

EMPLOYEE RELATIONS

BULLETIN

December 19, 1989

To:

Heads of all Departments of City Government (except Water and Power)

Subject: CHANGES IN THE CITY EMPLOYEE'S RETIREMENT SYSTEM TO

COMPLY WITH THE INTERNAL REVENUE CODE

The City Council has recently adopted an ordinance amending the City Employee's Retirement System (CERS) to comply with Section 415 of the Internal Revenue Code. The purpose of the ordinance is to ensure that CERS maintains its tax-qualified status, thereby allowing employees to continue to defer taxes on their benefits until received at retirement. It was enacted following negotiations and agreement with a coalition of employee organizations representing CERS members.

Although Section 415 places limitations on benefits that can be paid from tax-qualified plans, it also provides an option for avoiding those limits for employees who become CERS members prior to January 1, 1990. The Council, in amending CERS, has taken advantage of the Section 415 provision that protects (grandfathers) the benefits of all such employees. Therefore, all employees who are CERS members prior to January should be assured that their benefits will not be affected by compliance with Section 415.

The Committee report adopted by Council that explains the basis for the Council action is attached.

10-31, 11-15, 12-1

WITH ALMANS TRATIVE OF FILL

File No. 89-2065

TO THE COUNCIL OF THE CITY OF LOS ANGELES

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Your

HUMAN RESOURCES AND LABOR RELATIONS

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AND

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Committee

report as follows:

		Yes_	<u>No</u>
Public	Comments	X	

Subject

HUMAN RESOURCES AND LABOR RELATIONS COMMITTEE and BUDGET AND FINANCE COMMITTEE REPORT and ORDINANCE relative to required changes in the City's retirement plans as mandated by Internal Revenue Code Section 415.

Recommendations for Council Action, as recommended by the City Administrative Officer:

For the City Employees' Retirement System (CERS):

- 1. Your Committees recommend adoption of an ordinance amending the City Employees' Retirement System to comply with Internal Revenue Code Section 415 limits. Your Committees recommend that Council take the following actions in accordance with Council policy for ordinances introduced pursuant to Charter Section 512.2:
 - a. PRESENT the accompanying ordinance on first presentation at the time this Committee report is adopted, and PLACE the matter again on the Council Agenda on December 1, 1989.
 - b. HOLD a Public Hearing before the full City Council on November 15, 1989, and CONTINUE such public hearing to December 1, 1989.
 - c. CONCLUDE the Public Hearing and ADOPT the subject ordinance on December 1, 1989 (second presentation).

The abovementioned ordinance would enable the City to exercise the option allowed by Internal Revenue Code Section 415(b)(10) to grandfather benefits for employees who are plan members prior to January 1, 1990, and incorporate other applicable provisions of Section 415 into the plan for employees who are plan members on or after January 1, 1990. The ordinance would further enable the City to maintain the current level of benefits for future employees subject to reductions under the Internal Revenue Code.

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2. AUTHORIZE the City Administrative Officer to negotiate and execute a contract with the actuary for the City Employees' Retirement System to develop options for supplemental retirement/benefit plans that would provide benefits for new employees comparable to the benefits of grandfathered employees.

For the Fire and Police Pension System

INSTRUCT the City Administrative Officer to meet and confer on ballot measures to amend Fire and Police Pension System Articles 17, 18 and 35 of the City Charter.

The ballot measure amendments would exercise the option allowed by Internal Revenue Code Section 415(b)(10) to grandfather benefits for employees who are plan members prior to January 1, 1990, and incorporate other applicable provisions of Section 415 into the plan for employees who are plan members on or after January 1, 1990. The ballot measure amendments would further provide authority to maintain benefits for members subject to reduction under IRC Section 415, and maintain the tax-qualified status of the System under other Internal Revenue Code sections.

SUMMARY

The City Administrative Officer reports that a change in Internal Revenue Code Section 415, the section that establishes benefit limits for tax-qualified plans, necessitates amendments to the City's civilian and sworn pension plans. The subject change in Section 415 was enacted with the Technical and Miscellaneous Revenue Act (TAMRA) of 1988.

Background of Internal Revenue Code Section 415

Section 415 of the Internal Revenue Code establishes the requirements for tax-qualified pension plans. The City's three retirement systems are considered tax-qualified, and therefore must comply with the IRS Code in order to maintain their tax-qualified status. Qualified status allows employees to defer taxes on the value of their vested benefits until retirement. A plan must also be qualified in order for employees to be eligible to defer taxes on their own contributions.

In contrast, members of a non-qualified plan are taxed in advance of receiving benefits. Each year they pay taxes on: 1) their share of contributions made by the employer, 2) the earnings on the employer contributions, and 3) the earnings on their after-tax contributions. Additionally, if a plan is disqualified, employees can immediately

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become liable for taxes on the current imputed value of their vested benefits as of the date of disqualification.

Since its effective date in 1976 and indexed until 1982, Section 415 dollar limits were high enough not to raise concerns for government plans. Additionally, the Internal Revenue Service had ruled in 1977 to defer enforcement for government plans until specific regulations could be developed.

Since 1976, Section 415 limits have been changed several times. Limits were reduced in 1982 and 1986. In 1986, for the first time, government plans were specifically addressed in the legislation, in an apparent attempt to bring them more in line with private plans and to share the burden of the Federal deficit. They were still, however, partially protected by a provision that retained higher limits (a \$75,000 "floor" for retirements between ages 55 and 62) contained in the 1982 Act, and by a special rule (a \$50,000 "floor") for plans covering police and firefighters. The assumption at the time was that these higher limits would protect most government plans from violation of Section 415.

The Passage of TAMRA by Congress in 1988 marked a significant change in the status of government plans under Section 415. The TAMRA legislation, along with a recent ruling by the IRS rescinding its prior non-enforcement policy, is a clear indication that the Federal government is serious about application of Section 415 to public plans.

However, the TAMRA legislation provides a "window of opportunity" for government plans to comply with the Section 415 limits. TAMRA allows plans maintained by public employers to "grandfather" the benefits of participants (employees who become plan members) into the City's existing benefits before January 1, 1990, even though those benefits may exceed current Section 415 limits, in exchange for complying with more stringent rules for new employees. Election of the grandfather option would restrict a plan from modifying benefits for current and future employees that would exceed the limits.

Impact on the City's Three Pension Plans

The City's primary concerns are the following defined limits of Section 415. For 1989, they are the lesser of:

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- a. \$98,064, payable at Social Security Retirement Age (reduced for early retirement; e.g., \$37,306 at age 55 for civilians), or
- b. 100% of a member's highest 3-year average earnings.

These limits apply only to benefits paid for by the employer. The precise dollar limits are affected by employee contributions and by amounts contributed to deferred compensation plans.

 $\overline{\text{All}}$ employees in the pension plan must comply with the Section 415 limits. If even one employee earns benefits exceeding the limits, the entire pension plan can be disqualified.

Numerous actions, including Charter amendments as outlined in the recommendations of this report, must be taken as soon as possible. Concurrently, the City should continue to seek legislative relief from these regulations.

1. City Employees' Retirement System (CERS)

The actuary for the City Employees' Retirement System has concluded that current member benefits are likely to exceed the Section 415 limits. A few highly compensated employees exceed the current maximum dollar limits; lower paid employees with long periods of service can exceed the 100% of the highest 3-year average earnings limit. Employees hired since 1986, whose entire employee contribution is made on a pre-tax basis, are the most likely to earn benefits that exceed the limits.

If the grandfather election is made, <u>current</u> employees would not be in violation, regardless of benefits paid. However, persons becoming members of CERS after January 1, 1990 would be subject to the private sector limits. Thus, future employees retiring at age 55 after 30 years of service from all classes currently earning over \$59,000 could not receive a retirement allowance exceeding \$37,306. The 100% of highest 3-year earnings limit affects employees at all income levels. A typical City employee who retires earning \$40,000 after 35 years with maximum compensation deferrals and whose employee contributions were made on a tax-deferred basis has a Section 415 limit of \$28,600, or \$1,640 a year less than the \$30,240 that would be received under the City's current plan.

The City Administrative Officer recommends that the City should exercise the grandfather/compliance option. If the City does not, the current pension plans could become disqualified, resulting in severe income tax consequences to employees. Current employees

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could possibly face an immediate tax liability of several thousand dollars on the current value of their pensions. All employees, both current and future, could be taxed annually on the amounts contributed to their pension accounts and the earnings on those accounts.

In addition to exercising the grandfather/compliance option, the CAO also recommends that the City explore alternatives to make new employees "whole", i.e. devise a system whereby the benefits for new employees would comply with the new law and also be comparable with the benefits of grandfathered employees.

The unions representing members of CERS have agreed to the grandfather election on the assumption that the City shall maintain benefits for current and future employees subject to possible reductions under Section 415.

2. Fire and Police System

The actuary for Fire and Police System has determined that <u>current</u> members of the Article 18 plan who retire below age 55 and earn over \$75,000 (i.e., Police Captain and above), as well as employees receiving maximum service disability pensions, would earn benefits exceeding the Section 415 limits. Therefore, the actuary recommends that the grandfather option be adopted.

For <u>future</u> employees (all under Article 35), the maximum pay limits would probably only affect the ranks of Chief of Police and Chief Engineer. This is because members of the Article 35 plan pay 8% in after-tax employee contributions, thereby reducing the employer paid benefit portion. Additionally, employees receiving maximum disability pension could continue to receive benefits in excess of the limits. The benefits of these members would have to be reduced in order to comply with the limits.

Changes to the Fire and Police Pension Plan can only be made by Charter Amendment. The Board of Pension Commissioners has adopted a resolution requesting that such a measure be placed on the June 1990 ballot, that would elect the grandfather option and incorporate the provisions of Section 415 into the City Charter. However, this raises concerns about the status of employees who become plan members between Janaury 1, 1990 and the date of that election. It is uncertain whether the Charter amendment can apply retroactively to these employees. It is possible that the IRS could provide transitional relief (i.e., not enforce the limits) for this group. If not, it will be necessary for the City to provide a supplemental benefit for employees facing a benefit

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reduction. The City Council could be provided with authority to provide such a benefit by ordinance.

The unions representing members of the Fire and Police Pension System are not yet prepared to agree to specific Charter language concerning Section 415. The unions are waiting for the report from the actuary outlining alternatives to preserve benefits before moving forward. It is understood that all pertinent meet and confer sessions must be completed in sufficient time to place the matter on the June 1990 ballot.

3. Water and Power System

The Department of Water and Power Plan does not appear to have current members whose benefits will violate the limits because it has a defined contribution component that allows testing against different Section 415 limits. Department management and the unions are exploring alternatives as to whether the grandfather option is desireable. The Board of Administration of the Water and Power Employees' Retirement System, with the consent of the Board of Water and Power Commissioners, has the independent authority to amend its own plan and adopt the grandfather option to comply with Section 415.

Mitigating the Impact of Section 415 on New Employees

Once the grandfather election is made, attention must be directed toward the impact of Section 415 on new employees. One alternative that could preserve existing benefits of CERS members, as recommended by the CERS actuary, would be to design a type of qualified plan that combines features of both defined benefit and defined contribution plans, so that the total benefit would be identical to the current plan benefit (2.16% X years of service). This approach would require additional administrative expense but minimal, if any, additional City cost for benefits.

For the Fire and Police System, a non-qualified supplemental plan might be more feasible to preserve the level of benefits for those few employees subject to reductions under the 415 limits.

Further, some mechanism will be required to ensure that the combined benefits of an employee receiving retirement allowances from more than one System (e.g. Fire and Police and CERS) cannot exceed the Section 415 limits.

Finally, the City Administrative Officer recommends that lobbying efforts should continue to exempt the public sector from the Section

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415 limits, or to mitigate its impact. However, in the meantime, action should continue to comply with existing law, to protect City employees from adverse tax consequences and to demonstrate the City's good faith. Thus, if difficulties arise during, or as a consequence of compliance, the City will be in a more favorable position to express its problems and needs.

Your Committees concur in the recommendations of the City Administrative Officer to take the necessary steps to amend the City Employees' Retirement System and the Fire and Police Pension System, in order to comply with Internal Revenue Code Section 415 limits.

Respectfully submitted,

HUMAN RESOURCES AND LABOR RELATIONS COMMITTEE

BUDGET AND FINANCE COMMITTEE

JL 10-25-89