

GOVERNMENT & TAX EXEMPT PLANS REPORT

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Message From the Firm

We are proud and excited to be offering our first issue of this Firm newsletter addressed exclusively to government and non profit clients and potential clients. For many years, we have published Firm newsletters covering other topics such as the ERISA Audit Report and the ERISA Report for Plan Sponsors as well as the ERISA Controversy Report. This newsletter will be devoted to practical advice on employee benefits for government and non-profit employers. A copy of this newsletter can also be viewed on our web site at www.reish.com.

Our first article is an overview of many topics that affect employee benefits for government employees. Over the next several issues, we will be expanding on each of these summaries to present in depth insights into each of the topics.

The second article explains fiduciary rules for government plans. Unlike most pension plans, the rules promulgated under ERISA don't apply to government plans. What does this mean for fiduciaries of such plans?

The final article addresses a particular type of pension plan qualified under IRC Section 401(a) known as a "pick-up plan." These plans are like 401(k) plans but better. What are they? When do you use them? How do they work?

As always, we welcome your comments and questions.

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Government Retirement Plans: What You Don't Know Can Hurt You

By Marty Heming, Esq. (MartyHeming@Reish.com) and
 Bruce Ashton, Esq. (BruceAshton@Reish.com)



Every government employer ought to be able to answer certain questions concerning its employee retirement plans. To assist you in this regard, we have included important questions and brief answers below. We will feature each question individually and provide a more in depth answer in upcoming issues.

Q: Why does it matter if the plan is a "government plan"?

A: Government plans (those sponsored by the U.S. government or the government of a State or political subdivision thereof or any of its agencies or instrumentalities) are exempt from the rules of the Employee Retirement Income Security Act of 1974, as amended (ERISA) and are subject to only some, but not all, of the rules that govern retirement plans of private employers under the Internal Revenue Code of 1986 (Code). This means that many of the provisions found in a typical "prototype" plan document don't apply and shouldn't be included. If they are included, they must be complied with, or the plan will lose its tax qualification. That's bad for the employees. It also means that the plan is subject to state laws, which may vary depending on the type of governmental entity. Finally, it means that the plan is

subject to different administrative issues than a private sector plan, which makes it important to work with service providers who are familiar with these requirements to avoid unnecessary cost.

Q: What fiduciary rules apply to government plans?

A: The Employee Retirement Income Security Act of 1974, as amended (ERISA) doesn't apply to plans of "governments." Thus, the rules generally governing the fiduciary duties and responsibilities established by ERISA for private sector pension and welfare plans don't apply to plans established by a government entity. Nevertheless, these plans are subject to fiduciary rules (see article by Fred Reish on page 3) that affect the duties and potential liability of those charged with the duty of operating the plans. These rules are found under state law. For example, California law provides that for a Code section 457 plan, the fiduciaries must act prudently and in the best interests of the participants and beneficiaries of the plan. Often, the state law rules are nearly identical to those under ERISA, so generally speaking, if the fiduciaries follow the ERISA rules they will most likely be considered to have met the California requirements. However, for other plans, special fiduciary rules may apply under state law that are very different from the rules for fiduciaries under ERISA.

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Q: Which individuals who perform services for the government entity are deemed to be employees?

A: This seemingly simple question can cause an unbelievable number of very complex answers. For instance, is a member of the Board of a Water District an employee even if he or she works less than 500 hours per year and has another full time job or owns his or her own business? Can part time or temporary employees who work more than 1,000 hours per year be excluded from the pension plan of a government entity without violating the Internal Revenue Code? Are there any restrictions on who can be excluded from a pension or profit sharing plan of a government entity?

Q: Does your 457 plan comply with the rules?

A: Most government 457 plans meet the rules of 457(b) for eligible deferred compensation plans. There are also ineligible plans described in 457(f). Only 457(b) plans are described here. Generally, these are written plans for the deferral of employee salary reduction amounts that are limited to the lesser of \$15,000 (in 2006, subject to adjustment) or 100 percent of the participant's compensation. These limits were increased in 2002 under a law called EGTRRA. Each government 457 plan should have been amended to comply with EGTRRA as well as the proposed regulations. One of the most important changes for 457(b) plans is the requirement that all of the assets that are used to fund the plan must be placed in a trust. Moreover, the trustee is responsible for prudently investing the assets in the trust. It is possible to mitigate this responsibility if the participants are given the right to choose the investment vehicles for their portion of the trust assets. However, even if this is done, the trustees have continuing responsibilities to select and monitor the investment choices. Because

government plans are not covered by ERISA, the trustees' duties are governed by state law. In addition, the IRS has recently proposed changes to the rules regarding deferral of accrued vacation and sick pay, and this will require a plan amendment when the new rule becomes final.

Q: Can a government sponsor a 401(k) plan?

A: Maybe. Under current law, governments may not sponsor a 401(k) plan, even though it is the most widely known plan in America. There is an important exception, however, and that is for a 401(k) plan adopted before May of 1986 and constantly maintained thereafter—though these three innocent sounding words have been the subject of extensive IRS scrutiny and analysis. These plans do require periodic amendment to comply with changes in the law in order to maintain their tax qualified status.

Q: What is a pick-up plan?

A: In a nutshell, a pick-up plan is a special type of qualified plan generally described in Code section 401(a). A pick up plan is similar to a profit sharing plan with a 401(k) elective contribution feature. Since governments may not adopt a 401(k) plan (except as noted above), a pick-up plan serves a very similar purpose. It is a pension, profit sharing or thrift plan with a fixed mandatory after-tax employee contribution with a capability for converting the after-tax employee contribution to a pre-tax contribution by an action of the government body. This could be a very valuable plan for employees generally and can be used to provide additional benefits in some cases for selected employees. (See Marty Heming's article on page 4.)

Q: If the plan is out of compliance, what can you do before the IRS audits the plan?

A: Government plans, like all private sector plans, are subject to audit by the IRS. Thus, if a government plan document is not written correctly or if the plan isn't

operated in accordance with its terms, it can be disqualified. If this occurs, the employees will be taxed on their vested accounts and the earnings in the trust will be taxed to the trust. This result can be avoided if the plan is submitted to the IRS under the voluntary correction program described in Rev. Proc. 2003-44. The fee for submitting the plan to the IRS for a compliance letter is very small compared to the adverse consequences of an IRS audit.

Q: What are the critical differences between government plans and the retirement plans of private employers?

A: Government plans are not subject to ERISA. The rules governing such plans are found in state law as well as the rules under the Internal Revenue Code. Moreover, government plans are not subject to any of the following rules that govern plans in the private sector. The Taxpayer Relief Act of 1997 (TRA '97) permanently exempted "government plans" from the rules of the following Code sections: 401(a)(3), 401(a)(4), 401(a)(26), 401(k), 401(m), and 410(a) and (b). What this means is that a government plan isn't subject to the rules that prevent discrimination in favor of the highly compensated employees in the plan. On a practical level it means that any government plan must be drafted specifically for governments so as to eliminate the anti-discrimination rules normally contained in a standardized document generally sold to private sector employers by the investment community. Unless the plan is tailored correctly, the government plan could be subjected to rules that could have been avoided in a properly drafted document.

Q: Are there any traps for the unwary for government employers when establishing a retirement plan for its employees?

A: Because government plans aren't subject to ERISA and certain provisions of the Code, it is easy to not only apply adverse rules meant to govern only the

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Universal Prudence



By Fred Reish, Esq. (FredReish@Reish.com)

With the aging of the baby boomers and their rapidly approaching retirement (the first boomers hit 60 on January 1, 2006), employers—both public and private—are focusing on retirement benefits. As a result, increasing attention is being paid to the people responsible for managing retirement plans... the fiduciaries.

While the laws on fiduciary responsibility for state and local retirement plans are, for the most part, not particularly well developed, the members of these retirement boards and committees can look at the law governing private sector plans, ERISA, for guidance. Because of the rich history of legislation, regulation and litigation in the private sector, there is a large body of authoritative analysis and interpretation of the responsibilities of fiduciaries.

There are three reasons state courts will look to that federal law. The first is simply the volume of thoughtful guidance. The second is that ERISA and most state fiduciary laws are based on the same investment concepts such as modern portfolio theory and other generally accepted investment principles. The third is that a number of governments have, as a practical matter, adopted ERISA's fiduciary provisions.

For example, ERISA's prudent man rule requires that fiduciaries act:

"...with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;..."

Compare that to the prudent person rule governing the Federal Thrift Plan, which is the largest defined contribution plan in the world and which is participant directed:

"...with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent individual acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like objectives;..."

And, finally, compare those two to the provisions of the California State Constitution governing retirement systems, including 457(b) plans:

"...with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of a like character and with like aims."

Other than a few minor word changes, the provisions are identical. And, the substantive rule is unchanged from ERISA's language.

As a result, members of government retirement boards and committees need to be aware of the fiduciary interpretations of the prudent person rule under ERISA. The most common mistakes we see come from a lack of awareness. That is unfortunate, because it is easily avoided with fiduciary training and good legal and investment advisors.

To help solve this problem, we have begun offering fiduciary training to those responsible for the management of government plans. ❖

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private sector but also to overlook the many rules adopted under state law specifically applicable to government plans. For example, one such law in California prevents members of the elected Boards of special districts from adopting a plan for its legislative members that is more advantageous for such elected official than for the other employees.

Q: What do you need to know about social security opt out?

A: The short answer is that the rules are complex and if not carefully followed, can lead to extremely adverse results for both the government entity and the employees.

Q: What do you need to know about the state PERS?

A: While we believe that many other states have laws similar to those in California, this comment focuses on the California Public Employees' Retirement System (CalPERS). In California, all public safety personnel and university employees must participate in CalPERS. However, municipalities, utility districts, water district and other special districts are not required to join CalPERS, but all governments in California may become miscellaneous members and, as such, be entitled to benefits at a level permitted by law and agreed to by the government entity's governing board. The employees pay a portion of the cost with pretax contributions that reduce otherwise payable salary, and a portion is paid directly by the government entity. The decision of whether or not to join CalPERS requires a detailed analysis. ❖

What Is a Pick-up Plan and Why Would You Want to Adopt One?



By Marty Heming, Esq. (MartyHeming@Reish.com)

A pick-up plan is a special type of tax qualified plan authorized by IRC Section 401(a) and 501(a). It is only available to state or local governments or political subdivisions agencies or instrumentalities thereof. Any pension or profit sharing plan sponsored by a government is known as a government plan. Generally, a government plan is the same as any other qualified plan under Internal Revenue Code section 401(a) except that it is exempt from the non-discrimination rules applicable to private sector plans as well as being exempt from all of the Employee Retirement Income Security Act of 1974 as amended (ERISA) rules.

How does a pick-up plan work?

A pick-up plan is very similar to a profit sharing plan with a 401(k) elective contribution (commonly known as 401(k) Plan) which is generally available to all companies that are not governments. Despite the popularity of 401(k) plans among the private sector companies, a government may not maintain a 401(k) plan unless it was adopted before May of 1986 and has been constantly maintained thereafter.

However, it is possible for a government to have a profit sharing or money purchase plan, which provides for mandatory employee after tax contributions. If the government entity adopts such a plan, it may add a special provision permitted under IRC 414(h) known as a pick-up feature. When a pick-up feature is adopted as part of a government plan, it converts the after-tax employee mandatory contributions in the plan to pre-tax employee contributions.

For example, if a government has a thrift plan which requires each employee who

elects to enter the plan to make a fixed level of after tax employee contribution, the plan can be amended to permit the government to reduce the compensation of the employee by the amount of the otherwise required after tax contribution. This reduction by the government, unlike a 401(k) elective deferral, eliminates the amount of the otherwise payable compensation without any election on the part of the participant. The amount of the reduction cannot be changed by the participant.

In short, the IRS has issued a series of Revenue Rulings, General Counsel Memorandums, and Private Letter Rulings that make it absolutely clear that the government pick-up can be affected by a reduction in the otherwise payable salary of the employee. The only requirement imposed by the IRS on the government's ability to pick-up the employee contribution using a reduction in the otherwise payable compensation of the employee, is that the employee must not be given a choice or option as to whether he or she can elect cash compensation, or have it put in the plan as a pick-up contribution. Thus, unlike a 401(k) plan, the employee doesn't get to choose whether or to what extent his or her compensation will be reduced. After the employee elects to be a participant in the plan his contribution will be picked-up automatically by reducing his otherwise payable compensation in the amount of the employee contribution mandated in the plan document.

The following example demonstrates how the pick up works in contrast with a 401(k) plan:

In the 401(k) plan the participant is given the option to elect how much he wants his salary reduced and he may change

the amount of the reduction periodically using the appropriate forms. Moreover, the participant may elect zero reduction in his compensation during one period and then resume deferrals at a later time.

In a pick up plan, the participant is given a one time option to join the plan at one or more fixed levels of compensation. Once he elects to participate, he cannot periodically revisit the decision. However, the plan may allow a one time permanent option to opt out of the Plan. Thus, a pick up plan is much less flexible than a traditional 401(k) plan.

In its rulings, the IRS succinctly summarizes the rules governing pick-up by government entities as follows: "...two criteria must be met: (1) the employer must specify that the contributions, although designated as employee contributions, are being paid by the employer in lieu of contributions by the employee; and (2) the employee must not be given the option of choosing to receive the contributed amounts directly instead of having them paid by the employer to the pension plan... For purpose of the application of Section 414(h)(2) of the Code, it is immaterial whether an employer picks-up contributions through a reduction in salary, an offset against future salary increases or a combination of both."

In addition, the IRS provides that the pick-up resolution must be in place before the pay is earned. Thus, the pick-up can only be operational for salary earned after the date of the signature of the plan that permits the pick-up and/or the resolution of the government entity authorizing the pick-up.

Why should a government adopt a pick-up plan?

To answer this question, one must first remember that many governments have adopted a defined benefit pension plan with both a mandatory employee contribution and an employer contribution. The employee contribution to the plan is

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Pick-up Plan

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generally picked up by the government by reducing the employees' otherwise payable compensation.

In California, this defined benefit plan is known as CalPERS. It promises a monthly benefit starting a normal retirement equal to a percentage of pay based on years of service with the government. It is a well funded and very popular plan.

In addition, many governments have a 457 nonqualified deferred compensation plan. These plans are funded by elective employee contributions and sometimes contain a matching employer contribution. All eligible government 457 plans have definite limits on elective contributions comparable to the limits on deferral permitted to a 401(k) plan. For 2006, this limit will be \$15,000 per year.

Accordingly, a government that is a good candidate for a pick-up plan is one that seeks to have additional retirement de-

ferred in excess of those permitted under CalPERS and their 457 plan. This is because the limits on the amount that can be deferred under the pick-up plan is not limited by amounts deferred to either of the other two plans. The limits on each are completely separate.

Moreover, the pick-up plan, like the 457 plan, is generally funded exclusively by the otherwise payable compensation of the employee, not from government funds.

Why would a government offer a pick-up plan in addition to CalPERS and its 457 plan?

First and most obvious, any government entity that has opted out of Social Security may feel the need to permit its employees to save for their retirement at a level equal to those who are in the Social Security system.

Second, any government that for one reason or another either has not elected CalPERS or has chosen not to adopt a 457 plan may want to provide some form of tax-favored retirement vehicle for its employees.

Third, any government that has one or more classes of employees that have a desire for deferrals in addition to those generally offered may be able to take advantage of a pick-up plan. Because a government plan may pick and choose who shall participate in a pick-up plan without the restrictions of the discrimination rules otherwise applicable to qualified plans, the government may offer individualized plans for special categories or groups of individuals. For example, a government may have certain individuals who seek a vehicle to defer large sums late in their careers to provide sufficient retirement benefits. The pick-up plan fulfills a need to provide substantial benefits to selected individuals up to the IRC 415 dollar limit (currently \$42,000 per year).

Conclusion

A pick-up plan may be the not-so-obvious answer to attracting and retaining valuable employees who read about 401(k) plans and want to defer more than may otherwise be permitted in their other government plans. ❖

Around the Firm

Reish Luftman Reicher & Cohen will be exhibiting at the Association of California Water Agencies (ACWA) Fall Conference, taking place November 29th-December 1st in San Diego. Bruce Ashton and Marty Heming will give a technical presentation at the Conference on the topic of "Government Retirement Plans: What You Don't Know Can Hurt You."

Fred Reish and Bruce Ashton spoke on the topic of fiduciary responsibility and 457 plans at the City of Anaheim's Defined Contribution Administrator's Meeting on November 1, 2005. Nick White was a presenter at the National Institute of Pension Administrators (NIPA) Annual Conference in May 2005 on "403(b) Arrangements: What Are They and Why Do I Care." In addition, Fred presented a training seminar on fiduciary responsibility to the Federal Retirement Thrift Investment Board on February 22, 2005.

Marty wrote an article entitled "What is a Pick-up Plan and Who Cares?" for the Fall 2005 issue of *Plan Horizons*. Fred and Bruce co-wrote an article for the Winter 2005 issue of the *Journal of Pension Benefits* entitled "Fiduciary Rules Applicable to '(b)' Plans." Fred also wrote a column for the September 2004 issue of *Plan Sponsor* magazine on the subject "'B' Ware: Mind Your 'b's' as well as your 'k's'."

Bruce is a member of the Tax Exempt and Government Entities Sub-Committee of the American Society of Pension Professionals and Actuaries (ASPPA) Government Affairs Committee.

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