Qualification Considerations, Plan Corrections and Fiduciary Duties: How All of These Intersect with Current Employer Challenges and Proposed Legislation

Presented by: *Robert L. Gauss, Partner*

Ice Miller LLP

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Topics for Discussion:

1. Plan Qualification
2. Picked-Up Contributions – 414(h)(2)
3. Normal Retirement Age, Retiree Reemployment and Early Distributions
4. Plan Corrections
5. Fiduciary Duties

Topic 1:

Plan Qualification

- **Type of Plan**
  - Most Governmental Retirement Systems are established and maintained as qualified governmental plans under Internal Revenue Code ("Code") §§ 401(a) and 414(d)

- **Sources of Requirements for a Qualified Plan**
  - The Code as amended by Congress
  - Treasury Regulations
  - Revenue Rulings
  - Revenue Procedures
  - Private Letter Rulings (PLRs)
  - Notices
  - Other– Announcements, Newsletters, Court Decisions (*i.e. Supreme Court Decisions*)

Why is Qualification So Important?

- **Taxation**
  - **<u>Employer contributions are not taxable to members</u>**
  - **<u>Earnings/income are not taxed to the trust or members</u>**
  - Favorable tax treatments may be available to members upon plan distributions (*i.e.* rollovers, QDROs)
  - Employers/members generally do not pay employment taxes when contributions are made or benefits are paid
  - Tax recapture available for qualified plans in tax treaty countries

Why is it So Important to be a Governmental Plan?

- **Exemption**
  - Governmental plans are exempt from the Employee Retirement Income Security Act of 1974 ("ERISA")
  - Governmental plans are exempt from Pension Benefit Guaranty Corporation ("PBGC") premium payments
  - Governmental Plans are exempt from many Code requirements

What Does It Mean to be "Qualified"

- Code § 401(a)
- "A trust created or organized in the United States and forming part of a . . . **pension** . . . plan . . . For the exclusive benefit of his employees or their beneficiaries shall constitute a qualified trust. . ."
- (1) . . . **Contributions** are made to the trust by such employer, or employees, or both . . . **for the purpose of distributing** to such employees or their beneficiaries the corpus and income . . . **in accordance with such plan**.
- (2) **it is impossible** for any part of the corpus or income to be used for, or diverted to **purposes other than for the exclusive benefit** of his employees or their beneficiaries. . .
- 11:264-3; 11:264-4; 11:2225.2

"Pension Plan"

- **What is a Pension Plan?**
  - Plan must be established and maintained by an employer(s) for employees
  - Plan's Assets must be held in trust as determined under state law
  - **Trustees must exercise fiduciary duties**
  - Plan must be established to provide systematically for the payment of definitely determinable benefits
  - **Payment from the plan must be made to employees over a period of years, usually for life, after retirement**

Topic 2:

Picked-Up Contributions – 414(h)(2)

Picked-Up Contribution – 414(h)(2)

- Picked-up Contribution
  - Employer paying contributions in lieu of employee
  - Employee has no option of receiving picked-up amounts
  - Official action
  - Timing of pick-up
  - Irrevocable elections
- Importance of PLR vs. Favorable Determination Letter

Mandatory vs. Optional Membership

- **If the plan provides for optional participation, the option must be**:
  - A one-time irrevocable election or
  - A grandfathered cash or deferred arrangement (*i.e.*, pre-May 6, 1986 401(k))
- **Membership Options: Areas of Inquiry**
  - **Optional participation**
  - **Ongoing or revocable elections**
  - Transfers to another plan maintained by the employer

Topic 3:

Normal Retirement Age, Retiree Reemployment and Early Distributions

What is a "Normal Retirement Age"?

- IRS issued final regulations defining normal retirement age in 2007
  - It must be a number!
  - 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
- Notice of Proposed Regulations Issued January 2012
  - Safe Harbors for Qualified Public Safety Employees:
    - Age 50 or later
    - Combined age and years of service of 70 or more
    - Any age with 20 years of service
- No Developments Since 2015 (specific to Charter Schools)

What is a "Normal Retirement Age"? *(Cont'd)*

- 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 bona fide 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.

What is a "Normal Retirement Age"? *(Cont'd)*

- This also affects the HELPS eligibility for the $3,000 exclusion (§402(l)).
- The IRS is focused on "in-service" distributions.

Issues:

- Qualification for the Plan
  - Has the individual reached the earlier of age 59½ or normal retirement age.
  - Is there a bona fide separation from service with the employer.
- Taxation for the Individual
  - Has the individual reached age 50, 55 or 59½.
  - Is there a bona fide separation from service.

Keys

- Length of separation
  - Facts and Circumstances Test.
  - No Established Length of Separation ("Safe Harbor").
  - 12 months? 6 months? 3 months?
- Separation – real or not
  - No Pre-Arranged Agreement
  - No Continuation of Employment Arrangement
- Same Employer

Topic 4:

Plan Corrections

Corrections

- Employee Plans Compliance Resolution System ("EPCRS")
  - Set forth in Revenue Procedure 2021-30
- Based on Following Principles:
  - Encouragement of practices and procedures to ensure plans are operated in accordance with **Code and plan terms**
  - Voluntary and timely correction of plan failures
  - Provide employees with expected benefits, including favorable tax treatment
  - Correction will restore the plan and member(s) to where each 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

Corrections *(Cont'd)*

- Types
  - Self-Correction Program ("SCP")
  - Voluntary Correction Program ("VCP")
  - Audit Closing Agreement Program ("Audit CAP")
- Goal
  - Preserve Tax Deferred Benefits for Participants and Qualified Plan Status

Corrections *(Cont'd)*

- Common Issues for Correction
  - Erroneously excluded employees
  - Overpayments of benefits/contributions; underpayment of member contributions
  - § 401(a)(9), 401(a)(17) and 415 Failures
  - Lost Participants
  - **Failure to operate the Plan in accordance with Plan terms**

Exceptions to Full Correction

- Reasonable estimates vs. Reasonable interest rate
- Recovery of Small Overpayment ($250.00 or less)
- Delivery of Small Benefits (total corrective distribution is $75.00 or less) and reasonable direct costs of processing and delivering the distribution would exceed the amount of the distribution

Topic 5:

Fiduciary Duties

Fiduciary Defined

- **Look to function and designation**
  - Function: Discretionary administrative or investment decisions related to the plan
  - Designation: Named in governing documents, trust document, or statute as a fiduciary
  - Trustees – both by function and designation
    - Internal Revenue Code § 4975(e)(3); ERISA § 3(21)
    - 11:263; 11:2226

Who is a Fiduciary?

- The State determines the scope of authority of the fiduciaries and gives authority to the Board by statute.
- Fiduciaries for MPERS include:
  - The Board as an entity
  - Any individual member of the Board
  - The appointed trustee
  - Any other agents appointed or engaged by the Board
  - All persons serving as Program staff
- In addition, State law establishes a fiduciary relationship between trustees and the trust's beneficiaries. *See* 11:263; 11:2225.2; 11:2226

Sources of Fiduciary Duty

Federal Law	State Law	Common Law	Plan and Plan-related documents
• **Internal Revenue Code** • **ERISA** (not directly applicable, but excellent resource) • **Uniform Prudent Investor Act** ("UPIA")	• **Statutory Fiduciary Rules** • **State Constitution** • **Administrative Code**	• **Restatement (Third) of Trusts** (collection of common law) • **Uniform Management of Public Employees Retirement Systems Act**	• **Investment Policy Statement** • **Trust Document** • **Board Policies and Resolutions** • **Board Governance Manual**

Fiduciary Duties

Duty of Loyalty

Duty of Prudence

Duty to Follow Plan Documents

Duty of Loyalty

Duty to act solely in the interest of participants and beneficiaries

Duty to act for the exclusive purpose of providing benefits or paying reasonable plan expenses

Duty to act independently and without conflicts of interest

Duty to act impartially among differing interests

Duty of Prudence

Duty to act with the care, skill, prudence, and diligence that a prudent person would exercise in managing their own affairs

Duty to be informed

Duty to delegate responsibilities outside of experience

Duty to diversify investments

Questions?

Robert L. Gauss, Partner
Ice Miller LLP
One American Square, Suite 2900
Indianapolis, IN 46282
(317) 236-2133
gauss@icemiller.com