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by City Manager's Office

Memorandum

TO: HONORABLE MAYOR AND
CITY COUNCIL

FROM: Alex Gurza

SUBJECT: Retiree Reimbursement Program

DATE: July 23, 2010

Approved

Date

7/23/10

INFORMATION

In the March Budget Message for Fiscal Year 2010-2011, the Mayor made a recommendation that the City Manager explore a reimbursement program for qualified City retirees who suspend their medical benefits as part of the retiree healthcare reform.

In April 2010, the Association of Retired San Jose Police Officers & Firefighters sent the Mayor and City Council a letter supporting a retiree health in-lieu program and requested that the Association be included in designing such a program.

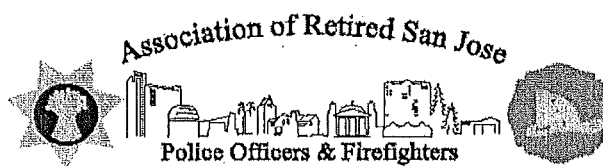
The Association indicated that it is in support of a retiree health in-lieu program, however, the City Attorney's Office issued a Memorandum in January 2008 indicating that a retiree health in-lieu program is not compliant with Internal Revenue Code Section 401(h) and, thus, could result in the disqualification of the retirement plans under Section 401(a). The City Attorney's Office has also noted that the Municipal Code currently has provisions that could cause the suspension of coverage by retirees to lose their entitlement to medical benefits under some circumstances.

The City will be exploring a reimbursement program for qualified City retirees who suspend their medical benefits. The City will be in negotiations in Fiscal Year 2010-2011 with all bargaining groups and will continue to discuss this item, as part of pension and retiree healthcare reform. As the City Administration explores a retiree medical reimbursement program, the Administration will coordinate with the City Attorney's Office to ensure that any program that is recommended for implementation complies with all applicable legal requirements including the Internal Revenue Code. The City Administration will also request a meeting with each retiree association to seek input as it explores a retiree medical reimbursement program.

Alex Gurza
Director of Employee Relations

C: Rick Doyle, City Attorney

Attachment



April 7, 2010

Honorable Mayor and City Council
City of San Jose
200 E. Santa Clara Street
San Jose, CA 95113

Re: Retiree Health Care In-Lieu

Dear Mayor and City Council,

We were pleased to read your recommendation for creating a retiree health care reimbursement in-lieu program in the Mayor's March 2010 Budget Message. As we wrote in our August 4, 2009 letter to you and the City Council, we are supportive of the City Council creating a retiree health care in-lieu program that will save the City money on an ongoing basis—especially in these tough budget times.

As stated in the City Auditor's June 2009 *Audit of the Employee Medical Benefits*, "An in-lieu program for retirees could save the City substantially in annual retiree medical expenses, and may also improve the City's projected long-term retiree healthcare liability."¹ **Specifically, the Auditor estimated that if just 200 current retirees elected to participate in such a program, the City would save \$1,000,000 a year.**

We believe the process to design this program should begin immediately so the City can begin to realize the savings as soon as possible.

Because this program requires retirees to opt in to be successful, it must provide current retirees with strong assurances that they can re-enroll in the City's health care plan at a later date if personal circumstances warrant. As the Auditor stated, "Retirees would be more likely to suspend City medical benefits if they were given some kind of incentive to suspend benefits and were given assurance that they could re-enroll after a qualifying event."² We agree with the Auditor's conclusion in this regard.

We respectfully request that the Association of Retired San Jose Police Officers & Firefighters be included as an active participant in designing this program so we can ensure that the program provides the appropriate assurances to attract the largest amount of voluntary participants possible—maximizing the City's potential savings. Further, as part of our participation, our association will commit to promoting this new program to our members to assist the City in signing-up as many willing participants as possible.

¹ *Audit of the Employee Medical Benefits*, Sharon Erickson, Pg. 30

² *Audit of the Employee Medical Benefits*, Sharon Erickson, Pg. 28

We know that you and the City Council are struggling for ways to balance the City budget while protecting services. The retiree in-lieu program is a good idea—one that can save the City significant money—that should be implemented as soon as possible. We hope that you will provide us with the opportunity to be part of the solution.

Sincerely,

Jay Wendling
President

C: City Manager

Memorandum

TO: JEANNE GROEN
BENEFITS REVIEW FORUM

FROM: SUSAN DEVENCENZI
Senior Deputy City Attorney

SUBJECT: *Medical In-Lieu for Retirees*


DATE: January 24, 2008

At the January meeting of the Board of Administration for the Police and Fire Department Retirement Plan, one of the Board members indicated that the Benefits Review Forum (BRF) has raised the issue of providing a medical in-lieu program for retirees. The Board member requested that I send information to the BRF as to why such a program can not be implemented in the retirement plans.

Section 401(h) of the Internal Revenue Code permits a qualified retirement plan to make provisions for the payment of sickness, accident, hospitalization and medical expenses of retired employees, their spouses and their dependents. However, certain requirements must be satisfied. One of these requirements is that there must be a separate account established and maintained with respect to the contributions to fund medical benefits. In addition, it must be impossible, at any time prior to the satisfaction of all liabilities under the plan to provide such medical benefits, for any part of the corpus of the separate account to be used for, or diverted to, any purpose other than providing the medical benefits.

Municipal Code Chapter 3.36 (the Police and Fire Plan) and Chapter 3.28 (the Federated System) each contain provisions establishing the separate medical accounts. However, if the separate accounts were used to implement a medical in-lieu program for retirees, there would be no restriction on what retirees could use the payments for. A retiree could pay for medical benefits from other sources of income and spend the medical in-lieu payment on something else. Under the Treasury Regulations, that would mean the plans would not satisfy the impossibility-of-diversion requirement. Failure to satisfy the 401(h) requirements would jeopardize the retiree medical program.

Please let me know if additional information is needed.


SUSAN DEVENCENZI
Senior Deputy City Attorney

cc: Police and Fire Retirement Board
Federated Retirement Board

CITY OF SAN JOSÉ - MEMORANDUM

TO: DARRELL DEARBORN
Deputy City Manager

SUBJECT: Health In Lieu Program For
Police and Fire Department
Retirement Plan

FROM: SUSAN DEVENCENZI
Sr. Deputy City Attorney

DATE: April 29, 1996

BACKGROUND

The Office of Employee Relations has requested information regarding tax qualification issues that would arise in connection with a "health in lieu" program for the Police and Fire Department Retirement Plan. This memorandum is in response to that request.

In preparing this analysis we consulted with James G. Leathers, a tax specialist, who serves as the City Attorney's Office's legal consultant on tax matters.

DESCRIPTION OF THE PROGRAM

Part 14 of the Police and Fire Department Retirement Plan provides medical insurance coverage for retired members and their dependents who satisfy the eligibility requirements of San José Municipal Code Sections 3.36.1900, 3.36.1910, and 3.36.1920. The coverage must be with a medical plan with which the City has a contract for provision of hospital, medical, surgical and related benefits. Eligible participants must pay that portion of the insurance premium which would be paid by an active employee; the remainder of the premium is paid by the Retirement Plan.

The proposal under consideration would permit a retired member who can demonstrate proof of alternate medical coverage to elect to receive a monthly cash payment in lieu of the medical insurance coverage paid by the Retirement Plan. The cash payment would be in an amount equal to a portion of the insurance premium.

ANALYSIS

The Police and Fire Plan is a tax-qualified governmental pension plan under Section 401(a) of the Internal Revenue Code. Under Section 401(h), the Plan may make provision for the payment of sickness, accident, hospitalization, and

medical expenses¹ of retired employees, their spouses and their dependents, but only if certain requirements are satisfied. One of these requirements is that there must be a separate account established and maintained with respect to the contributions to fund the medical benefits.² In addition, it must be impossible, at any time prior to the satisfaction of all liabilities under the plan to provide such medical benefits, for any part of the corpus of the separate account to be used for, or diverted to, any purpose other than the providing of the medical benefits.

The Treasury Regulations provide that a plan which permits funds in the medical benefits account to be used for any retirement benefit (as opposed to a medical benefit) does not satisfy the impossibility-of-diversion requirement of Section 401(h) and, therefore, would not be a qualified plan under Section 401(a).

We believe the proposed cash payment in lieu of medical insurance premium payment would be viewed as a use of the medical benefits account for the payment of a retirement benefit prior to the satisfaction of all liabilities for medical benefits. Thus, the cash payment would not satisfy the impossibility-of-diversion requirement of Section 401(h).

CONCLUSION

Implementation of the proposed health in-lieu program in the Police and Fire Department Retirement Plan does not appear to be in accordance with Internal Revenue Code Section 401(h) and, thus, could result in the disqualification of the Plan under Section 401(a).

If additional information is needed, please contact the City Attorney's Office at your convenience.

/s/
SUSAN DEVENCENZI
Senior Deputy City Attorney

¹ "Medical expenses" means expenses for "medical care" as defined in Internal Revenue Code § 213. (Treasury Regulations § 1.401-14(b)(4)(ii).) Under Internal Revenue Code § 213(d)(1) expenses for "medical care" means amounts paid for diagnosis, cure, mitigation, treatment, or prevention of disease; transportation primarily for and essential to the medical care; or insurance covering the medical care.

² The separate account is for recordkeeping purposes only. Funds contributed for medical benefits may be invested with funds set aside for retirement purposes. Earnings must be allocated to the retirement and medical benefits accounts in a reasonable manner.