July 16, 2018

Item Name: Senate Bill 1124 – Administration of Reportable Compensation

As Amended May 25, 2018

Sponsor: California Professional Firefighters

Program: Legislation

Item Type: Action

Recommendation
Adopt an **OPPOSE, UNLESS AMENDED** position on Senate Bill (SB) 1124 (Leyva) to remove its requirement that the California Public Employees' Retirement System (CalPERS) continue to pay benefits to specified retired members and their beneficiaries when the System determines a portion of the retiree's benefit was based on compensation reported by their former employer in error or that is inconsistent with the CalPERS Plan provisions set forth in the Public Employees' Retirement Law (PERL).

Executive Summary
Among other things, SB 1124 allows the state and contracting agencies to submit memoranda of understanding (MOUs) entered into on or after January 1, 2019 for CalPERS review and certification for compliance with specified statutes and regulations that identify allowable elements of reportable compensation. In the case of an active state or contracting agency member covered by an MOU entered into before that date, it requires the employer to discontinue reporting compensation that conflicts with the provisions of all applicable laws and regulations, and provides for the return of contributions, as specified. The bill also requires the ongoing allowances of all similarly situated retired members and beneficiaries whose benefits have, or may in the future, be reduced because they were predicated on disallowed compensation, to remain unchanged under specified conditions. In addition, it requires the former employer to make direct payment for the cost of the prior benefit paid, and pay projected cost of the ongoing benefit, as specified.

The bill, in its current form, limits CalPERS' ability to correct errors in the calculation of non-management state and contracting member benefits, and is thereby contrary to Internal Revenue Service (IRS) guidelines for maintaining tax-qualification status.

Strategic Plan
Enactment of this proposed change undermines the 2017-22 CalPERS Strategic Plan goal to strengthen the long-term sustainability of the pension fund and reduce complexity across the enterprise.

Background
The CalPERS defined benefit Plan (the Plan) is a tax-qualified plan under Section 401(a) of the Internal Revenue Code (IRC) and in order to maintain its tax-qualified status, CalPERS must

comply with IRS guidance relating to Section 401(a). One such requirement is that the Plan must operate in accordance with the terms of its Plan document. CalPERS' Plan provisions are found in the PERL (Gov. Code § 20000 et seq. and the implementing regulations (Cal. Code Regs., Tit. 2 §550 et seq.). The PERL provisions set forth, among other things, the type of compensation that may be included for purposes of calculating a member's final compensation. The Plan terms also contain provisions for how to correct errors and methods for making benefit adjustments when a reporting error is identified. In addition, to remedy operational mistakes (i.e. the failure to follow the terms of the Plan) and avoid the consequences of plan disqualification, the Internal Revenue Service (IRS) has provided specific guidance for plan administrators in the IRS Employee Plans Compliance Resolution System (EPCRS) correction procedures.

As part of CalPERS Plan administration practices, the CalPERS Office of Audit Services performs between 240 and 340 compliance reviews of state agencies, school districts and contracting public agencies annually. The primary objective of each review is to assess whether the employer complies with applicable sections of the PERL, sections of the California Code of Regulations that relate to CalPERS, and prescribed reporting and enrollment procedures contained in CalPERS Employer Guides and Circular Letters. The various compliance areas may include, but are not limited to, compensation, payroll, membership enrollment, unused sick leave conversions, contracts, working after retirement, and industrial disability retirement.

Occasionally, team members make an audit finding or multiple audit findings for an individual employer that are related to key elements of the data used to determine members' benefits, including their time base, compensation (regular earnings and special compensation), and the associated retirement contributions reported to the System. CalPERS team members will work with the employer to resolve the finding and to take the necessary corrective actions to comply with the PERL.

Existing law requires CalPERS to correct errors and omissions made by an employer or by the System in accordance with its Plan provisions. Once an error is discovered, CalPERS must take corrective action and may only pay those benefits authorized under the PERL. When an error in compensation is identified, the employer is required to withdraw its initial payroll reporting to the System, including any associated contribution amounts, then correct any errors, and re-report that information and associated contributions to the System. This process credits the employer with the member and the employer contribution amounts. If the member contributions associated with any disallowed compensation were paid by the member, the employer is responsible for returning the contributions to the member through its payroll process.

The timeliness and accuracy of employer reporting lays the foundation for members, employers and CalPERS, to monitor and verify the key elements of data used to determine benefit allowances. Non-reporting, irregular reporting, and inaccurate reporting can negatively impact members by delaying the processing of retirement applications, receipt of incorrect retirement and survivor allowances, reducing allowances, and deducting overpayments out of their ongoing monthly benefits. Between April 2017 and April 2018, CalPERS team members processed approximately 335 downward adjustments to retirement allowances for state and contracting agency members due to auditing findings.

While we do have some measures in place to review payroll at the time of submission or throughout a career, due to the volume of payroll data received each month, the majority of payroll reviewed for a member is at the time of retirement. Parameters are used to determine specific high-risk compensation errors that should be reviewed at the time of retirement. To validate all compensation contained in memorandums of understanding and paid at the time of retirement to prevent overpayments from occurring at benefit inception will require a different approach and an increase to resources to address new workload.

Analysis

1. Proposed Changes:
   - Expresses legislative intent to ensure that a retired member is protected when alleged misapplication or calculation of compensation occurs as a result of an employer's error.
   - Expresses legislative intent that errors made on the part of the employer, with respect to a promise to a retiree, be borne by the employer rather than through a retroactive overpayment and prospective permanent reduction in the retired member's pension.
   - For state and contracting agency employees covered by an MOU entered into before January 1, 2019, it requires their employers to discontinue reporting compensation that conflicts with the California Public Employees' Pension Reform Act of 2013 (PEPRA), the elements of "compensation earnable" as described in the PERL, or the administrative regulations of CalPERS. It also prohibits payment of benefits based upon disallowed compensation, except as specified for retired members.

     Specifically, for active members, it:
     - Requires employer contributions made on disallowed compensation to be credited back to state or contracting agencies against future contributions.
     - Requires member contributions made on disallowed compensation to be credited back to the member, including employer-paid member contributions.

     Specifically, for retired members and their beneficiaries whose compensation pursuant to an MOU was disallowed by the System after their date of retirement, it:
     - Requires CalPERS to permanently adjust retirement benefits predicated upon disallowed compensation to include the disallowed compensation.
     - Prohibits retirees and beneficiaries from repaying benefits that were based on disallowed compensation.
     - Requires applicable state and contracting agencies to pay to CalPERS the full cost of any benefit paid, as a direct payment, and pay any projected future benefit payments calculated using the permanently adjusted benefit.

   - For state and contracting agency employees covered by an MOU entered into on or after January 1, 2019, it allows employers to submit to CalPERS any compensation proposal intended to provide the basis of a pension benefit calculation, and requires the System to determine its compliance with PEPRA, the elements of "compensation earnable" as described in the PERL, and the administrative regulations of CalPERS.
   - Stipulates its provisions do not alter or abrogate any responsibility of the employer to meet and confer in good faith with the employee organization regarding the impact of the disallowed compensation or the effect of any disallowed compensation on the rights of the employees and the obligations of the employer to its employees, including those that become exempt from representation, but whose benefit was the product of collective bargaining.

   The findings and declarations section of SB 1124 describes events following a 2017 CalPERS employer audit finding, where a retired member was determined to have received benefits based on compensation that was erroneously reported and not pensionable. The member was required to pay back to CalPERS the benefit overpayment, and the benefit was also reduced on an ongoing basis, consistent with existing law.

The sponsor points out that during collective bargaining, the employer agreed in an MOU to create special compensation schemes that were intended to be reportable to CalPERS. SB 1124 would further incentivize state and contracting agency employers to take active steps to validate conformity of negotiated items of compensation with existing law and regulations, and, in specified instances, to be financially responsible for compensation that CalPERS later determines is not pensionable.

The bill would also incentivize CalPERS to strengthen its compensation review procedures in order to reduce additional operational workload and potential compliance risks associated with the proposed recognition of disallowed compensation for purposes of calculating retirement benefits. However, expanding efforts to review all MOUs entered into between CalPERS' state and local government employers and members' exclusive bargaining representatives, or to review all compensation previously reported to members' accounts at the time of retirement will require a significant amount of additional resources for management and analytical staff.

2. Impacts to Existing Practices and Procedures
While elements of SB 1124 that specify the treatment of disallowed compensation for active members and the associated retirement contributions, are declarative of existing law or align with existing CalPERS practices, other elements of the bill related to retired members appear to conflict with existing Plan provisions that ensure compliance with federal requirements for tax-qualified defined benefit (DB) plans.

Currently, when CalPERS identifies erroneously reported compensation was used to determine a retired member's benefit, the employer is required to update its reporting consistent with CalPERS findings. This action credits the employer with the erroneously reported member and employer contribution amounts. There is no physical return of money; rather, they receive a credit and are able to submit less money on a future payroll report. The bill would instead require the employer that misreported the compensation to make a direct payment to CalPERS equaling the cost of the benefits provided to the member for the period of time prior to its discovery, instead of requiring the member to repay the cost of the benefit to the System and potentially receiving the member contributions they paid on that disallowed compensation from their former employer.

Even more problematic from a plan administration and compliance perspective, are the provisions of SB 1124 that would require CalPERS to permanently adjust the member's retirement benefits to include the disallowed compensation and require the employer that misreported the compensation to pay to CalPERS any projected future benefit payments.

Among the duties of CalPERS fiduciaries, is to maintain the System's tax-qualification status under Section 401(a) of the IRC. One of the requirements to keep the System tax-qualified is to operate in accordance with the Plan terms, which includes the duty to correct errors in administration as soon as possible. Indeed, the PERL and the IRS EPCRS set forth a process for CalPERS to correct errors and omissions of the System.

SB 1124 conflicts with that important duty by essentially prohibiting, in certain circumstances, CalPERS from correcting errors in reported compensation. Instead CalPERS would be required to further preserve the error by establishing the erroneously reported compensation as part of the new "approved" or "corrected" compensation – in effect, requiring CalPERS to ignore established errors. As a result, SB 1124 may call into question whether CalPERS is failing to correct an operational failure in accordance with EPCRS. In order to maintain CalPERS' operational compliance with the Plan terms as required by the IRC, team members recommend removing the provision that requires the System to pay out benefits to the member on an ongoing basis that are calculated using the disallowed compensation, and funded by the employer responsible for the erroneous reporting.

In addition, making the misreporting employer financially responsible to the System for these ongoing benefit payments does not recognize that a retired member's other employers may have already funded a portion of those benefit costs. Stakeholders may, at some point, expect CalPERS to begin such transfers so any employers that did not erroneously report compensation, but nevertheless share the duty to fund the member's and their beneficiaries' ongoing benefits associated with that compensation, are no longer financially responsible for those liabilities. This is a time-consuming manual process that CalPERS is only beginning to implement for specified managerial employees that move between CalPERS contracting agencies and receive large pay increases.

Budget and Fiscal Impacts

Benefit Costs

Failure to maintain the tax-advantaged status of the DB Plan can result in significant increased retirement costs to CalPERS members and employers.

Administrative Costs

CalPERS team members have identified five IT system enhancements to my|CalPERS costing approximately $130,000. The team has also identified the need for additional analytical and managerial resources should CalPERS be required to review all MOUs developed after 2019.

Benefits and Risks

Benefits:

- Protects the retirement of CalPERS members by ensuring that any collectively-bargained compensation agreed to by their employer cannot be subsequently and retroactively be removed from the retired member's pension allowance as a result of incorrectly reported compensation.
- May potentially lower the amount of disallowed compensation audit findings for represented state and contracting agency members.

Risks:

- Places CalPERS' tax qualification status at risk by paying benefits not in accordance with the Plan terms and not allowing CalPERS to correct errors in reported compensation.
- Increases System cost and complexity to administer affected members' ongoing benefits.
- Entails potential significant costs to strengthen compensation monitoring and compliance necessary to reduce such risks.

Attachments

Attachment 1 – Legislative History
Attachment 2 – Support and Opposition

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