



Memorandum

TO: HONORABLE MAYOR
AND CITY COUNCIL

FROM: Richard Doyle
City Attorney

**SUBJECT: Ordinance to Implement New
Health Care Trusts for Police
and Fire Retirement Plan**

DATE: May 26, 2011

RECOMMENDATION

Consider an Ordinance amending Title 3 of the San José Municipal Code to add new Chapters 3.54 and 3.56, and to amend Sections 3.36.575, 3.36.1925, 3.36.1930, 3.36.2030 and 3.36.2050 for the purposes of establishing a new trust pursuant to section 115 of the Internal Revenue Code related to retiree health care benefit funding and payment of retiree health care benefits.

BACKGROUND

The Police and Fire Department Retirement Plan (the "Police and Fire Plan") pays 100% of the premium cost for the lowest cost medical plan (Health Benefits) and the costs of dental premiums (Dental Benefits) for certain retired members and other persons who receive retirement allowances from the Police and Fire Plan. The premium payments are currently made through a medical benefits account established by the City Council under Section 401(h) of the Internal Revenue Code (IRC). The 401(h) account is funded by contributions made by the City and active employees.

Through fiscal year 2009, contributions to the Police and Fire Plan's medical benefits account for Health and Dental Benefits for both the City and the participating Police and Fire employees were based upon an actuarially determined percentage of employees' base salary sufficient to provide adequate assets to pay benefits when due over the next 15 years. In April, 2009, the City reached an agreement with the POA to phase in to full funding of the annual required contributions (ARC) for the Health and Dental Benefits for police members of the Plan over a five year period. In April, 2011, the City reached an agreement with the Local 230, IAFF to phase in to full funding of the annual required contributions (ARC) for the Health and Dental Benefits for fire members of the Plan over a five year period.

Section 401(h) of the IRC is one vehicle that allows employee contributions for retiree health care benefits to be made on pretax basis, and allows earnings in the fund to accumulate tax free. However, as a condition of this favorable tax treatment, IRC Section 401(h) limits the total amount of contributions that can be made to the medical

benefits account. Once the limit is reached, future 401(h) contributions would be limited to one-third of the pension normal cost contributions. In order to ensure that the IRC contribution limit would not affect the ability to implement full funding of the ARC, the agreements with the bargaining units provided that the City would establish a qualified trust that would become the sole funding vehicle for Police and Fire retiree healthcare benefits.

Earlier this year, the City Attorney's Office engaged Ice Miller, LLP, as outside tax counsel, to assist with preparation of trust documents for both the Police and Fire Plan and the Federated City Employees Retirement Plan. The ordinance that has been drafted for the Council's consideration includes Municipal Code amendments to implement a qualified trust as contemplated by the agreements with the bargaining units.

ANALYSIS

The draft ordinance would establish two new trust funds pursuant to Section 115 of the Internal Revenue Code. The ordinance as drafted contains the following key provisions:

- The new Trust Funds would be administered by a Board of Trustees composed of the Board members of the Police and Fire Department Retirement Plan.
- City contribution for retiree health care would begin to be deposited into the new Trust Fund effective July 15, 2011, assuming the proposed ordinance is adopted by the City Council no later than June 14, 2011.
- Employee contributions would continue to be deposited into the existing 401(h) account until a private letter ruling has been obtained from the Internal Revenue Service confirming that the employee contribution can go into the new trust on a pretax basis. A request for a private letter ruling will be filed as soon as the ordinance is approved. Retirement Services staff has indicated that the Police and Fire employee contributions can continue to go into the 401(h) account for at least some portion of fiscal year 2011-12 without violating IRC Section 401(h). If, for any reason, a private letter ruling cannot be obtained before the limit will be reached, the City Attorney's Office and staff will return to Council with a recommendation on how to continue the ramp up to full funding.
- As long as the employee contributions continue to be deposited into the 401(h) account, employees who take a return of contributions from the Plan (usually those with less than 5 years of service) will continue to receive an extra payout amount from the pension fund in the amount of their contributions to the medical benefits account plus 2 % interest. After

employee contributions start being deposited in the new trust fund, this extra payout will cease, as the Trust Fund and Pension Fund are two completely separate funds; and direct payment for qualified 115 trusts can only be made for health and welfare benefits.

- Retiree health premium payments would continue to be paid out of the medical benefits account until it is exhausted, unless the new Board of Trustees determines that some or all of the premium payment should be made out of the new Trust Fund. The purpose of this provision is to ensure that there is a default provision for ensuring that premium payments will continue to be made, while providing the trustees with flexibility for liquidating investments in the existing medical benefits account.
- The ordinance retains current Code language regarding the nature of the health benefit provided to retirees and other persons who receive retirement allowances from the Police and Fire Plan (lowest cost plan premium for medical).
- The ordinance retains current Code language regarding contribution rates for medical and dental benefits (this section has been renumbered, but not altered).
- Although it is anticipated that City contributions for FY 2011-12 will be made before the new Ordinance becomes effective, in the event that City contributions do come in between July 15, 2011 and the first time the new Boards can meet, there is a delegation of authority to the Director of Retirement Services to make banking and investment arrangements for the new trust until a meeting of the Boards of Trustees of the new Police and Fire Employees Health Care Trusts can be convened.

EVALUATION AND FOLLOW-UP

If approved by Council, the ordinance title will be published and the ordinance will thereafter be placed on the City Council agenda for adoption. As indicated above, if for any reason, a private letter ruling concerning the pre-tax status of employee contributions to the new trust fund cannot be obtained before the limit will be reached, the City Attorney's Office and staff will return to Council with a recommendation on how to continue the ramp up to full funding.

POLICY ALTERNATIVES

The City and employees cannot continue to ramp up to full funding for retiree health care within the existing Police and Fire Retirement Plan structure. The agreements with the bargaining units specify that the City will establish a trust to implement the ramp up to full funding for retiree health care. For these reasons, other alternatives have not been considered at this time.

PUBLIC OUTREACH/INTEREST

The draft ordinance was posted for consideration by the Police and Fire Board at its June 2, 2011 meeting and posted for public review prior to the Council meeting. Any Board or public comments made at the Board meeting will be provided to Council. The City Manager's Office of Employee Relations will also circulate the draft of ordinance to affected employee bargaining units for review and comment.

COORDINATION

Preparation of this memorandum and the draft ordinance has been coordinated with the Department of Retirement Services, the Finance Department 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.

RICHARD DOYLE
City Attorney

By 
MOLLIE DENT
Sr. Deputy City Attorney

cc: Debra Figone
Russell Crosby
Scott Johnson
Alex Gurza

For questions, please contact Mollie Dent, Sr. Deputy City Attorney, at (408) 535-1905.