

FREQUENTLY ASKED QUESTIONS REGARDING ERS PRIVATE LETTER RULING FROM THE IRS ON ACT 1, 2016

March 16, 2017

1. What is a Private Letter Ruling from the Internal Revenue Service?

Response:

Private Letter Rulings are written decisions by the Internal Revenue Service (IRS) in response to taxpayer requests for guidance. It is a written statement issued to a taxpayer by the IRS that interprets and applies the tax laws to a specific set of facts and binds both the IRS and the requesting taxpayer (in the event the matter is further disputed or litigated), but only those parties.

2. What is Act 1?

Response:

Act 1, which was approved during the Second Special Session of the 2016 Legislature, is intended to assist the employees of the Hawaii Health Systems Corporation ("HHSC") who are separated from State service as the result of the transfer of the HHSC's facilities in the County of Maui to a private entity. Act 1 provides the affected employees the right to choose between a severance payment and a special early retirement benefit.

3. What was the reason for the ERS lawsuit against the State?

Response:

The Board of Trustees of the ERS ("Board") wanted to ensure that the choice of benefits offered by Act 1 did not jeopardize the tax-qualified status of the ERS.

The Board raised concerns that the choice may constitute an impermissible "cash or deferred arrangement" under the Internal Revenue Code and that the existence of the choice, as well as its implementation, puts the ERS's status as a tax-qualified defined benefit governmental pension plan in jeopardy. The Board therefore filed a lawsuit against the State of Hawai'i and the HHSC (*Board of Trustees of the Employees' Retirement System of the State of Hawai'i v. State of Hawai'i et al.*, Civil No. 16-1-1543-08, Circuit Court of the First Circuit, State of Hawai'i) on August 9, 2016 seeking to enjoin the implementation of Act 1 until the requested IRS rulings have been issued. A preliminary injunction staying the implementation of Act 1 was granted on September 28, 2016, pending a Private Letter Ruling from the Internal Revenue Service (IRS) on the impacts of Act 1 on the tax-qualification of the ERS and its members.

4. What did the ERS request from the IRS in the Private Letter Ruling?

Response:

The requested rulings would clarify the impact of Act 1 on the tax status of the ERS and the federal tax treatment of benefits for its members.

The rulings may have an indirect impact on the provision of health care on the County of Maui, and a direct impact on the members of the Retirement System, who constitute 8% of the total population of the State of Hawai'i, and the near 1500 State employees who will be displaced by the transfer of public hospitals on Maui and Lana'i to a private operator.

The Retirement System requested the following expedited rulings;

1. Does Act 1, Hawai'i Second Special Session Laws 2016 ("Act 1"), create a "cash or deferred arrangement"?
2. If Act 1 creates a "cash or deferred arrangement," would this be a tax-qualification failure for the Retirement System under Section 401(a) of the Internal Revenue Code?
3. If this would be a tax-qualification failure for the Retirement System under Section 401(a) of the Internal Revenue Code, what would be the federal tax consequences to the Retirement System and its members and beneficiaries?

5. What was the IRS's response?

Response:

The implementation of Act 1 would jeopardize the tax-exempt status of the ERS and, consequently, the preferable federal tax treatment of its members.

The IRS responded in a ruling dated March 9, 2017, which the ERS received on March 13th. They ruled as follows:

1. If Act 1 were to become effective, it would provide a "cash or deferred election" to the eligible employees. This election would create an impermissible "cash or deferred arrangement" with respect to the Internal Revenue Code's provisions and restrictions for tax-exempt pension plans, such as the ERS.
2. Accordingly, if Act 1 were to become effective and require the ERS to allow for this "cash or deferred arrangement," the ERS would not satisfy the requirements of Section 401(a) of the Internal Revenue Code and would therefore be disqualified as a tax-exempt governmental plan.
3. The IRS declined to rule on the Federal tax consequences to the Plan and its members and beneficiaries of disqualification of the Plan, because such a ruling would

involve facts pertaining to taxpayers other than the Plan and would be hypothetical given that Act 1 is not currently effective and may never become effective.

See the attached copy of the IRS Private Letter Ruling.

6: What does the loss of tax-qualification mean to the ERS?

Response:

The loss of the ERS's tax-qualified status would be catastrophic. The ERS plan is already severely underfunded by \$12.4 billion as of June 30, 2016, and disqualification could further raise its unfunded liability.

The potential consequences to all State and county employees are also severe:

- Current employees would have to pay federal income tax on their employee contributions when the contributions are paid to the ERS instead of deferring taxes until the contributions are distributed to them at retirement or at an earlier termination of employment. Currently, active Contributory and Hybrid members contribute between 6% and 14.2% of their salaries to the ERS.
- All members would be subject to federal income tax on the portion of their accrued retirement benefits that are funded by employer contributions when the benefits become vested, even if the benefits were not yet payable.
- All members would lose their right to the tax deferred rollover of their benefits to other retirement vehicles, such as IRAs.

The loss of the tax deferral described above would represent the loss of the primary federal tax benefits conferred on employees by a tax-qualified plan. In as such as this is an untested area, there may be tax consequences to individuals or to the Plan beyond those noted.

7. How does this ruling on Act 1 affect HHSC Maui employees?

Response:

Based on the IRS ruling, and in order to prevent the disqualification of the plan, the ERS will seek to have the First Circuit Court declare Act 1 to be null and void retroactive to its effective date (July 20, 2016). If Act 1 is declared null and void or is permanently stayed by the court, the severance or special retirement benefits provided by Act 1 will no longer be available to transitioned employees of HHSC Maui. They will, however, still retain and be entitled to benefits accrued without Act 1 provisions – regular and early retirement, vested retirement, refunds, etc.

An alternative to prevent Plan disqualification would be for the Hawaii State Legislature to repeal Act 1 retroactive to its effective date.