

# WHAT ARE THE IMPORTANT IRS ISSUES FOR PUBLIC PENSION PLANS?

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# What is a "governmental plan"?

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- IRS issued an "Advance Notice of Proposed Rulemaking" (ANPRM) – 11/8/2011
- ANPRM contains draft proposed regulations defining what is a governmental plan under I.R.C. § 414(d)
  - Federal government
  - Federal instrumentality or agency
  - State governments
  - Political Subdivisions
  - Instrumentality or agency of a State or Political Subdivision

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# What is a "governmental plan"? *(cont'd)*

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- **Political subdivisions**
  - **Governing body must be publicly elected or appointed by state officials AND**
  - **Must exercise sovereign powers (taxation, eminent domain, police power)**

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# What is a "governmental plan"? *(cont'd)*

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- Instrumentality or agency
  - 5 main factors
  - 8 other factors
- Critical issues
  - Control
  - Funding (direct through tax revenues or other)
  - Statutory Authorization
  - Treatment of Employees
  - Tax Status
  - Any Judicial decision by State or Federal Court
  - Serves a Government Purpose

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# What is a "governmental plan"? *(cont'd)*

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- What are the big issues?
  - Privatizations
  - Charter schools
  - For profit/non-profit entities
  - Economic Development Entities
  - Municipal Utilities
  - Associations
- Transition
- Grandfathering
  - Employees
  - Entities

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# What is a "normal retirement age"?

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- IRS issued final regulations defining normal retirement age in 2007
  - Age 62 – safe harbor
  - Age 55-62 – OK if the age represents a typical retirement age
  - Age 50 or above – safe harbor for public safety
- Final regulations will not apply to governmental plans until 2015 (Notice 2012-29)

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## What is a "normal retirement age"? *(cont'd)*

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- The IRS is focused on when is a benefit nonforfeitable.
- Sham Transactions – the IRS has issued a PLR saying that an employee can't retire one day and be rehired the next and draw a benefit unless the employee has hit normal retirement age.
  - When is there a true separation from employment?
  - This is also a taxation issue – if a benefit is paid before 59½ without a separation from service, the employee could be subject to a 10% penalty.
- This also affects the HELPS eligibility for the \$3,000 exclusion.
- The IRS is also focused on "in-service" distributions.



# When can employee contributions be "picked-up"?

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- The IRS says that employee contributions can be "picked-up" (made pre-tax) if:
  - I.R.C. § 414(h)
  - Employer or state law says that the contributions will be picked up AND
  - The employee contributions are mandatory and employees have no choice except upon initial employment.
    - Affects choice of tier



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# Determination Letters

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- Members of the Coalition have received favorable determination letters in the past Cycle C – one for all Police Plans (Chapter 3) and one for all Firefighter Plans (Chapter 4).
- The IRS has approved a similar approach for this cycle. The filing entity is the Insurance Department Pension Division. The two filings will be done before January 31, 2014.

# What are the issues that the IRS is raising for determination letters?

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- Application of limits on compensation (I.R.C. § 401(a)(17) – this is the limit on compensation used in the calculation of contributions and benefits.
  - There is a grandfathered group – those hired before 1996.
- Application of limits on contributions (DC plans) and benefits (DB Plans) (I.R.C. § 415(b).
  - There is a grandfathered group – those hired before 1990.
  - An excess benefit plan can be established.

# What are the issues that the IRS is raising for determination letters? *(cont'd)*

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- Have all required amendments been made (2012 Cumulative List)?
  - Pension Protection Act of 2006
  - U.S. Troop Readiness, Veterans' Care, Katrina Recovery and Iraq Accountability Appropriations Act of 2007
  - Heroes Earnings Assistance and Relief Tax Act (HEART) – 2008
  - Worker, Retiree, and Employer Recover Act (WRERA) – 2008
  - Small Business Jobs Act of 2010
  - Preservation of Access to Care for Medicare Beneficiaries and Pension Relief Act of 2010
  - Moving Ahead for Progress in the 21<sup>st</sup> Century Act (Map-21)

# What are the issues that the IRS is raising for determination letters? *(cont'd)*

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- In other states for DROP – the IRS has certain formats that it will approve
  - The DROP account is really part of a defined benefit plan.
  - The primary question is how interest is credited on DROP accounts.

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# Corrections

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- **Employee Plans Compliance Resolution System ("EPCRS")**
  - Set forth in Revenue Procedure 2013-12
- **Based on Following Principles:**
  - Encouragement of practices and procedures to ensure plans are operated in accordance with I.R.C.
  - Voluntary and timely correction of plan failures
  - Provide employees with expected benefits, including favorable tax treatment
  - Correction will restore the plan to where it would have been had the failure not occurred
  - Correction should keep assets in the plan
  - Full correction must be made for all members and all plan years
  - The correction method should be applied consistently

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# Corrections *(cont'd)*

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- **Types**
  - Self-Correction Program ("SCP")
  - Voluntary Correction Program ("VCP")
  - Audit Closing Agreement Program ("Audit CAP")
- **Goal**
  - Preserve Tax Deferred Benefits for Participants
  - § 401(a) – Qualified Plans
  - § 403(b) – Tax-Sheltered Annuities
  - § 408(k) – SEPs and SARSEPs
  - § 408(p) – Simple IRAs



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# Corrections *(cont'd)*

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- **Common Issues for Correction**
  - **Erroneously excluded employees**
  - **Funding of qualified non-elective contributions**
  - **Overpayments**
  - **§ 415 Failures**
  - **Lost Participants**
  - **Hardship distributions and loans**
  - **Failure to operate the Plan in accordance with Plan terms**
  - **Failure to suspend deferrals**



# United States Supreme Court *Windsor* Decision - Defense of Marriage Act ("DOMA")

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- Ruled unconstitutional the Federal Definition of "spouse" and "marriage"
- Did not rule upon full faith and credit provision
  - Does one state have to recognize a same-sex marriage from another state?
  - Currently, 13 states and the District of Columbia provide for legal, same-sex marriage
  - 7 states and District of Columbia provide for state-level spousal rights (includes Illinois which began recognizing civil unions in 2011)
  - Importantly, many ERISA and I.R.C. questions remain unanswered
    - Retirement / Pension Plans
    - Health and Welfare Plans

# IPPFA Midwest Pension Conference

IRS Compliance Program Update  
October 4, 2013



# IRS Audits

- » We haven't seen any concerted effort to audit governmental plans-yet
- » Governmental employer audits often focus on employment tax issues
- » Goals are to improve filing, payment and reporting compliance and reduce the employment tax portion of the “tax gap”
- » In fiscal year 2012 IRS examined 2,600 tax returns focusing on: Worker reclassification, employment taxes on fringe benefits, settlement payments, international taxes, and information return reporting
- » Also conducted 840 compliance checks-assess level of employer compliance not full audit

# IRS Audits – FY 2013 Initiatives

- » IRS Announced for FY 2013 a reduction in compliance checks and examinations due to reduced staffing and modifications to the types of examinations conducted
- » IRS will devote its resources to the Employment Tax National Research Program (ET-NRP)
  - » ET-NRP is an examination project designed to develop data to identify and quantify the tax gap related to employment taxes
  - » It will increase the number of examination issues with potential international tax issues, the number of large entity examinations, and will continue to conduct examinations in all market segments
  - » IRS expects to address a greater number of claims for refund primarily related to of Section 218 Agreement coverage issues (social security and medicare coverage)
- » We recommend that employers and plans review processes to avoid costly audit issues

# Taxability of Pensions

- » The taxability of the pension depends on the source of the funds being contributed to the Fund
- » There are various types of contributions:
  - » Employer contributions
  - » Employee required contributions
  - » Employee elected contributions for purchase of prior service credit

# Taxability of Pensions

- » Employer contributions
  - » Will be taxable to participant when pension received as employee did not pay tax on receipt of contribution
- » Employee required contributions
  - » If pick-up contribution made, contributions were made on a pretax basis so pension will be taxable upon receipt
  - » If no pick-up contribution made a portion of the pension will not be taxable as recovery of after tax contributions

# Taxability of Pensions

- » Employee elected contributions for purchase of prior service credit
  - » Revenue Ruling 2006-43 states that in order to qualify as a pick-up contribution the arrangement must “not permit a participating employee from and after the date of the “pick-up” to have cash or deferred election right (within the meaning of Section 1.401(k)-1(a)(3)) with respect to designated employee contributions. Thus, for example, participating employees must not be permitted to opt out of the “pick-up,” or to receive the contributed amounts directly instead of having them paid by the employing unit to the plan.”



# Taxability of Pensions

- » Employee elected contribution for purchase of prior service credit – source of funds:
  - » Payroll deductions - Rev Ruling 2006-43 any payroll deductions made to purchase prior service credits should be treated on a POST tax basis and basis should be tracked as with other after tax contributions to the Fund
  - » Rollover from a pretax account (such as IRA) - Contributions would be treated as pretax and amount taxable upon distribution
  - » Lump sum payment - Treated as post tax payment and basis should be tracked and amount would not be taxable upon distribution

# Pick-Up Contribution Elections

- » Generally amounts withheld from employee paychecks need to be after tax unless there is an IRS code section allowing pre-tax treatment
- » For pension contributions, in order to be pre-tax the employer must elect to “pick-up” the contributions
- » The IRS provides in Section 414(h)(2) pretax pension contributions if certain conditions are met
- » This is not covered under a determination letter request, if specific approval from the IRS is desired a private letter ruling must be applied for

# Pick-Up Contribution Elections

- » In Revenue Ruling 2006-43 the IRS stated that in order for a contribution to a qualified plan to be treated as pick-up by the employer the following must occur:
  - » The employer must take formal action to elect to pick-up the contribution and the action must apply prospectively and be evidenced in writing, i.e., in a resolution, ordinance or minutes of a meeting
  - » The participant must not have the right to opt out of the “pick-up” or the right to receive the amounts directly in lieu of having them paid into the plan

# Basis Recovery – Form 1099-R Reporting Issues

- » It is the Fund's responsibility to prepare accurate Form 1099-R's for the pensioner
- » The IRS can assess penalties for failure to file correct returns
- » If pick-up contribution election was made then the pre-tax contributions result in taxable pension benefits

# Basis Recovery – Form 1099-R Reporting Issues

- » If no pick-up election was made then pensioners have basis in their pension payments
- » The after tax contributions of pensioners should be tracked
- » Upon retirement the basis should be allocated over the expected payment term of the pension

# Basis Recovery – Form 1099-R Reporting Issues

- » The basis should be calculated by the Fund and provided to the pensioner on Form 1099-R – depending on the year of retirement it can be a complex calculation
- » For pensions beginning after December 31, 1997 the method outlined in IRC Section 72(d)(1) should be used

# Basis Recovery – Form 1099-R Reporting Issues

- » For pensions beginning before this date a variety of other methods were used and the date the pension began will dictate which recovery method should be used
- » Upon the cessation of the pension benefit any unrecovered basis is used to offset taxable benefits in that year



# Basis Recovery Calculation

- » Annuity starting dates after November 18, 1996
  - » Recovery of basis calculation is determined under amended IRC §72(d)(1)
  - » The excludable portion of the monthly annuity payment is the total unrecovered basis as of the annuity starting date divided by the anticipated number of payments under the annuity
  - » The anticipated monthly payments are determined from tables A & B (see later slide)

# Basis Recovery Calculation

- » Use Table A for all annuities (whether based on one or two lives) with an annuity starting date after November 18, 1996, and before January 1, 1998
- » For annuity starting dates after December 31, 1997, use Table A if the annuity is for one life (i.e., the participant's life)

# Basis Recovery Calculation

- » Use Table B if the annuity is for two lives (i.e., the lives of the participant and a beneficiary) –determine ages as of the annuity starting date
- » Guidance on the use of these tables is provided in IRS Notice 98-2

# Basis Recovery Calculation – Per IRS Notice 98-2

Table A		Table B	
<u>Age of Participant</u>	<u>Anticipated Payments</u>	<u>Combined age of Participant &amp; beneficiary</u>	<u>Anticipated Payments</u>
55 and under	360	110 and under	410
56-60	310	111-120	360
61-65	260	121-130	310
66-70	210	131-140	260
71 and older	160	More than 140	210

# Federal Income Tax Withholding

- » Each pensioner should complete IRS Form W-4P

# Illinois Income Tax Withholding

- » Illinois does not currently tax pensions
- » No IL withholding required to be withheld on pensions
- » Some pensioners request IL withholding
- » Optional for pension fund to withhold for IL
- » If Pension funds desire they may register with IL to remit taxes to IL and will be subject to any applicable penalties for failure to properly withhold and remit
- » Pensioners should complete form IL-W-4-P to elect amount of withholding

# Member Refund of Contributions – Distribution Issues

- » Obtain election in writing if officer wants to cash out refund or elects to rollover to an IRA
- » If a cash payment is elected then the IRS requires a mandatory 20% income tax withholding on the taxable amount (for refunds)
- » Early withdrawal penalties could apply
- » The premature distribution penalty equal to 10% is an additional tax levied on distributions paid to the participant before he/she attains age 59½ (IRC §72(t))



# Exception to Early Withdrawal Penalty

- » IRC Section 72(t) provides list of exceptions
- » Age 55 exception (age 50 for certain public safety employees)
  - » If a public safety officer separates from service after reaching age 50, payments received from the plan are not subject to the penalty. See IRC §72(t)(2)(A)(v). The IRS has interpreted the age 50 separation requirement to be satisfied if the participant separates from service during the calendar year in which he/she reaches age 50, even if the actual separation date is before his/her 50<sup>th</sup> birthday. See IRS Notice 87-13, A-20.

# Exception to Early Withdrawal Penalty

- » Age 55 exception (age 50 for certain public safety employees) (continued)
  - » Payments under this exception may be made in any manner. They do not have to satisfy the substantially equal payments rule. If a participant separates from service before age 50, but waits until age 50 to commence payments, this exception is not applicable. In that case, the payments would have to satisfy another exception, such as the substantially equal payments exception, to escape the penalty.

# Member Refund of Contributions – Distribution Issues

- » Provide 402(f) notice
  - » IRC §402(f) requires the participant to receive a written explanation of the rollover option, the tax consequences of not making the rollover (e.g., mandatory income tax withholding) and, if applicable, any special income tax elections available (e.g., income averaging under §402(d) for certain lump sum distributions)
  - » The notice requirement is sometimes referred to as the "section 402(f) notice" or the "special tax notice"
  - » A sample safe harbor notice is prescribed by the IRS in Notice 2009-68. This sample may need to be modified to meet the specifics of the Fund.

# Form 1099-R Reporting

- » A 1099-R should be issued for payments of taxable benefits/refunds during the calendar year
- » Show gross distribution in Box 1 of 1099-R
- » Show taxable portion in Box 2a of 1099-R
- » Show non-taxable portion in Box 5 of 1099-R
- » Include code for tax attributes in Box 7
- » PSO \$3,000 health insurance reporting has no impact on 1099-R reporting discussed later

# Form 1099-R Reporting

- » Deadlines for forms:
  - » Provide copies of 1099-R form to recipient by January 31<sup>st</sup> after year of payment
  - » File a copy of the 1099-R, 945 and 1096 forms with the IRS by February 28<sup>th</sup> of the year after the payment
  - » If you file electronically the due date is the end of March/early April (varies)

# 1099-R Codes

- » Service Pensions
  - » Taxable except for basis recovery
  - » Code 7 if pensioner is age 59 ½ or older
  - » Code 2 if pensioner is age 50 and under age 59 1/2
- » Non-duty Disability Pensions
  - » Taxable except for basis recovery
  - » Code 3

# 1099-R Codes

- » Duty Disability/Occupational Disease Disability
  - » Generally nontaxable
  - » If the payment exceeds the 65% of salary that would have been received upon retirement then a portion may be taxable
  - » Code 7 for any taxable portion

# 1099-R Codes

- » Surviving Spouse Pension
  - » The tax status of the pensioner's payment carries over to the spouse
  - » If employee dies in the line of duty then surviving spouse payments are generally tax free
  - » Code 4



# 1099-R Codes

- » Refund of Contributions
  - » If pretax contributions made then taxable if not rolled over
  - » If after tax contributions made then not taxable
  - » Code G if rolled over
  - » Code 1 if NOT rolled over and member is less than 50
  - » Code 2 if NOT rolled over and member is age 50 or older

# Public Safety Officers – Health Insurance Premiums

- » Effective January 1, 2007, IRS added a provision allowing for an exclusion from taxation \$3,000 of health insurance premiums. In order to be eligible the following conditions must be met:
  - » Withheld from distributions from an “Eligible Plan”
  - » Paid to “Public Safety Officer”
  - » Paid for “Qualified Health Insurance Premiums”
  - » May not also deduct the premiums as medical expenses

# Eligible Plans

- » An eligible retirement plan for purposes of this rule is any governmental plan described in IRC §401(a) or §403(a) (“qualified plan”), IRC §403(b), or IRC §457(b)
- » Article 3 and Article 4 are considered 401(a) plans

# Eligible Retired Public Safety Officers

An individual who, by reason of disability or attainment of normal retirement age, is separated from service as a public safety officer with the employer who maintains the eligible retirement plan – see IRC §402(l)(4)(B).

# Eligible Retired Public Safety Officers

If retirement occurs before normal retirement age, and the employee is not retiring by reason of disability, this exclusion is not available, and the terms of the eligible plan control to determine the reason for retirement – see Notice 2007-7, Q&A-20.

# Eligible Retired Public Safety Officers

A public safety officer is an individual serving a public agency in an official capacity, with or without compensation, as a law enforcement officer, a firefighter, a chaplain, or as a member of a rescue squad or ambulance crew – see IRC §402(l)(4)(C), Notice 2007-7, Q&A-21, and section 1204(9)(A) of the Omnibus Crime Control and Safe Streets Act of 1968 (42 U.S.C. §3796b(9)(A)).

# Eligible Retired Public Safety Officers

So long as the employee retires as a public safety officer, benefits under the plan that are attributable to service other than as a public safety officer are eligible for favorable tax treatment under IRC §402(I) – see Notice 2007-7, Q&A-24.

# Qualified Health Insurance Premiums

Premiums for coverage for the eligible retired public safety officer, his or her spouse, and dependents (as defined in IRC §152), by an accident and health plan or qualified long-term care insurance contract (as defined in IRC §7702B(b)) – see IRC §402(l)(4)(D) (as modified by §108(j) of the Worker, Retiree, and Employer Recovery Act of 2008 (WRERA)).



# Qualified Health Insurance Premiums

Payments for premiums must be made directly by the eligible retirement plan by deducting the amount from the distribution – see IRC §402(l)(5)(A) (as modified by §108(j) of WREERA) and Notice 2007-7, Q&A-22.

# Qualified Health Insurance Premiums

- » Self-insured plans are eligible
- » The accident or health plan receiving the payments of qualified health insurance premiums is permitted to be a self-insured plan – see Notice 2007-7, Q&A-23, as modified by Notice 2007-99
- » The Plan does NOT need to for a plan sponsored by the employer

# Form 1099-R Reporting Issues

- » Public Safety Officer \$3,000 Exclusion
  - » Should not be reported on Form 1099-R as a reduction in taxable income
  - » Should not reduce the amount of taxable pension used for withholding purposes
  - » The pensioner should report this amount on their Form 1040, line 16b and note “PSO” on that line OR include the insurance premiums with other out-of-pocket medical expenses (7.5% AGI)
  - » Funds should consider providing supplemental information regarding amount of premiums paid by the officer and inform them that the premiums have not been reflected on their Form 1099-R

# 1099-Misc Reporting

- » Must file Form 1099-Misc for payments for services of \$600 or more per year
- » If paid to a corporation no 1099-Misc reporting required, unless an exception applies such as:
  - » Paid to an attorney
  - » Paid for medical expenses

# 1099-Misc Issues

- » Make sure to obtain W-9 for all payments for services to ensure you have documentation of type of organization
- » Upon audit IRS will want to review and can impose penalties for failure to file 1099-Misc and require back up withholding at a rate of 28%

# Questions?

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