



Mendocino County Employees' Retirement Association

Next Steps: IRS Determination Letter and VCP
Compliance Statement

Board of Retirement Meeting

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For Discussion Today

New IRS determination letter (“DL”) and VCP compliance statement received by MCERA dated January 29, 2014

- What does receiving MCERA’s favorable determination letter mean?
- What does receiving MCERA’s VCP compliance statement mean?
- What did MCERA agree to do as a condition for the IRS honoring the determination letter and the VCP compliance statement?
 - Corrections applying to the all ’37 Act systems operating under the CERL
 - Corrections applying to MCERA-specific errors
- Next Steps for MCERA/Board of Retirement

MCERA's Favorable Determination Letter

What does your DL say?

- “We have made a favorable determination on the plan identified above based on the information you have supplied.”
- “Continued qualification of the plan under its present form will depend on its effect in operation. See section 1.401-1(b)(3) of the Income Tax Regulations. We will review the status of the plan in operation periodically.”

What does the DL mean?

- The DL is based on the information provided. We disclosed all of the items that presented tax qualification issues with respect to the CERL. Based on MCERA's review of its operations, MCERA disclosed all the issues specific to the system that we were aware of at the time of the filing.
- MCERA's letter is based on full disclosure—can rely on it for any problematic issues raised, most of which applied to all '37 Act systems.

What does the DL mean? (Con't)

- Does not cover operational issues--Operational issues that were identified are covered by the VCP compliance statement
- Retain copies of all information forwarded to the IRS as part of MCERA's permanent records.
- Must continue to operate in compliance with IRS rules to remain tax-qualified
- “We will review the status of the plan in operation periodically.”
 - Means IRS may do audits and compliance checks

What does your DL say?

- “This letter may not be relied on after the end of the plan’s first five year remedial amendment cycle that ends more than twelve months after the application was received. This letter expires on January 31, 2014.”
- “This letter considered the 2009 Cumulative List of Plan Qualification Requirements.”

What does that part of the DL mean?

- Does not cover changes that the IRS has announced since those that were required for the last Cycle C filing (due 12/31/11).
- Before each filing Cycle IRS announces the “Cumulative List” that includes all the changes needed to bring the plan up to date for that filing Cycle. (MCERA’s filing was based on the 2009 Cumulative List.)
- DL expires on 1/1/14 (because these were Cycle C filings).
- BUT, can continue to rely on the letter dated 1/29/14 if MCERA meets the requirements for delayed filing for governmental plans under Rev. Proc. 2012-50.

Requirements to Have Protection During Period From 2/1/14-1/31/16 (Rev.Proc. 2012-50)

- Must “demonstrate” timely compliance with the required changes that are effective beginning February 1, 2014 (i.e. starting with Cycle C requirements), and each year as any changes become effective, up to having to show compliance with all of the requirements for the Cycle E filing due on January 31, 2016.
- Must be a review of any required changes each year, and a determination of how MCERA (and other '37 Act systems) will deal with them (i.e. required change to '37 Act or amendments to regulations or a new model regulation).
- Work through SACRS to establish process to produce annual review and recommend changes prior to end of each year.
- File new DL application by January 31, 2016.

What does your DL say?

- “This determination is subject to your adoption of the proposed amendments submitted in your letter dated 12/30/2013.”

What does that part of the DL mean?

- This letter was provided information requested by the IRS in its review and addressed changes requested by the IRS in our negotiations, including changes to the original language submitted on vesting under the CERL.
- These letters specifically responded to the IRS suggestion that we request the IRS agree to the changes to Section 31485 of the CERL to reflect the new felony forfeiture provision added under PEPRA, since this was changing the original amendment to the CERL we had submitted.

What does your DL say?

“The proposed amendments should be adopted on or before the date prescribed by the regulations under Code section 401(b).”

What does that part of the DL mean?

- Amendments to the CERL (and model regulations) must be adopted on or before date prescribed under regulations under Code section 401(b) (remedial amendment period):
 - Governmental plan must adopt amendments required by its favorable DL or VCP compliance statement by the 91st day after the last day of the first regular legislative session beginning more than 120 days from the date the favorable DL was issued.
 - MCERA's DL is dated January 29, 2014. The next legislative session beginning more than 120-days from that date will begin on December 1, 2014, and end on November 30, 2016.
 - Technically MCERA thus has until March 1, 2017 – the 91st day after November 30, 2016 – to get the proposed amendments to the CERL adopted (and the model regulations formally approved). If the amendments to the CERL contained in AB 2473 are passed in the next legislative session that deadline clearly will be met. Would be best to have adopted prior to next IRS submission due January 31, 2016.

What does your DL say?

- “This is not a determination with respect to any language in the plan or any amendment to the plan that reflects Section 3 of the Defense of Marriage Act, Pub. L. 104-1.99, 110 Stat. 2419 (DOHA) or U.S. v. Windsor, 133 S. Ct. 2675 (2013), which invalidated that section.”

What does that part of the DL mean?

- Does not deal with DOMA (treatment of same-sex marriage for federal tax law) changes
- IRS guidance on DOMA changes was issued on September 16, 2013 and recent further advice was issued on April 4, 2014.
- Changes required for DOMA have been made to the model regulations included in your materials today for review and later discussion prior to adoption at a future meeting. These and any other “new” changes in IRS rules will be reviewed by the IRS in MCERA’s next IRS filing.

What does the DL say and mean?

- Does not cover other federal(i.e. non-tax statutes) or local statutes.
 - Need to review for compliance with other federal law.
 - For example, DOMA changes. Model regulations for MCERA have been revised accordingly
 - Need to review for compliance with state law (e.g. new PEPRA requirements).
 - For example, we have reviewed for PEPRA changes and revised model regulations for MCERA accordingly

Why Is a Favorable Determination Letter Important?

- In an audit, IRS cannot retroactively disqualify MCERA. Disqualification could mean immediately taxable benefits for all active members (even if benefits are not payable yet) and the trust fund becomes taxable.
- IRS has said it intends to audit governmental plans (informally indicating they will start with plans that did not file for a determination letter).
- In the future, MCERA can use the IRS Self-Correction Process for many types of error corrections, avoiding IRS filing fees and formal VCP process (which we will discuss next). Self-Correction is only available if MCERA has a current favorable determination letter.
- IRS encouraged governmental plans to file and many did. The IRS Commissioner over Tax-Exempt/Governmental Entities in 2008 said that the IRS estimated that one in five employees in the United States is a government employee and governmental plans hold \$3.5 trillion in assets. Thousands of governmental plans have gone through the IRS process, many with issues similar to the '37 Act systems. Now this process will be on-going—and hopefully simpler.

IRS VCP Compliance Statement

What Does Your Compliance Statement Say?

“Enclosed is your compliance statement. A compliance statement constitutes an enforcement resolution solely with respect to certain failures of an employee retirement plan that is intended to satisfy the requirements of the Internal Revenue Code.”

What does that part of the VCP compliance statement mean?

- VCP Compliance Statement covers only those issues disclosed. That's why there was an exhaustive review of the CERL and of all of the operations for each of the '37 Act systems. Everything disclosed by MCERA is covered by the recently issued IRS letters.
- It is an enforcement resolution—meaning that the IRS has agreed with respect to the specific things that were disclosed it will not seek enforcement against MCERA or the other '37 Act systems that had similar disclosures.
- This process was followed by the '37 Act systems and most other governmental plans across the country.

What Does Your Compliance Statement Say?

“At a later date, you may be required to verify that the correction of the failures and any modification of administrative procedures (upon which your enforcement resolution is conditioned) have been timely made.”

What does that part of the VCP compliance statement mean?

- MCERA may (and most likely will) be required to verify that the corrections agreed to in the VCP filing (upon which the enforcement resolution is conditioned) have been timely made.
- MCERA may (and most likely will) be required to verify that any modification of administrative procedures (upon which the enforcement resolution is conditioned) has been timely made.
- MCERA's enforcement resolution—meaning the IRS's agreement not to enforce penalties against MCERA—is conditioned upon complying with these requirements—and being able to verify that MCERA did so timely.

What Does Your Compliance Statement Say?

Section I: Describes the Errors Addressed in the VCP Review

- First, description of 10 errors that were CERL errors applicable to all the '37 Act systems
- Second, description of 4 errors that were MCERA-specific

What Does Your Compliance Statement Say? (Cont'd)

Section II: Describes the Corrections for All Errors Addressed in the VCP Review

- First, description of corrections for all 10 errors that were CERL errors applicable to all the '37 Act systems
- Second, description of corrections for the 4 errors that were MCERA-specific

Next, we will review all of the errors and the agreed-upon corrections for MCERA.

CERL Error #1 and Agreed-Upon Correction

- CERL Error #1: “The Plan does not include language required under section 401(a)(7) of the Code that participants must become 100% vested in benefits accrued upon plan termination or the complete discontinuance of employer contributions.”
- Correction of Error #1: “The Applicant will correct the qualification failure by adopting the proposed amendments to the CERL that satisfy the requirements of section 401(a)(7) of the Code.”
- NEXT STEP:
 - Required amendment language included in AB 2473—support adoption through SACRS process.

CERL Error #2 and Agreed-Upon Correction

- CERL Error #2: “The Plan provides for a reasonable good faith interpretation of section 401(a)(9) of the Code as permitted by the Pension Protection Act of 2006 as applicable to governmental plans. With respect to payments of survivor benefits to other than the surviving spouse and the surviving child of the member, the Plan does not include the basic rules under 401(a)(9) as they apply to governmental plans since CERL does not include provisions that comply with Treasury Regulation 1.401(a)(9)-6, Q&A-2 addressing how life annuities must be paid in these survivor situations in order to satisfy the required minimum distribution requirements.”
- Correction of Error #2: “The Applicant will correct the failure by adopting proposed model regulations in accordance with a reasonable good faith interpretation of section 401(a)(9) of the Code and the Treasury regulations thereunder, as applicable to a governmental plan.”
- NEXT STEP:
 - Adopt required model regulations. Implement any operational changes required.

CERL Error #3 and Agreed-Upon Correction

- CERL Error #3: “The Plan provides the required limitation under section 401(a)(17) on the amount of compensation that can be taken into account for purposes of computing benefits. The language used in the CERL to adopt the grandfathered section 401(a)(17) rules did not take into account that a retirement system could operate on a calendar year basis.”
- Correction of Error #3: “The Applicant will correct the failure by adopting the proposed amendments to the CERL and the proposed model regulations which will ensure compliance with 401(a)(17) of the Code as applicable to a governmental plan.”
- NEXT STEP:
 - Required amendment language included in AB 2473—support adoption through SACRS process AND adopt required model regulations.

CERL Error #4 and Agreed-Upon Correction

- CERL Error #4: “The Plan was not amended to comply with the requirements of section 401(a)(31) of the Code under the Unemployment Compensation Amendments of 1992 ("UCA") regarding rollover distributions or the requirements of section 402(c) of the Code regarding accepting eligible rollovers in the Plan or the Economic Growth and Tax Relief Act of 2001 ("EGTRRA") regarding the expansion of the definition of eligible retirement plans to include 403(b) and 457(b) plans until 2009. CERL §31685.2 allows nonmembers who are a party to a domestic relations order to obtain a refund of the accumulated contributions in his or her separate account under the plan but does not provide that these alternate payees may make rollovers from a system as required by section 402(c) and Treasury Regulation § 1.402(c)(2), Q&A-12(a).”
- Correction of Error #4: “The Applicant corrected the qualification failures by: (1) adopting CERL § 31485.15, effective January 1, 2009 and (2) agreeing to adopt the model regulations which provide the rules regarding rollover distributions and accepting rollover contributions effective September 22, 2009.”
- NEXT STEP:
 - Adopt model regulations. CERL 31485.15 already adopted.

CERL Error #5 and Agreed-Upon Correction

- CERL Error #5: “The Plan provides health benefits to retirees but does not contain the plan language required by section 401(h) of the Code.”
- Correction of Error #5: “The Applicant will correct the qualification failure by adopting the proposed amendments to the CERL and the proposed model regulations that satisfy the requirements of section 401(h) of the Code.”
- NEXT STEP:
 - Required amendment language included in AB 2473—support adoption through SACRS process AND adopt required model regulations.

CERL Error #6 and Agreed-Upon Correction

- CERL Error #6: “The Plan includes a provision that may violate USERRA rules regarding granting service credit applicable to qualified military service in a plan that does not provide for mandatory employee contributions.”
- Correction of Error #6: “The Applicant will correct the qualification failure by adopting an amendment to the CERL deleting the provision not in compliance with USERRA.”
- NEXT STEP:
 - Required amendment language included in AB 2473—support adoption through SACRS process.

CERL Error #7 and Agreed-Upon Correction

- CERL Error #7: “The Plan incorporates section 415 of the Code by reference but does not set out the detailed provisions of section 415 that are required or optional under section 415, including not explicitly providing the actuarial equivalence factors, which plan will be "primary" in the case where a member participates in more than one defined benefit plan of the employer, and the treatment of any benefits that may be subject to the defined contribution limits.”
- Correction of Error #7: “The Applicant will correct the failure by adopting the proposed model regulations that comply with the Code and Treasury regulations issued under section 415(b) and (c) of the Code that are required or optional under section 415 as applicable to a governmental plan.”
- NEXT STEP:
 - Adopt required model regulations.

CERL Error #8 and Agreed-Upon Correction

- CERL Error #8: “The Plan does not comply with the restrictions on distributions before the earliest of death, disability, normal retirement age, severance from employment or plan termination. The following CERL provisions permit distributions prior to these events in certain circumstances: CERL §§ 31486.2, 31489, 31496.7 and 31499.2 (refunds); CERL § 31553 (withdrawals by elective officers; CERL § 31564 (participating district withdrawals); CERL § 31627.2 (refunds of supplemental member contributions); CERL § 31653 (refunds of contributions for military credit); CERL § 31680.1 (temporary reemployment of judges); CERL §§ 3168.2 and 31680.3 (reemployment limitations).”
- Correction of Error #8: “The Applicant will correct the qualification failure by adopting the proposed amendment to the CERL and adopting the proposed model regulations that satisfy the distribution requirements of section 401(a) of the Code.”
- NEXT STEP:
 - Required amendment language included in AB 2473—support adoption through SACRS process AND adopt required model regulations.

CERL Error #9 and Agreed-Upon Correction

- CERL Error #9: “The Plan contains a provision (CERL § 31656) that permits a party other than the employer to make a contribution to the Plan on behalf of an employee who is on authorized leave to serve as an official of a recognized employee bargaining unit.”
- Correction of Error #9: “The Applicant will correct the qualification failure by adopting the proposed amendment to the CERL to provide that only the employer may make contributions to the retirement system on behalf of his or her employee who is on authorized leave to serve as an official of a recognized employee bargaining unit.”
- NEXT STEP:
 - Required amendment language included in AB 2473—support adoption through SACRS process.

CERL Error #10 and Agreed-Upon Correction

- CERL Error #10: “The Plan permits a refund of contributions in violation of the exclusive benefit rule which requires that plan assets must be used for the exclusive benefit of employees and their beneficiaries (CERL § 31564).”
- Correction of Error #10: “The Applicant will correct the qualification failure by adopting the proposed amendment to the CERL to remove the provision permitting refunds of contributions in violation of the exclusive benefit rule.”
- NEXT STEP:
 - Required amendment language included in AB 2473—support adoption through SACRS process.

MCERA Error #1 and Agreed-Upon Correction

- MCERA Error #1: “The Plan did not comply with the requirements of Section 401(h) of the Code and did not pay benefits from an account structured to comply with 401(h). In addition, from June 30, 2002, through June 30, 2006, MCERA credited amounts to retiree health insurance reserves even where MCERA had no excess earnings in violation of CERL 31592.4, which increased MCERA’s unfunded actuarial liability by \$9,557,912.”
- Correction of Error #1: “The Applicant has indicated that it ceased providing retiree health benefits as of August 1, 2011. Up to that date, the Applicant complied with the proposed model regulations, except to the extent disclosed in the VCP filing, that satisfy the requirements of section 401(h) of the Code. Effective October 2011, the Applicant complied with the model regulations. The Applicant will ensure that the \$9,557, 912 in unfunded actuarial liability improperly credited to the retiree health reserves (and not to pension reserves) shall be repaid to the Plan by: 1) crediting the \$658,653 in unused health reserves as of June 30, 2012 to the Plan, and 2) using employer contributions to pay off the remaining balance in amortized installments.”
- NEXT STEP: Verify that \$658,653 is credited to pension reserves and repay the remainder of the \$9,557,912 using the amortization schedule prepared by MCERA’s actuary (using MCERA’s methodology for repaying unfunded liabilities under MCERA)

MCERA Error #2 and Agreed-Upon Correction

- MCERA Error #2: “The Plan failed to revise its 402(f) notices to reflect the law changes made by EGTRRA and the Pension Protection Act of 2006 (“PPA”).”
- Correction of Error #2 : “The Applicant will correct the operational failure by utilizing “safe harbor” 402(f) notice prescribed by IRS Notice 2009-68 for all future distributions.”

NEXT STEP:

- Updated 402(f) notice has been prepared and is being used by MCERA.

MCERA Error #3 and Agreed-Upon Correction

- MCERA Error #3: “The Plan failed to comply with the minimum distribution requirements of section 401(a)(9) of the Code with regard to two Plan participants.”
- Correction of Error #3: “The Applicant corrected the failure by distributing the required minimum distributions plus interest to the affected Plan members.”
- NEXT STEP:
 - Verify and retain substantiation that correction for the 2 affected individuals has been made.

MCERA Error #4 and Agreed-Upon Correction

- MCERA Error #4: “The Plan established incorrect contribution rates for Plan Years ending June 30, 2010, June 30, 2011, and June 30, 2012, which led to member overpayments and employer underpayments of approximately \$290,000, \$275,000, and \$200,000 in the aggregate, respectively, for each of those years. The member contributions consisted of pre-tax salary reduction contributions (employer pick-up contributions under section 414(h)(2) of the Code) and pre-tax contributions made by employers on behalf of members without any reduction in the member’s salary.”
- Correction of Error #4: “The Applicant corrected the failure by: 1) correcting the rates effective January 1, 2012, 2) crediting the excess member contributions to the participating employers with affected members, and 3) reducing required future contributions for those contributing employers with affected members on a dollar-for-dollar basis, provided that these employers directly repay affected members the amount attributable to deductions from the affected members’ salaries.”
- NEXT STEP:
 - Verify and retain substantiation that correction has been made.

Additional CERL Error —Actuarial Assumptions Need To Be Available

- IRS allowed MCERA to provide letters from actuary stating the actuarial assumptions being used to determine the optional forms of benefits
- Going forward, this information needs to be available where participants can have access to the information (e.g. on MCERA's web site)

NEXT STEP: Consider asking actuary to include required information as a page in the valuation that is always posted on MCERA's website. Discussed informally with MCERA's actuary and they agreed would not be difficult to include.

Commitment Regarding Revision of Administrative Procedures

What Commitment Did You Make Regarding Revision of Administrative Procedures?

“The State Association of County Retirement Systems ("SACRS") has established an ad hoc task force to deal with tax compliance. SACRS intends to establish an on-going committee (or modify the charter of an existing committee) to monitor tax compliance issues for all SACRS member plans such as the Plan. This committee will meet at least annually and more often if necessary. It will be tasked to review tax compliance issues and make recommendations for any new CERL or model regulation provisions or changes.”

NEXT STEP: Participate in the SACRS process

Summary Overview – NEXT STEPS

- Review DL and VCP terms today
- Support adoption of AB 2473 changes through SACRS process (Addresses CERL Errors 1,3,5,6,8,9,and 10)
- Review model regulations today with action scheduled to adopt regulations at a later meeting
 - Regulation for Code Section 401(a)(9) (Addresses CERL Error #2)
 - Regulation for Code Section 401(a)(17) (Addresses CERL Error #3)
 - Regulation for Code Section 401(a)(31) and 402(c) (Addresses CERL Error #4)
 - Regulation for Code Section 401(h) (Addresses CERL Error #5)
 - Regulation for Code Section 415 (Addresses CERL Error #7)
 - Regulation for Code Section 401(a) (Addresses CERL Error #8)

Summary Overview – NEXT STEPS

- Verify that all MCERA-specific corrections have been made
 - Verify with actuary that \$658,653 is credited to pension reserves and that the remainder of the \$9,557,912 is repaid to MCERA by the County using the methodology proposed by MCERA's actuary to track repayment under MCERA's method for funding unfunded liabilities over MCERA's amortization schedule (Addresses MCERA Error #1)
 - Verify that MCERA is using updated 402(f) notice for distributions of withdrawals and death benefits (Addresses MCERA Error #2)
 - Verify that minimum distributions have been made to 2 participants over age 70 ½ who did not elect to begin MCERA benefits (including payment of interest on delayed payments) (Addresses MCERA Error #3)
 - Verify that all corrections for contribution rate errors have been made (Addresses MCERA Error #4)

Summary Overview – NEXT STEPS

- Support SACRS committee process that will offer help for compliance with annual IRS changes (Addresses commitment to change administrative processes)
- After Cycle E requirements are published in early 2015, begin preparations for filing by January 31, 2016

Thank You!

- Other Questions Regarding the IRS Process and Next Steps?