The Application of Federal Tax Laws to LOSAP (Length of Service Award Programs): Beware of the Pitfalls

By Edward Holohan and Anthony Hill

A local government and/or a not-for-profit corporation might establish and maintain (i.e. fund) a Length of Service Award Program (LOSAP) because the LOSAP allows the agency to provide cash pension-type benefits to its emergency services volunteers. By establishing a LOSAP, the sponsoring agency hopes to improve emergency services volunteer retention and recruitment.

From a federal taxation perspective, the LOSAP is a unique entity. It is specifically excluded from the limitations imposed on deferred compensation of tax-exempt and governmental employers under section 457 of the Internal Revenue Code (IRC). While this exclusion eliminates some very undesirable income tax treatment, the other federal tax requirements that allow LOSAP payments to volunteers to escape taxation until distribution cannot be ignored. Therefore, where possible, the intent is to have the LOSAP treated as a non-qualified deferred compensation arrangement sponsored by a governmental entity (technically, a LOSAP is not an IRS qualified pension plan because the volunteers are typically not employees as far as the IRS is concerned) as opposed to being treated as if the program provided direct compensation to a volunteers when the volunteer performs emergency services. Establishing the LOSAP as a governmental non-qualified deferred compensation arrangement is advantageous from both a tax perspective (if the benefits are not considered current compensation, they are not reportable to the IRS as W-2 income) and an administrative cost perspective (because governmental deferred compensation plans are not required to comply with the complicated and/or administratively burdensome Employee Retirement Income Security Act (ERISA) applicable to non-governmental pension plans).

The sponsoring agency must properly design and administer the LOSAP to ensure it is securing these advantages. Unfortunately, especially for a very popular version of a LOSAP called a Defined Benefit program, there is little IRS guidance to rely on for agencies to be absolutely certain their LOSAP will achieve the goal. Here are the four items of potential risk that an agency must address when sponsoring a LOSAP:

1) Compliance with Internal Revenue Code Section 457(e)(11)

   Language specific to LOSAPs was added to IRC Section 457 in 1996. While it was not perfect, the addition of the language helped practitioners and attorneys resolve the long standing debate about what sections of the Internal Revenue Code were not applicable to LOSAPs, but it was not as helpful in determining which specific sections of the IRC did apply.

   IRC Section 457(e)(11) exempts a LOSAP from the requirements of IRC Section 457 and also provides other advantageous tax treatment by providing that the payments made from a LOSAP are not considered wages and therefore not subject to FICA taxes or other "payroll" taxes. To secure these advantages, a LOSAP must meet three requirements:

   a) A volunteer eligible to participate in the LOSAP must be a "bona fide volunteer", meaning the only compensation received by such volunteer is reimbursement for expenses incurred

in the performance of such volunteer services, reasonable benefits (including the LOSAP) and/or nominal fees for such services.

b) The volunteer must be providing "qualified services", meaning fire fighting and prevention services, emergency medical services and ambulance services.

c) The aggregate amount of service awards accruing with the respect to any year of service credit earned by a volunteer in a LOSAP must not exceed $3,000.

We will assume for these purposes of explaining how these requirements are met that volunteers are "bona fide volunteers" and that they are performing "qualified services" as an active member of volunteer emergency services organization. While meeting these first two requirements can be an issue, complying with the $3,000 accrual limit is typically the most problematic for Defined Benefit LOSAPs.

If the agency designs the LOSAP as a Defined Contribution program, where a program "account" is maintained for each participating volunteer and the sponsoring agency deposits a contribution into the account annually (like a 401(k) plan), the application of this $3,000 accrual limit is generally very straight forward – the agency can deposit up to $3,000 into the volunteer's LOSAP account for any year of service credit earned by the volunteer. Adopting a Defined Contribution LOSAP consequently easily enables the sponsoring agency to be 100% certain it complies with this $3,000 limitation.

If the agency designs the LOSAP to be a Defined Benefit program, the application of the $3,000 accrual limit is more convoluted. The most common understanding of how this limitation applies to a Defined Benefit program is the actuarial value of the LOSAP payments (typically lifetime monthly payments) to the volunteer earned for any one year of service credit must be less than $3,000. This actuarial value is calculated using assumptions selected by an actuary such as an assumed investment rate of return on the program assets and mortality assumptions (how long the volunteers will live and therefore be paid the LOSAP payment the volunteer earned for one year of service credit). The calculation is also dependent upon the specific program provisions such as the age when the LOSAP payments commence to the volunteer. Based on reasonable assumptions commonly used by actuaries when performing actuarial funding calculations for LOSAPs, if a LOSAP is designed to pay for each year of service credit earned a $20 (or less) lifetime monthly payment (i.e., a $20 service award) with payments beginning at an age from 55 to 65, the actuarial value of any one year of service credit earned does not exceed the $3,000 limit.

If an agency designs a Defined Benefit program with a monthly lifetime Service Award greater than $20 for each year of service credit earned, there is a very high likelihood that the actuarial value of the Service Award payments would exceed $3,000. The LOSAP would therefore not comply with section 457(e)(11) of the Internal Revenue Code As contributions are being made to the LOSAP trust fund established by the sponsor to pay Service Awards, this means that, after the volunteer attains a vested status in the LOSAP, the sponsoring agency would have to issue a form W-2 each year to each participating volunteer whose earned service award was vested reporting the actuarial value of LOSAP payments the volunteer earned for that year of volunteer service. The agency would also file a copy of the form W-2 with the IRS. The agency would also have to withhold payroll taxes as well as pay their portion of payroll taxes. In effect, the failure of the Defined Benefit LOSAP to comply with IRC Section 457(e)(11) would force the sponsoring agency to treat vested volunteers as if they were

paid employees of the sponsoring agency receiving W-2 compensation each year. Moreover, volunteers would be required to include in taxable income LOSAP payments which they have not yet received and, worse yet, may not receive for 30-40 years.

For all these reasons, Penflex strongly recommends that any agency considering sponsoring a Defined Benefit LOSAP choose a service award that is likely to comply with IRC Section 457(e)(11). Defined Benefit LOSAPs that pay benefits which exceed the actuarial value of a $20 monthly lifetime service award for each year of service credit earned by a volunteer will generally not comply with IRC Section 457(e)(11).

2) Application of Employee Retirement Income Security Act (ERISA)

ERISA grants governmental plans an unqualified exemption from the requirements of ERISA, and therefore ERISA would not (and does not) apply to a LOSAP sponsored by a governmental entity. On the other hand, if the sponsoring agency is not a governmental agency, the unqualified exemption from ERISA for governmental plans does not apply, even if the sponsoring agency is a not-for-profit entity (like a fire company or an ambulance squad). How ERISA would actually apply to a LOSAP is not clear and certainly would be complex. In our opinion, is it is undesirable, arguably senseless in some respects and probably unintended (meaning, it is not intended for ERISA to apply to only certain LOSAPs). In any event, the application of ERISA requirements would complicate and increase the cost of the administration of a LOSAP.

It may be possible for a not-for-profit corporation that would like to sponsor a LOSAP to avoid ERISA coverage by using funds paid to the agency by local government entities for providing emergency services. Although it is not clear from applicable guidance, contributions made to a LOSAP out of funds provided to the agency by the state and local government might be considered for the purpose of the ERISA governmental exclusion (and therefore the LOSAP would not be subject to ERISA). In any event, until further guidance is published on this issue, not-for-profit corporations that sponsor a LOSAP may find that the LOSAP is required to comply with ERISA even if it is funded solely with funds provided by a local government entity.

3) Establishment of a Grantor Trust (or Rabbi Trust)

In a “qualified” pension plan (i.e., one satisfying the requirements of IRC Section 401(a)), the IRC (and ERISA) requires that the plan be funded by the sponsor as the benefits are being earned. These pension plan funds must be held in trust for the exclusive benefit of pension plan participants and beneficiaries. The IRC and the related regulations set forth the rules that must be followed when establishing trusts for qualified plans. Importantly, the funds in a qualified plan trust are, in effect, the property of the plan participants and their beneficiaries and only in very specific situations can any of those funds ever be paid to anyone other than the plan participants and beneficiaries.

Since LOSAPs are typically not qualified plans, the rules outlined in the IRC for qualified pension plan trusts do not apply. Although they are not pension plans, LOSAPs provide deferred payments to volunteers for having performed emergency services (which makes them similar to pension plans, but not really pension plans). By requirement of the applicable sections of the IRC, LOSAPS must be “unfunded” arrangements in order to avoid taxation on the service awards (i.e. the deferred payments) as they are being earned and before they are actually being paid to volunteers. If a LOSAP was

considered by the IRS to be a funded arrangement, the LOSAP would be in the same exact situation described above if a LOSAP fails to comply with IRC Section 457(e)(11). However, it is desirable for many reasons to fund a LOSAP as the benefits are accrued rather than having a truly "unfunded" or a pay-as-you-go approach to funding a LOSAP. In addition, many states require a LOSAP to be funded as benefits are accrued and that the funds must be held in trust.

In order for an agency to fund a LOSAP yet still be considered an unfunded arrangement by the IRS, the LOSAP trust must be a grantor or "Rabbi" trust under which the assets are the property of the sponsoring agency and in the view of the IRS are therefore subject to a substantial risk of forfeiture. Under the IRS rules for these kinds of trusts, the trustee must be someone other than the sponsoring agency. Often, LOSAPs are not established and administered that way – typically the trustee is the sponsoring agency's governing board.

While there are states which have enacted LOSAP legislation which may not be consistent with the IRS "Rabbi Trust" requirements regarding who should be or could be the LOSAP trustee and while having a separate trustee may increase the cost of administering a LOSAP, Penflex recommends that the Rabbi Trust established by the sponsoring agency for a LOSAP be completely compliant with IRS requirements and therefore the trustee be someone other than the sponsoring agency, its governing board, or any one related to the sponsoring agency or its governing board (i.e. the trustee should be someone such as a special committee or board, or a corporate trustee such as a bank or trust company). We also recommend that any and all state LOSAP laws which are not consistent with the IRC and the related rules and regulations be amended to comply with the IRC and the related rules and regulations.

If the trust is not considered a Rabbi Trust by the IRS, then the same undesirable tax consequences described in #1 above could then apply (i.e. the amounts are includible in the volunteer's income, W-2s would have to be issued, etc).

4) IRS Constructive Receipt Doctrine

IRS qualified pension plans typically offer optional forms of payment to plan participants. No matter what optional form of payment of his or her pension is selected by a plan participant, the participant is taxed on the amounts actually paid to him or her during the tax year under the terms of the optional form of payment selected.

Since LOSAPs are not qualified pension plans and are not subject to the requirements of the IRC, any LOSAP that offers optional forms of payment of a service award to a participant or optional payment commencement dates may create federal income tax problems for participating volunteers.

There certainly are LOSAPs which provide one form of payments which will pay larger payments to the participant than all other forms of payment. If the forms of payment are actuarially equivalent, there should not be a tax consequence for choosing one form over another.

For example, a participating volunteer in a Defined Benefit LOSAP might have a "life annuity" option of being paid a $500 monthly lifetime service award with the payments ceasing upon the participant's death, or being paid an actuarially equivalent lump sum of say $50,000. Under the IRS "constructive receipt" doctrine, if the participating volunteer has this option of choosing a lump sum payment, the

IRS may consider the participating volunteer to be in "constructive receipt" of the $50,000 lump sum amount even though the volunteer is being paid a lifetime annuity of $500 per month. The IRS may then argue that the volunteer's taxable income for the year should be calculated as if the volunteer had actually elected the higher lump sum payment option of $50,000 that would have paid instead of the $500 a month annuity he or she elected.

There are also potential issues that arise if a LOSAP is designed so that a volunteer can elect to defer payment. Typically, a LOSAP is designed to pay the accrued service award at a specific age, called the entitlement age. For example, suppose that in a Defined Contribution LOSAP a volunteer can elect to be paid a lump sum equal to his or her account balance of $42,300 at age 60 or can defer payment to a later age or date. Under the same IRS constructive receipt doctrine, the IRS could consider the volunteer to be in constructive receipt of $42,300 during the tax year the $42,300 could have been paid to the volunteer even if the volunteer may have elected to defer payment until a subsequent tax year under the LOSAP rules. The IRS could then argue that the volunteer's taxable income for that year must be increased by $42,300 (despite the fact that the volunteer didn't receive the $42,300).

A LOSAP can be designed with IRS approved elections so that a participant can defer payment and avoid constructive receipt, however these elections must be made in a calendar year before the service award payments began (or may begin) to be made to a participant. In our experience, we have found the administration of these elections (ensuring they are done timely and accurately) is a burden and the explanation of these elections and the consequences of making these elections to be very complicated and confusing.

To avoid constructive receipt problems with LOSAP provisions, Penflex recommends allowing only one form of payment in a LOSAP or including a single default form of payment in a LOSAP, and permitting an alternate form of payment only if the form is an actuarially equivalent annuity that is elected prior to the commencement of payments. We also recommend mandating that LOSAP payments commence or are made on the same date for all participating volunteers (such as the first day of the month of the participant's 60th birthday in a Defined Benefit program).

Edward Holohan is the President & Actuary and Anthony Hill is the Vice President & Director of Operations of Penflex Inc. of Latham, New York. Penflex, Inc. provides consulting, administration and actuarial services for about 400 LOSAPs in the USA. Both strongly advocate the adoption of the proposed amendments to the Internal Revenue Code recommended by the National Volunteer Fire Council which will fix many of the problems described in this article. For the past five years, Edward Holohan has been a member of the special committee of the National Volunteer Fire Council which drafted the initial version of these proposed amendments. In the 110th Congress, the proposed legislation bill numbers were HR2160 and S1840.