



# 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 1, 2012

## 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 for the Police and Fire Retirement Plan.

## 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.

In early 2011, the City Attorney's Office engaged Ice Miller, LLP, as outside tax counsel, to assist with preparation of the trust documents for both the Police and Fire Plan and the Federated City Employees' Retirement System. An ordinance was drafted to implement the new health care trust and presented for Council consideration on June 7, 2011. At the request of the bargaining units representing the members of the Police and Fire Department Retirement Plan, Council deferred consideration of the ordinance to allow for discussion and comment on the ordinance.

### **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 and employee contributions for retiree health care would begin to be deposited into the new Trust Fund as soon as the ordinance becomes effective. The draft ordinance presented for Council consideration on June 7, 2011, provided that 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. This provision has been eliminated in light of the IRS response to the Federated System private letter ruling request.
- 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).
- In the event that contributions come into the Trust Fund before 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. There is not sufficient time to submit the revised ordinance to the Board of Administration for the Police and Fire Department Retirement Plan if the Council wants the ordinance to be effective by the first pay period in fiscal years 2012-13. If Council adopts the revised ordinance on May 22, 2012, the ordinance will be referred to the Board for consideration at its June 5, 2012 meeting, so that Council can consider any Board comments that might be submitted pursuant to San José Municipal Code Section 3.36.485.B. The City Manager's Office of Employee Relations will also circulate the revised draft ordinance to affected employee bargaining units for review and comment.

### **POLICY ALTERNATIVES**

The only alternative to the recommended ordinance is to continue depositing City and/or employee contributions into the existing 401(h) account. It cannot be stated with a certainty that failure to adopt the recommended ordinance will cause contributions to exceed the 401(h) limit in fiscal year 2012-13. However, based on the projections in Police and Fire Department Retirement Plan June 30, 2011 Actuarial Valuations, it appears that establishment of the health trust will be needed in order to fully implement the ramp up to the full funding of retiree health care costs. In addition, 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.

### **PUBLIC OUTREACH/INTEREST**

This memorandum and the draft ordinance have been posted on the City's web site for the May 8, 2012 City Council agenda. The earlier version of the draft ordinance was

reviewed by the Board of Administration for the Police and Fire Department Retirement Plan on June 7, 2011, pursuant to San José Municipal Code Section 3.36.485.A. The Board voted to recommend approval of the then proposed ordinance, subject to the acknowledgement that bargaining units may not have reviewed the ordinance, and recognition that the costs to administer the trusts need to be reviewed.

**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 

ED MORAN  
Assistant City Attorney

cc: Debra Figone  
Russell Crosby  
Julia Cooper  
Alex Gurza

For questions, please contact ED MORAN, Assistant City Attorney, at (408) 535-1900.