



Memorandum

TO: HONORABLE MAYOR
AND CITY COUNCIL

FROM: Richard Doyle
City Attorney

SUBJECT: Tax Qualification Ordinances for
City Retirement Plans

DATE: January 13, 2011

RECOMMENDATION

- a) Approve an ordinance amending Chapter 3.28 of Title 3 of the San José Municipal Code to incorporate provisions related to primary purpose of the Federated City Employees' Retirement Plan, use of retirement plan assets, prohibited retirement plan transactions, pension benefit vesting, pension benefit and contribution limits, required benefit payments, permissive purchases of service credit, rollover of employee contributions into other tax qualified plans and accounts, permissive retirement plan investment vehicles, qualified domestic relations orders and contributions, benefits, service credit for qualified military service, date of establishment of medical benefits account, and to make other technical amendments related to Internal Revenue Code provisions for qualified governmental retirement plans.
- (b) Approve an ordinance amending Chapter 3.36 of Title 3 of the San José Municipal Code to incorporate provisions related to primary purpose of the Police and Fire Department Retirement Plan, use of retirement plan assets, prohibited retirement plan transactions, pension benefit vesting, pension benefit and contribution limits, required benefit payments, permissive purchases of service credit, rollover of employee contributions into other tax qualified plans and accounts, permissive retirement plan investment vehicles, qualified domestic relations orders and contributions, benefits, service credit for qualified military service, date of establishment of medical benefits account, and to make other technical amendments related to Internal Revenue Code provisions for qualified governmental retirement plans.

BACKGROUND

In 2010, the City Attorney's Office engaged Ice Miller, LLP as outside tax counsel for the Boards of Administration of the City's two Retirement Plans. The purpose of the outside tax counsel engagement was to assist the Boards in making recommendations to the City Council for amendments to the Plans to ensure that the Plans maintain their tax qualified status, and to assist the Boards in evaluating whether to seek a written determination from the Internal Revenue Service (IRS) as to the tax qualified status of

the Plans. The information contained in this memorandum is based on the review conducted by the Boards' outside tax counsel and was derived from a presentation made by outside tax counsel to a joint session of both Boards on October 20, 2010.

Advantages of Qualified Governmental Plan Status for Retirement Systems

Most governmental retirement systems, like those for the City of San José, have been established and maintained as qualified governmental plans under the Internal Revenue Code ("IRC" or "Code") § 401(a). Qualified governmental plan status has a number of advantages for public employers and public employees, including:

A. Taxation

1. Employer contributions are not taxable to members as they are made (or even when vested); taxation only occurs when plan distributions are made.
2. Employee contributions to a governmental plan can be made ("picked up" as if made by employer) on a pre-tax basis and not taxed until distribution.
3. Earnings and income are not taxed to the trust or the members (until distribution).
4. State and local government plans have favorable rules that apply when changes in the law occur.
5. Special service purchase opportunities exist only for governmental plans. (IRC § 415(n), for example)
6. Certain favorable tax treatments may be available to members when they receive plan distributions; for example, the ability to rollover eligible distributions.
7. Employers and members do not pay employment taxes (even if the positions are Social Security covered) when employer contributions are made or when benefits are paid.
8. Governmental plans are exempt from many IRC requirements, including many time consuming and costly testing requirements.
9. Tax recapture is available for qualified plans in tax treaty countries.

B. Bankruptcy

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCA") provides greater protection for retirement funds that qualify for favorable federal tax treatment.

C. Exemption from Federal Requirements

1. Governmental plans are exempt from the Employee Retirement Income Security Act of 1974 ("ERISA").

2. Governmental plans are exempt from Pension Benefit Guaranty Corporation ("PBGC") premium payments.

Key Elements of a Qualified Governmental Retirement Plan

There are a number of sources for the elements of a qualified governmental retirement plan, including:

1. The Internal Revenue Code ("Code"). The Pension Protection Act of 2006 ("PPA"), the Heroes Earnings Assistance and Relief Act of 2008 ("HEART"), and the Worker, Retiree, and Employer Recovery Act of 2008 ("WRERA") are the most recent major enactments affecting qualified governmental plans.
2. Treasury Regulations, interpreting the Code. The most recent Treasury Regulations of interest include the Final 415 Regulations.
3. Revenue Rulings issued by the IRS/Treasury. For example, the IRS has dealt with pick-ups primarily through revenue rulings.
4. Notices, Revenue Procedures, Announcements, Newsletters, etc. issued by the IRS.
5. Other federal laws such as the Age Discrimination in Employment Act, the Americans with Disability Act, and the Uniformed Services Employment and Reemployment Rights Act ("USERRA").

The key elements of a qualified governmental retirement plan, as identified by the Board's outside tax counsel are:

1. Each plan must be established and maintained by an employer or employers and operated and maintained for the exclusive benefit of employees and their beneficiaries.
2. Each plan's assets must be held in trust as determined under state law.
3. Trustees must exercise fiduciary duties.
4. The primary purpose of the Plan must be to provide systematically for the payment of definitely determinable benefits. In a defined benefit plan, forfeitures must not be applied to increase the benefits any employee would receive under the plan. Forfeitures may be used for plan expenses or to offset employer contributions.
5. Benefits must be paid to former employees over a period of years, usually for life, after retirement.
6. The Plan must make it impossible, at any time prior to the satisfaction of all liabilities with respect to employees and their beneficiaries for any of the corpus or income to be used for or diverted to, purposes other than for the exclusive benefit of employees or their beneficiaries.

IRS Determination Letters & the Voluntary Compliance Program

The IRS issues "determination letters" which confirm the qualified status of a retirement plan. Although governmental plans are not required to apply for a determination letter, they are encouraged to do so by the IRS; and the IRS has adopted extended remedial amendment periods for governmental plans that are applying for determination letters. In addition, plans seeking a tax determination letter can also apply to the IRS to address certain compliance failures which may be addressed through self-correction or an IRS-approved voluntary correction program ("VCP").

The current deadline for governmental plan submission of a tax determination letter request is January 31, 2011. The Boards of Administration of both retirement plans have authorized the filing of applications for tax determination letters and related VCP filings, contingent on Council approval of the ordinances that have been recommended by the Boards' outside counsel. The Municipal Code amendments contained in the proposed ordinances have been recommended by the Boards' outside tax counsel as amendments needed to apply for a tax determination letter.

ANALYSIS

The Code amendments recommended by the Board's outside tax counsel were primarily technical in nature. The IRS uses "checklists" in reviewing plans for issuance of tax determination letters and, in some cases, has very specific language that it wants to see in the Plan documents. In addition, through the determination letter process, the IRS reviews whether a plan has been timely amended to reflect changes in law that have occurred since the last time it reviewed the plan. For plans that have never had determination letters, such as San José's Plans, this can require Plan amendments and the filing of a VCP application to address failure to timely adopt required amendments.

The following is a brief summary of the Municipal Code amendments that have been recommended by the Boards' outside tax counsel:

Exclusive Benefit Rule

- The plan must be established and operated for the exclusive benefit of employees and their beneficiaries.
- The plan must make it impossible, at any time prior to the satisfaction of all liabilities with respect to employees and their beneficiaries for any of the corpus or income to be used for, or diverted to, purposes other than for the exclusive benefit of employees or their beneficiaries
- Recommendations: Outside tax counsel proposed Municipal Code amendments to conform language for the Police and Fire Department Retirement Plan and the Federated City Employees Retirement System to these requirements. This should have no impact on Plan or System operations.

- See Proposed Ordinances Section Nos.:

Police and Fire	Federated
11	10

Prohibited Transactions

- The plan may not engage in “prohibited transactions,” subject to very limited exceptions. These prohibitions include transactions with the City, such as loans or purchases of City property.
- Recommendations: Outside tax counsel proposed Municipal Code amendments to conform language for the Police and Fire Department Retirement Plan and the Federated City Employees Retirement System to these requirements. These amendments should have no impact on Plan or System operations.
- See Proposed Ordinances Section Nos.:

Police and Fire	Federated
9	8

Vesting Requirements

- The Plan must provide 100% vesting for any benefit the member has accrued if there is a partial or complete termination of the plan, or complete discontinuance of contributions, but in either situation only to the extent benefits are funded.
- Governmental plans are subject to pre-ERISA vesting rules. Pre-ERISA vesting would also require 100% vesting of accrued benefit at normal retirement age, defining that as the date eligible for an unreduced retirement benefit.
- Recommendations: Outside tax counsel proposed Municipal Code amendments to conform language for the Police and Fire Department Retirement Plan and the Federated City Employees Retirement System to these requirements. These amendments should have no impact on Plan or System operations.
- See Proposed Ordinances Section Nos.:

Police and Fire	Federated
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Limits on Contributions

- Post-tax employee contributions to a defined benefit plan are capped by the limit on “annual additions” to plan – the lesser of 100% of compensation or \$40,000 (adjusted for inflation by the IRS) – \$49,000 for 2010.
- These limits are modified for permissive service credit purchases in a defined benefit plan.
- Special rules apply to restoration of withdrawals.
- If the employer plan provides for a pick-up of members' mandatory contributions, the pick-ups must be in compliance with IRS guidelines, and then the attributable benefit will be tested under IRC § 415(b).

- **Recommendations:** Outside tax counsel proposed Municipal Code amendments to conform the existing contribution limit language to these requirements. These amendments should have no impact on Plan or System operations.
- See Proposed Ordinances Section Nos:

Police and Fire	Federated
22	21

Benefit Limits

- Benefits from a defined benefit plan are subject to the “dollar limit” – \$160,000 (adjusted for inflation by the IRS– \$195,000 for 2010).
- Certain employees can be “grandfathered” (payment of higher benefit allowed.)
- The benefit tested as the straight life annuity starting at age 62. Benefits that are not paid as a straight life annuity starting at age 62 must be converted to an equivalent benefit using IRS required factors.
- Eligible police/fire members have more favorable limits. No reductions for starting benefits before age 62 for eligible police/fire members with at least 15 years of service.
- The benefit tested must also be adjusted for other items, such as less than 10 years of plan participation.
- **Recommendations:** An ordinance amending the Municipal Code for Police and Fire Department Retirement Plan members, to conform the Plan’s benefit limit language to these requirements as recommended by the Boards’ outside tax counsel, was adopted by Council in June 2010. An additional Code amendment for the Police and Fire Plan is now being recommended to cover service purchases. Outside tax counsel has also recommended that these same changes now be adopted for the Federated City Employees’ Retirement System. These amendments should have no impact on Plan or System operations.
- See Proposed Ordinances Section Nos.:

Police and Fire	Federated
17	21

Limits Related to Compensation

- The plan must limit the compensation that may be considered in determining benefits to \$200,000 (as adjusted for inflation) (IRC § 401(a)(17) – \$245,000 for 2010).
 - a. Also applies to employee contribution calculation (generally not for employer contribution purposes).
 - b. Applies to benefit calculation.
- Certain employees are “grandfathered” (consideration of higher compensation allowed.)

- Recommendations: Outside tax counsel proposed Municipal Code amendments to conform language for the Police and Fire Department Retirement Plan and the Federated City Employees Retirement system to these requirements. These amendments should have no impact on Plan or System operations.
- See Proposed Ordinances Section Nos.:

Police and Fire	Federated
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Required Benefit Payments

- The plan must set forth the IRC's distribution requirements and contain statements that the plan will comply with those requirements notwithstanding any of the plan's distribution provisions.
- Benefits must be distributed or begin to be distributed by the required beginning date (RBD) – April 1 of the calendar year that follows the calendar year in which the participant attains 70½ or separates from service, whichever is later.
- Benefits must be distributed over the period of life of the employee or over the lives of such employee and a designated beneficiary (or over a period not extending beyond life expectancy(ies)).
- Benefits must meet the post-retirement minimum distribution incidental benefit (MDIB) requirement – to make sure that benefit is primarily for retirement. Optional forms of payment to non-spouses beneficiaries are limited under this requirement.
- Recommendations: Outside tax counsel proposed Municipal Code amendments to conform language for the Police and Fire Department Retirement Plan and the Federated City Employees Retirement System to these requirements. The provision limiting the optional forms of payment to non-spouse beneficiaries will require changes to Plan and System operations. Retirement Service staff is aware of, and prepared to implement, this change.
- See Proposed Ordinances Section Nos.:

Police and Fire	Federated
20	22

Rollovers

- The plan must provide for rollovers out of the plans by employees and beneficiaries and give the appropriate notices.
- Distributions from the Plans may be rolled over into:
 - a. qualified plans,
 - b. 403(b) plans,
 - c. governmental 457(b) plans, and
 - d. IRAs.
- Non-spouse beneficiary rollovers are mandatory for plan years after December 31, 2009.

- Retirement plans are not required to accept rollover contributions (such as for service purchases); these are permissive.
- Automatic rollovers to an IRA are required for distributions over \$1,000 to participants who do not make an election under existing provisions. If a plan does not wish to establish the automatic rollover procedures, it needs to eliminate mandatory distributions over \$1,000. This would not work within the current fundamental design for elections.
- Recommendations: Outside tax counsel proposed Municipal Code amendments to conform language in the Police and Fire Department Retirement Plan and the Federated City Employees Retirement System to these requirements. The provision requiring mandatory rollover of non-elective distributions will require changes to Plan and System operations. Retirement Service staff is aware of, and prepared to implement, this change.
- See Proposed Ordinances Section Nos.:

Police and Fire	Federated
10, 24, 25	9,12,13

Group Trust

- A qualified plan may be invested in a group trust if permitted in the Plan document.
- Assets of qualified plans (401(a)), 457(b) plans, and deemed IRAs) may be commingled for investment purposes.
- Recommendations: Outside tax counsel proposed additional technical language for both the Police and Fire Department Retirement Plan and the Federated City Employees Retirement System to offer maximum flexibility, particularly for the purpose of potentially reducing investment fees.
- See Proposed Ordinances Section Nos.:

Police and Fire	Federated
11	10

Military Service

- Contributions, benefits and service credit with respect to qualified military service must meet the requirements of USERRA.
- HEART requires the plan to provide that, for a participant who dies while performing qualified military service, the survivors of the participant are entitled to any additional benefits (such as accelerated vesting, ancillary life insurance benefits, or other survivor benefits contingent on termination of employment on account of death; other than benefit accruals relating to the period of qualified military service) provided under the plan as if the participant had re-employed and terminated employment on account of his or her death. Optional provisions regarding other benefits in the case of military deaths or disabilities while on military service may be implemented as well.

- **Recommendations:** Outside tax counsel proposed Municipal Code amendments to conform language in the Police and Fire Department Retirement Plan and the Federated City Employees Retirement System to these requirements. The optional provisions were incorporated only where they represent the current practice, e.g., treatment of death while on military leave. Some of these changes will require development of new administrative procedures. Retirement Service staff is aware of, and prepared to implement necessary changes.
- See Proposed Ordinances Section Nos.:

Police and Fire	Federated
14	14, 24

Picked Up Employee Contributions

- Governmental plan employers may “pick-up” employee contributions to the plan, providing for pre-tax treatment of the contributions. IRS guidance has significantly restricted the ability to pick-up voluntary employee contributions under a one-time irrevocable election. However, the member can still purchase the service, using post-tax contributions, rollovers, and transfers.
- **Recommendations:** Both Plans currently permit pick-ups of certain voluntary employee contributions. Outside tax counsel’s recommended Code amendments to end this practice. Education of members on options for funding service purchases will be critical in this area and Retirement Services staff is aware of and prepared to implement this change.
- See Proposed Ordinances Section Nos.:

Police and Fire	Federated
13,15,16, 23	15,16, 17,19

Qualified Domestic Relations Orders

- A distribution from a governmental plan under a domestic relations order will be treated as a Qualified Domestic Relations Order if it meets the Code definition, which then results in the anticipated tax treatment (i.e., benefits paid to spouse or former spouse will be taxed to the spouse or former spouse).
- **Recommendations:** Outside tax counsel proposed Municipal Code amendments to conform language for the Police and Fire Department Retirement Plan and the Federated City Employees Retirement system to these requirements. These amendments should have no impact on Plan or System operations
- See Proposed Ordinances Section Nos.:

Police and Fire	Federated
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Health Benefits Account

- Under IRC § 401(h), a qualified governmental plan may maintain an account for payment of medical benefits. The regulations prescribe permissible uses and funding for a 401(h) account. The regulations also proscribe limits on the amount

that can be placed in a medical benefits account, which requires consideration of the plan "establishment date."

- **Recommendations:** Outside tax counsel recommended defining an account establishment date of July 1, 1995 for each account to establish the starting date for certain funding calculations.
- See Proposed Ordinances Section Nos.:

Police and Fire	Federated
12, 15, 16	7, 14

Miscellaneous

- **Recommendations:** Outside tax counsel made additional minor technical recommendations based on the IRS checklist and their past experience in negotiations with the IRS on behalf of governmental plans. See Proposed Ordinances Section Nos.:

Police and Fire	Federated
1, 18, 19	1,7

EVALUATION AND FOLLOW-UP

If approved by Council, the ordinance titles will be published, and the ordinances will return to Council for adoption on the February 6, 2011 consent calendar.

POLICY ALTERNATIVES

Council is not required to approve or adopt the proposed ordinances. However, unless the proposed ordinances are adopted, it is highly unlikely that the City's two Retirement Plans could obtain tax determination letters from the IRS or address certain compliance failures which may be addressed through self-correction or IRS approved VCP, including the lack of a medical benefits account establishment date in the Plans. Approval of the ordinances is therefore recommended in order to facilitate the Plans' application for tax determination letters.

PUBLIC OUTREACH/INTEREST

The proposed ordinances were posted for public review prior to consideration by the City's two Retirement Boards, and again prior to the Council meeting. The Retirement Boards held a joint tax study session as a public meeting prior to consideration of the proposed ordinances and public meetings after the ordinances had been drafted to obtain comments on the proposed ordinances. The City Manager's Office of Employee Relations also circulated drafts of the proposed ordinances to employee bargaining units for review and comment. All comments received to date have been incorporated into the proposed ordinances.

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Subject: Tax Qualification Ordinances

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COORDINATION

Preparation of this memorandum and the proposed ordinances has been coordinated with the Police & Fire Department Retirement Plan and the Board of Administration of the Federated City Employees' Retirement Plan, the Department of Retirement Services and the City Manager's Office of Employee Relations.

BUDGET REFERENCE

N/A

CEQA

Not a Project; File No. PP10-068(b), Municipal Code or Policy.

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