

January 24, 2013

Michael Seville
IFPTE Local 21 Interim Senior Representative
4 North Second Street, Suite 430
San Jose, CA 95113

RE: Retiree Healthcare Negotiations Request for Information

Dear Michael:

We are in receipt of the letter you sent on behalf of IFPTE, Local 21, regarding Retiree Healthcare Negotiations. During our negotiation session with AEA, AMSP and CAMP on January 8, 2013, we discussed the information request and provided some responses. The following is responsive to the remainder of the information request.

Section 12.2

1. *Under what circumstances might it be necessary or not necessary to amend the Municipal Code and/or applicable plan documents?*

If any agreement conflicts with what is currently included in the Municipal Code and/or applicable plan documents, then, to the extent necessary, an amendment may be added to the appropriate document.

Section 12.2

2. *Can you specify which component of the ARC may vary upward or downward and how that is different from "the amount of each increase"?*

The Annual Required Contribution is comprised of the cost to pay the current year's benefit and the pay the amortized unfunded liability, thus any impact to the benefit, the normal cost, or the unfunded liability may adjust the ARC.

The "amount of each increase" phrase was a statement in the previous agreement that was necessary due to the potential for the contribution amount to increase or decrease as the ARC could fluctuate based on the annual actuarial valuations. This proposal limits the increase in contribution rate to 0.75%, per year.

Section 12.4

1. *We see that the 10% member contribution in this section is based on pensionable pay. Can you please provide us with a breakdown of what you take into account when calculating "pensionable pay"? What is the dollar equivalent of 10% of pensionable pay?*

For IFPTE, pensionable pay can also be defined as base pay. The 10% would vary based on the base pay of each employee.

2. *What is the current percentage for member contribution based on or derived from? In other words, what is the base from which the current member contribution is calculated from?*

Please refer to the enclosed 2009 Retiree Healthcare Tentative Agreement and the current OPEB valuation, which you received at the January 8, 2013, negotiation session.

3. *What is the quantitative difference, in dollar amount and percentage, of what employee contribution is now and what the planned contribution is? In other words, please provide us the percent and dollar amount contributed for retiree healthcare by both members and the City for the last 5 years.*

The current proposal limits contributions increases to 0.75% until the cap is reached. The current contribution rate is 7.26%. The dollar amount will vary by employee.

Please refer to the OPEB actuarial valuations from 2007-2012. These valuations can be found on the San Jose Retirement Services website.

Please use the following links to navigate to the valuations:

2007:

<http://www.sjretirement.com/uploads/FED/Item12GASB2424SanJose2007revised01262009.pdf>

2009:

<http://www.sjretirement.com/uploads/Fed/Item%2015%20Discuss%20Health%20Study%20GRS.pdf>

2010:

<http://www3.sanjoseca.gov/employeeRelations/retirementbenefits/January2011CheironOPEBValuation.pdf>

2011:

<http://www3.sanjoseca.gov/employeeRelations/retirementbenefits/ActuarialValuationAndPresentationofOPEB6.30.11.pdf>

2012:

<http://www.sanjoseca.gov/DocumentCenter/View/11178>

4. *When you use the term "implicit subsidy," what does that mean?*

Currently, the health insurance companies pool together active and retired employees for the health plan rates. If retired employees were covered separately from active employees, their rates would be more costly. This results in an "implicit subsidy" for the retirees as their rates are lower than if they had separate insurance premiums.

5. *Please provide us with a breakdown of what the 10% of pensionable pay for the City (excluding implicit subsidy) is in dollar amounts and what the source of that subsidy is currently and for the last five years?*

The amount of pensionable pay varies per employee. Please see above for the source of the subsidy. The OPEB valuations indicate the value of the implicit subsidy due to the reporting requirement of GASB 45.

6. *How does the 10% paid by the City measure up to the 10% paid by members in dollar amounts? Please provide us with what the dollar equivalents are now and what they will be under your proposal. Does the 10% paid by the City equal the 10% paid by members in dollar amounts?*

If the contribution amount is 10%, the City will pay 10% of pensionable payroll. The cost for retiree medical is shared between the City and employees, 50/50. Please refer to the OPEB valuation for any dollar amounts.

7. *What are examples of "alternatives" that might be discussed to reduce retiree healthcare costs? We would appreciate a clarification of what this could be?*

We provided an answer to this question verbally during the January 8, 2013, negotiation session.

8. *Please provide information and substantiation of how this provision provides a cap similar to the one in place for Police and Fire? How are they similar? What are their caps?*

Please refer to the Agreement with Police in 2009 and the Agreement with Fire in 2011, both are enclosed.

9. *How often have the City and Police and Fire exceeded these caps in the last ten years, and what has been the contractual procedure in situations where the ARC cap has been exceeded? Please provide us with an annual breakdown for the last ten years. In the cases where the cap was exceeded, what has been the outcome of these processes on outcome of Police and Fire member contribution?*

The cap has never been exceeded for either Police or Fire.

Section 12.5

10. Please provide us with a plan description of the 115 trust fund and any documentation supporting your decision to establish this 115 trust.

Please refer to the Council Memo from May 13, 2011, from City Attorney Rick Doyle, which is enclosed.

11. Please provide documents to describe what the referenced IRS limit on existing medical benefits account are.

Please refer to the April 11, 2012, letter from Cheiron that was distributed at the January 8, 2013, meeting.

12. What is your estimation of the date by which there will be any potential of reaching the IRS limits on existing medical benefit account?

Please refer to the April 11, 2012, letter from Cheiron that was distributed at the January 8, 2013, meeting.

13. Specifically, in what ways are the City and/or members impacted or affected by these IRS limits on existing medical benefits account?

The City and employees will no longer be able to contribute to the 401(h) account if the limit is reached. In addition, the tax status of the plan is jeopardized if the limit is exceeded.

14. What sort of advice is the City anticipating from Tax Counsel about the proposal in 12.5 and when do you expect this information?

The City Council and the both Retirement Boards have asked tax counsel for an opinion regarding the tax status of employee contributions. Tax counsel is continuing to review the possibility of obtaining an IRS ruling that employee contributions can be treated as pre-tax contributions. There is no clear timeframe for that determination.

15. What, if any, IRS rulings does the City have that contributions can be treated as pre-tax? Have you requested from IRS a ruling of any kind that contributions can be treated as pre-tax? Please provide us with all supporting documentation, including when such requests were made, and any documentation received from IRS?

Please refer to the Council Memo from April 26, 2012, from City Attorney Rick Doyle, which is enclosed.

Section 12.7

16. *What studies have you relied on to support the proposal that switching to a defined contribution plan for new members would be beneficial?*

As we discussed at our previous meeting, we believe that this topic is best discussed at the bargaining table. We have not relied on any particular studies.

17. *In light of the recent report by the City of San Jose on the negative trends in recruitment and retention, have you analyzed the potential negative impacts of this new plan on recruitment and retention of highly qualified workforce?*

At this time, the City has not conducted any formal analysis regarding the recruitment and retention impacts of the proposal. However, we believe that by not requiring new employees to enter into a retiree healthcare system that requires such a significant employee contribution, the City's proposal will assist with recruitment and retention.

18. *What studies and/or documents do you have on the impacts this new plan, and the subsequent freezing out of contributions from new members, may have on the ARC? In other words, please provide us with any and all documentation you have looked at that addresses the likely increase in overall ARC that will result as a result of new money coming in, and what the effect will be on City and member contributions.*

We have some information regarding the impact to the plan that we would be happy to discuss during our next meeting.

19. *If this plan were in effect today and the City were contributing 1% along with an employee contribution of 1%, what percentage of salary would new employees have to provide in order to receive the same benefits as received by current members? For the next five years, what is the projected dollar amount and percentage of salary equivalent that new members would have to pay to match to effectively have the same quality of retirement health benefits as current members?*

We do not have this information and we can discuss this question further at our next meeting.

20. *What would a 1% match from the City equate to in dollar amount today for new members under this proposal?*

It would depend on the base pay of the employee.

21. *What are the criteria for the City to match up to 1%?*

The employee would have to contribute at least 1% to the defined contribution program. The City would then match that amount up to 1%.

Section 11.1

22. *Why are you instituting a 4-tier rate structure?*

As we discussed, the current trend is to institute multiple tier structures. This provides employees with premiums that better match the number of dependents an employee has to cover under the healthcare plans.

23. *What is the basis, from an insurance premium point of view, of making a distinction between these four tiers?*

We are unclear as to your question and would be happy to discuss this during our next meeting.

Sincerely,



Alex Gurza
Deputy City Manager

c: John Mukhar, AEA President
Dale Dapp, AMSP President
Matt Farrell, CAMP President

Enclosures

**CITY OF SAN JOSE AND ASSOCIATION OF ENGINEERS AND ARCHITECTS,
IFPTE LOCAL #21
MEDIATION TENTATIVE AGREEMENT**

ARTICLE 12 RETIREMENT

~~12.1 The parties have not reached any agreement on the subject of retiree healthcare benefits. Therefore, the parties agree to continue to Meet and Confer regarding changes to these benefits notwithstanding Article 3 of this MOA. Current retirement benefits set forth in the Municipal Code will continue during the term of this Agreement unless modified pursuant to the Meyers Millias-Brown Act (MMBA).~~

~~The parties intend to engage in the foregoing negotiations in a coalition bargaining process with all other interested represented bargaining units, if any. However, negotiations between the City and AEA shall commence no later than March 2008 with or without the participation of any other bargaining unit. The City and AEA shall negotiate in good faith in an effort to reach a mutual agreement.~~

~~If no agreement is reached, the parties will follow the impasse procedures set forth in the City of San Jose's Employer-Employee Relations Resolution (#39367) and the MMBA. The City and AEA agree that impasse will not be declared any earlier than June 30, 2008. The City agrees that it will not unilaterally implement changes to retiree healthcare benefits for AEA until any changes to retiree healthcare benefits become effective for the Municipal Employees' Federation (MEF).~~

ARTICLE 12 RETIREE HEALTHCARE FUNDING

12.1 The City and the Employee Organization agree to transition from the current partial pre-funding of retiree medical and dental healthcare benefits (referred to as the "policy method") to pre-funding of the full Annual Required Contribution (ARC) for the retiree healthcare plan ("Plan"). The transition shall be accomplished by phasing into fully funding the ARC over a period of five (5) years beginning June 28, 2009. The Plan's initial unfunded retiree healthcare liability shall be fully amortized over a thirty year period so that it shall be paid by June 30, 2039 (closed amortization). Amortization of changes in the unfunded retiree healthcare liability other than the initial retiree healthcare liability (e.g. gains, losses, changes in actuarial assumptions, etc.) shall be determined by the Plan's actuary. The City and Plan members (active employees) shall contribute to funding the ARC in the ratio currently provided under Section 3.28.380 (C) (1) and (3) of the San Jose Municipal Code. Specifically, contributions for retiree medical benefits shall be made by the City and members in the ratio of one-to-one. Contributions for retiree dental benefits shall be made by the City and members in the ratio of eight-to-three. When determining the contribution rates for the Plan, the Plan actuary shall continue to use the Entry Age Normal (EAN) actuarial cost method and a discount rate consistent with the pre-funding policy for the Plan as outlined in this Article.

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[Signature]

**CITY OF SAN JOSE AND ASSOCIATION OF ENGINEERS AND ARCHITECTS,
IFPTE LOCAL #21
MEDIATION TENTATIVE AGREEMENT**

- 12.2 The City and the Employee Organization further agree that the Municipal Code and/or applicable plan documents shall be amended in accordance with the above agreement and that the Employee Organization will support such amendments.
- 12.3 It is understood that in reaching this agreement, the parties have been informed by cost estimates prepared by the Federated City Employees' Retirement System Board's actuary and that the actual contribution rates to reach full pre-funding of retiree healthcare will differ. The phase-in to the ARC shall be divided into five steps (using a straight line method), each to be effective on the first pay period of the City's fiscal year in each succeeding year. The first increment of the phase-in shall be effective on June 28, 2009. It is understood that because of changes resulting from future actuarial valuations, the amount of each increase may vary upward or downward. The City and Employee Organization agree that the Plan member cash contribution rate shall not have an incremental increase of more than .75% of pensionable pay in each fiscal year and the City cash contribution rate shall not have an incremental increase of more than .75% of pensionable pay in each fiscal year. For example, if the members' contribution rate is 4% of pensionable pay, the subsequent fiscal year's contribution rate for retiree healthcare cannot exceed 4.75% of pensionable pay. Notwithstanding the limitations on the incremental increases, by the end of the five year phase-in, the City and plan members shall be contributing the full Annual Required Contribution in the ratio currently provided under Section 3.28.380 (C) (1) and (3) of the San Jose Municipal Code.
- 12.4 The City will establish a qualified trust ("Trust") before June 27, 2010. Until such time as a Trust is established, the City and employee contributions under this agreement shall be made into the existing Medical Benefits Account for as long the contributions can be made into the Medical Benefits Account in accordance with IRS limitations. If the Trust is not established prior to reaching the IRS limitation, the parties agree to meet and discuss alternative funding vehicles.
- 12.5 It is the objective of the parties that the Trust created pursuant to this agreement shall become the sole funding vehicle for Federated retiree healthcare benefits, subject to any legal restrictions under the current plan, or other applicable law.

ARTICLE 3 AGREEMENT CONDITIONS

3.1.5 Healthcare Cost Mitigation.

3.1.5.1 Notwithstanding any other provision of this Agreement, the parties agree to commence meeting and conferring between January 1, 2010, and January 19, 2010, on retiree healthcare benefits for future employees and a medical reimbursement program for future retirees.

3.1.5.2 The parties intend to engage in the foregoing negotiations in a coalition bargaining process with all other interested represented bargaining units, if any. However, negotiations between the City and Employee Organization shall commence no later than January 19, 2010 with or without participation of any

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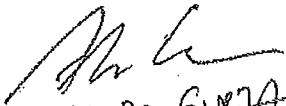
**CITY OF SAN JOSE AND ASSOCIATION OF ENGINEERS AND ARCHITECTS,
IFPTE LOCAL #21
MEDIATION TENTATIVE AGREEMENT**

other bargaining unit. The City and Employee Organization shall negotiate in good faith in an effort to reach a mutual agreement.

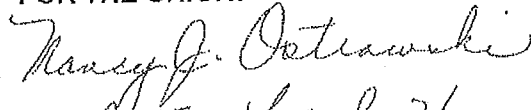
3.1.5.3 If no agreement is reached, the parties will follow the impasse procedures set forth in the City of San Jose's Employer-Employee Relations Resolution (#39367) and the Meyers-Millas-Brown Act. The parties understand that this means that, notwithstanding any other provision of this agreement, the City will have the right to unilaterally implement in the event that no agreement is reached at the conclusion of negotiations and mandatory impasse procedures. The City agrees that a unilateral implementation of retiree healthcare benefits for future employees shall not be effective before July 1, 2010.

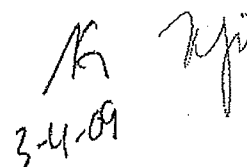
This agreement is still considered tentative and shall not be considered final or binding until ratified by the membership and approved by the City Council. This document sets forth the full agreements of the parties reached during confidential mediation. Anything not included in this document is not part of this tentative agreement. If this tentative agreement is not ratified by the membership or not approved by the City Council, the parties' positions will revert to the last on-the-record proposals prior to mediation. The provisions set forth above shall be incorporated in any successor Memorandum of Agreement.

FOR THE CITY:


ALEX GUERRA
3-4-09

FOR THE UNION:


Nancy J. Ostrowski
IFPTE Local 21
March 4, 2009


3-4-09

2009 CITY OF SAN JOSE – POA NEGOTIATIONS

CITY PROPOSAL

Proposal Retiree Healthcare Funding

Proposed Language

ARTICLE 50 RETIREE HEALTHCARE FUNDING (Current Article 50 and subsequent articles to be re-numbered)

- 50.1 The City and the Employee Organization agree to transition from the current partial pre-funding of police retiree medical and dental healthcare benefits (referred to as the "policy method") to pre-funding of the full Annual Required Contribution (ARC) for the police retiree healthcare benefits plan ("Plan"). The transition shall be accomplished by phasing into fully funding the ARC over a period of five (5) years beginning June 28, 2009. The Plan's initial unfunded retiree healthcare liability shall be fully amortized over a thirty year period so that it shall be paid by June 30, 2039 (closed amortization). Amortization of changes in the unfunded retiree healthcare liability other than the initial retiree healthcare liability (e.g. gains, losses, changes in actuarial assumptions, etc.) shall be determined by the Plan's actuary. The City and Plan members (active employees) shall contribute to funding the ARC in the ratio currently provided under Section 3.36.575 (C) (1) and (2) of the San Jose Municipal Code. Specifically, contributions for retiree medical benefits shall be made by the City and members in the ratio of one-to-one. Contributions for retiree dental benefits shall be made by the City and members in the ratio of three-to-one. When determining the contribution rates for the Plan, the Plan actuary shall continue to use the Entry Age Normal (EAN) actuarial cost method and a discount rate consistent with the pre-funding policy for the Plan as outlined in this Article.
- 50.2 The City and the Employee Organization further agree that the Municipal Code and/or applicable plan documents shall be amended in accordance with the above agreement and that the Employee Organization will support such amendments.
- 50.3 It is understood that in reaching this agreement, the parties have been informed by cost estimates prepared by the Police and Fire Department Retirement Plan Board's actuary, and that the actual contribution rates to reach full pre-funding of retiree healthcare will differ. The phase-in to the ARC shall be divided in five steps (using a straight line method), each to be effective on the first pay period of the City's fiscal year in each succeeding year. The first increment of the phase-in shall be effective on June 28, 2009. It is understood that because of changes resulting from future actuarial valuations, the amount of each increase may vary upward or downward. The City and Employee Organization agree that the Plan member cash contribution rate shall not have an incremental increase of more than 1.25% of pensionable pay in each fiscal year and the City cash contribution rate shall not have an incremental increase of more than 1.35% of pensionable pay in each fiscal year. For example, if the members' contribution rate is 4% of pensionable pay, the subsequent fiscal year's contribution rate for retiree healthcare cannot exceed 5.25% of pensionable pay.
- 50.4 If, at any time the calculated Plan member cash retiree healthcare contributions exceed 10% of pensionable pay or the calculated City cash retiree healthcare contributions

2009 CITY OF SAN JOSE – POA NEGOTIATIONS

exceed 11% of pensionable pay for the City (excluding implicit subsidy), the parties shall meet and confer on how to address any retiree healthcare contributions above 10% of pensionable pay for Plan members or 11% of pensionable pay for the City in order to fund the full ARC. Such discussions shall include alternatives to reduce retiree healthcare costs. If the parties are unable to agree on the manner in which to fully fund the retiree healthcare ARC (contributions exceeding 10% of pensionable pay for Plan members or 11% of pensionable pay for the City, excluding implicit subsidy), applicable impasse dispute resolution procedures shall apply.

Nothing in this Article shall be construed to obligate Plan members to pay more than 10% of pensionable pay or the City to pay more than 11% of pensionable pay to fund retiree healthcare.

- 50.5 The City will establish a qualified trust ("Trust") before June 28, 2009. If the Trust can not be established before June 28, 2009, then the City will hold in a separate reserve any required contributions over the policy method and then deposit, with interest actually earned, into the Trust as soon as practical after the Trust is established.
- 50.6 It is the objective of the parties that the Trust created pursuant to this agreement shall become the sole funding vehicle for Police retiree healthcare benefits, subject to any legal restrictions under the current plan, or other applicable law.

RETIREE HEALTHCARE FUNDING

ARTICLE 29 RETIREE HEALTHCARE FUNDING
(Current Article 29 and subsequent articles to be re-numbered)

- 29.1 The City and the Union agree to transition from the current partial pre-funding of fire retiree medical and dental healthcare benefits (referred to as the "policy method") to pre-funding of the full Annual Required Contribution (ARC) for the fire retiree healthcare benefits plan ("Plan"). The transition shall be accomplished by phasing into fully funding the ARC over a period of five (5) years beginning June 26, 2011. The Plan's initial unfunded retiree healthcare liability shall be fully amortized over a thirty year period so that it shall be paid by June 30, 2041 (closed amortization). Amortization of changes in the unfunded retiree healthcare liability other than the initial retiree healthcare liability (e.g. gains, losses, changes in actuarial assumptions, etc.) shall be determined by the Plan's actuary. The City and Plan members (active employees) shall contribute to funding the ARC in the ratio currently provided under Section 3.36.575 (C) (1) and (2) of the San Jose Municipal Code. Specifically, contributions for retiree medical benefits shall be made by the City and members in the ratio of one-to-one. Contributions for retiree dental benefits shall be made by the City and members in the ratio of three-to-one. When determining the contribution rates for the Plan, the Plan actuary shall continue to use the Entry Age Normal (EAN) actuarial cost method and a discount rate consistent with the pre-funding policy for the Plan as outlined in this Article.
- 29.2 The City and the Union further agree that the Municipal Code and/or applicable plan documents shall be amended in accordance with the above agreement and that the Union will support such amendments.
- 29.3 It is understood that in reaching this agreement, the parties have been informed by cost estimates prepared by the Police and Fire Department Retirement Plan Board's actuary, and that the actual contribution rates to reach full pre-funding of retiree healthcare will differ. The phase-in to the ARC shall be divided in five steps (using a straight line method), each to be effective on the first pay period of the City's fiscal year in each succeeding year. The first increment of the phase-in shall be effective on June 26, 2011. It is understood that because of changes resulting from future actuarial valuations, the amount of each increase may vary upward or downward. The City and Union agree that the Plan member cash contribution rate shall not have an incremental increase of more than 1.25% of pensionable pay in each fiscal year and the City cash contribution rate shall not have an incremental increase of more than 1.35% of pensionable pay in each fiscal year. For example, if the members' contribution rate is 4% of pensionable pay, the subsequent fiscal year's contribution rate for retiree healthcare cannot exceed 5.25% of pensionable pay.

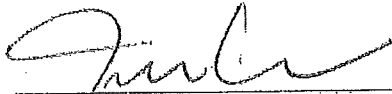
2011 CITY OF SAN JOSE -- SAN JOSE FIRE FIGHTERS, LOCAL 230

29.4 If, at any time the calculated Plan member cash retiree healthcare contributions exceed 10% of pensionable pay or the calculated City cash retiree healthcare contributions exceed 11% of pensionable pay for the City (excluding implicit subsidy), the parties shall meet and confer on how to address any retiree healthcare contributions above 10% of pensionable pay for Plan members or 11% of pensionable pay for the City in order to fund the full ARC. Such discussions shall include alternatives to reduce retiree healthcare costs. If the parties are unable to agree on the manner in which to fully fund the retiree healthcare ARC (contributions exceeding 10% of pensionable pay for Plan members or 11% of pensionable pay for the City, excluding implicit subsidy), applicable impasse dispute resolution procedures shall apply.

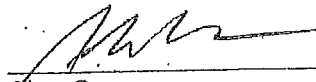
Nothing in this Article shall be construed to obligate Plan members to pay more than 10% of pensionable pay or the City to pay more than 11% of pensionable pay to fund retiree healthcare.

29.5 The City will establish a qualified trust ("Trust") by July 1, 2011.

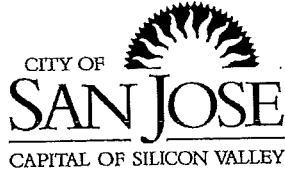
Tentatively Agreed on March 3, 2011



Jeff Welch
President
San Jose Fire Fighters, Local 230



Alex Gurza
Director of Employee Relations
City of San Jose



Memorandum

TO: HONORABLE MAYOR
AND CITY COUNCIL

FROM: Richard Doyle
City Attorney

SUBJECT: Ordinance to Implement New
Health Care Trust for Federated
City Employees' Retirement Plan

DATE: May 13, 2011

RECOMMENDATION

Consider an Ordinance amending Title 3 of the San José Municipal Code to add a new Chapter 3.52, and to amend Sections 3.28.380, 3.28.1980, 3.28.1995, 3.28.2030 and 3.28.2045 and add a new Section 3.28.385 to Chapter 3.28, for the purposes of establishing a new trust pursuant to section 115 of the Internal Revenue Code related to retiree health care benefit funding and payment of retiree health care benefits.

BACKGROUND

The Federated City Employees' Retirement Plan (the "Federated Plan") pays 100% of the premium cost for the lowest cost medical plan (Health Benefits) and the costs of dental premiums (Dental Benefits) for certain retired members and other persons who receive retirement allowances from the Federated Plan. The premium payments are currently made through a medical benefits account established by the City Council under Section 401(h) of the Internal Revenue Code (IRC). The 401(h) account is funded by contributions made by the City and active employees.

Through fiscal year 2009, contributions to the Federated Plan's medical benefits account for Health and Dental Benefits for both the City and the participating Federated employees were based upon an actuarially determined percentage of employees' base salary sufficient to provide adequate assets to pay benefits when due over the next 15 years. In April, 2009, the City reached agreements with ABMEI, AEA, AMSP, CAMP, IBEW, MEF, and CEO to phase in to full funding of the annual required contributions (ARC) for the Health and Dental Benefits over a five year period. The ramp up to full funding specified in these agreements was also implemented for unrepresented employees. These agreements provide that the initial unfunded retiree healthcare liability will be fully amortized over a thirty year period so that it will be paid by June 30, 2039.

The agreements also provide that the five year phase-in of the ARC will not have an incremental increase of more than 0.75% of pensionable pay in each fiscal year for the employee contributions and the City cash contribution rate will not have an incremental

increase of more than 0.75% of pensionable pay in each fiscal year. Notwithstanding these limitations on incremental increases, the agreements further provide that by the end of the five year phase-in, the City and the members "shall be contributing the full Annual Required Contribution in the ratio currently provided" in the relevant sections of the San José Municipal Code.

Section 401(h) of the 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 affect the ability to implement full funding of the ARC, the April 2009 agreements with the 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.

Earlier this year, the City Attorney's Office engaged Ice Miller, LLP, as outside tax counsel, to assist with preparation of trust documents for both the Federated Plan and the Police and Fire Department Plan. The ordinance that has been drafted for the Council's consideration includes Municipal Code amendments to implement a qualified trust as contemplated by the April 2009 agreements with the bargaining units. The Federated Trust Ordinance is being presented at this time in order to have a trust in place to receive contributions before the 401(h) limit is reached for the Federated Plan. Separate ordinances for Police and Fire will be presented to the City Council prior to the end of the fiscal year. The City Attorney's Office has been advised by staff that the limit on funding the 401(h) account for the Police and Fire Plan is not expected to be reached in the next fiscal year.

ANALYSIS

The draft ordinance would establish a new trust fund pursuant to Section 115 of the internal Revenue Code. The ordinance as drafted contains the following key provisions:

- The new Trust Fund would be administered by a Board of Trustees composed of the Board members of the Federated City Employees Retirement Plan.

- City contribution for retiree health care would begin to be deposited in the new Trust Fund effective July 1, 2011, assuming the proposed ordinance is adopted by the City Council no later than May 31, 2011.
- Employee contributions would continue to be deposited into the existing 401(h) account until a private letter ruling has been obtained from the Internal Revenue Service confirming that the employee contribution can go into the new trust on a pretax basis. A request for a private letter ruling will be filed as soon as the ordinance is approved. Retirement Services staff has indicated that the Federated employee contributions can continue to go into the 401(h) account for at least some portion of fiscal year 2011-12 without violating IRC Section 401(h). If, for any reason, a private letter ruling cannot be obtained before the limit will be reached, the City Attorney's Office and staff will return to Council with a recommendation on how to continue the ramp up to full funding.
- As long as the employee contributions continue to be deposited into the 401(h) account, employees who take a return of contributions from the Plan (usually those with less than 5 years of service) will continue to receive an extra payout amount from the pension fund in the amount of their contributions to the medical benefits account plus 2 % interest. After employee contributions start being deposited in the new trust fund, this extra payout will cease, as the Trust Fund and Pension Fund are two completely separate funds; and direct payment for qualified 115 trusts can only be made for health and welfare benefits.
- Retiree health premium payments would continue to be paid out of the medical benefits account until it is exhausted, unless the new Board of Trustees determines that some or all of the premium payment should be made out of the new Trust Fund. The purpose of this provision is to ensure that there is a default provision for ensuring that premium payments will continue to be made, while providing the trustees with flexibility for liquidating investments in the existing medical benefits account.
- The ordinance retains current Code language regarding the nature of the health benefit provided to retirees and other persons who receive retirement allowances from the Federated Plan (lowest cost plan premium for medical).
- The ordinance retains current Code language regarding contribution rates for medical and dental benefits (this section has been renumbered, but not altered).

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 19, 2011 meeting; and the ordinance will be placed on the City Council agenda of May 24 or 31, 2011 for adoption.

POLICY ALTERNATIVES

The City and employees cannot continue to ramp up to full funding for retiree health care within the existing Federated Retirement Plan structure. The 2009 agreements with the bargaining units specify that the City will establish a trust to implement the ramp up to full funding for retiree health care. For these reasons, other alternatives have not been considered at this time. As indicated above, if for any reason, a private letter ruling concerning the pre-tax status of employee contributions to the new trust fund cannot be obtained before the limit will be reached, the City Attorney's Office and staff will return to Council with a recommendation on how to continue the ramp up to full funding.

PUBLIC OUTREACH/INTEREST

The draft ordinance was posted for public review prior to the Council meeting. 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

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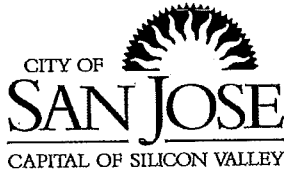
Not a Project; File No. PP10-068(b), Municipal Code or Policy.

RICHARD DOYLE
City Attorney

By Mollie Dent
MOLLIE DENT
Sr. Deputy City Attorney

cc: Debra Figone
Russell Crosby
Scott Johnson
Alex Gurza

For questions, please contact Mollie Dent, Sr. Deputy City Attorney, at (408) 535-1905.



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

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

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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

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