

**FREQUENTLY ASKED QUESTIONS REGARDING
EMPLOYEES' RETIREMENT SYSTEM vs. STATE OF HAWAII and the HAWAII
HEALTH SYSTEMS CORPORATION**

Date: August 9, 2016

1. What is the lawsuit that the Employees' Retirement System (ERS) filed against the State of Hawaii?

Response:

The ERS filed a lawsuit against the State of Hawaii to protect the tax-qualified status of the ERS and the retirement benefits of its almost 120,000 members. The ERS sued (1) to stop Act 1, Second Special Session Laws of Hawaii ("Act 1") from taking effect unless the United States Internal Revenue Service confirms to the ERS that Act 1 does not cause the ERS to violate the requirements of the Internal Revenue Code for a governmental plan that is a tax-qualified defined benefit pension plan; and (2) to declare Act 1 to be unconstitutional if Act 1 causes the ERS to violate the requirements of the Internal Revenue Code for tax-qualified governmental defined benefit pension plans.

For details, please see the attached copy of the Complaint filed in the State of Hawaii's First Circuit Court.

2. Why is the ERS Board of Trustees ("Board") listed as the Plaintiff in this case?

Response:

The law that established the ERS gave the Board the responsibility and authority for the administration and operation of the ERS and for making effective the provisions of the ERS law to provide retirement allowances and other benefits for State and county employees. The Board is comprised of eight elected and appointed Trustees who have sworn to support and defend the Constitution and laws of the State of Hawaii. The Trustees believe that Act 1 threatens the ability of the ERS to provide the benefits that were promised to its members and that are protected by the Hawaii Constitution. The Trustees believe that, in order to fulfill the Board's responsibilities, they must file this lawsuit to protect the ERS and its members and beneficiaries.

3. Why is the ERS filing a lawsuit against the State of Hawaii?

Response:

When the Legislature passed Senate Bill 2077 during the 2016 legislative session, the ERS asked the Governor to veto the bill because the ERS believed that the bill could cause the ERS to violate the requirements of the United States Internal Revenue Code (the Internal Revenue Code). Although the Governor vetoed the bill, the Legislature

overrode the Governor's veto and caused the bill to become law as Act 1, Second Special Session Laws of Hawaii 2016. The purpose of the lawsuit is to stop Act 1 from taking effect unless the United States Internal Revenue Service confirms that Act 1 does not cause the ERS to violate the Internal Revenue Code and, as a result, cause the ERS to lose its tax-qualified status.

4. What is the effect of Act 1 on the ERS?

Response:

If Act 1 causes the ERS to violate the Internal Revenue Code, the ERS could lose its "tax-qualified status."

5. Why does the ERS believe that Act 1 could cause a violation of the Internal Revenue Code?

Response:

Act 1 allows employees of the Hawaii Health System Corporation's Maui Regional facilities, whose State employment is terminated when the facilities are transferred to a private entity, to choose between receiving either a severance payment or a special retirement benefit. The Internal Revenue Code provides that a governmental plan that is a defined benefit pension plan, such as the ERS, may not offer "a cash or deferred arrangement." The ERS's tax lawyer advised the ERS that the choice, provided by Act 1, between a severance payment or a special retirement benefit is an impermissible "cash or deferred arrangement" under the Internal Revenue Code that could jeopardize the tax-qualified status of the ERS. A copy of the letter from the ERS's lawyer is attached.

6. What does tax qualification mean?

Response:

In order to be "tax-qualified," a pension plan must meet the requirements of Internal Revenue Code (IRC) section 401(a). The ERS has sought to meet those requirements and has tax-qualified status. Because of the ERS's tax-qualified status, the ERS and its members are entitled to favorable federal tax treatment. For example, ERS members do not have to include contributions made to the ERS as part of their taxable income until they receive a distribution from the ERS. Federal taxation may also be deferred (postponed) when an ERS member's contributions are "rolled-over" to another qualified plan, such as an IRA.

7. What would be the effect of the ERS losing its tax-qualified status?

Response:

First of all, please note that loss of tax qualification by a state governmental defined benefit pension plan is uncharted territory. To the ERS's knowledge, no public pension plan has lost its tax-qualified status. Most states make every effort to remain in compliance with the requirements for tax qualification.

The loss of the ERS's tax-qualified status would be catastrophic. The ERS plan is already severely underfunded by \$8.8 billion, and disqualification could 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.

8. What is the ERS requesting in this lawsuit?

Response:

The ERS is asking the State court to delay the effect of Act 1 so the ERS can seek guidance from the IRS. The IRS may consider the issues and respond by a "private letter ruling" to the ERS. This is the only definitive response acceptable to the ERS.

If the IRS rules that any portion of Act 1 would disqualify the ERS plan, the ERS is asking that the Court declare Act 1 to be unconstitutional and to permanently stop Act 1 from going into effect.

9. What is the effect of the ERS lawsuit with regards to Maui Regional HHSC employees affected by Act 103/2015?

Response:

The lawsuit is not intended to stop the transfer of the Maui Regional facilities. However, unless the IRS determines that Act 1 does not adversely affect the tax-qualified status of the ERS, the ERS does not plan to take any action to implement Act 1.