



GROOM LAW GROUP

CHARTERED

**Crosscheck<sup>sm</sup> Review**

**For State of Nebraska Public  
Employees Retirement System**

**Defined Benefit Plans  
for School Employees,  
Judges and State Patrol**

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# EXECUTIVE SUMMARY

## OVERVIEW

The Nebraska Public Employees Retirement System (“PERS” or the “System”) engaged Groom Law Group, Chartered and The Segal Company to perform an independent review of the Internal Revenue Code (“IRC”) §401(a) defined benefit retirement plans, IRC §401(a) defined contribution plans and IRC §457 deferred compensation plan and the administrative operations and practices of the System and to determine whether it meets standards set forth in the plan documents and determining the level of compliance with applicable federal laws.

The plans covered under this review are:

- Nebraska School Employees’ Retirement System
  - Defined Benefit Plan
- Nebraska Judge’s Retirement System
  - Defined Benefit Plan
- Nebraska State Patrol Retirement System
  - Defined Benefit Plan
- State Employees’ Retirement System\*
  - Cash Balance Benefit
  - Defined Contribution Benefit
- Retirement System for Nebraska Counties\*
  - Cash Balance Benefit
  - Defined Contribution Benefit
- Nebraska State Deferred Compensation Plan

\* We note that, for IRC purposes, the defined contribution plans for State and County employees participating on January 1, 2003 who elected to remain members in such defined contribution plans are treated together with cash balance plans of which they are a part as single plans in accordance with IRC §414(k) (for example, for IRS determination letter filing purposes those systems have been treated as one State Employees plan and one County plan).

The project included the following phases:

### **Phase 1: Information Collection**

In the initial phase, we requested numerous documents for each plan, including the plan document, statutes, summary plan description, forms, written procedures and other plan-related documentation. This documentation was reviewed to provide the team with a high-level understanding of each plan's provisions, which is key to our understanding for our evaluation of the administration processes that are required for each plan.

A workbook with questions specific to the type of plan, was then completed prior to the on-site interviews and used as a guide during the interview process. The purpose was to determine whether the actual responses with respect to administration supported what the plan documentation states.

### **Phase 2: Administration and Compliance Review**

The on-site visit was conducted on December 13, 2011 through December 15, 2011. We met with:

- Phyllis Chambers - Director
- Jason Hayes – Legal Counsel
- Randy Gerke – Deputy Director & Accounting/Finance Manager
- Theresa Zulauf – Internal Auditor
- Dennis Cooper – Data Services
- Sheila Linder – Administrative Assistant
- John Winkelman – Education Services
- Fred Turner – Technology Manager
- Miden Ebert – Benefits Manager

David W. Powell of Groom Law Group and Melanie Walker and Sue Thompson of the Segal Company conducted these interviews.

As a result of our discussions with PERS staff and observations from our interviews, we were able to obtain information about the various administration processes and systems used by PERS.

### **Phase 3: Executive Summary**

The Executive Summary provides our findings with respect to the issues we observed and the basic recommendations that we are providing to PERS about such issues.

This report documents our understandings and observations of the various functional areas of plan administration as those areas relate to the plan documents and required operational compliance with federal laws governing the administration of qualified retirement plans. Our analysis is based on our conclusions drawn from the information gathered throughout the project, our experience working with other plan administrators, and best practices.

Our goal is to ensure that we provide PERS with an objective review of the current administration (i.e., work processes and compliance) and technological environments at the time of the site visit.

We thank PERS for once again selecting us to conduct this project and look forward to discussing our findings and recommendations.

As a result of our compliance review, we conclude that the PERS retirement plans are substantially in compliance with the requirements under IRC §401 and related Treasury Regulations and other applicable federal laws.

The statutes and other plan provisions (principally regulations and the Benefits Manual) have some minor defects and do not include some language which, while not required under the Internal Revenue Code, will be required in order to obtain a favorable determination letter. While we have identified some changes which need to be made to the statute and it may be desirable to prepare draft legislation, the System may wish to consider whether to introduce any such legislation after the IRS has accepted the language changes as part of the determination letter process, to avoid having to make further changes.

Furthermore, our review has uncovered some areas of noncompliance in operation that should be corrected. While we note that, as a technical matter, even a minor failure to comply with a provision of the qualification requirements of §401(a) - including failure to follow the plan document, i.e., the statute, even if the plan provision is not required by the IRC - may cause a plan to fail to be qualified for tax purposes, correction mechanisms sanctioned by the IRS, including self-correction, may be used to avoid any significant adverse tax consequences.

We have identified a few areas of administration of the plans that may be of concern to PERS and could warrant further review and/or modification. Overall, however, it appears that administration of the plans is generally consistent with IRS rules and governing plan documents. During a compliance review of any plan, we have found operational and compliance issues and areas for improvement to the administrative processes. Retirement plan administration is inherently difficult by nature due to the number of constantly changing regulations required to be followed. While our report does identify several compliance-related operational issues, the majority of issues identified in this report relate primarily to administrative processes.

## SECTION 1. ISSUES AFFECTING THE SYSTEM OVERALL

Since the last compliance review of the System and its plans in 2001, there have been numerous changes in the IRC requirements for qualified plans by legislation, and an even greater number of changes in regulations and other administrative guidance from the IRS. In 2007, in particular, new Internal Revenue Service (“IRS”) procedures for the submission and handling of requests for determination letters on qualified plans were implemented, and in general the IRS began to strictly and narrowly apply timing rules for the adoption of plan amendments. In 2008, the IRS began a “Governmental Plans Initiative” to review issues with respect to governmental plans and devote more attention to a number of issues, such as the governmental plan definition and the definition of normal retirement age in governmental plans. Most of our comments grow out of these changes in the federal tax environment for governmental plans since 2001.

**Terms used to refer to the plans.** This report refers to the five qualified plans administered by the System as the State Employees, County, School Employees, State Patrol and Judges plans, each being referred to as a “plan”, and collectively as the “plans”. The defined contribution plans for State and County employees participating on January 1, 2003 who elected to remain members in such defined contribution plans are treated together with the cash balance plans of which they are a part are considered single plans in accordance with IRC §414(k), consistent with how they have been filed with the IRS for determination letters (i.e., there is one State Employees plan and one County plan).

### 1. Participation by Certain Employers and the Definition of Governmental Plan for IRC and ERISA Purposes.

Generally, under IRC §414(d) and a substantially parallel provision under ERISA section 3(33), all participating employers in a governmental plan must be a State, a political subdivision of a State, or an agency or instrumentality of a State or political subdivision of a State. There has been some vagueness in the term agency and instrumentality of a State or political subdivision of a State, and the Department of Labor (“DOL”) has in the past indicated that a de minimis number of plan participants who are not employed by such an employer may be acceptable. In the course of the review, we inquired as to whether any participating employers may raise a question as to whether they fit within the 414(d) definition.

At least two types of entities were identified as to which there may be some question, the Stuhr Museum and certain County authorities. Neither of these is expressly mentioned in the County plan statute. We understand that the museum and County authorities took the position in the past that their employees are County employees, and that even if employees of the separate entities, those entities are eligible to participate in a governmental plan. More recently, however, we understand that the Counties in question have advised the System that they may no longer be treating these plan members as County employees.

This raises two questions: first, are these employees eligible for participation in the County plan under the terms of the statute, and second, even if they are, are they eligible to participate in the County plan under IRC §414(d). Neb. Rev. Stat. §23-2302 provides that the County plan is for employees, which is defined as persons or officers who are employed by a county of the State of Nebraska. Neb. Rev. Stat. §23-2301(10). Thus, if the Board concludes

that these have not been County employees, then unless the statute is amended, there appears to be no basis for their having accrued benefits under the County plan for such period as they were not County employees. Further consultation may be necessary in this event to determine the best method for correcting such an error.

Second, even if these persons were determined by the System to be eligible to participate under the Nebraska Statutes, there is little clear authority on whether these employees are County employees or whether these are entities eligible to participate in a governmental plan for purposes of IRC §414(d). Further, even if the test itself were clear, it is a facts and circumstances determination. Recently, the IRS issued a Notice of Proposed Rulemaking (the “Notice”) in this area. If proposed rules along the lines of the Notice were adopted, there could be additional uncertainty as to whether these employees were eligible to participate in the County plan under the IRC. Moreover, as currently proposed in the Notice, failure of even one of these employees or entities to be eligible to participate in a governmental plan would cause the County plan to be disqualified for tax purposes, because the Notice currently indicates that the rule will not allow a de minimis number of nongovernmental employees to participate in a governmental plan, with certain exceptions not relevant here. That de minimis rule has in the past been viewed as something of a “safety valve” so that the status of every single participant in a plan being a governmental employee and every single participating entity being an agency or instrumentality of a State or political subdivision of a State within the meaning of the Internal Revenue Code was not essential to the plan being a governmental plan.

At this point, because there has only been a Notice of Proposed Rulemaking, actual proposed regulations have not yet been issued, let alone finalized, there may well be many changes from the Notice to the proposed and then final rule (a process likely to take years), and there is likely to be reasonable transition relief, if the System were to conclude that the employees in question were correctly participating in the County plan under the Nebraska Statutes, we would not advise making a change in the inclusion of these entities and their employees at this time. However, the System should monitor the area and be prepared to respond to eventual final IRS guidance on the definition of governmental plan if and when issued, and it is possible some changes in eligibility for the plans may be necessary at that time. The System may also wish to consider making comments to the IRS on these specific types of entities under the proposed regulations.

## 2. Timeliness and Completeness of Plan Amendments.

The five plans were submitted to the IRS for updated determination letters in August, 2008 as part of “Cycle C”, the first filing period for governmental plans as part of a new regular 5-year filing cycle for qualified plans established pursuant to Rev. Proc. 2007-44. The plans had previously received favorable IRS determination letters dated July, 2004 (January, 2005 in the case of the State Employees plan) for laws up to the Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”).

At the time of these submissions in August 2008, the IRS “Cumulative List” of IRC requirements for documents filed for Cycle C was contained in Notice 2007-94. At that time, the IRS had traditionally been lenient should they request that additional language be added to a

qualified plan to satisfy its criteria to be issued a favorable IRS determination letter. (We note that there has long been a difference between what language the IRC requires a plan to contain to be tax qualified under IRC §401(a) versus what language the IRS may administratively require to issue a favorable determination letters. Because such letters, which are rulings, are discretionary with the IRS, they have traditionally required more information to be contained in the plan document than that which might merely be required to avoid adverse tax consequences.)

In recent years, however, the IRS has become stricter as to what language it requires to be in a plan document, and has begun to more narrowly enforce what are referred to as the “remedial amendment” rules as to when a plan amendment must be executed. This has led, in our experience, to much more negotiation with the IRS as to amending plans, public and private, in the course of IRS review of determination letter applications. This is particularly true for governmental plans, and one of the main points of contention between governmental plans community and the IRS arising out of its “Governmental Plans Initiative” begun in 2008 has been the difficulty of amending a public plan given the unique nature of governmental plans, structured under statutes, regulations and other authority, unlike a traditional private sector plan. In our experience, issues of the sufficiency and timing of amendments has also been inconsistently applied to different plans by the IRS, due, we believe, to the discretion and expertise of different reviewers.

Consequently, even though the System has not yet been contacted by an IRS reviewer on any of the five submissions in 2008, one of the items we have reviewed is issues that we believe may be raised by the IRS reviewer as part of that process, which will look at changes in the law through the end of Cycle C (January 31, 2009). In addition, we have reviewed required changes since the end of Cycle C which the IRS may raise in the future.

A. Possible Issues in the Current Cycle C Submission.

i. Amendment for Final 415 Regulations. Amendments for the final regulations under IRC §415 were issued in April 2007 and effective for plan years beginning after July 1, 2007. The IRS takes the position that plans submitted in Cycle C should be compliant with the final 415 regulations for the Cycle C filing, even though the amendment deadline was generally not until March 15, 2009.

Technically, the IRS allows the 415 limits to be incorporated by reference; they do not have to be stated in detail. See EP Quality Assurance Bulletin FY 2010-2, Dec. 7, 2009. The plans have relied upon references in Title 303, Chapter 17, “Regulations Governing The Public Employees Retirement System - Administration of Internal Revenue Service Code Section 415” to satisfy those requirements. That cross-reference may be sufficient for IRS purposes, but that is not clear; we note that, at the time of the submission, the regulation did not address the following:

a. The treatment of the defined contribution plans under State and County employees. The regulation only refers to defined benefit plans in the title.



b. The definition of compensation used for testing (which is relevant only for the defined contribution plans). There are several alternatives, though there is also a default.

c. Whether COLAs are taken into account for applying the limit on the defined benefit plan – essentially, whether, if a retiree's benefit is limited by the 415(b) limit, their benefit can increase each year if the IRS limit increases for cost of living. Though perhaps currently moot since no one has exceeded the limit to date, under the 2007 415 regulations, the IRS limit cost-of-living increases do not apply unless the plan specifically so states. As a result, many public plans have been expanding their 415 language to so provide.

Since that time, Chapter 17 was revised August 11, 2011 to address these matters and add more complete language regarding the application of the 415 limits.

Recommendation: That the revised Title 303, Chapter 17 be submitted to the IRS to supplement the current Cycle C submissions currently pending. We intend to assert, should the IRS raise the question of whether the prior regulation was sufficient, that it was sufficient under their standard for incorporating 415 by cross-reference.

ii. Eligible Rollover Distributions - After-Tax Rollovers under EGTRRA. EGTRRA allowed for after-tax contributions to qualified plans to be rolled over in direct transfers to 401(a) defined contribution plans (subject to separate accounting) for distributions after 2002. The Pension Protection Act of 2006 (“PPA”) expanded this to distributions to all 401(a), governmental 457(b), and 403(b) plans and for Roth IRAs for distributions after 2006. Although the plans generally provide for pre-tax contributions, after-tax contributions may have been made to purchase past service credit. See, e.g., Title 303, Chapter 15, Section 008.03. The deadline for amending a plan for the PPA was the end of the plan year beginning in 2011.

The provisions regarding rollovers out of the plans (State Employees at Neb. Rev. Stat. §84-1312; Counties at Neb. Rev. Stat. §23-2323.02; State Patrol at Neb. Rev. Stat. §81-2031.03; Judges at Neb. Rev. Stat. §24.710.05, School Employees at Neb. Rev. Stat. §79.933.01) are silent on the treatment of after-tax monies. Arguably that is sufficient for EGTRRA purposes, but it is not clear the IRS would agree.

There is currently language in Legislative Bill 916, which we understand became law in April 2012, to add certain provisions regarding rollovers, discussed in more detail below.

Recommendation: Though arguably sufficient, more complete language on eligible rollover distributions is preferable. Language similar to model language used for private sector plans (for which the rules are substantially similar) could be added to regulations, or the language could be modified in the statute, if possible, to be more complete regarding after-tax contributions.

B. Plan Amendments Post-dating Cycle C.

i. Eligible Rollover Distributions – Pension Protection Act of 2006.

With respect to the PPA changes, Legislative Bill 916 added references to Roth IRAs and nonspouse beneficiaries in those referenced sections. We note that these similar rollover provisions are, however, lacking an express statement that a member may elect to rollover all distributions that are eligible rollover distributions (along the lines of “a distributee may elect to have any portion of an eligible rollover distribution paid directly to an eligible retirement plan specified by the distributee in a direct rollover”), though the IRS also did not object to that in the 2004-2005 determination letters, which may extend certain protections against the IRS raising any qualification sufficiency of the language under IRC §7805(b).

The remedial amendment period under EGTRRA was extended to the end of the initial applicable five-year remedial amendment cycle by Section 1.03 of Rev. Proc. 2007-44. Originally this was Cycle C, but the IRS also allowed governmental plans to file in Cycle E (ended January 31, 2011), and though not entirely clear, this seems to have extended the EGTRRA remedial amendment period to January 31, 2011 for governmental plans.

The PPA amendment period for the plans would be June 30, 2012 for the Schools, State Patrol and Judges, but was December 31, 2011 for State Employees and Counties, which we understand to be on a calendar year plan year.

Recommendation: With respect to the timeliness of amendments for the IRC changes in rollover eligible rollover distributions, for the State Patrol, Judges and Schools plans, Legislative Bill 916 became law in April 2012, prior to June 30, 2012, and so was timely. For the State Employees and County plans, however, the IRS could take the position that the PPA rollover provisions are late since they were not adopted prior to the end of 2011. This is correctable by a fairly straightforward filing with the IRS under a Voluntary Correction Program (“VCP”) set forth in Revenue Procedure 2008-50. The VCP filing fee for a late amendment, if the filing is made within one year of the deadline, would be \$12,500 for a plan with more than 10,000 participants (half the usual filing fee). We also suggest that the language could be added or modified in a regulation, which would not require legislative action, and would offer the opportunity to more clearly state that members be able to elect to rollover eligible distributions.

ii. HEART Act Amendments.

The HEART Act requires that governmental plans be amended by the end of the 2012 plan year to provide that survivors of a member who dies while in “qualified military service” are entitled to survivor benefits as if the member had resumed and then terminated employment on account of death. Legislative Bill 916 added such a provision to the plans.

iii. Waiver of RMDs under Defined Contribution Plan for 2009.

Neb. Rev. Stat. §§23-2315, 23-2317(5), 23-2319 and 84-1317, 84-1319(5) and 84-1321 provide language that for members participating in the defined contribution plans, no distribution

was required for the plan year commencing January 1, 2009 through December 31, 2009. This amendment was made prior to the end of the 2011 plan year, by LB 188 in 2009. This was timely, therefore, though we note that it is not the same as the model language provided in IRS Notice 2009-82, shown below. We also note that it was not clear from the statute whether this was elective, and what the default (distribution or no distribution for 2009) was if an election was not made. It is possible, though not clear, that the IRS could object to the sufficiency of the language. It is difficult to predict whether the IRS will do so. However, if a VCP filing for the eligible rollover provisions is made as described above, that could cover this as well, and moot the issue.

[Model language from IRS Notice 2009-82 for an elective provision for a 2009 waiver is as follows:

“Notwithstanding section \_\_\_\_\_ of the plan, a participant or beneficiary who would have been required to receive required minimum distributions for 2009 but for the enactment of section 401(a)(9)(H) of the Code ('2009 RMDs'), and who would have satisfied that requirement by receiving distributions that are (1) equal to the 2009 RMDs or (2) one or more payments in a series of substantially equal distributions (that include the 2009 RMDs) made at least annually and expected to last for the life (or life expectancy) of the participant, the joint lives (or joint life expectancy) of the participant and the participant's designated beneficiary, or for a period of at least 10 years ('Extended 2009 RMDs'), will receive those distributions for 2009 unless the participant or beneficiary chooses not to receive such distributions. Participants and beneficiaries described in the preceding sentence will be given the opportunity to elect to stop receiving the distributions described in the preceding sentence. In addition, notwithstanding section \_\_\_\_\_ of the plan, and solely for purposes of applying the direct rollover provisions of the plan, certain additional distributions in 2009, as chosen by the employer in the adoption agreement, will be treated as eligible rollover distributions.”]

### 3. Compliance with “Pick-up” Requirements of IRC §414(h)(2).

As noted above, in Rev. Rul. 2006-43, the IRS clarified what it believed the requirements to be for a valid “pick-up” of employee contributions to be treated as employer contributions (pre-tax):

a contribution to a qualified plan established by a State government will not be treated as picked up by the employing unit under §414(h)(2) unless the employing unit:

(1) Specifies that the contributions, although designated as employee contributions, are being paid by the employer. For this purpose, the employing unit must take formal action to provide that the contributions on behalf of a specific class of employees of the employing unit, although designated as employee contributions, will be paid by the employing unit in lieu of employee contributions. A person duly authorized to take such action with respect to the employing unit must take such action. The action must apply only prospectively

and be evidenced by a contemporaneous written document (e.g., minutes of a meeting, a resolution, or an ordinance).

(2) Does not permit a participating employee from and after the date of the “pick-up” to have a cash or deferred election right (within the meaning of § 1.401(k)-1(a)(3)) with respect to designated employee contributions. Thus, for example, participating employees must not be permitted to opt out of the “pick-up”, or to receive the contributed amounts directly instead of having them paid by the employing unit to the plan.

For the County plan, the Nebraska statute expressly states that:

Each employee who is a member of the retirement system shall pay to the county or have picked up by the county a sum equal to four and one-half percent of his or her compensation for each pay period. The county shall pick up the employee contributions required by this section for all compensation paid on or after January 1, 1985, and the contributions so picked up shall be treated as employer contributions in determining federal tax treatment under the Internal Revenue Code as defined in section 49801.01, except that the county shall continue to withhold federal income taxes based upon these contributions until the Internal Revenue Service or the federal courts rule that, pursuant to section 414(h) of the code, these contributions shall not be included as gross income of the employee until such time as they are distributed or made available. The county shall pay these employee contributions from the same source of funds which is used in paying earnings to the employee. The county shall pick up these contributions by a compensation deduction through a reduction in the cash compensation of the employee. Employee contributions picked up shall be treated for all purposes of the County Employees Retirement Act in the same manner and to the extent as employee contributions made prior to the date picked up.

Similar language appears for the Judges plan at Neb. Rev. Stat. §24-703(1), for School Employees at Neb. Rev. Stat. §79-958(3) and (4), State Patrol at Neb. Rev. Stat. §81-2017(4) and State Employees at Neb. Rev. Stat. §84-1308(2).

We understand that it is intended that each employing unit treat the contributions as picked up contributions under IRC §414(h)(2). However, we note that the state statute indicates that income tax withholding is to apply “until the Internal Revenue Service or the federal courts rule that, pursuant to section 414(h) of the Code, these contributions shall not be included as gross income of the employee until such time as they are distributed or made available”.

Rev. Rul. 2006-43 states that the formal action to make the pick-up must be made by a “person duly authorized to take such action with respect to the employing unit”. However, the IRS has not addressed whether a state statute can serve as the basis for such a pick-up contribution by a different political subdivision such as a county, i.e., whether the state legislature is authorized to act on behalf of the county, though we believe it is not uncommon for states to take the position that it does. This language is also somewhat vague as to whether Nebraska must obtain a ruling by the IRS that the contributions are picked-up contributions.

As we understand it, the System does not confirm that the local employing units have taken any separate formal action to state as required by Rev. Rul. 2006-43, though it does take efforts to confirm that employees are not allowed to “opt-out” of the pick-up.

Recommendation:

Though the language of Neb. Rev. Stat. §23-2307 is arguably sufficient, we would suggest amending the language to mandate pick-up of employee contributions to more closely conform to the recent language of Rev. Rul. 2006-43. Further, it may be advisable to seek an opinion of the Attorney General as to whether the Nebraska legislature has sufficient authority for those statutes to provide for such pick-ups “on behalf of the employing unit” such that separate actions (e.g., county ordinances) are not required at the employing unit level to meet Rev. Rul. 2006-43.

4. Missing or Unresponsive Participants and Beneficiaries.

Retirement plan administrators often must deal with the problem of missing participants and/or beneficiaries when administering plan distributions. Under ERISA section 404 fiduciary duty rules, plan sponsors and administrators are required to make a reasonable effort to locate missing participants. While ERISA’s specific fiduciary duties do not apply to the Nebraska plans, clearly these rules describe best practices for a retirement plan. Also, qualified plans under IRC §401(a) have a substantially similar duty to make a reasonable effort to locate missing participants when a minimum distribution is required to be paid in accordance with IRC §401(a)(9). Failure to exercise due diligence in administration of the plans with respect to locating missing participants or beneficiaries may lead to a variety of problems, including improper tax reporting, payment of benefits to the wrong person and non-compliance with required minimum distribution rules.

The Department of Labor (“DOL”) provides guidance addressing the obligations of plan fiduciaries with respect to missing or unresponsive participants by setting forth mandatory search methods, additional search methods to consider and distribution options when the participant still cannot be located. This guidance is limited in application to defined contribution plans that are terminating and must distribute all plan assets; however, it is still relevant in describing the elements of a prudent approach to locating missing persons in a retirement plan. See DOL Field Assistance Bulletin 2004-02.

The DOL guidance describes four mandatory search methods when regular first-class mail or electronic notification fails to locate a missing participant: (a) notice sent by certified mail; (b) checking related plan records, such as the employer’s health plan or payroll records; (c) contacting the participant’s designated plan beneficiaries; and (d) using either the IRS or Social Security Administration (“SSA”) letter-forwarding service. Pursuant to DOL Field Assistance Bulletin 2004-02, the expense of using these methods can be charged to the participant’s account if the expenses are reasonable and plan documents provide for such fees. The DOL guidance also describes other search options that plan fiduciaries should consider, such as Internet searches, commercial locator services and credit-reporting agencies. If the cost of using these other search options will be charged to the participant’s account, the plan fiduciary must consider

the size of the account balance in relation to the cost of the search when deciding what options to utilize.

If a participant or beneficiary still cannot be located after reasonable efforts to do so, the plan fiduciaries must decide when and how to distribute benefits on behalf of a missing person. The DOL guidance indicates that if a defined contribution plan participant cannot be located using the search methods, the preferred method of distribution is setting up an IRA for the missing person, in accordance with a fiduciary safe harbor method described in DOL regulations. Other distribution methods described in the DOL guidance include transferring the account balance to an interest-bearing, federally insured bank account in the name of the missing person or transferring the account balance to the state unclaimed property fund. Both of these methods would result in the account becoming subject to applicable income taxes and being reported as a distribution on IRS Form 1099-R, and all of the methods of distribution described in this paragraph can only be utilized if the participant's account is eligible for distribution and the plan either considers the account forfeitable or subject to a forced cashout under the plan rules.

One additional method of distributing the account balance in defined contribution plan would be to forfeit the missing participant's account balance, subject to restoration if the participant is later located, after a reasonable search and a specified number of years. The use of such forfeiture accounts is described in more detail below, and is subject to certain limitations. The methods of distribution for lost or unresponsive participants described in this paragraph are mostly relevant for retirement plans with individual accounts, including a defined benefit plan where the only benefit available to the participant is a lump sum cash refund of contributions. For defined benefit plans, it is common for unclaimed pension amounts to remain in the trust fund, and the trustee is responsible for distributing benefits should the participant be located at a later date.

Based on our discussion with the System staff during on-site interviews, it appears that the System makes a significant effort to locate missing or unresponsive participants and beneficiaries, utilizing various search methods, some that are low cost and some that are commercial services for a fee. However, it does not appear that the plans have a formal, written policy and procedures for dealing with missing person.

Recommendation:

Adopt a formal, written policy and procedures for administering benefits for missing or unresponsive participants and beneficiaries. Such policy and procedures should address, at a minimum, the following elements:

A. Methods of searching for missing persons – A procedure describing search methods, listed in order from first to last resort is advisable. The System should give serious consideration to including in such list some or all of the mandatory search methods described in DOL guidance. The procedures for using the IRS letter-forwarding program are described in Rev. Proc. 94-22, and information about the SSA letter-forwarding program is available at [www.socialsecurity.gov/foia/html/ltrfwding.htm](http://www.socialsecurity.gov/foia/html/ltrfwding.htm). In addition, the search methods utilized should include at least one method of determining whether or not participants are deceased. We understand that many plan administrators consider the commercial locator services to be most effective.

B. Cost of search methods – The System should determine who will bear the cost of utilizing each search method, taking into consideration the size of the account balance and the likelihood of success of each method, and then describe the cost allocation in writing.

C. Timing of search methods – A written policy and procedures for locating missing participants should indicate the timing and frequency of each search method utilized, including a description of each event that will trigger the formal search process.

D. Uncashed checks – It may be advisable to include procedures for handling uncashed or returned checks, as part of a policy for dealing with missing persons. Such procedures should include proactively performing due diligence in determining why the check was returned or uncashed (e.g., individual is deceased or has a new address or there is a typographical error in bank account information) and attempting to reconcile the issue causing the check to be returned or uncashed. The procedures should also dovetail with procedures on locating missing participants and procedures on distributing unclaimed benefits, as those are important means to avoiding uncashed checks.

E. Distributing unclaimed benefits - Currently, it appears the only method for distributing unclaimed benefits is for the plans to transfer amounts to the State of Nebraska's unclaimed property fund, as required by statute. For distribution of individual accounts, including lump sum refunds from the defined benefit plans, the System may wish to consider adopting mandatory distribution provisions for small account balances with automatic rollover to an IRA where a participant is eligible to receive a distribution but does not elect another form of payment. For an ERISA plan, a small account balance can be cashed out if it is \$5,000 or less; however, there is no maximum account balance for mandatory cashouts from a governmental plan, so the plan can determine what account balance is appropriate for cashouts. If the System forces cashouts of account balances greater than \$1,000, in accordance with IRC §401(a)(31), the plan is required to automatically rollover the cashout amount to an appropriately selected IRA to the extent the participant does not affirmatively elect another form of distribution. Alternatively, for the defined contribution and cash balance plans, the System may establish a formal policy which provides for forfeiture of benefits of a missing participant or beneficiary after a specified time period. The forfeited amounts should be allocated to the accounts of remaining participants, subject to restoration should the missing person be located at a later date.

For the defined benefit plans, the System may wish to consider requesting a statutory change whereby unclaimed pension amounts are forfeited after a specified time period but assets remain in the trust fund as an actuarial experience gain, subject to restoration should the missing participant reappear.

F. Correction of errors - To the extent required minimum distributions have not been made in a timely manner due to missing participants or beneficiaries or uncashed checks, corrective actions should be taken as soon as possible. The plans should consider utilizing the IRS voluntary correction program (including the self-correction program) for this purpose, if applicable.

5. IRC §402(f) Rollover Notice.

The System currently utilizes the IRS safe harbor model notice regarding rollovers, as updated by IRS Notice 2009-68, including one notice for the Deferred Compensation Plan and a separate notice for all other plans. The two notices include the IRS model language verbatim, without customization to reflect applicable rules of each individual plan.

Recommendation:

Revise the rollover notices used by the System to more accurately describe the rollover rules under the plans by removing extraneous language that is inapplicable to governmental plans in general, including language referencing ESOPs, employer stock, plan loans and life insurance provisions.

6. Tax Withholding for Non-US Payees.

Based on discussions during on-site interviews with System staff, it does not appear that the plans have procedures in place to prohibit United States citizens living abroad from rejecting income tax withholding. The IRC generally requires that federal income tax be withheld from all pension or annuity payments, unless the retiree specifically elects no tax withholding. However, United States citizens or holders of a valid green card living in other countries are not permitted to reject income tax withholding. Pension plans must send an annual reminder to retirees of their right to change their election with regard to federal income tax withholding.

Recommendation:

Develop and implement a process for ensuring non-US payees of pensions or annuities do not reject federal income tax withholding, including annual notification of affected retirees about federal income tax withholding rules and elections.

7. Death Before Payments Commence.

Based on discussions during our on-site interviews with System staff, there appears to be uncertainty as to how to pay benefits if a member dies after applying for benefits but before actual benefit payments commence. This problem is common for defined benefit plans or defined contribution plans where the standard form of payment is a periodic annuity. Under the Nebraska plans, generally a member's retirement date occurs after he or she both terminates employment and files an application for benefits. However, the distinction between benefits payable upon pre-retirement death or upon post-retirement death is generally described as dependent upon the date benefit payments actually commence.

Recommendation:

The System should consider making a decision as to whether a member's death after filing an application for benefits but before payments actually commence will be treated as a pre-retirement death or a post-retirement death, and distribute benefits accordingly under plan provisions. Based on our experience, governmental plans (both defined benefit and defined contribution plans) most often treat a death in this situation as a pre-retirement death. In fact, many defined benefit plans will consider a death that occurs before the actual payment



commencement date as a pre-retirement death, even where the plan is informed of the death within a reasonable period after payments commenced. In such situation, the plan may adjust future benefit payments to a beneficiary in a manner that is consistent with the interpretation that a pre-retirement death has occurred.

In addition, the System should consider revising statutory provisions that describe both pre-retirement and post-retirement deaths in a manner that is consistent with actual administration of the plans, so that it is clear how the plans will treat a death that occurs after application for benefits but before payments commence.

#### 8. Best Practices of Internal Administration.

The Nebraska Public Employees Retirement System is a very large public entity in both membership (over 100,000 members) and assets (over \$8 billion), as well as a complex system with multiple plan types and plan designs. Overall, the benefits staff at PERS is doing a good job administering and supporting the retirement plans and appears to have the knowledge and skill required to administer a large, complex retirement system. Although the scope of our compliance review does not include a review of the quality of the administrative and technological resources available to the System, we have extensive experience working with and evaluating large public sector retirement systems. To this end, it is our general impression that the System relies heavily on manual processes and the knowledge of individual personnel as compared against industry standards and best practices for large public sector entities. It appears that the System may not utilize technological tools to maximize efficiency and minimize risk to the extent as of other similar systems we are familiar with.

#### Recommendation:

The System may wish to consider conducting a formal evaluation of the System's current administrative processes, staffing structure, operational policies and procedures, and the supporting technological infrastructure and software applications related to the administration of the retirement plans. Such evaluation should utilize the services of experts with comprehensive administration and technology industry knowledge, market insight and experience with retirement plan administrative operations. The purpose of such evaluation would be to ensure that the System is capitalizing on their technological expenditures and maximizing the return on technology investments. Ultimately, an administration and technology evaluation could support the System's efforts to reduce administrative expenses, improve the quality of services to members and increase productivity of the System's staff.

#### 9. Employee Communication

If there are plan changes that require communication with members, they are notified by newsletter or supplemental letter attached with to quarterly statements. Changes are also posted on the website. The changes are communicated to the recordkeeper as well.

The plans' handbooks are generally updated after every legislative session (once a year) on an as needed basis. Supplies of the handbooks are provided to participating agencies and employers, to distribute to new employees upon hire. There is an ad hoc process for distributing

copies of any supplemental communications to the agencies and employers between handbook updates to ensure that new employees are receiving all current communication information.

Recommendation:

Supplies of the supplemental communications should be provided to the various agencies and employers with instructions such information is to be distributed with the handbooks to new employees and existing employees requesting a copy of the handbook. Pursuant to information provided subsequent to our on-site interviews, the System currently notifies employers and agencies when there is an update to a handbook or form, either directly or via newsletter. Also, employers and agencies are given new member packets that informs new employees of all documentation about the appropriate plan or plans, including directing them to the System website so they have access to updated handbooks and forms.

10. Contributions

Some employer contributions come directly into the System (e.g., actual checks not handled via wire transfer), through the mail room and are delivered to the accounting department. The checks are not scanned upon receipt by the System. During the State annual audit, a sampling of transactions are audited. There is no formal process to document the receipt of all incoming checks to the System.

Recommendation:

Formal procedures should be developed for the receipt and disposition of contributions submitted directly to the System. Procedures should include tracking of employers that submit checks to the System to ensure that checks are timely received in the office, maintaining documentation of such checks (e.g., scan upon receipt at the System's offices and procedures for the intake by the mail room staff to the delivery to the accounting department).

## SECTION 2. ISSUES AFFECTING THE DEFINED BENEFIT PLANS (JUDGES, STATE PATROL AND SCHOOL EMPLOYEES)

### 1. IRC §415 Testing.

The System does not maintain a formal IRC §415(b) dollar limit calculation testing and limit process because accrual levels will not generally produce annual benefit levels that would be in excess of the 415(b) limits. While no 415(b) dollar limit violations were identified or are anticipated, a formal testing process has not been conducted to verify compliance.

#### Recommendation:

Conduct a formal 415(b) dollar limit test for retirement benefits for all three defined benefit plans (Judges, State Patrol and School Employees). The test should focus on early retirees before age 62 with relatively long service and highly paid participants. Also, the plans should obtain an actuarial table of 415(b) dollar limits for early retirement to ensure no compliance problems exist. Such formal testing should continue to be conducted periodically in the future.

### 2. DROP Account Issues.

Neb. Rev. Stat. §81-2401 provides for a DROP account, under which, generally, amounts that would be paid as annuity distributions during the deferred retirement period of up to five years will instead be deposited into the DROP account. Upon actual retirement, the amount in the DROP account is paid and annuity payments under the State Patrol plan then commence to be paid to the retiree.

A. IRC §415 Testing. It does not appear that the DROP account is taken into account for 415 testing. However, all distributions from a defined benefit 401(a) plan must be taken into account in the aggregate for such testing. If, as we understand, the State Patrol plan is transferring assets to another 401(a) defined contribution account under the State Patrol plan, such transfers are permissible, and the amount transferred would not have to be treated as a contribution (annual addition) to the defined contribution plan under 415(c), but the transfer to the 401(a) defined contribution plan would have to be tested in the aggregate with other distributions from the State Patrol plan under the 415(b) limitations for defined benefit plans.

B. Nature of the DROP Account. Neb. Rev. Stat. §81-2401 is not clear, but suggests that the DROP account is either a hypothetical account, like the cash balance plan, or an actual account in a defined contribution plan, which if a 401(a) qualified plan would be permissible under IRC §414(k). As noted, we have been advised that the funds are held under the State Patrol plan in separate participant-directed accounts (presumably treated as a defined contribution plan under 414(k)), but the description of that in the statute or regulations is not clear. The handbook for the DROP does not describe what the DROP account is, though it also mentions the Deferred Compensation Plan (the 457(b) plan).

Recommendation:

The System should clarify by statute or regulation how the DROP funds are held and invested, and that they are held under the State Patrol plan in a defined contribution 414(k) account. The DROP portion of the plan should be taken into account and tested for the 415 limits together with the other benefits being paid under the State Patrol plan consistent with the structure of the DROP plan.

3. Review of Creditable Service and Final Average Compensation.

During our on-site interviews, System staff indicated that although they have a rigorous process for reviewing and confirming creditable service and final average compensation amounts at termination or retirement, there are no formal processes in place for identifying inaccurate reporting of contributions, service and compensation from the employers during a member's employment. Members receive an annual statement that indicates service credit and contributions for each year, so that if there is a discrepancy, it is the member's responsibility to inform their employer and/or the System of a problem. System staff indicated that there are few such problems reported in the State Patrol and Judges plans, but they do receive complaints from members of the School employees plan regarding the accuracy of service and contributions reported by the employer.

Employers are obligated to make timely and accurate contributions to the applicable plans. It is the employer's responsibility to ensure that appropriate procedures are in place to identify eligible employees and to initiate applicable payroll procedures to remit the contributions and employment data to the System on a timely basis.

The System staff indicated that they do not follow up with the employer to verify termination of employment or loss of eligibility if the plan stops receiving contributions on behalf of an eligible employee. If the System discovers an employee should have been receiving contributions to a plan, they will develop a make-up agreement with the employer to collect past contributions (both employee and employer) up to two years prior to the discovery. This two-year limit on the period of recovery of contributions is established by statute. The System will allow *employees* to make-up missed contributions for a period longer than two years prior. However, if no contributions are received by employer and/or employee, no service is credited for the period without contributions.

It appears that the System's current processes for verifying creditable service, contributions and compensation information from employers does not provide for timely correction of errors and missed contributions. Consequently, it is possible that employees could work in creditable service and ultimately not receive benefits for that service under the defined benefit plans because contributions were not made for such period of work. A defined benefit plan that does not credit all years of service does not provide definitely determinable benefits as required by Treas. Reg. §1.401-1(b)(1)(i). See also Rev. Rul. 85-130.

Recommendation:

Establish formal processes for verifying information reported by employers at least annually, particularly in the School plan, including periods of employment, contributions and

compensation amounts. Such processes should include a method of reconciling an employee's termination of employment or change in employment status when contributions cease to be reported on said employee's behalf. Consider revising statutory language which limits recovery of missed contributions for a period of only two years. Finally, since it is a qualification requirement under the IRC, the System should provide credit for periods of employment covered by the plan even where contributions are not received. This qualification requirement serves as an impetus for the System to ensure contributions are collected from employers and accurately reported to employees on the annual statements.

We recommend ongoing communication with the employers to reiterate the contribution requirements for the employers and the need for accurate and timely remittance of contributions and employment information to the System and an explanation of the plans' qualification requirements under the IRC to credit appropriate service to employees.

#### 4. Definition of Normal Retirement Age.

In 2007, the IRS issued final regulations regarding permissible normal retirement age definitions for qualified pension plans (See Treas. Reg. §1.401(a)-1(b)). Since then, the IRS has twice extended the deadline for governmental plans to comply with these regulations. Currently, governmental plans must comply with the normal retirement age regulations as of the first plan year beginning on or after January 1, 2013 (See IRS Notice 2009-86). The extensions were provided to give the IRS additional time to address comments on the application of the regulations to governmental plans.

These regulations originally did not permit a normal retirement age based solely on years of service or a combination of years and service where the age may be below 55 (or below age 50 for public safety employees). Such restrictions on normal retirement age under the regulations were problematic for many governmental plans, especially in jurisdictions where state law does not permit reduction of benefits provided under a retirement plan in order to comply with federal laws and regulations. Currently, only the Judges plan explicitly defines normal retirement age in relevant statutes, and that plan defines normal retirement at age 65, which would comply with those IRS regulations issued in 2007. The School and State Patrol plans only describe unreduced retirement at various ages, years of service or combinations thereof, some of which would not have complied with IRS regulations.

On April 30, 2012, though, the IRS issued Notice 2012-29 which states that the IRS intends to modify the 2007 regulations to provide that governmental plans that do not provide for in-service distributions before age 62 will automatically satisfy the regulations, regardless of the plan's definition of normal retirement age or whether it has one. Thus, it does not appear that any change to the plans on this account will be required, though the System should review the modified regulations when issued.

#### Recommendation:

Monitor future IRS revisions to the normal retirement age regulations for governmental plans.

### SECTION 3. ISSUES AFFECTING THE DEFINED CONTRIBUTION AND CASH BALANCE PLANS (STATE AND COUNTY EMPLOYEES)

#### 1. Question of Cash or Deferred Arrangement in Voluntary Part-Time Employee Election to Participate.

Under the State Employees and County plans, pursuant to Neb. Rev. Stat. §84-1307, permanent part-time employees who have attained the age of twenty years may exercise the option to begin participation in the retirement system. Any such permanent part-time employee who exercises that option must remain in the retirement system until his or her termination of employment or retirement, regardless of any change of status as a permanent or temporary employee. The statute does not state when the permanent part-time employee must exercise that option.

As we understand it, in practice, such a permanent part-time employee is permitted to make that election at any time. Prior to the issuance of IRS Rev. Rul. 2006-43, the IRS position did not seem to require any specific timeframe for an election to participate in a plan and have contributions picked up under IRC §414(d), as long as the election was one-time and irrevocable. The IRS had, in fact, issued many private letter rulings to various public plans indicating that such elections late in employment were permissible as long as irrevocable. However, such private rulings can only be relied on by the taxpayer to which they are issued.

In Rev. Rul. 2006-43, the IRS stated that a plan must “not permit a participating employee from and after the date of the 'pick-up' to have a cash or deferred election right (within the meaning of Treas. Reg. §1.401(k)-1(a)(3)) with respect to designated employee contributions.” The IRS has since indicated that this means that the pick-up election must not be a “cash or deferred election” under the cited regulation, which includes a requirement that the one-time irrevocable election must be “made no later than the employee's first becoming eligible under the plan or any other plan or arrangement of the employer that is described in section 219(g)(5)(A) [which includes 401(a), 403(b), and other tax-qualified plans such as the State Employees and County plans]”.

Consequently, it now appears that permitting employees an election to participate or not participate in a governmental plan must be made reasonably contemporaneously with when the employee would first become eligible to join the plan. Though the IRS has not clearly addressed it in this situation, by analogy to other election rules, this would normally mean within 30 days of first becoming eligible to make the election.

#### Recommendation:

That prospectively, any such election to participate or not participate by a permanent part-time employee must be made within the first 30 days of hire. (We note that there is proposed federal legislation to loosen this rule, but its enactment is uncertain.)

2. Question of Cash or Deferred Arrangement (CODA) in Missed Contribution Makeup.

We understand that in some cases, when an employee contribution to the State Employee and County plans is discovered not to have been made and is more than two years late, the System permits the employee to elect whether to make up the delinquent contribution or not. This raises the same cash or deferred election issue as referred to above. IRS correction procedures under Rev. Proc. 2008-50 generally require correction of missed contributions for all open years, with interest or earnings, unless to do so “is unreasonable or not feasible. Even in these situations, the correction method adopted must be one that does not have significant adverse effects on participants and beneficiaries or the plan, and that does not discriminate significantly in favor of highly compensated employees.” Section 6.02(5) of Rev. Proc. 2008-50. One option to correct this issue would be to hold the participating employer liable for any failure to have deducted the employee's contribution from salary and contributed to the plan (and for lost earnings thereon), because the error was caused by the participating employer. Moreover, we note that, under IRC §414(h), for tax purposes, these contributions are considered employer contributions because they have been “picked up” on a pre-tax basis.

Recommendation:

That a policy be adopted to require all missed contributions, with earnings, to be made up unless it is unreasonable or not feasible to do so, and that it not be at the election of the member. Alternatively, or in addition, to the extent not paid by the employee, that the System consider seeking a requirement that the participating employer that failed to collect and remit the missed contributions be made liable to pay those to the plan, with earnings.

3. Exclusive Benefit Rule, Forfeiture Accounts and the Cash Balance Plans.

Under Neb. Rev. Stat. §84-1321(3), vesting in the employer contribution portion of the State Employee's plan generally requires three years of participation.

Neb. Rev. Stat. §84-1321.01(1) provides that such forfeitures are credited to the State Employees Retirement Fund, and then used to pay the expenses of administering the system, with such charges being credited to the State Employees Defined Contribution Retirement Expense Fund if the member participated in the defined contribution plan, and to the State Employees Cash Balance Retirement Expense Fund if the member participated in the cash balance plan.

When a member is rehired prior to having a five-year break in service, the reemployed member may repay all or part of the value of any termination benefit withdrawn, the value of the member's forfeited employer account or employer cash balance account, as of the date of forfeiture, is restored in a ratio equal to the amount of the benefit that the employer has repaid, divided by the termination benefit received. The employer account or employer cash balance account is restored first out of the current forfeiture amounts and then by additional employer contributions. Neb. Rev. Stat. §84-1322(b) and (c). The statute does not appear to address what happens if the member is rehired within the five-year period but has not taken a withdrawal.

Neb. Rev. Stat. §84-1321.01(3) provides that a State Employer Retirement Expense Fund is created, and that the fund is to be administered by the Board. “The fund shall be established and maintained separate from any funds held in trust for the benefit of members under the retirement system. The fund shall be used to meet expenses of the State Employees Retirement System of the State of Nebraska whether such expenses are incurred in administering the member's employer account or in administering the member's employer cash balance account when the funds available in the State Employees Defined Contribution Retirement Expense Fund or State Employees Cash Balance Retirement Expense Fund make such use reasonably necessary.”

Substantially similar provisions apply to the County plan at Neb. Rev. Stat. §§ 23-2319 and 23-2319.01.

The structure of the forfeitures and their use raise several issues:

- A. Holding of forfeitures by the plan. Neb. Rev. Stat. §84-1321.01(1) and (3) (and their County plan counterparts) appear to conflict. One states that forfeitures are credited to the State Employees Retirement Fund and then credited to the State Employees Defined Contribution Retirement Expense Fund if the member participated in the defined contribution plan, and to the State Employees Cash Balance Retirement Expense Fund if the member participated in the cash balance plan, while the other seems to indicate that they are to hold the funds in State Employer Retirement Expense Fund “established and maintained separate from any funds held in trust for the benefit of members under the retirement system”.
- B. Holding of defined contribution forfeitures separate from cash balance forfeitures. It is not clear that the forfeitures from the defined contribution arrangement are held separately from the forfeitures under the cash balance plan, though the statute contemplates that the forfeitures from each are to pay the expenses of the related plan.
- C. Holding of defined contribution forfeitures unused. It is not clear how long the amounts once forfeited under the defined contribution plan are held, either in the State Employees Defined Contribution Retirement Expense Fund or the State Employer Retirement Expense Fund (or their County plan counterparts).

Generally, because of the “exclusive benefit” requirement of IRC §401(a)(2), forfeitures under one plan cannot be transferred to another plan. While the defined contribution plan and the cash balance plan are treated as a single plan for purposes of IRC §414(k), it is not clear that this applies for purposes of IRC §401(a)(2), and we believe the better view is that it does not. In addition, forfeitures under a defined contribution plan can only be used for three purposes: to pay expenses, to reduce employer contributions that would otherwise be paid, or be allocated to member accounts. Further, forfeitures under a defined contributions plan must be used or allocated in the plan year incurred. The IRC does not authorize forfeiture suspense accounts in defined contribution plans to hold unallocated monies beyond the plan year in which they arise.



Rev. Ruls. 80-155, 84-156; Treas. Reg. §1.401-7(a).<sup>1</sup> This rule does not apply to defined benefit plans, though, IRC §401(a)(8) prohibits forfeitures from being used to increase defined benefits otherwise being paid. The IRS has begun to pay more attention to this issue (see, e.g., “The Fix Is In: Common Plan Mistakes - Improper Forfeiture Suspense Accounts” at [www.irs.gov](http://www.irs.gov).)

Recommendation:

We recommend that the statutes more clearly provide for the holding of forfeitures under the plan to which they relate, and that in the case of the defined contribution plan, that they only be used to pay expenses or reduce employer contributions related to that plan, or be allocated as earnings to the accounts of members, and that the forfeiture account be reduced to zero by the end of each plan year. In addition, it would be advisable to clarify that where the member does not take a withdrawal of employee contributions, and so does not have to repay that distribution, all of the employer contribution is reinstated upon reemployment within the five-year period.

4. Exclusion of Certain Clerks from Participation in the State Employees Retirement Plan.

Neb. Rev. Stat. §84-1307(2) provides that “all permanent full time employees” are to participate in the State Employees plan upon employment. However, we understand that the non-career clerks of the Nebraska Supreme Court have not been enrolled in the plan, and that the State Court Administrator had taken the position that it did not have to do so, essentially on the grounds of separation of powers under the State Constitution. If the position of the Court is correct, then presumably the provision of the statute is not being violated, but if the position of the Court is not correct, the State Employees plan is not being operated in accordance with its terms, as required by the Internal Revenue Code.

Recommendation:

We recommend that the System seek a resolution of the question of whether such non-career clerks are excludable from participation in the State Employees plan by opinion of the Attorney General or by a court of appropriate jurisdiction. We understand that the Court Administrator’s office has reviewed this issue and has agreed that such employees are eligible to participate in the plan. The System is currently in the process of bringing these clerks into the State plan.

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<sup>1</sup> We note that these authorities were discussed in the letter to Jason Hayes from Gary Clatterbuck dated July 20, 2011 and certain follow-on emails.

## SECTION 4. ISSUES AFFECTING THE DEFERRED COMPENSATION PLAN

We have the following comments regarding the Deferred Compensation Plan (“DCP”), a 457(b) plan. We would note that, under the so-called “flush language” between IRC §§457(b) and 457(c), there is a special retroactive correction period for governmental 457(b) plans that generally allows compliance errors to be corrected prior to the first day of the first plan year beginning more than 180 days after the IRS notifies the State in writing that the plan has been administered in a manner that is inconsistent with IRC §457(b) or the regulations thereunder. Consequently, correction of any 457(b) errors is a simpler matter than 401(a) plan errors.

1. Post-Termination Pay. We would advise that the DCP document be amended to provide, consistent with the final 415 regulations, that compensation paid after termination of employment can be made the subject of elective deferral if, consistent with Treas. Reg. §1.415(c)-2(e)(3)(ii) and (iii), it is regular compensation for services that, absent the severance from service, would have been paid to the former employee if he or she had continued in employment with the employer (the last paycheck, for example), or payment for accrued but unused bona fide sick, vacation, or other leave that the former employee would have been able to use if employment had continued, to the extent such payments would have been included in compensation if paid before severance, and provided that the payment is made within the later of 2 and ½ months after the employee's severance from service date or the end of the calendar year that includes the severance from service date. See Treas. Reg. §1.457-4(d).
2. Age 70½ limit for Normal Retirement Age. We would advise that the DCP be amended to clarify that the normal retirement age that may be designated by a participant for purposes of the last three-years catch-up cannot be later than 70½. See Treas. Reg. §1.457-4(c)(3)(v) and Section 5(b)(iii)(D) of the DCP. This should be referenced in the DCP handbook as well.
3. Last Three-Years Catch-up Verification. The DCP provides the rules under the last three-years catch-up that the amount of underutilized prior years' maximum contribution limitation which an individual may seek to have made up is determined only with respect to years for which the individual was eligible to participate in the DCP. This is a complex calculation and the System relies primarily on the participant to make the calculation, by having them fill out the “3-Year Catch-Up Provision Worksheet”. The System should verify that the information contained on the worksheet is accurate or verified by the participating employer.
4. Monitoring of 6-month Holdout Following Unforeseeable Emergency Distribution. With respect to distributions on account of unforeseeable emergency under Section 9 of the DCP, we understand that it is possible that the provision of Section 9(e) that employees who take such distributions are required to stop elective deferrals to the plan for 6 months may not be monitored. We would recommend that the System or its third party administrator monitor compliance with the 6-month holdout provision.

5. Allocable Net Income on Return of Excess Contributions. In the case of contributions made to the DCP in excess of the limits of IRC §§457(b)(2) and (3) and 414(v), those would be taxable in the year of the contribution, and they must be returned to the employee “with allocable net income, as soon as administratively practicable after the plan determines that the amount is an excess deferral”. See Treas. Reg. §1.457-4(e)(2). We understand that those are generally being returned prior April 15 of the year following the year of the contribution. However, it is not clear whether income allocable to excess DCP contributions is being determined and distributed, or if so, if it is being reported as taxable for the year of distribution and not treated as an eligible rollover distribution amount.
6. FICA. The DCP handbook and enrollment forms do not mention that FICA is paid on salary reduction contributions to the DCP. See IRC §§3121(a)(5), (v)(2), and IRS Notice 2003-20. We would advise that the System remind the participating employers of this and also refer to it in the DCP handbook.
7. USERRA Make-Up Contributions. Based on discussions during our on-site interviews, it appears that DCP participants may not consistently be offered the opportunity to make-up contributions missed due to qualified military service, as required by the Uniformed Services Employment and Re-employment Rights Act (USERRA). System staff indicated that they have not had any participant make-up contributions under USERRA, even though they have processed make-up contributions under USERRA for the State and County plans. This plan relies on employers to remind returning veterans of their USERRA rights under all plans, including the DCP. We recommend that the System establish processes and procedures to ensure that returning veterans are consistently notified of their rights to make-up contributions under all plans of the System, to the extent applicable. One way to do this is to track employees on military leave as a change of employment status that affects plan eligibility, and then notify employees of their USERRA rights under the plans upon returning to participation in one or more plans of the System. It may also be advisable to provide regular training and communications to employers on USERRA rights under a retirement plan.