GROOM LAW GROUP

MEMORANDUM

March 17, 2025

TO: North Carolina Department of State Treasurer, Retirement Systems Division

FROM: David N. Levine
Kimberly M. Boberg

RE: Proposed Legislation Regarding High Need Retired Teachers

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This memorandum provides a review of House Bill 106, *Revive High Need Retired Teachers Program* ("HB 106"),[1] which revives the program established under Senate Bill 399 and Senate Bill 621 ("Prior Legislation"). We outline below (1) the Plan's qualified status, (2) a summary of the Prior Legislation and related private letter ruling ("PLR") issued by the Internal Revenue Service ("IRS"), (3) a summary of HB 106, (4) applicable Internal Revenue Code (the "Code") provisions and related IRS guidance, and (5) application of the IRS guidance to HB 106.

Background

The Teachers' and State Employees' Retirement System (the "Plan") is a governmental plan under Code section 414(d) that is qualified for tax purposes under Code section 401(a). The tax-qualified status of the Plan language was confirmed through a favorable determination letter issued by the IRS on September 29, 2016. In addition, 20 NCAC 02A .0104 incorporates the Code by reference, thereby requiring compliance with its terms, with certain Code provisions explicitly cited and described in the General Statutes and North Carolina Constitution.[2]

Prior Legislation and PLR Request

The Prior Legislation amended the terms of the Plan to permit the hiring of high need retired teachers ("HNRTs"). On behalf of the Department of State Treasurer ("DST"), we submitted a request to the IRS for a PLR that the provisions of the Prior Legislation did not create an impermissible cash or deferred arrangement under Code section 401(k)(4)(B)(ii) and Treasury Regulation section 1.401(k)-1(e)(4)(i). On April 9, 2020, the IRS provided a favorable ruling, subject to certain limitations.

The favorable ruling specifically provides that the amended Plan language permitting the hiring of retirees as HNRTs "does not create an employee election that could constitute a cash or

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[1] Our review is based on proposed PCS H106-CSBEap-4 (v2) provided to the Retirement Systems Division by legislative staff on March 14, 2025.

[2] *See e.g.* N.C. Const. Art. V, Section 6(2); and N.C. G.S sections 135-2 and 135-18.7.

deferred arrangement within the meaning of" Code section 401(k). The ruling focuses on two main points relating to these plan provisions: (1) the timing of an individual's retirement, and (2) the inability of an individual to elect between a position as an HNRT and a different, benefit-eligible position.

Application of Ruling

To the first point, the ruling anchors on there being no prearrangement for the retiree to return to employment. Specifically, the ruling focuses on the fact that to be eligible for rehire as an HNRT, a member must have retired on or before February 1, 2019, which was prior to the passage of the legislation. Therefore, the member could not have had a prearrangement with an employer to return to service at the time of his or her retirement.

To the second point, language that creates a cash or deferred arrangement ("CODA") under the Plan would raise a qualification concern, as governmental plans may not create new CODAs under the Code. A CODA would arise where an individual has the choice between cash now or deferred amounts later. While not a direct choice between the two, the IRS treats an election between a position that is not benefit-eligible, where all amounts are received as current compensation, and a different position that is benefit-eligible, where some amounts are deferred until a later date, as a CODA. Therefore, to avoid CODA concerns, the language of the PLR reinforces that an individual must not be able to elect between an HNRT position and a different position that is benefit-eligible.

Limitations of Relief

The ruling focuses on the fact that a member could not have had a prearrangement to return because they were required to have retired prior to passage of the legislation. Therefore, any expansion of the language to permit members who retired at a later date to be rehired as HNRTs would likely be outside the scope of the ruling, and would raise the risk that the IRS could find a prearrangement to return, which is a plan qualification concern.

In all cases, the employer must make the decision to offer an HNRT position to an individual. To avoid a CODA, the individual must not be given the opportunity to choose between a position that is not benefit-eligible and one that is benefit-eligible.

The ruling also reflects that an individual hired as an HNRT is to be hired on a one-year contract. While the ruling does not limit recurring one-year contracts for those eligible under the ruling to be hired as an HNRT, it does reflect that, in addition to making the decision to hire an individual as an HNRT, it is the employer's decision whether an individual is hired for a subsequent year.

Proposed Legislation

As with the Prior Legislation, HB 106 proposes to allow the rehire of retired members into an HNRT position. To be eligible for such position, a member must have retired at least two months prior to their scheduled rehire date, and must have attained (1) the age of at least 65 with five years of creditable service, (2) the age of at least 60 with 25 years of creditable service, or (3) 30 years of creditable service. In addition, such members may not have a choice on rehire

between an HNRT position and a position that is benefit-eligible. HB 106 generally tracks the Prior Legislation, with an important difference, in that the Prior Legislation only applied to members who had already retired when the legislation was passed, while HB 106 does not have such limitation.

Legal Background

Cash or Deferred Arrangement

Code section 401(k)(2) provides that "[a] qualified cash or deferred arrangement is any arrangement which is part of a profit-sharing or stock bonus plan, a pre-ERISA money purchase plan, or a rural cooperative plan which meets the requirements of subsection (a)—(A) under which a covered employee may elect to have the employer make payments as contributions to a trust under the plan on behalf of the employee, or to the employee directly in cash."

Code section 401(k)(4)(B)(ii) provides that "[a] cash or deferred arrangement shall not be treated as a qualified cash or deferred arrangement if it is part of a plan maintained by a State or local government or political subdivision thereof, or any agency or instrumentality thereof."

Treasury Regulation section 1.401(k)-1(a)(1) provides that "[a] plan, other than a profit-sharing, stock bonus, pre-ERISA money purchase pension, or rural cooperative plan, does not satisfy the requirements of section 401(a) if the plan includes a cash or deferred arrangement. A profit-sharing, stock bonus, pre-ERISA money purchase pension, or rural cooperative plan does not fail to satisfy the requirements of section 401(a) merely because the plan includes a cash or deferred arrangement. A cash or deferred arrangement is part of a plan for purposes of this section if any contributions to the plan, or accruals or other benefits under the plan, are made or provided pursuant to the cash or deferred arrangement."

Treasury Regulation section 1.401(k)-1(a)(2)(i) provides that, with exceptions not applicable here, "a cash or deferred arrangement is an arrangement under which an eligible employee may make a cash or deferred election with respect to contributions to, or accruals or other benefits under, a plan that is intended to satisfy the requirements of section 401(a) (including a contract that is intended to satisfy the requirements of section 403(a))."

Treasury Regulation section 1.401(k)-1(a)(3)(i) provides that "[a] cash or deferred election is any direct or indirect election (or modification of an earlier election) by an employee to have the employer either—(A) Provide an amount to the employee in the form of cash (or some other taxable benefit) that is not currently available; or (B) Contribute an amount to a trust, or provide an accrual or other benefit, under a plan deferring the receipt of compensation."

Treasury Regulation section 1.401(k)-1(e)(4)(i) provides that "[a] cash or deferred arrangement does not satisfy the requirements [to be a qualified cash or deferred arrangement] if the arrangement is adopted after May 6, 1986, by a State or local government or political subdivision thereof, or any agency or instrumentality thereof (a governmental unit)."

Bona Fide Termination

Treas. Reg. section 1.401(a)-1(b)(1)(i) provides that "[i]n order for a pension plan to be a qualified plan under section 401(a), the plan must be established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits to its employees over a period of years, usually for life, after retirement or attainment of normal retirement age . . . ."

Treas. Reg. section 1.401(a)-1(b)(3) provides that "[f]or purposes of paragraph (b)(1)(i) of this section, retirement does not include a mere reduction in the number of hours that an employee works. Accordingly, benefits may not be distributed prior to normal retirement age solely due to a reduction in the number of hours that an employee works."

Private Letter Ruling 201147038 (Apr. 20, 2010)[3] provides that a termination of employment must be bona fide (i.e., not a mere subterfuge in order to initiate an otherwise impermissible distribution where no substantial change in employment has occurred). Further, the PLR indicates that where there is an agreement between the employer and employee that an employee will return to service after their termination, a bona fide separation from service has not occurred. The PLR specifically provides that "if both the employer and employee know at the time of 'retirement' that the employee will, with reasonabl[e] certainty, continue to perform services for the employer, a termination of employment has not occurred upon 'retirement' and the employee has not legitimately retired." Further, "employees who 'retire' on one day in order to qualify for a benefit under the Plan, with the explicit understanding between the employee and employer that they are not separating from service with the employer, are not legitimately retired."

Analysis

To maintain its tax-qualified status, the Plan terms and operations must comply with the qualification requirements of the Code. Therefore, the requirements of the Code, Treasury Regulations, and related guidance control, and the Plan must be interpreted in a manner consistent with these requirements and any changes to Plan language or operations must continue to comply with the Code.

To avoid the creation of an impermissible CODA, members must not have an opportunity to choose between an HNRT position and a benefit-eligible position. Therefore, strict compliance with Section 2.(i) of HB 106 would be required to maintain the Plan's qualified status.

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[3] Code section 6110(k)(3) provides that a PLR "may not be used or cited as precedent." Thus, in any dispute between the IRS and a taxpayer other than a taxpayer that receives a PLR, the PLR may not be cited as valid authority. However, although a PLR is not formal precedent that may be cited, it is authority that a taxpayer may consider to establish the tax consequences of a potential transaction or situation. *See Hanover Bank v. Comm'r*, 369 U.S. 672, 686-687 (1962) ("although the petitioners are not entitled to rely upon unpublished private rulings which were not issued specifically to them, such rulings do reveal the interpretation put upon the statute by the agency charged with the responsibility of administering the revenue laws."); *Ogiony v. Comm'r*, 617 F.2d 14, 17 (2d Cir. 1980) (concurring opinion).

Further, as benefits have commenced to these members, and in-service distributions are not permitted under the Plan, Code section 401(a) requires that any separation from service must be "bona fide" in order for a member to be eligible for benefits from the Plan. While the IRS looks to all of the facts and circumstances in determining whether a bona fide termination has occurred, including hiring practices and whether there is an expectation of the ability to return, an important factor for the IRS in granting the PLR regarding the Prior Legislation was the fact that any impacted member would have retired before the passage of the Prior Legislation, such that a member could not have had a prearrangement to return to employment. Therefore, the need to show a bona fide termination with respect to each member hired as an HNRT under the Prior Legislation was not needed. Here, the same rationale is not available, such that it must be shown that each member rehired as an HNRT had a bona fide termination of employment. As such, it would be key that with respect to a member who "retires" at the end of one school year as school ends for the summer break period, there is no preconceived plan to rehire the individual as a HNRT at the start of the next school year.

As the intent of the parties may be difficult to demonstrate at times, it is common for governmental plan sponsors to establish minimum time periods during which employment must have ceased in order for any terminated and rehired employee to be treated as having had a bona fide termination of employment, such as the two-month separation period under HB 106. However, while such a period may be helpful in limiting IRS scrutiny, such a period alone is not sufficient, the absence of a prearrangement for rehire is still required. Where there is an understanding at the time of the member's retirement that he would return to employment (i.e., a prearrangement), the length of his separation is generally treated as less relevant, and there is a greater risk that the IRS would find that no bona fide termination of employment had occurred. Without a bona fide termination, any distribution would be treated as a distribution while a member is still employed and would be an impermissible in-service distribution.

Therefore, the conservative approach, which is most protective of the Plan and its members and beneficiaries, is to provide that the proposed legislation will not take effect until a PLR is obtained confirming that the proposed legislation complies with the Code and related guidance. This approach would avoid the risks noted below and any related corrective action that could be required if the legislation is enacted without prior IRS approval and a violation is later found. Although DST could pursue (and bear the cost of pursuing) a PLR, there is no guarantee the IRS would issue a PLR on this topic, whether favorable or unfavorable. Specifically, there is a risk that the IRS would, even if not disclosed to DST or us, conclude that a two-month waiting period is insufficient to result in a "bona fide" termination for employees whose normal annual work schedules involve at least two calendar months between academic years. As a result, there is a significant risk DST would pay the costs of pursuing a PLR, but would not receive a favorable PLR.

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MEMORANDUM

April 25, 2021

TO: North Carolina Department of State Treasurer, Retirement Systems Division

FROM: David N. Levine
Kimberly M. Boberg

RE: Private Letter Ruling Regarding High Need Retired Teachers

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This memorandum provides a summary of the key points in the private letter ruling dated April 9, 2021 ("PLR") received by the Department of State Treasurer ("DST") with respect to language regarding the hiring of high need retired teachers (each a "HNRT") under Senate Bill 399 and Senate Bill 621. We outline below (1) the request made, (2) the specific relief granted by the Internal Revenue Service under the PLR, (3) what the ruling means in operation, and (4) the limitations of the relief provided.

PLR Request

On behalf of DST, we submitted a request to the Internal Revenue Service for a PLR that the provisions of Senate Bill 399 and Senate Bill 621 amending the terms of the Teachers' and State Employees' Retirement System (the "Plan") to permit the hiring of HNRTs do not create an impermissible cash or deferred arrangement under section 401(k)(4)(B)(ii) of the Internal Revenue Code (the "Code") and Treasury Regulation section 1.401(k)-1(e)(4)(i). On April 9, 2020, the Internal Revenue Service provided a favorable ruling, subject to certain limitations.

Relief Granted

The favorable ruling specifically provides that the amended Plan language permitting the hiring of retirees as HNRTs "does not create an employee election that could constitute a cash or deferred arrangement within the meaning of" Code section 401(k).

Application of Ruling

The ruling focuses on two main points relating to these plan provisions: (1) the timing of an individual's retirement, and (2) the inability of an individual to elect between a position as an HNRT and a different, benefit-eligible position.

To the first point, the ruling anchors on there being no prearrangement for the retiree to return to employment. Specifically, the ruling focuses on the fact that to be eligible for rehire as an HNRT, a member must have retired on or before February 1, 2019, which is prior to the passage of the legislation. Therefore, the member could not have had a prearrangement with an employer to return to service at the time of his or her retirement.

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Limitations of Relief

The ruling focused on the fact that a member could not have had a prearrangement to return because they were required to have retired prior to passage of the legislation. Therefore, any expansion of the language to permit members who retired at a later date to be rehired as HNRTs would likely be outside the scope of the ruling, and would raise the risk that the IRS could find a prearrangement to return, which is a plan qualification concern.

In all cases, the employer must make the decision to offer an HNRT position to an individual. To avoid a CODA, the individual must not be given the opportunity to choose between a position that is not benefit-eligible and one that is benefit-eligible.

The ruling also reflects that an individual hired as an HNRT is to be hired on a one-year contract. While the ruling does not limit recurring one-year contracts for those eligible under the ruling to be hired as an HNRT, it does reflect that, in addition to making the decision to hire an individual as an HNRT, it is the employer's decision whether an individual is hired for a subsequent year.