reached normal retirement age. However, Congress recently added another option – Code § 401(a)(36) that now provides that a qualified pension plan may be designed to make an "in-service" distribution at age 62, even if that is less than normal retirement age under the plan. This means that a qualified plan can provide for payment of a pension benefit if a member reaches age 62 (but this applies only if the plan permits an in-service distribution at 62 or older).

Therefore, returning to work **for the same employer** without a bona fide severance from employment especially if the period of severance is less than a reasonable period of time (such as six months), will not qualify as retirement.

(iii) Substantially Equal Periodic Payment Exception. Code § 72(t)(2)(iv) provides that the 10% premature distribution tax does not apply to a series of substantially equal periodic payments that are paid **after separation from service** and not less frequently than annually for the life or life expectancy of the member, or the joint lives or joint life expectancies of the member and his or her designated beneficiary. Code § 72(t)(4) imposes a recapture tax if the series of equal payments is subsequently modified within five years of the date of the first payment or, if later, before the employee attains age 59½. Under the recapture provisions, the employee's tax in the year of the modification is increased by the amount of the 10% excise penalty that would have been imposed on all distributions to the member but for the exception under Code § 72(t)(2)(A)(iv), plus interest from the time the first distribution was made.

c. Exception For Distributions Payable After Age 55 (Age 50 for Qualified Public Safety Employees). Although Code § 72(t)(2)(v) literally requires members to attain age 55⁶ **before** separating from service to qualify for the exception from the premature distribution tax, guidance issued by the IRS permits a more favorable position to be followed for members who separate from service and attain 55 years of age **later during the same calendar year**. IRS Notice 87 13, Q&A-20 and IRS Publication 575 detail this exception, so that premature distribution tax does not apply to distributions made after the member separates from service if the separation occurs **during or after the calendar year in which the member reached age 55**. See also IRS Notice 2009-68, 2009-39 I.R.B. 423 (safe harbor rollover notice permitting this interpretation). **This rule is also applicable to the qualified public safety employee age 50 exception.**⁷

d. Exception for Distributions on Account of IRS Levy. The 10% tax on premature distributions will not apply to distributions made on account of an IRS levy on a taxpayer's qualified retirement plan. Code § 72(t)(2)(A)(vii). However, the exception does not apply when

⁶ The participant is not liable for 10% early withdrawal penalty only if, after he or she attains age 55, he or she withdraws funds from the employer's qualified plan. If the participant rolls the funds over to an IRA first and then withdraws from the IRA, he or she will be liable for the 10% tax unless one of the exceptions under Code § 72(f) applies.

⁷ The qualified public safety exception only applies to a defined benefit plan. The IRS takes the position that, if a lump sum is rolled over to a defined contribution plan, the exception will not apply to that plan.

the IRS has not levied upon the taxpayer's retirement plan and the taxpayer withdraws funds to pay taxes in order to avoid a levy or obtain a release of a levy on other interests. Committee Report No. 105-599.

C. Disability Benefits – Non-Line of Duty

For non-line-of-duty benefits payable due to a disability, two situations must be considered: pre- and post-retirement disability payments. Employer contributions to a retirement plan on behalf of employees to provide accident or health benefits, including disability payments, are specifically dealt with in Treas. Reg. § 1.72-15. These contributions are never treated as contributions for retirement benefits and are governed instead by the provisions of the Code relating to accident and health benefits, *i.e.*, Code §§ 104 (governing retirement benefits in the nature of workman's compensation) and 105 (governing the taxability of amounts received for personal injuries and sickness). Treas. Reg. § 1.72-15(b). Employee contributions allocable to health and accident benefits do not become a part of the employee's basis for retirement benefits. Treas. Reg. § 1.72-15(c). The position of the IRS, as communicated in Publication 575, is that basis recovery under a disability retirement annuity may not begin until the taxpayer reaches minimum retirement age, (*i.e.*, the age at which the member could begin to receive annuity payments without a disability). Therefore, depending on the facts and circumstances applicable to each applicant for disability benefits, basis recovery would begin based on the member's earliest retirement date under the applicable statutory provisions.

For benefits payable due to a disability not sustained in the course of employment, payments are treated as ordinary income until the individual reaches the earliest retirement age under the plan. These payments are subject to income tax and withholding, and the individual should complete a Form W-4P to make the appropriate withholding elections.

After the individual reaches his earliest retirement age under the plan, the benefits are taxed under Code § 72, and basis is recoverable.

D. Plan Loans

Qualified plans may provide for participant loans subject to Code and regulatory limits. *See* Code § 72(p) and Treas. Reg. § 1.72(p)-1.

II. CODE §§ 101(h) AND 104(a): TAXATION OF LINE-OF-DUTY DISABILITY AND DEATH BENEFITS

A. Disability Benefits in the Nature of Workers' Compensation

Code § 104(a)(1) excludes from gross income amounts received under workers' compensation acts as compensation for personal injuries or sickness. In fact, Treas. Reg. § 1.104-1(b) states that Code § 104(a)(1):

excludes from gross income amounts which are received by an employee under a workmen's compensation act. . . or under a statute in the nature of a workmen's compensation act which

provides compensation to employees for personal injuries or sickness incurred in the course of employment.

(emphasis added).

Treas. Reg. § 1.104-1(b) further provides that Code § 104(a)(1) also applies to compensation which is paid under a workmen's compensation act to the survivor(s) of a deceased employee to the extent such benefits are a continuation of the employee's benefits which were excludable under Code § 104(a)(1). Rev. Rul. 80-44, 1980-C.B.34. However, Code § 104(a)(1) does not apply to a retirement pension or annuity to the extent that it is determined by reference to the employee's age or length of service or the employee's prior contributions, even though the employee's retirement is the result of an occupational injury or sickness. Finally, Code § 104(a)(1) does not apply to amounts which are received as compensation for nonoccupational injury or illness nor to amounts which exceed the amount provided in the applicable workmen's compensation statute(s). Treas. Reg. § 1-104-1(b). *See*, however, Treas. Reg. §§ 1.105-1 through 1.105-5 for rules relating to exclusion of such amounts from gross income.

The IRS has taken the position in several published revenue rulings that a statute which authorizes the payment of disability benefits to a class of employees who are injured in the line of duty or within the scope of employment qualifies as a statute in the "nature of a workmen's compensation act." *See, e.g.*, Rev. Rul. 85-104, 1985-2 C.B. 52; Rev. Rul. 85-105, 1985-2 C.B. 53; Rev. Rul. 80-14, 1980-1 C.B. 33; Rev. Rul. 80-44, 1980-1 C.B. 34; Rev. Rul. 80-84, 1980-1 C.B. 35.

The United States Tax Court has followed the IRS' interpretation of Code § 104(a)(1) and Treas. Reg. § 1.104-1(b) and has held that in order for a statute to be in the "nature" of a worker's compensation act, such statute must expressly provide "payments solely for personal injuries or sickness incurred in the course of employment." *Clifford v. Com'r.*, 48 T.C.M. 524, 525 (1984) (emphasis added). *See also, Green v. Commissioner*, T.C.M. (RIA) 2008-130 (2008); *Kane v. U.S.*, 43 F.3d 1446,1449 (CA Fed. Cir. 1994) *aff'g* 28 Fed. Cl. 10 (1993); *Benjamin v. Com'r.*, 66 T.C.M. 1488 (CCH) (1994); *Weidmaier v. Com'r.*, 48 T.C.M. 1350 (CCH) (1984), *aff'd* 774 F.2d 109 (6th, Cir. 1985); *Haar v. Com'r.*, 78 T.C. 864, *aff'd per curium*, 709 F.2d 1206 (8th Cir. 1952); *Riley v. United States*, 156 F. Supp. 751 (Claims Ct. 1957); *Stanley v. U.S.*, 140 F.3d 890 (10th Cir. 1998).

Based on the foregoing analysis, the position of the IRS and the Federal Courts with respect to Code § 104(a)(1) is clear: in order for a statute to be considered in the "nature" of a workmen's compensation act, such statute must expressly provide benefits to a class of employees which is restricted to those employees who are injured in the line of duty or within the scope of employment, and benefits cannot be measured by a formula which uses the employee's age, length of service or prior contributions.

B. Survivor Benefits Attributable to Service by Public Safety Officers Killed in the Line of Duty Under Code § 101(h)

TRA '97 added to Code § 101(h) a federal income tax exclusion for certain amounts paid as a survivor annuity on account of the death of a "public safety officer" killed in the line of duty.

1. **The exclusion applies:**

- a. If the survivor annuity is provided by a qualified § 401(a) plan to the spouse, former spouse, or a child of the officer; and
- b. To the extent the annuity is attributable to the officer's service as a public safety officer.

2. **The exclusion does not apply if:**

- a. The death was caused by the intentional misconduct of the officer or by such officer's intention to bring about such officer's death;
- b. The officer was voluntarily intoxicated at the time of death;
- c. The officer was performing such officer's duties in a grossly negligent manner at the time of death; or
- d. The payment is to an individual whose actions were a substantial contributing factor to the death of the officer.

3. **Definition of "public safety officer"**

In accordance with 42 U.S.C. § 3796b, a public safety officer includes 1) an individual serving a public agency in an official capacity, with or without compensation, as a law enforcement officer, a firefighter, a chaplain, or as a member of a rescue squad or an ambulance crew or 2) with some limitation, an employee of a State, local or tribal emergency management or civil defense agency who is performing official duties in cooperation with the Federal Emergency Management Agency.

4. **Effective Date**

The exclusion has applied to amounts received in tax years beginning after December 31, 1996, for officers dying after that date. TRA '97 § 1528(a); Code § 101(h). The Fallen Hero Survivor Benefit Fairness Act, enacted June 15, 2001, extended favorable tax treatment described above in the case of public safety officers who were killed in the line of duty on or before December 31, 1996, for amounts received in tax years beginning after December 31, 2001.

III. CODE § 401(a): INTRODUCTION TO PLAN QUALIFICATION REQUIREMENTS

In order to constitute a qualified plan under Code § 401(a), there are certain requirements that must be met under the introductory language to Code § 401(a). Currently, Code § 401(a) has 37 separate paragraphs, each setting forth a qualification requirement. However, governmental plans are not required to satisfy all requirements.

A. The Plan Must Constitute a "Pension Plan"

Most governmental plans must meet the definition of a pension plan as set forth in Treas. Reg. § 1.401-1(b)(1)(i).⁸ A pension plan is defined as "a plan established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to his employees over a period of years, usually for life, after retirement." Treas. Reg. § 1.401-1(b)(1)(i). The elements set forth by this definition and Treasury Regulation § 1.401-1(b)(1)(i) are analyzed in the following:

1. Medical Benefit Provisions

One of these elements is that the plan not include medical benefits "except medical benefits described in § 401(h) as defined in paragraph (a) of § 1.401-14." *Id.*

2. Definitely Determinable Benefits and Actuarial Assumptions

In order to constitute a pension plan, the plan must provide definitely determinable benefits.

3. General Prohibition Against an In-Service Distribution

The IRS has developed certain limitations on in-service withdrawals of members' funds prior to retirement, arising from Treasury Regulation § 1.401-1(a)(2)(i). In general, a member may not withdraw contributions made by the employer, or earnings on such contributions, before normal retirement, termination of employment, or termination of the plan. Rev. Rul. 74-254, 1974-1 C.B. 94. Generally, a member may withdraw employer contributions upon reaching normal retirement age. *See* Treas. Reg. § 1.401(a)-1(b). In addition, the PPA permits a plan to allow in-service distributions at age 62. Code § 401(a)(36). Finally, a member may withdraw member contributions (and perhaps earnings) under certain limited circumstances.

4. Disability Benefits Provision

The IRS allows a plan to provide for a pension due to disability. Treas. Reg. § 1.401-1(b)(1)(i). Such disability benefits will not preclude the plan from being a pension plan, and consequently losing its qualified status.

⁸ Many governmental entities which have a grandfathered § 401(k) type defined contribution plan are established as profit sharing plans.

5. Contributions and Benefits Not Determined by Profits

Generally, in order to constitute a pension plan, neither contributions nor benefits may be based upon the employer's profits. In a pension plan the amount of contributions is determined by what is actuarially necessary to meet the definitely determinable benefits. Treas. Reg. § 1.401-1(b)(1)(i).

6. Crediting Years of Service

A plan that does not credit all years of service does not provide definitely determinable benefits as required by Treas. Reg. § 1.401-1(b)(1)(i). **NOTE:** Governmental plans are subject to special rules with regard to vesting.

7. Retirement Benefits Usually for Life

Pension plans generally provide benefit payments to "employees over a period of years, usually for life, after retirement." Treas. Reg. § 1.401-1(b)(1)(i). Use of the qualifying word "usually" indicates that the IRS does not mandate that in every case payments be made over the entire remaining life of the member.

B. There Must Be a Trust as Part of the Public Pension Plan

In order to constitute a qualified plan, the plan's assets must be held in a trust. Code § 401(a). The IRS takes the position that the trust must be in writing, and contain the specific terms of the trust for reference in the event of disputes, even if the applicable state law does not require trusts to be in writing. Rev. Rul. 69-231, 1969-1 C.B. 118.

C. The Trust Must Be Created or Organized in the United States

In order to be a qualified plan, the trust "must be created or organized in the United States as defined in § 7701(a)(9), and it must be maintained at all times as a domestic trust in the United States." Treas. Reg. § 1.401-1(a)(3)(i); Code § 401(a).

D. The Plan Must Be for the Exclusive Benefit of Employees or Their Beneficiaries

1. General Rule

Code § 401(a) requires that the plan of the employer be "for the exclusive benefit of [the employer's] employees or their beneficiaries . . ." Therefore, the plan may not benefit a person other than the employees or their beneficiaries. This also means that investments made on behalf of the employees must be for the exclusive benefit of those employees and their beneficiaries. However, in certain cases, funds may be distributed to persons other than a participant or beneficiary (e.g., to satisfy a criminal fine or restitution order pursuant to a garnishment). Rev. Rul. 72-240, 1972-1 C.B. 108.

2. Incidental Benefits

Payments made to non-members must be incidental. Thus, even though the plan only benefits the participant and his or her beneficiaries, in order to be qualified, a determination must be made

whether benefits to the beneficiaries are incidental. The IRS has defined a series of situations that they were willing to agree were "incidental."

3. Investments

Another element of the exclusive benefit rule is that "[w]here the trust funds are invested in stock or securities of, or loaned to, the employer. . . , full disclosure must be made of the reasons for such arrangement and the conditions under which such investments are made in order that a determination may be made whether the trust serves any purpose other than constituting part of a plan for the exclusive benefit of employees." Treas. Reg. § 1.401-1(b)(5)(ii); *see also* Code § 503. This situation may arise in the context of government plans where the employer borrows plan assets or invests plan assets in government bonds.

E. Fiduciary Obligations

Under Code § 401(a)(2) and the trust laws of the state in which the plan is located, plan trustees are obligated to exercise fiduciary duties in the fulfillment of their duties.

IV. CODE § 401(a)(1): CONTRIBUTIONS MAY BE MADE ONLY BY EMPLOYERS AND EMPLOYEES

A. General Rule

In order to be a qualified plan, contributions only may be made by the employer and/or the members. Code § 401(a)(1). In addition, such contributions must be made "for the purpose of distributing to such employees or their beneficiaries the corpus and income of the fund accumulated by the trust in accordance with such plan." The IRS has set certain limitations relating to these contributions in Code § 415.

B. Governmental Employers

The law with respect to whether non-governmental employees and employers may participate in a governmental plan remains unsettled. Without any IRS direction under Code § 414(d) on this issue, it remains risky to permit any non-governmental employees to participate in a governmental plan and still have the plan retain its tax favorable status under Code § 401(a) *et seq.* See the section below on Code § 414(d) for a more detailed discussion.

C. Tribal Governments

A Native American tribe generally is not considered a state or local government or an agency or instrumentality of a state or local government. However, pursuant to the PPA, a plan maintained by an Indian Tribal Government, a subdivision of an Indian Tribal Government or an agency or instrumentality of either will be considered a governmental plan, provided it only covers employees substantially all of whose services are provided in the performance of essential governmental functions that are not commercial activities. Code § 414(d).

V. CODE § 401(a)(2): TRANSFER OF TRUST FUNDS IS LIMITED

In order to be qualified, a plan must make it "impossible, at any time prior to the satisfaction of all liabilities with respect to employees and their beneficiaries . . . for any of the corpus or income to be . . . used for, or diverted to, purposes other than for the exclusive benefit of employees or their beneficiaries. . . ." Code § 401(a)(2). Thus, generally, no funds may revert back to the employer until the trust is terminated and all liabilities are paid. Liabilities include contingent liabilities which result, for example, from the required years of service yet to be performed by a participant. Treas. Reg. 1.401-2(b)(2).

This provision does not apply to medical benefit transfers made out of the plan pursuant to Code §§ 401(h) and 420. Treas. Reg. § 1.401-2(a)(1). In addition, contributions may sometimes be returned if made due to a mistake of fact.

VI. PRE-ERISA CODE § 401(a)(7): EMPLOYEE'S INTEREST MUST VEST AS REQUIRED

A trust will not constitute a qualified trust unless the plan satisfies the requirements of Code § 411. Code § 401(a)(7). However, governmental plans are only required to comply with "the vesting requirements resulting from the application of §§ 401(a)(4) and 401(a)(7) as in effect on September 1, 1974." Code § 411(e). This requires that a governmental plan must provide 100% vesting of accrued benefits if there is a partial or complete termination of the plan, or complete discontinuance of contributions, but only to the extent the benefits are funded.

Also, governmental plans are subject to the vesting requirements set forth in Revenue Ruling 66-11, 1966-1 C.B. 71. Under this revenue ruling, a pension plan must provide for full vesting of an employee's interest upon attaining normal retirement age and completion of the required years of service and any other reasonable requirements set forth in the plan.

VII. CODE § 401(a)(8): FORFEITURES MAY NOT INCREASE BENEFITS TO REMAINING MEMBERS

The Code requires that a defined benefit plan provide "that forfeitures must not be applied to increase the benefits any employee would otherwise receive under the plan." Code § 401(a)(8). Thus, if a member were to separate from service of the employer before becoming vested in the plan, the member's forfeited funds may not cause other members' benefits to increase. However, forfeitures may be used first to reduce administrative expenses and then to reduce employer contributions. Treas. Reg. § 1.401-7; *see also* Rev. Rul. 84-156, 1984-2 C.B. 97.

VIII. CODE § 401(a)(9): DISTRIBUTIONS MUST MEET FORM AND TIMING REQUIREMENTS

All qualified retirement plans, including governmental plans, must comply with Code § 401(a)(9) in order to maintain qualified status. Code § 401(a)(9) and the applicable regulations contain complex rules regarding the timing of distributions from qualified plans both to members and to beneficiaries. These provisions address when distributions must begin, in what form distributions may be made, distributions requirements based upon the death of the member (including differences based upon whether the member died before or after retirement), incidental benefit requirements, when the

chosen form of distributions may be modified, how distributions must be made in the event of the participant's death, etc.

In essence, Code § 401(a)(9) requires a qualified plan to provide the entire interest of the employee will be distributed, beginning not later than the required beginning date, in accordance with the applicable regulations. There are specific regulations which establish what constitutes the "required beginning date." See Treas. Reg. § 1.401(a)(9)-2, Q&A-2; Treas. Reg. § 1.401(a)(9)-3. However, in general, the required beginning date means April 1 of the calendar year following **the later of** (i) the calendar year in which the employee attains age 70½ or (ii) the calendar year in which the employee retires. Code § 401(a)(9)(c)(i). (Emphasis added).

Importantly, there are a series of complex regulations interpreting Code § 401(a)(9), culminating in the final regulations issued in 2004. **NOTE:** pursuant to the PPA, governmental plans are deemed to be in compliance with Code § 401(a)(9) if they follow a reasonable and good faith interpretation of the statutory language. Treas. Reg. § 1.401(a)(9)-1, Q&A-2(d). This provides governmental plans with a great deal more flexibility in complying with the minimum distribution requirements. Notwithstanding, given the complexities involved with these rules, plans are encouraged to consult with their plan counsel or actuary regarding compliance with these rules. **Note:** Required minimum distributions are not eligible for rollover. Treas. Reg. § 1.402(c)-2.

IX. CODE § 401(a)(16): CONTRIBUTIONS AND BENEFITS MUST BE LIMITED

Code § 401(a)(16) requires a qualified plan to abide by Code § 415, which imposes annual limits on the amount of contributions and benefits. The provisions of Code § 415 are discussed in Chapter XXVII of this Primer.

X. CODE § 401(a)(17): COMPENSATION CONSIDERED FOR PLAN PURPOSES MUST BE LIMITED

Code § 401(a)(17) limits the maximum amount of annual compensation that may be taken into account for a participant in a qualified retirement plan. For 2014, the limit is \$260,000. The limit increases in \$5,000 increments. The prohibition on taking more than the Code § 401(a)(17) amount into account means:

- Compensation in excess of the Code § 401(a)(17) limit may not be used when computing the pension benefit (*i.e.* benefit accruals and benefit allocations).
- Any employee contributions may not be computed on more than the Code § 401(a)(17) limit.

However, employer contributions to a defined benefit plan are not limited by the Code § 401(a)(17) limit so long as those contributions go into a general pool and do not benefit a specific employee.

In the case of an "eligible participant" in a governmental plan (within the meaning of Code § 414(d)), the annual compensation limit under Code § 401(a)(17) does not apply to the extent that the application of the limitation would reduce the amount of compensation that is allowed to be taken into account under the plan below the amount that was allowed to be taken into account under the plan as in effect on July 1, 1993. Treas. Reg. § 1.401(a)(17)-1(d)(4)(ii)(A). Thus, for example, if a

plan as in effect on July 1, 1993, determined benefits without any reference to a limit on compensation, then the annual compensation limit in effect under this section will not apply to any "eligible participant" in any future year. An "eligible participant" is an individual who *first* became a participant in the plan prior to the first day of the first plan year beginning after the earlier of (1) the last day of the plan year by which a plan amendment to reflect the amendments made by section 13212 of OBRA '93 is both adopted and effective; or (2) December 31, 1995. Treas. Reg. § 1.401(a)(17)-1(d)(4)(ii)(B).

XI. CODE § 401(a)(24): A GROUP TRUST MAY BE ESTABLISHED

A group trust is utilized by a number of qualified trusts and individual retirement accounts for the purpose of diversifying investments. Such a trust is not a plan itself, but merely an investment medium for a number of individual plans. However, such a trust will qualify for tax exemption and the participating plans will not have their qualification adversely affected by participation in such a trust if certain requirements are met. Code § 401(a)(24). A group trust will itself be an exempt entity under Code §§ 401(a) and 501(a) if it meets the requirements set forth in Rev. Rul. 81-100 (1981-1 C.B. 352), as clarified and modified by Rev. Rul. 2004-67 (2004-28 I.R.B. 28), and Rev. Rul. 2011-1 (2011-2 I.R.B. 251).

XII. CODE § 401(a)(25): ACTUARIAL ASSUMPTIONS MUST BE SPECIFIED

Code § 401(a)(25), which must be satisfied for a plan to be qualified, requires that, if a defined benefit plan provides any benefits based on actuarial assumptions, the assumptions must be specified in the plan in a way that precludes employer discretion. A plan that fails to properly specify its actuarial assumptions will not be treated as providing definitely determinable benefits. The plan must specify the assumptions in enough detail to allow one to calculate optional forms of the benefit.

This presumably could be met by either (i) specifying the actuarial factors to be used or (ii) specifying the interest, mortality, and any other actuarial assumptions to be utilized in determining benefits under the plan. Any employer discretion in the determination of benefits violates Code § 401(a)(25); *see also* Treas. Reg. § 1.411(d)-4, Q&A-4.

XIII. CODE § 401(a)(27): GOVERNMENT PROFIT SHARING PLANS

Governmental plans may constitute profit sharing plans notwithstanding the fact that tax exempt organizations -- such as governments -- do not have profits. Code § 401(a)(27). The Code specifically provides that "[t]he determination of whether the plan under which any contributions are made is a profit-sharing plan shall be made without regard to current or accumulated profits of the employer and without regard to whether employer is a tax-exempt organization." Code § 401(a)(27)(A).

XIV. CODE § 401(a)(30): ELECTIVE DEFERRALS MUST BE LIMITED

Governmental plans may not have elective deferrals under a § 401(k) plan unless they were "grandfathered" prior to May 6, 1986. Treas. Reg. § 1.401(k)-1(e)(4)(i). For a grandfathered plan which allows elective deferrals, in order for it to be qualified, the plan must provide that such deferrals for a calendar year "may not exceed the amount of the limitation in effect under § 402(g)(1) for taxable years beginning in such calendar year." Code § 401(a)(30).

XV. CODE § 401(a)(31): ROLLOVERS TO ELIGIBLE RETIREMENT PLANS MUST BE PERMITTED

A. General Rule

Code § 401(a)(31) requires qualified plans to permit an individual receiving certain distributions from such a plan to elect to have the distribution paid in the form of an "eligible rollover distribution," which is made directly to an "eligible retirement plan," as specified by the distributee, in the form of a direct rollover. The terms "eligible rollover distribution" and "eligible retirement plan" are defined in Code §§ 402(f)(2)(A) and 402(c)(8)(B), respectively.

Code § 402(c) provides that any "eligible rollover distribution" from a qualified trust described in Code § 401(a) may be rolled over to an "eligible retirement plan" within 60 days. Code § 402(c)(3). The amount of any such distribution that is actually rolled over to an eligible retirement plan is not included in the recipient's taxable income. Code § 402(c)(1).

B. Rollover Notice Requirements

Code § 402(f) requires a plan administrator to provide a notice meeting specific requirements to distributees prior to making an eligible rollover distribution. Plan administrators are required to furnish members, spouses and, effective on or after January 1, 2010, designated non-spouse beneficiaries with a written explanation of the general rollover rules. Code § 402(f) outlines the contents of the written explanation that must be provided to recipients of distributions eligible for rollover treatment. Treas. Reg. § 1.402(f)-1, Q&A-1.

C. Definition of Eligible Rollover Distribution

An "eligible rollover distribution" means any distribution from a qualified plan to a distributee, (an employee, a surviving spouse or, on and after January 1, 2007, a designated non-spouse beneficiary of an employee) of all or any portion of the balance to the credit of the employee in a qualified plan, except for the following:

1. Any distribution that is one of a series of substantially equal periodic payments made (not less frequently than annually) over any one of the following periods: the life of the employee (or the joint lives of the employee and the employee's designated beneficiary), the life expectancy of the employee (or the joint life and last survivor expectancy of the employee and the employee's designated beneficiary), or a specified period of ten (10) years or more;
2. Any distribution to the extent the distribution is required by the required minimum distribution provisions of Code § 401(a)(9) (distributions required after the later of attainment of age 70½ or actual retirement). For the purpose of determining the amount of the required minimum distribution necessary to satisfy Code § 401(a)(9)(A) for any calendar year, the plan may assume that there is no designated beneficiary;
3. Any distribution which is made upon hardship of the employee;
4. Elective deferrals, as defined in Code § 402(g)(3), that, pursuant to Treas. Reg. §1.415-6(b)(6)(iv), are returned as a result of the application of the Code § 415 limitations, together

with the income allocable to these corrective distributions (**NOTE:** although this exception explicitly refers only to the return of elective deferrals, the IRS applies this exception to all corrective distributions);

5. Corrective distributions of excess deferrals as described in Treas. Reg. §1.402(g)-1(e)(3), together with the income allocable to these corrective distributions;
6. The portion of any distribution that is not includible in gross income (*i.e.*, the employee's tax basis), unless the amount is directly rolled over to an IRA or if the plan agrees to separately account for the after-tax dollars (and earnings thereon), a qualified defined contribution plan, and (effective for distributions after December 31, 2006) a qualified defined benefit plan, or a 403(b) plan; and
7. Additional items designated by the IRS Commissioner in revenue rulings, notices, and other guidance of general applicability. Examples of those items that already have been designated include dividends on employer securities (**NOTE:** not applicable to the governmental plans), plan loans that are treated as deemed distributions, taxable cost of life insurance coverage (P.S. 58 costs) (**NOTE:** not applicable to the governmental plans), and corrective distributions for 401(k) plans (**NOTE:** likely not applicable to most governmental plans).

Code §§ 402(c)(2) and (4) and 403(b)(8)(B); Treas. Reg. §§ 1.402(c)-2, Q&A-3 and Q&A-4; Treas. Reg. § 1.402(c)-2, Q&A-3(a); and Treas. Reg. § 1.403(b)-7.

There are three areas on which the governmental plan should primarily focus in terms of determining what is excluded from the definition of "eligible rollover distribution":

1. The plan must determine whether any payment made is one of a series of substantially equal periodic payments made (not less frequently than annually) over any one of the following periods: the life of the employee (or the joint lives of the employee and the employee's designated beneficiary), the life expectancy of the employee (or the joint life and last survivor expectancy of the employee and the employee's designated beneficiary), or a specified period of ten (10) years or more.
2. The plan must determine whether any portion of the distribution is a required minimum distribution under Code § 401(a)(9). This issue is important for any of the members whose only benefit is in the form of a lump sum distribution, *i.e.*, a cash-out of contributions plus earnings. In such a case, the member would not be able to roll over the portion of the distribution that represents the required minimum distribution.
3. The plan must determine whether any portion of a distribution is non-taxable. The non-taxable amount should be determined even if the member is directly rolling over the amount to an IRA, a qualified plan or a 403(b) plan that separately accounts for after-tax dollars. This issue is important for any member receiving a lump sum distribution, if that member has made any after-tax contributions (*e.g.*, regular contributions or service purchases).

D. Automatic Rollovers

On December 29, 2004, the IRS released Notice 2005-5, which provides guidance relating to the automatic rollover provisions of Code § 401(a)(31)(B). The automatic rollover provisions apply to all mandatory distributions from 401(a) plans, 457(b) governmental plans, and 403(b) plans, provided that the mandatory distributions are also eligible rollover distributions. The new guidance requires a plan to automatically rollover such mandatory distributions over \$1,000 into an IRA on behalf of any member who does not elect a method of distribution. A mandatory distribution is a distribution that is made without the member's consent before the member attains the later of age 62 or the plan's normal retirement age. A distribution to a surviving spouse or alternate payee is not a mandatory distribution for purposes of these requirements. There are also other exceptions such as plan loan offsets.

XVI. CODE § 401(a)(36)—DISTRIBUTIONS DURING WORKING RETIREMENT

Section 905 of the PPA amended Code § 401(a) and ERISA § 3(2)(A) to permit distributions from qualified pension plans to individuals who have not separated from employment. Thus, a qualified pension plan is allowed, but not required, to provide that a distribution may be made to an employee who reaches age 62 even though the employee has not separated from service. Previously, the IRS had indicated that the prohibition on in-service distributions did not prevent benefit commencement to an employee who had reached normal retirement age.

On May 22, 2007, the IRS issued final regulations (Treas. Reg. § 1.401(a)-1(b)) clarifying that a pension plan (a defined benefit plan or money purchase pension plan established under Internal Revenue Code § 401(a)) must be designed primarily to provide systematically for the payment of definitely determinable benefits to its employees, usually for life, **after retirement or attainment of normal retirement age**. (Emphasis added). The final regulations establish the following standard for defining normal retirement age: "the normal retirement age under a plan must be an age that is not earlier than the earliest age that is reasonably representative of the typical retirement age for the industry in which the covered workforce is employed." Treas. Reg. § 1.401(a)-1(b)(2).

The final regulations then address three age ranges. First, the regulations provide a "safe harbor" for a plan with a normal retirement age of age 62 or older, which is deemed to be not earlier than the earliest age that is reasonably representative of the typical retirement age for the industry in which the covered workforce is employed. Second, the regulations provide that if a pension plan's normal retirement age is earlier than age 62, but not earlier than age 55, the IRS will examine all of the relevant facts and circumstances to determine whether the normal retirement age satisfies the standard. Generally, the IRS will give deference to an employer's reasonable determination that a normal retirement age between 55 and 62 satisfies the standards in the final regulations. Finally, if the plan's normal retirement age is lower than age 55, the age is presumed to be earlier than the standard established in the final regulations.

The final regulations also provide a special rule for pension plans in which substantially all of the participants are "qualified public safety employees." In such plans, a normal retirement age of age 50 or later will be considered to satisfy the standard established by the final regulations. A "qualified public safety employee" means "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."

The final regulations were generally applicable on May 22, 2007.

However, with Notice 2012-29, the IRS indicated its anticipated issuance of guidance regarding the applicability of the normal retirement age rules to governmental plans as defined under IRC § 414(d). In particular, the Notice requested public comment on the guidance under consideration which (a) would clarify that governmental plans which do not provide for in-service distributions before age 62 do not need to have a definition of normal retirement age and (b) would modify the age – 50 safe harbor rule for qualified public safety employees. With the Notice, the IRS announced its intention to change the effective date of the regulations for governmental plans 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 legislative session of the legislative body with the authority to amend the plan that begins on or after the date that is three months after the final regulations are published. Until the normal retirement age regulations are amended, governmental plan sponsors may rely on Notice 2012-29. To date, the IRS has not issued final regulations regarding normal retirement age rules for governmental plans.

XVII. CODE § 401(a)(37): MANDATORY MILITARY DEATH BENEFITS

The HEART Act made several important changes and additions that extend the pension protections afforded to noncareer military members under USERRA. Among these, the HEART Act added Code § 401(a)(37), which provides that a qualified plan **must** provide that, for a participant who dies while performing qualified military service (as defined in Code § 414(u)), the survivors of the participant are entitled to any additional benefits (**other than benefit accruals** relating to the period of qualified military service) provided under the plan as if the participant had resumed employment the day before death and then terminated employment on account of death. Thus, if a plan provides for accelerated vesting, ancillary life insurance or lump sum death benefits, or other survivor benefits contingent on a participant's termination of employment on account of death, the plan must provide those same benefits to the beneficiary of a participant who dies during qualified military service.

XVIII. CODE § 401(b): RETROACTIVE REMEDIAL AMENDMENTS MAY BE PERMITTED

Code § 401(b) governs the ability of a qualified plan to make retroactive remedial amendments in order to maintain qualified status. The period in which retroactive corrections are allowed is known as the "Remedial Amendment Period." If corrections are made by the end of the Remedial Amendment Period, the amendments are treated as retroactively effective throughout the entire Remedial Amendment Period and the plan is deemed to have satisfied the qualification requirements of Code § 401(a) during that time. Governmental employers need to consult state law authorities to determine their ability to make retroactive amendments.

XIX. CODE § 401(h): RETIREE MEDICAL BENEFITS MUST BE STRICTLY LIMITED

Code § 401(a) and Treas. Reg. § 1.401-1(b)(1)(i) impose a limit on the provision of medical benefits by a qualified plan. **A qualified governmental plan may not include medical benefits "except**

medical benefits described in § 401(h) as defined in paragraph (a) of § 1.401-14. Code § 401(h) is critical for two very different reasons. First, it is a method whereby a qualified plan can provide medical benefits. Second, 401(h) dictates the member's taxation of benefits received. Thus, one must consider § 401(h) for both reasons – to protect the plan under the qualification rules and to protect the member from the "normal" taxation rules concerning payments from a retirement plan. Code § 401(h) permits pension annuity plans to provide for the payment of benefits for sickness, accident, hospitalization and medical expenses (as defined in Code § 213(d)(1)) of **retired employees, their spouses and their dependents (as defined in Code § 152).** However, under Code § 106 participants have no current gross income resulting from the employer's contributions, and when paid, Code § 401(h) benefits are excludable from the recipient's gross income under Code § 105(b). *See, e.g.* PLR 8747069. Thus, in analyzing Code § 401(h), the requirements of Code § 105(b) and § 106 must also be considered. Again, plans are encouraged to consult with their plan counsel regarding compliance with these rules.

XX. CODE § 401(k): CASH OR DEFERRED ARRANGEMENTS ARE GENERALLY NOT PERMITTED

The general rule is that a Code § 401(a) plan may not include a "cash or deferred arrangement" ("CODA") unless the plan meets the requirements of Code § 401(k). However, state and local governments (and their subdivisions, agencies, and instrumentalities) are prohibited from having 401(k) plans unless the organization had adopted the plan before May 6, 1986.

CODA is defined broadly and includes an election or modification of an election which provides the employee with a choice between cash or a taxable benefit and a deferral. There is an exception for a one-time irrevocable election made no later than the employee first becoming eligible under the plan or any other plan of the employer. However, the IRS is applying this rule strictly and governmental plans must be very careful about offering participants elections of any type, even within a defined benefit plan. *See, generally,* Rev. Rul. 2006-43.

XXI. CODE § 402: DISTRIBUTIONS ARE SUBJECT TO SPECIAL TAX TREATMENT

Distributions from plans qualified under Code § 401(a) are subject to special tax treatment under Code § 402(a). Under Code § 402(a), a distribution from a qualified plan is taxable to the recipient in the year in which it is **distributed**. Therefore, participants in a qualified plan are not taxed on benefits they are eligible to receive until they actually receive the benefits. Such benefits are then taxable under Code § 72.

XXII. CODE § 408(q): DEEMED IRAS MAY BE PERMITTED

Effective for years beginning after 2002, EGTRRA provides that employers may permit employees to make voluntary contributions to deemed traditional IRA accounts and deemed Roth IRA accounts under "qualified employer plans." For purposes of this provision, a qualified employer plan includes 401(a) plans, 403(a) annuity plans, 403(b) plans and 457(b) plans. Deemed IRAs would be separate accounts within the plan.

If these accounts meet the statutory requirements applicable to IRAs or Roth IRAs, they will be treated as if they are an IRA (or Roth IRA) and not like a "qualified employer plan."

XXIII. CODE § 414(d): DEFINITION OF A GOVERNMENTAL PLAN

Code § 414(d) defines a governmental plan as one which is "established **and** maintained for its employees by the Government of the United States, by the government of any State or political subdivision thereof, or by any agency or instrumentality of any of the foregoing." *See* Revenue Ruling 89-49, 1989-1 C.B. 117, for a discussion of the factors applied to determine whether an organization is an agency or instrumentality of the U.S., a state or a political subdivision. As previously mentioned in this Primer, as amended by PPA, the term "governmental plan" also includes an Indian Tribal government, a subdivision of an Indian Tribal government or an agency or instrumentality of either. The IRS has long taken the position that a "governmental plan" may not include any non-governmental employees, although the DOL permits a *de minimis* number of non-governmental employees. DOL Opinion No. 99-07A (June 1, 1999). The IRS, the DOL and the PBGC are currently engaged in a joint guidance project on the definition of a governmental plan, which should result in consistency among the definitions used by the three agencies.

As of the date of this Primer, the IRS has pending proposed rulemaking on the definition of a "governmental plan." ANPRM Reg.-157714-06 (filed November 7, 2011). If the rules are adopted, a facts and circumstances analysis will determine whether an entity constitutes an agency or instrumentality of the United States or an agency or instrumentality of a state or political subdivision of a state and will adopt factors used in this analysis. Based upon the AMPRM, the factors would be categorized into major factors and other factors. The factors include the following:

- Control;
- Funding (whether direct, through tax revenues or otherwise);
- Statutory authorization;
- Treatment of employees;
- Tax status;
- Any judicial decision by state or federal court; and
- Whether the entity serves a government purpose.

XXIV. CODE § 414(h): EMPLOYER MAY PICK-UP EMPLOYEE CONTRIBUTIONS

In general, a contribution designated as an employee contribution will not be treated as an employer contribution and therefore cannot be treated as a pre-tax deduction from the employee's salary. For governmental plans, the employer may choose to "pick up" the employee contributions, which results in treating those contributions as employer contributions, including pre-tax treatment. (Under a pick-up plan, the governmental employer must actually pay such contributions, but it does not matter whether those contributions are paid from salary reduced amounts or other money). Consequently, if a governmental employer correctly picks up employee contributions, such contributions will no longer be included in the employee's gross income, nor will they be subject to income tax withholding. Treas. Reg. § 1.402(a)-1; Rev. Rul. 77-462, 1977-2 C.B. 358. However, certain pick-up contributions are taken into account as "wages" for FICA purposes. Code § 3121(v)(1)(B). There

are a number of requirements, including specific employer action, which must be satisfied in order to receive pick-up treatment. Rev. Rul. 2006-43. Again, plans are encouraged to consult with their plan counsel regarding compliance with these rules.

XXV. CODE § 414(p): QUALIFIED DOMESTIC RELATIONS ORDERS MAY BE ACCEPTED

While most plans qualified under Code § 401(a) are required to prohibit assignment or alienation of the benefits except pursuant to a QDRO, governmental plans are not subject to this prohibition. However, because of desirable tax treatment provisions for QDROs, governmental plans that honor domestic relations orders ("DRO") generally wish to have federal QDRO treatment for those orders.

If the alternate payee under a QDRO is a former spouse, Code § 402(e)(1)(A) applies, such that the alternate payee is treated as the "distributee" and the amount paid under the QDRO is includible in the former spouse's gross income for purposes of Code §§ 72 and 402(a). This is a **required tax treatment** and the employer has no option in this respect. The spousal alternate payee also is considered the distributee for withholding purposes, both for general withholding and for special withholding on eligible rollover distributions. On the other hand, if the QDRO provides for payments to **non-spousal** alternate payees, the distribution would be included in the member's gross income. QDRO treatment also provides advantages with respect to the basis recovery rules, rollover rules, and applicability of the 10% premature distribution tax.

XXVI. CODE § 414(u): USERRA AND HEART GOVERN MEMBERS WHO ENGAGE IN QUALIFIED MILITARY SERVICE

USERRA requires employers to reemploy and preserve job security, pension, and welfare benefits for "qualified" employees who engage in military service. USERRA § 4318 provides for the protection of retirement benefits for individuals who are reemployed and otherwise entitled to the rights and protections under USERRA with respect to both employer and employee contributions.

In 2008, the HEART Act expanded on the USERRA requirements in various respects. First, Code § 414(u)(9) provides that for benefit accrual purposes, an employer sponsoring a retirement plan may treat an individual who dies or becomes disabled (as defined under the terms of the plan) while performing qualified military service with respect to the employer maintaining the plan as if the individual had resumed employment in accordance with the individual's reemployment rights under USERRA on the day preceding death or disability (as the case may be), and had terminated employment on the actual date of death or disability.

In other words, a plan is **permitted** (but **not required**) to treat an individual who leaves service with the plan's sponsoring employer for qualified military service, and who cannot be reemployed on account of death or disability, as if he had been rehired as of the day before his death or disability (a "deemed rehired employee"), and then terminated employment on the date of his death or disability. For such a "deemed rehired employee," a plan may comply fully or partially with the benefit accrual restoration provisions that would be mandatory under Code § 414(u)(8) had the individual actually been rehired. If a plan implements this provision, the special § 414(u) rules regarding the interaction of USERRA with the otherwise applicable benefit limitation and nondiscrimination rules apply.

In addition, Code § 414(u)(12) **requires** that active military service members receiving differential pay be treated as employees with compensation for retirement plan purposes. Rev. Rul. 2009-11 provided guidance on reporting and withholding differential wage payments under Form W-2. Under this Revenue Ruling, for an employee in active military service for periods exceeding 30 days, any differential wage payments paid by the employer are subject to the following:

- Differential wage payments are treated as wages for federal income tax withholding purposes, and the employer must withhold federal income taxes on these payments. These payments are treated as supplemental wage payments.
- Differential wage payments are not treated as wages for purposes of FICA and FUTA taxes.

Differential wage payments must be reported on Form W-2 and must be treated as compensation for purposes of Code § 415(c)(3) and Treas. Reg. § 1.415-2(d).

Notwithstanding the newly enacted rule that a person receiving differential pay is to be considered an employee, for purposes of § 401(k), § 403(b) and § 457(b) plans, an individual shall be treated as having severed employment while in USERRA covered service. Therefore, the individual may take a distribution from the plan. In such a circumstance, the individual may not make an elected deferral or employee contribution during the six-month period beginning on the date of the distribution. This provision is mandatory and is effective in 2009. For governmental plans, plan amendments must have been made on or before the end of the 2012 plan year.

XXVII. CODE § 415: BENEFITS AND CONTRIBUTIONS MUST BE LIMITED

The IRS issued final regulations under Code § 415 in April 2007. The final regulations generally are applicable to limitation years beginning on or after July 1, 2007. However, governmental plans have an extended compliance date: 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.

A. Code § 415(b): Benefit Limits

One of the requirements for a defined benefit plan to remain qualified is that the total amount of pension benefits each member accrues cannot exceed the amount specified in Code § 415(b). If even **one** member accrues an annual benefit greater than Code § 415 allows, or contributes more than Code § 415 allows, **the penalty provided is that the entire plan will be disqualified**. For a governmental plan, the basic requirement of Code § 415(b) is that the annual benefit provided to a member at Social Security retirement age (in the form of a straight life benefit, with no ancillary benefits) may not exceed \$160,000 as adjusted for inflation (\$210,000 in 2014). The limit is adjusted when the benefit begins before the participant reaches age 62 (except for qualified police officers and firefighters) or after age 65 (in limited cases), and also when the participant has less than 10 years of service.

B. Code § 415(c): Defined Contribution Limits

Beginning in 2002, annual additions to defined contribution plans may not exceed the lesser of 100% of the participant's compensation or \$40,000 as adjusted for inflation (\$52,000 in 2014). The term "annual addition" means the sum, credited to a participant's account for any limitation year, of employer contributions, employee contributions, and forfeitures. Certain items, such as rollovers to a defined contribution plan or repayment of a loan, are excluded from annual additions. Picked up contributions are not treated as annual additions; instead, the benefit attributable to those contributions is tested under Code § 415(b). Mandatory employee contributions to a defined benefit plan that are not picked-up must be treated as contributions to a separate defined contribution plan. Treas. Reg. § 1.415-3(d)(1).

C. Code § 415(m): Qualified Governmental Excess Benefit Arrangements

Benefits in excess of the Code § 415(b) limits may be paid from a qualified governmental excess benefit arrangement under Code § 415(m).

D. Code § 415(n): Treatment of Service Purchase Provisions

Purchases of "permissive service credit" may be tested against either a modified Code § 415(b) limit or a modified Code § 415(c) dollar limit. These limits can be applied on a participant-by-participant basis rather than choosing a limit to apply plan-wide. For example, some participants could satisfy the defined benefit limit, while others could satisfy the defined contribution limit.

Permissive service credit is any service credit that is taken into account by the governmental plan for calculating a member's benefit; that the member does not already have credited under the plan; and that the member can receive only by an additional voluntary contribution, the amount of which is determined by the governmental plan and does not exceed the amount necessary to fund the benefit attributable to this service credit. Certain types of permissive service credit are considered "nonqualified service" and are limited so that the plan may not allow the purchase of more than 5 years of nonqualified service, and such purchases can only occur after the participant has 5 years of service.

Section 821 of the PPA clarified that **participants** (as opposed to just current employees) are eligible for this provision. Second, this Section provides that permissive service may include periods for which there is no performance of service ("airtime") (subject to the limits on nonqualified service), and also may include service already credited in the plan, where an increased (or enhanced) benefit is being purchased. Third, it clarifies the definition of educational organization service to include non-U.S. schools. Fourth, the Section clarifies that the limits on nonqualified service credit purchases do not apply to trustee-to-trustee transfers from a § 457(b) plan or a § 403(b) plan. Fifth, the Section provides that, once a trustee-to-trustee transfer is made from such a plan to a governmental defined benefit plan, the defined benefit distribution rules are applicable to the transferred amounts and to the benefits attributable to these amounts. Again, the rules under Code § 415 are very complicated and the violation of them, in theory, can result in disqualification of the entire plan. Accordingly, plans are encouraged to consult with their plan counsel or actuary in order to ensure compliance with these rules and the applicable regulations.

XXVIII. CODE § 503(b): PLANS MUST AVOID PROHIBITED TRANSACTIONS

Code § 503(b) describes certain transactions that are prohibited under the Code. Although a governmental plan is not subject to the excise tax in Code § 4975, engaging in a prohibited transaction could result in a loss of the plan's qualified status. Code § 4975(g)(2); Code § 503(a)(1)(B). The Code defines "prohibited transactions" by listing several transactions that, if engaged in, would constitute a prohibited transaction. These prohibited transactions include a number of specific transactions between the plan and a "disqualified person." A "disqualified person" is the creator of the plan, a person who has made a substantial contribution to the plan, a member of the family of a person who is the creator or substantial contributor, or a corporation controlled by the creator or substantial contributor to the plan. Code § 503(b).

XXIX. METHODS OF CORRECTION – EMPLOYEE PLANS COMPLIANCE RESOLUTION SYSTEM

Rev. Proc. 2013-12 establishes the Employee Plans Compliance Resolution System ("EPCRS") and provides guidance on correction methods available under EPCRS. EPCRS is available to plan sponsors (plan administrators and employers) of Code §§ 401(a), 403(b), 408(k) or 408(p) plans. EPCRS permits plan sponsors to correct certain failures thereby continuing to provide their employees with retirement benefits on a tax favored basis. The components of EPCRS are the self-correction program ("SCP"), the voluntary correction program ("VCP") and the audit closing agreement program ("Audit Cap").

EPCRS is based on the following general principles (*see* Rev. Proc. 2013-12, §§ 1 and 6):

- Sponsors and administrators should be encouraged to establish administrative practices and procedures that ensure the plans are operated properly in accordance with the applicable code requirements.
- Sponsors and administrators should satisfy the applicable plan document requirements of the Code;
- Sponsors and administrators should make voluntary and timely correction of any plan failures;
- Voluntary compliance is promoted by providing for limited fees for voluntary corrections approved by the IRS, thereby reducing employers' uncertainty regarding the potential tax liability and participants' potential tax liability;
- Fees and sanctions should be graduated in a series of steps so that there is always an incentive to correct promptly;
- Sanctions for plan failures identified on audit should be reasonable in light of the nature, extent and severity of the violation;
- Administration of EPCRS should be consistent and uniform;

- Sponsors should be able to rely on the availability of EPCRS in taking corrective actions to maintain the tax-favored status of their plan;
- Generally, full correction must be made with respect to all members and beneficiaries and for all taxable years;
- Correction should restore the plan to the position it would have been in had the failure not occurred, including restoration of current and former members and beneficiaries to the benefits and rights they would have had if the failure had not occurred;
- The correction method should keep plan assets in the plan, except to the extent the Code or regulations provide for distribution to members or return of assets to the employer;
- The selected correction method should be applied consistently in correcting all failures of that type for the plan year.

The types of correction programs are as follows:

Self-Correction Program ("SCP")

A plan sponsor that has established compliance practices and procedures may, at any time without paying any fee or sanction, correct insignificant operational failures under a qualified plan. In the case of a qualified plan that is the subject of a favorable determination letter from the IRS, the plan sponsor generally may correct even significant operational failures without payment of any fee or sanction if the correction is made within the applicable time limitations.

Voluntary Correction Program ("VCP")

A plan sponsor, at any time before audit, may pay a limited fee and receive the IRS' approval for correction of a qualified plan.

Correction on Audit Program ("Audit Cap")

If a failure, other than a failure corrected through SCP or VCP, is identified on audit, the plan sponsor may correct the failure and pay a sanction. The sanction imposed will bear a reasonable relationship to the nature, extent and severity of the failure, taking into account the extent to which correction occurred before audit. Rev. Proc. 2013-12, § 1.03.

Whether a particular operational failure, or several operational failures in aggregate, would be considered insignificant depends on the following factors:

- Whether other failures occurred during the period being examined;
- The percentage of plan assets and contributions involved in the failure;
- The number of years the failure occurred;

- The number of members affected relative to the total number of members in the plan;
- The number of members affected by the failure compared to the number that could have been affected by the failure;
- Whether the failure was corrected within a reasonable period of time after discovery; and
- The reason for the failure.

Common failures experienced by governmental pension plans include: failure of a plan to be amended to reflect a new qualification requirement within the applicable remedial amendment period under Code §401(b) or to be timely and properly amended by adopting good faith or interim amendments (referred to as "Plan Document Failures"), failure to follow plan provisions (referred to as an "Operational Failure"), overpayments to/from participants or beneficiaries (\$100.00 or greater) and underpayments to/from participants or beneficiaries (\$75.00 or greater). Specifically as it relates to overpayments and underpayments, principal and interest should be collected/paid in order to fully correct the failure.

NOTE: It is very important that the plan consult with its plan counsel regarding any failure(s) and the options available to the plan under EPCRS.

This publication is intended for general information purposes only and does not and is not intended to constitute legal advice. The reader must consult with legal counsel to determine how laws or decisions discussed herein apply to the reader's specific circumstances.

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**INTERNAL REVENUE CODE PROVISIONS FROM WHICH QUALIFIED
GOVERNMENTAL PLANS ARE EXEMPT**

<u>Code Section</u>	<u>Subject</u>
401(a)(3)	Minimum Participation and Coverage Requirements. ⁹
401(a)(4)	Nondiscrimination Rules. Code § 401(a)(5)(G) exempts governmental plans from this requirement. However, Pre-ERISA 401(a)(7) makes pre-ERISA 401(a)(4) applicable to vesting upon termination.
401(a)(6)	Quarterly Participation Test.
401(a)(10) & 416	Top-Heavy Provisions.
401(a)(11) & 417	Joint and Survivor Annuities.
401(a)(12) & 414(l)	Plan Merger.
401(a)(13)	Anti-alienation.
401(a)(14)	Benefit Commencement.
401(a)(15)	No Retirement Benefit Reductions.
401(a)(19)	Withdrawal of Employee Contributions.
401(a)(20)	Qualified Total Distributions.
401(a)(26)	Additional Participation Requirements.
401(a)(28)	Additional Requirements Relating To Employee Stock Ownership Plans.
401(a)(29)	Benefit Limitations.
401(a)(32)	Treatment of Failure to Make Certain Payments.
401(a)(33)	Prohibition on Benefit Increases.
401(a)(34)	Benefits of Missing Participants.
401(a)(35)	Diversification Requirements.
401(l)	Permitted Disparity in Plan Contributions or Benefits (Integration with Social Security).

⁹ Governmental plans are treated as satisfying Code §§ 401(a)(3) [minimum participation rules of Code 410(b)], 401(a)(4) [general nondiscrimination rules], 401(a)(26) [minimum participation rule], 401(k) [salary reduction nondiscrimination rules], 401(m) [matching employer contribution nondiscrimination rules], 403(b)(1)(D) and 403(b)(12) [403(b) nondiscrimination rules], and 410 [minimum participation rules] for all taxable years beginning before enactment of TRA '97.

401(m)	Nondiscrimination Test for Matching Contributions and Employer Contributions.
410	Minimum Participation Standards.
411	Minimum Vesting. Pre-ERISA requirements of 401(a)(4), which stipulate that a plan may not discriminate in favor of officers, shareholders, supervisors or highly compensated, and 401(a)(7), which requires 100% vesting upon plan or discontinuance of employer contributions, must be met.
412	Minimum Funding Standards. Plan must meet pre-ERISA requirements of 401(a)(7) which requires 100% vesting upon plan termination or discontinuance of employer contributions.
416	Special Rules for Top-Heavy Plans.
417	Definitions and Special Rules for Purposes of Minimum Survivor Annuity Requirements.
418, 418A, 418B, 418C 418D, 418E	Reorganization Status (Multiemployer Plan) and related provisions.
430	Minimum Funding Standards for Single-Employer Defined Benefit Pension Plans.
431	Minimum Funding Standards for Multiemployer Plans.
432	Additional Funding Rules for Multiemployer Plans in Endangered or Critical Status.
436	Funding-Based Limits in Benefits and Benefit Accruals under Single-Employer Plans.
4965	Excise Tax on Certain Tax-Exempt Entities Entering Into Prohibited Tax Shelter Transactions. However, a plan administrator ("entity manager") who approves or causes the plan to be a party to a prohibited tax shelter transaction, and who knows or has reason to know that the transaction is prohibited, must pay a \$20,000 tax for each approval or act. NOTE: governmental 457(b) plans are specifically covered. Code § 4965(c)(6), as are tax-exempt entities described in Code § 501(c) or (d) or 5170(c) other than the United States, or an Indian tribal governmental that is a party to such a transaction.
4971	Taxes on Failure to Meet Minimum Funding Standards.
4972	Tax on Nondeductible Contributions to Qualified Employer Plans.
4975	Excise Tax on Prohibited Transactions.
4980	Excise Tax on Reversion of Plan Assets.

6057	Annual Registration Statement (Schedule SSA)
6058	Annual Return (Form Series 5500)
6059	Actuarial Report

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