Pension & Health Benefits Committee

California Public Employees' Retirement System

Agenda Item 5d

August 20, 2013

ITEM NAME: Senate Bill 277 (Beall) – State Peace Officers' and Firefighters' Defined Contribution Plan: Closure

As Amended June 18, 2013

Sponsor: California Correctional Peace Officers Association (CCPOA)

PROGRAM: Legislation

ITEM TYPE: Action

RECOMMENDATION

Adopt a **Neutral** position on Senate Bill (SB) 277 because the bill proposes policy changes that if signed into law would reflect agreement between labor, as the bill's sponsor, and management, with the Legislature passing the bill and the Governor signing the bill. Also, the bill, as currently drafted, appropriately recognizes the primacy of the Internal Revenue Code in regulating plan terminations and plan-to-plan transfers as anticipated by this legislation.

EXECUTIVE SUMMARY

SB 277 would terminate the State Peace Officers' and Firefighters' Defined Contribution Plan (POFF) on the later of January 1, 2014, or upon obtaining appropriate approvals from the Internal Revenue Service (IRS), including a favorable determination letter on plan termination from the IRS. Subject to such approvals, all plan assets in the POFF will be distributed in accordance with federal and State law. To the extent the California Public Employees' Retirement System (CalPERS) does not receive an election instruction from the participant or beneficiary (i.e., distribution or rollover request), SB 277 provides that the participants' POFF accounts will be rolled over to the CalPERS-administered Supplemental Contributions Plan (SCP). In this regard, the SCP will serve as the default plan for participants or beneficiaries who do not elect a distribution option prior to plan termination. The bill requires that the termination process and all distributions be conducted consistent with appropriate federal and State laws. The plan termination required by this bill is consistent with the bargaining agreement between the State and the California Correctional Peace Officers Association (CCPOA), the official representatives of Bargaining Unit (BU) 6 which, among other things, ended the State's contributions to the POFF in 2011.

CalPERS has not previously terminated a retirement plan like the POFF. If this legislation is enacted, and the IRS provides the appropriate approvals to implement the proposed plan termination as presented in SB 277, staff may encounter unanticipated issues, and would keep the CalPERS Board of Administration (Board) and interested parties informed of the outcome.

STRATEGIC PLAN

This item is not a specific product of the Annual or Strategic Plans, but is a part of the regular and ongoing workload of the Office of Governmental Affairs.

BACKGROUND

1. Peace Officers' and Firefighters' Defined Contribution Plan (POFF)

   The POFF was created by the Legislature when it ratified the Memorandum of Understanding (MOU) between the State and BU 6 in 1998, through Chapter 21 of 1998 (SB 615, Burton) and its clean-up measure Chapter 820 of 1998 (Assembly Bill 2472, Leonard). The POFF is intended to be a tax qualified money purchase pension plan under Internal Revenue Code (IRC) section 401(a) funded only through employer contributions. As of May 1, 2013, the POFF had 36,357 participants and approximately $495.3 million in assets.

   Under the current POFF provisions, employees of BUs 8 and 6 are eligible to participate in the POFF pursuant to the terms of an MOU. To date, State employees of BU 8 have not participated in the POFF. State employees of BU 6, and certain supervisors and managers of BU 6 employees, participate in the POFF. The negotiated employer contribution rate to the POFF is set by MOU, and was historically 2 percent of the eligible BU 6 employee's monthly salary. The POFF is not a participant-directed plan. Rather, the employer contributions are invested by CalPERS and credited to each participant's account along with any net earnings. The balance of the POFF account is available to POFF participants only at retirement or upon permanent separation from all State employment.

   Until 2011, the State employer contributed an amount equal to two percent of each eligible BU 6 employee's base pay to his or her POFF account. Following the ratification of the MOU between the State and BU 6 in 2011, the State ceased employer contributions for rank and file employees beginning on April 1, 2011, and subsequently stopped contributions for excluded employees beginning with the May 2011 pay period. The MOU noted that ending POFF employer contributions was in exchange for increases in health care benefit rates and an additional one percent increase for the top step of the salary range on July 1, 2013.

2. CalPERS Supplemental Contributions Plan

   The CalPERS Supplemental Income Program currently includes the SCP, which is also intended to be a tax qualified money purchase pension plan under IRC section 401(a). As currently structured, the SCP is an after-tax money purchase pension plan that does not allow employer contributions. Eligibility to participate in the SCP is currently extended to employees of the State of California who are active members of the CalPERS Defined Benefit Plan, the Legislators' Retirement System, and the Judges' Retirement System (I and II).

Participation in the SCP is voluntary and allows participants to self-direct their investments among the investment options available under the plan. Participants may contribute any amount at any time on an after-tax basis, subject to the maximum IRC Section 415(c) annual contribution limit, which is generally the lesser of 100 percent of an employee's compensation or $51,000 for 2013. This 415(c) limit, however, must be coordinated with other applicable annual contributions made by the participant in that year. Existing law permits the Board to authorize in-service withdrawals to the extent allowed by federal and State laws; however, the Board has not established the terms and conditions to permit in-service withdrawals at this time.

As of May 1, 2013, the SCP had 558 participants with approximately $19.7 million in total assets invested, and $12,903 in total monthly contributions.

ANALYSIS

1. <u>Proposed Changes</u>

   Specifically, SB 277 does the following:

   - Makes a legislative finding that the employer contributions to the POFF on behalf of BU 6 members have been eliminated.
   - Prohibits all future contributions to the POFF.
   - Prohibits any new participants in the POFF, including employees of BU 6 and 8 and their respective supervisors and managers.
   - Terminates the POFF on the later of January 1, 2014, or upon obtaining appropriate IRS approvals, including a receiving a favorable determination letter on plan termination from the IRS.
   - Requires all POFF moneys to be distributed in accordance with federal and State law, as part of the termination process.
   - Requires POFF accounts to be rolled over to the SCP if the participant or beneficiary makes no distribution election.
   - Requires POFF accounts that are rolled over to the SCP to be invested in the applicable target retirement date investment fund option until the participant affirmatively chooses another investment option.
   - Authorizes the SCP to receive rollover contributions from the POFF through the termination distribution process, if the Board establishes a separate rollover account in the SCP for each POFF account transferred to the SCP.
   - Clarifies that any fiduciary of the SCP, including CalPERS, shall not be liable for investment losses resulting from investment choices made by plan participants or from the default fund option if a participant does not provide affirmative investment instructions.

- Authorizes POFF participants whose accounts have rolled over to the SCP to take a distribution of moneys prior to separation from State employment, subject to applicable federal and State laws.
- Specifies that the distribution of a POFF account, pursuant to the termination process, constitutes a complete discharge and release of liability for the Board.
- Repeals the never-used authority for BU 8 (CDF Firefighters) to bargain for inclusion in the POFF.
- Makes other technical and clarifying changes to the SCP statutes necessary to execute plan transfers from POFF accounts.

2. Supporters' Rationale

The sponsor of the bill, CCPOA, states, "In the late 1990's, CCPOA and the State agreed to establish a supplemental retirement program for correctional peace officers. The program was funded by our members taking a two percent less salary increase and the state depositing two percent of salaries into a tax-deferred account with CalPERS. The plan provided our members with a 401(k)-like account, but one that was managed only by CalPERS.

"In our 2011 collective bargaining agreement, the parties agreed to stop contributions to the members' accounts as of April 2011, and agreed that so long as it was consistent with relevant State and federal law, the individual members could manage their balances in a manner similar to the way private sector employees could manage their 401(k) accounts."

Furthermore, the author states, "Current law regarding PO/FFDCP does not allow an employee to withdraw or roll over PO/FFDCP funds prior to separation from employment or retirement. The BU 6 employees with funds in PO/FFDCP would like to have the ability to roll over funds into other tax-qualified retirement plans or to make withdrawals, consistent with federal laws and tax requirements for defined contribution plans."

3. Distribution of Moneys from the POFF and the SCP

Under current law, the POFF prohibits distribution of moneys in the plan unless the participant has separated from his or her employer, either through retirement or termination from employment. The POFF was created as a pre-tax employer-funded qualified money purchase pension plan under IRC section 401(a), for which federal law prohibits in-service distributions. The SCP is currently an after-tax employee-funded plan for which federal law does not necessarily prohibit in-service distributions. However, under the current SCP provisions, CalPERS must set terms and conditions before such in-service SCP distributions may occur, and this has currently not been done.

Termination of the POFF creates a distribution event under federal law, regardless of whether the participant has separated from the employer or not. As such, POFF accounts may be distributed during the termination process, and if rolled over to another eligible retirement plan, the rolled over funds from POFF accounts generally retain eligibility for subsequent distribution provided the funds are separately accounted for in accordance with federal law and to the extent the transferee plan (i.e., the plan receiving the rolled over funds from the POFF) allow for such distributions. SB 277 also changes the SCP provisions to permit in-service distribution from the SCP for those accounts rolled over from the POFF pursuant to terms and conditions established by the board.

4. Complexity of Plan Termination
Closing a retirement plan is not the same as a plan termination. Governments regularly close one plan to new participants and open a new tier of retirement benefits, and members of the closed plan continue to accrue benefits through that closed plan. Whereas, plan termination ends the plan and all participants and assets must be distributed in accordance with federal law and State law. The IRS generally requires final distribution of plan assets (i.e., POFF assets) within one year of the plan's termination date. Since this will be the first plan termination for a plan like the POFF, we are not necessarily certain of the level of complexity or time it may take to implement the termination.

Federal law requires all accounts in a terminating plan to be distributed within specific timeframes, generally within one year of the plan's termination date. A plan with approximately 36,000 participants, like the POFF, will inevitably have participants who do not make any affirmative election for distribution before the plan is terminated. In order to meet the required termination timeframes and minimize the potential tax liability incurred by the participants who may not necessarily want to receive a distribution, SB 277 provides for the CalPERS-administered SCP as the default plan.

The Board has not established procedures under the SCP to allow in-service distributions, and the SCP has significantly fewer participants and assets than the POFF. The SCP is self-directed plan with several investment fund options for its participants while the POFF is not a self-directed plan and rather has a single investment allocation. In the absence of a default plan, CalPERS would have to distribute funds directly to the participants that failed to elect an option, who would then have to pay all associated taxes and penalties. Therefore, SB 277 included a specified default plan to minimize unintended adverse tax consequences.

In addition, SB 277 makes several changes to the SCP governing statutes to make explicit the participant's ability to elect investment fund options under the plan, to allow the receipt of POFF rollover accounts, to distribute POFF rollover accounts as permitted under federal law, and to account properly for POFF rollover accounts. These accounts will be separately accounted for within the SCP in accordance with federal law to retain their status as pre-tax employer funded deferred compensation. The SCP and the POFF have the same third-party record-keeper, which should help facilitate the management of POFF accounts transferred to the SCP.

5. Plan Termination is a Process and May Present Challenges
Terminating the POFF is a complex process that may present numerous challenges to CalPERS. SB 277 requires termination of the POFF to occur on the later of January 1, 2014, or upon CalPERS obtaining the appropriate approvals from the IRS, including a favorable determination on plan termination from the IRS. CalPERS will with work the IRS to obtain a determination letter on plan termination. This approval process will likely take longer than the alternative termination date of January 1, 2014, as specified in the bill.

   Once the IRS provides the appropriate approvals, CalPERS will begin the process of establishing distribution timelines, distribution options, and communicating those options and timelines to participants and beneficiaries. The third-party recordkeeper for the POFF will conduct these efforts, and CalPERS staff will provide direction and oversight. While this part of the process does not begin until after IRS approval, staff planning and due diligence has already begun. If SB 277 is signed into law, additional staff planning and resources may be required so that if the appropriate IRS approval is obtained, CalPERS will be in a better position to start the termination process. In addition, as we get further along in the POFF plan termination, there may be a need for additional changes to State law (e.g., in response to IRS technical changes), unanticipated administrative costs, or both.

   While the details of the process are still in it the early stages, there will be a timeframe for participants and beneficiaries to elect a distribution option for their POFF account. Communications to participants will begin before the distribution window opens and will continue until the POFF terminates and the window closes. In the absence of a distribution election by the participant or beneficiary, their POFF account will be rolled over to the applicable target retirement date fund in the default plan (i.e., the SCP). At that point, the participant will receive additional information about the SCP and its investment options and distribution options.

6. Plan Termination Allows Participants To Act In Ways That Diminish Retirement Security
In general, CalPERS does not encourage participants to withdraw moneys from their deferred compensation accounts prior to retirement, because the tax advantages for these accounts generally only apply if distribution occurs on or after retirement. In addition, retirement security for members is best served when retirement accounts are not used to pay pre-retirement expenses, or eroded by additional tax penalties associated with in-service and early distributions. If an individual takes an early (i.e. before age 59 ½) lump-sum withdrawal from the POFF, he or she would be responsible for paying the appropriate rate of federal

and State income taxes based on his or her current income, plus an additional tax penalty of 12.5 percent (10 percent for federal penalties and 2.5 percent for State penalties).

Participants may avoid unwanted taxes and penalties by rolling over their POFF accounts to eligible tax-qualified retirement accounts, such as an IRC Section 401(k) or 457 deferred compensation plan, or an Individual Retirement Account, though this will generally be at the discretion of the transferee plan. Any benefit costs to participants are associated with their account distribution choices, which may be subject to taxes and additional penalties, as well as the investment choices they make and the associated investment and administrative fees they pay in the future.

BUDGET AND FISCAL IMPACTS

1. Benefit Costs
   There are no employer benefit costs because contributions by the State on behalf of active participants have already ceased. Benefit costs for POFF participants will vary based on their future investment and distribution choices.

2. Administrative Costs
   There would be one-time estimated costs of at least $700,000 to the POFF administrative account, which is funded through account fees. This account is expected to have sufficient reserves to cover the administrative and recordkeeping costs associated with implementing SB 277. These implementation activities involve member outreach, managing the distributions from the terminating POFF, legal and business services, and managing the account rollover into the SCP. Through third-party administrators, this bill will impose implementation costs for the following activities:
   - General implementation of the plan termination, including participant data analysis, establishing rollover source, add on-line functionality for distribution (POFF & SCP), manage default distributions of less than $1,000, facilitate data and fund transfers, and review and update website, publications and forms.
   - Participant Communication, including a general announcement, reminder letters, SCP welcome kits, and search for missing participants.
   - System and business analyses for the transfer of assets from the POFF to the SCP.

BENEFITS/RISKS

1. Benefits of SB 277 Becoming Law
   - POFF participants will gain the account distribution options sought on their behalf by their exclusive bargaining representative.
   - New participants into the SCP.

2. Risks of SB 277 Becoming Law
   - The IRS may reject the plan termination request, leaving the statutory status of the POFF in question.
   - POFF participants may reduce their own retirement security if they make account withdrawals that subject them to federal and state taxes and early withdrawal penalties.
   - Because CalPERS has never administered a plan termination as required by this bill, the administrative costs may be higher or lower than expected.

ATTACHMENTS
Attachment 1 – Legislative History
Attachment 2 – Excerpts from BU 6 MOUs

DANNY BROWN, Chief
Office of Governmental Affairs

ANN BOYNTON
Deputy Executive Officer
Benefit Programs Policy and Planning