SCPP · 2016 Merger Study

FEDERAL LEGAL ANALYSIS

IceMiller
LEGAL COUNSEL

MEMORANDUM

Via Electronic Mail

TO:	**Anne Hall, Senior Counsel** **Washington State Attorney General's Office**
FROM:	**Mary Beth Braitman and Robert L. Gauss** MBB **ICE MILLER LLP**
DATE:	**November 29, 2016**
RE:	**Federal Tax Considerations related to a Potential Merger of LEOFF Plan 1 and TRS Plan 1**

This Memorandum follows-up to our telephone conversation on October 27, 2016 and supplements our draft Memorandum dated September 26, 2016 and November 11, 2016 (which considered certain legal questions raised by stakeholders related to a potential merger of LEOFF Plan 1 with TRS Plan 1 (collectively referred to as the "Plans")). This Memorandum also addresses certain additional questions and/or concerns raised during the SCPP hearing on November 15, 2016.

In particular, this Memorandum will address the federal tax considerations of a merger between two qualified governmental defined benefit plans in accordance with the Internal Revenue Code ("Code") and applicable Treasury Regulations.

I. EXECUTIVE SUMMARY

As will be discussed in greater detail in this Memorandum, under the Code and applicable Treasury Regulations, the term "merger" means the actual merger of assets and liabilities of more than one qualified plan into a single plan where the assets and liabilities are "usable" across the spectrum of merged plans. In order for a merger to be considered "legal" or "valid" for purposes of federal tax law, each participant in the merging plans must receive benefits on a termination basis from the plan immediately after the merger which are equal to or greater than the benefits the participant would have received on a termination basis immediately before the merger. Code §§ 401(a)(12) and 414(l). In this regard, a plan member who has reached normal retirement age or reached other vested status under the merging plans must be vested in his/her accrued benefit as of that date. Finally, in order for a merger to be valid it must comply with the exclusive benefit rule under Code § 401(a)(2). Accordingly, as part of the merger, it must be impossible for any part of the corpus or income of the merged plans to be used for or diverted to purposes other than for the exclusive benefit of the employees or their beneficiaries before there has been a complete satisfaction of all liabilities with respect to employees and their beneficiaries under the Plans.

Based upon our review of Senate Bill ("SB") 6668, we believe SB 6668 is drafted to comply with the Code requirements for a valid merger. Accordingly, and for the reasons detailed in this Memorandum, the merger contemplated by SB 6668 would not be prohibited under the federal tax laws applicable to qualified governmental pension plans.

In order to confirm that the merger would be approved by the Internal Revenue Service ("IRS"), we normally would strongly recommend that DRS and/or the Plans seek a new determination letter on the new merged plan in order to ensure its qualified status under the Code. Unfortunately, the Plans' ability to obtain a new determination letter will be limited by the IRS' new procedures for determination letters for individually designed plans (*see* Revenue Procedure 2016-37). In particular, we believe that a merger could be structured so that a new plan is created by the two existing plans coming together. If such a structure is decided upon, we believe a determination letter request would be accepted by the IRS. Regardless, we also recommend that the Plans and/or DRS seek a PLR to confirm that the merger does not result in any qualification issues for the merged plans and/or tax consequences to any affected members.

II. CONSIDERED MATERIALS

For purposes of this Memorandum, this will confirm that we have reviewed and considered the following information and legal opinions previously submitted to either the Office of the State Actuary ("OSA") or others regarding the current or previously proposed mergers involving LEOFF 1:

1. 2011 LEOFF Merger Study by the OSA.

2. Letter from Mr. Robert Klausner to Mr. Steven Nelsen dated April 26, 2011.

3. Memorandum from Mr. Phil Talmadge to Mr. Dick Warbrouck (President of the Retired Firefighters of Washington) dated May 2, 2011.

4. Letter from Mr. Phil Talmadge to Mr. Dick Warbrouck (President of the Retired Firefighters of Washington) and Mr. Jerry Taylor (President of Retired Seattle Police Officers' Association) dated June 21, 2011.

5. Ice Miller letter to David Nelson at the Washington State Department of Retirement Systems ("DRS"), Anne Hall at the Washington State Attorney General's Office and Aaron Gutierrez at the OSA dated October 5, 2011.

6. Letter from Mr. J.E. Fischnaller to Mr. Matthew M. Smith dated October 22, 2011.

7. Letter from Mr. J.E. Fischnaller to the LEOFF 1 Coalition Board dated January 12, 2012.

8. Letter from Mr. J.E. Fischnaller to the LEOFF 1 Coalition Board dated January 30, 2012.

9. Letter from Mr. Phil Talmadge to Mr. Dick Warbrouck and Mr. Jerry Taylor dated January 31, 2012.

10. Letter from Mr. Phil Talmadge to Mr. Dick Warbrouck (President of the Retired Firefighters of Washington) and Mr. Jerry Taylor (President of Retired Seattle Police Officers' Association) dated February 1, 2012.

11. Letter from Ice Miller LLP to Mr. Aaron Gutierrez (OSA) dated June 13, 2013.

12. Letter from Ice Miller LLP to Mr. Aaron Gutierrez (OSA) dated April 23, 2015.

13. Memorandum from Mr. Phil Talmadge to Mr. Dick Warbrouck dated February 29, 2016.

14. Letter from Mr. Phil Talmadge to Mr. Dick Warbrouck dated February 29, 2016.

15. Letter from Mr. Robert D. Klausner to Mr. Dennis Lawson (President, Washington State Counsel of Firefighters) dated March 4, 2016.

16. The Actuary's Fiscal Note for SB 6668 dated October 27, 2016.

Also, for purposes of our consideration, please know that we have considered DRS's Comprehensive Annual Financial Report ("CAFR") for the year ended June 30, 2015 (this is the most recent CAFR available). In particular, we have considered:

- LEOFF Plan 1 had an actuarial value of assets in the approximate amount of $5.5 billion, it is stated to have a funding surplus of $1.1 billion and a funded ratio of 127%;

- TRS Plan 1 had an actuarial value of assets in the approximate amount of $6.4 billion and a funded ratio of 69%.[1]

Finally, this will confirm our understanding that the Select Committee on Pension Proposals ("SCPP") has been asked to perform an updated study of a potential merger of LEOFF Plan 1 with TRS Plan 1. In this regard, we understand that OSA, the Attorney General's Office ("AG") and DRS have entered into an agreement to provide resources for the study, and that OSA is handling the actuarial analysis of a potential merger for the study. We also understand that SCPP, OSA, the AG's Office, DRS, each of the Plans and the members of each of the Plans collectively want to understand the requirements and/or restrictions for a potential merger for purposes of federal tax law. Finally, we understand that LEOFF Plan 2 also is considering whether a proposal for a merger of LEOFF Plan 1 and LEOFF Plan 2 should be made.

[1] The data regarding the funding and funded status of each plan was as of June 30, 2014, the most recent actuarial valuation date contained in the CAFR (pg. 160). We also understand that the Actuary's Fiscal Note for SB 6668 has not updated either the surplus analysis for LEOFF Plan 1 or the funded status of LEOFF Plan 1 from the analysis in the 2015 CAFR.

III. BACKGROUND

Before responding to the questions you have forwarded to us, we want to consider the possible meanings of the word "merger." As discussed below, under the Code "merger" has a very distinct meaning – it is the actual merger of assets and liabilities into a single plan, where the assets and the liabilities are "useable" across the spectrum of merged plans. This concept is to be distinguished from a number of other transactions. For example, policy makers may wish to consider forms of joint administration of plans, which we have referred to as "consolidation." We are aware that substantial consolidation already exists – for example, DRS administers TRS Plan 1 and LEOFF Plan 1 (among a number of other plans) and the Washington State Investment Board handles the investments for each of the Plans. In this consideration each Plan's assets are strictly assets of each individual Plan – they are not "useable" across the spectrum of consolidated plans. For example:

- LEOFF Plan 1 is a cost-sharing multiple-employer defined benefit plan which was established by the Washington State Legislature during the 1969 session. It covers all full-time, fully compensated, local law enforcement and firefighters who established membership on or before September 30, 1977. The Plan is closed to new members. Based on membership data from the CAFR, there were 120 active members as of June 30, 2014 and 7,607 retired or inactive members. Based upon information provided to us from the AG's Office, we understand there currently are 54 active members and 6,752 retired or inactive members. LEOFF Plan 1 members are eligible for retirement at the age of 50 with five years of service. RCW 41.26.090. Also, members are vested after the completion of 5 years of eligible service. RCW 41.26.170. Based upon information in the CAFR (page 190), for the fiscal year ended June 30, 2015, LEOFF Plan 1 included 19 county and/or municipality employers and 4 other political subdivisions. Finally, LEOFF Plan 1 has certain local disability boards to adjudicate disability claims.

- TRS Plan 1 is a cost-sharing multiple-employer defined benefit plan which was established by the Washington State Legislature during the 1938 session and covers teachers who established membership before October 1, 1977. RCW 41.32.010(31). Eligibility for membership requires service as a certificated public school employee working in an instructional, administrative or supervisory capacity. The Plan is composed of the State of Washington, component units of the State and individual school districts. Based upon information in the CAFR, for the fiscal year ended June 30, 2015, TRS Plan 1 covered the State of Washington and 34 component units of the State, as well as 208 individual school districts. Also, there were 1,824 active members and 35,962 retired or inactive members. Members are vested after the completion of 5 years of eligible service. RCW 41.32.470. Finally, members are eligible for retirement at any age after 30 years of service, or at the age of 60 with 5 years of service, or at the age of 55 with 25 years of service. RCW 41.32.480; WAC 415-112-500.

Under SB 6668, the assets and liabilities of TRS Plan 1 and LEOFF Plan 1 are proposed to be merged specifically to "improve the actuarial soundness of the teachers' retirement system plan 1 . . ." SB 6668 also stated that the Legislature intends that the merger of assets, liabilities and membership will be accomplished in a way which does not impact benefits provided to members of either plan. Indeed, under Section 2 of SB 6668, the assets, liabilities and membership of LEOFF Plan 1 are proposed to be merged into TRS Plan 1. As a result, the current assets and liabilities of LEOFF Plan 1 are proposed to become the assets and liabilities of TRS Plan 1. Importantly, Section 3 of SB 6668 states that "each member of each of these plans is entitled to receive benefits immediately after the merger on the effective date of this section that are equal to the benefits the member would have been entitled to receive immediately before the merger in accordance with plan terms." Further, the merger is proposed to not impact the disability boards established in RCW 41.26.110 for LEOFF Plan 1. In order to entice LEOFF Plan 1 members, Section 6 of SB 6668 establishes that LEOFF Plan 1 members, including inactive vested members, retirees and survivors, shall be eligible to receive a $5,000 lump sum payable on either January 3, 2017 or on the member's retirement date, whichever is later (if there are multiple survivor beneficiaries for a single member, the lump sum shall be divided equally between those survivor beneficiaries).

Finally, the Actuary's Fiscal Note evaluates that the proposed merger potentially results in an expected long-term total employer savings of about $2.1 billion through reduced contribution requirements over the next 25 years for employers of TRS Plan 1 (there are not currently any member or employer contributions required for LEOFF Plan 1 unless the most recent actuarial evaluation report shows the plan has unfunded liabilities). For purposes of the Actuary's Fiscal Note, the Actuary assumed that the LEOFF Plan 1 funding policy would remain in effect. However, the Actuary also discussed the possibility that, under pessimistic projections, remaining LEOFF Plan 1 members and their local employers would be required to contribute 6% of LEOFF Plan 1 salaries if LEOFF Plan 1 drops below its fully-funded status, and that any remaining required contributions would be allocated to the state's general fund.

IV. OVERVIEW OF FEDERAL LAW - MERGER

In this section, we consider the federal tax law requirements for a plan merger – the rules that would apply to any merger of assets and liabilities of two or more governmental plans. (We will not cover the situation where a governmental plan and a nongovernmental plan would merge, as we do not believe that would be pertinent or helpful in the current discussion.)

A. Source of Guidance

Governmental pension plans are subject to certain specific provisions of the Code and related Treasury Regulations. In general, governmental pension plans are not subject to the Employee Retirement Income Security Act of 1974 ("ERISA"). In lieu of ERISA provisions, governmental plans are often subject to pre-ERISA guidance from the Internal Revenue Service ("IRS") on a particular subject (*e.g.*, vesting at normal retirement age). Governmental plans may also follow ERISA provisions by analogy or as a "best practice."

B. Exclusive Benefit Rule

One of the threshold rules in the qualified plan world is the "exclusive benefit" rule. This rule dictates that plan assets cannot be used other than to pay benefits to members and beneficiaries and to pay reasonable administrative expenses. In this regard, Code § 401(a)(2) requires that for a plan to be qualified, it must be "impossible, at any time prior to the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust, for any part of the corpus or income to be . . . used for, or diverted to, purposes other than for the exclusive benefit of the employees or their beneficiaries . . ." *See also* Treas. Reg. § 1.401-2(a). Accordingly, the IRS has held that "funds accumulated under a qualified plan in trust are intended primarily for distribution to employee participants." Rev. Rul. 72-240, 1972-1 C.B. 108. This exclusive benefit requirement applies to all qualified pension plans, including governmental plans, and, therefore, must be considered in any plan merger. It is important to note that the exclusive benefit rule is incorporated into each of the Plans at WAC 415-02-756.

C. Qualified Plan Status

Pre-ERISA guidance provides that only qualified plans under Code Section 401(a) may be merged. Revenue Ruling 67-213. In a merger of governmental plans, it is important to ascertain or confirm the qualified status of each plan prior to the merger, as well as the qualified status of the "surviving" plan.

D. Consideration of Termination Issues

Pre-ERISA guidance also provides that, if the merger results in the termination of one plan, then all accrued benefits under the terminating plan must be 100% vested to the extent that benefits are funded. Code § 401(a)(7)(1974). Whether a plan is terminated is generally a question to be determined with regard to all the facts and circumstances in a particular case. A plan is not considered to be terminated merely because an employer consolidates or replaces that plan with a comparable plan. Treas. Reg. § 1.401-6(b)(1); Rev. Rul. 67-213, 1967-2 C.B. 149. A comparable plan is not necessarily one of the same type, but it is one of the same category (e.g., defined benefit vs. profit-sharing). Rev. Rul. 67-213 (citing Treas. Reg. § 1.381(c)(11)-1(d)(4)). Therefore, in a merger of qualified defined benefit plans, the IRS could find that one (or all) of the merged plans had not terminated, but that determination is based on all the facts and circumstances involved in the merger.

E. Participant Elections

In some cases, policy makers may ask if they could give plan participants the option of whether or not to be part of a merger. Pre-ERISA, it was permissible to give participants the option of moving from one plan to another, so long as there was no option to receive a distribution. Rev. Rul. 67-213. However, at the current time, and as to a governmental plan, giving existing employees a choice among plans will currently not be approved by the IRS if the choice impacts the employees' pre-tax contributions and, as a result, creates a cash or deferred arrangement ("CODA"). Revenue Ruling 2006-43, 2006-35 I.R.B. 329; *see also* PLR

201532036.[2] While we realize there are very few active employees (54 in LEOFF Plan 1 and 1353 in TRS Plan 1), any active employees still would cause problems in terms of the IRS' prohibition on impermissible CODAs. Given the current prohibition and IRS position, we have set this potential approach aside, both because it would not seem to be a useful design in the circumstance and because it would raise issues that would likely significantly impede any resolution.

F. Assets/Liabilities

Pre-ERISA guidance applicable to governmental plans does not provide any specific guidance with respect to the treatment of the merger of assets and liabilities/benefits. Code §§ 401(a)(12) and 414(l) establish merger requirements for private sector plans, which requirements are intended to demonstrate compliance with the exclusive benefit rule. Government plans, such as LEOFF Plan 1 and TRS Plan 1, are not required to follow these merger rules. Treas. Reg. § 1.414(l)-1(a)(1). However, we believe that certain essential elements of these federal laws provide a good road map for a merger of plans and would demonstrate to the IRS the intent of the Legislature to comply with the exclusive benefit rule. We believe it would be difficult for the IRS to make an adverse decision on a merger that satisfied these essential IRS rules.

In this respect, the Code takes a broader position than might be expected. Code § 401(a)(12) provides that, in the case of **a merger, consolidation or a transfer of assets or liabilities, each participant must receive benefits on a termination basis from the plan immediately after the merger or transfer which are equal to or greater than the benefits the participant would receive on a termination basis immediately before the merger, consolidation or transfer**. *See also* Treas. Reg. § 1.414(l)-1(a)(2) (Emphasis added). This treatment is not limited solely to a merger, but also includes consolidation where the assets may be used for the consolidating plans. A "merger" or "consolidation" means the combining of two or more plans into a single plan…. [A] merger or consolidation will not occur if two plans are not combined into a single plan, such as by using one trust which limits the availability of assets of one plan to provide benefits to participants and beneficiaries of only that plan." Treas. Reg. § 1.414(l)-1(b)(2).

A 'transfer of assets or liabilities' occurs when there is a diminution of assets or liabilities with respect to one plan and the acquisition of these assets and/or the assumption of these liabilities by another plan. For example, the shifting of assets or liabilities pursuant to a reciprocity agreement between two plans in which one plan assumes liabilities of another plan is a transfer of assets or liabilities. However, the shifting of assets between several funding vehicles used for the assets of a single plan (such as between trusts, between annuity contracts, or between trusts and annuity contracts) is not a transfer of assets or liabilities. Treas. Reg. § 1.414(l)-1(b)(3).

In accordance with Treas. Reg. § 1.414(l)-1(b)(3), the term "benefits on a termination basis" means the benefits that would be provided exclusively by the plan assets pursuant to

[2] While Private Letter Rulings ("PLRs") are only binding on the taxpayer to whom they are issued, they are instructive on the IRS' views regarding the issues covered in them.

ERISA § 4044 and the regulations thereunder if the plan terminated. Treas. Reg. § 1.414(l)-1(b)(5). As noted above, for governmental plans, the pre-ERISA minimum vesting standards require 100% vesting of benefits accrued to: (i) the date of termination upon normal retirement, (ii) the date of plan termination, and (iii) the date or discontinuance of employer contributions to the plan.

Importantly, based upon WAC 415-02-753(3) "the Plan may only be terminated by action of the legislature and employer contributions must be paid in accordance with state law. In the event the legislature took action to terminate a plan, in whole or in part, or discontinue employer contributions to the plan, any applicable state law and constitutional protections would apply to accrued benefits. In such event, pursuant to the state and federal rules, a plan member's accrued benefit under the plan is nonforfeitable to the extent funded."

G. Benefit Changes

To the extent that a merger results in benefit changes post-merger, there would have to be a state law analysis with respect to pension protections under state law; this would include an analysis of federal and state constitutional protections. From a federal tax law perspective, the accrued benefit of a plan member (at the time of the merger) under the plan must be protected to the extent funded.

H. Plan Terms

A qualified plan must always follow its written terms and conditions, so long as those terms do not violate relevant federal and state law. Thus, any transaction, such as a merger, must be reflected in each involved plan's terms via an amendment. This must be done before the merger occurs. The terms of the merger could be that one plan merges into the other. Alternatively, the terms could be that a new plan is created and both existing plans would merge into the new plan. Separately, the amendment may state whether one or both of the plans are being terminated. Of course, a final analysis of the potential legal issues will depend on the structure of the merger as determined by the Legislature.

I. Taxation

To confirm that the merger of one plan into another does not have a taxation impact on the members, and considering the possibility that the merger could include one overfunded plan with an underfunded plan, we strongly recommend that a PLR be sought from the IRS. The purpose of the PLR would be to confirm that the merger complies with the exclusive benefit rule and the pre-ERISA vesting requirements, and does not result in any adverse tax consequences to the members.

J. On-going Compliance Post Merger

After the merger, the merged plans must be maintained in compliance with Code § 401(a).

K. Consolidation

In the case of consolidation, the exclusive benefit rule must be applied – in that the plan assets of one plan could only be used for the benefit and expenses attributable to that plan.

In a consolidation, the above described issues of maintenance of qualified status, participant elections, and plan terms would still need to be considered. However, consolidation is not necessarily treated the same as a merger - the treatment depends on whether the plan assets of a consolidating plan are available to fund benefits for any other consolidating plan or not, and, therefore does or does not raise issues with regard to vesting and valuation of benefits on a termination basis. *See* Treas. Reg. § 1.414(l)-1(b)(1)(v).

L. Reversion of Excess Assets

Under ERISA, for an employer to accept a reversion of excess assets, the plan must have always provided for such reversion or have been amended more than five plan years before the termination to permit a reversion. ERISA § 4044(d)(2). As a result, under ERISA, an employer is prohibited from amending a plan in conjunction with a plan termination to give excess assets back to the employer if the plan previously provided for a different allocation of excess assets. Even if an excess asset reversion to the employer is permitted, Code § 4980 imposes a tax of 20% of the amount of any employer reversion from a qualified plan. The 20% excise tax may be increased to 50% of the reversion from a qualified plan if the employer does not establish or maintain a qualified replacement plan or the employer does not provide a pro rata increase in the accrued benefits of all qualified participants. Code § 4980(d). However, the ERISA requirements related to plan amendments and the excise tax on a reversion of qualified plan assets to the employer specifically **do not apply to a governmental plan**. Code § 4980(c)(1)(B). As a matter of interest, the Treasury Regulations do specifically recognize that a merger likely would involve a "lower funded plan." Treas. Reg. § 1.414(l)-1(b)(6). These rules are all part of the federal plan insurance provisions of ERISA and the Pension Benefit Guarantee Corporation, and consequently, the parallels and basics are quite different between governmental plans (not covered by the federal plan insurance program) and nonqualified governmental plans. Therefore, we would not anticipate using these provisions in the governmental settings.

Based upon WAC 415-02-753, without further amendment to the Plans by the Legislature, the Legislature could discontinue employer contributions to the remaining/resulting plan as part of the merger. In response to certain questions raised during the SCPP hearing on November 15, 2016, it is important to note that if a merger involving LEOFF Plan 1 included a reduction in employer contributions in the merged plan for TRS Plan 1 employers, such a reduction in employer contributions would not constitute a reversion of excess assets for purposes of either ERISA Section 4044 or Code Section 4980.

V. CONSIDERATION OF SPECIFIC MERGER POSSIBILITIES

Based upon SB 6668 and our discussions with you, we understand that the proposed merger transaction would be one of the following scenarios (we have shown what we assume are the most likely scenarios):

1. Merger of LEOFF Plan 1 and TRS Plan 1

LEOFF 1 → TRS 1 (merger of assets and liabilities; no change in benefits)

TRS 1 → LEOFF 1 (merger of assets and liabilities; no change in benefits)

LEOFF 1 → TRS 1 (new tier with new benefits formula and/or benefit provisions and all assets and liabilities merged)

Under the Pre-ERISA rules, the merger of one plan into another plan would not be considered a termination if a qualified plan is replaced by a comparable plan (a plan of the same type) and so long as the plan assets are not distributed to the members. Therefore, from a termination perspective, it will not matter if LEOFF Plan 1 is merged into TRS Plan 1 (or vice versa), because two conditions are met:

1. Both LEOFF Plan 1 and TRS Plan 1 are the same type of plan – qualified defined benefit plans under IRC Section 401(a); and

2. No distribution will be made of plan assets to current members.

Using Code § 414(l) as a guide, and in accordance with WAC 415-02-753, members must be entitled to receive the same benefit after a merger or transfer of assets as they would have received before the merger. The calculation of those benefits is done on a termination basis. This would be true, under the 414(l) model, where the benefits have to be tested as though there had been a plan termination, even though there is not necessarily a plan termination. This testing of benefits would apply if LEOFF Plan 1 is merged into TRS Plan 1 (or vice versa).

If the merger of the two plans results in a lower cost and thus a lower required contribution rate, federal law would not dictate whether the employers' or the employees' (mandatory) contributions were adjusted. That would be a matter of state law and plan design.

2. Merger of LEOFF 1 and TRS 1 into a New Plan:

LEOFF 1 and TRS 1 → New Plan (new tier(s) with new benefits formula and/or provisions; assets and liabilities merged)

If the two plans were to merge into a single new Plan, policy makers could choose that the benefits could stay exactly the same (two tiers incorporating current provisions), or there could be a new structure with new benefits (for example, all members in the new Plan have the same retirement eligibility, *etc*.)

We understand the Washington AG's office is going to be advising OSA with respect to whether benefits can be changed as part of the merger from a state law perspective, including an analysis of vested rights.

From a federal tax law perspective, a plan member who has reached normal retirement age or reached other vested status under the plan must be vested in his accrued benefit as of that date. It is our understanding that every participant in LEOFF Plan 1 has reached normal retirement age under the terms of the plan and has met all requirements for vesting. If our understanding is correct, then all benefits **accrued to date** for members in LEOFF Plan 1 cannot be changed as part of a proposed merger with TRS Plan 1. To the extent that participants in TRS Plan 1 have reached normal retirement age and met the requirements for vesting, those benefits **accrued to date** also cannot be changed. Therefore, any benefit change that is adopted as part of a merger between LEOFF Plan 1 and TRS Plan 1 could only affect new members (of which there would be none), non-vested members (of which there are very few) and/or vested members (which constitutes virtually all of the members) prospectively with regard to future accruals.

If this approach is taken, we believe there is a good chance the new plan could secure a determination letter, even under the IRS' new restricted determination letter program.

3. Consolidation:

LEOFF 1 and TRS 1	→	New consolidation of administration of benefit plans; no change in benefits; with on-going segregation of assets and liabilities.

From a federal tax law perspective, there would be fewer issues to address – primarily the exclusive benefit rule.

VI. IRS APPROVAL

Finally, if some type of merged or consolidated plan is passed by the Legislature, then we strongly recommend that DRS seek a new determination letter on the new structure in order to ensure the qualified status of the new structure under the Code. Unfortunately, based upon the IRS' recent changes to the determination letter program, this would be dependent on whether a new plan is being created or any plan(s) is/are being terminated as part of the merger. In this regard, whether a determination letter can be requested will have to be done in accordance with the IRS' new procedures for determination letters for individually designed plans (*see* Revenue Procedure 2016-37). We do recommend creating a new merged plan consisting of what had been the LEOFF Plan 1 and TRS Plan 1 plans.

If some type of asset transfer is passed by the Legislature, then we also recommend that DRS and/or the Plan(s) seek a PLR to confirm that the transfer does not result in any qualification issues to the merged plans and/or tax consequences to any affected members. This is not affected by the new determination letter changes, and should be done regardless of whether the determination letter process is available or not.

VII. LEGAL QUESTIONS RAISED BY STAKEHOLDERS OF THE POTENTIAL MERGERS

Considering the background information contained in this Memorandum, we received from you certain questions which were raised and submitted to the SCPP by stakeholders of the

Plans being considered for a potential merger (at least LEOFF Plan 1 and TRS Plan 1, if not also stakeholders from LEOFF Plan 2). Those stakeholder questions and answers are being attached to this Memorandum as Appendix A.

VIII. CONSIDERATIONS RELATED TO SB 6668

Based upon our review of SB 6668, Section 2 of the proposal indicates that the Legislature intends that the merger of assets, liabilities and membership will be accomplished in a way which does not impact benefits provided to members of either plan. Further, Section 3 states that "each member of each of these plans is entitled to receive benefits immediately after the merger on the effective date of this section that are equal to the benefits the member would have been entitled to receive immediately before the merger in accordance with plan terms." In this regard, we note that the merger proposes to retain the disability boards for LEOFF Plan 1, including any official action of those boards. Therefore, to the extent that the LEOFF Plan 1 disability boards are a vested right in accordance with state law, the vested benefit appears to be preserved as part of the proposed merger. Similarly, we note that SB 6668 does not contemplate a distribution of surplus assets from LEOFF Plan 1 (to the state and/or LEOFF Plan 1 participating employers) as part of the merger. Accordingly, in its current form, SB 6668 does not contain a reversion of excess assets. Finally, we note that under Section 15 of SB 6668, the proposed merger is intended to comply with the Code, including Code § 401(a) (which contains the exclusive benefit rule at Code § 401(a)(2)).

Based upon the analysis of the federal tax considerations related to a merger which we are providing in this Memorandum, we believe that SB 6668 is intended to comply with the Code requirements for a valid merger, including Code §§ 401(a)(2), 401(a)(12) and 414(l). Accordingly, and subject to final approval by the IRS, as drafted, the merger proposed by SB 6668 would not be prohibited under the federal tax laws applicable to qualified governmental pension plans.

IX. CONCLUSION

We hope that this Memorandum provides DRS, OSA and the SCPP with pertinent information regarding the federal tax considerations for a potential merger under SB 6668. We welcome the opportunity to discuss these issues with you at the SCPP meetings on November 15, 2016.

APPENDIX A

Question No. 1: What is the purpose of a merger?

Answer No. 1: As discussed in Section IV, under the Code, the purpose of a merger is generally to merge the assets and liabilities of two or more plans into a single plan. As a result, the assets and liabilities become useable across the spectrum of the merged plan.

Question No. 2: Why merge two different entities?

Answer No. 2: The question is somewhat confusing to us because of the use of the word "entities." Assuming that "entities" means plans, we believe the reason a Legislature could be considering a merger would be to consolidate the assets and liabilities of the Plans. Presumably, the fact that LEOFF Plan 1 is a better funded plan (based on the most recent actuarial analysis) and TRS Plan 1 is a lower funded plan (based on the most recent actuarial analysis) is a factor in the Legislature's consideration.

Question No. 3: Why not merge other plans instead? For example:

(a) All state plans into one with the same benefits?

(b) Legislator's pension plan with the Teachers' Retirement System 1 (TRS 1)?

(c) Public Employees' Retirement System (PERS 1), TRS 1, and the Law Enforcement Officers' and Fire Fighters' Plan 1 (LEOFF 1) into one big plan?

(d) Washington State Patrol Retirement System with TRS 1?

(e) Public Safety Employees' Retirement System with LEOFF 2?

(f) LEOFF 2 with TRS 1?

(g) TRS 1 with TRS 2?

Answer No. 3: These questions are better directed to the Legislature as they involve policy decisions.

Question No. 4: How would a merger benefit:

(a) LEOFF 1 members?

(b) Employers?

Answer No. 4: As discussed in Section IV.F. and G., the merger does not automatically result in enhanced benefits for LEOFF Plan 1 members. Whether enhanced benefits will be provided is a determination for the Legislature. As it relates to participating employers, depending on the actuarial analysis of the merger, the merger could result in a long-term cost savings for the employers.

<u>Question No. 5:</u> Why not wait until all benefits are paid out?

(a) What would happen to the surplus after all remaining members have died?

<u>Answer No. 5:</u> "Why not wait until all benefits are paid out" raises a policy decision for the Legislature. However, if the Legislature waited until all remaining members of LEOFF Plan 1 have passed away and all liabilities under the Plan have been satisfied, in accordance with Code § 401(a)(2) and Treas. Reg. § 1.401-2(a), and WAC 415-02-753 and 756, the remaining assets would be returned to the employers involved in LEOFF Plan 1.

<u>Question No. 6:</u> Will the merger be temporary?

(a) *i.e.*, once TRS 1 is fully funded, will they be unmerged?

(b) Would it be like a loan of funds, with interest?

<u>Answer No. 6:</u> As discussed in Section IV.F., a merger is not temporary nor is it like a loan of funds (with or without interest). Instead, the merger results in combining two (or more) Plans into a single Plan. Whether there would be any future separation of the merged plans would be a future decision for the Legislature.

<u>Question No. 7:</u> Benefit improvements.

(a) Can LEOFF 1 and LEOFF 2 be merged to allow enhanced LEOFF 2 benefits like medical benefits, a higher multiplier, or earlier retirement?

(b) Can any excess funding in LEOFF 1 be used to increase benefits for LEOFF 1 members instead?

<u>Answer No. 7:</u> As discussed in Section IV.G., a merger does not automatically result in enhanced benefits for the members of either plan (the plans) being merged. Whether enhanced benefits will be provided is a determination for the Legislature. As discussed in Section IV.F., as a matter of federal tax law, members in a merged plan must be vested and entitled to benefits calculated on a termination basis from the Plan immediately after the merger which are equal to or greater than the benefits the members would have been entitled to on a termination basis immediately before the merger, consolidation or transfer. *See also* Treas. Reg. § 1.414(l)-1(a)(2). For purposes of federal tax law, assuming compliance with the exclusive benefit rule, members must be vested in their benefits, (not in an allocated account balance based on an actuarial equivalent of their benefits).

Finally, as discussed in Section IV.H., the Legislature would have to pass specific amendments to modify the Plans being merged.

B. Legal

Question No. 8: Is a merger legal?

(a) What legal entities control (e.g., Internal Revenue Service (IRS), State Supreme Court)?

(i) What are their respective roles and jurisdictions?

(b) What case law is relevant, and what does it tell us?

(i) Does it prevent/prohibit a merger?

(ii) Will the *Bakenhus* case apply to the new plan?

(c) What are the terms of the contract that exists between LEOFF 1 members and the state?

(i) i.e., what do members have a right to?

(ii) Benefits?

(iii) Funding plan?

(iv) Cash in the trust fund?

(1) Are LEOFF 1 members vested in the money itself?

(2) i.e., is the money being "stolen" from the trust fund?

(d) What laws need to be changed to complete a merger?

(e) What protections exist for vested rights and financial interests of plan participants?

Answer No. 8: Federal law controls the continuation of the qualified status of the plans involved in a merger. The federal law on mergers focuses on the protection of each member's/survivor's benefit payable from the separate plans and from the merged plan. As a matter of federal tax law, and as discussed in Section IV.F., a merger is a combination of the assets and liabilities of two or more qualified defined benefit plans. Accordingly, based upon the IRS' rules, a merger is legal provided that there is compliance with the exclusive benefit rule and, in accordance with Code § 414(l), the members of the merged plans receive the same benefits after a merger or transfer of assets as they would have received before the merger. This rule must be met in order to retain the qualified status of the funds involved. Consequently, federal law covers the vested rights of the members' and individuals' benefits pre and post-merger.

Whether members have a vested right to certain features or assets (the "contract" between LEOFF/members and the state) under each of the Plans, (as opposed to their individual benefits) would require an analysis of Washington State law which is not being provided as part of this Memorandum. As to the questions about case law, based upon our review of the prior legal opinions from other attorneys which we listed in Section II, we anticipate that the State law analysis would include an analysis of the case *Bakenhus v. City of Seattle*, 48 Wn.2d, 695, 296 P.2d 536 (1956) and its progeny.

Question No. 9: Who are the fiduciaries for each plan?

(a) Is the Legislature a fiduciary to both the plan and the general state?

Answer No. 9: Determining who are the fiduciaries of a qualified plan generally is based upon an analysis of common law trust principles and state law requirements. This primarily is because in accordance with Treas. Reg. § 1.401-1(a)(3)(i), one of the requirements for a qualified plan is that the plan assets must be held in trust. We note that RCW 43.33A.030 vests trusteeship of the Plans' assets in the voting members of the State Investment Board. Also, under RCW 41.50.060 the Director of DRS is responsible for the Plans and, under RCW 41.50.077, the State Treasurer is the custodian of funds of the Plans. ERISA § 3(21) defines a "fiduciary" with respect to a plan as a person to the extent (i) the person exercises any discretionary authority or discretionary control respecting management or dispositions of its assets, (ii) the person renders investment advice for a fee or other compensation or has authority of responsibility to do so, or (iii) the person has any discretionary authority or discretionary responsibility in the administration of the plan. Code § 4975(e)(3) defines "fiduciary" (for purposes of prohibited transactions) in essentially the same manner:.

> (3) Fiduciary.
>
> For purposes of this section, the term "fiduciary" means any person who –
>
> (A) exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets,
>
> (B) lends investment advice for a fee or other compensation, direct or indirect, with respect to any monies or other property of such plan, or has any authority or responsibility to do so, or

(C) has any discretionary authority or discretionary responsibility in the administration of such plan.

Based upon these federal definitions, we believe that the IRS would consider DRS, the Washington State Investment Board ("WSIB"), the individual WSIB Board members, the LEOFF 1 Retirement Board, the individual LEOFF 1 Board members, the TRS Plan 1 Retirement Board, the individual TRS Plan 1 Board members, as fiduciaries. In addition, there would be a number of financial and investment related fiduciaries (*e.g.*, registered investment advisors to DRS and WSIB), custodial bank(s), *etc*.) that likely are considered fiduciaries of the Plans.

Question No. 10: Who owns the surplus?

(a) Does case law from Alaska on excess funding show that any surplus belongs to the members?

Answer No. 10: As a matter of federal tax law, unless the plan terms specify otherwise, the employer (or employers) sponsoring the plan generally owns any surplus but only once there has been a complete satisfaction of all liabilities with respect to employees and their beneficiaries under the trust. *See* Treas. Reg. § 1.401-2(b). Plan terms can establish a different structure.

We defer to the Washington state law analysis on whether the Alaska case law would be persuasive to Washington.

Question No. 11: Will there be any direct tax impact on the members?

(a) e.g., will a medically disabled member lose their individual tax exempt status?

Answer No. 11: A merger would not change the tax treatment of any benefits to members of LEOFF Plan 1 (or to the members of another plan with which LEOFF Plan 1 might be merged). So, a LEOFF Plan 1 member who is receiving a service-connected disability benefit which is exempt from federal taxation (whether in whole or in part) would continue to receive the same tax treatment of his/her disability benefit after a merger.

Question No. 12: Are there any other IRS issues?

(a) What would be the impact of an unfavorable opinion by the IRS?

(i) What are the range of outcomes?

(ii) Would the plan members be made whole/held harmless under those scenarios?

(1) If so, how?

(iii) Would the merger be undone?

(1) If so, how?

(b) Does each plan's funded status impact the ability to merge?

Answer No. 12: If the IRS did not approve the merger, the results could range from i) the IRS requiring the Legislature to cease the merger, ii) the IRS requiring the Legislature to make necessary amendments to the merger to address the concern(s) raised by the IRS, to iii) the ultimate penalty by the IRS is disqualification of the underlying plans and/or the merged plan. Disqualification of the underlying plans would be an extreme result, which typically would only be considered if the merger disregarded the exclusive benefit rule or did not provide benefits to participants in the merged plans which were at least equal to or greater than the benefits the members would have received on a termination basis immediately before the merger.

To the extent that any of the involved plans were disqualified by the IRS that would raise an individual taxation issue for the involved members. Whether the affected plan, DRS or the state would reimburse the members or hold them harmless from the potential taxes would depend on legislative action.

Finally, as discussed in Section IV.L., each plan's funded status does not affect the ability to merge. *See also* Treas. Reg. § 1.414(l)-1(b)(6).

Question No. 13: How will the state pay if it needs to defend a merger in court?

Answer No. 13: Whether or not legal expenses incurred to defend a merger in court are appropriate plan expenses or whether they are settlor expenses which should be paid by the State are questions of both federal law and state law. From the federal law perspective, protection of a plan's qualified status could be argued to be a reasonable and necessary expenditure of the affected plan.

We leave the state law analysis to others. We note that RCW 41.50.255 authorizes the director of DRS to pay from the interest earnings of the trust funds of the Plans lawful obligations of the appropriate [retirement] system for legal expenses which are incurred for the purpose of protecting the appropriate trust fund or are incurred in compliance with statutes governing such funds.

Question No. 14: Can you charge separate rates for the different tiers of benefits within a merged plan?

Answer No. 14: Governmental plans, whether or not merged, are able to have different employee and/or employer contribution rates between tiers in the plan.

Question No. 15: Is a plan trust more like an escrow account to pay benefits or a savings/investment account to accumulate funds?

Answer No. 15: A plan trust is neither an escrow account nor a savings/investment account. Rather, it is a trust under Washington State law, governed in part by federal law, in which employee and employer contributions are held and co-invested for the payment of benefits under the terms of the plan.

Question No. 16: Is there a process for appealing or opposing a merger?

Answer No. 16: This is a question of state law.

Question No. 17: Would employers receive refunds for contributions used for members of another system?

Answer No. 17: As discussed in Section IV.L., the Legislature can decide how to handle any excess assets. *See also* Answer Nos. 10 and 34.

Question No. 18: Are plan members trustees or fiduciaries of their plans?

Answer No. 18: In general, no. However, a plan member may be a trustee or a fiduciary in his/her individual capacity. *See* Answer No. 9.

C. Fiscal/Actuarial

Question No. 19: Historical.

(a) How did gainsharing impact TRS 1?

(i) Is that partly why LEOFF 1 is in such good shape and TRS 1 is not?

(b) What is the funding history for each plan?

(i) Who paid what?

(c) Is LEOFF 1 cost sharing the same as other plans?

(i) *i.e.*, did the state only put in 20 percent of contributions?

(d) What would have happened if there had been no general fund contributions to LEOFF 1?

(i) Or the Prior Act systems (*e.g.*, City of Seattle)?

Answer No. 19: These are historical and actuarial questions which are not being addressed by this Memorandum.

Question No. 20(a): Related to a merger.

(a) What is the financial situation before and after?

(i) What does the "surplus" represent?

(1) Is it the excess of funds needed to pay benefits this month? This year?

(ii) Is the surplus "real" or just projected?

(1) How reasonable is the investment return assumption?

(2) What would it look like under alternate scenarios (*e.g.*, 7 percent or 6 percent)?

(iii) If the surplus disappears, would it be too late to insure the LEOFF 1 benefits?

(1) *E.g.*, ensuring payment under a pay-go scenario versus insuring through plan immunization.

(iv) Would a merger be revenue neutral?

Answer No. 20(a): *See* Answer No. 10. Also, the current funding level of each Plan, and whether each Plan has a funding surplus or funding deficit of plan assets necessary to satisfy the benefits obligations under each Plan, is a matter of actuarial analysis. The actuarial analysis will state the assumptions used as part of the analysis. To the extent that a merged plan would have a deficit of total plan assets, *see* Answer No. 20.c. Finally, we do not understand the question as to whether a merger would be revenue neutral. Rather, whether something is "revenue neutral" to a plan typically means that an increased benefit is offset by an increase in contributions (whether employer or employee). In other words, the increased benefit is considered to be revenue neutral because the plan's net revenues remain unchanged (*i.e.* the cost is offset by the increased contributions).

Question No. 20(b):

(b) How might the funds be used?

(i) Clarify: Usable across the merged plan vs. usable outside either of the retirement plans (other obligations).

(ii) Should it be treated like a reserve for LEOFF 1 only?

(iii) Can money be "skimmed out" of the fund during transfer from LEOFF 1 to TRS 1?

Answer No. 20(b): As discussed in Section IV.F., under a merger, a transfer of assets and liabilities occurs when there is a diminution of assets or liabilities with respect to one plan and the acquisition of these assets or the assumptions of these liabilities by another plan. *See* Treas. Reg. § 1.414(l)-1(b)(3). Further, based upon the pre-ERISA minimum vesting standards, if qualified governmental defined benefit plans are merged, they are required, to the extent funded, to have 100% vesting of benefits accrued to the date of merger. Accordingly, if a merger combined LEOFF Plan 1 and another Plan, but the Plan assets of LEOFF Plan 1 were not available to pay for benefits other than for the original members (and beneficiaries) of LEOFF Plan 1, then a merger will not have occurred, and assets of one plan could not be used for payments to members of another plan. *See* Treas. Reg. §§ 1.414(l)-1(b)(1)(v) and 1.414(l)-1(b)(2). If the assets were combined to pay benefits for both plans, there would be a merger, and the federal laws explained above would apply.

In this regard, the assets of LEOFF Plan 1 are not considered "skimmed out" of the LEOFF Plan 1 trust fund. Rather, the assets of LEOFF Plan 1 and TRS Plan 1 remain in the merged plan and are combined into a single trust to pay benefits to all members and beneficiaries of both plans. Treas. Reg. §1.414(l)-1(b)(2).

Question No. 20(c):

(c) What happens in the event of a deficit?

(i) If the funded status were 87 percent, would that mean I only get 87 percent of my current check amount?

(ii) Before merger?

(iii) After?

(iv) Who pays what?

(v) Who will be paid first? (Overlap with legal/admin analysis)

(vi) Could the state default on the pensions?

Answer No. 20(c): As discussed in Section IV.F., as part of a merger, each member must be entitled to benefits on a termination basis from the Plan immediately after the merger or transfer which are equal to or greater than the benefits the member would have been entitled to on a termination basis immediately before the merger or transfer. It is important to note that we are not aware that the merger concept to be used would provide an immediate liquidation of the trusts, which would raise, at least in part, the concept of a reduced benefit. Instead, we anticipate that the members in pay status would continue to receive their full monthly benefits, unless otherwise legally altered by the legislature. These benefits would be paid by the merged plan. Of course, the ultimate funding level of the merged plan and cost of benefits from the merged plan depends on plan earnings, market value of investments and the actuarial experience of the merged plan, including mortality experience. Finally, this answer is ultimately dependent on the analysis of state law issues regarding vested rights.

<u>Question No. 20(d):</u>

(d) Would there be other costs (*e.g.,* admin)?

<u>Answer No. 20(d)</u>: Certainly, it should be anticipated that a merger would have an increase in administrative costs in the short term. However, it also should be anticipated that there may be savings in administrative costs over a longer term because there could be some cost savings in only administering one plan as opposed to administering two separate plans.

<u>Question No. 20(e):</u>

(e) How would a merger impact financial reporting (GASB) for state and local governments?

<u>Answer No. 20(e)</u>: Based on the actuarial analysis of the merged plan, we would expect that the required financial reporting under GASB 67 (for the merged plan) and the required financial reporting under GASB 68 (for the participating employers in the merged plan) would be different than the financial reporting would have been if the merger did not occur.

<u>Question No. 20(f):</u>

(f) Who is constitutionally liable for future benefit payments?

<u>Answer No. 20(f)</u>: The constitutional obligation for future benefit payments under the merged plan is not a matter of federal tax law. Notwithstanding, *see* Answer No. 20.c.

<u>Question No. 20(g):</u>

(g) Are there other options to address TRS 1 underfunding?

<u>Answer No. 20(g)</u>: Whether there are other options to address underfunding in TRS Plan 1 is not a matter of federal tax law. Rather, it is a policy determination to be made by the Legislature.

D. Benefits

<u>Question No. 21:</u> Will benefits be impacted?

(a) i.e., can they be reduced?

(b) Will benefits be increased in exchange for the merger?

(i) Would LEOFF 1 benefits be given to teachers?

(1) e.g., will TRS 1 members receive health benefits similar to LEOFF 1?

(c) Would LEOFF 1 be paying for TRS 1 benefits?

(d) Will it impact rights for Prior Act City of Seattle or Seattle Police Pension Board (which "interprets the rights" for members)?

(e) Will this include survivor benefits?

(f) Will benefits be interrupted (e.g., are there any administrative issues that might delay issuing checks)?

Answer No. 21: *See* Answer Nos. 20.b. and 20.c.

Question No. 22: Will COLAs be impacted?

(a) Can TRS 1 COLA be reinstated without negative impact to LEOFF 1?

(b) Can LEOFF 1 COLAs be modified so as to not be dependent on date of retirement?

Answer No. 22: As discussed in Answer Nos. 8 and 20.c, as part of a merger, each member must be entitled to benefits on a termination basis from the Plan immediately after the merger or transfer which are equal to or greater than the benefits the member would have been entitled to on a termination basis immediately before the merger or transfer. Whether COLAs under LEOFF Plan 1 and TRS Plan 1 are vested rights requires an analysis under Washington State law which is not being provided as part of this Memorandum.

Question No. 23: Will medical coverage be impacted?

(a) LEOFF 1

(i) Source of medical benefit payments?

(ii) Disability boards.

(iii) Can it be provided to spouses?

(b) TRS 1 PEBB subsidy?

<u>Answer No. 23:</u> As discussed in Answer Nos. 8 and 20.c., as part of a merger, each member must be entitled to benefits on a termination basis from the Plan immediately after the merger or transfer which are equal to or greater than the benefits the member would have been entitled to on a termination basis immediately before the merger or transfer. Whether medical benefits under LEOFF Plan 1 and TRS Plan 1 are vested rights requires an analysis under Washington State law which is not being provided as part of this Memorandum.

<u>Question No. 24:</u> Will survivor benefits be impacted?

(a) Are reductions for survivor benefits considered contributions to the plan?

<u>Answer No. 24:</u> *See* Answer Nos. 22 and 23.

<u>Question No. 25:</u> Will LEOFF 1 have priority in benefit payments over TRS 1?

<u>Answer No. 25:</u> As discussed in Section IV.F. and Answer No. 8, based upon the IRS' rules, the members of a merged plan receive the same benefits after a merger or transfer of assets as they would have received before the merger. Each member's/survivor's benefits payable from the separate plans are protected and become payable by the merged plan. Therefore, it would not be appropriate for one of the merged Plan's members to have priority in the payment of benefits after a merger.

<u>Question No. 26:</u> Will I still be considered a "retired police officer" as opposed to a general state retiree?

(a) Does this definition have legal implications (*e.g.*, qualifying for certain benefits) or just personal ones?

<u>Answer No. 26:</u> For the reasons discussed in Answer No. 11, and for purposes of federal tax law, whether a member qualifies as a "qualified public safety employee" under the Code will not be affected by a merger.

<u>Question No. 27:</u> Under SB 6668, could members individually refuse the $5,000 lump sum?

<u>Answer No. 27:</u> Based upon our understanding of SB 6668, there is not a provision to specifically allow LEOFF Plan 1 members to individually refuse the lump sum defined benefit which was contemplated under Section 6. If they have an unrestricted right to the benefit, it does present a question of whether federal constructive receipt concepts would apply. We think the better answer would be that the federal constructive receipt concept would not apply and, instead, benefits would only be taxed when received under Code Section 402. Whether LEOFF Plan 1 members would be eligible to disclaim the lump sum defined benefit would be a State law consideration.

E. Governance

Question No. 28: Will governance be impacted?

(a) Will there be equal representation on the LEOFF 2 Board?

(b) Will LEOFF 1 oversee TRS 1 benefits?

(c) Will LEOFF 2 Board control LEOFF 1 benefits?

Answer No. 28: Certainly, governance of the merged plan is something which should be addressed by the Legislature. Notwithstanding, to the extent that LEOFF Plan 2 is not part of the merger, then, presumably, there would not be any change to the governance and/or administration of LEOFF Plan 2.

F. Other General Questions

Question No. 29: Is this a redistribution of the member's income?

Answer No. 29: For the reasons discussed in Answer No. 20.b., no.

Question No. 30: Would a LEOFF1/TRS 1 merger impact LEOFF 2?

Answer No. 30: For the reasons discussed in Answer No. 28, no.

Question No. 31: Would a LEOFF 3 be created for new hires?

Answer No. 31: This question is better directed to the Legislature as it involves a policy issue.

Question No. 32: Can LEOFF 1 members opt out and "take their money out" entirely?

Answer No. 32: Unless the Legislature decided to change the distribution rights of LEOFF Plan 1 members as part of the merger, the members of LEOFF Plan 1 would be limited to the Plan's current provisions related to the distribution of benefits.

Question No. 33: Is lump sum still on the table? If so:

(a) Some feel it should be higher than $5,000.

(b) Why not pay it now, regardless of a merger?

(c) Employers would like a share.

Answer No. 33: These questions are better directed to the Legislature as they involve policy decisions.

Question No. 34: Can any excess be distributed every few years: one-third state, one-third employer, one-third member?

Answer No. 34: As discussed in Section IV.L., generally the Legislature can decide how to handle any excess assets. However, the IRS likely would not approve a reversion of plan assets **before all obligations were liquidated**. For example, if commercial annuities were purchased for all members/survivors pursuant to the respective plan terms, the IRS likely would determine that after the annuities were purchased, then (and only then) could the Legislature provide for a distribution of excess assets. We do note that SB 6668 does not currently contemplate a distribution of excess assets.

Question No. 35: Even if the overall idea is sound, could a mistake in administration jeopardize benefits?

Answer No. 35: As a matter of federal tax law, mistakes in administration are considered operational failures which can be corrected in accordance with Revenue Procedure 2013-12. The IRS' correction procedures are intended to help qualified plans correct their failures and preserve their qualified status.

Question No. 36: Why not just increase the contribution rates for new members of these plans?

Answer No. 36: This question is better directed to the Legislature as it involves a policy issue.

Question No. 37: Will the state be able to make further changes after a merger (*i.e.* slippery slope)?

Answer No. 37: This question is better directed to the Legislature as it involves a policy issue. Notwithstanding, it should be noted that a merger of the Plans does not necessarily preclude the Legislature from making other plan changes. However, all the federal restrictions would still apply. In other words, the exclusive benefit rule must be followed and the members of the merged plans must receive the same benefits after a merger or transfer of assets as they would have received before the merger. *See* Answer No. 8.

Question No. 38: Could recruitment be impacted by a merger?

Answer No. 38: This is not a question of federal tax law.

Question No. 39: How does a merger benefit taxpayers?

Answer No. 39: This question is better directed to the Legislature as it involves a policy issue.

Question No. 40: Will plan members retain their voting rights in plan governance?

Answer No. 40: *See* Answer Nos. 28 and 57.

Question No. 41: Are pension plans governed by local oversight boards, and will those boards be allowed to vote on a proposal?

Answer No. 41: *See* Answer Nos. 28 and 57.

Question No. 42: Can LEOFF 1 members cash out of the retirement system entirely?

Answer No. 42: *See* Answer No. 32.

G. Concerns

Question No. 43: Benefits should be fully funded.

Question No. 44: Funds should be kept separate – TRS with TRS, etc. – and never go back to the general fund.

Question No. 45: A plan should not be merged with a "lesser" plan.

Question No. 46: LEOFF 1 should be administered locally, and not be "some unknown voice in Olympia."

Question No. 47: LEOFF 1 funding was frozen in 2000 without consent of members.

(a) Some members feel employer contributions should have continued up until now.

(b) Some members feel the remaining active members should have been paying over the last 16 years.

Question No. 48: LEOFF 1 system was forced on city and county plan members.

Question No. 49: LEOFF 2 benefits are already substantially higher than LEOFF 1.

Question No. 50: The LEOFF 1 funded status should never drop below 125 percent.

Question No. 51: Transparency in process.

(a) All stakeholders need sufficient notification of any potential changes or discussions.

(b) Members of the plan should be able to vote since it is their plan and not the Legislature's.

Question No. 52: Dual member provisions for members who leave LEOFF 2 should be reviewed.

Question No. 53: There is no guarantee the state will make required contributions.

Question No. 54: Employers have expressed concerns about medical benefits being expanded.

Question No. 55: Local governments are facing high costs for LEOFF 1 medical.

Answer Nos. 43-55: To the extent that Question Nos. 43-55 are questions, they should be directed to the Legislature as they involve individual policy issues/considerations.

Question No. 56: Any payout must be conditional on IRS approval.

Answer No. 56: For the reasons discussed in Section VI, we agree that approval of a merger should be obtained from the IRS before a merger is finalized.

H. Additional Questions

Question No. 57: Will it require a vote of all members and beneficiaries to agree to the merger before a merger can occur?

Answer No. 57: As a matter of federal tax law, unless the respective Plans' terms specifically require it (which we do not see that they do), a vote of all members and beneficiaries is not necessary to agree to a merger before it may occur.

Question No. 58: Has the Legislature reserved its right to change the pension system?

Answer No. 58: Ultimately, this is a question of state law and, therefore, is not being addressed by this Memorandum.

Question No. 59: Is the LEOFF 2 Board a vested right to which members are constitutionally entitled?

Answer No. 59: Whether or not the establishment of the LEOFF Plan 2 Board is a vested right is not a matter of federal tax law. Rather, it is a matter of state law.

Question No. 60: Is a merger of the two plans, where the merger reduces assets, a violation of members' and retirees' constitutional rights?

Answer No. 60: This is a question which is being analyzed separately by the AG's Office. However, it should be noted that a merger itself cannot inherently reduce plan assets.

Question No. 61: Is there a history of mergers in Washington and have there been any legal challenges to mergers in LEOFF 1? How about in 1970 when LEOFF 1 began?

Answer No. 61: This is not a question which is being addressed by this Memorandum.

Question No. 62: Are one or the other of the plans terminated?

Answer No. 62: Whether one of the Plans is being terminated as part of a merger is a determination to be made by the Legislature as a part of the design of the merger. For purposes of federal tax law, and as discussed in Section IV.D., a merger does not require the termination of one of the Plans being consolidated.

Question No. 63: Do the plan terms prevent a merger?

Answer No. 63: As a matter of federal tax law, we do not believe that the Plans' terms prevent a merger.

Question No. 64: If merger is found to be illegal, how do we un-merge? How do you separate the funds? What will happen to the $xxxx that is given to each LEOFF 1 member/retiree/beneficiary – how are you going to get that back?

Answer No. 64: Because we strongly recommend that both a PLR and an updated determination letter (if a new plan is being created or if one or both of the merged plans are being terminated) be obtained from the IRS as part of the merger, the merger would be contingent on receiving these favorable rulings from the IRS. If this is done, there would not be any concern about having to "unwind" a merger based upon an unfavorable ruling by the IRS.

Question No. 65: Can we get the process underway for IRS review of the merger?

Answer No. 65: It is important to note that the IRS will not issue a PLR on a "hypothetical" situation. Accordingly, a piece of "draft" legislation likely would not be considered by the IRS for purposes of a PLR. Similarly, the IRS will not issue a determination letter on a "hypothetical" basis. Rather, the IRS will only consider a determination letter request based upon an action which has been authorized and/or is in process.