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### REPORT TO CITY COUNCIL

### SUMMARY OF AMENDMENTS TO CITY OF SAN DIEGO 401(K) PLAN

### INTRODUCTION

This Report summarizes the proposed amendments to the City of San Diego 401(k) Plan (Plan). All of the proposed changes are shown in the strike-out/redline version of the Plan, which is included in the back up materials for the “Resolution of the Council of the City of San Diego Approving the Amended and Restated City of San Diego 401(k) Plan.” The City’s negotiating team provided the recognized employee organizations with a memorandum summarizing the proposed amendments, a strikeout redline version of the Plan showing the changes, and a clean version of the Plan as amended. In addition, the negotiating team met with the representatives of the employee organizations to explain and discuss the proposed amendments. They had no objections to any of the proposed changes.

The propose amendments fall into the following three categories:

- A. Substantive and Discretionary Amendments: These changes are advisable and benefit employees and the City, but they are not required to keep the Plan in compliance with federal tax law.
- B. Legally-Mandated Changes: These changes are necessary to comply with State or federal law, or to maintain the Plan’s tax qualification. They are required either because of a change in law, or because the operation of the Plan has changed.
- C. Non-Substantive Amendments: These changes are intended to make the Plan more intelligible and user friendly, both for employees and the City staff charged with administering the Plan. The vast majority of the proposed amendments fall into this third category.

### I. SUBSTANTIVE, DISCRETIONARY CHANGES

- A. Sections 2.02 (Participation in the Plan) and 3.01 (Participant Contributions): These sections must be amended to allow employees to contribute Flexible Benefits credits directly to the 401(k) Plan. The San Diego City Council (Council) approved a corresponding amendment to the City’s Flexible Benefits Plan on April 21, 2015.

- B. Section 3.08 (Rollover Contributions): This amendment would allow the Plan to accept rollover contributions from other “qualified retirement plans,” such as San Diego City Employees’ Retirement System (SDCERS), Supplemental Pension Savings Plan (SPSP), and Supplemental Pension Savings Plan for Hourly Employees (SPSP-H). Employees would be able to roll over lump sum distributions from SDCERS into their 401(k) Plan accounts at termination or retirement, including their DROP account at retirement or employee contribution account balances at separation. Refunds of SDCERS surviving spouse contributions at retirement would also qualify, as well as any pre-tax amounts from the SPSP and SPSP-H Plans (currently only employer contributions). The amendment adds options for employees, and does not eliminate any options employees currently have.
- C. Section 5.02 (Investment of Funds): This amendment would give the 401(k) trust fund more flexibility as to where the funds may be invested. Specifically, the Plan would be able to offer the SDCERS trust fund as an investment option (subject to approval by the City Council, the Board of Administration for SDCERS, and the City’s Defined Contribution Plans Board). Similar amendments are contemplated for the SPSP and SPSP-H Plans. This amendment would not eliminate any investment options for employees, former employees or beneficiaries.
- D. Section 6.01 (Hardship Withdrawals): This section would be amended to conform to the federal safe harbor rules for hardship withdrawals.

A 401(k) plan may, but is not required to, provide for hardship distributions. If the plan does so, it must set forth the specific criteria used to make a hardship determination.

To qualify for a hardship distribution: (1) the employee must have “an immediate and heavy financial need,” and (2) the distribution cannot exceed the amount necessary to satisfy the financial need. The need of the employee includes the need of the employee’s spouse, dependent, or beneficiary. It may include the need of the employee’s domestic partner, but only if the partner is either the employee’s beneficiary or tax dependent.

Under the safe harbor method, there are six expense categories that the IRS automatically deems to be immediate and heavy:

1. medical expenses;
2. costs relating to the purchase of a principal residence;
3. tuition and related educational fees and expenses;
4. payments necessary to prevent eviction from, or foreclosure on, a principal residence;
5. burial or funeral expenses; and
6. expenses for the repair of damage to the employee’s principal residence.

The 401(k) Plan currently does not satisfy the safe harbor. Fortunately, however, very little modification to the City's Plan is required. The only significant change is the addition of a provision imposing a six-month suspension of elective deferrals and voluntary contributions to the City's defined contribution plans after a hardship withdrawal. But, the Plan already provides that a participant cannot receive a hardship withdrawal without demonstrating that his or her financial need cannot be relieved by, among other things, stopping voluntary contributions to all City plans.

The safe harbor rules recognize that hardship withdrawals should be avoided except as a last resort. Because hardship withdrawals cannot be repaid, the employee's retirement account is permanently reduced by the amount of the withdrawal. In addition, the employee must pay income taxes on the withdrawal, plus a 10% early withdrawal penalty on in-service withdrawals (unless the employee is over 59 ½ or the distribution is to pay medical expenses).<sup>1</sup>

E. Section 7.01 (Distribution of Benefits Upon Retirement, Disability, Death, or Other Termination of Employment):

1. This section would be amended to add distribution options for terminated or retired participants. Currently, the Plan states that the benefits will be distributed "in a single lump sum cash payment or in substantially equal installments." The proposed amendment would allow a former employee to receive his or her benefits in (1) a lump sum, (2) two or more partial distributions, or (3) a series of substantially equal payments. This adds flexibility for participants, and does not eliminate any options they currently have.
2. The amendments in section 7.01 subsection (c) benefit participants who have designated beneficiaries who are not their spouses. This would extend the deadline for a participant's non-spouse beneficiary to take a full distribution of his or her interest in the participant's account, from one year to five years after the participant's date of death. This amendment provides non-spouse beneficiaries the maximum flexibility permitted under federal tax law.

F. Section 8.07 (Claims Procedures): This section would be amended to give participants one year to file a civil action from the date the appeal of his benefit claim is denied by the Plan Administrator.

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<sup>1</sup> For illustration, an employee who is under 59½, and in the 25% federal income tax bracket, must withdraw more than \$15,000 to net \$10,000 after taxes and penalties.

- G. Section 12.03 (Qualified Domestic Relations Orders): This section would be amended to follow federal qualified domestic relations order (QDRO) rules when administering domestic relations orders (DROs), allowing the IRS to treat the DROs as “qualified.” California law would also apply. This change would protect participants by ensuring that the tax liability on amounts awarded to a former spouse transfers to the former spouse. In addition, once the plan assets are split pursuant to a finalized QDRO, the former spouse would be able to take a distribution, including a direct rollover to another plan, even if the participant is still employed by the City. This change would have no impact on participants, since the funds are already segregated and removed from the participant’s account at this point.

## **II. MANDATORY AMENDMENTS FOR TAX QUALIFICATION, OR TO COMPLY WITH STATE OR FEDERAL LAW**

- A. Sections 4.02 (Allocation of Investment Earnings and Losses), 5.01 (Investment of Funds), and 5.03 (Valuation of Investments): These amendments are required to be included in plans that allow participant-directed investments. Additional changes are needed because the Plan now has daily valuation of accounts.
- B. Section 4.03 (Limitation on Annual Additions): This amendment adds required language regarding coordination with other City defined contribution (DC) plans in determining whether a participant has reached the aggregate limit on annual additions to all qualified DC plans maintained by an employer.
- C. Section 7.05 (Direct Rollover to an Eligible Retirement Plan): This section is renumbered to section 7.02. The amendment to subsection (b) is required because federal tax law no longer distinguishes between a 401(k) and a non-401(k) hardship withdrawal, for purposes of defining an eligible rollover distribution. Also, required language must be added to subsection (c) regarding non-spouse beneficiaries.
- D. Section 7.04 (Required Minimum Distributions): Federal legislation permitted qualified plans to allow participants to waive their required minimum distributions in 2009, which was at the height of the financial crisis. Plans wishing to offer this option were required to add language permitting this into their plan documents. The Plan allowed participants to waive their 2009 required minimum distributions, but the Plan was never amended to allow this. The City must now retroactively amend the 401(k) Plan (and the City’s other defined contribution plans) to permit this.
- E. Section 8.02 (Powers and Duties of the Plan Administrator): This section must be amended to conform to State law allowing DROs for dissolution of registered domestic partnerships, and to conform to federal law allowing QDROs for child support.

### III. EXAMPLES OF NON-SUBSTANTIVE CHANGES

- A. Article I (Definitions): A number of defined terms should be deleted, because they are not used elsewhere in the Plan or are not applicable to the 401(k) Plan. By way of example, the following terms should be eliminated: (1) break-in-service, hour of service, service, inactive participant (these terms do not apply because there is no vesting schedule in this Plan – the terms *do* apply to the SPSP plan, and were probably copied from that plan in error), (2) highly compensated employee (this term is part of the nondiscrimination rules, which apply only to private sector plans), (3) investment income or loss, limitation year (these terms are not used anywhere else in the plan), (4) normal retirement age (this Plan is not required to have a normal retirement age because all contributions are employee contributions that are fully vested at all times, and employees cannot take distributions at normal retirement age without separating service), (5) co-trustees (the “co” is unnecessary), and (6) prospective beneficiary (there is no need to distinguish between beneficiaries and prospective beneficiaries).
- B. Section 2.04 (Employment after Normal Retirement Age): This provision, which states that a participant who reaches normal retirement age continues to be a participant, is not needed because all employees may participate in the 401(k) Plan regardless of age, and there are no provisions in the Plan that indicate otherwise.
- C. Section 2.05 (Transfer to Ineligible Status): This section should be amended to clarify that an employee who terminates City employment or retires may leave his or her funds on account, and may continue to direct the investment of his or her funds in the 401(k) Plan.
- D. Sections 7.01 through 7.04 (Distributions): These sections are consolidated into one section addressing distributions, rather than repeat the same language in separate sections for each type of distribution.
- E. Section 8.08 (Correction of Administrative Errors): This section should be amended to remove the reference to the Department of Labor, which has no jurisdiction over governmental plans, which are exempt from the Employee Retirement Income Security Act of 1974 (ERISA).

**CONCLUSION**

Most of the amendments contained in the proposed Amended and Restated City of San Diego 401(k) Plan are intended to make the Plan more intelligible and user friendly for employees and City staff. All substantive changes are legally required or intended to benefit Plan participants, or both. None of the City's employee organizations has objected to any of the proposed changes.

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