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CITY HALL

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MEMORANDUM

TO: All Pension Plan Boards of Trustees
FROM: Christiansen & Dehner, P.A.
RE: IRS Determination Letter - Governmental Defined Benefit Plans
DATE: October 15, 2010

The purposes of establishing a Defined Benefit (DB) plan is generally to reward long-term service with compensation that is not subject to current income tax and employment tax, although income tax may apply upon receipt. A DB plan may only accomplish these goals if it is drafted and operated in accordance with the Internal Revenue Code (IRC) § 401(a) and other applicable IRC sections. As your Board Attorney, we have consistently recommended changes to your plan to maintain the tax qualification requirements. Many of the recommended changes were based on advice that we received from a tax attorney who reviewed our document and suggested changes. While we as attorneys can express our opinion and thoughts on whether a particular DB plan would be found to comply with IRC § 401(a), only the IRS can formally make this determination.

If a DB plan is not drafted and administered in compliance with IRC § 401(a), then amounts contributed are not eligible for the more favorable income and employment tax treatment and the plan sponsor (i.e., the municipality or district) and the plan fiduciaries (i.e., the DB plan board) may be responsible for one or more of the following:

1. Failure to properly withhold income taxes;
2. Failure to properly withhold employment taxes;
3. Failure to timely remit income taxes;
4. Failure to timely remit employment taxes;
5. Late fees, penalties, and interest on each of the above items;
6. Potential sanctions or excise taxes.

Other consequences may be:

1. Members have to pay income tax on the increasing value of their accrued benefit.
2. No pre-tax contributions by members.
3. Income tax would be due on plan earnings.

A plan sponsor or plan administrator can ask the IRS to review its plan document by submitting a request for a “favorable determination letter.” The most significant benefits to obtaining an IRS favorable determination letter on a DB plan document is that (i) the recipient knows that the DB plan complies with the IRC § 401(a) and would withstand IRS scrutiny on this issue and (ii) the plan administrator knows that if it operates the DB plan in accordance with its terms, it is likely to be found to have operated the DB plan in accordance with IRC § 401(a).

GOVERNMENTAL PLANS

The IRS has become more interested in governmental retirement plans and governmental entities, in general. In fact, on June 9, 2010, the Advisory Committee on Tax Exempt and Governmental Entities (an advisory committee to the IRS), issued a report indicating that governmental entities, in general, do not properly pay income and employment taxes. The IRS’ specific interest in governmental retirement plans was also recently shown by the following:

1. The establishment of a webpage on the IRS website (www.irs.gov) specifically for governmental retirement plans.
2. A “round table discussion” with IRS presentations geared specifically towards governmental entities on April 22, 2008.
3. The 2009 establishment of a questionnaire for the IRS’ “Governmental Plans Initiative.”
4. The issuance of formal guidance for governmental retirement plans, including the following:
 - A. IRS Revenue Procedure 2009-36, which extended the original January 1, 2009 deadline for governmental retirement plans to be restated and submitted to the IRS for review;
 - B. IRS Revenue Procedure 2007-44, allowing governmental DB plans more time within which to properly adopt amendments required by the IRC and IRS;
 - C. IRS Revenue Ruling 2006-43 addressing governmental “pick-up contribution” requirements;
 - D. IRS Notice 2009-86 delaying the effective date of normal retirement age guidance for governmental plans so the IRS can further examine how governmental plans utilize their normal retirement age provisions.

The above shows an increase in IRS interest over governmental plans and we expect that this will relate to increased audit activity in this area. Thus, governmental pension plans should seriously consider authorizing submission to the appropriate IRS program for plan document approval.

RECOMMENDED PROCESS

Because the IRS often identifies matters of concern in their review of a plan we recommend that we take advantage of an optional IRS program known as the “voluntary compliance program.” In general, the IRS fees for this program range from as little as \$375 to more than \$5,000. Completion of this program would result in IRS approval and a formal statement indicating that even though certain issues are identified and plan changes are requested by the IRS, penalties, if any will be minimized.

Upon completion of the voluntary compliance program, we would then apply to the IRS for a “favorable determination letter.” The IRS application fee for the favorable determination letter is \$1,000. Some IRS reviewers scrutinize DB plans very thoroughly and others need assistance in understanding the DB plan’s terms prior to issuing their approval. For this reason, legal fees estimates are hard to predict for services required once the application is, in fact, submitted.

Since most of the IRC provisions in DB plans drafted by our firm, Christiansen & Dehner, P.A., are worded similarly, we would try to reduce costs by requesting a single reviewer for that group of DB plans so that if provisions need to be explained to the reviewer, we could explain the provisions a single time to a single reviewer, as opposed to having to explain similar provisions in separate plans to separate reviewers. The IRS would not be obligated to grant this request.

FEES

The amount of the IRS and attorney fees can vary widely based on a number of circumstances including, but not limited to, the status of the current provisions of the plan (which should be up to date if our recommended changes have been adopted), the timeliness of the adopted IRS requirements, the number of active and retired members of the plan, plan administration and the IRS reviewer. For the process described above, the IRS and attorneys fees will probably be in the range of \$10,000 to \$20,000 for the complete process.

We would request that this subject be included on the next meeting agenda for a decision. It may be appropriate to consult with the City/District, as plan sponsor, to determine whether or not the City/District would favor seeking the favorable determination letter. The deadline for submission of an application for a favorable determination letter in the current application cycle is January 31, 2011. The next cycle during which we could apply would be between February 1, 2013 and January 31, 2014.