

**Testimony of Philip C. Stittleburg**  
**Chief of the La Farge (WI) Fire Department and**  
**Chairman of the National Volunteer Fire Council (NVFC)**  
**Submitted to the House Committee on Ways and Means' Retirement/Pensions Working Group**  
**Regarding the Federal Taxation of Length of Service Award Programs**  
**April 15, 2013**

Thank you for the opportunity to provide information regarding the impact that federal taxation has on recruitment and retention incentives that many communities provide to their volunteer emergency responders as a reward for their service. My name is Philip C. Stittleburg and I have been the Chief of the La Farge (WI) Fire Department since 1977 and a member of the Board of the National Volunteer Fire Council (NVFC) since 1979. Since 2001 I have served as the Chairman of the NVFC Board. A short version of my bio is included at the end of my testimony.

LOSAPs are retirement accounts designed for volunteer emergency responders. Approximately 20 percent of the nation's 756,400 volunteer firefighters are enrolled in some type of LOSAP. The basic idea behind LOSAP is that the department or in some cases the local or state government contributes money into an account for every year that someone volunteers. Once the volunteer reaches retirement age, however that is defined in the plan, they draw a benefit.

#### **Recruitment and Retention Challenges**

To provide some context as to why recruitment and retention incentives are important, let me use my own fire department as an example. La Farge FD is an all-volunteer fire department that has a first-due response area covering approximately 135 square miles and containing about 2,750 residents and 85 commercial buildings. Approximately 1/3 of our personnel have been members of the FD for 20 or more years, 1/3 for 10-20 years and the remaining 1/3 for less than 10 years.

My Department's long-rang planning committee has determined that due to the age of our firefighters that we will need to replace approximately 1/3 of our personnel in the next few years AND retain almost all of the rest of the department's personnel that are not approaching retirement age simply to maintain our existing level of service provision. We have found that long term commitments to the department are becoming increasingly difficult to cultivate with increasing demands on volunteers' family and personal time. Additionally, being located in a rural community, many of our current and prospective volunteers are commuting out of the area for work, making them unavailable for daytime, weekday responses and leaving less time on nights and weekends for training.

Just this year, my department established a length of service award program (LOSAP) with a goal of stabilizing our staffing levels. Our circumstances at La Farge FD are fairly typical of volunteer fire departments around the country, especially those protecting our nation's smallest communities. As training and certification standards have increased in recent decades we have seen a significant decrease in the number of younger people entering the volunteer fire service and the number of volunteer firefighters overall has declined as well.

Between 1983 and 2011, the number of volunteer firefighters in the United States declined from 884,600 to 756,400, a 15 percent reduction. More than half of that decline has occurred since 2008. As the number of younger volunteer firefighters has fallen off, a greater number of older volunteers have chosen to put off "retiring" from the fire department. As a result, between 1987 and 2011, the number

of firefighters under the age of 40 serving communities of 2,500 or fewer residents dropped from 282,821 to 176,063 while the number of over-40 firefighters serving these same communities rose from 164,681 to 199,338.

For a while, the decrease in recruitment of younger firefighters was offset to a degree by greater retention of older firefighters. Over time, however, this created a situation in many volunteer fire departments where a large number of core personnel are nearing retirement. Close to 30 percent of firefighters in communities of 2,500 or less are now over the age of 50 and there are fewer younger volunteers coming up to replace them than in the past.

LOSAP is an effective tool for retaining volunteer personnel. Recruiting, training and equipping volunteers is a costly and time-consuming process. Many departments have found that offering a modest retirement benefit for long-serving volunteers can be the difference between someone leaving the department after a few years or sticking around for a few decades. The value of the services donated by volunteer firefighters annually is estimated to be \$129.7 billion and communities recognize that providing small benefits to bolster recruitment and retention is actually the most cost-effective strategy for providing quality emergency services and maintain staffing.

I won't delve any further into discussing recruitment and retention in my formal testimony but I am including as an addendum, additional background information on the challenges facing the volunteer emergency services. The charts that the data cited above are taken from as well as copies of 13 articles published in just the last year detailing how recruitment and retention issues are affecting local volunteer fire departments across the country are attached.

### **Federal Tax Status of LOSAP**

Prior to 1996, LOSAP was nowhere to be found in the federal tax code. It was generally treated like a normal retirement plan but there was a lot of ambiguity, which made LOSAP difficult to administer and led to other problems. In 1996, Congress addressed this by formally adding LOSAP in Internal Revenue Code Section 457(e)(11)(B). This fixed a number of problems but, we realized years later, unintentionally created several new issues. In 2003 the NVFC formed a LOSAP Committee to study these issues and develop solutions.

The first issue identified by the Committee was that for certain types of LOSAP, contributions made into a plan cannot be guaranteed to the volunteer that they are intended for. The tax code specifies that employer contributions into a retirement account cannot be larger than 100 percent of compensation in the form of salary, wages or other benefits. This might make sense for an employee who receives a regular wage or salary in addition to pension contributions, but for volunteers who receive no compensation outside of the LOSAP it is problematic. To comply with the '100 percent rule' many LOSAPs are either not funded or the funds are set aside but not guaranteed to the individual volunteers. As a result, if the entity responsible for the LOSAP declares bankruptcy, volunteers risk losing their benefits.

The second issue is that the 1996 law established a \$3,000 annual ceiling on contributions into an individual's LOSAP. This cap has never been adjusted for inflation and as nominal contribution levels have increased this has led to difficulty for a number of departments. Plans that provide higher contribution levels for each year of service have been particularly affected by this as an increasing number of volunteers serve their departments later in life.

Finally, many volunteer fire and EMS agencies are private, non-profit organizations that are typically funded by and authorized to provide services based on the terms of a written agreement with a local unit of government. These types of arrangements typically came about in places where the emergency services agency was established prior to the local government unit. Because these agencies are not technically governmental their LOSAPs are treated as private plans for the purposes of taxation. This means that they are subject to far much more stringent reporting requirements than governmental plans, despite the fact that LOSAPs are, on average, extraordinarily modest retirement accounts and the agencies that provide them are quasi-governmental.

Because the federal tax treatment of LOSAP is unnecessarily confusing and restrictive, some states have been hesitant to pass laws authorizing local departments and/or governments to establish plans. Without state authorization, plans are difficult to establish and local governments are frequently prevented from contributing funds. Even in states that do authorize LOSAP, application of the three problematic rules referenced above can make administering plans unnecessarily costly and confusing.

The NVFC supports passage of the Volunteer Emergency Services Recruitment and Retention Act, H.R. 1009, which fixes the problems related to taxation of LOSAP addressed in this testimony. For a more detailed and technical explanation of the specific changes that legislation would make and why they are necessary, I would refer you to companion testimony being submitted by Ed Holohan, President and Actuary of Penflex, Inc.

*Chief Philip C. Stittleburg, B.A., J.D., FIFireE, CFO, entered the volunteer fire service in 1972 after working as a paid member of a combination fire department. He has served as chief of the La Farge (Wisconsin, USA) Fire Department since 1977. Chief Stittleburg is currently serving his sixth two-year term as chairman of the board of directors of the National Volunteer Fire Council (NVFC) and his first one-year term as chairman of the board of directors of the National Fire Protection Association (NFPA). He is also a member of the board of directors of the National Fallen Firefighters Foundation (NFFF). In 1998, Chief Stittleburg was named Fire Chief magazine's volunteer fire chief of the year.*

*Chief Stittleburg has authored over 100 published articles on various fire service topics and has been a regular contributor to Fire Chief magazine's legal column for over twenty years. He has written portions of several fire service books, writes and teaches undergraduate university fire service courses, and frequently speaks to fire service audiences throughout the United States and internationally.*

**PROVIDING RECRUITMENT AND RETENTION INCENTIVES CALLED “LENGTH OF SERVICE AWARD PROGRAMS” FOR EMERGENCY SERVICES VOLUNTEERS**

**Submitted by Edward J. Holohan, President and Actuary, Penflex, Inc.**

**Background and Problems with Present Law**

The decline in the number of emergency services volunteers over the past three decades has been dramatic and is creating a life and/or property threatening situation for citizens living in communities all across the United States. While many communities have had to hire emergency services personnel or to contract with emergency services providers, far more have not because their residents simply cannot afford to pay the cost. To help recruit and retain volunteers, some state and local government officials as well as volunteer emergency services providers have resorted to providing employee benefit like perks to volunteers.

While most of these perks are just beginning to evolve, many are complicated because of taxation issues and/or have unattractive open ended cost implications. One volunteer recruitment and retention tool has been somewhat successful, has withstood the test of time and has resulted in the adoption of enabling legislation in about one-half of the fifty states (including authorizing and specifying funding sources). These programs are referred to as “length of service award programs”.

Length of service award programs ("service award programs") provide benefits in the form of deferred payments to volunteers in firefighting and prevention services, emergency medical services and ambulance services. In effect, these programs resemble pension plans. Currently 20% of the approximately 800,000 volunteer firefighters in the United States of America participate in service award programs.

A service award program may be either an individual account, "defined contribution plan," where the local government sponsor's contribution is determinable but the final cash payment to the volunteer depends, among other things, on investment results, or a "defined benefit plan," where the final cash payment is recurring and is determinable based on a formula generally related to the length of volunteer service, but the sponsor's cost to fund the benefit may vary depending on investment return and other factors.

The federal tax treatment of cash service award program benefits paid to volunteers is not clear and is deficient. As a result many attorneys, accountants, actuaries and other practitioners do not agree about the taxation and as a consequence state/local governments, emergency services officials and emergency services volunteers have opted not to establish these recruitment and retention programs.

Section 457 of the Internal Revenue Code of 1986, as amended ("Code"), provides the primary framework for federal taxation of deferred compensation arrangements of state and local governments and tax-exempt organizations, which would generally include volunteer fire and emergency services organizations. However, Code Section 457(e)(11)(A)(ii) specifically excludes from Section 457 application "any plan paying solely length of service awards to bona fide volunteers (or their beneficiaries) on account of qualified services performed by such volunteers" if the plan meets certain requirements related to the definition of "bona fide volunteer" performing "qualified services" and receiving only "reimbursement for (or reasonable allowance for) reasonable expenses incurred in the performance of such services, or reasonable benefits (including length of service awards), and nominal fees for such services, customarily paid by eligible employers in

connection with the performance of such services by volunteers." Accruals under the Code Section 457(e)(11)(A) exclusion are limited to \$3,000 per year of volunteer service, with no adjustment for cost of living increases.

The exclusion of service award programs from the Code Section 457 definition of a deferred compensation plan has been helpful relief from the contribution strictures of Section 457, but it has left open many issues. The first is the core issue: the federal taxation of service awards paid to volunteers from a service award program. Code Section 457(e)(11)(A) leaves no doubt that they are not deferred compensation programs under Code Section 457, but does not address where they otherwise fit in the Code. As result, it is necessary to rely on miscellaneous other Code provisions to defer taxation of contributions and benefits until the volunteer is eligible to receive payment of the service award benefit. Moreover, to comply with what are commonly believed to be applicable code provisions, many length of service award programs impose a substantial risk of forfeiture of benefits on participants, and are "unfunded" for tax purposes, which leads to insecurity as to whether there will be adequate resources available to pay benefits when due to volunteers.

Another question arises as to whether service award programs are subject to the pension plan requirements of the Employee Retirement Income Security Act of 1974, as amended, ("ERISA"). Some service award program sponsors report to the IRS the "nominal fees for services" paid to volunteers as wages, which may suggest that the volunteers are employees, and length of service awards are pension benefits subject to ERISA. In addition, not all volunteer fire and emergency service entities are governmental entities, so the unqualified exemption from ERISA for governmental plans is not available to non governmental entities whose volunteer members provide emergency services. Also, contrary to ERISA requirements, many service award programs are unfunded arrangements that utilize grantor, or "rabbi" trusts to avoid the immediate inclusion of contributions and benefits in volunteers' income as they are accrued and before they are paid. This leads to an inequitable position between emergency services organizations that are governmental units and those that are not. Moreover, if service award programs are subject to ERISA, then service award programs established by governmental entities may be maintained for the benefit of all emergency service workers, while those established by non-governmental organizations would be prohibited from providing these benefits to workers who were not members of a select group of management or highly compensated employees. Clearly such a differentiation in the service award program participation consequences of similarly situated emergency workers is unintended and undesirable.

Another issue arises with the limitation on accruals in service award. The exemptions from Code Section 457 do not apply if the aggregate amount of length of service awards accruing with respect to any year of service for any bona fide volunteer exceeds \$3,000. This limitation, established by the Small Business Job Protection Act of 1996, is quite modest and has not indexed for inflation and has never been updated. Further, it is unclear whether the limitation is measured on a contributions-basis (as would be appropriate for a defined contribution plan) or as the value of the accrual at normal retirement age (in the case of a defined benefit plan.).

Finally, the definition of a "bona fide volunteer" as an individual performing "qualified services," currently defined as fire fighting and prevention services, emergency medical services, and ambulance services, may be too narrow to describe the range of volunteer services for which a recruitment and retention tool like the service award program might be useful.

### **Reasons for Change**

Ambiguities in the tax status of length of service award programs, interpretation of the requirements of Code Section 457(e)(11)(B)(ii), the application of ERISA, and the failure to update accrual limitations for inflation, has diminished the effectiveness of service award programs as a recruiting and retention tools for volunteer emergency service organizations.

State/local governments as well as non governmental emergency services providers would be far more likely to establish or improve existing service award programs in a more consistent and clearer statutory environment.

**Proposal:** Treat Service Award Programs as if they were Eligible Deferred Compensation Plans maintained by a governmental employer, at the election of the program sponsor.

The proposal would accomplish three major objectives:

1. Unlike most current service award programs provide a secure funding source (as required by Code Section 457) for payment of service award program benefits.
2. Clarify the tax and ERISA treatment of service award programs.
3. Simplify the requirements for service award programs and reduce the administrative burden of both governmental agencies and potential sponsors by using existing Code Section 457 statutory and regulatory schemes.

The proposal would allow all sponsors of a service award program as long as the program met certain requirements to elect the service award program which they sponsor to be treated as an "eligible deferred compensation plan" under Code Section 457(b) maintained by an employer described in Code Section 457(e)(1)(A) (i.e., as if all program sponsors were governmental employers).

The election to be treated as an eligible deferred compensation plan would be available to service award programs meeting the definition contained in Code Section 457(e)(11)(a)(ii), i.e., "any plan paying solely length of service awards to bona fide volunteers (or their beneficiaries) on account of qualified services performed by such volunteers." However, under this proposal, the special rules applicable to length of service award plans contained in Code Section 457(e)(11)(B) would be updated and clarified as follows:

- "Bona fide volunteer," in Code Section 457(e)(11)(B)(i), would be amended to replace "nominal" fees with "fees customarily paid by eligible employers in connection with the performance of qualified services by such volunteers."
- "Qualified Services," in Code Section 457(e)(11)(C), would be expanded to include "emergency rescue services."
- The limitation on accruals in Code Section 457(e)(11)(B)(ii) would be
  - Increased to \$5,500;
  - Updated to state that the limitation on accruals would be automatically adjusted to reflect cost of living changes at the same time and in the same manner as under Code Section 415(d), except that the base period would be the calendar quarter beginning July 1, 2012 and any increase that is not a multiple of \$500 shall be rounded to the

next lowest multiple of \$500, so that this limitation would be indexed in the same manner as other similar limitations under the Code (e.g., the Code Section 402(g) limitation); and

- o Clarified so that the limitation, as applied to defined benefit length of service award plans, applies to the actuarial present value of the benefit under the service award plan commencing at the later of normal retirement age under the terms of the plan or current age, using reasonable actuarial assumptions and methods.

If eligible deferred compensation plan status was elected, the following provisions of Code Section 457 would apply to a service award program:

- An electing defined contribution service award program would be structured as an individual account, deferred compensation plan.
- Amounts would be held in trust or custodial accounts.
- The maximum annual deferral amount would be the applicable dollar amount under Code Section 457(b)(15), i.e., \$17,500 in 2013, not the Code Section 457(e)(11)(B)(ii) limitation on accruals. Changes to the Code would provide that the 100% of compensation limit under Code Section 457(b)(2)(B) would not to apply to avoid issues of defining "compensation" for volunteers. Catch-up contributions (Code Section 457(b)(3)) would be available.
- Distributions from a service award program would generally follow the requirements of Code Section 457(d) (not earlier than the calendar year in which participant attains 70 ½ , severance from employment or unforeseeable emergency) but, for a service award program, the "severance from employment" distribution event would be deemed satisfied at the later of the specified payment date under the terms of the plan or cessation of qualified services as a bona fide volunteer. A one-time deferral of the commencement of distributions would be available (Code Section 457(e)(9)(b)).
- Plan-to-plan transfers to other eligible governmental plans, rollovers to other "eligible retirement plans" (such as individual retirement accounts), and trustee-to-trustee transfers to purchase permissive service credit on a defined benefit governmental plan, would be available in the same manner as permitted for all other eligible deferred compensation plans of governmental employers.
- Amounts deferred under the service award program would be includible in income when paid, therefore the proposal should have a very low tax cost (derived from the increase in the accrual limit and the deferral of tax revenue).
- Amounts deferred under a service award program would be held in trust for the exclusive benefit of participants and beneficiaries, or in custodial accounts and contracts described in I.R.C. § 401(f) (Code Section 457(g)).

Finally, the proposal would instruct the Secretary of Labor to issue regulatory guidance that would clarify that a service award program, whether established pursuant Code Section 457(e)(11)(A)(ii) or electing to be treated as an eligible deferred compensation plan maintained by a governmental employer, would not be considered an "employee pension benefit plan" under ERISA.

All changes under the proposal would be effective prospectively, except the exemption of service award programs from ERISA, which would be retroactively applied. The proposal does not eliminate the exception for a length of service award program contained in Code Section 457(e)(11)(A)(ii). Consequently, the legislative history would state that both existing and new service award programs could be established and maintained pursuant to current law requirements, as updated and clarified by this proposal. This would provide an alternative for state-specific programs that may not fit the requirements of an eligible deferred compensation plan.

*Edward J. Holohan is an Associate of the American Society of Actuaries and has since 1990 helped hundreds of state and local governments establish and administer Service Award Programs for emergency services volunteers. Ed is a member of the NVFC's LOSAP Committee.*