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City Manager's Office

# Memorandum

**TO:** HONORABLE MAYOR AND  
CITY COUNCIL

**FROM:** RUSSELL CROSBY

**SUBJECT:** SEE BELOW

**DATE:** 03-01-11

Approved

Date

3/3/11

## INFORMATION

### **SUBJECT: POTENTIAL TAX LIMITATION ON CONTRIBUTIONS FOR HEALTH AND DENTAL BENEFITS FOR FEDERATED RETIREMENT SYSTEM**

On February 10, 2011, the Federated City Employees' Retirement System's Board of Administration received the attached report dated February 2, 2011 from its actuary, Cheiron Inc., indicating that projected contributions to the System's medical and dental benefits account were expected to exceed the subordination limits set forth in Internal Revenue Code Section 401(h) during the fiscal year ending June 30, 2012. The System's actuary further advised that once the limit is reached, future 401(h) contributions would be limited to one-third of the pension normal cost contributions.

## BACKGROUND

Section 401(h) of the Internal Revenue Code permits a pension plan to provide retiree health care benefits under certain conditions, one of which is that the medical benefits are subordinate to the pension benefits. In order to be considered subordinate, Treasury regulations require that the aggregate contributions for medical benefits not exceed 25% of the total contributions, including pension contributions (other than UAAL contributions) and medical benefit contributions. Violation of the 25% rule could potentially void the plan's tax qualified status.

## SUMMARY

In order to assure that the ramp up to full prefunding of retiree healthcare benefits can continue, the City must actively pursue establishment of an alternate vehicle to fund medical and dental benefits, such as an IRC 115 trust. The establishment of an alternative funding vehicle is an urgent matter, as the Systems actuary has estimated that a violation of the 25% rule could occur as early as the beginning of the 2011-2012 fiscal year, depending on whether the City prefunds

HONORABLE MAYOR AND CITY COUNCIL

**Subject: Potential Tax Limitation on Contributions for Health and Dental Benefits for Federated Retirement System**

March 1, 2011

its pension and retiree healthcare contributions for the 2011-12 fiscal year. The Office of Employee Relations and the City Attorney's Office are aware of Cheiron's notification to the Federated City Employees' Retirement System's Board of Administration and are actively pursuing the establishment of an alternative funding vehicle prior to July 1, 2011.

/s/

RUSSELL U. CROSBY

Director, Retirement Services

For questions please contact Russell Crosby, Director of Retirement Services, at (408) 794-1000.

cc: Board of Administration, Federated City Employee's Retirement System





February 2, 2011

**VIA ELECTRONIC MAIL**

Mr. Russell Crosby  
Director of Retirement Services  
Federated City Employees' Retirement System  
1737 North 1<sup>st</sup> Street, Suite 580  
San Jose, CA 95112

**Re: 401(h) Subordination Limit Test Results**

Dear Russell:

As requested, we performed an analysis to determine if the subordination limits described in Internal Revenue Code Section 401(h) have been satisfied historically and are likely to be satisfied in the future. Our analysis confirms that the limits have been satisfied through June 30, 2010. However, we project that the limit will be reached around June 30, 2011. Consequently, we recommend that the limit be monitored closely as the fiscal year progresses. Furthermore, the planned contributions to the 401(h) account for the fiscal year ending June 30, 2012 would exceed the subordination limit.

***Basis for Analysis***

Section 401(h) of the Internal Revenue Code permits a pension plan to provide retiree health care benefits under certain conditions, including that a separate account is maintained for the health care benefits and that retiree health care benefits are subordinate to the pension benefits. Under Treasury regulation §1.401-14(c), "The medical benefits described in section 401(h) are considered subordinate to the retirement benefits if at all times the aggregate of contributions (made after the date on which the plan first includes such medical benefits) to provide such medical benefits and any life insurance protection does not exceed 25 percent of the aggregate contributions (made after such date) other than contributions to fund past service credits."

Based on discussions with legal counsel, we applied the following parameters to our analysis:

- The Section 401(h) account and retiree health care benefits first became a part of the pension plan effective July 1, 1995.
- The Retirement Fund and the COLA Fund are part of the same pension plan.
- In determining aggregate contributions to the pension plan, only normal cost contributions are included. Contributions toward the UAL are excluded.
- In determining aggregate contributions to the 401(h) account, both normal cost and UAL contributions are included.

To determine the dollar amounts contributed to the pension plan and the 401(h) account since July 1, 1995, we relied on financial statements provided by the City of San Jose Federated Employees Retirement System. By design, all employee contributions to the pension plan



were for normal cost. However, City contributions were for both normal cost and UAL payments. Based on the relevant actuarial valuation reports and financial statements, we determined the percent of payroll that was to be contributed for normal cost each fiscal year compared to the total percent of payroll that was to be contributed. We, then, attributed that proportion of the dollar amount contributed by the City to be a normal cost contribution. The table below summarizes this calculation.

City Pension Contributions					
FYE	Percent of Payroll			Dollar Amounts	
	Normal Cost	UAL	Total	Total	Normal Cost
1996	13.66%	1.37%	15.03%	\$ 23,756	\$ 21,591
1997	12.20%	3.86%	16.06%	\$ 27,162	\$ 20,634
1998	12.20%	3.87%	16.07%	\$ 30,367	\$ 23,052
1999	11.59%	3.78%	15.37%	\$ 30,139	\$ 22,727
2000	11.59%	3.78%	15.37%	\$ 34,146	\$ 25,748
2001	11.07%	4.26%	15.33%	\$ 35,284	\$ 25,479
2002	11.07%	5.33%	16.40%	\$ 41,011	\$ 27,678
2003	10.73%	3.09%	13.82%	\$ 38,411	\$ 29,823
2004	10.73%	3.09%	13.82%	\$ 39,534	\$ 30,695
2005	11.36%	3.60%	14.96%	\$ 41,552	\$ 31,553
2006	11.36%	3.60%	14.96%	\$ 41,267	\$ 31,336
2007	11.62%	6.54%	18.16%	\$ 51,004	\$ 32,636
2008	11.62%	6.54%	18.16%	\$ 54,958	\$ 35,166
2009	11.66%	6.65%	18.31%	\$ 57,020	\$ 36,311
2010	11.66%	6.65%	18.31%	\$ 54,566	\$ 34,748

*Amounts in thousands*

It should be noted that based on the 1996-97 financial statements, the City pension contribution rate was 16.06% for FYE 1997, and based on the 1997-98 financial statements, the City pension contribution rate for FYE 1998 was 16.69% through January 10, 1998, and 15.37% from January 11, 1998 through June 30, 1998. Similarly, the 2001-02 financial statements indicate that the City pension contribution rate was 15.33% from July 1, 2000 through August 18, 2001, 16.64% from August 19, 2001 through June 22, 2002, and 13.82% from June 23, 2002 through June 30, 2002. Since payroll was not available for these interim periods, we estimated an annual rate for the entire fiscal year based on the portion of the fiscal year each rate was in effect.

The table below summarizes the pension and 401(h) contributions for each fiscal year since the 401(h) account was established.

Total Annual Contributions for Subordination Limit Test									
FYE	Pension Normal Cost			401(h)			Grand Total		
	City	Employee	Total	City	Employee	Total			
1996	\$ 21,591	\$ 8,997	\$ 30,588	\$ 4,656	\$ 3,878	\$ 8,534	\$ 39,122		
1997	\$ 20,634	\$ 7,810	\$ 28,444	\$ 4,279	\$ 3,566	\$ 7,845	\$ 36,289		
1998	\$ 23,052	\$ 9,078	\$ 32,130	\$ 2,326	\$ 2,051	\$ 4,377	\$ 36,507		
1999	\$ 22,727	\$ 8,812	\$ 31,539	\$ 2,248	\$ 1,921	\$ 4,169	\$ 35,708		
2000	\$ 25,748	\$ 10,804	\$ 36,552	\$ 1,679	\$ 1,596	\$ 3,275	\$ 39,827		
2001	\$ 25,479	\$ 10,306	\$ 35,785	\$ 1,750	\$ 1,462	\$ 3,212	\$ 38,997		
2002	\$ 27,678	\$ 11,071	\$ 38,749	\$ 4,127	\$ 2,787	\$ 6,914	\$ 45,663		
2003	\$ 29,823	\$ 11,776	\$ 41,599	\$ 3,866	\$ 3,032	\$ 6,898	\$ 48,497		
2004	\$ 30,695	\$ 12,394	\$ 43,089	\$ 3,948	\$ 3,191	\$ 7,139	\$ 50,228		
2005	\$ 31,553	\$ 12,393	\$ 43,946	\$ 5,996	\$ 5,219	\$ 11,215	\$ 55,161		
2006	\$ 31,336	\$ 12,395	\$ 43,731	\$ 5,961	\$ 5,226	\$ 11,187	\$ 54,918		
2007	\$ 32,636	\$ 12,370	\$ 45,006	\$ 10,728	\$ 9,612	\$ 20,340	\$ 65,346		
2008	\$ 35,166	\$ 13,366	\$ 48,532	\$ 11,560	\$ 10,403	\$ 21,963	\$ 70,495		
2009	\$ 36,311	\$ 13,848	\$ 50,159	\$ 16,368	\$ 15,076	\$ 31,444	\$ 81,603		
2010	\$ 34,748	\$ 13,396	\$ 48,144	\$ 17,027	\$ 15,815	\$ 32,842	\$ 80,986		

*Amounts in thousands*

**Results of Analysis**

The subordination limit test is based on the ratio of cumulative contributions to the 401(h) account compared to the sum of cumulative normal cost contributions to the pension plan and cumulative contributions to the 401(h) account since the 401(h) account was established. As shown in the table below, this ratio has never exceeded 25%.

401(h) Subordination Limit Test					
FYE	Cumulative Contributions			Ratio	
	Pension	401(h)	Total		
1996	\$ 30,588	\$ 8,534	\$ 39,122	21.8%	
1997	\$ 59,031	\$ 16,379	\$ 75,410	21.7%	
1998	\$ 91,161	\$ 20,756	\$ 111,917	18.5%	
1999	\$ 122,700	\$ 24,925	\$ 147,625	16.9%	
2000	\$ 159,252	\$ 28,200	\$ 187,452	15.0%	
2001	\$ 195,037	\$ 31,412	\$ 226,449	13.9%	
2002	\$ 233,787	\$ 38,326	\$ 272,113	14.1%	
2003	\$ 275,385	\$ 45,224	\$ 320,609	14.1%	
2004	\$ 318,474	\$ 52,363	\$ 370,837	14.1%	
2005	\$ 362,420	\$ 63,578	\$ 425,998	14.9%	
2006	\$ 406,151	\$ 74,765	\$ 480,916	15.5%	
2007	\$ 451,157	\$ 95,105	\$ 546,262	17.4%	
2008	\$ 499,689	\$ 117,068	\$ 616,757	19.0%	
2009	\$ 549,848	\$ 148,512	\$ 698,360	21.3%	
2010	\$ 597,992	\$ 181,354	\$ 779,346	23.3%	

*Amounts in thousands*

Mr. Russell Crosby  
February 2, 2011  
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However, it is clear that current contribution rates to the 401(h) account will cause the 25% limit to be exceeded shortly. The table below shows our projections for the fiscal years ending June 30, 2011 and June 30, 2012.

Projected 401(h) Subordination Limit Test					
FYE	Projected Cumulative Contributions			Ratio	
	Pension	401(h)	Total		
2011	\$ 648,476	\$ 215,187	\$ 863,663	24.9%	
2012	\$ 700,928	\$ 255,212	\$ 956,140	26.7%	

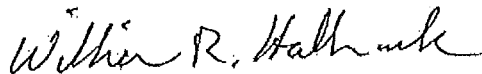
*Amounts in thousands*

These projections are based on the contribution rates set in the June 30, 2009 and June 30, 2010 valuations for the fiscal years ending June 30, 2011 and June 30, 2012 respectively. These projections are based on estimated payroll provided by the City of \$278 million and \$285 million for the fiscal years ending June 30, 2011 and June 30, 2012 respectively. The FYE 2012 amounts also reflect the policy of the City contributing no less than the dollar amount specified in the valuation.

Once the limit is reached, future 401(h) contributions are limited to one-third of the pension normal cost contribution. With a total normal cost rate of 17.44% calculated in the June 30, 2010 actuarial valuation, that limit would be 5.81% of payroll compared to the City and employee combined contribution rate of 13.67% calculated for the fiscal year ending June 30, 2012 in the 2010 OPEB valuation report. If the City pays its pension contribution for the 2011-12 fiscal year at the beginning of the year in the amount of \$86,888,000 (\$39,114,000 for normal cost), the maximum contribution (City and employee) to the 401(h) account for that fiscal year would be approximately \$13,038,000 ( $\$39,114,000 \div 3$ ) plus one-third of actual employee pension contributions (1.56% of pay).

If you have any questions about this analysis, please let us know.

Sincerely,  
Cheiron



William R. Hallmark, ASA, FCA, EA, MAAA  
Consulting Actuary

cc: Mollie Dent  
Mike Moehle  
Carmen Racy-Choy  
Gene Kalwarski  
Jim Holland