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June 29, 2012

REPORT TO THE HONORABLE MAYOR AND CITY COUNCIL
IMPLEMENTATION OF PROPOSITION B

INTRODUCTION

This Report provides further information regarding the implementation of the defined contribution plan (DC Plan) for new hires under Proposition B, as discussed in this Office's June 7, 2012 Report to the Honorable Mayor and City Council. Specifically, this Report, along with the attached Memorandum prepared by Marcus Wu, the City's outside employee benefits counsel, addresses questions that have been raised related to mandatory Social Security Coverage in the event that the City hires employees who are not covered by a Safe Harbor retirement plan.

QUESTIONS PRESENTED

1. If the City does not impose a hiring freeze after Proposition B becomes effective, and proceeds to hire employees (other than sworn police officers) before a DC Plan is adopted, will those employees be covered by Social Security?
2. If so, what happens once the City adopts a DC Plan that covers the employees who are participating in Social Security?

SHORT ANSWERS

1. Yes. By operation of federal law, any employee the City hires who is not covered by a Safe Harbor retirement plan must be covered by Social Security. The City and the employee will each be required to pay Social Security taxes equal to 6.2% of the employee's compensation, up to the Social Security wage base (which is \$110,100 for 2012).
2. If the City ultimately adopts a DC Plan that meets the Social Security Safe Harbor requirements, and makes that plan available to the employees then participating in Social Security, the employees' compensation will no longer be subject to Social Security taxes.

ANALYSIS

San Diego Charter (Charter) section 140, which was added by Proposition B, states that all officers and employees (except "sworn police officers") who are initially hired or assume office on or after the effective date of Charter section 140 may "participate only in such Defined

Contribution Plans as authorized by Sections 150 and 151 of this Charter.” As discussed in this Office’s June 7, 2012 Report (the June 7 Report), this means that as soon as Proposition B takes effect, which could be as early as mid or late-July, all new City officers and employees (other than sworn police officers) will be ineligible to participate in the defined benefit plan (DB Plan). If these employees are not covered by a Safe Harbor DC Plan for some period of time, the employees and the City will be required to pay Social Security taxes on the employees’ compensation.

The City cannot adopt either an interim or a permanent DC Plan for new employees represented by an affected employee organization without first engaging in meet and confer.¹ However, the City should immediately adopt an interim Safe Harbor DC Plan for new unrepresented employees, so that these new hires will be covered by a retirement plan until the negotiated plan is adopted.

Charter section 150 (added by Proposition B) sets the parameters of the new DC Plan, including any interim plan, limiting the City’s contributions on behalf of elected officers and most employees to 9.2% of the officer or employee’s compensation. Employer contributions for “uniformed safety officers” are limited to 11% of the officer’s compensation. These are the maximum contributions the City may pay; section 150 does not set a minimum level for employer contributions.

Section 150 also states that the new DC Plan must meet the legal requirements for the City to retain its Social Security safe harbour status, “unless the City enrolls in the Social Security System.” If the City decides to “re-enroll” in Social Security, the City’s “total cost for retirement benefits” (the combined total of the Social Security taxes paid on an employee’s behalf and the City’s contributions to that employee’s DC Plan account) may not exceed the 9.2% and 11% limits.

As discussed on page 7 of the June 7 Report, there are two ways that City employees may become covered by Social Security: (1) voluntary coverage, and (2) mandatory coverage.

Voluntary Social Security Coverage

Section 150 authorizes the City to “re-enroll” in Social Security, subject to limitations on total City contributions. This provision appears to address voluntary Social Security coverage. Under voluntary coverage, the City may elect to “re-enroll” some or all of its new employees in Social Security, in addition to offering them a Safe Harbor DC Plan. But, before it could do so, the City must hold a referendum of the affected employees, which would be conducted by the Social Security Administrator. The referendum could be conducted on a majority or divided vote basis, as described more fully in the June 7 Report. Under either type of referendum, all

¹ As discussed in the June 7 Report, Proposition B requires the Council to determine the details of the new DC Plan, including the level of employer and employee contributions, the vesting period for employer contributions, whether the plan will replace Social Security, and the types of death and disability benefits that will be provided to participants. These discretionary decisions are subject to meet and confer. Before the DC Plan or Plans may be implemented for represented employees, the City must complete the meet and confer process with its impacted employee organizations to agreement or impasse and exhaustion of impasse procedures.

future eligible employees would be covered by Social Security. For example, if the City held a referendum and re-enrolled all employees covered by the new DC Plan in Social Security, all future employees covered by the new DC Plan would have to be covered by Social Security. The enrolment of this class of employees would be irrevocable.

Mandatory Social Security Coverage

Mandatory Social Security coverage operates much differently. As discussed in the June 7 Report, the wages of a state or local government employee whose employer has withdrawn from Social Security² are subject to Social Security taxes unless the employee is a "member of a retirement system" maintained by the governmental employer that provides at least a minimum level of retirement benefits.³ As discussed in the June 7 Report and in Mr. Wu's Memorandum, a DC Plan satisfies the minimum retirement benefit requirement with respect to an employee for periods during which at least 7.5% of the employee's compensation is allocated to his or her retirement account.⁴ The 7.5% requirement applies only up to the Social Security wage base,⁵ which is \$110,100 for 2012.⁶

This Office has recommended that the City: (1) immediately adopt an interim Safe Harbor Plan for unrepresented employees hired after Proposition B becomes effective, and (2) implement a hiring freeze for represented positions, other than sworn police officer positions, until a negotiated Safe Harbor Plan is adopted. The negotiated plan could be an interim plan to cover represented employees while a more comprehensive plan is negotiated.

If the City does not implement a hiring freeze, and proceeds to hire employees (other than sworn police officers) after Proposition B is in effect, but before a Safe Harbor DC Plan is adopted, the employees will be covered by Social Security by operation of federal law. The City will be required to pay Social Security taxes equal to 6.2% of the employee's compensation up to the Social Security wage base. The City will also be required to withhold 6.2% in Social Security taxes from the employee's compensation (up to \$110,100).⁷

As explained in Mr. Wu's Memorandum, the City and the employee may never see any benefit from the Social Security taxes, especially if the employee is ultimately covered by a Safe Harbor plan.⁸ But, if an interim Safe Harbor Plan is adopted for unrepresented employees, and can be negotiated and adopted for represented employees, the City and employees' contributions

² The City withdrew from Social Security effective January 1, 1982. *See* San Diego Resolution R-255609 (Jan. 4, 1982).

³ I.R.C. § 3121(b)(7)(F).

⁴ Treas. Reg. § 31.3121(b)(7)-2(e)(2)(iii)(A). For this purpose, the definition of compensation "must be no less inclusive than the definition of the employee's base pay"; overtime, bonuses, and certain single-sum payments may be disregarded. Treas. Reg. § 31.3121(b)(7)-2(e)(iii)(B).

⁵ *See* Treas. Reg. § 31.3121(b)(7)-2, example under subsection (e)(2)(iii)(B), which confirms that once an employee reaches the wage base, he or she is a qualified participant in the plan for the entire year "without regard to whether the employee ceases to participate at any time after reaching the maximum contribution base."

⁶ Section 1.401(l)-1(c)(34) of the Treasury Regulations defines the taxable wage base as the contribution and benefit base under section 230 of the Act. Rev. Ruling 2012-5 sets the wage base for 2012 at \$110,100.

⁷ For 2011 and 2012, the employee's share has been temporarily reduced to 4.2%.

⁸ This is because an employee must generally have at least 40 quarters in Social Security to receive a benefit.

June 29, 2012

will be credited to the employee's DC Plan account. While the employer's contributions may be subject to a vesting schedule, the employee's contributions would be non-forfeitable immediately, whereas the Social Security taxes paid by the City and the employee are essentially "forfeited" if the employee never qualifies for a benefit from Social Security.

JAN I. GOLDSMITH, CITY ATTORNEY

By: _____/s/_____
Roxanne Story Parks
Deputy City Attorney

RSP:mr

Attachment

cc: Andrea Tevlin, Independent Budget Analyst
 Scott Chadwick, Director of Human Resources Department

RC-2012-17

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Memorandum

TO: Jan Goldsmith
Roxanne Story Parks

FROM: Marcus Wu *MW*

DATE: June 28, 2012

RE: Application of Social Security Taxes to Future Employees

This memorandum discusses the application of Social Security taxes to employees hired by the City of San Diego on or after Proposition B's effective date.¹

A. Overview of Social Security Taxation of City Employees

The City does not participate in the federal Social Security tax system. Under the tax laws governing non-participating employers such as the City, an employee's City compensation is exempt from Social Security taxes only if the employee is covered by a qualifying retirement system — that is, a "Safe Harbor Plan" — maintained by the City.² By contrast, if the employee is not covered by a Safe Harbor Plan, his or her City compensation is subject to Social Security taxes.³ These rules are discussed below in light of Proposition B.

B. Safe Harbor Plan — No Social Security Taxes

SDCERS, a defined-benefit plan, qualifies as a Safe Harbor Plan. This means that all City employees covered by SDCERS are exempt from Social Security taxes on their City compensation.

Proposition B, however, generally excludes new hires (other than sworn police officers) from SDCERS, requiring that they be covered by a defined-contribution plan, or DC plan.

The City maintains two DC plans that qualify as Safe Harbor Plans: (1) the SPSP-H, and (2) the SPSP (for elected officials). Generally, the SPSP-H covers the City's part-time and hourly employees. The SPSP generally covers elected officials and non-safety employees hired before July 1, 2009, but qualifies as a Safe Harbor Plan only for elected officials. (This is because the allocations provided under the SPSP to other participants are less than required minimums discussed below.)

¹ The memorandum addresses only the relevant tax laws. It does not address other legal topics, including but not limited to any obligation that the City may have to meet and confer regarding the new defined-contribution plan or the application of Social Security taxes.

² Internal Revenue Code (IRC) § 3121(b)(7)(F).

³ *Id.*

Memorandum To:
Jan Goldsmith
Roxanne Story Parks
June 28, 2012
Page 2

In sum, the City has three Safe Harbor Plans: SDCERS, SPSP-H, and SPSP (for elected officials). City compensation earned by employees covered by these plans is exempt from Social Security taxes.

C. No Safe Harbor Plan — Mandatory Social Security Taxes

If a City employee is *not* covered by a Safe Harbor Plan, Social Security taxes are mandatory. In other words, the employee's City compensation up to the Social Security wage base (\$110,100 for 2012) is, by law, subject to Social Security taxes.⁴ Consequently, the City must pay Social Security taxes equal to 6.2% of the employee's compensation up to the limit; and, the employee also must pay 6.2%, which would be deducted by the City from his or her compensation.⁵

D. Social Security Consequences of Gap Period for New Employees

Most employees hired after Proposition B's effective date will not be covered by any of the City's current Safe Harbor Plans.

More specifically, except for sworn police officers, none will be covered by SDCERS due to Proposition B. The SPSP or SPSP-H will cover any new employees who fit in one of the limited eligibility classifications — i.e., part-time and hourly employees or elected officials — but the majority of new employees will be full-time and therefore ineligible for SPSP or SPSP-H under these plans' current terms.

I understand that the new DC plan mandated by Proposition B will be designed to qualify as a Safe Harbor Plan. But because of meet-and-confer requirements, it could take a substantial period for the City to adopt the new DC Plan. Consequently, in the interim, there will be a "gap period" during which most new employees hired by the City will not be covered by any Safe Harbor Plan and will therefore be subject to Social Security taxes.

Absent a hiring freeze, the City has two options regarding these employees:

1. Do nothing, in which case each employee's City compensation during the gap period would be subject to Social Security taxes; or
2. Add the new employees to a DC Safe Harbor Plan, in which case each employee's City compensation would be exempt from Social Security taxes. (The DC Safe Harbor Plan for these employees can be added to one of the City's existing DC plans, such as the SPSP-H.)

⁴ IRC § 3121(b)(7)(F).

⁵ For 2011 and 2012, the employee's share has been temporarily reduced to 4.2%, reducing each year's aggregate Social Security taxes from 13.4% to 10.4%.

Memorandum To:
 Jan Goldsmith
 Roxanne Story Parks
 June 28, 2012
 Page 3

If the City implements a DC Safe Harbor Plan *after* any new employee's hire date, the employee's compensation will be subject to Social Security taxes until the employee is covered by the Safe Harbor Plan, at which point Social Security taxes would no longer apply.

The following table compares some of the significant features associated with the two options:

	Option 1: No Safe Harbor Plan for New Employees	Option 2: DC Safe Harbor Plan ⁶ for New Employees
Social Security taxes	Employees not covered by a Safe Harbor Plan are subject to Social Security taxes	Covered employees are exempt from Social Security taxes
Required contributions	<p>In the aggregate, Social Security taxes equal 13.4% of the employee's "compensation" up to the Social Security wage base (which for 2012 is \$110,100), of which the employee and City must each pay 6.2%.⁷</p> <p>Compensation for this purpose includes overtime,⁸ which I understand can be significant for certain employees.</p>	<p>Aggregate allocations to an employee's account under a Safe Harbor Plan must equal at least 7.5% of the employee's "compensation" up to the Social Security wage base (which for 2012 is \$110,100). The allocations may come from employer contributions (e.g., 7.5% City contribution), employee contributions (e.g., mandatory 7.5% deduction from the employee's compensation), or a combination of both (e.g., 3.75% each).</p> <p>Compensation for this purpose generally may be defined more narrowly than for Option 1. For instance, the City may exclude overtime for the 7.5% calculation, as long as overtime does not constitute pensionable compensation under SDCERS.⁹</p>

⁶ Please note that a DC plan must satisfy certain other requirements not discussed below in order to constitute a Safe Harbor Plan, including minimum earnings requirements for assets under the plan. For a detailed explanation of these requirements, please see the City Attorney's memorandum dated June 7, 2012, to the Mayor and City Council.

⁷ Same as footnote 5.

⁸ IRC § 3121(a).

⁹ Treas. Reg. § 31.3121(b)(7)-2(e)(2)(iii)(B).

Memorandum To:
 Jan Goldsmith
 Roxanne Story Parks
 June 28, 2012
 Page 4

	Option 1: No Safe Harbor Plan for New Employees	Option 2: DC Safe Harbor Plan ⁶ for New Employees
Vesting	A person generally must have Social Security wages for at least 40 calendar quarters in order to qualify for Social Security benefits. ¹⁰ If the person never reaches 40 quarters, he or she generally is not entitled to Social Security benefits; any Social Security taxes paid by the person — or for him or her by the employer — would effectively be forfeited.	Under the City's two current Safe Harbor Plans — the SPSP-H and SPSP (for elected officials) — any <i>employee</i> contributions are 100% vested, so the employee will receive benefits from his or her contributions. If it wishes, the City may impose a vesting schedule on any City contributions for new employees; ¹¹ however, City contributions for part-time, seasonal, and temporary employees must always be 100% vested. ¹²
Implementation	I understand that the City's payroll department is not currently equipped to administer Social Security taxes, and that it could take a substantial period to update the system for this purpose.	If the City adds these employees to SPSP-H, its existing Safe Harbor DC Plan, the payroll department should be able to implement the change.
Next steps	If the City selects Option 1, the City should coordinate with the payroll department as soon as possible to determine the earliest possible implementation date.	If the City selects Option 2, it would need to decide certain parameters for the Safe Harbor Plan. These include the vesting schedule for City contributions; the contribution levels; and, whether to add the Safe Harbor Plan to the SPSP-H or another existing City DC plan. Once the City determines the parameters, it should notify the City Attorney's Office and the payroll department so that both may begin implementing the City's decisions.

¹⁰ Social Security Act § 214(a).

¹¹ City contributions under the SPSP are subject to vesting at 20% per year of service, until 100% vesting after five years of service. SPSP § 8.02. As required by the tax laws, City contributions under the SPSP-H, which currently covers only hourly and part-time employees, are 100% vested at all times. If the City adds new employees to the SPSP-H, it could impose any vesting schedule of its choosing on City contributions made for any employees who are not part-time, seasonal, or temporary.

¹² Treas. Reg. § 31.3121(b)(7)-2(d)(2)(i).

Memorandum To:
Jan Goldsmith
Roxanne Story Parks
June 28, 2012
Page 5

	Option 1: No Safe Harbor Plan for New Employees	Option 2: DC Safe Harbor Plan ⁶ for New Employees
		The City Attorney's June 2012 memorandum provides further details about the parameters. ¹³ We would be happy to help further define them, if you wish.

* * *

If you have any questions about this memorandum, please contact Marcus Wu, (415) 995-5829, mwu@hansonbridgett.com.

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¹³ Referenced in footnote 6.