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May 24, 2019

*Via Email Only (karen.bachus@warwickschools.org)*

School Committee of the City of Warwick  
Attn: Karen Bachus, Chairwoman  
69 Draper Avenue  
Warwick, RI 02889

**Re: Federal Tax Consequences of Proposed Pension Plan Withdrawal**

Dear Ms. Bachus:

The School Committee of the City of Warwick (the "School Committee") has asked for our opinion regarding whether a withdrawal from the Warwick School Committee Employee Retirement Plan, Amended and Restated as of July 1, 1997 (the "Plan") to fund general school operations is allowed under the Internal Revenue Code of 1986, as amended (the "Code"), and the federal tax consequences of such a withdrawal. The opinion expressed in this letter is limited solely to federal tax consequences arising under the Code and does not address issues or considerations arising under the Employee Retirement Income Security Act of 1974 or any corresponding provisions of Rhode Island law governing the Plan.

**I. Facts.**

**a. The Mediator/Arbitrator Decision and Withdrawal Order.**

A Mediator/Arbitrator's Decision and Award, dated May 1, 2019 (the "Decision"), intended to resolve a so-called "Caruolo Action" by the School Committee against the City of Warwick, ordered the School Committee to make a withdrawal from the Plan in an amount up to \$4,000,000.00 (the "Withdrawal"). In general, the dispute involves the alleged underfunding of the School Committee budget by the City. Evidence presented to the Mediator/Arbitrator showed that the School Committee funded \$4,100,000.00 in excess of the actuarial required contributions to the Plan for fiscal years 2014-2019. The Decision assumes that the Withdrawal would be legally permissible and that there would be no financial penalty or adverse tax consequences as a result. However, the Mediator/Arbitrator explicitly noted in the Decision that he was not charged with vetting the accuracy or legality of the Withdrawal.

b. **The Plan.**

The Plan is a pension plan established by the School Committee to benefit employees of the School Committee and School Committee members. The Plan's assets are held in a tax-exempt trust pursuant to Code § 401(a). The Plan is intended to be structured and operated as a "qualified plan" within the meaning of Code § 401(a) with the Plan assets held in a trust. For federal tax purposes, including for purposes of satisfying the "qualified plan" requirements under Code § 401(a), a "pension plan" must be "a plan established and maintained by an employer primarily to provide... for the payment of definitely determinable benefits to... employees over a period of years, usually for life, after retirement".<sup>1</sup> The primary focus must be on the employee's retirement although disability and other ancillary benefits can be paid earlier.<sup>2</sup> For a pension plan to benefit from the tax-favored provisions of the Code, the pension plan must satisfy the Code § 401(a) requirements in form and in operation including, without limitation, compliance with the Code's prohibition on divergence of qualified plan funds to benefit persons other than permitted beneficiaries of the qualified plan.

Consistent with the requirements of Code § 401(a), Plan Section 2.3(b) requires the School Committee to administer the Plan for the "exclusive benefit of the Participants and their Beneficiaries." The School Committee is prohibited, by Plan Section 2.3(b) from taking any action inconsistent with the Plan's operation as a "qualified plan" within the meaning of Code § 401(a). In particular, Plan Section 11.5 prohibits the School Committee from diverting Plan funds for purposes other than the exclusive benefit of Participants, Retired Participants and their Beneficiaries, "any part of the corpus or income of any trust fund or contract maintained pursuant to the Plan or any funds contributed thereto..."<sup>3</sup>

II. **The Withdrawal is not Permitted under the Code.**

Code § 401(a)(2) establishes the "exclusive benefit rule". Under the exclusive benefit rule, a qualified plan is prohibited, at any time before the satisfaction of all the plan's liabilities to employees and their beneficiaries, from diverting any part of the corpus or income from the qualified plan's trust for any purpose other than providing benefits to employees and their beneficiaries. The Treasury Regulations mandate that a qualified plan's trust instrument make it

<sup>1</sup> Treasury Regulations § 1.401-1(b)(1)(i).

<sup>2</sup> *Id.*

<sup>3</sup> Code § 401(a)(2) requires that a qualified plan's governing instrument prohibit the use or divergence of any part of the corpus or income of the plan from being used for, or diverted to, any purpose other than providing benefits to employees and their beneficiaries. Failure to expressly include this prohibition in a qualified plan's governing document can cause the plan to lose its tax-exempt status.

**"impossible... for any part of the trust corpus or income to be used for, or diverted to, purposes other than the exclusive benefit of [beneficiaries]" (emphasis added).**<sup>4</sup>

Courts interpret the Code § 401(a)(2) exclusive benefit rule strictly. For example, Courts have held that inadvertent mathematical errors affecting the actuarial calculation of distributions payable to beneficiaries under qualified plans can violate the exclusive benefit rule even though plan funds were still paid to beneficiaries (See, e.g., *Piggly Wiggly Stores, Inc. v. PBGC*, 82 F.3d 430 (11<sup>th</sup> Cir. 1996)). Additionally, the distribution of plan assets to non-beneficiaries in violation of the Code § 401(a)(2) exclusive benefit rule can cause a qualified plan and trust to lose its tax-exempt status and qualification under Code § 401 (See, e.g., *Gallade v. Commissioner*, 106 T.C. 355 (1996)).<sup>5</sup>

There can be no doubt that the Withdrawal, which is intended to be used to fund general education expenses for the City of Warwick, will not be used to provide benefits to the Plan's Participants and Beneficiaries. Accordingly, if the Withdrawal is made, it would violate the Code § 401(a) exclusive benefit rule.

### III. **Federal Tax Consequences of the Withdrawal.**

The federal tax consequences of a violation of the Code § 401(a)(2) exclusive benefit rule are severe. The Code establishes a range of consequences subject, in pertinent part, to Internal Revenue Service ("IRS") discretion. Therefore, it is impossible to opine as to the exact consequences to the Plan and the School Committee if the Withdrawal is implemented. This letter will address, in order of severity, a range of possible consequences should the School Committee proceed with the Withdrawal in violation of the Code.

#### a. **Disqualification of the Plan as a Tax-Exempt Trust.**

The Plan's assets are held in a trust that is tax-exempt under the Code. The Withdrawal may cause the IRS to disqualify the Plan as a qualified plan under Code § 401 as of the date of the Withdrawal.

<sup>4</sup> Treasury Regulations § 1.401-2(a)(1). Failure to include this prohibition in a qualified plans governing instrument automatically causes a qualified plan to lose its qualified status under Code § 401. The Plan's exclusive benefit rule compliance statement is contained in Section 11.5.

<sup>5</sup> There are situations when a qualified plan can distribute plan assets to non-beneficiaries, such as upon the termination of a qualified plan after all plan liabilities have been satisfied (*Blessitt v. Retirement Plan for Employees of Dixie Engine Co.*, 848 F.2d 1164 (11th Cir. 1988); Treasury Regulations § 1.401-1(a)(3)(iv)). The Plan's most recent Disclosure Report for Measurement Period Ending June 30, 2018 establishes that the Plan is not fully funded. Statements No. 67 and 68 of the Governmental Accounting Standards Board (GASB) report prepared for the School Committee by USI Consulting Group and dated September 28, 2018 states that, as of the June 30, 2018 reporting date, the Plan was 92.95% funded. This means that as of September 28, 2018, the Plan's total projected liabilities (i.e., obligations to plan beneficiaries) exceed the Plan's assets. The Plan is not terminating in connection with the Withdrawal and, even if the Plan were terminating, the Plan has insufficient assets to satisfy its liabilities.

When a qualified plan becomes disqualified, the trust which holds the plan assets, ceases to be tax-exempt under Code § 501(a) and becomes a taxable trust governed under Subchapter J of the Code. Accordingly, if the trust becomes taxable, it would then pay tax on its investment earnings in each year during which the Plan remained disqualified. In addition, contributions made to the Plan on behalf of employees would become income taxable to employees under Code § 402(b)(1). The Plan would also be required under Code § 404(a) to maintain a separate account for each participant for purposes of determining each participant's share in the trust assets and income. After a plan becomes disqualified, lump sum distributions to plan beneficiaries cease to be eligible for tax-free rollovers to other tax advantaged retirement accounts.

**b. The Withdrawal may be subject to tax as a Prohibited Transaction.**

In the event the Plan proceeds with the Withdrawal and the IRS audits the Plan, the Plan could be subject to tax on the Withdrawal under Code § 4975. Tax-exempt qualified plans are nonetheless subject to an excise tax under Code § 4975 in connection with certain "prohibited transactions" not permitted to be engaged in by a qualified plan. In the Withdrawal is a prohibited transaction under Code § 4975, then the Plan would be subject to an excise tax in the amount of 15% of the Withdrawal, plus interest and penalties. The Code § 4975 excise tax is independent of whether the IRS would seek to terminate the Plan's status as a qualified plan under Code § 401. As part of an IRS examination determining that the Withdrawal is a prohibited transaction, the IRS would likely require any money withdrawn from the Plan to be returned together with interest to compensate the Plan for lost earnings.

**c. Internal Revenue Service Voluntary Closing Agreement Request.**

The Withdrawal, if implemented, would represent a significant operational failure of the Plan. The IRS has an administrative program available to permit qualified plans not presently under examination or investigation to self-report, correct and remediate operational failures.<sup>6</sup> Qualified plans remediating significant operational failures prior to being contacted by the IRS are generally permitted to enter into settlement agreements, referred to as "Closing Agreements", and retain their status as qualified plans under Code § 401 without incurring negative tax consequences such as disqualification or incurring other penalties such as those described in Paragraph III (a) above. In the context of the Withdrawal, self-correction of this significant operational failure would likely require returning the funds withdrawn back to the Plan plus interest to compensate the Plan for lost earnings.

A similar situation occurred in 1991 when Rhode Island withdrew approximately \$20,000,000.00 from the Employees' Retirement System of Rhode Island to fund a state budget shortfall. The IRS determined that this withdrawal violated the Code § 401(a)(2) exclusive benefit rule. In a Closing

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<sup>6</sup> Code § 7121.

Agreement approved by the IRS District Director on February 4, 1994, Rhode Island agreed to repay this approximately \$20,000,000.00 withdrawal to the Employees' Retirement System plus accrued interest at a rate of eight percent, retroactive to the date of withdrawal.<sup>7</sup> If the School Committee proceeds with the Withdrawal in violation of Code § 401(a)(2), it is likely that any corrective action taken thereafter would require repayment of the Withdrawal with interest.

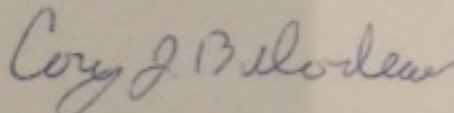
#### IV. Conclusion.

The Withdrawal is not permitted under the Code or the Plan. In compliance with the Code § 401(a)(2) exclusive benefit rule, the Plan's governing instrument expressly prohibits the School Committee from making the Withdrawal as ordered by the Decision. In the event the School Committee proceeds with the Withdrawal, the Plan faces federal tax consequences ranging in severity from the loss of the Plan's tax-exempt status as a qualified plan under Code § 401 to potential liability for excise tax on the amount of the Withdrawal plus penalties and interest. Additionally, Plan Participants and Beneficiaries could suffer significant personal financial consequences if the Plan loses its tax-exempt status. The Withdrawal cannot be made without incurring "financial penalty or adverse tax consequences" as discussed in the Decision.<sup>8</sup>

In rendering this opinion, we have relied on copies of the Plan and Decision provided to us, each of which we understand remains in full force and effect as of the date hereof. Capitalized terms used in this letter but not defined shall have the meanings ascribed thereto in the Plan.

Thank you for your attention to this matter. If you have any questions or concerns, please do not hesitate to contact me.

Sincerely yours,



Cory J. Bilodeau  
CJB/maw

<sup>7</sup> Employees' Retirement System of Rhode Island, Notes to Required Supplementary Information, Fiscal Year Ended June 30, 1998. Note 2.

<sup>8</sup> The Decision states, in the event that the Withdrawal triggers any penalty, taxes or interest, the School Committee will "bear the fiscal consequences". As a practical matter, if the School Committee proceeded with the Withdrawal, the IRS would at a minimum likely require that the Withdrawal be returned to the Plan with interest, leaving the School Committee in a worse financial position it would have been in had the Withdrawal never been made.