NEBRASKA RETIREMENT SYSTEMS COMMITTEE

2020

LR 315

Legal Compliance Audit of Nebraska Public Employees Retirement Systems

Committee Members

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Senator Brett Lindstrom, Vice-Chair
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Senator Mike Groene
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Senator John Stinner

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Background of IRS Legal Compliance Audit Report

Background

Neb. Rev. Stat. 84-1503 lists the Public Employees Retirement Board and Nebraska Public Employees Retirement System Director duties. The relevant compliance audit language is in subdivision (2)(h) of this section, which states:

(2) In administering the retirement systems listed in subdivision (1)(a) of this section, it shall be the duty of the board:

> (h) To obtain auditing services for a separate compliance audit of the retirement systems to be completed by December 31, 2020, and from time to time thereafter at the request of the Nebraska Retirement Systems Committee of the Legislature, to be completed not more than every four years but not less than every ten years. The compliance audit shall be in addition to the annual audit conducted by the Auditor of Public Accounts. The compliance audit shall include, but not be limited to, an examination of records, files, and other documents and an evaluation of all policies and procedures to determine compliance with all state and federal laws. A copy of the compliance audit shall be given to the Governor, the board, and the Nebraska Retirement Systems Committee of the Legislature and shall be presented to the committee at a public hearing

Public Employees Retirement Board Process

Pursuant to this statute, the PERB solicited bids for a legal compliance by issuing a Solicitation Announcement Letter. Groom Law Group was awarded the contract along with subcontractor Segal to perform an independent review of the administrative operations and practices of:

1. Internal Revenue Code (IRC) section 401(a) defined benefit plans
2. IRC section 401(a) defined contribution plans
3. IRC section 457 deferred compensation plan
4. The administrative operations and practices of the system
5. To determine whether it meets standards set forth in the plan documents
6. To determine the level of compliance with applicable federal and state laws.

The contractor and subcontractor worked closely with Public Employees Retirement Board and the Nebraska Public Employees Retirement System staff by reviewing numerous documents and completing a multi-day on-site visit. The NPERS staff responded to follow-up questions posted by Groom Law and Segal.

The draft Legal Compliance Audit was presented to the Public Employees Retirement Board at the Board's July 20, 2020 meeting. David Powell of Groom Law Group and Melanie Walker from Segal presented their reports by teleconference.

Summary of Compliance Audit Recommendations

Defined Benefit Plans

1. If an overpayment to an employer does not meet Rev. Rul. 91-4 criteria for repayment, provide for a credit to the employer in the amount of the overpayment the employer could apply to future contributions

2. Review and document expenses reasonably allocated among the plans

3. The State Treasurer, rather than NPERS, is responsible for cybersecurity over the funds held for NPERS. Continue to monitor potential cyber-threats to participant information and funds

4. Modify system procedures for locating lost participants to include attempting at least one contact with lost participants via certified mail

5. Consider more outreach and education to employers and their human resources personnel and auditors to reduce misunderstandings. In addition, the system could require that the employer and/or individual filing allow the system to review IRS Publication 963

6. Consider requesting a private letter ruling on return to work re: bona fide termination.

Cash Balance Plans

1. The IRS is studying the definition of "government plan" and developing proposed regulations on when an entity is an agency, or instrumentality or political subdivision of the state eligible to participate in a government plan. The County Plan may have entities in the eligibility "grey area" --, e.g. a county hospital, a healthcare entity and certain athletic/fitness facilities. Continue to monitor the grey area employers, Take needed action when regulations proposed.

2. Strongly advise the submission of the Cash Balance Plans for IRS Determination Letters for the State and County Plans, which are due before September 1, 2020. Having an up-to-date IRS determination letter affords protection against retroactive disqualification for form defects.

Deferred Compensation Plan

1. Allow Deferred Compensation members to make investment changes by specifying a dollar amount (in addition to specifying percentage amount)

2. Recommend the DCP eliminate the rule suspending deferrals after an unforeseeable emergency distribution since sections 41113 and 41114 of the Bipartisan Budget Act of 208 and applicable

NPERS Responses to 2020 Legal Compliance Audit

NPERS
Nebraska Public Employees Retirement Systems

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Date: November 5, 2020

To: Senator Mark Kolterman, Chairperson
Nebraska Retirement Systems Committee of the Legislature

From: Orron T. Hill, Legal Counsel
Nebraska Public Employees Retirement Board (PERB) &
Nebraska Public Employees Retirement Systems (NPERS)

RE: Response to the 2020 Legal Compliance Audit

Section 1. Issues Affecting All Plans

A. Cash or Deferred Arrangement (CODA) Issue on Repayments for All Plans.

The compliance auditors noted the Internal Revenue Service (IRS) reversed its position on allowing pre-tax repayments of overpayments and pre-tax purchases of service. NPERS must change its current practice and stop allowing pre-tax repayments of overpayments and pre-tax purchases of service.

NPERS' regulations state installment payments to repay overpayments and installment payments for purchases of service may be done on a "tax deferred basis" (a.k.a. pre-tax basis).[1] The PERB directed a revision to the regulations. NPERS staff are drafting the revisions.

B. Earnings on Repayment of Overpayments.

The compliance auditors stated the rate of earnings (a.k.a. interest rate) required on repayments of overpayments should be defaulted to "the rate of earnings of the plan itself for the period involved, which would restore the plan to the position it would have been in had the overpayment not occurred" with an alternative to be used only if a reasonable estimation of the rate of earnings for the plan could not be calculated.

NPERS' regulations discuss repayments of overpaid benefits, but do not set an interest rate.[2] The PERB directed a revision to the regulation. NPERS staff are drafting the revisions.

C. Return of Contributions Made by Mistake.

The compliance auditors pointed out that the Internal Revenue Code (IRC) allows mistaken contributions to be returned only if: (a) the contribution was due to a mistake of fact, and (b) it is returned within one (1) year of the date the contribution was deposited in the plan. Such reversions are not to be increased for earnings, but may be reduced for losses. If more than one (1) year has passed since the date the contribution was deposited, the only remedy is to provide the employer a credit on future contributions filed with subsequent payrolls.

NPERS' regulations on adjustments require adjustments on excess contributions to be completed within one (1) year.[3] However, NPERS' materiality regulations set the materiality threshold for ineligible contributions at "...less than $50 during a specific time period that is no more than two years in length...."[4] The PERB directed a revision to the regulations for consistency, and to align with the compliance auditor's recommendations. NPERS staff are drafting the revisions.

B. Cash or Deferred Arrangement (CODA) Issues for the School Plan.

The compliance auditors and NPERS representatives discussed some challenges surrounding flat salaries and health benefits under "dual option negotiated agreements" for school employees. Under dual option negotiated agreements, legacy school employees are given the choice to maintain a flat salary (which is compensation for retirement purposes) or elect health benefits (which are not compensation for retirement purposes), while new employees are required to take health benefits. Employers state they must offer this choice to legacy employees due to Nebraska's continuing contract laws for certificated educators/teachers.

The compliance auditors opined that the "dual option negotiated agreements" between employers and employees participating in the School Plan that provide employees a choice between flat salary and employer-provided health benefits may present an impermissible CODA.

After considering the options proposed in the report, the PERB and NPERS will continue educating plan members, employers, and stakeholders, on the risks such CODAs present to the plan's qualified status.

Section 3. Issues Affecting the Defined Contribution and Cash Balance Plans (State and County)

A. Eligible Employers – the County Plan.

The compliance auditors mentioned there is a continuing question about whether several entities participating in the County Plan qualify as an agency or instrumentality of the state, or a political subdivision of the state, eligible to participate in a governmental plan. They also noted the IRS has not proposed final regulations in this area, but some litigation has been initiated on this topic.

The PERB currently has an ad hoc committee that reviews employer eligibility. We will continue to monitor regulations proposed by the IRS, and the pending litigation, to determine whether any employers present a risk to the plan's qualified status.

B. Submission of the Cash Balance Plans for IRS Determination Letters.

The compliance auditors informed us there was a limited window to submit the State and County Cash Balance plans for a more current IRS Determination Letter and recommended doing so.

The PERB directed NPERS to take all necessary steps to obtain a more current IRS determination letter. The NPERS Director took the necessary steps, and the documents were timely filed. The IRS confirmed receipt with date stamped copies. We are waiting for the IRS determination.

Section 4. Issues Affecting the § 457(b) Deferred Compensation Plan (DCP).

A. Contributions to the DCP.

The compliance auditors noted Section 6.2 of the DCP Plan Document provides that participants may only elect investment changes in percentages, but, in practice, NPERS allows DCP participants to make investment changes in specific dollar amounts.

There may have been some confusion during this portion of the interview phase of the compliance audit. NPERS representatives may have misunderstood the question, and were discussing investment transfers under Section 6.3, and not investment changes under Section 6.2. NPERS

DROP. In that case, participants who did not elect to participate in DROP were entitled to receive leave payouts upon termination and have those amounts included as compensation in their retirement benefit calculation at their actual retirement. Ultimately, the IRS accepted the plan's argument that there was no CODA and issued a favorable determination letter.

The compliance auditors stated it is difficult to predict whether the outcome would be the same in other cases. They advised NPERS to monitor the IRS's trends in this area, and address changes accordingly. We will continue to comply with their advice.

We note for completeness that the current Labor Contract between The State of Nebraska and The Law Enforcement Bargaining Unit represented by The State Law Enforcement Bargaining Council (SLEBC), July 1, 2019, through June 30, 2021, specifically discusses the payout of unused compensatory time at the time of entry into DROP.[6] This labor contract clause may present a plan qualification issue if the IRS reviews the Patrol Plan's DROP provisions and takes a different approach than they did in the prior case, or if the IRS publishes broad guidance applicable to all DROP plans that treats such lump sum leave payouts as impermissible CODAs.

D. Rollovers to DCP.

NPERS asked for guidance on permitting rollovers into the DCP by terminated members.

The compliance auditors recommended amending the DCP Plan Document to include a limitation that the DCP will not accept rollover contributions of after-tax and Roth amounts, and language to the effect that the DCP will accept a rollover contribution of an eligible rollover distribution, except for any portion of a distribution that is not includible in gross income or is a Roth rollover.

The PERB has directed changes be drafted to comply with the recommendations.

Please let us know if you have any questions regarding our response.

Respectfully,

Orron T. Hill
Legal Counsel

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[1] Title 303, Nebraska Administrative Code (NAC), Chapter 15, Paragraph 007.01.
[2] Title 303, NAC, Chapter 18, Paragraph 005.
[3] Title 303, NAC, Chapter 18, Paragraph 003.
[4] Title 303, NAC, Chapter 3, Paragraph 003.06.
[5] Title 303, NAC, Chapter 9, Paragraph 003.
[6] See Article 32.2 of the SLEBC Labor Contract.

PowerPoint Presentation – Review of NPERS by Groom Law and Segal

Review of the Nebraska Public Employees Retirement Systems

Groom Law Group, Chartered | Segal

David W. Powell / Melanie Walker

GROOM LAW GROUP Segal

Plan Review and Analysis

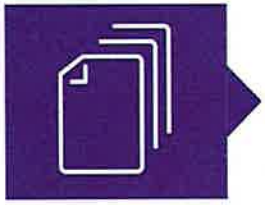
- IRC requirements for qualified §401(a) retirement plans and §457(b) deferred compensation plans
- Permitted distribution rules
- Anti-alienation provisions and domestic relations orders
- Benefit cashouts and lump sum payments
- Special rules and exemptions for governmental plans
- IRC income tax reporting and withholding requirements

Methodology

Data Collection

Document Review and Analysis

On Sight Interviews



Written Report

Cash or Deferred Arrangement Issue for All Plans

Earnings on Repayment of Overpayments

Contributions Made by Mistake

Reasonable Allocation of Expenses

Cybersecurity

Due Diligence in Searching for Lost Participants

Alternatives to State Unclaimed Property Fund

Cash or Deferred Arrangement Issue for All Plans

- However, IRS since Rev. Rul. 2006-43 has taken the position that to be pre-tax under IRC §414(h)(2), any election of a contribution by the employee must be entered into at the first time the employee is eligible to participate in any plan of the employer — and repeatedly ruled that any employee choice between out-of-pocket and a tax deferred benefit is impermissible for governmental plans

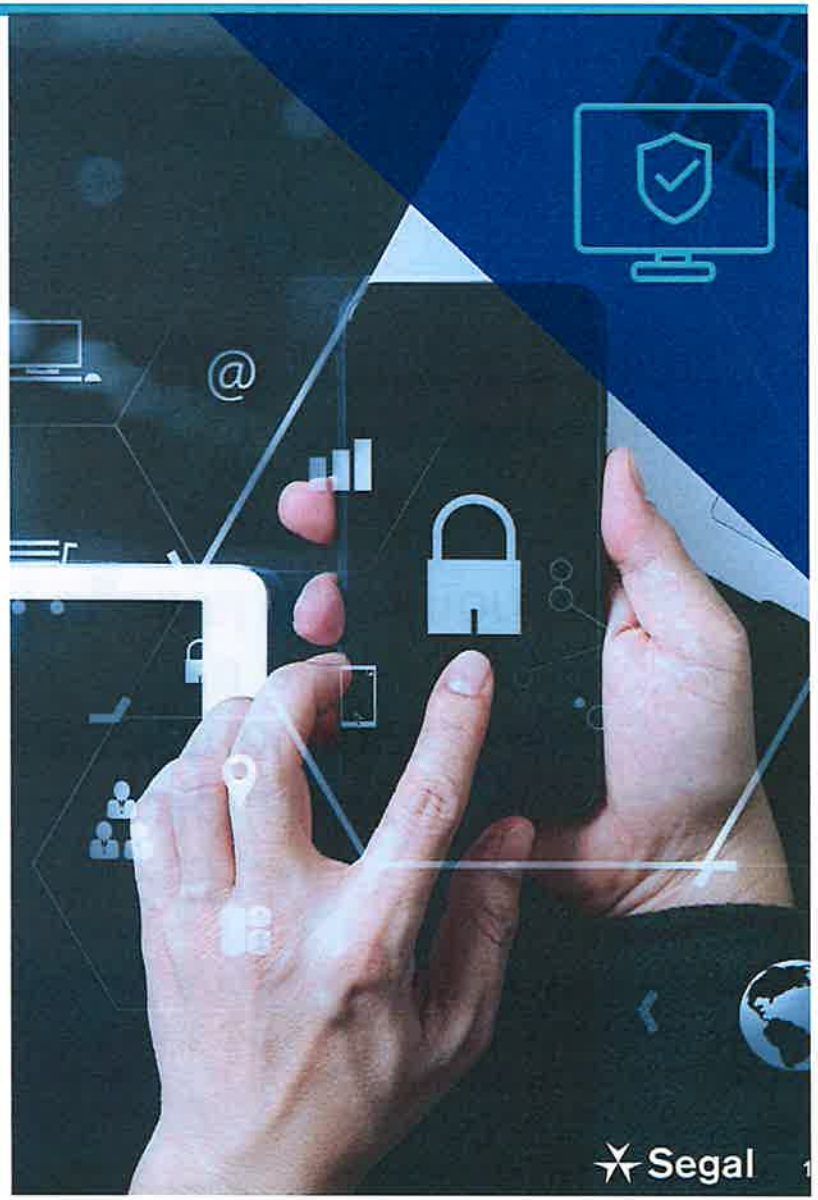
Solutions: allow only after-tax payroll deductions, after tax lump sum payments, or rollovers from other tax-qualified plans or IRAs

Contributions Made by Mistake

- The IRS allows a return of contributions to an employer only if the contribution was due to a mistake of fact and is returned within one year of the contribution. Such reversions are not to be increased for earnings, but may be reduced for losses. See IRS Rev. Rul. 91-4
- There is a workaround, however, as the rule only prohibits payments out of the plan back to the employer. If an overpayment does not meet the Rev. Rul. 91-4 criteria for repayment, the plan could instead provide a credit to the employer in the amount of the overpayment that the employer could apply to future contributions

Cybersecurity

- Cybersecurity is an increasing concern with retirement plan accounts, not only for the systems of recordkeepers and service providers, and NPERS' own systems, but in the area of hacking of plan members' own information (e.g., account usernames and passwords)



Due Diligence in Searching for Lost Participants

- IRC §401(a) and §457(b) plans have a duty to make reasonable efforts to locate missing participants when a minimum distribution is required to be paid in accordance with IRC §401(a)(9)
- The System's procedures for locating lost participants follow the steps set forth in the IRS guidance, other than it appears that the System attempts to contact lost participants via first-class mail, rather than certified mail
- Considering the focus on enforcement of required minimum distributions by the IRS, we recommend that the System modify their procedures for locating lost participants to include attempting at least one contact with lost participants via certified mail

Alternatives to State Unclaimed Property Fund

- A method commonly used by statewide retirement systems for dealing with such benefits is that such benefit are forfeited and the related assets then remain in the trust fund of the Plan, subject to restoration and distribution of a benefit to a lost participant or beneficiary who contacts the System
- It would require a statutory change, but keeping forfeited assets (and the investment income thereon) in the System to offset plan liabilities likely would be beneficial to the funding status of the Plans. However, it may not be beneficial to the System overall to be responsible for keeping participant records for some time with any attendant monetary costs and administrative burden of such maintenance

Bona Fide Termination of Employment

Cash or Deferred Arrangement Issues for School Plan

Bona Fide Termination of Employment

- As with many other public plans, the Plans have adopted various "return–to-work" provisions in order to make it less likely that a non-bona fide termination of employment can occur
- Connected with the possibility that a particular claimed termination of employment may not have been bona fide, is that some individuals may claim to return to work as independent contractors when they are in fact common law employees

Bona Fide Termination of Employment

Recommendations

- Possibility of a Private Letter Ruling on Return to Work
- Plan Amendment
  - If there is a desire by the legislature to allow in-service distributions without a termination of employment for certain categories of plan members, the statutes could be to permit that after the individual has attained normal retirement age

Section 3

Issues Affecting the Defined Contribution and Cash Balance Plans (State and County)

Eligible Employers — the County Plan

- The IRS has continued to have the definition of "governmental plan" under study and has been developing proposed regulations on when an entity is an agency or instrumentality of the state or a political subdivision of the state eligible to participate in a governmental plan

The County Plan is the plan most likely to have entities that may be in the "grey area" of whether participation is permitted or not

Submission of the Cash Balance Plans for IRS Determination Letters before September 1

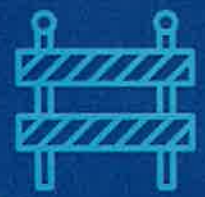
- Under IRS Rev. Proc. 2019-20, the IRS will accept a determination letter application for an individually designed "statutory hybrid plan" as defined in Treasury Regulations during the 12-month period beginning September 1, 2019, and ending August 31, 2020

Having an up to date IRS determination letter affords protection against retroactive disqualification for form defects. We would strongly advise that such a filing be made

Contributions to the DCP

Suspension of Deferrals Due to Unforeseeable Emergency Distribution

Suspension of Deferrals Due to Unforeseeable Emergency Distribution



- Section 7.6.7 of the Deferred Compensation Plan restricts participants who receive an unforeseeable emergency distribution from making elective deferrals to the Plan for a period of six months
- Pursuant to the Bipartisan Budget Act of 2018 and applicable final Treasury Regulations, plans are now prohibited from suspending a participant's contributions as a condition of obtaining a hardship distribution
- For this reason, we recommend that the Deferred Compensation Plan eliminate the rule suspending deferrals after an unforeseeable emergency distribution

Appendix — Additional NPERS Matters Discussed

- DCP Online Enrollment – Timing and Payroll Period Considerations
- Certain School Plan Athletic Officials as Independent Contractors
- DROP as a Potential CODA
- Ability to Rollover Distributions into the DCP

Legal Compliance Crosscheck Review – Full Report

Crosscheck[sm] Review

State of Nebraska Public Employees Retirement Systems

Submitted jointly by:

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Segal

Executive Summary

Groom Law Group, Chartered and Segal were engaged by the Nebraska Public Employees Retirement System (NPERS or the System), to perform an independent review of the administrative operations and practices of their 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 to determine the level of compliance with applicable federal laws.

This Executive Summary describes our findings and analysis from the comprehensive compliance review, which includes a review of Plan documents, governance structure and administrative functions, compliance with applicable federal laws and consistency of administration with Plan rules, as well as provides recommendations and suggestions for improvements in Plan administrative functions and operational compliance with federal tax law.

We wish to thank Mr. Randy Gerke and his staff, along with Mr. Orron Hill, for their immense cooperation and support during the project. The System was gracious and candid and provided full access to staff and documents during the review process.

As a result of our compliance review, we conclude that the Plan is substantially in compliance with the requirements under IRC §401(a) and §457(b) and related Treasury Regulations and other applicable federal laws. We have identified a few areas of administration of the Plan that may be of concern to NPERS and could warrant further review and/or modification. Overall, however, it appears that administration of the Plan is generally consistent with Internal Revenue Service (IRS) rules and governing Plan documents. During a compliance review of any plan, we often find 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, and no plan document is free from ambiguity and the need for interpretation. From our review, it is apparent that NPERS administers their Plan pursuant to rigorous and thorough internal control procedures developed for and consistently applied to Plan operations.

Groom Law Group and Segal's compliance review services, known as ***Crosscheck***, is a comprehensive review of plan operating procedures to determine whether they are in compliance with applicable requirements of the Internal Revenue Code and other federal legislation and regulatory guidance, as well as with the provisions of the Plan documents. The goal of a ***Crosscheck*** review is to:

1. **Assess** the current state of plan administration.
2. **Confirm** that procedures correspond to what the plan documentation states.
3. **Review** operational compliance with the Internal Revenue Code and other federal laws.
4. **Identify** potential risks and penalties associated with noncompliance.

- Notices and benefit statements to participants
- Benefit calculation procedures
- Plan distributions, including lump sum payments and optional forms
- Tax withholding requirements and basis recovery methods
- Required minimum distributions

Project Methodology

To understand our findings and recommendations, it is important to describe our process and methodology. As background, our review of NPERS followed our ***Crosscheck*** compliance review and analysis methodology, which was individually tailored for the Plan's specific compliance needs.

Step One: Data Collection

Prior to the on-site visit at the NPERS offices, various Plan documents were requested and collected from NPERS, including Nebraska Revised Statutes (NRS) and official Board policies and procedures. In addition, we reviewed all Plan communications, publications, forms and financial, actuarial and audit reports contained on the Plan's website.

Step Two: Documentation Review and Analysis

A brief familiarity review was performed of the Plan documentation, in order to prepare for on-site interviews with NPERS staff. In addition, Plan documentation was thoroughly analyzed by Groom Law Group and Segal. A ***Crosscheck*** workbook, with questions specific to the type of plan, was used as a guide during the interview process.

Our documentation analysis also reviewed the consistency of Plan documents, including:

- "Fit" of participant communications with governing documents, including recent revisions;
- Consistency of operational processes and procedures, as well as other written materials with governing documents and employee communication materials; and
- Consistency of administrative actions with governing documents and written policies and procedures for Plan administration.

Step Three: On-site Interviews

The on-site visit to the NPERS offices consisted of interviews with the key individuals who are responsible for the day-to-day operation of the Plan over the course of two days (February 19 and 20, 2020). The goal of the interview process is to ensure that Groom Law Group and Segal, as well as those involved with administration of the Plan, understand the rules of the Plan, and that NPERS staff actually administer those rules according to Plan documentation. As indicated above, we covered an extensive array of questions that were designed by Groom Law Group and Segal regarding Plan administration and operational issues. The interviews also provided

Section 1. Issues Affecting All Plans

This report refers to the five qualified plans administered by the System as the State, County, School, 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 Plan and one County Plan).

The following points are to discuss compliance issues identified from the process above.

A. Cash or Deferred Arrangement Issue on Repayments for All Plans

Overview

Most of the qualified plans of the System (State, County, School, and Patrol), allow members to make payments via irrevocable payroll deduction authorization to the Plans, including to repay a refund, purchase service credit, and repay of benefits required upon return to work. Pursuant to State statutes and Plan rules, these payments are made on a pre-tax basis utilizing employer pick up under IRC §414(h)(2). However, such payment arrangements may constitute impermissible cash or deferred elections under IRC §401(k). If these payroll deductions constitute a cash or deferred arrangement ("CODA"), then the payments do not meet requirements for pre-tax employer pick up under IRC §414(h)(2).

The School Plan allows employer pick up under IRC §414(h)(2) for member repayment of refunds under NRS §79-921(5)(b), purchase of past service credit under NRS §§79-933.03, 79-933.0, 79-933.05 and 79-933.06 pursuant to an irrevocable payroll deduction authorization. NRS §79-958(4) states:

> The employer shall pick up the member contributions made through irrevocable payroll deduction authorizations pursuant to section 79-921 and 79-933.03 to 79-933.06, and the contributions so picked up shall be treated as employer contributions ....

In addition, the NPERS Board may set rules for repayment of benefits for the School Plan under NRS §79-904.01. It is our understanding that the Board allows irrevocable payroll deductions that are picked up by the employer under IRC §414(h)(2) for such repayment of benefits.

The Judges Plan statutes do not specify how members may repay refunds, and there is no purchase of service provisions in these statutes.

repayment of benefits required upon return to work permitted under State statutes and Plan rules do not meet the requirements for this exemption from being a cash or deferred arrangement. The opportunity to elect a payroll deduction can be made more than one time and for multiple purposes, and although the authorization is irrevocable once made, such election to defer compensation would normally be made later than the date the employee is first eligible under the applicable Plan. Therefore, these irrevocable payroll deduction authorizations generally do not meet the requirements for a one-time, irrevocable election under Treas. Reg. §1.401(k)-1(a)(3)(B)(v).

Furthermore, an irrevocable payroll deduction authorization to make such repayments permitted under State statutes and Plan rules are impermissible cash or deferred arrangements, only to the extent the payroll deductions are contributed on a pre-tax basis. When members agree to an irrevocable payroll deduction authorization in order to purchase service credit or repay a refund or repay benefits to the Plans on a pre-tax basis, they are choosing to receive a benefit under a plan that defers compensation, such as qualified plan under IRC §401(a) or a deferred compensation plan under IRC §457(b), in lieu of receiving cash compensation. This is because the payroll deduction amounts are being treated as picked up by the employer as pre-tax contributions to the Plans in accordance with IRC §414(h)(2) and State statutes and Plan rules.

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):

> [C]ontributions 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.

Since the irrevocable payroll deduction authorizations do not meet requirements for a one-time, irrevocable election under Treas. Reg. §1.401(k)-1(a)(3)(B)(v) for the reasons described above, these authorizations are a CODA and do not satisfy the requirement in item (2) above.

It should be recognized that this issue has developed over time. In prior years, IRS rulings allowed more than one salary reduction election by an employee to purchase service credit on a pre-tax basis (for example, see Private Letter Ruling 9750053). However, beginning in 2005, the IRS generally would no longer provide an opinion on the validity of an employer pick up

> If the board determines that termination of employment has not occurred and a retirement benefit has been paid to a member of the retirement system pursuant to section 84-1321, the board shall require the member who has received such benefit to repay the benefit to the retirement system....

NRS §84-1301(31) (State); *see also* NRS §§23-2301(36), 23-2320(5) (County); NRS §24-701(26) (Judges); NRS §81-2014(20) (Patrol).

Such incorrect payments are referred to by the IRS as "overpayments". *See* IRS Rev. Proc. 2019-19, Section 5.01(3)(c) ("The term 'Overpayment' means a Qualification Failure due to a payment being made to a participant or beneficiary that exceeds the amount payable to the participant or beneficiary under the terms of the plan".)[3]

In order to correct an overpayment, the plan sponsor is to take "reasonable steps to have the Overpayment *(with appropriate interest)* returned by the recipient to the plan and reduce ... future benefit payments (if any) due to the employee.... To the extent the amount returned by the recipient is less than the Overpayment, *adjusted for Earnings at the plan's earnings rate*, then the Plan Sponsor or another person contributes the difference to the plan." Rev. Proc. 2019-19, Sections 6.06(3) [regarding correction for overpayments for defined benefit plans], 6.06(4) [for defined contribution plans], and Appendix B, Sections 2.04(1) and 3. Overpayments to a participant or beneficiary of $100 or less do not have to be recovered. Id., Section 6.02(5)(c).

This emphasis in the IRS correction procedures for overpayments being recovered with earnings is founded in the general principle of correction under Rev. Proc. 2019-19 that "The correction method should restore the plan to the position it would have been in had the failure not occurred, including restoration of current and former participants and beneficiaries to the benefits and rights they would have had if the failure had not occurred." Id., Section 6.02(1).

In the case of a defined benefit plan, therefore, including a cash balance plan, the earnings component for requesting return of an overpayment is the rate of earnings of the plan itself for the period involved, which is what would restore the plan to the position it would have been in had the overpayment not occurred. On the other hand, in the event of recoupment of an overpayment by reducing future annuity payments, the actuarial present value of the reduction should equal the amount of the overpayment plus interest at the interest rate used by the plan to determine actuarial equivalence. Id., Appendix B, Section 2.04(1).

In the case of a defined contribution plan, if a plan permits employees to direct the investment of account balances into more than one investment fund, the earnings rate is based on the rate applicable to the employee's investment choices for the period of the failure. For administrative convenience, if most of the employees for whom the corrective contribution or allocation is made are nonhighly compensated employees, the rate of return of the fund with the highest rate of return under the plan for the period of the failure may be used to determine the earnings rate for all corrective contributions or allocations. If the employee had not made any applicable investment choices, the Earnings rate may be based on the rate of return under the plan as a whole (that is, the average of the rates earned by all of the funds in the valuation periods during

[3] This assumes, consistent with our understanding, that the requirement to repay is imposed because the original requirement of a bona fide termination of employment allowing the payment in the first instance was not met, as opposed to the original distribution having been valid under the terms of the plan, but subject to a repayment if rehired with a set period.

up any such erroneously picked up contributions to the employee would be the responsibility of that employer, which would then report them as wages to the employee on a Form W-2.

We would recommend that NPERS consider adopting a rule to refund mistaken contributions only in accordance with Rev. Rul. 91-4, and to provide a credit to the employer who made them in other situations.

D. Reasonable Allocation of Expenses

As noted above, the IRC requires that the assets held in trust for a qualified plan must be used exclusively for the benefit of the participants and beneficiaries of that plan. *See* IRC §401(a)(2). This effectively also means that plans should only pay expenses allocable to that plan. Where expenses arise in connection with administering the plans as a whole, they should also be reasonably allocated among those plans, to avoid using the assets of one plan to subsidize the expenses of another plan. Proper allocation of expenses to qualified plans is an area that has been receiving more attention lately. There is little clear guidance on how to make such allocations, but it must be reasonable, and the process to determine it should be documented. We note that the contract with Ameritas for administration of the State (DC and cash balance) Plan, County (DC and cash balance) Plan, DCP and Patrol DROP Plan includes both per member annual charges (which vary by plan) and per event, per member charges (such as a charge for a distribution). It may be advisable for the Board to confirm with Ameritas that they believe that charging expenses to the plans in question in this manner is a reasonable allocation of expenses among each Plan for purposes of the exclusive benefit rule, and as expenses are incurred, to review and document whether they are being reasonably allocated among the various Plans consistent with the exclusive benefit rule.

E. Cybersecurity

Cybersecurity is an increasing concern with retirement plan accounts, not only for the systems of recordkeepers and service providers, and NPERS' own systems, but in the area of hacking of plan members' own information (e.g., account usernames and passwords) which can then lead to unauthorized plan distributions. In this case, we note that the State Treasurer, rather than NPERS, is responsible for cybersecurity over the funds held under NPERS. In the area of participant requests for distributions, currently, paper distribution forms that are notarized are required by NPERS, which likely assists in protection against unauthorized distribution requests. However, NPERS should continue to monitor developments in this evolving area to stay on top of potential cyber-threats to participant information and funds.

F. Due Diligence in Searching for Lost Participants

Qualified plans under IRC §401(a), as well as eligible deferred compensation plans under IRC §457(b), have a duty to make reasonable efforts 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 an excise tax (up to 50%) on late

G. Alternatives to State Unclaimed Property Fund

Related to the issue of missing participants, we discussed with NPERS staff an alternative method for dealing with benefits from the Plans for which the member cannot be located or will not cash a check other than transferring assets to the State's unclaimed property fund pursuant to the Uniform Disposition of Unclaimed Property Act in NRS §§69-1301 to 69-1329. A method commonly used by statewide retirement systems for dealing with such benefits is that such benefit are forfeited and the related assets then remain in the trust fund of the Plan, subject to restoration and distribution of a benefit to a lost participant or beneficiary who contacts the System.

Regulations under the vesting provisions of the IRC provide that "a right is not treated as forfeitable … merely because the benefit is forfeitable on account of the inability to find the participant or beneficiary to whom payment is due, provided that the plan provides for reinstatement of the benefit if a claim is made by the participant or beneficiary for the forfeited benefit." Treas. Reg. section 1.411(a)-4(b)(6). If that exception applies to private sector plans subject to the strict vesting rules of ERISA, it should apply to governmental plans subject to the less strict pre-ERISA vesting rules.

Currently, all qualified Plans of the System (State, County, School, Judges, and Patrol) are required by statute to transfer any benefits that the Plan is unable to distribute to a member by their required beginning date, in accordance with IRC §401(a)(9), to the State Treasurer to be held in the State's unclaimed property fund. For example, the School Plan statutes, at NRS §79-932(2), state:

> The board shall make reasonable efforts to locate the member or the member's beneficiary and distribute benefits by the required beginning date as specified by section 401(a)(9) of the Internal Revenue Code and the regulations issued thereunder. If the board is unable to make such a distribution, the benefit shall be distributed pursuant to the Uniform Disposition of Unclaimed Property Act and no amounts may be applied to increase the benefits of any member would otherwise receive under the School Employees Retirement Act.

Similar language is set forth in statutes governing the other Plans of the System. The provisions of the Nebraska Uniform Disposition of Unclaimed Property Act ("the Act") describe when benefits must be delivered to the State Treasurer, what penalties apply if such delivery is not made, and when benefits are presumed to be abandoned.

As discussed, following is a brief description of some of the relevant issues for the System to consider with respect to maintaining forfeited assets in the System rather than transferring such assets to the State's unclaimed property fund.

1. Currently, benefits forfeited after a member's required beginning date are required by law to be transferred to the State's unclaimed property fund. No further action is necessary. However, in order for the System to be permitted to maintain assets related to forfeited benefits in the Plans' trust funds, a statutory change would be required. The System would need to develop and communicate to stakeholders persuasive arguments that this change would be beneficial to members, including preparing a response to any counterarguments.

Section 2. Issues Affecting the Defined Benefit Plans (Judges, Patrol and School)

A. Bona Fide Termination of Employment

Overview

As detailed below, all of the Plans require a retirement and termination of employment to receive a benefit. No Plans allow a distribution while a member is still in service. Though it would be permissible in some cases for plans to be amended to provide for certain in-service distributions, the Plans do not currently permit it.

In discussions with NPERS staff, the issue was raised that, while the plan documents may comply with the IRC, in operation, some members being paid on the basis of having retired and terminated employment might not have terminated employment in fact. This is a tax qualification issue because, as noted above, the IRS takes the position that a failure to follow the plan document is an operational failure resulting in disqualification of the plan unless and until corrected. Paying an amount to which a member is not entitled under the plan terms is such a violation, referred to in the IRS guidance as an "overpayment", which generally must be corrected by making efforts to recover the overpayment.

As with many other public plans, the Plans have adopted various "return–to-work" provisions in order to make it less likely that a non-bona fide termination of employment can occur resulting in an overpayment and a potential disqualification of the plan if not corrected.

Connected with the possibility that a particular claimed termination of employment may not have been bona fide, is that some individuals may claim to return to work as independent contractors when they are in fact employees. Such misclassification can result in such person being paid while not having had an actual termination of employment or to have returned to work but not treated as having done so under that particular plan's return to work rules.

Summary of Recommendation

NPERS could identify those classes of employees where compliance in operation with the bona fide termination of employment and return to work rules has been questioned and put procedures in place to ensure better compliance by participating employers.

provided for in the School Employees Retirement Act within one hundred eighty days after ceasing employment unless such service:

(a) Is bona fide unpaid voluntary service or substitute service, provided on an intermittent basis; or

(b) Is as provided in subsection (2) of section 79-920.

Nothing in this subdivision precludes an employer from adopting a policy which limits or denies employees who have terminated employment from providing voluntary or substitute service within one hundred eighty days after termination.

A member shall not be deemed to have terminated employment if the board determines that a claimed termination was not a bona fide separation from service with the employer or that a member was compensated for a full contractual period when the member terminated prior to the end date of the contract; and

(45) Voluntary service or volunteer means providing bona fide unpaid service to any employer.

NRS §79-902(44), (45).

Substitute Employee is defined as follows:

(41) Substitute employee means a person hired by a public school as a temporary employee to assume the duties of regular employees due to a temporary absence of any regular employees. Substitute employee does not mean a person hired as a regular employee on an ongoing basis to assume the duties of other regular employees who are temporarily absent;

NRS §79-902(41).

c. The Deferred Compensation Plan

Consistent with the IRC, the Deferred Compensation Plan (the "DCP") provides that "any amount shall not be available to the participant or beneficiary prior to (a) the calendar year in which the participant attains age seventy and one-half years, (b) when the participant is separated from service with the state, or (c) when the participant has an unforeseeable emergency as determined by the Public Employees Retirement Board." NRS §84-1506. *See also* DCP Article 7 (which also permits certain de minimis in-service distributions of small inactive accounts, consistent with IRC §457(e)(1)(A)).

The DCP at section 2.16 provides a definition of "Severance from Employment" or "Separation from Service" as:

The date on which a Participant experiences a bona fide dissolution of the employment relationship with the Participant's current Employer, the date of which dissolution is determined by the Employer. The Employer will notify NPERS within 15 calendar days after the date such separation has occurred. Separation from service does not include ceasing employment if the Participant enters another employment relationship with the

and independent contractors are permitted to participate, independent contractors are not permitted to participate in a §401(a) plan. *See, e.g.,* Rev. Proc. 2002-21. However, note that purported independent contractor status can raise a number of issues, as described in further detail below.

3. Application of the Definition of Termination of Employment under the Plans

Each of the Plans other than the School Plan has a provision that termination of employment is required to commence a benefit. A benefit cannot commence while the member is still employed, and a termination occurs on the date on which the participating employer determines that the member's employer-employee relationship with the employer and any other agency of the State of Nebraska is dissolved.

Moreover, each Plan other than the School Plan provides that termination of employment does not include ceasing employment with the participating employer if the member returns to regular employment with the employer or another agency of the State of Nebraska and there are less than 120 days between the date when the employee's employer-employee relationship ceased and the date when the employer-employee relationship re-commenced with the employer or another Nebraska state agency.

In the case of the School Plan, the hold-out period is 180 days after ceasing employment, but there are certain exemptions:

- bona fide unpaid voluntary service or substitute service, provided on an intermittent basis; and
- as provided in subsection (2) of NRS §79-920 (certain employees who return to employment in a position covered by the State Plan).

For this purpose, voluntary service or volunteer means providing bona fide unpaid service to any employer. Substitute service is as defined above.

However, the statute also provides that in any event, a member shall not be deemed to have terminated employment if the board determines that a claimed termination was not a bona fide separation from service with the employer or that a member was compensated for a full contractual period when the member terminated prior to the end date of the contract.

4. Common Use of Hold-out Periods

Because in a state retirement system situation, unlike the private sector, a retirement board as plan administrator is more removed from the participating employer, it can be difficult for the board to have much knowledge of what the intention of the employer and the employee are at the time of a purported termination of employment. For that reason, it is common for public retirement systems to provide for the types of "hold-out" periods described above during which no return to employment is permitted. This is not to satisfy a bright line test for what constitutes a bona fide termination of employment, but rather to make it difficult to "game" the system" with phony terminations where there is an intent to return to employment. The use of such hold-out

the employment taxes under the IRC, a safe harbor that if a taxpayer did not treat an individual as an employee for any period, then the individual shall be deemed not to be an employee, unless the taxpayer had no reasonable basis for not treating the individual as an employee. For any period after December 31, 1978, this relief applies only if both of the following consistency rules are satisfied: (1) all federal tax returns (including information returns) required to be filed by the taxpayer with respect to the individual for the period are filed on a basis consistent with the taxpayer's treatment of the individual as not being an employee (the "reporting consistency rule"), and (2) the taxpayer (and any predecessor) has not treated any individual holding a substantially similar position as an employee for purposes of the employment taxes for periods beginning after December 31, 1977 (the "substantive consistency rule").

b. IRS Guidance on Independent Contractor versus Employee Status in the Governmental Context

Further, the IRS has issued some guidance specific to whether certain governmental workers are employees or independent contractors under certain facts and circumstances. For example, IRS Publication 963, the Federal-State Reference Guide, provides as follows:

> In many worker classification cases, some facts will support independent contractor status and others will support employee status. Independent contractors are rarely totally unconstrained in the performance of their contracts, and employees almost always have some degree of autonomy. The determination of a worker's status, therefore rests on the weight given to the facts as a whole, keeping in mind that no one factor is determinative.
>
> Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding
>
> In difficult cases, the IRS can provide a determination as to whether a worker is an employee or an independent contractor. To obtain a determination from the IRS, file Form SS-8. Either a governmental entity or a worker may submit Form SS-8. The IRS will acknowledge receipt of the Form SS-8 and will also request information from the worker. If a contract has been executed between the worker and the entity, a copy of the contract should be submitted with Form SS-8. In some cases, the IRS will contact the State Social Security Administrator to determine whether the entity and position are covered by a Section 218 Agreement. The IRS will generally issue a formal determination to the entity and will send a copy to the worker.

In another illustration of the issues that can arise regarding proper classification of school employees, the IRS, in Chief Counsel Advice 200147006, the IRS analyzed the situation of a school superintendent claiming to be an independent contractor:

> In this case, there is a written contract stating that the parties envisioned an independent contractor relationship. A and B have also formed limited liability company and a regular corporation, for which no information reporting is required.
>
> The realities of the situation suggest otherwise, however. The School Districts have sufficient behavioral control over the two school superintendents under State statute to create an employer-employee relationship. This statutory right to control cannot be

4. We understand that there may be other instances of plan members "retiring" and commencing benefits but returning to work as purported independent contractors within the relevant hold-out period, sometimes immediately.

Conclusion

To attempt to reduce noncompliance with the termination of employment and return to work rules, NPERS could identify those classes of employees where compliance in operation with the those rules has been questioned and put procedures in place to ensure better compliance by participating employers. For specific categories, such as officiating at athletic events and mentoring programs, the facts could be determined and appropriate uniform treatment adopted.

1. More Outreach to Employers

One step NPERS may want to consider is more outreach and education to employers and their human resources personnel and auditor on these issues to reduce misunderstandings and to enhance compliance.

2. Use of IRS Form SS-8

As discussed in IRS Publication 963 quoted above, for difficult situations where the system and the participating employer and purported employee or independent contractor differ on whether the individual is in fact an employee or independent contractor, it may be possible to have a Form SS-8 filed to resolve the question based on the facts. We would note, however, that a Form SS-8 can only be filed by the employer or the individual. The system would not have standing to file. But the system could require that the employer and/or individual filing allow the system to review it first. In addition, an SS-8 can be filed for a class of employees. However, one of the questions in the SS-8 is "Did the worker perform services for the firm in any capacity before providing the services that are the subject of this determination request? ... If "Yes," what were the dates of the prior service? If "Yes," explain the differences, if any, between the current and prior service." If there are not material differences, it can be expected that the IRS will rule that the person is an employee.

3. Possibility of a Private Letter Ruling on Return to Work

Another possible avenue for obtaining more clarity on whether particular facts for a return to work situation would be to seek a private letter ruling from the IRS, similar to PLR 201147038 discussed above. The IRS has the discretion to decide not to rule and return a ruling request, but we believe the IRS would likely entertain another ruling request in this area.

4. Plan Amendment

Finally, though it is a matter at the discretion of the legislature, if there is a desire by the legislature to allow in-service distributions without a termination of employment for certain categories of plan members, the statutes could be amended consistent with the IRC to permit that, but only after the individual has attained normal retirement age under the plan in question.

that is not currently available; or (2) contribute an amount to a trust, or provide an accrual or other benefit, under a plan deferring the receipt of compensation.

Essentially, a CODA provides an employee the ability to choose between cash compensation in the present or a benefit under a plan that defers the inclusion of income on compensation until a later date.

However, a cash or deferred election does not include a one-time, irrevocable election 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 IRC §219(g)(5)(A). Note that IRC §219(g)(5)(A) includes a qualified plan under IRC §401(a). *See* Treas. Reg. §1.401(k)-1(a)(3)(B)(v).

Based on the definition of a one-time, irrevocable election, it appears that the opportunity for current employees to elect to change from Option 1 to Option 2 does not meet the requirements for this exemption from being a cash or deferred arrangement. Although the opportunity to elect into Option 2 can only be made one time and is irrevocable once made, such election can be made later than the date the employee is first eligible under the School Plan. Therefore, the opportunity to elect into Option 2 is not a one-time, irrevocable election under Treas. Reg. §1.401(k)-1(a)(3)(B)(v).

Though there is little guidance on these facts to point to, we have seen this issue raised by the IRS in connection with elections that result in more or less salary being paid in exchange for other nontaxable benefits when it has an impact on the amount of pension benefits.

In addition, there is a separate constructive receipt issue as to whether a current employee's ability to continue to receive an additional flat salary amount or to elect to receive less salary in exchange for employer-provided health and dental insurance in a plan that does not meet the requirements of IRC §125 permits the difference in flat salary to be treated as a pre-tax employer contribution for health and dental insurance. However, this is a complex issue for the employer, not for the Plans, so we will not address it further here.[6]

Conclusion

Therefore, it appears that the "dual option negotiated agreements" between employers and employees that participate in the School Plan, which provides employees a choice between additional flat salary amounts under Option 1 and employer-provided health and dental insurance under Option 2, may present an impermissible cash or deferred arrangement as defined in Treas. Reg. §1.401(k)-1(a)(3).

[6] See, e.g., PLR 200704005: "Taxpayer's employees will have the option to have contributions made to the [medical] Plan in lieu of receiving a portion of regular compensation or accrued leave, or both. Contributions will be pursuant to an election. Once the election is made, the Plan provides that the election is irrevocable; it cannot be reversed or revoked by the employee, and the employee cannot receive cash refunds of the contributions. Employees will have 30 days from initial eligibility within which to make a one-time irrevocable election to participate in the Plan. Employees who have not previously elected to participate will have an annual period of 30-60 days in which to make a one-time irrevocable election.... Based on the representations made and authorities cited above, we conclude that, pursuant to employees' elections, contributions that are made to the Plan in lieu of employees receiving a portion of their regular compensation or accrued leave, or both, are not excludable from employees' gross income under section 106 of the Code. Contributions to the Plan are includable in employees' gross income under section 61 of the Code." See also Rev. Rul. 75-539. But see also Chief Counsel Advice (CCA) 201640015.

by third parties that the plans in form meet the tax qualification requirements. In addition, the recipient of a determination letter can generally request relief under IRC §7805(b) from retroactive disqualification for a provision on which the IRS has issued a determination letter if it has relied on the letter in good faith. *See* Rev. Proc. 2020-1, Sections 11 and 13. Accordingly, since the filing of a determination letter application is available for these two plans prior to September 1, 2020, we would strongly advise that such a filing be made.

Appendix. Additional Issues

In addition to the above, NPERS had a number of specific questions. Although we have responded in email, our answers (in substantially the same form) are reproduced here.

A. DCP Online Enrollment

NPERS requested guidance in implementing an online enrollment option for the §457(b) Deferred Compensation Plan. Specifically, you asked for implementation guidance on how the timing of elections affects the timing of payroll deferrals and to which annual deferral limit payroll deferrals apply.

Timing of Election

A §457(b) deferred compensation plan must provide that compensation for a given month may be deferred only if the deferral is elected before the first day of that month. The regulation interpreting the first of the month rule provides as follows:

> To be an eligible plan, the plan must provide that compensation for any calendar month may be deferred by salary reduction only if an agreement providing for the deferral has been entered into before the first day of the month in which the compensation to be deferred under the agreement would otherwise be paid or made available, and any modification or revocation of such an agreement may not become effective before the first day of the month following the month in which the modification or revocation occurs. However, a new employee may defer compensation in the first calendar month of employment if an agreement providing for the deferral is entered into on or before the first day the participant performs services for the eligible employer. An eligible plan may provide that if a participant enters into an agreement providing for deferral by salary reduction under the plan, the agreement will remain in effect until the participant revokes or alters the terms of the agreement.

Prop. Treas. Reg. §1.457-4(b)(1).[7]

Thus, the rule is essentially that:

1. Existing employees can elect in month 1 to defer an amount provided that it is not payable before month 2, i.e., it is not payable in month 1. Thus, where a payroll period begins in month 1, but the pay cannot be paid until the end of the payroll period in month 2, an election in month 1 can be made for the month 2 payment, even though it covers some money earned in the month 1 period.
2. Under a clarification added by the proposed regulation, the existing employee rule applies to later changes in the election as well. For example, under the same facts as in 1., if that employee then elects at the beginning of month 3 to stop deferrals, that cannot be applied

[7] Although we quote the proposed regulation, this language is substantially similar to the current regulation and can be relied upon.

As a preliminary matter we note that, based on the outlined fact pattern and the definitions under NRS §79-902, unless the alternative duties of a teacher as an athletic official would be reasonable to exclude from the definition of "Service" (because such duties do not constitute "employment") and/or the teacher's duties are not part of his or her work as a "Regular employee" (because the teacher is not acting as an "employee" during such time), such definitions of "Regular employee," "Service," and "Compensation," which are otherwise relatively broad, would likely require the inclusion of compensation tied to officiating duties for retirement purposes under NPERS. The issue therefore essentially boils down to one item: whether there is a credible argument that the teacher might be considered both an employee and an independent contractor, for different services at the same time.

As a general matter, to determine whether an individual is an employee, Nebraska courts have considered ten factors, with the "right of control" being recognized as the "chief factor distinguishing an employment relationship from that of an independent contractor." *See, e.g.*, Keller v. Tavarone, 628 N.W.2d 222 (Neb. 2001). This emphasis on the "control" exercised over the individual generally aligns with similar worker classification standards used by the IRS (*see generally,* Internal Revenue Manual section 4.23.5[8]; *see also* Rev. Rul. 87-21, and the IRS Federal-State Reference Guide, Publication 963), the Tax Court (*see, e.g.,* Schramm v. Commissioner, T.C. Memo. 2011-212), and the Supreme Court (*see* Nationwide Mut. Ins. Co. v. Darden, 503 U.S. 318 (1992)).

While the D.C. Circuit in *PIAA v. NLRB* did hold that athletic officials were independent contractors, this holding was largely based on "the few times on which PIAA actually pays the officials and the short duration of the officials' employment." And, as noted by NPERS, that case was concerned with the relationship between the officials and the athletic association, not with the school districts (and even noted the fact that the schools directly paid the officials for most of their games was a point against finding the officials to be employees of the athletic association). *See* Pennsylvania Interscholastic Athletic Association, Inc. v. National Labor Relations Board, 926 F.3d 837 (D.C. Cir. 2019). Though not entirely on point, this holding that a referee was not an employee of the athletic association is generally consistent with most other courts, and guidance from the IRS, that have examined similar issues with respect to athletic associations. *See, e.g.,* IRS FSA 1995 WL 1918516 (which details the distinction between Rev. Rul. 67-119 and 57-119, both of which dealt with athletic associations, but reached different conclusions based on the differences in control exercised over the officials), and Collegiate Basketball Officials Ass'n, Inc. v. N.L.R.B., 836 F.2d 143 (1987).

Additionally, mostly in the context of worker's compensation-related determinations of employee vs. independent contractor status, state courts have largely held that athletic officials be treated as independent contractors (for both the school district and the school itself) (*see, e.g.,* Farrar v. D.W. Daniel High School, 309 S.C. 523 (1992) and Brighton School Dist. v. Lyons, 873 P.2d 26 (1993); *see also* NASO Special Report: Officials & Independent Contractors, which is somewhat dated, but provides a good general overview and additional cases that are reasonably on point).

But please note that these cases do not appear to conduct the independent contractor analysis in the context of teacher who is also employed full-time by the same school district or school (and notably, there is dicta in *Brighton* indicating that the court's decision there was at least

[8] https://www.irs.gov/irm/part4/irm_04-023-005r

officials as contractors) from coverage, unless they are officiating a game run by the entity that normally employs them (*see* NASO Special Report, page 10).

Given the above, this appears to be a close call, but on balance, as NPERS has indicated that most other school districts treat teachers who officiate athletic events as employees (and include the related wages on their Forms W-2), we believe the better view would be to continue this past practice in all school districts and require the reporting of officiating-related wages to NPERS as compensation for retirement purposes (particularly if similar facts in the past have specifically caused a particular school district to reach a different conclusion on employee versus independent contractor status, as a change in treatment could potentially invite IRS interest).

We also note that there are no explicit carve-outs for "independent contractors" in the applicable definitions under NRS §79-902, and so even given that some of the guidance discussed above would allow for separate treatment as an independent contractor when officiating games for Internal Revenue Code purposes, the argument outlined by NPERS as being made by a particular school district that the Pennsylvania Interscholastic Athletic Association case supports independent contractor status is arguably less persuasive when specifically applied to the provisions of NPERS.

And as a final matter, we note that while employee vs. independent contractor determinations are ultimately based on the relevant facts and circumstances, as the tax-related consequences of misclassification are ultimately more negative when an employee is improperly treated as an independent contractor, the general conservative position in these circumstances is erring on the side of classifying the individual as an employee. As also outlined above, the employer and the teacher in question, presumably with the involvement of NPERS, could also file a form SS-8 to obtain IRS review of the status as well.

C. De Facto Cash or Deferred Arrangement and DROP

The IRS tends to examine public plans very closely to determine whether a DROP election includes a potential cash or deferred arrangement (CODA) as described above. The following is an example from a public plan other than NPERS.

The DROP provision in question provided that DROP participants were eligible to receive lump sum annual leave payments and to have these payments included as compensation in their retirement calculations upon entry into DROP. As it happened, participants who did not elect to participate in DROP were entitled to receive leave payouts upon termination of employment and have those amounts included as compensation in their retirement benefit calculation at their later actual retirement. The IRS questioned whether this made the DROP election a CODA, since one choice or the other might lead to a larger annuity benefit.

The state plan argued that the same amount of leave is paid (or available to be taken as actual leave, which the plan argued is the same thing) regardless of the DROP election being made or not. Though one choice may result in a higher determination of compensation at a particular time and therefore a higher benefit than the other, the election did not result in a difference in leave available to be paid out in cash. Thus, the plan argued that the there was no direct or

Alternatively, you may want to consider adding language to the effect that the DCP will accept a rollover contribution of an eligible rollover distribution, except the portion of any distribution that is not includible in gross income or is a Roth rollover. NPERS may wish to be more detailed in any employee communications to avoid confusion.

Nebraska Retirement Systems Committee
November 6, 2020 Hearing Transcript

KOLTERMAN: Welcome, everyone. Thank you for coming. This is a Retirement Systems Committee hearing. My name is Senator Mark Kolterman. I'm from Seward, Nebraska, and represent the 24th Legislative District. And I serve as, as Chair of this committee. The committee will take up the bills in order that are posted. Our hearing today is your, is your public part of the legislative process. And this is where we will get reports from various people that have been asked to testify. Committee members will come together. Come, I think-- I think what you see is what you get today. I am not sure if Senator Groene is coming. They have some COVID issues in his office, I do know that. Senator Bolz, I'm not sure-- she's indicated she won't be here. Senator Kolowski will not be here. And Senator Stinner will call in. So that's-- if you hear somebody click in and out, that will be Senator Stinner, probably. Please silence your cell phones. We ask that you wear a mask, if you have one with you, I appreciate that, while testifying. Move to the front when you're ready to testify and then spell your name for the record before you testify. If you are calling in, please do not put your cell phones on speaker mode because it gives us bad feedback in here. Last time we had one of these hearings, it was kind of ugly. The other thing that I would say is if you do have to leave the conference from the distance, hang up and call back in, because if you put yourself on hold, then we get background music. So we're just trying to be a little bit proactive on how we deal with the call-ins. The first hearing today will be LR315. It's a presentation of the legal compliance audit. Randy Gerke, the NPERS director, and Orron Hill, the NPERS legal counsel, who are usually in attendance at these hearings, notified me this morning that they've been exposed to COVID. And to be cautious, they're monitoring the hearing and Orron will call in when it's time to testify. The second hearing, we'll just have the presentation of reports by the political subdivisions with the underfunded defined benefit plans. We'll probably take a short break between the hearings. But with that, I'll open the hearing number LR315 and the presentation of the legal compliance audit. I believe, Orron, are you on the line?

ORRON HILL: Yes, Senator, I'm on the line.

KOLTERMAN: OK, do you want to go ahead and-- we have your handout in front of us.

KATE ALLEN: [INAUDIBLE]

KOLTERMAN: Pardon me?

DAVID POWELL: But I hear the feedback anyway.

KOLTERMAN: Well, that's better than it was so.

KATE ALLEN: He's hearing that.

DAVID POWELL: OK, well, well, I'll proceed. And we'll largely be following the PowerPoint report that I think you have in paper form and is based on the lengthier [INAUDIBLE] report [INAUDIBLE] that you should also have.

KOLTERMAN: Can, can--

DAVID POWELL: But to introduce ourselves first--

KOLTERMAN: Can you hold on for a second?

DAVID POWELL: I'm David Powell.

KOLTERMAN: We're, we're not getting a good signal here. Can you hold on for just a minute, please?

DAVID POWELL: Yes, I'll hold.

CHUCK HUBKA: I'm trying to think of what to suggest, since he's the only one.

_____: The caller--

STINNER: John.

_____: -- has joined the conference.

KOLTERMAN: Welcome, Senator Stinner. Would you make sure that you don't-- that you kind of mute us and just listen, because we're having audio difficulties again.

STINNER: OK, thanks.

KOLTERMAN: Yeah. Kate, can you control anything with that over there?

KATIE QUINTERO: Just the volume.

KOLTERMAN: Just the volume. Turn-- try turning the volume down just a little bit. Mr. Powell, are you still there? Mr. Powell?

DAVID POWELL: Yes.

the plan, the state law requirements, the Internal Revenue Code, Section 41(a) and 457. These requirements that apply to the systems plan and the [INAUDIBLE] regulations and their applicable federal laws. There is no such thing as a plan that does not have any errors, but we did identify a few areas of administration, not as to form or statute, but as to administration, that warrant further review by the system. And we'll be getting into those. We would observe that the retirement plan administration is inherently difficult and, yeah, there's no such thing as a plan that is entirely free from ambiguity. But we did find that Nebraska PERS administers their plan pursuant to internal control governing or reviewing the plan procedures and consistent with those plan operations. Melanie, can I turn it over to you for just a brief overview of exactly what we did in our review?

MELANIE WALKER: Yes, thank you, David. The next couple pages of our presentation describe the areas of federal income tax law that apply to qualified plans, which we reviewed for this compliance audit. And I won't read you these, I'll let you just review them yourself. But as you can see, our review covered a wide array of Internal Revenue Code rule, regulations, and workplace laws and just general plan administration topics. Then if you, if you keep going one more page, I think it's important before we discuss our findings to give a brief overview of the methodology we followed for this review. First, we requested from the system various documents that govern the plan and administration statutes, board policies, forms and procedures and then we reviewed these documents, first to become familiar with how your plans operate, but also to review the plan documents to determine if they comply with IRS code. The next step in the process is we came on site there in Nebraska and interviewed some retirement system executive staff on all aspects of plan operations over one and a half days. And then finally, we drafted this report, this report of our findings and recommendations, which form the basis of this discussion today. It's important to note that the topics we covered in the report include both issues being covered through our interviews and plan document review, as well as some issues that the, the retirement system specifically asked us to address. And I will-- I, I keep going, yeah. So let's go, keep going through the presentation. We're in section one, and we divided our report into sections. And this first section covers issues that relate to all of the plans or multiple plans under the system. And then later sections will cover issues that affect specific types of plans that we reviewed. The next page just lists the topics that are covered in this section. And I'm going to talk about the first topic which addresses the plan you-- that allow at the state, county [INAUDIBLE] plans to make-- the members can make

KOLTERMAN: OK.

DAVID POWELL: Yeah. Same here. Just holding it up to my face.

KOLTERMAN: That's a little bit better. Try turning your volume down just a hair, if you can.

CHUCK HUBKA: Is it possible one of them just can call direct into the room and then they just give the report, just the one?

KATE ALLEN: They each-- they're breaking up the report. They each give part of it.

DAVID POWELL: Right. Is this any better? I did turn the, the sound down, but I still hear the feedback.

KOLTERMAN: Well, that's a lot better.

MELANIE WALKER: Yes, David, that time, I didn't hear your echo.

KOLTERMAN: Let's--

DAVID POWELL: [INAUDIBLE]

MELANIE WALKER: Can you guys hear me a little better?

KOLTERMAN: Let's talk one, let's talk one at a time and take it very slow, if you would.

MELANIE WALKER: OK, I will do it. And if I'm getting garbled, please speak in again. That's, that's helpful. We'll try to address that. So we are on page eight of the presentation and we're talking about a rule, a plan rule that allows the state, county and school and patrol plan. The members can make payments from their payroll deductions to the plan to repay a refund or purchase service credit or repay benefits as required if they return to work before a bona fide termination. These payments are made to a irrevocable payroll deduction authorization on a pretax basis. You can do this through a special rule for governmental plan under the tax code that allows employers to deduct amount from the employee's paycheck on a pretax basis. And they make their payments to the qualified plan, so long as they meet certain requirements under IRS guidance. Those requirements are that the employer specifies in writing that the contributions employee makes is-- are picked up by the employer through a formal action. Employees also can have no ability to elect out of this deduction and receive the pay in cash. So that's the basis of our--

DAVID POWELL: Oh, yes, they do.

MELANIE WALKER: Yes, they do.

CLEMENTS: Now, does that mean you can add some years of service to your actual years of service with the payment?

MELANIE WALKER: Correct.

CLEMENTS: And does Nebraska allow that?

KOLTERMAN: Yes.

KATE ALLEN: Yes.

CLEMENTS: OK.

KATE ALLEN: The school plan does.

CLEMENTS: Thank you.

KOLTERMAN: The school plan does allow for that.

DAVID POWELL: Yeah, the statute.

KOLTERMAN: Any other questions? All right. Thank you. Go ahead.

DAVID POWELL: OK, I will pick up with the next--

_____: The caller has joined the conference.

DAVID POWELL: -- 10 on page 10, and it is that when erroneous payments are made occasionally to participants, such as a person starts to receive a benefit claiming a termination of employment, but it turns out not to have been bona fide. They come back fairly quickly within the holdout time period, which is 120 days for most plans. There are procedures in the plan for having those paid back to the plan. But one thing that we discovered was that those repayments do not include any interest for the period that the participant mistakenly held them. And the IRS revenue procedures on correcting overpayments, which is what these are called, overpayments to participants, states that not only do you have to make efforts to recover the overpayment, but that that should also include earnings on that overpayment. The theory being that it should put the plan assets back in the position they would have been in had the overpayment not occurred. But as I just mentioned, the, the current processes don't include such interest. The, the IRS has issued a number of different ways in which you can

against their next contributions. So what we were suggesting is that for older mistaken contributions by employers that are outside of the one-year period, that those mistakes be corrected through giving them a credit, rather than sending money out [INAUDIBLE].

KOLTERMAN: OK.

DAVID POWELL: Assuming there's no questions on that.

KOLTERMAN: Yeah, do we have any questions from the committee? OK, we're with you. Thank you. Move on to cybersecurity.

DAVID POWELL: Certainly. Well, also, reasonable allocation of expenses on page 12. Just to touch on this. It is an important point that each of these separate plans, there are really five qualified plans here, plus the 457(b) plan, only pay for their own expenses. Now, sometimes expenses are a little difficult to divide up. You are permitted to make reasonable allocations. The record keepers that, outside record keepers that assist the system do make such efforts when they enter into the contract with the system. But we suggested that the system should review how they're dividing it up and just document that, in fact, you know, each, each plan is only paying its own reasonable share of the expenses. Moving on, we didn't, we did not find an error in that, we just suggested that they beef up their documentation. On cybersecurity on page 13, this is something that we, we raised not because we found an issue in it, but because it is such a prominent concern right now. As an employee benefits firm, we are seeing a lot of our clients having hacking attacks. And it is not just at the record keepers and at the employer's system. What is more frequently happening all the time is hacks of the participants obtaining information so that the hackers access the participants' benefits and have benefits distributed into accounts where they can no longer be recovered or traced. This is an increasing issue. We did discuss it with the system. As you can see on the following page, 14, in this case, it is the State Treasurer rather than the Nebraska PERS that is responsible for the cybersecurity. But moreover, the Nebraska system continues to use paper distribution forms, but because of the notarial requirements, which are much harder for criminals to, to use to create a false distribution request. So our only real point on this, even though we think it's important and raised it, is that Nebraska PERS should continue to monitor this because it is an increasingly criminal cyber activity. If there's no questions on that, I would turn it over to Melanie for some discussion on what we found on lost participants and uncashed checks.

advantage to keeping the forfeited assets and the investment income on those amounts in the system would, would be that these assets can offset plan liabilities, which would be beneficial to the funding status of the plan. On the other hand, you have to note that keeping the money in the system's trust fund may or may not be beneficial to the system overall, it would have to be something that was determined, because they would be responsible for keeping participant records for a long period of time and then administrative costs to, to maintain a system for finding lost participants and keeping these unclaimed benefits in their own trust fund. Although it is sort of, on the other side, it PERS-- the system is already required to do due diligence in searching for lost participants, as we just discussed, so they may already be taking much of the effort that's needed before they, they transfer money to the unclaimed property fund. So this is just a discussion that we had and that it was important that we captured in our report, if this is something that the system or the Legislature wants to explore. And then I would like to just update on this. There is some new guidance on, from the IRS on unclaimed property funds, state unclaimed property fund. And there's two pieces. Mainly the IRS said that when a system transfers assets of unclaimed benefits to, to this sort of unclaimed property fund of a state, this is considered a distribution and the plan must withhold taxes on that amount and report it on the form 1099-R. Further, the IRS said that when this type of distribution is made, once the participant comes to claim it, they could claim and self-certify that they, this is one reason why they did not get an opportunity to roll over the benefit and avoid the taxation, so that there's usually a rule, a rule that says you have to, once you receive a distribution, whether in actuality or it's, it's considered that because others in federal income tax rules, that you have to, you have 60 days to roll it over and avoid that income tax. So the IRS basically says if that money is sent to unclaimed property fund, you have to pay taxes, the system, the retirement plan has to take taxes out of it. And but the participant who did not get an opportunity to roll it over could at some point roll it over someone-- somewhere and get, you know, those tax amounts back. OK, I'm going to pause for a minute and see if there's questions. And if not, I'm going to turn it over to section 2, issues affecting your defined benefit plans, to David.

KOLTERMAN: I don't see any questions. Go ahead and take section 2.

DAVID POWELL: OK. OK, I'm going to talk about some issues that affect the defined benefit plans in particular. And if you look at page 19, I have two listed there. One is bona fide terminations of employment and the other is cash or deferred arrangement issues. One thing about both

at length the, the rules for differentiating between employees, bona fide common-law employees and independent contractors, as well as when someone is an employee. And the standard for determining when there is a bona fide termination of employment, which is a facts and circumstances determination. It's, it's really based on the intent at the time of the departure--

_____: The caller--

STINNER: John.

_____: -- has joined the conference.

DAVID POWELL: -- Nebraska's particular holdout period. So what our recommendations on this were are, again on page 22. And the first one is more outreach to the employers to understand the implications of this, that it is important from a tax qualification standpoint and to understand how to differentiate between bona fide employees, common law, bona fide common-law employees and independent contractors and the rules around return to work. We also pointed out that there is, in fact, an IRS form. If, if the facts and circumstances are difficult, the form can be filed by an individual or it could be filed by the employer. Technically, the system does not have standing to file, but they can certainly ask to review the form. But those forms, once filed with the IRS, laying out the facts of the particular employment arrangement or a purported independent contract [INAUDIBLE] do lead to the IRS ruling one way or the other. So you have something you can rely on. In addition, if there are particular questions, it's possible to go for an IRS private letter ruling on return to work. We had pointed out to them that there is a very well-known one from 2011 pointing out that you cannot simply say that you're retiring and then come right back to work. That that is not a termination of employment and that the IRS would likely be happy to issue another such ruling on other facts. And then lastly, just for completeness, to point out that even though what I was referring to is double dipping, when you're receiving your pension and your salary at the same time, is not very common in the public plan space. It's somewhat more common in the private sector. It is not always impermissible under the Internal Revenue Code. It's to point out in particular to the Legislature that the IRS would allow a distribution from a retirement plan while the person is in service if the plan allows and if the person is over normal retirement age. So in theory, the statute could be amended to say once a particular type of employee, like a teacher reaches age 65, they could continue to work and they could start to receive their retirement benefit. I do want to point that out. However, it's not

And it could be temporary or it could be permanent and the process can be controlled by the Legislature, by, or by the system, however, works best for your particular situation. So there I do see that in many different states.

KOLTERMAN: I might just say that this is a problem that we've had long before COVID came around. Especially in light of the fact that we have some of these school districts in rural areas, that it's hard to attract young people to come back to and it's just been a challenge. But we'll, we'll continue to look at that and continue to work at it. And I know that the PERB and NPERS and OSERS are constantly looking at that issue. So-- but thank you for your input there. Let's move on to section 3 of issues affecting the defined contribution cash balance.

ORRON HILL: Senator Kolterman.

MELANIE WALKER: [INAUDIBLE].

ORRON HILL: Senator Kolterman, this is Orron.

KOLTERMAN: Yes?

ORRON HILL: Do you mind if I ask one point of clarification really quickly, please?

KOLTERMAN: Absolutely. Go ahead.

ORRON HILL: David or Melanie, whoever would like to answer, in order to drop that age to 62 or 59 and a half, we would actually have to lower the normal retirement age in the plans to those ages. Is that correct?

DAVID POWELL: Yes, yes.

ORRON HILL: That was my understanding, I just wanted to make sure that, that I understood that correctly.

KOLTERMAN: And Orron, that would have to be done through statute.

DAVID POWELL: Yes.

ORRON HILL: Yes, Senator, that was [INAUDIBLE].

KOLTERMAN: We might have some work to do this year. Let's, let's move on to section 3. Thank you.

regulations on it. They even have draft regulations already out. The one plan where there may be some gray area entities is really the county plan. We, we've raised this in the past, we raised it again with the Nebraska PERS. And it does happen that they have a subcommittee that is monitoring those employers. In other words, a county hospital, healthcare entity, athletic fitness facility, those are the sort of things we consider in the gray area. We don't generally advise moving gray area entities into or out of the plans at this point. But just note that it's important to continue to monitor it. And if the IRS comes out with guidance to evaluate it then and see if there are any entities where there's an issue as to whether they can really be in the county plan or not, subject to whatever transition relief the IRS would decide to issue. On page 29, we had recommended that the system put the cash balance plans into the IRS for a determination letter. There just happens to be a window of opportunity for cash balance plans to get an updated IRS determination letter. So I should probably mention the IRS closed down the opportunity to get an IRS review and a favorable opinion letter a number of years ago. But they've made a couple of exceptions over time and they made one for cash balance plans. And in fact, at the direction of Nebraska PERS, we did file those with the IRS back on August 21. It will probably be many months before we hear from the IRS again. But, but that was done. Melanie, would you like to talk about section 4?

KOLTERMAN: Before you go there--

MELANIE WALKER: Yes?

KOLTERMAN: -- can I ask a question of either Orron or one of you? When we talk about these, these small, like the hospitals and athletic fitness facilities, we're very limited in what we have there, aren't we?

ORRON HILL: Senator, this is Orron. Yes, there is few employees at the fitness centers. The county hospitals can be a little bit larger in employee number, but there's very few of the hospitals that actually participate in the plan. So few in employer number and then, depending on which type of employer, few in employee number as well.

KOLTERMAN: OK. So it's not a huge concern on our part, but it is--

_____: The caller--

STINNER: John.

DAVID POWELL: Well, I will just point out that on page 35, we have a list of a few additional items that we had discussed the legal aspects of with Nebraska PERS. Not really so much issues as to questions as to how things should operate, including how some very quirky rules for the 457(b) plan on making salary reduction elections work with different payroll cycles was one. We had discussions about various particular employee independent contractor issues, including say coaches or teachers who might also be acting as athletic official. There's, there's some discussion of that at the end of our longer report. Happy to discuss that further. That there be sensitivity around the deferred retirement option plan designs, the DROP, as to any potential CODAs there, because as we mentioned a couple of times, the IRS does not want to see any employee making a choice that will have a-- in return for a different impact on their salary or payments of leave, severance, things like that in exchange for a different benefit. Not a particular policy reason for that, but it's in the Internal Revenue Code, it's been there since 1986. And the IRS feels strongly that those sort of elections that affect your benefits and salary should not be permitted. And lastly, we addressed the rules for rollovers into the deferred compensation plan. That I think summarizes our report. I would then open it up for any further questions that you all may have.

KOLTERMAN: Thank you very much for your report, David and Melanie. I appreciate your patience as we work through the challenges of the audio here. Orron, do you have anything else you would like to say or anything you'd like to bring forward? We do have as a committee, we've got your response and we have the crosschecked review from, from Groom Law as well as Segal, the subcontractor, that will be put in as part of the record. So Orron, this is your opportunity if you have anything you'd like to address. Otherwise, your response has been very thorough. Appreciate that.

ORRON HILL: OK, Senator, there's just a couple of things I want to, I guess, touch on real quick in response to perhaps some of the questions that came in, if, if I may.

KOLTERMAN: Go ahead.

ORRON HILL: OK, so one of the things that was discussed was the possibility of lowering the normal retirement age to allow for either in-service distributions or potential quicker returns to work. I do want to make sure that it's pointed out that the Legislature understands that lowering the normal retirement age can have a significant cost to the plan and increase the cost of the benefits. So