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| <b>COUNTY OF SONOMA<br/>AGENDA ITEM SUMMARY REPORT</b>  |                                 |  | Clerk of the Board Use Only<br>Meeting Date                      Held Until<br>___/___/___                              ___/___/___<br><br>Agenda Item No:                      Agenda Item No:<br>_____                              _____ |
| <b>Department:</b> Human Resources  |                                 |  | <b>(    ) 4/5 Vote Required</b>   |
| <b>Contact:</b><br>Ann Goodrich   | <b>Phone:</b><br>(707) 565-2875 | <b>Board Date:</b><br>June 16, 2009                | <b>Deadline for Board Action:</b><br>June 16, 2009  |
| <p><b>Agenda Short Title:</b><br/>Sonoma County Replacement Plan</p> <p><b>Requested Board Action:</b><br/>Adopt Sonoma County Replacement Plan as attached, pursuant to Calif. Government Code Sections 53215-53224, and 31482.5 effective June 16, 2009, and direct the Chairman of the Board of Supervisors to sign the Plan document. Direct staff to return with a Trust agreement that will be necessary to implement the Replacement Plan. Authorize staff to submit the plan and trust to the Internal Revenue Service for a "determination letter"; authorize Chairman of the Board to amend the Plan and trust as required by the IRS to obtain a favorable determination letter, as long as such amendments do not cause a material increase in the cost of providing benefits under the plan or trust. Authorize staff to return to the Board with a 3<sup>rd</sup> party Trust administrator for the Replacement Plan.</p> |                                 |  |   |
| CURRENT FISCAL YEAR FINANCIAL IMPACT  |                                 |  |   |
| <b><u>Expenditures</u></b>  |                                 | <b><u>Add'l Funds Requiring Board Approval</u></b> |   |
| Estimated Cost  | \$                              | 0  | Contingencies   |
|   |                                 |  | (Fund Name: )   |
| Amount Budgeted   | \$                              | 0  | Unanticipated Revenue   |
|   |                                 |  | (Source: )  |
| Other Avail Approp<br>(Explain below)   | \$                              | 0  | Other Transfer(s)   |
|   |                                 |  | (Source: )  |
| <b>Additional Requested:</b>  | <b>\$</b>                       | <b>0</b>   | <b>Add'l Funds Requested:</b>   |
|   |                                 |  | <b>\$</b>   |
| <p><b>Explanation (if required):</b> There is no cost in current fiscal year. The costs in the future will vary depending on the plan participants as determined by the Board of Supervisors. The initial cost for the first plan participant assuming a 5 year funding of the amount is \$ 37,047.30 per year for 5 years .</p>  |                                 |  |   |
| <p><b>Prior Board Action(s):</b></p>  |                                 |  |   |
| <p><b>Alternatives – Results of Non-Approval:</b> Current and future employees will not receive supplemental benefits to replace those that would otherwise be lost under the County Retirement System Law.</p>   |                                 |  |   |

**Background:**

The Sonoma County Employees' Retirement Association ("SCERA") operates under both California law (The County Employees Retirement Law of 1937 or "CERL") and the rules governing federal tax qualification (Section 401(a) et seq of the Internal Revenue Code ("Code")). Federal tax law limits the annual amount of benefits that can be paid to a retiree by SCERA (the "output" limit) and for some County employees additionally limits the compensation that SCERA can take into account in calculating benefits (the "input" limit).

The CERL requires that any "output" limit that would reduce an employee's SCERA benefits be replaced by the County with a replacement benefits plan as permitted by the Code, and the County has adopted such a plan. The CERL does not mandate a replacement plan for reductions in SCERA benefits on account of the "input" limit. At this time there are 2 employees seriously impacted by this lack of a replacement plan, and 2 who are currently slightly impacted. This is based on the current IRS cap, current salaries and benefits available to employees that impact their potential retirement income. A few years ago before the federal cap was raised the number of county employees negatively impacted was higher. The number of employees will likely grow as salaries exceed the federal limit. Without a replacement plan, the County most likely will have serious problems recruiting management and other specialized employees, as described below.

**Discussion:**

The current input limit (sometimes called the "401(a)(17) limit" after the Code section) is \$245,000. This is periodically indexed for the same cost of living adjustments that apply to Social Security benefits.

There are two classes of employees under the tax rules for the input limit: those who are "grandfathered" and those who are not. An employee who was a member of SCERA before July 1, 1996 is grandfathered. 60% of all of our employees have been hired after 1996 and are not grandfathered. The input limit does not affect any grandfathered employee and affects all other employees. Therefore, as the County recruits professional occupations and senior management from outside the County's ranks, or promotes employees hired after 1996 into senior management positions it will need to deal with concerns of reduced pensions because of loss of grandfathered status. The 37 Act counties are also in a recruiting disadvantage versus PERS agencies regarding the 1996 grandfathering date. PERS considers all of its agencies as one for the 401(a) (17) limits. Employees hired by one PERS agency can move to any number of other PERS agencies without being impacted by the IRS limit. 37 Act agencies are all considered as separate agencies for 401(a) (17) purposes and movement of an individual from one 37 Act county to another, or from a PERS agency to a 37 Act eliminates the grandfathering protection for the individual. That will make recruiting in critical areas in the future more difficult. It also creates an inequity of treatment between pre and post 1996 hired employees in their retirement benefits.

The CERL provides a method for replacement of benefits lost due to the "input limit" through A.B. 1963 (2008) enacting Government Code sec. 31482.5. One of the specific reasons for enactment

**Attachments:** Plan document

**On File With Clerk:**

**CLERK OF THE BOARD USE ONLY**

**Board Action** (If other than "Requested")

**Vote:**

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## Background (continued):

of A.B. 1963 was to provide a method for establishing a replacement plan for the input limit. Under 31482.5 the County could adopt and establish a supplemental tax qualified pension plan as permitted under federal tax laws. The plan would be in the form of a “cash balance” “defined benefit” plan. Generally, this form is proposed because it comes the closest to being able to replace the benefits lost under SCERA because of the input limit.

- Eligibility for the Plan would be those employees selected by the Board of Supervisors. It is expected that the only employees who would be selected would be those whose SCERA benefits would be reduced because of the input limit. The plan would not have an automatic eligibility rule for employees subject to the input limit. Instead employees would be added to the plan on an individual by individual basis. This is required to comply with the tax rules. This also means that the Board would maintain final review of those it would determine to be eligible to participate in the Plan. The Board would exercise total control over eligibility of Members into the Plan as well as the amount of the benefit paid to each member of the plan. The County would contract separately with the retirement system’s actuary to calculate the lost benefit for eligible individuals.
- A “cash balance” plan looks like an individual account plan (such as a 401(k) or 457 plans) but operates like a defined benefit plan. For this reason it is called a “hybrid” plan. The retirement benefit in the plan would be stated as a cash amount, targeted to replace the present value of the monthly benefit reduced due to the reduction in the SCERA benefit because of the 401(a)(17) cutbacks to the Member and the Spouse of the Member. As the benefit is determined, the plan would be amended to add the stated amount of benefit for each individual. Because individual circumstances are different, the amount of the benefit would be stated separately for each member and would be calculated by the retirement system’s actuary for the Board of Supervisors.
- The Plan Effective date would be June 16, 2009, and a separate Trust will need to be established to hold the assets of the Plan, established under the tax qualification rules. The County would administer the plan. Investments would be separate from County funds and could be any investments that meet the fiduciary rules of the California Constitution. Additionally, under the CERL both the plan and trust must be submitted to the IRS for a “determination letter” on tax qualification. The County would contract with a Trust company to both administer the “Plan” and also invest the Plan assets. Under the tax laws, a qualified plan must be funded on a regular basis but this does not require immediate “full funding”. In the usual circumstance, the Plan would be funded over the time from when the employee became a member to retirement plus the time required for payment of benefits.

Human Resources have worked with representatives of our benefit consultant the Segal Company and with outside counsel Robert Blum of the law firm of Hansen Bridgett. Staff along with these individuals has taken a very conservative view is designing this replacement plan in order to protect the County while still providing an adequate replacement benefit. The primary risk involves the projected retirement benefit. Generally under California’s “vested rights” law as well as under the tax laws, once a retirement benefit is promised under a retirement plan, the member has a right to that benefit. The risk comes from the fact that the input limit is set by the Congress and has changed over the years. For the most part, the input limit has changed with the cost of living index used for Social Security benefits. However, it has also changed by amendment of the tax laws, and has been both reduced and increased. If the input limit is reduced giving a larger amount for replacement, then the Board can control any additional benefit under the proposed cash balance plan because any increase in benefit must be approved by the Board. If the limit is *increased*, however, then the replacement amount may decrease because the SCERA benefit would increase and there would be less of a “gap” to replace.

## **Background (continued):**

This is the primary economic risk. This risk is highest for employees who will not retire for many years, because it is very difficult to reasonably predict what will happen to the input limit over many years. The best way to moderate (but not eliminate) this risk is for the Board to be cautious and conservative in setting the replacement plan's benefits in years well before the employee's anticipated retirement. In the period before retirement when a more precise replacement benefit can be set, the benefit for the individual can be "trued up" to adequately compensate the employee for the other lost benefits. The second important issue in administering this type of plan comes from the tax rules. A cash balance plan is subject to special rules and it is very important that the County follow them meticulously. Also, the plan cannot be written to state (directly or indirectly) that the only employees who are eligible are those whose SCERA benefits are affected by the input limit. If the tax rules are not met, then the plan can be disqualified, which in turn can result in quite adverse taxation to employees and income on assets held in trust. Finally, the County will need to get regular advice -- at least annually -- of a pension actuary for the operation of this type of plan. Without that advice, it is too easy for errors to be made in the plan's operation.

Staff as part of this agenda item, is directed to take steps to obtain a determination letter from the IRS approving the qualified status of Sonoma's Replacement Plan. If for some unknown reason this determination letter is not able to be obtained the plan participants would still receive their statement benefit amount, but would be taxed in a different manner than if the plan is qualified plan. Additionally, prior to the determination letter being obtained the County will need to adopt a trust agreement to go along with this Plan Document. Also the Replacement Plan will need a trustee and a plan administrator selected to hold the assets and manage the Plan. Staff will return with a Trust document and after a Request for Proposal process with a service agreement with a 3<sup>rd</sup> party provider for the Board to consider.

### Cost

The cost for each participant would vary and, a separate targeted benefit and annual contribution would be calculated for each individual. The funding period for each would be the time from the fiscal year of eligibility to the projected fiscal year of retirement, plus five years, but not more than fifteen years total.

The anticipated cost of the benefit for the County Administrator who is the first plan participant is \$ 37,047.30 each for 5 yearly installment payments to fund the present day value of the benefit described in the Plan document.

### Recommendations

Adopt Sonoma County Replacement Plan as attached, pursuant to Calif. Government Code Sections 53215-53224, and 31482.5 effective June 16, 2009, and direct the Chairman of the Board of Supervisors to sign the Plan document. Direct staff to return with a Trust agreement that will be necessary to implement the Replacement Plan. Authorize staff to submit the plan and trust to the Internal Revenue Service for a "determination letter"; authorize chairman of the Board to amend the Plan and trust as required by the IRS to obtain a favorable determination letter, as long as such amendments do not cause a material increase in the cost of providing benefits under the plan or trust. Authorize staff to return to the Board with a 3<sup>rd</sup> party Trust administrator for the Replacement Plan.