

**RE: Internal Revenue Code Qualification Rules Applicable to
Governmental Defined Benefit Plans**
FROM: Paul Zorn*
DATE: December 2, 2008

This memorandum summarizes key qualification rules for state and local government retirement plans under Internal Revenue Code (Code) § 401(a). However, the author is not an attorney and the information provided is not legal advice or opinion. Moreover, the memorandum is not intended to provide a detailed description of the qualification rules. Plan administrators should consult with qualified legal counsel to ensure plan provisions comply with applicable laws and regulations.

To maintain their federal tax-qualified status, governmental retirement plans are subject to a variety of rules established under § 401(a) of the Internal Revenue Code and related statutes and regulations. Tax qualification has several advantages for plan members, including:

- Employer contributions to qualified plans are not taxable as income to plan members when the contributions are made and investment income is not taxable to members when earned by the plan. Members are taxed when the benefits are distributed to them as income.
- Employee contributions to qualified governmental plans are not taxable income when the contributions are made, provided the employer elects to “pick-up” the contributions. Again, taxation occurs when the benefits are distributed as income. Employer pick-ups are discussed later in this report.
- Income taxes on eligible rollover distributions may be delayed if the distributions are rolled into another qualified plan (or into §§ 401(k), 403(b), or 457(b) plans or an IRA).
- For eligible retired public safety officers, certain payments made by the plan for health benefits or long-term care are not taxable.¹

In the private sector, tax qualification also allows employers sponsoring qualified plans to deduct plan contributions as business expenses, within certain limits. Because state and local governments are tax-exempt entities, the deductibility of employer contributions does not apply.

Due to fundamental differences between public- and private-sector entities, many of the rules that apply to private-sector plans do not apply to governmental plans.² Nevertheless, governmental plans are subject to certain qualification rules that govern how they are established and operate. Not following the rules could jeopardize the plan’s tax-qualified status,

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¹ The 2006 Pension Protection Act allows retired public safety officers to take an income tax exclusion of up to \$3,000 annually for health and long-term care paid directly from the governmental plan to the health plan.

² Governmental plans are exempt from much of the 1974 Employee Retirement Income Security Act (ERISA), including Titles I, III, and IV, and certain sections of Title II, as provided under ERISA § 4(b)(1). As a result, governmental plans are not subject to many of the vesting, funding, and disclosure requirements that apply to private-sector plans. However, governmental plans are subject to certain sections of the Internal Revenue Code as described in this memorandum.

prevent certain tax advantages for plan members, and subject the plan to the costs associated with plan corrections and IRS audits, including possible monetary penalties.

GENERAL REQUIREMENTS

The qualification rules of Code § 401(a) apply to stock bonus plans, pension (defined benefit and defined contribution) plans, and profit sharing plans.³ This research memorandum primarily focuses on governmental defined benefit pension plans. A pension plan is defined as “a plan established and maintained by the 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.”⁴

Governmental Plan. The Code defines a “governmental plan” as a plan “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.” It also includes a plan established and maintained by an Indian tribal government, a subdivision of an Indian tribal government, or an agency or instrumentality of either, that is established for participants who perform essential governmental functions (but not commercial activities).⁵

Comment: The IRS is currently reviewing the governmental plan definition and has announced that it will issue new guidance in the near future. Readers should watch for this guidance and offer comments to the IRS as necessary.

Formal Trust and Written Plan. To constitute a qualified plan, the plan’s assets must be held in a trust created or organized in the United States and maintained as a domestic trust.⁶ The IRS takes the position that the trust needs to be in writing even if applicable state law does not require written trusts, and be specific enough to resolve disputes.⁷ According to attorney David Powell with the Groom Law Group, if there is a formal trust document in addition to the statute, there would be no trouble meeting the trust requirement. However, if there is no formal trust document, the trust requirement would apparently be satisfied if the statutory language provides that the assets of the plan will be held in trust.⁸

Definitely Determinable Benefits. In general, a plan does not provide definitely determinable benefits if a member’s ability to receive benefits (or the amount received) is conditioned on the employer’s discretion.⁹ Moreover, for the benefits to be definitely determinable, the actuarial assumptions used to calculate the benefits are to be specified in the plan document.¹⁰ According to David Powell, some governmental plans have met the actuarial assumption requirement by specifying the assumptions in administrative procedures or regulations which can be considered part of the plan document.¹¹

³ Code § 401(a).

⁴ Treas. Reg. § 1.401-1(b)(1)(i).

⁵ Code § 414(d).

⁶ Code § 401(a); Treas. Reg. § 1.401-1(a)(3)(i).

⁷ Rev. Rul. 69-231.

⁸ Powell, David, 372-3rd, T.M., *Church and Governmental Plans*, F.1. (This is published by the Bureau of National Affairs Inc., as one of their Tax Management Monographs.)

⁹ Treas. Reg. 1.401(a)-4, Q&A 3.

¹⁰ Code § 401(a)(25).

¹¹ Powell, David, 372-3rd, F.1.a.

Exclusive Benefit Rule. The plan also needs to operate for the exclusive benefit of plan members and beneficiaries. Under the trust, it must be “impossible, at any time prior to the satisfaction of all liabilities with respect to employees and their beneficiaries” ... for any part of the trust to be ... “used for, or diverted to, purposes other than for the exclusive benefit of his employees or their beneficiaries.”¹² According to attorneys Mary Beth Braitman and Terry Mumford with Ice Miller LLP, this also means that plan investments must be made for the exclusive benefit of employees and their beneficiaries.¹³

Comment: However, the exclusive benefit rule does not prevent the plan from paying administrative costs from plan assets. Additionally, in the event of plan termination, it does not prevent the return of assets (if any) to the plan sponsor after all benefits and other liabilities owed by the plan have been paid.¹⁴

VESTING

Vesting refers to the period of service required for a plan member to earn a legal right to plan benefits. Although governmental plans are not subject to the vesting requirements that apply to private-sector plans under the Employee Retirement Income Security Act of 1974 (ERISA), they are subject to the pre-ERISA vesting requirements in effect on September 1, 1974.¹⁵ This requires a governmental plan to provide 100% vesting of accrued benefits when a participant reaches normal retirement age.¹⁶ In addition, it requires the plan to provide 100% vesting if there is a partial or complete termination of the plan, or complete discontinuance of contributions, but in either case only to the extent the benefits are funded.¹⁷

COMPENSATION LIMITS

The qualification rules also limit the annual compensation that may be taken into account for determining the benefits paid by a qualified defined benefit plan and the contributions made to a qualified defined contribution plan.¹⁸ For private-sector plan members, and for governmental plan members hired after 1995, the maximum annual compensation that may be taken into account is determined by an annual dollar limit (\$245,000 in 2009), indexed for inflation.¹⁹ Appendix A provides a history of the compensation and benefit limits from 1975 through 2009.

Example: A participant in a § 401(a) defined benefit plan retires at the end of 2009 with a pension equal to 50% of final annual compensation and final annual compensation of \$250,000. Under § 401(a)(17), the participant’s benefit would be limited to \$122,500 (50% x \$245,000) rather than \$125,000 (50% x \$250,000).²⁰

Example: A participant in a § 401(a) defined contribution plan is required to contribute 10% of annual compensation, and annual compensation in 2009 is \$250,000. Under § 401(a)(17), the participant’s 2009 contribution would be limited to \$24,500 (10% x \$245,000) rather than \$25,000 (10% x \$250,000).

¹² Code § 401(a)(2).

¹³ Braitman, Mary Beth, et. al., *Ice Miller’s Guide to Governmental Retirement Plans*, December 2002, p. 20.

¹⁴ Treas. Reg. 1.401-6(a)(2)(ii); Rev. Rul. 80-229.

¹⁵ Code § 411(e).

¹⁶ Rev. Rul. 66-11.

¹⁷ Code § 401(a)(7) in effect September 1, 1974.

¹⁸ Code § 401(a)(17). Employer contributions to a defined benefit plan are not limited by Code § 401(a)(17).

¹⁹ IRS Release IR-2008-118.

²⁰ The examples in this memorandum are for illustrative purposes only and are simplified in order to highlight key principles. Actual situations are likely to be more complicated.

Special rules apply to some public-sector plan members hired before 1996. In 1993, the Omnibus Budget Reconciliation Act (OBRA '93) amended Code § 401(a)(17), lowering the maximum compensation limit from \$235,840 to \$150,000. However, the Act allowed governmental plans to “grandfather” the compensation limits that were specified in the plan as of July 1, 1993. These grandfathered limits could be applied to employees hired before 1996, but only if the plan was amended to apply the OBRA '93 limits to employees hired in 1996 and after.

This generally means that, for governmental plans applying the pre-OBRA '93 limits, the maximum compensation limit for grandfathered employees is an annual dollar limit (\$360,000 in 2009), indexed for inflation.²¹ However, for governmental plans that had no maximum compensation limit as of July 1, 1993, and that amended the plan to grandfather these provisions, benefits for grandfathered employees can be determined without reference to any compensation limit.²²

Example: As of July 1, 1993, a governmental plan limited compensation to \$235,840 for benefit purposes. Responding to the 1993 change in the compensation limit, the plan sponsor amended the plan to grandfather employees hired before 1996, and applied the new limit to employees hired in 1996 and after. As a result, the 2009 compensation limit is \$360,000 for plan members hired before 1996 and \$245,000 for plan members hired after. However, if the plan had no limit on compensation as of July 1, 1993, and amended the plan to grandfather these provisions, there would be no limit on compensation for members hired before 1996.

BENEFIT AND CONTRIBUTION LIMITS

To be qualified, the plan must also apply the benefit and contribution limits provided under Code § 415.²³ The 415 rules are complicated and a full explanation is beyond the scope of this memorandum. For a more detailed explanation, see the GRS Research Memorandum: “Final 415 Regulations Related to Governmental Defined Benefit Plans,” available on the GRS web site (http://www.gabrielroeder.com/news/pdf_research/RM_415FinalRegs2007.pdf).

Benefit Limits. Generally, Code § 415(b) limits the employer-provided benefits that can be paid to members in a defined benefit plan to the lesser of a dollar limit (\$195,000 in 2009), indexed for inflation, or 100% of a participant's average compensation for the highest three years. Although private-sector plans are subject to both limits, governmental plans are exempt from the 100% of average compensation limit.

Example: A participant in a governmental defined benefit plan retires at age 62 with an annual benefit under the plan's formula of \$200,000, paid as a straight-life annuity.²⁴ The participant makes no contributions to the plan, so all of the benefit is provided through contributions made by the employer. Under § 415(b), the participant's benefit payable from the qualified plan in 2009 would be limited to \$195,000. However, as discussed later in this memorandum, benefits above the § 415 limit may be paid through a qualified excess benefit arrangement.

²¹ IRS Release IR-2008-118.

²² Treas. Reg. § 1.401(a)(17)-1(d)(4)(ii).

²³ Code § 401(a)(16).

²⁴ A straight-life annuity is defined by the IRS as a benefit paid in equal periodic amounts over the recipient's lifetime.

Adjustment for Benefits Beginning Before Age 62. If a benefit begins before age 62, the dollar limit is actuarially reduced using factors specified by the IRS. However, no age-reduction is made for a participant with at least 15 years of service in the plan as: (1) a full-time employee of a governmental police or fire department providing police protection, firefighting services, or emergency medical services, or (2) as a member of the U.S. Armed Forces.²⁵

Example: A participant in a governmental defined benefit plan retires at age 55 with an employer-provided annual benefit under the plan's formula of \$120,000, paid as a straight-life annuity. If the participant is not a full-time employee of a police or fire department with at least 15 years of service, the 2009 benefit would be limited to about \$116,500 due to the actuarial age-reduction of the dollar limit. However, if the participant is a full-time employee of a governmental police or fire department with at least 15 years of service in the plan, the dollar limit would not be age-reduced and would remain at \$195,000.

Adjustment for Benefits Not Paid as Straight Life Annuities. Code § 415(b) also requires benefits that are not paid as straight-life annuities (or as qualified joint and survivor annuities)²⁶ to be actuarially adjusted to the equivalent value of a straight life annuity for testing under the § 415(b) limit.²⁷

Example: A participant retires at age 65 with an employer-provided benefit of \$146,000 paid as a straight-life annuity with a 10-year certain feature. This feature requires the benefit to be paid over a period of at least 10 years, even if the participant dies during that period. When this benefit is actuarially adjusted to an equivalent straight-life annuity, its value would be closer to \$152,000 (depending on the actuarial equivalence factors used).

Adjustment for Employee Contributions. As noted above, Code § 415(b) limits the employer-provided benefits that can be paid to members in a defined benefit plan. Consequently, the actuarial value of the benefit attributable to employee contributions (specifically after-tax employee contributions) is not included in the benefit that is tested under § 415(b).

Example: A participant in a governmental defined benefit plan retires at age 62 with an annual benefit of \$210,000, paid as a straight-life annuity. The employee's after-tax contributions to the plan, when actuarially valued, are equivalent to \$30,000 of the benefit. Therefore, the employer-provided benefit tested under § 415(b) would be \$180,000 (\$210,000 - \$30,000).

An employer sponsoring a governmental defined benefit plan may "pick-up" employee contributions by deeming the employee contributions to have been made by the employer.²⁸ As a result, employee contributions to the plan are excluded from the employee's taxable income at the time the contributions are made. For governmental employers that "pick-up" employee contributions, the contributions are treated as part of the employer-provided portion of benefits

²⁵ Code § 415(b)(2)(G) and (H). The preamble to the final regulations for § 415 clarifies that the reference to police or fire "department" applies based on the organization's function rather than its name.

²⁶ Generally, a qualified joint and survivor annuity is an annuity for the life of the participant with a survivor annuity for the life of the participant's spouse. The amount of the annuity may not be less than 50% or more than 100% of the annuity payable during the period the participant and spouse are both alive.

²⁷ Code § 415(b)(2)(B).

²⁸ Code § 414(h)(2).

and so are tested under the § 415(b) dollar limits. Pick-ups are also subject to additional rules, discussed later in this memorandum.²⁹

Adjusting the Dollar Limit for Inflation. The § 415(b) dollar limit is increased periodically for inflation and Code § 415(d) sets out how these increases are calculated. Code § 415(d) also provides how benefits that are subject to the limit may be increased to reflect the § 415(d) increase in the dollar limit. This would be the case, for example, when a retired employee's benefit was originally restricted by the § 415(b) limit, but may be increased in later years as a result of the § 415(d) adjustment to the dollar limit. However, in order for the plan to increase such benefits, the plan document must specifically provide that the limit be increased in the manner established under § 415(d) and related regulations.

Contribution Limits. Code § 415(c) limits the maximum amount of "annual additions" that can be contributed to a defined contribution plan. The limit is the lesser of a specific dollar amount (\$49,000 in 2009), indexed for inflation, or 100% of annual compensation. Governmental plans are subject to both limits. Annual additions include employer and employee contributions, as well as forfeitures. As defined in this context, annual compensation includes elective deferrals to §§ 401(k), 403(b), governmental 457(b), 132(f)(4) transportation plans, and 125 "cafeteria" plans.

Comment: For governmental defined benefit plans that do not "pick-up" employee contributions, mandatory employee contributions are treated as contributions to a defined contribution plan and are subject to the § 415(c) limits.³⁰ Voluntary after-tax employee contributions are also subject to the § 415(c) limits.

Qualified Excess Benefit Arrangements. While Code § 415(b) limits the benefits that can be paid from a qualified defined benefit plan, Code § 415(m) allows benefits that exceed the § 415(b) limits to be paid through a qualified excess benefit arrangement (QEBA).³¹ Under this approach, the qualified defined benefit plan would pay the benefit up to the § 415(b) limit, and the QEBA would pay the amount over the limit. In establishing a QEBA, plan sponsors and administrators should be aware of several constraints:

- The QEBA may only provide benefits that exceed the § 415(b) limit as a result of the plan's benefit formula. In other words, the plan may not allow members to elect to defer additional compensation through the QEBA.
- Benefits limited by other sections of the Code, such as by the compensation limit under § 401(a)(17), are not payable from the QEBA. The QEBA may only provide benefits in excess of the § 415 limits.
- Operationally, benefits from the QEBA may not be paid from the qualified plan's trust. QEBA benefits may be paid on a pay-as-you-go basis or through a separate trust established for the sole purpose of providing the excess benefits.

²⁹ Rev. Rul. 2006-43.

³⁰ Treas. Reg. § 1.415(b)-1(b)(2)(iii).

³¹ Code § 415(m).

SERVICE CREDIT PURCHASES

Governments often allow members to purchase additional service credit in a defined benefit plan. The qualification rules for such purchases are provided under Code § 415(n). Generally, the § 415 limits for the purchase of “permissive service credit” are satisfied if:

- The member’s payment for permissive service credit in a given year does not exceed the § 415(c) defined contribution dollar limit for that year (when added to other § 415(c) annual additions), or
- The member’s annual benefit (including the benefit from the purchased service credit) does not exceed the § 415(b) dollar limit.³²

Consequently, if the payment for purchased service credit (plus any other § 415(c) annual additions) in a given year does not exceed the § 415(c) limit for the year, the benefit purchased can be excluded from the benefit tested under the § 415(b) limit.

Example: A participant in a defined benefit plan purchases service credit in 2009 with an after-tax payment of \$45,000 and makes no other after-tax contributions that year. Since the participant’s payment for service credit (plus other § 415(c) additions) for 2009 does not exceed the § 415(c) limit of \$49,000, the value of the benefit purchased would not be included in the benefit tested under § 415(b). However, if the payment (plus other § 415(c) additions) exceeded the annual 415(c) limit, the value of the benefit purchased would be included in the benefit tested under § 415(b).

Permissive Service Credit. “Permissive service credit” is defined as credit: (1) recognized by the governmental plan in calculating a participant’s benefit, (2) for service which the participant had not already received as credit under the plan, and (3) which the participant receives only by making an additional voluntary contribution to the plan that does not exceed the amount necessary to fund the service purchased.³³

Comment: The 2006 Pension Protection Act broadened the definition of permissive service credit to include service credit for “periods when there is no performance of service” (often referred to as “airtime”) and service credit to provide an “increased benefit for service which a participant is receiving under the plan.”³⁴ Consequently, the new law allows participants to purchase credit for an increased benefit in the plan, even if the increase applies to service already credited under the plan.

Nonqualified Service. Code § 415(n) also limits the amount of “nonqualified service” that can be included in permissive service credit. Nonqualified service is defined as service **other than** service as (i) a Federal, state, or local government employee, (ii) an employee of an educational institution providing elementary or secondary education (through grade 12), (iii) an employee of an association representing governmental employees, and (iv) military service.³⁵ Nonqualified service also includes service in (i), (ii), and (iii) that would cause a participant to receive a benefit for the same service under more than one plan. No more than 5 years of nonqualified

³² Code § 415(n)(2).

³³ Code § 415(n)(3)(A).

³⁴ Code § 415(n)(3)(A).

³⁵ Code § 415(n)(3)(C).

service may be included in permissive service credit and nonqualified service may only be included if the participant has at least 5 years of participation in the plan.³⁶

Comment: Military service does not become nonqualified if it causes a participant to receive a benefit for the same service under more than one plan. Consequently, more than 5 years of military service may be used to purchase service credit in a governmental plan, even if it is also used to provide a military pension.

Trustee-to-Trustee Transfers. Because “airtime” would fall under the definition of nonqualified service, such service would generally be limited to 5 years and includible only if the participant has at least 5 years of participation in the plan. However, the 2006 Pension Protection Act amended § 415(n) to make an exception for nonqualified service purchased with trustee-to-trustee transfers from § 403(b) accounts or governmental § 457(b) plans. Consequently, such trustee-to-trustee transfers may be used to purchase more than 5 years of service credit and may be used to purchase such service credit even if the participant has less than 5 years of participation in the plan.³⁷

MINIMUM DISTRIBUTION RULES

To maintain their qualified status, retirement plans, including governmental plans, are subject to the minimum distribution rules under Code § 401(a)(9). Generally, a governmental plan is deemed to comply with § 401(a)(9) if it complies with a “reasonable good faith interpretation” of its statutory requirements.³⁸

Comment: Prior to the 2006 Pension Protection Act, governmental plans were subject to federal regulations interpreting § 401(a)(9) in addition to the statutory requirements. However, governmental plans now have more flexibility in defining their compliance strategy, so long as it complies with the statutory provisions of § 401(a)(9).

In any compliance strategy, the plan provisions would need to reflect the following:

- Minimum distributions will begin by the employee’s “required beginning date,” defined as April 1 of the calendar year following the **later of** (1) the calendar year in which the employee attains age 70½ or (2) the calendar year in which the employee retires.³⁹
- The entire interest of an employee will be distributed, beginning no later than the required beginning date, over the life of the employee or over the lives of the employee and designated beneficiary (or over a period not extending beyond the life expectancy of the employee and designated beneficiary).⁴⁰
- Except in the case of a life annuity, the life expectancy used to determine the period over which payments are made may be redetermined, but not more frequently than annually.⁴¹

³⁶ Code § 415(n)(3)(B).

³⁷ Code § 415(n)(3)(D). Note that when amounts are transferred from a 403(b) account or 457(b) plan to a defined benefit plan, the transferred amounts become subject to the distribution rules that apply to the defined benefit plan. For example, while 457(b) plans are not subject to the in-service distribution rules, amounts transferred from a 457(b) plan to a governmental defined benefit plan would become subject to the in-service distributions rules that apply to defined benefit plans.

³⁸ Pension Protection Act of 2006, § 823.

³⁹ Code § 401(a)(9)(C). For 5-percent owners and IRA owners, the required beginning date is April 1 of the calendar year following the calendar year in which the employee attains age 70 ½, even if the employee has not retired.

⁴⁰ Code § 401(a)(9)(A)(ii).

⁴¹ Code § 401(a)(9)(D).

- If the employee dies **after** distributions have begun, the employee's interest will be distributed at least as rapidly as under the distribution method used for the employee.⁴²
- If the employee dies **before** required minimum distributions have begun, the employee's interest will be either:
 - distributed over the life or life expectancy of the designated beneficiary with the distributions beginning no later than one year after the employee's death, or
 - distributed within five years after the employee's death.⁴³ However, a surviving spouse may wait until the date the employee would have attained age 70½ to begin taking required minimum distributions, if the plan so provides.⁴⁴

The distribution is also subject to the "incidental death benefit" requirement of Code § 401(a).⁴⁵ The reference to incidental death benefit reflects the general principle that qualified plans are intended to provide retirement benefits to plan members and their beneficiaries. Other types of benefits, such as death benefits, are considered incidental to retirement benefits and, consequently, are limited in qualified plans. Questions remain about how this rule should be applied to governmental plans and assistance from qualified legal counsel would be useful in this regard.

IN-SERVICE DISTRIBUTIONS AND NORMAL RETIREMENT AGE

"In-service distributions" refer to retirement benefits that are paid to a member while the member is still employed by the employer sponsoring the retirement plan. Prior to the 2006 Pension Protection Act, a member could only receive an in-service distribution after reaching normal retirement age. However, the 2006 Pension Protection Act changed the rules to allow in-service distributions after the member reaches the earlier of (1) normal retirement age or (2) age 62.⁴⁶

To implement the new in-service distribution rules, the Treasury and IRS issued regulations defining normal retirement age. The regulations require a pension plan's normal retirement age be an "age that is not earlier than the earliest age that is reasonably representative of the typical retirement age" for the industry covering the workforce. The regulations establish age 62 as the "safe harbor" normal retirement age for all plans. The regulations also explain that the IRS will presume the following ages to be typical of earliest normal retirement ages, depending on the facts and circumstances: (1) age 55 for non-public safety employees, and (2) age 50 for public safety employees. Accordingly, the IRS would not presume ages earlier than 50 for public safety employees and 55 for non-public safety employees to be reasonably representative. However, the IRS Commissioner has the authority to determine lower ages to be reasonably representative, based on facts and circumstances.

It should be noted that the new regulations do not prevent a plan from providing unreduced benefits prior to normal retirement age or basing benefits on the completion of years of service. As stated in IRS Notice 2007-69, "an early retirement benefit, including an unreduced early retirement benefit, is permitted to be conditioned on completion of a stated number of years of service." However, the early retirement benefit may only begin to be paid after separation from service.

⁴² Code § 401(a)(9)(B)(i).

⁴³ Code § 401(a)(9)(B)(ii) and (iii).

⁴⁴ Code § 401(a)(9)(B)(iv).

⁴⁵ Code § 401(a)(9)(G).

⁴⁶ Code § 401(a)(36).

For governmental plans, the normal retirement age regulations were originally scheduled to become effective for plan years beginning on or after January 1, 2009; however, the IRS has recently extended this effective date to plan years beginning on or after January 1, 2011.⁴⁷

Comment: The implications of the new regulations for governmental plans are unclear and potentially problematic. Since they are located within the regulations related to Code § 401(a), the new regulations are applicable to governmental plans. However, the rules were added in the context of allowing pension plans to make in-service distributions. Consequently, while they clearly apply to in-service distributions, their application outside of that context is less clear. However, there is now additional time to resolve these issues.

RETIREE MEDICAL BENEFITS

Generally, a qualified pension plan may not pay sickness, accident, hospitalization, and medical expenses of retired employees, their spouses, and their dependents. However, such benefits may be paid if the plan applies the rules under Code § 401(h), including:

- A separate § 401(h) account is established and maintained within the pension trust to provide retiree medical benefits.
- The employer's contributions to the separate account are "reasonable and ascertainable." Employees are also allowed to contribute, but not on an elective basis.
- The plan document specifies the medical benefits that are available and includes provisions for determining the amount that will be paid.
- All contributions to the § 401(h) account are used to pay benefits provided under the retiree medical plan and are not diverted to purposes other than providing the medical benefits.

Subordination Limit. In addition, contributions to the plan for medical benefits are subject to a subordination limit. To be subordinate, the actual annual contributions for medical benefits (plus contributions for life insurance) cannot exceed 25% of the total actual contributions to the plan (excluding contributions to fund past service costs), aggregated from the date the § 401(h) account was established.⁴⁸

EMPLOYER PICK-UPS

As discussed above, a governmental employer that sponsors a defined benefit plan may "pick-up" employee contributions by deeming the employee contributions to have been made by the employer.⁴⁹ The effect of this employer "pick-up" is that employee contributions are excluded from the employees' taxable income in the year the contributions are made. Taxation occurs when the benefits are distributed to the members as income. For the pick-up to be qualified under the Code, specific conditions need to be met, including:

- The plan is qualified under Code § 401(a).
- The employer takes formal action to specify that the contributions, although designated as employee contributions, are being paid by the employer in lieu of employee contributions.⁵⁰

⁴⁷ IRS Notice 2008-98.

⁴⁸ Code § 401(h), final paragraph.

⁴⁹ Code § 414(h)(2).

⁵⁰ Rev. Rul. 2006-43.

- The employee is not given the option of choosing to receive the contributed amounts directly instead of having them paid by the employer to the pension plan. In other words, the pick-up may not be an optional decision for each employee.⁵¹

The last point is a source of concern for the IRS with respect to service purchases involving pick-ups. Earlier in this decade, the IRS issued several letter rulings to the effect that service credit purchases could be picked-up by the employer, provided the purchase was made through a one-time irrevocable election.⁵² However, in Revenue Ruling 2006-43, the IRS changed its position on these types of arrangements. While funds and employers with earlier private letter rulings on service purchase pick-ups may continue to rely on them, other funds and employers should carefully consider Revenue Ruling 2006-43.

ROLLOVERS

To be qualified, plans must allow participants to have their “eligible rollover distributions” directly rolled over to another eligible plan.⁵³ An eligible rollover distribution is essentially defined as any benefit distribution paid to an employee (or the employee’s surviving spouse”), except:

- A distribution made as one of a series of substantially equal payments (not less frequently than annually) over the life (or life expectancy) of the employee (or joint lives of the employee and designated beneficiary), or over 10 years or more;
- A required minimum distribution under § 401(a)(9);
- A hardship distribution; and
- Other distributions as determined by the IRS Commissioner.

Rollovers are permitted to be made from and to a broad range of eligible plans including: qualified defined benefit plans; qualified defined contribution plans; § 401(k) plans; § 403(b) plans; and governmental § 457(b) plans. While qualified plans are required to allow participants to directly rollover eligible distributions, they are not required to accept rollovers from other plans.

Comment: The 2006 Pension Protection Act (PPA) allows after-tax contributions to be included in direct rollovers from a qualified plan to another qualified plan or tax-sheltered annuity, for tax years beginning after 2006. However, the transfer must be made through a direct rollover and the receiving plan must be able to separately account for the after-tax contributions and related earnings.⁵⁴

Rollover Notice Requirements. In order to assist plan members understand the rollover rules and their potential tax consequences, plan administrators are required to provide members with a clear explanation of the rollover provisions.⁵⁵ To this end, the IRS publishes a “safe harbor” explanation of the rollover rules, which is deemed to satisfy the explanation requirements.

Comment: The most recent safe harbor explanation was published in 2002 and does not include recent changes to the rollover rules, including rules for Roth IRAs.⁵⁶ However, an updated explanation is a high priority for the IRS, and should be available shortly. In addition, the IRS has issued proposed regulations regarding these notices,

⁵¹ Rev. Rul. 2006-43. See also Rev. Rul. 81-35 and 81-36.

⁵² See Private Letter Ruling 200317034.

⁵³ Code § 401(a)(31).

⁵⁴ Code § 402(c)(2)(A), as amended.

⁵⁵ Code § 402(f).

⁵⁶ Notice 2002-3.

which implement a PPA change that extended the notice period from 90 days to 180 days prior to the annuity starting date.⁵⁷

Rollovers to Nonspouse Beneficiaries. After 2006, the PPA allows nonspouse beneficiaries to directly roll an eligible rollover distribution from a qualified retirement plan to an individual retirement account, specifically established to receive the distribution (i.e., an “inherited IRA”).⁵⁸ However, the PPA does not require qualified plans to offer direct rollovers to a nonspouse beneficiary; nor are the rollovers subject to the rollover notice requirements, or the mandatory 20% withholding requirements.⁵⁹

Comment: The 2008 Pension Protection Technical Corrections Acts, passed by the U.S. House and Senate, would require qualified plans to allow rollovers by nonspouse beneficiaries starting in 2009. However, the Acts have yet to be taken up by the Conference Committee and so may not be enacted this year.

Rollovers to Roth IRAs. As clarified in IRS Notice 2008-30, the PPA amended the rollover rules to require qualified plans to allow rollovers to Roth IRAs, effective in 2008. Notice 2008-30 also clarifies that an eligible rollover distribution paid directly to an eligible retirement plan (including a Roth IRA) is not subject to the mandatory 20% withholding requirement, even if the distribution is includable in gross income. However, the member may elect voluntary withholding if the plan permits.

PLAN AMENDMENTS

Prior to 2006, when Congress changed a qualification rule it also established a “remedial amendment period” during which a plan could be retroactively amended to reflect the change.⁶⁰ Generally, this period began on the change’s effective date and continued to the end of the designated remedial amendment period. Provided the plan was operated in accordance with the change as of the change’s effective date, plan amendments made by the end of the remedial amendment period would be treated as retroactively effective and deemed to satisfy the qualification requirements.

Beginning in 2006, the IRS established a new process, creating a series of standardized 5-year remedial amendment cycles, labeled A through E. This was done in connection with changes to the IRS’s determination letter process, through which the IRS reviews plans to determine whether they conform to the qualification rules. For private-sector plans, the cycle is based on the employer’s tax identification number. Originally, all governmental plans were placed in Cycle C, which began February 1, 2008, and ends January 31, 2009, repeating every 5 years thereafter.⁶¹ However, in November 2008, the IRS announced it will offer governmental plans a one-time option to file in Cycle E, which begins February 1, 2010, and ends January 31, 2011.⁶²

Comment: Plan sponsors may take advantage of this extension by simply filing under Cycle E. No advance notice is required by the IRS. Plan sponsors who have already

⁵⁷ 73 Federal Register 59575.

⁵⁸ Pension Protection Act § 829.

⁵⁹ IRS Notice 2007-7, Q&A-14 and 15.

⁶⁰ Code § 401(b).

⁶¹ To assist plans, the IRS issues an annual list of the applicable statutory and regulatory changes, referred to as the Cumulative List of Changes in Plan Qualification Requirements. For Cycle C, IRS Notice 2007-94 specifies the applicable changes.

⁶² This announcement was made in the November 2008 issue of *Employee Plans News*, published by the IRS. It is available on the web at: <http://www.irs.gov/pub/irs-tege/se1108.pdf>.

filed under Cycle C may withdraw their application and receive a refund of the user fee, so long as the request for determination letter was filed before November 7, 2008. For plan sponsors filing in Cycle E, plan documents will need to be amended to include all relevant changes to the qualification rules and regulations applicable for Cycle E. After 2011, all governmental plan sponsors will again be subject to Cycle C, with the next Cycle C ending January 31, 2014.

Generally, interim plan amendments are also required during the remedial amendment period to implement a good faith interpretation of the change in the qualification rule. For an interim amendment to be considered timely, it would need to be made by the later of:

- The last day of the plan year in which the remedial amendment period begins, or
- The last day of the applicable governing body's next regular legislative session beginning after the amendment's effective date.⁶³

However, due to the complexity of the remedial amendment rules, it would be useful to discuss the details with legal counsel.

CONCLUSION

This research memorandum is intended to offer a concise overview of the key qualification rules that apply to state and local government retirement plans. However, it is not intended as a comprehensive examination of the rules, or as legal advice or opinion. Retirement plan officials should consult with legal counsel to determine whether their plan provisions comply with the qualification requirements.

Circular 230 Notice

Pursuant to IRS Circular 230, to the extent this communication concerns tax matters, it is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax-related penalties under the Internal Revenue Code or (ii) marketing or recommending to another party any tax-related matter addressed within. Each taxpayer should seek advice based on the individual's circumstances from an independent tax advisor.

⁶³ Rev. Proc. 2007-44, § 5.06.

Appendix A
Annual Limits on Compensation, Benefits, and Contributions

Year	401(a)(17) Compensation Limit	401(a)(17) Compensation Limit in Lieu of OBRA '93	415(b)(1) Defined Benefit Limit*	415(c)(1) Defined Contribution Limit
1975			\$75,000	\$25,000
1976			\$80,475	\$26,825
1977			\$84,525	\$28,175
1978			\$90,150	\$30,050
1979			\$98,100	\$32,700
1980			\$110,625	\$36,875
1981			\$124,500	\$41,500
1982			\$136,425	\$45,575
1983			\$90,000	\$30,000
1984			\$90,000	\$30,000
1985			\$90,000	\$30,000
1986			\$90,000	\$30,000
1987			\$90,000	\$30,000
1988			\$94,023	\$30,000
1989	\$200,000	\$200,000	\$98,064	\$30,000
1990	\$209,200	\$209,200	\$102,582	\$30,000
1991	\$222,220	\$222,220	\$108,963	\$30,000
1992	\$228,860	\$228,860	\$112,221	\$30,000
1993	\$235,840	\$235,840	\$115,641	\$30,000
1994	\$150,000	\$242,280	\$118,800	\$30,000
1995	\$150,000	\$245,000	\$120,000	\$30,000
1996	\$150,000	\$250,000	\$120,000	\$30,000
1997	\$160,000	\$260,000	\$125,000	\$30,000
1998	\$160,000	\$265,000	\$130,000	\$30,000
1999	\$160,000	\$270,000	\$130,000	\$30,000
2000	\$170,000	\$275,000	\$135,000	\$30,000
2001	\$170,000	\$285,000	\$140,000	\$35,000
2002	\$200,000	\$295,000	\$160,000	\$40,000
2003	\$200,000	\$300,000	\$160,000	\$40,000
2004	\$205,000	\$305,000	\$165,000	\$41,000
2005	\$210,000	\$315,000	\$170,000	\$42,000
2006	\$220,000	\$325,000	\$175,000	\$44,000
2007	\$225,000	\$335,000	\$180,000	\$45,000
2008	\$230,000	\$345,000	\$185,000	\$46,000
2009	\$245,000	\$360,000	\$195,000	\$49,000

* Dollar limit before reduction for retirement benefits beginning before age 62.