TAX QUALIFICATION AND PPA ISSUES GUIDEBOOK

AN OVERVIEW OF WHAT NCPERS MEMBERS NEED TO KNOW TO MAINTAIN THE QUALIFIED STATUS OF A PLAN

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INTRODUCTION

The purpose of this guidebook is to give an overview of the basic qualification requirements of the Internal Revenue Code as applicable to governmental plans. This guidebook is not an exhaustive study of each requirement but instead provides a brief summary.

Why is qualification under Code Section 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;
- 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 would generally not apply to a non-qualified plan.

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. Additionally, governmental plans are exempt from many Code requirements that were made applicable by ERISA to retirement plans. 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 their 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 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 that are more favorable than private sector plans; and
- certain service purchase opportunities apply only to governmental plans.

Attached as Attachment A is a list of Code provisions that are and are not currently applicable to governmental plans. This Guidebook 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 initial portion of the Guidebook is organized in Code-cite order.

This Guidebook also provides information regarding the staggered cycle for determination letter filings established by the IRS in 2005 as it applies to governmental plans. Finally, the Guidebook provides a brief overview of those provisions of the PPA which are of most interest to governmental plans.

Please note that this Guidebook does not address plans intended to be covered under Code Section 403(b) or 457.

DEFINITIONS

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

ADEA	Age Discrimination in Employment Act
CODA	Cash Or Deferred Arrangement
Code or IRC	Internal Revenue Code of 1986, as amended
DOL	Department of Labor
EGTRRA	Economic Growth and Tax Relief Reconciliation Act of 2001
ERISA	Employee Retirement Income Security Act of 1974
IRA	Individual Retirement Account
IRS	Internal Revenue Service
JCT Explanation	Joint Committee on Taxation Technical Explanation of the PPA
PBGC	Pension Benefit Guaranty Corporation
PPA	Pension Protection Act of 2006
QDRO	Qualified Domestic Relations Order
USERRA	Uniformed Services Employment and Reemployment Rights Act of 1994, as amended

OVERVIEW OF QUALIFICATION REQUIREMENTS

I. CODE SECTION 401(a): INTRODUCTION TO PLAN QUALIFICATION REQUIREMENTS

In order to constitute a qualified plan under Code Section 401(a), there are certain requirements that must be met under the introductory language to Code Section 401(a). Currently Section 401(a) has 36 separate paragraphs, each setting forth a qualification requirement. However, governmental plans are not required to satisfy all requirements. (See Attachment A.)

A. The Plan Must Constitute a "Pension Plan"

In order for a plan to be qualified, it must constitute a stock bonus, pension, or profit sharing plan. Code Section 401(a). Because stock bonus plans are not applicable to governmental employers, and profit sharing plans generally are not applicable to governmental employers, most governmental plans must meet the definition of a pension plan as set forth in Treasury Regulation § 1.401-1(b)(1)(i). 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 § l.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 Section 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. A member may also generally 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 Section 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.

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 Treasury Regulation § 1.401-1(b)(1)(i), and will also fail to meet the minimum participation and vesting standards of Code Sections 410 and 411. Note, however, that governmental plans are subject to special rules with regard to both vesting and minimum participation requirements.

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 Section 401(a). The IRS takes the position that the trust must be in writing, which contains 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 Section 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 Section 401(a).

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

1. General Rule

Code Section 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 others 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 Section 503. This situation may arise in the context of government plans where the employer borrows plan assets or invests plan assets in government bonds.

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

A. General Rule

In order to be a qualified plan, contributions may only be made by the employer and/or the members. Code Section 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."

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 Section 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 Section 401(a) et seq. See the section below on Code Section 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 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.

III. CODE SECTION 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 Section 401(a)(2). Thus, no funds may revert back to the employer until the trust is terminated and all liabilities are paid.

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

IV. PRE-ERISA CODE SECTION 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 Section 411. Code Section 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 Section 411(e). That is, the plan must provide 100% vesting 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.

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. Upon satisfaction of those criteria, distribution of the employee's interest must begin, unless the employee continues in employment beyond normal retirement age.

V. CODE SECTION 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 Section 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. Rev. Rul. 84-156, 1984-2 C.B. 97.

VI. CODE SECTION 401(a)(9): DISTRIBUTIONS MUST MEET FORM AND TIMING REQUIREMENTS

All qualified retirement plans, including governmental plans, must comply with Code Section 401(a)(9) in order to maintain qualified status. Code Section 401(a)(9) and the applicable regulations contain complex rules regarding the timing of distributions from qualified plans. These provisions address when distributions must begin, in what form distributions may be made, when the chosen form of distributions may be modified, how distributions must be made in the event of the participant's death, etc. There have been a series of complex regulations interpreting Code Section 401(a)(9), culminating in the final regulations issued in 2004. However, pursuant to the PPA, governmental plans will be deemed to be in compliance with Code Section 401(a)(9) if they follow a reasonable and good faith interpretation of the statutory language. This provides governmental plans with a great deal more flexibility in complying with the minimum distribution requirements.

VII. CODE SECTION 401(a)(16): CONTRIBUTIONS AND BENEFITS MUST BE LIMITED

Code Section 401(a)(16) requires a qualified plan to abide by Code Section 415, which imposes annual limits on the amount of contributions and benefits. The provisions of Code Section 415 are discussed below.

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

Code Section 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 2008, the limit is $230,000. The limit increases in $5,000 increments. The prohibition on taking more than the 401(a)(17) amount into account means:

- Compensation in excess of the 401(a)(17) limits may not be used when computing the pension benefit.

- Any employee contributions may not be computed on more than the 401(a)(17) limit.

- Compensation in excess of the 401(a)(17) limit may not be used in applying certain specified nondiscrimination rules.

However, employer contributions to a defined benefit plan are not limited by the 401(a)(17) limit.

In the case of an "eligible participant" in a governmental plan (within the meaning of Code Section 414(d)), the annual compensation limit under Code Section 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. 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)(C).

IX. CODE SECTION 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 Section 401(a)(24). A group trust will itself be an exempt entity under Code Sections 401(a) and 501(a) if it meets the requirements set forth in Revenue Ruling 81-100 (1981-1 C.B. 352), as clarified and modified by Revenue Ruling 2004-67, 2004-28 I.R.B. 28.

X. CODE SECTION 401(a)(25): ACTUARIAL ASSUMPTIONS MUST BE SPECIFIED

Code Section 401(a)(25) 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 could presumably 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 Section 401(a)(25).

XI. CODE SECTION 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. 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 Section 401(a)(30).

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

A. General Rule

Code Section 401(a)(31) requires a plan to permit certain individuals receiving distributions to elect to have an eligible rollover distribution paid directly to an eligible retirement plan, specified by the individual, in the form of a direct rollover. The plan accepting the rollover does not need to require an IRS determination letter from the first plan. In general, rollovers by participants and their spouses are permitted out of and into qualified plans, 403(b) plans, governmental 457(b) plans, and IRAs. However, retirement plans will not be required to accept all types of rollovers; these are permissive.

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

B. Recent Developments

The PPA expanded rollover opportunities in three ways: (1) rollovers of after-tax amounts can be directly made to qualified defined benefit plans and 403(b) plans; (2) direct rollovers may also be made by non-spouse beneficiaries to an inherited IRA; and (3) direct rollovers may be made to a Roth IRA.

C. Rollover Notice Requirements

Plan administrators are required to furnish distributees a written explanation of rollover rules. Code Section 402(f) outlines the contents of the written explanation that must be provided to recipients of distributions eligible for rollover treatment. See also Treas. Reg. § 1.402(f)-1 Q&A-1.

D. Automatic Rollovers

On December 29, 2004, the IRS released Notice 2005-5, which provides guidance relating to the automatic rollover provisions of Code Section 401(a)(31)(B). The automatic rollover provisions apply to mandatory distributions from 401(a) plans, 457(b) governmental plans, and 403(b) plans, if the mandatory distributions are also eligible rollover distributions. The new guidance requires a plan to rollover these mandatory distributions into an IRA on behalf of a participant who may be missing or otherwise does not consent to the distribution. A mandatory distribution is a distribution that is made without the participant's consent before the participant attains the later of age 62 or 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.

XIII. CODE SECTION 401(b): RETROACTIVE REMEDIAL AMENDMENTS MAY BE PERMITTED

Code Section 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 Section 401(a) during that time. Governmental employers need to consult state law authorities to determine their ability to make retroactive amendments. See "Staggered Cycle for Determination Letter Submissions" below for a discussion of the cyclical procedure for remedial plan amendments.

XIV. CODE SECTION 401(h): RETIREE MEDICAL BENEFITS MUST BE STRICTLY LIMITED

Code Section 401(a) and Treasury Regulation § l.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 Section 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. Code Section 401(h) establishes several specific requirements regarding the structure and funding of 401(h) medical benefits.

XV. CODE SECTION 401(k): CASH OR DEFERRED ARRANGEMENTS ARE GENERALLY NOT PERMITTED

The general rule is that a 401(a) plan may not include a CODA unless the plan meets the requirements of Code Section 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.

XVI. CODE SECTION 402: DISTRIBUTIONS ARE SUBJECT TO SPECIAL TAX TREATMENT

Distributions from plans qualified under Code Section 401(a) are subject to special tax treatment under Code Section 402(a). Under Code Section 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 Section 72.

XVII. CODE SECTION 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.

XVIII. CODE SECTION 414(d): DEFINITION OF A GOVERNMENTAL PLAN

Code Section 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. 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. 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.

XIX. CODE SECTION 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 Section 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.

XX. CODE SECTION 414(p): QUALIFIED DOMESTIC RELATIONS ORDERS MAY BE ACCEPTED

While most plans qualified under Code Section 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 generally wish to have federal QDRO treatment for those orders.

If the alternate payee under a QDRO is a former spouse, Code Section 402(e)(1)(A) applies, such that the alternate payee is treated as the "distributee" and the amount paid under the DRO is includible in the former spouse's gross income for purposes of Code Sections 72 and 402(a). The spousal alternate payee is also 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 <u>non-spousal</u> 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.

XXI. CODE SECTION 414(u): USERRA GOVERNS MEMBERS WHO ENGAGE IN 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.

XXII. CODE SECTION 415: BENEFITS AND CONTRIBUTIONS MUST BE LIMITED

The IRS issued final regulations under Code Section 415 in April 2007. The final regulations are applicable to generally 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 Section 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 Section 415(b). If even <u>one</u> member accrues an annual benefit greater than Code Section 415 allows, or contributes more than Code Section 415 allows, <u>the penalty provided is that the entire plan will be disqualified</u>. For a governmental plan, the basic requirement of Code Section 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 ($185,000 in 2008). 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, and also when the participant has less than 10 years of service.

B. <u>Code Section 415(c): Defined Contribution Limits</u>

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 ($46,000 in 2008). 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 Section 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. <u>Code Section 415(m): Qualified Governmental Excess Benefit Arrangements</u>

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

D. <u>Code Section 415(n): Treatment of Service Purchase Provisions</u>

Purchases of "permissive service credit" may be tested against either the 415(b) limit or the 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.

XXIII. <u>CODE SECTION 503(b): PLANS MUST AVOID PROHIBITED TRANSACTIONS</u>

Code Section 503(b) describes certain transactions that are prohibited under the Code. Although a governmental plan is not subject to the excise tax in Code Section 4975, engaging in a prohibited transaction could result in a loss of the plan's qualified status. Code Section 4975(g)(2); Code Section 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.

STAGGERED CYCLE FOR DETERMINATION LETTER SUBMISSIONS

I. GENERAL PROCEDURE FOR DETERMINATION LETTER SUBMISSIONS

The IRS has established a cyclical procedure under Code Section 401(b) for qualified plans to make remedial plan amendments. Under this system, every individually designed plan qualified under Code Section 401(a) has a regular, five-year remedial amendment cycle. The cycles are staggered and spread over five-year periods. As a result, plan sponsors need to apply for new determination letters generally only once every five years. In addition, every master and prototype and volume submitter plan (a pre-approved plan), generally has a regular, six-year remedial amendment cycle. As a result, sponsors, practitioners, and adopters of pre-approved plans generally will need to apply for new opinion, advisory, or determination letters only once every six years. Sponsors, practitioners, and plan sponsors will need to submit their plan only once for an opinion, advisory, or determination letter that rules on all amendments adopted and made effective within the applicable remedial amendment cycle.

Revenue Procedure 2007-44 provides guidance related to the new staggered remedial cycles. This revenue procedure was the culmination of several years of work by the IRS and the private sector in developing a new program which creates processing and resource efficiencies for both the private sector and the IRS. It should allow plan sponsors, participants, and employers to place more reliance on opinion, advisory, and determination letters.

II. SPECIFIC PROVISIONS FOR GOVERNMENTAL PLANS

Currently, all governmental plans are in Cycle C, meaning that all governmental plans seeking an updated determination letter must file during the period beginning on February 1, 2008, and ending on January 31, 2009.

III. OFF-CYCLE FILINGS ARE DISCOURAGED

Any determination letter filings received at a time other than within the period specified for that plan will receive lowest priority. That is, such off-cycle filings will be addressed only after all on-cycle filings are resolved. This may result in significant delays both for new plans filing for an initial determination letter and for existing governmental plans wishing to obtain an updated determination letter, as is frequently the case when significant state or local legislation is adopted amending the plan.

PENSION PROTECTION ACT OF 2006

I. INTRODUCTION TO THE PPA

On July 28, 2006, the House of Representatives passed the massive PPA, and on August 3, 2006, the Senate adopted the PPA in the same form. The Act was signed by President Bush on August 17, 2006. The 907 page PPA makes significant changes to the federal law affecting defined benefit plans, "hybrid" plans (such as cash balance plans), and defined contribution plans, as well as a variety of other plans, resulting in extensive and far-reaching effects on a broad spectrum of employee benefit plans.

The following provides a summary overview of those PPA provisions of most interest to qualified governmental pension plans. We have generally arranged our discussion in Internal Revenue Code section order, followed by ERISA and ADEA provisions of interest and then followed by non-code amendments. We have also included a discussion of applicable IRS guidance issued since the passage of the PPA.

RELEVANT PPA PROVISIONS AFFECTING THE INTERNAL REVENUE CODE

I. CODE SECTION 72(t)—WAIVER OF 10 PERCENT EARLY WITHDRAWAL PENALTY BY CERTAIN DISTRIBUTIONS OF PENSION PLANS FOR PUBLIC SAFETY EMPLOYEES (PPA § 828)

Section 828 of the PPA amends Code Section 72(t) to provide important relief for public safety employees in governmental defined benefit plans with some type of a partial lump sum option, a deferred retirement option feature, a lump sum refund, or other non-substantially equal periodic payments. It creates an exception to the 10% premature distribution penalty for payments made to a qualified member who separates from service (e.g., retires) after age 50 (rather than age 55). Notice 2007-7 clarifies that a qualified public safety employee is an employee of a state or political subdivision whose principal duties include services for an area within the jurisdiction of the employer, provided the services require specialized training in the area of police protection, firefighting services, or emergency medical services.

Effective for distributions after August 17, 2006.

II. CODE SECTION 401(a)(9)—CLARIFICATION OF MINIMUM DISTRIBUTION RULES FOR GOVERNMENTAL PLANS (PPA § 823)

Section 823 of the PPA requires the Secretary of the Treasury to issue regulations to provide relief for governmental plans with respect to the minimum distribution rules of Code Section 401(a)(9). The regulations must allow governmental plans to comply with "a reasonable good faith interpretation of the statutory requirements."

The provision is effective August 17, 2006. However, the JCT Explanation states the Congressional intent that the regulations apply for periods before August 17, 2006.

III. CODE SECTION 401(a)(36)—DISTRIBUTIONS DURING WORKING RETIREMENT (PPA § 905)

Section 905 of the PPA amends Code Section 401(a) and ERISA § 3(2)(A) to permit distributions from qualified pension plans to individuals who have not separated from employment. This Section allows (but does not mandate) a qualified pension plan 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 has indicated that the prohibition on in-service distributions did not prevent benefit commencement to an employee who had reached normal retirement age (or eligibility for an unreduced benefit under the terms of the plan).

Effective for distributions made in plan years beginning after December 31, 2006.

IV. CODE SECTION 402—ROLLOVERS OF AFTER-TAX AMOUNTS (PPA § 822)

Section 822 of the PPA amends Code Section 402(c)(2)(A) to permit qualified plans (whether defined benefit or defined contribution) and section 403(b) plans to accept after-tax direct rollover amounts from a qualified retirement plan, so long as the plan separately accounts for such after-tax amounts. (Previously only qualified defined contribution plans and IRAs could accept such after-tax rollover amounts.)

Effective for taxable years beginning after December 31, 2006.

V. CODE SECTION 402(c)—ROLLOVERS BY NONSPOUSE BENEFICIARIES OF CERTAIN RETIREMENT PLAN DISTRIBUTIONS (PPA § 829)

Section 829 of the PPA amends Code Sections 402(c), 403(b), and 457(b) to allow plans to provide an additional option for nonspouse beneficiaries who are eligible to receive distributions from qualified retirement plans, section 403(b) plans and section 457(b) governmental plans. If the distribution would otherwise be an eligible rollover distribution, a nonspouse beneficiary, who is a designated beneficiary as defined by Code Section 401(a)(9)(E), may rollover the distribution to an individual retirement account or individual retirement annuity established for the purpose of receiving the distribution and the account or annuity will be treated as an "inherited" individual retirement account or annuity. This means, for example, that distributions from the inherited IRA would be subject to the minimum distribution rules applicable to IRA beneficiaries, rather than the five-year rule for distributions from a qualified plan.

Notice 2007-7 states that the individual retirement account or annuity must be clearly identified as being established with respect to a deceased individual and should identify both the deceased individual and the beneficiary – i.e., "Tom Smith as beneficiary of John Smith." The beneficiary may be a trust, provided the beneficiaries of that trust are designated beneficiaries as required by Code Section 401(a)(9)(E). The Notice also makes it very clear that a nonspouse beneficiary rollover is treated as an eligible rollover distribution only for purposes of Code Section 402(c) and is not subject to the direct rollover requirements of Code Section 401(a)(31), the notice requirements of Code Section 402(f) or the mandatory withholding requirements of Code Section 3405(c).

Effective for distributions after December 31, 2006.

VI. CODE SECTION 402—DISTRIBUTIONS FROM GOVERNMENTAL RETIREMENT PLANS FOR HEALTH AND LONG-TERM CARE INSURANCE FOR PUBLIC SAFETY OFFICERS (PPA § 845)

Section 845 of the PPA amends Code Section 402 and makes one of the most dramatic changes in the Act. This section allows "eligible retired public safety officers" to make an election to exclude from federal gross income up to $3,000 of their retirement plan benefits used for health insurance or long term care insurance premiums. (This election is made on the individual's Form 1040.) This exclusion pertains to distributions from governmental defined benefit plans, governmental defined contribution plans, section 403(b) plans, and section 457(b) plans. All eligible retirement plans must be treated as a single plan, i.e., a retiree gets only one $3,000 exclusion per year.

An eligible public safety officer must be separated from service as a public safety officer by reason of disability or attainment of normal retirement age with an employer maintaining or participating in the retirement plan from which the distributions are made. Unlike other tax laws that use different definitions of public safety officers, this Section uses the definition in Section 1204(8)(A) of the Omnibus Crime Control and Safe Streets Act of 1986 (42 U.S.C. 3796b(9)(A)).

Initially, the IRS has interpreted the phrase "accident or health insurance plan" to mean that the payments must be made to a plan providing insurance issued by an insurance company regulated by a state. See Notice 2007-7. However, in Notice 2007-99, the IRS expanded that interpretation so that payments to a self-insured plan will qualify for the exclusion.

Effective for distributions in taxable years beginning after December 31, 2006.

VII. CODE SECTION 408A—DIRECT ROLLOVERS FROM RETIREMENT PLANS TO ROTH IRAS (PPA § 824)

Section 824 of the PPA amends Code Section 408A(d) and adds Code Section 408A(e) to allow members in eligible retirement plans (including qualified defined benefit and defined contribution plans, section 403(b) plans, and section 457(b) governmental plans) to make direct rollovers of eligible rollover distributions from such plans to Roth IRAs, subject to the rules that apply to rollovers from a traditional IRA to a Roth IRA. These rules provide that a rollover from a qualified retirement plan into a Roth IRA is includible in gross income (except to the extent it represents a return of after-tax contributions). Additionally, the 10% premature distribution tax does not apply. Such rollovers are subject to the limitations on rollovers to Roth IRAs based on modified adjusted gross income under Code Section 408A(c)(3)(B). This means that an individual with adjusted gross income of $100,000 or more could not elect this direct rollover option. See Notice 2008-30.

Effective for distributions made after December 31, 2007.

VIII. CODE SECTION 415(n)—CLARIFICATIONS REGARDING PURCHASE OF PERMISSIVE SERVICE CREDIT (PPA § 821)

Section 821 of the PPA amends Code Section 415(n) (containing more favorable limits for permissible service credit purchases). First, it clarifies 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 <u>not</u> apply to trustee-to-trustee transfers from a section 457(b) plan or a section 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.

The provision is generally effective as if included in the amendments made by Section 1526 of the Taxpayer Relief Act of 1997 (contributions after December 31, 1997), except that the provision regarding trustee-to-trustee transfers is effective as if included in the amendments made by Section 647 of EGTRRA (transfers after December 31, 2001).

RELEVANT PPA PROVISIONS AFFECTING ERISA AND ADEA

I. <u>ERISA § 204(b), CODE SECTION 411, & ADEA § 4(I)—BENEFIT ACCRUAL STANDARDS (PPA § 701)</u>

Section 701 of the PPA amends ADEA § 4(i), ERISA § 204(b) and Code Section 411(b) concerning benefit accrual standards and the treatment of participants based on age. The PPA ends the legal uncertainty surrounding hybrid plans such as cash balance pension plans, but only for periods on or after June 29, 2005. In particular, Section 701 of the PPA provides guidance as to when a plan will violate the age discrimination rules, how the accrued benefit may be expressed, how a plan may credit interest, and vesting requirements.

These PPA provisions on hybrid plans are broadly applied. That is, an "applicable defined benefit plan" means "<u>a defined benefit plan under which the accrued benefit (or any portion thereof) is calculated as the balance of a hypothetical account maintained for the participant or as an accumulated percentage of the participant's final average compensation</u>." The Secretary of the Treasury is directed to issue regulations on how defined benefit plans, or a portion thereof, may fall within this definition.

On December 21, 2006, the IRS released Notice 2007-6, 2007-3 IRB 272, which is the first interpretation of the new PPA provisions that apply to hybrid plans for purposes of Code Section 411. The Notice also clarifies several PPA terms and introduces a few new ones. For example, the Notice refers to "statutory hybrid plans" (the PPA called them "applicable defined benefit plans"), and refers to "accumulated benefits," which is the benefit tested for age discrimination (the PPA called this the "accrued benefit"). Two key points of the Notice include:

- *Definition of Statutory Hybrid Plan* – The Notice defines a statutory hybrid plan as a defined benefit plan consisting entirely or partially of either a "lump sum based plan" or a plan that has a similar effect.

- *Market Rate of Return* – Starting in 2008, statutory hybrid plans cannot credit interest at greater than a market rate of return. The Notice indicates the IRS expects to issue further guidance during 2007 addressing the market rate standard and clarifying the application of the PPA's anti-cutback relief to amendments that change a plan's interest-crediting rate. Until then, the Notice provides a safe harbor for determining the market rate.

The changes apply to periods beginning on or after June 29, 2005, to distributions after August 17, 2006, and to plan years beginning after December 31, 2007, unless the plan sponsor elects the application of such requirements for any period after June 29, 2005, and before the first year beginning after December 31, 2007. A delayed effective date applies to collectively bargained plans. Although the amendments to the ADEA are applicable to a governmental plan and governmental employer, it is not clear how the IRS guidance will apply because the amendments to Code Section 411 would not be applicable.

On December 27, 2007, the IRS issued proposed rules on several of the PPA issues but reserved the "market rate of interest" provisions for further action. Language providing an exemption for governmental plans has been proposed.

RELEVANT NON-CODE PPA PROVISIONS

I. SECTION 811 OF THE PPA—PENSIONS AND INDIVIDUAL RETIREMENT ARRANGEMENT PROVISIONS OF ECONOMIC GROWTH AND TAX RELIEF RECONCILIATION ACT OF 2001 MADE PERMANENT

Section 811 of the PPA makes the expiration of EGTRRA inapplicable to the changes made to pension and individual retirement arrangements by EGTRRA. Under EGTRRA, the provisions relating to pensions and IRAs did not apply for taxable, plan or limitation years beginning after December 31, 2010.

Effective August 17, 2006.

II. SECTION 1101 OF THE PPA—EMPLOYEE PLANS COMPLIANCE RESOLUTION SYSTEM

Section 1101 of the PPA encourages the IRS to expand and extend the Employee Plans Compliance Resolution System and in particular the use of the Self-Correction Program.

Effective August 17, 2006.

III. SECTION 1107 OF THE PPA—PROVISIONS RELATING TO PLAN AMENDMENTS

Section 1107 of the PPA provides that plan amendments with respect to the PPA must be made by the last day of the first plan year beginning on or after January 1, 2009 (2011 for government plans).

ATTACHMENT A

BASIC PLAN QUALIFICATION REQUIREMENTS FOR A GOVERNMENTAL DEFINED BENEFIT 401(a) PLAN

LIST OF CODE SECTIONS APPLICABLE TO GOVERNMENTAL PLANS

Code Requirement

DEFINITION OF INTERNAL REVENUE CODE

The Internal Revenue Code should be defined in the Plan in accordance with state drafting rules.

CODE SECTION 401(a)(1)

Formal Plan Required. A qualified plan that allows contributions to a trust for the sole purpose of distributing benefits to employees and beneficiaries with favorable tax treatment must be written. Contributions may be made only by (i) the employer, (ii) the employees, or (iii) both the employer and the employees. Plan must be administered in accordance with its terms.

"Pension Plan": a pension plan is a plan established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to employees over a period of years, usually for life, after retirement. Treas. Reg. § 1.401-1(b)(1)(i).

Definitely Determinable Benefit: for a defined benefit plan, requirement is satisfied where the benefit (including disability, death and early retirement) for each participant can be computed in accordance with an express formula contained in the plan. Rev. Rul. 74-385; Treas. Reg. § 1.401-1(b)(1)(i). See also Code § 401(a)(25) (if benefit is determined on the basis of actuarial assumptions, such assumptions must be specified in plan so as to preclude employer discretion).

Mortality Tables. For a defined benefit plan, the IRS requires specific provisions setting forth the actuarial assumptions to be used in determining actuarial equivalence.

Incidental Benefit rules (non-retirement benefits, e.g., disability and death benefits). Treas. Reg. § 1.401-1(b)(1).

CODE SECTION 401(a)(2)

Exclusive Benefit to Employees. All qualified plan assets must be used exclusively for the benefit of employees or their beneficiaries. This rule involves a review of both form and operation.

In order to comply with this "exclusive benefit" rule, it must also be shown that not only are payments made solely to members and their beneficiaries, but also that payments made to beneficiaries are incidental to those payments made to the member.

Nondiversion of Trust Funds: Plan must make it impossible prior to satisfaction of all liabilities for funds to be diverted for purposes other than exclusive benefit of employees or beneficiaries. Treas. Reg. § 1.401-2(a)(2).

No In-Service Distributions: Generally, a member may not receive distributions from a qualified plan prior to death, disability, separation from service, termination of plan, or attainment of normal retirement age.

Note: Code Section 401(a)(36) and IRS Final Regulations on Normal Retirement Age.

CODE SECTION 401(a)(7)

Vesting Requirements. Pre-ERISA minimum vesting standards, requiring 100% vesting upon retirement and upon plan termination or discontinuance of employer contributions, must be met.

- Rev. Rul. 66-11: Requires full vesting at normal retirement age and completion of required years of service.

CODE SECTION 401(a)(8)

Forfeitures. Forfeitures may not be used to increase plan benefits in a defined benefit plan.

CODE SECTION 401(a)(9)

Required Distributions. Governmental plans must make distributions to an employee no later than April 1 of the calendar year in which he or she attains age 70½ or in which he or she retires, if later. The basic rule is that such distributions must be over the life of the employee or over the lives of the employee and a designated beneficiary or over a period not extending beyond the life expectancy of such employee or the life expectancy of such employee and a designated beneficiary. If an employee dies before his/her entire interest is distributed, the remaining portion must be distributed at least as rapidly as under the method of distribution being used at the date of death. If an employee dies before distribution of his/her interest has begun, the entire interest must be distributed over the beneficiaries lifetime or within 5 years after the employee's death. There are limited exceptions to the 5-year rule, and special rules if the surviving spouse is the designated beneficiary.

- PPA: Good faith compliance standard

- GUST: Provide for required beginning date and required actuarial adjustment for all benefits. Deadline for adoption was latest of (1) 02/28/2002, (2) the last day of the 2001 plan year, or (3) the last day of the first plan year beginning on or after the "2000 legislative date".

- TRA'86: Minimum required distributions at age 70½. Deadline for adoption for government plans extended to end of GUST RAP.

IRC § 4974 provides a penalty for failure to make minimum distribution.

Note: Final Regulations provide for transitional period and grandfathering of certain benefits.

CODE SECTION 401(a)(16)

Benefits or contributions may not exceed 415 limits. See 415 discussion below.

CODE SECTION 401(a)(17)

Maximum Compensation. For years beginning after December 31, 2001, the compensation limit will be increased to $200,000 and indexed thereafter in $5,000 increments. Certain governmental employees who qualify as eligible participants are grandfathered to limit in effect under plan on 7/1/93.

- EGTRRA: Increased limit to $200,000. Deadline good-faith amendment under Notice 2001-42 later of (1) end of plan year in which EGTRRA change is required or optionally put into effect, or (2) end of plan's GUST RAP.

- GUST: Repealed family aggregation rules. Deadline for adoption was latest of (1) 02/28/2002, (2) the last day of the 2001 plan year, or (3) the last day of the first plan year beginning on or after the "2000 legislative date".

- OBRA '93: Decreased limit to $150,000. Grandfathering for eligible participants in governmental plans that timely adopted. Effective for governmental plans on or after 01/01/1996. Deadline for adoption was latest of (1) 02/28/2002, (2) the last day of the 2001 plan year, or (3) the last day of the first plan year beginning on or after the "2000 legislative date".

- TRA '86: Limited compensation to $200,000. Deadline for adoption for government plans extended to end of GUST RAP.

CODE SECTION 401(a)(24)

Participation in Group Trusts. A group trust can remain tax-exempt while accepting funds from a governmental plan or government maintained 457(b) plan or accepting funds intended to satisfy governmental obligations with respect to such plans.

CODE SECTION 401(a)(25)

Stated Actuarial Assumptions. Whenever the amount of any benefit is determined on the basis of actuarial assumptions, a defined benefit plan must specify actuarial assumptions in a manner that precludes employer discretion in order to provide definitely determinable benefits.

CODE SECTION 401(a)(31)

Eligible Rollover Distribution. This section requires a plan to permit distributees to elect to have an eligible rollover distribution paid directly to an eligible retirement plan specified by the distributee in a direct rollover. For distributions made after December 31, 2001, plans may permit participants to rollover account balances among 401(a) plans, 403(b) tax-sheltered annuities, and 457 governmental deferred compensation plans. In addition, rollovers may be allowed from IRAs to these employer retirement plans. After-tax contributions in qualified plans may be rolled over to defined contribution and defined benefit plans and 403(b) plans that will account for them separately or to IRAs. Surviving spouses may be permitted to rollover distributions to a qualified plan, 403(b) plan, or 457 plan. Starting in 2007, non-spouse rollovers are permissible to inherited IRAs. Starting in 2008, rollover to Roth IRA must be offered by qualified plan. Also, the law provides a hardship exception to the requirement that rollovers be made within 60 days of distribution, permitting the IRS to waive the 60 day requirement if the failure to do so would be against equity or good conscience.

- PPA: Expanded rollovers.

- EGTRRA: Expanded rollovers. Deadline good-faith amendment under Notice 2001-42 later of (1) end of plan year in which EGTRRA change is required or optionally put into effect, or (2) end of plan's GUST RAP.

- UCA '92: Added provisions for direct rollover effective distributions after 12/31/1992. For governmental plans adoption deadline is end of GUST RAP, which was latest of (1) 02/28/2002, (2) the last day of the 2001 plan year, or (3) the last day of the first plan year beginning on or after the "2000 legislative date".

Code Section 402(f) establishes a notice requirement and Code Section 6652 sets a penalty for failure to give notice.

Note: Code Section 402(c) provides total and partial rollover and distribution rules, and general tax rules.

CODE SECTION 401(a)(36)

In-service distribution rules.

CODE SECTION 401(b)

Establishes required amendment periods for qualified plans. See Rev. Proc. 2007-44.

CODE SECTION 401(h)

Retiree Medical Benefits. Pension or annuity plan may provide limited sickness, accident, hospitalization and medical benefits for retirees, their spouses and their dependents.

Note: Proposed regulations issued.

CODE SECTION 401(k)

Cash or Deferred Arrangements. Governmental organizations generally cannot maintain a qualified cash or deferred arrangement. However, the Code contains an exemption for arrangements adopted by governmental plans before May 6, 1986. Those plans would have to conform to appropriate 401(k) provisions.

Optional participation in other retirement plans raise an issue as to whether such an option creates a cash or deferred arrangement, but the IRS regulations provide that a one-time irrevocable election by an employee to participate in a retirement plan, which election is available at the time of employment or at the time participation is first available, does not render a governmental plan a 401(k) plan.

CODE SECTION 413

Collectively Bargained Plans and Multiple Employer Plans

CODE SECTION 414(d)

Governmental Plan. Defined as "a plan established and maintained by its employees by ... the government of any State or political subdivision thereof, or by any agency or instrumentality of any of the foregoing." The inclusion of non-governmental or quasi-governmental employers/employees can cause loss of governmental plan status.

Five Factors Considered:

- degree of control of government over organization's every day operations
- whether there is special legislation creating the organization
- source of funds for organization
- manner in which organization's trustees/operating board are selected
- whether applicable governmental unit considers employees of organization to be employees of governmental unit.

Rev. Rul. 89-49.

CODE SECTION 414(h)

Government "Pick-ups". Allows a government entity to treat certain employee contributions as employer contributions. Revenue rulings have established the following requirements for an effective pick-up:

- The employer must take formal action, evidenced by a contemporaneous written document, specifying that the contributions, although designated as employee contributions, are being paid by the employer in lieu of contributions by the employee. A person duly authorized to take such action with respect to the employer must do so. The action must apply prospectively only.
- The employee must not be given the option, from and after the date of the pick-up, to have a cash or deferred election right (within the meaning of § 1.401(k)-1(a)(3)) with

respect to the designated employee contributions. Thus, the employees must not be able to opt out of the pick-up or be able to receive the contributed amounts directly instead of having them paid by the employer to the pension plan.

Rev. Rul. 2006-43; see also Rev. Rul. 81-35; Rev. Rul. 81-36; and Rev. Rul. 87-10.

Note: IRS approval obtained through PLR.

CODE SECTION 414(j)

Definition of Defined Benefit Plan. A defined benefit plan means any plan that is not a defined contribution plan, i.e., "a plan that provides for an individual account for each participant and for benefits based solely on the amount contributed to the participant's account, and any income, expenses, gains and losses, and forfeitures of accounts of other participants which may be allocated to such participant's account." Code § 414(i).

CODE SECTION 414(n)

Leased Employees. Definitions for leased employees.

- GUST: leased employee primary direction and control test. Deadline for adoption was latest of (1) 02/28/2002, (2) the last day of the 2001 plan year, or (3) the last day of the first plan year beginning on or after the "2000 legislative date".

- TRA '86: Defined employee to include leased employees.

CODE SECTION 414(p)

Definition of Qualified Domestic Relations Order. A distribution from a governmental plan, which is not subject to Code § 401(a)(13), made pursuant to a domestic relations order will be treated as a QDRO if that order creates or recognizes the existence of an alternate payee's right to, or assigns to an alternate payee the right to, receive all or a portion of the benefits payable with respect to a participant under a plan. Code § 414(p)(1)(A)(i) and (ii).

- TRA '86: DRO restrictions. Deadline for adoption for governmental plans extended to end of GUST RAP, which was latest of (1) 02/28/2002, (2) the last day of the 2001 plan year, or (3) the last day of the first plan year beginning on or after the "2000 legislative date".

Note: Governmental plans are not required to accept QDROs. However, if plan does make distributions under DROs that meet these definition, the appropriate tax consequences are determined by federal law.

CODE SECTION 414(s)

Definition of Compensation. Code § 414(s) defines compensation by reference to Code § 415(c). However, Code § 415(c) permits compensation to include any elective deferrals under Code

§ 402(g)(3) (including 403(b) deferrals) and any amount deferred by employer at the election of the employee which is not includible in gross income under 125 or 457. However, picked-up contributions are not includible under the Code § 415(c) definition.

- Final 415 Regulations: Define compensation with respect to post-severance pay for certain purposes.

- CRTRA 2000: Must include transportation fringe benefits in compensation under 414(s)(2). Deadline for adoption latest of (1) end of 2002 plan year, (2) end of GUST RAP, or (3) June 30, 2003.

CODE SECTION 414(u) and USERRA

Reemployed Veterans. The Uniformed Services Employment and Reemployment Rights Act of 1994 expanded veterans rights and included various retirement plan provisions in the Internal Revenue Code. Generally, make- up employee contributions required under DB plan not subject to 415 limits for year make-up contributions made, but subject to applicable limits for year to which the contributions relate.

- GUST: USERRA effective 12/12/1994. Deadline for adoption was latest of (1) 02/28/2002, (2) the last day of the 2001 plan year, or (3) the last day of the first plan year beginning on or after the "2000 legislative date".

Note: Final DOL Rules

CODE SECTION 415(b)

Limitations on Benefits. Effective for years ending after December 31, 2001, the benefit limit will increase to $160,000, with future indexing in $5,000 increments. Special rules regarding benefit reductions apply to governmental plans and particularly plans maintained for certain police and fire plans. Governmental plans are not subject to the benefit limitation based upon 100% of salary.

- EGTRRA: Increased limit. Deadline for adoption of good-faith amendment under Notice 2001-42 was later of (1) end of plan year in which EGTRRA change is required or optionally put into effect, or (2) end of plan's GUST RAP.

- Rev. Rul. 2001-62: use '94 GAR Mortality Table to calculate maximum allowable benefit. Deadline was end of the plan year that included the '94 GAR effective date (distributions on or after 12/31/02, or any earlier date in 2002 if specified by the plan).

- GUST: Repealed 415(e) DB/DC aggregation rules. Deadline for adoption was latest of (1) 02/28/2002, (2) the last day of the 2001 plan year, or (3) the last day of the first plan year beginning on or after the "2000 legislative date".

- GUST: Requirement for actuarial adjustments and exemption for survivor and disability benefits under 415(b)2) and compliance with Rev. Rul. 98-1. Deadline for adoption was latest of (1) 02/28/2002, (2) the last day of the 2001 plan year, or (3) the last day of the first plan year beginning on or after the "2000 legislative date".

- TRA '86: Phase-in of dollar limit, maximum dollar amount before SSRA. Deadline for adoption for government plans extended to end of GUST RAP.

Note: Final IRS Regulations were issued in May 2007.

CODE SECTION 415(c)

Limitations on Contributions. For years beginning after December 31, 2001, the annual additions limit is increased to the lesser of $40,000 or 100% of compensation, with future indexing of the dollar limit in $1,000 increments. The 415(c) limit is not applicable to picked-up contributions or the receipt of roll-over distributions. Note: 1997 legislation also establishes a transitional rule for eligible participants to grandfather purchases of service allowable as of 8/5/97.

- EGTRRA: Deadline for adoption of good-faith amendment under Notice 2001-42 was later of (1) end of plan year in which EGTRRA change is required or optionally put into effect, or (2) end of plan's GUST RAP.

- GUST: Repealed 415(e) DB/DC aggregation rules. Deadline for adoption was latest of (1) 02/28/2002, (2) the last day of the 2001 plan year, or (3) the last day of the first plan year beginning on or after the "2000 legislative date".

Note: Final IRS Rules were issued in April 2007. Among the most significant changes were revisions to the definition of "compensation."

CODE SECTION 415(k)(3)

Repayments. In case of repayment (including interest) to plan with respect to an amount previously refunded upon a forfeiture of service credit under the plan or under another governmental plan maintained by a State or local government employer within the same State, any such repayment shall not be taken into account for purposes of Code § 415. After December 31, 2001, a governmental defined benefit plan may permit a trustee-to-trustee transfer from a 403(b) plan or a 457 plan to purchase permissive service credit (see Code § 415(n)) or to repay previously refunded contributions.

CODE SECTION 415(m)

Excess Benefits. The 1996 federal legislation authorizes the establishment of Qualified Excess Benefit Arrangements to deal with benefits and contributions in excess of 415 limits.

Note: IRS approval obtained through PLR.

CODE SECTION 415(n)

Service Purchases. Effective for 1998, there are modified 415(c) and 415(b) limits that apply to voluntary employee contributions for purchases of permissive service credit. After December 31, 2001, a governmental defined benefit plan may permit a trustee-to-trustee transfer from a 403(b) plan or a 457 plan to purchase permissive service credit or to repay contributions previously refunded under forfeiture of service credit (see Code § 415(k)(3)).

- PPA: Broadened definition of permissive service credit.

Note: IRS approval obtained through PLR.

CODE SECTION 503(b)

Prohibited Transactions. While governmental plan is not subject to excise tax of Code § 4975, engaging in prohibited transaction could result in loss of plan's tax-exempt status.

CODE SECTIONS 72, 101(h), 104, 402, and 3405

Governs taxation and withholding of various distributions from governmental plans.

LIST OF CODE SECTIONS NOT APPLICABLE TO GOVERNMENTAL PLANS

- Code Section 401(a)(3) Coverage Rules
- Code Section 401(a)(4) Nondiscrimination Rules
- Code Section 401(a)(5) Nondiscrimination Rules
- Code Section 401(a)(6) Nondiscrimination Rules
- Code Section 401(a)(10) and 416 Top Heavy Plans
- Code Section 401(a)(11) and 417 Joint and Survivor Rules*
- Code Section 401(a)(12) and 414(*l*) Plan Merger
- Code Section 401(a)(13) Anti-Alienation
- Code Section 401(a)(14) Benefit Commencement Rules
- Code Section 401(a)(15) Social Security Integration
- Code Section 401(a)(19) Forfeiture Rules
- Code Section 401(a)(20) Plan Termination
- Code Section 401(a)(26) Participation
- Code Section 401(a)(27) Profit Sharing Plans Only
- Code Section 401(a)(28) Employee Stock Ownership Plans
- Code Section 401(a)(29) 412 Plans Only
- Code Section 401(a)(30) Elective Deferrals (except for grandfathered plans)
- Code Section 401(a)(32) and 401(a)(33) Bankruptcy and Funding Rules
- Code Section 401(a)(34) PBGC Covered Plans
- Code Section 401(a)(35) Defined Contribution Plans
- Code Section 410 Participation
- Code Section 411* (Instead See Pre-ERISA 401(a)(7))
- Code Section 412 (Instead See Pre-ERISA 401(a)(7))

* Code Sections 411 and 417 must be considered for 415(b) testing under Final Regulations.

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