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July 7, 2016

Mr. Thomas Williams
Executive Director
Employees' Retirement System of the State of Hawaii
201 Merchant Street, Suite 1400
Honolulu, Hawaii 96813-2980

Re: Federal Tax-Qualification Issue with SB2077

Dear Thom:

We have reviewed SB2077, as passed by the Legislature this year. We conclude that SB2077 provides an impermissible "cash or deferred election," which would jeopardize the tax-qualified status of the Employees' Retirement System of the State of Hawaii (the "ERS"). Our analysis is as follows:

SB2077

SB2077 offers certain public employees whose employment is subject to Act 103, Session Laws of Hawaii 2015, an election to choose between a voluntary severance benefit and a special subsidized retirement benefit. The voluntary severance benefit would be currently taxable as wages. *See* 2016 General Instructions for Forms W-2 and W-3, p.4 ("Severance payments are wages subject to social security and Medicare taxes. . . . [S]everance payments are also subject to income tax withholding and FUTA tax.")

Federal Tax-Qualification Rules Applicable to the ERS

The ERS is a governmental defined benefit pension plan that must meet the requirements of section 401(a) of the Internal Revenue Code (the "Code") to maintain its status as a tax-qualified plan. The ERS would not meet the requirements of section 401(a) of the Code if it offered a "cash or deferred arrangement" because it is both a defined benefit pension plan and a governmental plan. Code § 401(k)(1) (specifying the type of plans that may offer "cash or deferred arrangements"); Treas. Reg. § 1.401(k)-1(a)(1) ("A plan, other than a profit-sharing, stock bonus, pre-ERISA money purchase pension, or rural cooperative plan, does not satisfy the requirements of section 401(a) if the plan includes a cash or deferred arrangement."); *see also*

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Code § 401(k)(4)(B)(ii) (stating that a governmental plan may not offer a qualified cash or deferred arrangement).

A "cash or deferred arrangement" is "an arrangement under which an eligible employee may make a cash or deferred election with respect to contributions to, or accruals or other benefits under, a plan that is intended to satisfy the requirements of section 401(a) [of the Code]." Treas. Reg. § 1.401(k)-1(a)(2)(i) (emphasis added).

A "cash or deferred election" is:

any direct or indirect election (or modification of an earlier election) by an employee to have the employer either—

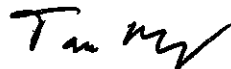
- (A) Provide an amount to the employee in the form of cash (or some other taxable benefit) that is not currently available; or
- (B) Contribute an amount to a trust, or provide an accrual or other benefit, under a plan deferring the receipt of compensation.

Treas. Reg. § 1.401(k)-1(a)(3)(i) (emphasis added).

Since SB2077, as passed by the Legislature, offers an election between a severance benefit taxable as wages and a special subsidized retirement benefit, it offers an impermissible cash or deferred election. This would jeopardize the ERS's tax-qualified status.

Sincerely,

D'AMATO & MALONEY, LLP



J. Thomas Maloney, Jr.

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