CalPERS

Finance and Administration Committee

Agenda Item 6b

December 19, 2017

Item Name: Proposed Modification to the Replacement Benefit Plan: Elimination of Replacement Benefit Fund

Program: Benefit Services Division

Item Type: Action

Recommendation

Team members seek direction from the CalPERS Board of Administration (Board) on whether to amend its Replacement Benefit Plan (RBP) by eliminating the Replacement Benefit Custodial Fund (RBF). This modification would require amending the RBP provisions that govern the RBF (Gov. Code, § 21750 et seq.) and the implementing regulations (Cal. Code Regs., tit. 2, § 589 et seq.).

Executive Summary

Per direction from the November Finance and Administration Committee meeting, team members prepared this agenda item to solicit the Board's input and direction regarding the RBF. Due to time limitation, team members have not had the opportunity to solicit stakeholder input and feedback prior to the development of this item.

Internal Revenue Code (IRC) section 415(b) limits the amount of benefits that tax-qualified plans can provide to participants. The Internal Revenue Service (IRS) annually adjusts the 415(b) limit to account for cost-of-living adjustments (COLA). Although not required by IRC section 415(m), CalPERS' RBP was designed to provide "excess benefits" to participants through a designated RBF, which is administered by the Board. Administering the RBF requires many time-consuming administrative tasks as team members serve as intermediaries between employers and participants to invoice, collect, track, and disburse funds into and out of the RBF to pay excess benefits to participants. Costs associated with administering the RBP, not covered by earnings on assets of the RBF, are borne by the participants.

GC section 21757(b) and California Code of Regulations (CCR) section 589.10(a) grants authority to the Board to modify the RBP. Team members are requesting the Board to select one of the following two options:

Option 1: Modify the RBP by eliminating the RBF. This would support the 2017-22 Strategic Plan to reduce complexity by simplifying the RBP program. Eliminating the RBF would help reduce administrative issues related to the program and eliminate participant's administrative fees.

Option 2: Maintain the status quo. Team members would continue to administer a complex program that is growing as more classic members retire.

Strategic Plan
Modifying the RBP supports Strategic Goal 3, Reduce Complexity, Objectives 1 and 2 of the 2017-22 Strategic Plan. Eliminating the RBF would simplify the program.

Background
IRC section 415(b) limits the amount of benefits that an individual may receive from a tax-qualified defined benefit (DB) pension plan like CalPERS. Effective January 1, 2018, the limitation on the annual benefit under a DB pension plan is $220,000 for participants that retire at age 62 to 65. The limit is actuarially reduced for members who retire before age 62.

In 1989 and 1990, the IRC 415 limits and the "grandfather" election were enacted in state law by two CalPERS' sponsored bills (Senate Bill (SB) 200 (Stats. 1989, Ch. 1305) and SB 2373 (Stats. 1990, Ch. 798). These bills also created a replacement benefit program intended to ensure that members affected by the IRC 415 limits are provided, to the extent reasonable, with commensurate replacement benefits. Subsequently, in 1996, Congress enacted the Small Business Job Protection Act of 1996, which amended IRC 415 by adding subdivision (m). IRC section 415(m) allows governmental pension plans to provide benefits that exceed the limit from a "qualified governmental excess benefit arrangement" (QGEBA). In 2001, the Board adopted regulations to establish the RBP in CCR, title 2, sections 589 through 589.10. Every CalPERS employer is deemed to participate in the RBP in accordance with Government Code section 21761.

There are now close to 1,000 CalPERS members that have retirement benefits that exceed the IRC section 415(b) limit. Approximately one-third of the participants in the RBP are safety members. Team members expect the number of RBP participants to temporarily increase as more classic members retire, however, other legislative changes will reduce participation in the program in the future.[1] Any retirement benefit that exceeds the IRC 415(b) limit cannot be paid from a pension plan's trust fund, like the Public Employees' Retirement Fund (PERF). These members receive pension benefits up to the IRC section 415(b) limit from the PERF and any benefits above the limit are paid from the RBF.

The Internal Revenue Service (IRS) annually adjusts the 415(b) limit to account for cost-of-living adjustments (COLAs). CalPERS' team members must annually test retirement benefits paid to retirees and beneficiaries to ensure they do not exceed the limit. If benefits exceed the limit, then team members invoice all prior employers proportionately to pay the member's excess benefits into the RBF. CalPERS establishes an RBF account for each participant to collect employer contributions and disburse benefits to participants on the monthly RBF benefit roll process once payment is received from the employer.

Analysis
The increasing number of RBP participants has presented administrative challenges for the program, especially the processes involving the RBF. Administering the RBF requires CalPERS' team members to invoice and track payments from employers into the RBF, and upon receipt of payment, to issue replacement benefits out of the RBF to retirees and beneficiaries. Team members are also experiencing an increasing number of telephone calls from participants who have not received payment and to employers for follow up on unpaid invoices.

[1] GC section 7522.43 prohibits any California employer from offering a replacement benefit plan for employees hired on or after January 1, 2013

Team members researched and analyzed how peer public pension systems administer their QGEBAs. The review found that several public pension systems use a similar administrative structure to CalPERS while other systems administer their excess benefits in other ways, such as:

- Not having a QGEBA and not allowing their members to receive benefits that exceed the IRC 415(b) limit.
- Contracting with a bank to distribute the excess benefit payments to members and providing them with the appropriate tax information at the end of the year.

In reviewing CalPERS' RBP, team members are asking the Board to consider two alternatives:

<u>Option 1:</u>
To reduce the complexity of the RBP for CalPERS, we could eliminate the RBF by amending the RBP provisions that govern the RBF (Gov. Code, § 21750 et seq.) and the implementing regulations (Cal. Code Regs., tit. 2, § 589 et seq.). All other RBP processes would remain the same. CalPERS' team members would still annually test benefit allowances against the new IRC 415(b) limit, notify employers and members when benefits exceed the limit, specify the amount of excess benefits proportioned to each employer, and assist members with general program inquiries.

Pros

- Supports the 2017-22 Strategic Plan by simplifying the RBP program and reducing complexity
- Eliminates CalPERS intermediary role and streamlines the administrative process
- Participants will no longer be billed the two percent administrative fee that CalPERS charges them to administer the RBF
- Simplifies CalPERS' team members' workload and administrative program costs

Cons

- Employers would need to establish processes to pay excess benefits, taxes, generate annual tax forms, and provide customer service to participants
- Participants may have difficulty collecting payments from employers, especially when there are multiple employers
- Requires legislative changes to amend the Public Employees' Retirement Law (PERL) and parallel modifications to the regulations
- Requires a one-time cost to update my|CalPERS system and inform stakeholders
- There will be no administrative fee to offset requirements of RBP

<u>Option 2:</u>
Maintain the status quo and continue to administer the RBF. CalPERS' team members would continue to annually test benefit allowances against the new IRC 415(b) limit, notify employers and member when benefits exceed the limit, and serve as the intermediary between employers and participants.

Pros

- Employers would not need to establish processes to pay excess benefits, taxes, generate tax forms or customer service
- Ensures that RBP participants receive their excess benefits without having to coordinate between multiple employers
- Does not require legislative changes or changes to my|CalPERS system
- No employer and member education requirement
- Costs to administer the RBP will continue to be paid through administrative fees paid by the participant

Cons

- o Does not support the 2017-22 Strategic Plan to reduce program complexity
- o Team members must continue to administer a complex program that requires them to serve as the intermediary between employers and participants
- o Participants would continue to be billed a two percent administrative program fee
- o Team members may experience increased workload and administrative challenges as more classic members retire

Budget and Fiscal Impacts

Option 1:

Amending the RBP would require my|CalPERS system modifications. Team members estimate a one-time cost of approximately $235,000 to remove the RBF component in my|CalPERS. This cost includes a staffing estimate of $86,130 and a consulting fee of $149,040. Team members would also need to notify all impacted employers and participants about the change to the RBP.

Option 2:

RBP will continue to be funded through participants' administrative fees and no my|CalPERS system modifications would be required.

Benefits and Risks

The benefits and risks vary per the options presented to the Board:

Option 1: Eliminate the RBF.

Eliminating the RBF would remove CalPERS from its intermediary role and simplify the program, and reduce administrative program costs for RBP participants, who are currently charged a two percent administrative fee.

There are also some potential risks involved with amending the RBP program which would impact employers, retirees, and beneficiaries. Employers may need to establish processes for paying excess benefits, taxes, generating annual tax forms and handling customer service issues. These processes may also include the need to establish a designated excess benefit fund to pay these benefits.

Retirees and beneficiaries may have difficulty collecting payments from previous employers, especially when there are multiple employers involved, or may not have the correct contact information to contact former employers if any issues arise. CalPERS team members can help provide employer's contact information to participants upon request. Most CalPERS employers pay participant's RBP benefits in a timely manner. Currently, less than four percent of employers in the RBP have outstanding invoices. Sixty percent of participants receive benefits from one employer, while 25 percent receive benefits from two employers, and 15 percent receive benefits from more than three employers.

Any statutory change to retirement plan provisions could potentially raise vested rights issues. Some participants may perceive the change to the RBP as eliminating the benefit. While disputes over benefits would be between employers and participants, CalPERS may be brought into litigation involving these issues. Team members could mitigate this risk by engaging in various forms of communication to educate participants about the plan and federal tax codes.

Option 2: Maintain status quo.

There are benefits to maintaining the status quo for CalPERS, employers, and participants. For CalPERS, the temporary increase in workload to propose legislative and regulatory amendments, make my|CalPERS system modifications, and educate employers and members about the changes to the RBP would not be needed. In addition, it reduces potential tax compliance risks. For employers, maintaining the status quo would not require them to establish processes to pay excess benefits or taxes, or implement any customer service procedures to resolve any issues that may arise. For members, maintaining the status quo helps ensure that they receive their excess benefits through CalPERS.

The risks involved with maintaining the status quo include the need for CalPERS team members to continue to administer a complex program that is growing and may result in further workload challenges as more classic members retire.

Attachments
None.

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