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*By E-mail: [davelang@profirefighter.com](mailto:davelang@profirefighter.com) and FedEx*

Mr. David Lang  
Professional Firefighters of New Hampshire  
25 Nashua Road  
Londonderry, NH 03053

**Re: Proposed Corrections Relating to 401(h) Subtrust under the New Hampshire Retirement System**

Dear David:

You have asked this firm to comment on the proposed reform of the methodology for funding the 401(h) subtrust maintained by the New Hampshire Retirement System (“NHRS”) for the purpose of subsidizing the cost of retiree health care for certain eligible retirees. Specifically, you have asked whether it is necessary to return \$26,384,000 that was allegedly transferred to the subtrust from the medical special account administratively established under the special account for supplemental benefits.

Factual Background

Under the pressure of mounting unfunded liabilities, the NHRS is undergoing a multiyear effort intended to reform and restructure the system. Pursuant to this process, new actuarial, investment and legal advisers have been retained and various commissions and committees have studied the issues and made recommendations.

Pursuant to such recommendations, legislation was enacted in 2007, that adopted the “Entry Age Normal” method as the system’s actuarial funding method in place of the “Open Aggregate Method” that had effectively minimized contributions to the state annuity accumulation fund (“SAAF”), sometimes referred to as the general fund or the NHRS trust corpus.<sup>1</sup> In addition, new limitations were imposed on the funding of the statutorily established “special account” that pays for cost of living adjustments (“COLAs”) and certain additional benefits. As reformed, earnings from the entire system (including the SAAF) are paid into the special account to the extent that they exceed 10.5%, but only if the system’s funded ratio is equal to or greater than 85%.<sup>2</sup>

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<sup>1</sup> N.H. Rev. Stat. Ann. §100-A:16.

<sup>2</sup> N.H. Rev. Stat. Ann. §100-A:16II(h)(2). In years before 2007, the earnings threshold that had to be met in order for contributions to be made to the special account was determined by a different formula that made it more likely that contributions to the special account would, in fact, be made.

The NHRS also provides a postretirement subsidy to certain retirees that partially covers the cost of continuing medical coverage under their former employer's health plan.<sup>3</sup> The subsidy is provided by a "401(h) subtrust" which, pursuant to statute, is to be funded by allocating to the subtrust 25 percent of future employer contributions made to the SAAF for each of the system's four employment classifications.<sup>4</sup> The NHRS statute also provides for the transfer of funds from the special account to the SAAF of an amount equal to the contributions made to the 401(h) subtrust.<sup>5</sup> This was intended to reduce potential funding short falls with respect to the SAAF, thereby easing the funding burden on contributing employers. In practice, these reimbursements were made from a medical special account that was established administratively as a subaccount of the special account. On each occasion that the state legislature approved or extended a medical subsidy, the present value of the resulting anticipated liability was, for bookkeeping purposes, transferred from the special account to the medical special account.<sup>6</sup> This device was apparently intended to satisfy the state constitutional prohibition of unfunded mandates.

A legal review of the funding of retiree health benefits through the 401(h) subtrust was conducted by the law firm of Ice Miller LLP. The resulting report, dated November 13, 2007, concluded that the funding methodology violated provisions of the Internal Revenue Code ("Code") that must be satisfied in order to maintain the status of the NHRS as a qualified plan. Thus, the report indicated that while the NHRS statute as well as Section 401(h) of the Code restricted contributions to the 401(h) subtrust to 25% of employer contributions, the 401(h) subtrust had, in fact, been credited with 33 $\frac{1}{3}$ % of employer contributions. In addition, the report stated that in the fiscal years 1990 to 2000, a total of \$26,384,000 had been transferred from the medical special account to the 401(h) subtrust.<sup>7</sup> The report did not indicate the source from which these facts were derived, but for purposes of our analysis herein, it is assumed that they are accurate. The report also took issue with the procedure pursuant to which amounts equal to the contributions made to the 401(h) subtrust were transferred from the medical special account to the SAAF.

### Legal Analysis

25% Limitation on Contributions to 401(h) Subtrust. One of the many conditions that a pension program, such as the NHRS, must satisfy in order to be a qualified plan under the Code is that any health related benefits provided under the plan must be subordinate to the plan's

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<sup>3</sup> N.H. Rev. Stat. Ann. §§100-A:52, 100-A:52-a and 100-A:52-b identify the retirees who are entitled to the subsidy and specify the amount of the subsidy.

<sup>4</sup> N.H. Rev. Stat. Ann. §§100-A:53-I (group II employees); 100-A:53-b-I (group I teachers); 100-A:53-c-I (group I political subdivision employees); and 100-A:53-d-I (group I state employees).

<sup>5</sup> N.H. Rev. Stat. Ann. §§100-A:53-II; 100-A:53-b-II; 100-A:53-c-II; and 100-A:53-d-II.

<sup>6</sup> Fiscal notes prepared in connection with each legislative enactment indicated the amount of the appropriation to be charged to the special account to pay for the subsidy. See Final Report of the Commission to Study the Long Term Viability of the NH Retirement System, at 89 (January 2, 2008).

<sup>7</sup> The Ice Miller report stated that these transfers were indeed to reimburse the 401(h) subtrust for retiree medical benefits that were paid to certain group II retirees.

primary purpose of providing retirement benefits. Under Section 401(h) of the Code, this test is met only if the “aggregate actual contributions” for medical benefits do not exceed 25% of the “total actual contributions” to the plan after the date it first includes medical benefits. For this purpose, contributions to fund past service credits are disregarded.<sup>8</sup>

As indicated above, the Ice Miller report does not indicate the source of the data concerning employer contributions to the SAAF and to the 401(h) subtrust that was used to determine whether the subordination test was satisfied. We note, however, that the notes to the comprehensive annual financial report (“CAFR”) for the NHRS generally contained a statement that payments to the 401(h) subtrust are “funded through contributions of the employers, which may not exceed 33⅓% of the normal cost for the respective membership classification.” This statement is consistent with the fact that contributions for retiree medical purposes equal to 25% of the employer contribution would be 33⅓% of the remaining amount (75%) paid to the SAAF.<sup>9</sup> Thus, we believe it to be likely that the subordination test was not violated, because the 33⅓% contribution rate was calculated on a one to three ratio of the amount actually contributed to the SAAF.

There are two other aspects of the subordination test which make it unlikely that there was a violation of the test by virtue of an excess contribution to the 401(h) subtrust. First, the contributions covered by the test include employee as well as employer contributions.<sup>10</sup> Our review of private letter rulings issued by the IRS with respect to the subordination test failed to discover any rule or principle that would limit the application of the test to employer contributions. Examination of the system’s 2006 CAFR indicates that contributions to the 401(h) subtrust were 19.28% of total contributions, thereby passing the 25% test by a substantial margin.<sup>11</sup>

Even if contributions to the 401(h) subtrust were found to exceed 25% of the total contributions to the subtrust and the SAAF in a given year, we note that the test under the Code is cumulative and that the 25% limitation would be calculated from 1988 (the beginning of the retiree medical obligation) until the present time. Thus, contributions less than the allowed maximum for any year, as in 2006, will make it easier to meet the test in a later year. We do not have access to all of the CAFRs for the NHRS since the inception of the retiree medical

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<sup>8</sup> Code §401(h); Treasury Regulation §1.401-14(c).

<sup>9</sup> NHRS CAFR for the Fiscal Year Ended June 30, 2006, Note 6 at p. 40-41. The note goes on to state that, “As provided by RSA 100-A, I, 33⅓% of certain Group I and Group II employer contributions are paid into the Medical Plan Subtrust.”

<sup>10</sup> Treasury Regulation §1.401-14(b)(3) acknowledges that contributions to a 401(h) subtrust may be made either on a contributory or noncontributory basis, without regard to whether contributions to fund retirement benefits are made on a similar basis. Thus, as under the NHRS, the regulations provide that “contributions to fund the medical benefits described in section 401(h) may be provided for entirely out of employer contributions, even through the retirement benefits under the plan are determined on the basis of both employer and employee contributions.”

<sup>11</sup> NHRS CAFR for the Fiscal Year Ended June 30, 2006, Statements of Changes in Plan Net Assets, at p. 29, indicates total contributions for 2006 of \$318,642,000 of which post retirement medical contributions of \$61,449,000 constituted 19.28%.

obligation, and have, therefore, not been able to determine the outcome of the subordination test aggregating all years and all types of contributions. However, in light of the factors discussed above, we believe that it is likely that the test would, in fact, be passed.

*Direct Transfers from Medical Special Account to 401(h) Subtrust.*

a. Preliminary Considerations Relating to Ice Miller Recommendations. The legal review of the funding methodology for retiree medical benefits resulted in a finding that a total of \$26,384,000 had been transferred from the medical special account to the 401(h) subtrust to reimburse it for retiree medical benefits paid to group II employees who had retired before July 1, 1988. The payments to the 401(h) subtrust were made on an annual basis over the eleven year period from 1990 to 2000. The Ice Miller report concludes that the transfers violated the exclusive benefit rule contained in Section 401(a)(2) of the Code which, like the subordination test, discussed above, is a condition of maintaining a tax-qualified plan. Accordingly, the report recommends that the erroneous transfers, plus interest, be returned to the special account, having also recommended that the medical special account be merged into the special account from which it was created.

Initially, we note that even if the transfer of funds to the 401(h) subaccount were found to be a violation of the exclusive benefit rule, which we think is not the case, the statute of limitations appears to have expired on the applicable transactions, the last of which occurred over seven years ago. Under Section 6501(a) of the Code, the statutory period during which the IRS may assess taxes for disqualification of a trust that an employer believed to be tax-exempt, but that later was determined not to be exempt, generally expires 3 years after the plan's Form 5500 was filed.<sup>12</sup> In certain circumstances, where there has been a substantial omission of items on the form, the limitations period may be extended to six years.<sup>13</sup> As noted above, all of the transactions in question occurred beyond the statutory period.

We also note that an application under the IRS's voluntary correction program ("VCP") to correct the transfers, as recommended in the Ice Miller report, would, in all likelihood, be rejected, since the revenue procedure that governs that program states that it is not available to correct failures relating to a diversion of assets.<sup>14</sup> Moreover, a condition for participating in the VCP, even assuming that such participation would otherwise allowed, which is highly doubtful, is that the correction must be implemented for all years, including years closed by the statute of limitations. Thus, participation in VCP would involve relinquishing the closure that otherwise occurs upon the expiration of the limitations period.

b. Discussion of Exclusive Benefit Rule. The exclusive benefit rule requires that it must be impossible for any part of the corpus or income of a trust that is part of a qualified plan

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<sup>12</sup> See e.g., Private Letter Ruling 8828001; see also Goulard v. Commissioner, TC Memo 1990-448.

<sup>13</sup> Code §6051(e)(3).

<sup>14</sup> Rev.Proc. 2006-27, §4.12.

to be “used for or diverted to, purposes other than for the exclusive benefit of his [the employer’s] employees or their beneficiaries.”<sup>15</sup> IRS regulations elaborate upon the nature of impermissible uses of plan assets by stating that they include “all objects or aims not solely designed for the proper satisfaction of all liabilities to employees or their beneficiaries covered by the trust.”<sup>16</sup> We note that retiree medical costs are a proper liability of the NHRS, even assuming, for argument’s sake, that the manner of funding the liability did not fully comport with IRS regulations, which we believe it did.

The regulations provide a separate set of rules relating to the diversion of assets from a Section 401(h) account.<sup>17</sup> These rules provide that assets held to provide medical benefits described in Section 401(h) may only be used to provide such medical benefits. However, they do not contain any prohibition on the use of retirement assets to provide medical benefits on behalf of employees.<sup>18</sup> Hence, transferring assets from the medical special account would not, in and of itself, constitute an exclusive benefit rule violation.

Section 420 of the Code provides rules for the transfer of certain excess retirement assets to a 401(h) account to hold assets that will be used for retiree medical purposes. A transfer of assets that meets these rules is not treated as failing to meet the requirements for being a qualified plan under Section 401(a) of the Code or the requirements of Section 401(h) solely by reason of such transfer. Similarly, such a transfer will not be treated as a reversion to the employer or constitute a prohibited transaction, and for-profit employers will have no amount includible in gross income. While certain transfers made to the 401(h) subtrust for NHRS retirees did not qualify as excess pension assets for this purpose, as the plan was never overfunded, a requirement of Section 420, the mere fact that the transfers did not meet such requirements does not mean that a violation of a qualified plan rule, such as the exclusive benefit rule, has necessarily occurred. Other negative consequences, such as a prohibited transaction or taxable income from a reversion, may result from a violation of Section 420. However, such consequences do not apply to this case, because assets are not being used for a prohibited purpose and the plan sponsor is a governmental employer that does not have taxable income.

We think that it is reasonable to conclude that a transfer of assets originally set aside to provide retirement benefits may be used to benefit employees in other ways. Title I of ERISA

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<sup>15</sup> Code §401(a)(2). Similar language appears in section 403 and 404 of Title I of the Employee Retirement Income Security Act of 1974 (“ERISA”); however, Title I is inapplicable to a government plan, such as the NHRS.

<sup>16</sup> Treasury Regulation §1.401-2(a)(3).

<sup>17</sup> Treasury Regulation §1.401-2(a)(1).

<sup>18</sup> Treasury Regulation §1.401-14(c)(4), in pertinent par, states that, “it must be impossible, at any time prior to the satisfaction of all liabilities under the plan to provide for the payment of medical benefits described in section 401(h), for any part of the corpus or income of the medical benefits account to be (within the taxable year or thereafter) used for, or diverted to, any purpose other than the providing of such benefits. Consequently, a plan which, for example, under its terms, permits funds in the medical benefits account to be used for any retirement benefit provided under the plan does not satisfy the requirements of section 401(h) and will not qualify under section 401(a).” This statement does not imply that assets held for purposes of providing retirement benefits may not be used to provide medical benefits.

contains a parallel version of the exclusive benefit rule that was considered by the Supreme Court in Hughes Aircraft Co. v. Jacobsen, 525 U.S. 432 (1999). At issue was an amendment to a contributory defined benefit pension plan that utilized surplus plan assets by establishing an early retirement program that provided significant additional benefits for certain eligible employees. Another amendment made the plan noncontributory for new participants. The effect of these changes was to change the nature of the benefits under the plan as well as the class of employees entitled to benefit from plan assets. The court held that the amendments did not violate the exclusive benefit rule in Section 403(c)(1) of ERISA, and that the employer did not act impermissibly in using the surplus assets from the contributory structure to add the noncontributory structure for a new class of employees. Thus, the focus of the exclusive benefit rule is merely on whether assets are used for the benefit of employees rather than to benefit the employer.<sup>19</sup>

It is consistent with this position that neither Section 401(h) nor Section 420 of the Code purport to provide relief from the exclusive benefit rule when assets set aside to provide retirement benefits are used to pay retiree medical costs. The reason for this is that such relief is not needed. A contrary conclusion would mean that a for-profit employer that made a transfer qualifying under Section 401(h) or Section 420 of the Code would, nevertheless, violate the exclusive benefit rule in Title I of ERISA which is not affected by the Code.

c. Likelihood of Enforcement. Assuming, for argument's sake, that the transfers from the medical special account to the 401(h) subtrust violated the exclusive benefit rule, which we do not believe it does, we think that it is unlikely that the IRS would disqualify the NHRS from the tax exemption that it currently enjoys. The plan's sponsor in this case is a state government that has no taxable income from which it may deduct its contributions to the system which is one of the primary advantages of maintaining a tax-qualified plan. The rules of the Code relating to the funding of retiree medical costs are, in large part, designed to limit the tax deduction that for-profit employers may claim for pre-funding such costs. On the other hand, the primary advantage to a government that maintains a qualified plan is the deferral of taxes on the benefits accruing to the system's participants. Thus, disqualification would hurt the beneficiaries of the system while not adversely affecting its government sponsor in any direct manner.

We note that the IRS has demonstrated a considerable amount of discretion and flexibility in similar cases. In a recent IRS investigation into the operations of several pension funds of the City of New York, the IRS entered into a closing agreement with the City that found no violations had occurred with respect to certain fund transfers that were analogous to those that occurred under the NHRS. New York had amended three pension trust funds (serving police officers, firefighters and general employees, respectively) to allow for the transfer of trust assets to a Variable Supplemental Fund ("VSF") established within each pension fund that provided non-

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<sup>19</sup> Accord Private Letter Ruling 200418051 in which a spinoff of assets from a qualified plan to a nonqualified plan maintained in a foreign country was held not to violate the exclusive benefit rule, because the assets of the new plan continued to be used to provide benefits for the same participants.

pension related supplemental benefits. The restructuring statute also permitted a reversion to the City of approximately 15% of the assets of several of the VSFs which was later repaid. The closing agreement concluded that there was no violation of the exclusive benefit rule by reason of the funding of the VSFs. The IRS did conclude that the reversions to the City had been illegal, but waived monetary sanctions in light of the fact that the City had repaid such amounts.<sup>20</sup>

d. Governing Law. Finally, any rules that the IRS may have promulgated in the matter of the proper usage of plan assets are subordinate to New Hampshire law, since the provisions of the Code only apply as a means of determining whether the consequences of being a qualified or nonqualified plan apply. Compliance with New Hampshire statutory enactments is, however, mandatory. New Hampshire law currently provides that funds accumulated in a 401(h) subaccount “shall not be used for or diverted to any purpose other than to provide said medical benefits.”<sup>21</sup> Further, if the obligation to provide medical benefits is discontinued, New Hampshire requires that “the funds allocated to provide such medical benefits, if any remain, shall be used to continue medical benefits to members who were eligible for them...”<sup>22</sup> These statutory commitments would be violated by a reversion of funds from the 401(h) subtrust to the special account.

*Effect of Transfers from Medical Special Account to General Account.* The SAAF has been reimbursed from the medical special account by the amount of employer contributions received by the 401(h) subtrust that would otherwise have been made to the SAAF. It has apparently been argued that this constitutes an indirect diversion of pension funds (i.e., funds from the medical special account which is part of the special account) to cover retiree healthcare costs that would be in violation of Section 401(h) of the Code.

There are two reasons why the procedure utilized by New Hampshire should not result in such a violation. First, there has been literal compliance with the terms of Section 401(h) in that the source of the funds actually contributed to the 401(h) subtrust is new employer contributions. Moreover, the funds transferred to the SAAF as compensation for the 25% reduction in employer contributions come from another account maintained for the provision of retirement-type benefits. Thus, the net amount of assets available for retirement benefits does not change as a result of the second step of the procedure which would not have been questioned

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<sup>20</sup> See *Borrelli v. Secretary of Treasury*, 343 F. Supp. 2d 249 (S.D.N.Y. 2004), affirmed 155 F. Appx. 556 (2<sup>nd</sup> Cir 2005) in which a challenge by certain members of the New York system to the discretionary action of the IRS to not disqualify the pension plans from tax-exempt status was rejected by both the United States District Court for the Southern District of New York and the Second Circuit Court of Appeals, because the plaintiffs failed to rebut the discretionary nature of the IRS’s choice. A description of the IRS review of the New York City plans and of the conclusions reached in the closing agreement appears in the brief for the municipal appellees that was filed in the appeal to the Second Circuit.

<sup>21</sup> N.H. Rev. Stat. Ann. §§100-A:53-III (group II employees); 100-A:53-b-II (group I teachers); 100-A:53-c-II (group I political subdivision employees); and 100-A:53-d-II (group I state employees).

<sup>22</sup> N.H. Rev. Stat. Ann. §§100-A:54-II.

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if independently undertaken. Consequently, we believe that New Hampshire's procedure is a viable method for funding retiree medical costs.

Conclusion

For the reasons stated above, we think that it is likely that annual contributions to the 401(h) subtrust maintained by the NHRS did not exceed the 25% limitation required by Section 401(h) of the Code. In addition, we think that it is reasonable to conclude that the \$26,384,000 transferred from the medical special account to the 401(h) subtrust between 1990 and 2000 would not be treated as diversion of assets requiring the subtrust's repayment of such amount to the special account. Finally, we believe that the procedure for funding the 401(h) subaccount followed by a reimbursement to the SAAF does not constitute an indirect diversion of pension funds, and, therefore, does not violate Section 401(h) of the Code. This opinion is based on current law and administrative guidance and is limited to our interpretation thereof.

Sincerely,

*/s/ Marcia S. Wagner*

Marcia S. Wagner

MSW/pec