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19TH ANNUAL CLIENT CONFERENCE

**HYATT PIER 66
FORT LAUDERDALE, FLORIDA**

MARCH 19-22, 2017

FEDERAL AND TAX OUTLINE

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FEDERAL AND TAX ISSUES

- I. WHAT IS THE DIFFERENCE IN NORMAL RETIREMENT AGE FOR IN-SERVICE DISTRIBUTIONS AND THE EARLY DISTRIBUTION PENALTY UNDER SECTION
 - A. In-Service Distribution and IRS Bulletin 2016-17
 1. Announced in January and issued on February 16, 2016.
 2. Maintains a safe harbor age of 62 but added additional measures.
 3. Non Public Safety Measures
 - a. Age 60 with 5 years.
 - b. Age 55 with 10 years
 - c. Rule of 80
 - d. 25 years at any age
 4. Public Safety
 - a. Age 50
 - b. Rule of 70
 - c. 20 years at any age
 5. Facts and circumstances test still available

C. The Full Text of the Proposed Regulation

§ 1.401(a)–1 Post-ERISA qualified plans and qualified trusts; in general.

* * * * *

(b) * * *

(2) * * *

(v) Rules of application for governmental plans—(A) In general. In the case of a governmental plan (within the meaning of section 414(d)) that provides for distributions before retirement, the general rule described in paragraph (b)(2)(i) of this section may be satisfied in accordance with paragraph (b)(2)(ii) of this section or this paragraph (b)(2)(v). In the case of a governmental plan that does not provide for distributions before retirement, the plan’s normal retirement age is not required to comply with the general rule described in paragraph (b)(2)(i) of this section or this paragraph (b)(2)(v).

(B) Age 60 and 5 years of service safe harbor. A normal retirement age under a governmental plan that is the later of age 60 or the age at which the participant has been credited with at least 5 years of service under the plan is deemed to be not earlier than the earliest age that is reasonably representative of the typical retirement age for the industry in which the covered workforce is employed.

(C) Age 55 and 10 years of service safe harbor. A normal retirement age under a governmental plan that is the later of age 55 or the age at which the participant has been credited with at

least 10 years of service under the plan is deemed to be not earlier than the earliest age that is reasonably representative of the typical retirement age for the industry in which the covered workforce is employed.

(D) Sum of 80 safe harbor. A normal retirement age under a governmental plan that is the participant's age at which the sum of the participant's age plus the number of years of service that have been credited to the participant under the plan equals 80 or more is deemed to be not earlier than the earliest age that is reasonably representative of the typical retirement age for the industry in which the covered workforce is employed. For example, a normal retirement age under a governmental plan that is age 55 for a participant who has been credited with 25 years of service would satisfy the rule described in this paragraph.

(E) Service-based combination safe harbor. A normal retirement age under a governmental plan that is the earlier of the participant's age at which the participant has been credited with at least 25 years of service under the plan and an age that satisfies any other safe harbor provided under paragraphs (b)(2)(v)(B) through (D) of this section is deemed to be not earlier than the earliest age that is reasonably representative of the typical retirement age for the industry in which the covered workforce is employed. For example, a normal retirement age under a governmental plan that is the earlier of the participant's age at which the participant has been credited with 25 years of service under the plan and the later of age 60 or the age at which the participant has been credited with 5 years of service under the plan would satisfy this safe harbor.

(F) Age 50 safe harbor for qualified public safety employees. A normal retirement age under a governmental plan that is age 50

or later is deemed to be not earlier than the earliest age that is reasonably representative of the typical retirement age for the industry in which the covered workforce is employed if the participants to which this normal retirement age applies are qualified public safety employees (within the meaning of section 72(t)(10)(B)).

(G) Sum of 70 safe harbor for qualified public safety employees. A normal retirement age under a governmental plan that is the participant's age at which the sum of the participant's age plus the number of years of service that have been credited to the participant under the plan equals 70 or more, is deemed to be not earlier than the earliest age that is reasonably representative of the typical retirement age for the industry in which the covered workforce is employed if the participants to which this normal retirement age applies are qualified public safety employees (within the meaning of section 72(t)(10)(B)).

(H) Service-based safe harbor for qualified public safety employees. A normal retirement age under a governmental plan that is the age at which the participant has been credited with at least 20 years of service under the plan is deemed to be not earlier than the earliest age that is reasonably representative of the typical retirement age for the industry in which the covered workforce is employed if the participants to which this normal retirement age applies are qualified public safety employees (within the meaning of section 72(t)(10)(B)). For example, a normal retirement age that covers only qualified public safety employees and that is an employee's age when the employee has been credited with 25 years of service under a governmental plan would satisfy this safe harbor.

(I) Reserved.

(J) Other normal retirement ages. In the case of a normal retirement age under a governmental plan that fails to satisfy any safe harbor described in paragraph (b)(2)(ii) of this section or this paragraph (b)(2)(v), whether the age is not earlier than the earliest age that is reasonably representative of the typical retirement age for the industry in which the covered workforce is employed is based on all of the relevant facts and circumstances.

(vi) Special normal retirement age rule for certain plans. See section 411(f), which provides a special rule for determining a permissible normal retirement age under certain defined benefit plans.

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(4) Effective/applicability date. * * * In the case of a governmental plan (as defined in section 414(d)), the rules in paragraph (b)(2)(v) of this section are effective for employees hired during plan years beginning on or after the later of: January 1, 2017; or the close of the first regular legislative session of the legislative body with the authority to amend the plan that begins on or after the date that is 3 months after the final regulations are published in the Federal Register. However, a governmental plan sponsor may elect to apply the rules of paragraph (b)(2)(v) of this section to earlier periods. * * *

D. Why Does this Matter?

1. Large numbers of employers are rehiring retirees without a true break in service.
2. In such cases, where employees are also receiving retirement benefits, an “in service distribution” issue is presented exposing the rehired employees to early

distribution penalties under Code Section 72.

E. A Discussion of “Independent Contractor” vs. Employees

1. The difference “fact dependent.”
2. The IRS has established a 20 part test.
3. Most rehired retirees are not contractors

II. SECTION 72 AND EARLY DISTRIBUTION

A. What Does Section 72 Provide?

1. If a benefit distribution is given to a member who separates from service prior to a certain age, there is a 10% penalty in addition to any ordinary income tax on the benefit.
2. The Pension Protection Act lowered the age for public safety employees to age 50 if the employee separated from service in or after the year in which the employee attained age 50. In such cases, the penalty does not apply.
3. For other public employees the penalty does not apply if the employee separated in or after the year in which they attained age 55.
4. If the employee separated prior to these dates, the early distribution penalty applies until attainment of age 59 ½.

B. Does This Affect DROP distributions?

1. If the DROP account is converted to an annuity based on life expectancy, there is never an early distribution penalty.
2. Regular retirement payments in substantially equal payments for life do not incur the penalty.
3. A rollover to an IRA or other qualified plan is not a distribution, but, once rolled over, is governed by age 59 ½.

III. IS DROP A DB PLAN OR A DC PLAN, WHY DOES IT MATTER?

- A. The IRS has opined that DROP is not a separate DB plan; it is a distribution method within a DB Plan.
- B. When DROP is distributed, the plan actuary must calculate the DROP as if it was an annuity payable over the life of the member. The value of that hypothetical annual payment is added to the annual forward retirement benefit. If the sum of the two equals or exceeds the limit in Section 415(b) of the Internal Revenue Code, there must be an excess benefit arrangement to pay the difference.
- C. The Tax Code limitations only relate to what the plan can pay; it is unrelated to the obligation of the employer to pay the full benefit earned. That obligation is a matter of state constitutional law.
- D. If DROP was a DC plan, the maximum amount payable into the DROP would be the DC contribution limit (\$54,000 per year) in Section 415c of the Internal Revenue Code.

IV. Federal Cases of Interest

A. *U.S. v. Seabrook*, 661 Fed.Appx. 84 (2d. Cir 2016)

A New York City Councilman transferred City funds to co-conspirators in a mail and wire fraud case. The Council member did not himself receive the funds. The funds were not recoverable from the co-conspirators. As a result, a federal criminal restitution order was directed to the Councilman's own funds and his pension was forfeited. The council member's claim that his pension was protected by the state constitution was rejected under the Supremacy Clause of the U.S. Constitution which was held to take precedence over a state constitution on a matter regulated by Congress.

B. *Cranston Firefighters v. Raimondo*, 2017 WL 899948 (D. R.I. March 7, 2017)

In 2011, the State enacted prospective reductions of pension benefits to address large unfunded liabilities. The service retirement age was increased, COLAs were reduced or delayed, final average salary went from the highest single year to the highest five year average, and the multiplier was lowered for future service. In 2016, a state trial court held in a lawsuit challenging the changes that the contract clause was not violated because the reductions were made for "a significant and legitimate public purpose." That state case is on appeal in the Rhode Island Supreme Court.

In 2014, a federal action was filed claiming violation of the federal contracts clause and the takings clause (loss of property without just compensation). In 2015, certain state court claims were settled involving retirees. The Cranston firefighters claimed they

were not part of the settlement. The federal court held that they should have appealed the settlement in the state court and dismissed the federal claim challenging the settlement. As to impairment of contract and takings claims, the Court dismissed those allegations without prejudice pending the results of the state appeal, finding it should abstain from taking jurisdiction. Lastly, the federal court found that the employee unions had failed to establish that the “pension contract” was intended to prevent prospective changes.