

May 17, 2012

Teague P. Paterson  
Beeson, Tayer & Bodine  
Rose House, Suite 200  
483 Ninth Street  
Oakland, CA 94607-4051

**RE: Amendments to the Federated Retiree Healthcare Trust**

Dear Mr. Paterson:

We are in receipt of your letter dated May 16, 2012. Please be advised that amendments to the ordinance relating to the Federated City Employees Healthcare Trust approved by the City Council on May 8, 2012, are outside the scope of bargaining. Additionally, the amendment does not trigger any meet and confer obligation on the City as the trust identified in the parties' tentative agreement from 2009 has been established and is the vehicle for employee contributions. Please find enclosed a memorandum dated April 26, 2012, from the City Attorney's Office which may provide you additional information regarding this matter.

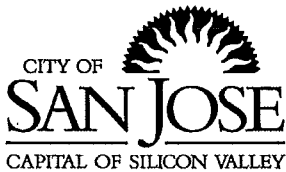
Sincerely,



Gina Donnelly  
Deputy Director of Employee Relations

c: Alex Gurza, Deputy City Manager  
LaVerne Washington, President, CEO, AFSCME Local 101  
Yolanda Cruz, President MEF, AFSCME Local 101  
Charles Allen, Business Agent, AFSCME Local 101

Enclosure



## Memorandum

**TO:** HONORABLE MAYOR  
AND CITY COUNCIL

**FROM:** Richard Doyle  
City Attorney

**SUBJECT:** Ordinance Related to Health  
Care Trust for Federated  
Retirement Plan

**DATE:** April 26, 2012

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### **RECOMMENDATION**

Consider an ordinance amending Section 3.52.100 of Chapter 3.52 of Title 3 of the San José Municipal Code to provide that, beginning June 24, 2012, employee contributions for retiree health care benefits will be deposited into the Federated City Employees Healthcare Trust, rather than the Federated City Employees Retirement System medical benefits account.

### **BACKGROUND**

Section 401(h) of the Internal Revenue Code (IRC) is one vehicle that allows employee contributions for retiree health care benefits to be made on pretax basis, and allows earnings in the fund to accumulate tax free. However, as a condition of this favorable tax treatment, IRC Section 401(h) limits the total amount of contributions that can be made to the medical benefits account. In order to ensure that the IRC contribution limit would not impair the ability of the City to implement agreements for the ramp up to full funding of the annual required contribution for Federated retiree health care benefits, the April 2009 agreements on retiree health care with the Federated bargaining units provided that the City would establish a qualified trust that would become the sole funding vehicle for Federated retiree healthcare benefits.

On February 10, 2011, the Federated City Employees' Retirement Plan Board of Administration received a report from its actuary, Cheiron Inc., indicating that projected contributions to the Plan's medical and dental benefits account were expected to exceed the limits set forth in Internal Revenue Code Section 401(h) during the fiscal year ending June 30, 2012. The Plan'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. In early 2011, the City Attorney's Office engaged Ice Miller, LLP, as outside tax counsel, to assist with preparation of trust documents for both the Police and Fire Plan and the Federated City Employees Retirement Plan. The ordinances would establish new trust funds pursuant to Section 115 of the Internal Revenue Code.

On May 24, 2011, the City Council adopted Ordinance No. 28914, establishing the Federated City Employees Health Care Trust Fund to allow for continued implementation of the ramp up to full funding for retiree health care benefits, as contemplated in agreements entered into by the City and employee bargaining units in April 2009. Ordinance No. 28914 became effective on June 24, 2011.

As established by Ordinance No. 28914, Chapter 3.52 of the Municipal Code provided for City contributions for retiree health care to begin being deposited in the new Trust Fund effective July 1, 2011; but for employee contributions to continue to be deposited into the existing 401(h) account until a private letter ruling has been obtained from the Internal Revenue Service (IRS) confirming that the employee contribution can go into the new trust on a pretax basis.

On October 17, 2011, tax counsel for the Federated City Employees Retiree Healthcare Trust Fund submitted a request to the Internal Revenue Service (IRS) for a private letter ruling on three issues; 1) that income into the trusts could be done on a tax free basis, 2) whether the trust would need to file tax returns and 3), that the employee contributions can go into the new trust on a pretax basis. In late November 2011, the IRS notified the Trust Fund's tax counsel that the IRS would decline to rule on the issue of the taxability of employee contributions to the Trust Fund. Based on this information, and because private letter rulings are discretionary with the IRS, the Trust Fund's tax counsel advised the Board of Administration for the Federated City Employees Retirement System (which also functions as the Trust Fund Board) to withdraw the ruling request related to employee contributions. The Trust Fund tax counsel also advised that in declining to rule, the IRS was not necessarily signaling that employee contributions to the Trust Fund would be treated as taxable.

On December 15, 2011, the Board approved the withdrawal of ruling request related to employee contributions, which allowed the IRS to move forward with consideration of other aspects of the private letter ruling request. On February 21, 2012, the Trust Fund received a favorable ruling from the IRS on its main private letter ruling request that the IRS confirm that income can accumulate in the Trust fund on a tax free basis. However, we do not have a ruling on whether the Trust will need to file a tax return or whether the employee contributions can be made on a tax free basis.

### **ANALYSIS**

Section 3.52.100 of the Municipal Code needs to be amended in order for employee contributions to begin being deposited into the Trust Fund in the absence of a private letter ruling. If employee contributions for retiree health care benefits continue to be made to the existing medical benefits (401(h)) account, the IRC limit may be reached, which would impair the ability of the City to implement agreements for the ramp up to full funding of the annual required contribution for Federated retiree health care benefits.

### **EVALUATION AND FOLLOW-UP**

If approved by Council, the ordinance title will be published; the ordinance will be considered by the Federated Board at its May 17, 2012 meeting; and the ordinance will be placed on the City Council agenda of May 22, 2012 for adoption.

### **POLICY ALTERNATIVES**

Because the IRS has advised that it will not rule on the taxability of employee contributions to the Trust Fund, the only alternative to the recommended ordinance is to continue depositing employee contributions into the existing 401(h) account. It cannot be stated with a certainty that the failure to adopt the recommended ordinance will impair the City's ability to ramp up to full funding for retiree healthcare in 2012-13. However, based on the February 11, 2011 Cheiron calculation of the 401(h) limit and the Federated City Employee Retirement System June 30, 2011 Actuarial Valuations, which include projected pension and retiree health care contribution rates, there is a good possibility that the full ramp could not be achieved if employee contributions into the 401(h) account must be capped at one-third of the pension normal cost contributions.

### **PUBLIC OUTREACH/INTEREST**

This memorandum and the draft ordinance have been posted on the City's web site for the May 8, 2012 City Council agenda. The draft ordinance will be considered by the Federated Board prior to final consideration by Council and any Board or public comments made at that meeting will be provided to Council. The City Manager's Office of Employee Relations will also circulate the draft of ordinance to affected employee bargaining units for review and comment.

### **COORDINATION**

Preparation of this memorandum and the draft ordinance has been coordinated with the Department of Retirement Services, the Finance Department and the City Manager's Office of Employee Relations.

### **BUDGET REFERENCE**

N/A

HONORABLE MAYOR AND CITY COUNCIL  
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**CEQA**

Not a Project; File No. PP10-068(b), Municipal Code or Policy.

RICHARD DOYLE  
City Attorney

By 

ED MORAN  
Assistant City Attorney

cc: Debra Figone

For questions, please contact ED MORAN, Assistant City Attorney, at  
(408) 535-1900