

**MWD**

METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA

June 16, 1993

To: Board of Directors (Organization & Personnel Committee--Information)
From: General Counsel
Subject: Internal Revenue Code Section 415--Limits on Retirement Benefits

Report

Section 415 of the Internal Revenue Code (IRC) provides limitations on amounts payable as benefits under retirement plans and deferred compensation plans if the plans are to remain qualified for federal income tax purposes.

Unlike many other sections of the IRC, Section 415 applies to state and local government plans. Legislation adopted in 1990 to ensure the federal tax exempt status of the Public Employees' Retirement System (PERS) incorporates the limits of IRC Section 415 and requires the PERS Board to establish a program of replacement benefits for members whose retirement benefits will be affected by those limitations.

PERS began testing benefits of retirees against the dollar limit provided under IRC Section 415 in January of this year, after implementation of the first phase of its replacement benefits program. One of the first three retirees identified whose benefits exceed the permitted amount and whose allowance is being cut back was Carl Boronkay. His situation alerted us to the possible impact of IRC Section 415 on other employees of Metropolitan upon their retirement.

At its meeting on June 15, 1993, the PERS Benefits and Program Administration Committee considered three alternatives for dealing with these retirees. PERS Staff presented three alternatives, as follows:

1. Apply the Section 415 limits to members' retirement allowances and do not replace the amounts by which their allowances exceed the limits;

2. Ignore the Section 415 limits, discontinue testing for the dollar limit and pay members their PERS benefits without regard to Section 415; or
3. Apply the Section 415 limits to members' allowances and explore whether other replacement benefits may be used to make up for the amount cut back under Section 415.

Representatives of Metropolitan submitted a position letter to the Committee and appeared at the Committee meeting to argue for the third alternative. A copy of the letter and the PERS agenda item are attached for your reference.

Metropolitan's position is that Alternative 1 is unacceptable because it results in reducing benefits of members below the amounts which they have earned and below the levels at which Metropolitan has contributed. Alternative 2 could result in losing the tax qualified status of PERS. If PERS is disqualified, all accrued benefits would be considered income taxed to PERS members in the year of disqualification and, on an ongoing basis, all contributions to PERS, and earnings on those amounts, would be taxed when they are contributed, not when the benefits are actually received.

Alternative 3 is the only alternative that preserves both the rights of affected retirees and the expectations of existing employees. A couple of possibilities for payment of benefits without impacting the tax qualified status of PERS are being explored by PERS staff in connection with Alternative 3. Only one of them is possible at this point but tax law changes have been proposed which would enable PERS to implement broader replacement benefits program.

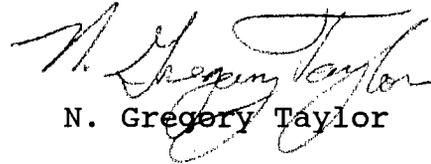
The Committee postponed consideration of this matter until more information on the possible replacement benefits is available. The Committee also requested that PERS legal staff provided more information on the likely outcome of a friendly lawsuit by an affected member in the event that the Committee decides to adopt Alternative 1.

Board Committee Assignment

This letter is referred for information to Organization and Personnel Committee pursuant to its authority under Administrative Code Section 2471, subdivision (c) to study, advise, and make recommendation with regard to all matters affecting pension plans and other employee benefits.

Recommendation

For information only.


N. Gregory Taylor

SBB:gm
bdltr\irc415

Attachment



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June 15, 1993

AGENDA ITEM 4

TO: MEMBERS OF THE BENEFITS AND PROGRAM ADMINISTRATION COMMITTEE

SUBJECT: APPLICATION OF INTERNAL REVENUE CODE SECTION 415 LIMITS

At the October 1992 meeting of the Board, an Internal Revenue Code Section 415 implementation plan was approved. This plan called for staff to begin Section 415 testing on service retirement applications received on and after January 1, 1993 for the dollar limit only. As staff time and priorities allowed, staff was to go back and test earlier retirement applications for both service and disability retirement for the dollar and percentage of pay limits. Also approved was the implementation of the first level replacement benefit (the Temporary Annuity/COLA Bank) for members who would suffer a cutback due to application of the dollar limit. The Board directed staff to bring back any cases where it was not possible to replace the entire amount limited under Section 415 with the Temporary Annuity/COLA Bank. A copy of the October 1992 agenda item to this Committee is attached for your information.

Since testing began, staff have identified three members whose allowances exceed the Section 415 dollar limits for their ages at retirement. In only one case can the Temporary Annuity/COLA Bank be used to fully replace the amount limited under Section 415. In the other two cases, the Temporary Annuity/COLA Bank is not effective because the members' PERS allowances exceed their Section 415 dollar limits by such large amounts. In these two cases, the members' "grandfathered" benefit is greater than their Section 415 limit so the "grandfathered" benefit is payable.

Staff is asking for the Committee's direction on how to proceed with regard to the two members whose benefits would be limited under Section 415 and whose benefits cannot be replaced under the Temporary Annuity/COLA Bank. Below are profiles of these two members and three alternative recommendations for the Committee's consideration.

MEMBER PROFILES**Member A:**

Managerial Employee, Metropolitan Water Dist. of So. Calif.
Miscellaneous member (2% @ 60 formula)

Retirement Date: April 1, 1993

Age at retirement: 63½

Service Credit:

16.895 years with Metropolitan Water Dist.

19.492 years with State Dept. of Justice

36.387 TOTAL (not including sick leave credit)

One-Year Final Compensation: \$15,750.80 per month¹

Unmod. Allowance (without sick leave credit): \$13,858.19

Opt. 2 Allowance (without sick leave credit): \$13,054.41

IRC Section 415 Dollar Limit at age 63½: \$9,636.75

Member's "grandfathered" Opt. 2 allowance: \$12,884.75

Under Section 415, the member is entitled to the greater of the Section 415 limit or the "grandfathered" benefit. --In Member A's case, he can be paid \$12,884.75 per month; a reduction of \$169.66 per month from his full PERS Opt. 2 benefit of \$13,054.41.

The \$169.66 per month cutback in Member A's allowance represents the value of the one-year final compensation benefit adopted by the State two years ago. This benefit was not grandfathered so is subject to limitation under Section 415. Similarly, Metropolitan Water Dist. amended its PERS contract in 1990 to include unused sick leave service. The value of this benefit (normally done as an adjustment after retirement) is \$92.88 and was not included in the above calculation. Since this benefit is also not grandfathered, it is subject to Section 415. The total amount of Member A's cutback is:

Value of State one-year final comp. benefit:	\$169.66
Value of unused sick leave from water dist.:	<u>92.88</u>
TOTAL:	\$262.54

Member A is currently on the payment roll receiving his grandfathered benefit at his request pending the Board's decision in this matter.

¹Member A's salary increased approximately 20% during the period June 1989 to April 1993. However, this compensation was audited and found to be in compliance with PERS statutes.

Member B

Police Captain, City of Santa Ana
Safety member (2% @ 50 formula)
Retirement Date: July 1, 1993
Age at retirement: 51 $\frac{3}{4}$
Service Credit:
29.000 years with City of Santa Ana
One-Year Final Compensation: \$10,265.93 per month²

Unmod. Allowance: \$6,683.63
Opt. 2 Allowance: \$6,416.28

IRC Section 415 Dollar Limit at age 51 $\frac{3}{4}$: \$5,353.75

Member's "grandfathered" Opt. 2 allowance: \$6,416.28

In Member B's case, the city is offering a Golden Handshake of two additional years of service credit for members retiring in the window period. Member B desires to retire and take advantage of the Golden Handshake. However, since the Golden Handshake benefit is not grandfathered, the allowance Member B would derive from this benefit is subject to limitation under Section 415. Since Member B's grandfathered allowance already exceeds the Section 415 limit, the total amount of the Golden Handshake benefit (\$442.50) would not be payable.

ALTERNATIVES

1. Apply the Section 415 limits to members' allowances and do not replace the amounts by which their allowances exceed the limits.

Discussion: This alternative is to strictly apply the IRC Section 415 dollar limit and not to take extraordinary measures to try to find a replacement benefit for amounts cutback under Section 415.

This alternative has precedence in other California retirement systems. Staff is aware that both the University of California Retirement System (UCRS) and some 1937 Act county systems are limiting benefits under Section 415 and not providing replacements. Alameda County recently provided a Golden

²Member B's salary increased approximately 42% during the period June 1989 through June 1993. However, this compensation was audited and found to be in compliance with PERS statutes.

Handshake benefit which was subject to Section 415 testing for both the dollar and percentage of pay limits. Because of this, some retiring members were not able to receive the full benefit of the Golden Handshake.

2. Ignore the Section 415 limits, discontinue testing for the dollar limit and pay members their PERS benefits without regard to Section 415.

Discussion: This alternative places the tax-qualified status of PERS at risk. As discussed in previous agenda items on this issue, loss of our tax-qualified status would mean that employee contributions to PERS could no longer be made on a tax-deferred basis, that employer contributions would be taxable to the member at the time the member became vested even if he or she never retired (i.e., never derived any benefit from these contributions) and the possibility that investment earnings of the fund could be subject to taxation.

3. Apply the Section 415 limits to members' allowances and explore whether other replacement benefits may be used to make up for the amounts cutback under Section 415.

Discussion: Two years ago the Committee was presented with an agenda item on an IRC Section 415 Benefit Protection Program developed by our consultant on this issue, WF Corroon. This program outlined several levels of replacement benefits; the first being the Temporary Annuity/COLA Bank. The second level (eligible IRC Section 457 plan) and third level (Retiree Health Spending Account) replacement benefits have been determined not to be administratively feasible at this time. However, one aspect of the second level (ineligible IRC Section 457(f) plan) appears to deserve closer study and may provide a viable alternative. Staff also obtained additional information from WF Corroon on the possibility of setting up an "excess benefit plan".

Section 457(f) Plan - Staff has had preliminary discussions on how a Section 457(f) plan might be used as a replacement benefit with staff from both WF Corroon and our tax counsel, Pillsbury, Madison & Sutro. In order to be in compliance with tax laws, this plan would have to be totally separate and apart from the PERS program and benefits would have to be paid from money in a completely separate fund. Money from the Public Employees' Retirement Fund could not be moved into this fund or used to loan this fund money. Therefore, the only source of money for this fund is directly from the employer.

The amount necessary to replace a member's Section 415 cutback would flow directly from the employer to a special Custodial Fund (administered by PERS) and then to the member. However, this type of plan has major tax implications for the member in that the tax authorities treat the full present value of the benefit as imputed income in the first year it becomes payable. This means that a member receiving a benefit from a Section 457(f) plan would be liable for taxes on the full present value of the benefit in the year he or she retires.

One alternative to deal with this adverse tax consequence is to pay the member the total present value of the replacement benefit in one lump sum. In this way, the member at least has receipt of the full amount upon which he or she is liable for taxes. However, this would also mean that the employer would have to pay the full present value in one lump sum.

Theoretically, at the time a member retires, his or her benefit is fully funded by the employer. Therefore, in a situation where a member's full PERS benefit is cutback because of the application of the Section 415 limits, the employer has actually overfunded the PERS benefit payable. Staff is exploring whether this could be considered a "surplus" and provide the authority to allow the employer to take this amount as a credit against contributions due. In this way the amount the employer paid to PERS would be offset by the amount paid directly to the Custodial Fund.

"Excess Benefit Plan" - Included in the amendments to Section 415 that are currently being proposed by public plans, is the authority to establish an excess benefit plan which would not have the adverse tax consequences of a 457(f) plan. Staff from WF Corroon have suggested an alternative to begin funding for this benefit even though the federal legislation has not yet passed. Under this alternative, monthly contributions would be made by the employer to the Custodial Account maintained for this plan. However, benefits could not be paid unless and until the federal law changed. The fact that funds were accruing in this account could provide some level of comfort to a member impacted by Section 415 in that he/she would be assured the benefit would be paid as soon as it was allowed under federal law.

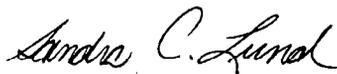
Staff has not had the opportunity to explore either the Section 457(f) or excess benefit plan replacement benefits fully enough to make a recommendation at this time. It is not known yet whether either would require legislation to implement or whether there are adverse consequences to PERS or the member. If the Committee selects this alternative, staff can study this area further and bring this issue back in July.

June 15, 1993

Representatives from Metropolitan Water District will be at the meeting and have asked to address the Committee on this issue. The Santa Ana police captain is also scheduled to be present. Drew James from WF Corroon will be available to answer any technical question on this item.



Barbara Hegdal, Chief
Benefit Application Services Division



Sandra C. Lund
Assistant Executive Officer
Member and Benefit Services

Attachment

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October 20, 1992

AGENDA ITEM 6

TO: MEMBERS OF THE BENEFITS AND PROGRAM ADMINISTRATION COMMITTEE

SUBJECT: IMPLEMENTATION OF INTERNAL REVENUE CODE
SECTION 415 BENEFIT LIMITS

At the September meeting, the Committee requested an item on the October agenda regarding application of the IRC Section 415 limits to members retiring under the "Golden Handshakes" provided recently by various PERS employers. Further, in an informational memorandum to Board members on this subject dated August 24, 1992, staff reported that an IRC Section 415 implementation plan would be presented at the November meeting. In the interest of time, these two subjects are consolidated in this agenda item today.

GOLDEN HANDSHAKE IMPACT

As you are aware, the state, California State University and several public agencies have opened Golden Handshake window periods for their employees in recent months. These Golden Handshakes provide from 2 to 4 years of additional service credit to members retiring during the window period. Providing this benefit, whether by Executive Order or local resolution or, as in the case of CSU, by enacting new legislation, is considered a benefit improvement. Therefore, the benefit derived from the Golden Handshake is not protected by the grandfather provision in Section 415.

PERS' Section 415 limit testing program is complete, fully tested and ready to be implemented. However, at this writing, the replacement benefit program is still incomplete. Therefore, since there is presently no way to replace limited benefits, PERS is not now testing retirement applications against the Section 415 limits. Below is a recommended implementation date for Section 415 testing which is past the date when we expect most applications will have been processed from members participating in Golden Handshake window periods which end prior to November 1, 1992. Therefore, these members, although subject to the Section 415 limits, will not be tested initially at implementation. This group will be tested, as will all members who have retired since October 14, 1987, as staff time and priorities allow. If, at

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IRC SECTION 415 IMPLEMENTATION

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that time, it is found that a member should have been limited and cannot be "made whole" through the replacement benefit program, our overpayment procedures will be applied including considering the doctrine of estoppel and Government Code Section 20180.

SECTION 415 TESTING AND REPLACEMENT BENEFIT PROGRAM
IMPLEMENTATION

We expect the first level replacement benefit, the Temporary Annuity/COLA Bank, to be installed and tested by the end of November. The replacement benefit program designed by our consultant, WF Corroon, contained two additional levels of benefits; (1) cash replacement benefits under either an eligible or ineligible deferred compensation plan and, (2) a Retiree Health Spending Account.

Cash Replacement Benefits

Eligible Deferred Compensation Plan under IRC Section 457(b) - This plan would provide a cash payment to the member for any amount the member's benefit was limited under Section 415 and could not be replaced through the Temporary Annuity/COLA bank. However, this cash payment is subject to a maximum derived from the annual contribution limits under IRC Section 457(b) and (c). This means that a member who contributed heavily to a Section 457 plan while working may not be able to receive much of a replacement benefit under this plan. Further, this plan requires that all PERS employers execute an agreement with PERS to provide these benefits.

Ineligible Deferred Compensation Plan under IRC Section 457(f) - This plan is similar to a Section 457(b) plan but is not subject to the maximum contribution limits. However, a member receiving cash payments under this plan could be subject to substantial tax liabilities.

Retiree Health Spending Account (RHSA)

This replacement benefit would be used in the event both the Temporary Annuity/COLA Bank and the cash replacement benefits described above failed to fully make up for the amount a member's benefit was limited under Section 415. This is a reimbursement account similar to the medical reimbursement accounts established under many cafeteria benefit plans. The RHSA, however, is not subject to the same "use it or lose it" provisions applicable to IRC Section 125 plans.

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At this time, no effort has been made to establish either the cash replacement benefit plans or the Retiree Health Spending Account for the following reasons:

1. The substantial amount of staff time required to counsel employers on the details of the deferred compensation plans and obtain signed agreements from all of them.
2. The law authorizing the replacement benefit program requires that it be administered at no additional employer cost. Implementation of the RHSA would require contracting with a claims administrator. The only source of funds for paying this administrator is the interest earnings from funds in the RHSA. Because this is the third level replacement benefit and it is felt few members will require it, staff does not believe sufficient interest would be generated to pay for processing the claims.
3. Proposed amendments to federal law would allow public plans to establish excess benefit plans. These types of plans provide greater flexibility in paying cash replacement benefits. If these amendments become law, we will want to pursue setting up one of these plans instead of the IRC 457 plans or the RHSA.

Proposed Federal Legislation

We continue to be hopeful that the amendments to IRC Section 415 proposed by public plans will eventually become law. They were contained in the tax bill vetoed by President Bush in March (these amendments were not the cause of the veto) and, at this writing, are contained in another tax bill moving through Congress. Our Washington lobbyist, David Vienna, assures us that these amendments are no longer considered controversial and are only awaiting the proper vehicle to become law. These amendments would, among other things, eliminate the need to test public plan benefits against the percentage of pay limit, exempt disability benefits from testing completely and allow public plans to provide excess benefit plans as mentioned above.

Implementation Recommendation

Staff recommends that PERS begin implementation of the IRC Section 415 testing and replacement benefit program for retirement applications received on and after January 1, 1993 subject to the following:

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IRC SECTION 415 IMPLEMENTATION

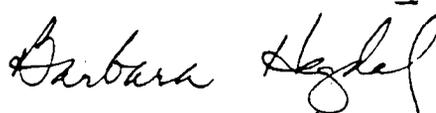
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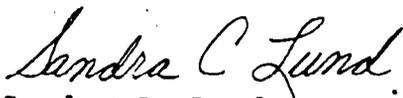
1. PERS will test for the dollar limit only.¹;
2. PERS will test service retirement applications only.
3. The only replacement benefit implemented will be the Temporary Annuity/COLA Bank. Members' allowances will be reduced by any amount limited under Section 415 which cannot be replaced by the Temporary Annuity/COLA Bank.
4. As staff time and priorities allow, PERS will go back and test members who have retired for either service or disability since October 14, 1987 for both the dollar limit and percentage of pay limit (subject to changes in federal law).

This recommendation reflects the limited staff time available to perform this workload and the fact that we anticipate changes to federal law in the near future. Staff also believes it reflects a good faith effort on PERS' part to comply with the intent of Section 415.

Staff is available to answer any questions.



Barbara Hegdal, Chief
Benefit Application Services Division



Sandra C. Lund
Assistant Executive Officer
Member and Benefit Services

¹In a review of over 6,000 service retirement applications and adjustments, only 1 was found which would have failed the dollar limit. This member had an annual salary of approximately \$115,000. However, it was determined that this member could have been "made whole" through the Temporary Annuity/COLA Bank replacement benefit.



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June 15, 1993

TO: Members of the Benefits and Program Administration Committee

SUBJECT: BPAC AGENDA ITEM 4
APPLICATION OF INTERNAL REVENUE CODE SECTION 415 LIMITS

Enclosed is additional material for Agenda Item 4 of
the BPAC Packet for the June 15, 1993 meeting.



MWD

METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA

June 7, 1993

General Counsel

Members of the Board of Administration
California Public Employees'
Retirement System
Lincoln Plaza
400 P Street
Sacramento, California 95814

Ladies and Gentlemen:

Application of Internal Revenue Code Section 415 Limits

Your staff has presented three alternatives for dealing with the excess benefits of members whose retirement benefits are limited by Section 415 of the Internal Revenue Code (I.R.C.) and who will not be made whole through the replacement benefits currently provided by the Temporary Annuity/COLA Bank. One of the members so impacted and whose case is currently before you is a former employee of Metropolitan.

As more and more retirees find their benefits limited by I.R.C. Section 415, The Metropolitan Water District of Southern California and other PERS employers will see more examples like Member A and Member B. On behalf of the employees of Metropolitan, we request your consideration of Alternative 3 presented in the letter from your staff with respect to Agenda Item 4. We urge you to take a course of action that will enable PERS to meet its contractual obligations to the members adversely affected by I.R.C. Section 415 in a way which preserves the tax-qualified status of PERS for all members.

Alternative 1--Proposed Alternative 1 is to pay retired members only the amounts permitted under I.R.C. Section 415 and not to attempt to replace benefits in excess of the Section 415 limits. This alternative ignores the contractual obligation of PERS to pay retirement benefits to each member at the levels at which member and employer contributions were calculated and which the member expects to receive.

Alternative 2--Proposed Alternative 2 is simply to ignore the Internal Revenue Code and pay the full benefit amount without regard to the Section 415 limits. As your

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Administration
California PERS

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staff recognizes, this alternative could result in loss of tax-qualified status of the entire PERS retirement program. Because of the potential for adverse tax consequences to all PERS members in the event of disqualification, we oppose this alternative.

Alternative 3--This alternative preserves the current tax-qualified status of PERS without disregarding the member's rights to receive the full benefits to which he or she is entitled. We request that you select this option.

Part 3.4 of the Public Employee Retirement Law (PERL), enacted to take advantage of the "grandfather" provisions of I.R.C. Section 415 and to implement the 415 requirements, requires your Board to set up a replacement benefits program or programs. Only one of the three members whose retirement allowances are greater than those permitted under Section 415 identified so far by your staff can receive full benefits through the Temporary Annuity/COLA Bank. Because of the likelihood that more and more retirees will be caught by the 415 limits, we urge you to continue to look for a replacement benefits plan that will be effective for more members than the Temporary Annuity/COLA Bank.

To the extent that such excess benefits may not currently be paid without exceeding the Section 415 limits, Section 21756 of the PERL requires establishment of an account in the Replacement Benefit Custodial Fund for the affected member. Amounts in such account accrue earning until they are debited upon payment of replacement benefits. Any balances revert to the trust fund of the employer of the retired member only if the Section 415 limits become inapplicable. The Replacement Benefit Custodial Fund provides the mechanism, already in place, for deferring payment of excess benefits pending further study.

Both of the two programs suggested for evaluation under Alternative 3 merit consideration. The proposed Section 457(f) plan is available under current law and would at least give the affected retiree his or her benefits at the contractual limits. The adverse income tax consequences of this approach are a disadvantage to the retiree, but would be mitigated by lump-sum distribution of the excess benefits.

On the other hand, if a tax-deferred excess benefit plan should become available, excess benefits could be

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received without immediate adverse income tax consequences and in a manner more consistent with members' expectations. This plan appears to provide to retired members. However, both possible programs should be studied to determine the one which best provides excess benefits to the most members who may find themselves in the positions of Member A and Member B.

No matter which program is chosen, excess benefits of affected members should remain on deposit in the Replacement Benefits Custodial Fund until expended, as required by Section 21756 of the PERL. The particular program under Alternative 3 should be selected and expenditure of excess benefits should begin as soon as possible and in no event later than the end of 1993.

The first and second alternatives, as discussed above, at best are short-term fixes to a long-term problem. The issues presented by the I.R.C. Section 415 limits will recur and could be significantly worsened by adoption of these alternatives.

We urge you to adopt Alternative 3 and to implement a program or programs which will satisfy PERS' obligations to its members while preserving the qualified status of its retirement plan.

Thank you for your consideration.

Very truly yours,

N. Gregory Taylor
General Counsel


Sydney B. Bennion
Deputy General Counsel