

MEMORANDUM OF LAW

DATE: June 25, 1990

TO: Larry Grissom, Retirement Administrator
FROM: City Attorney
SUBJECT: Impact of Section 415(b)(10) of the Internal Revenue Code of 1986 On The City Employees' Retirement System

You have asked if the recent benefit changes to the City Employees' Retirement System (CERS) will have any effect on the City of San Diego's ability to adopt the "amnesty" or "grandfather" provisions of Section 415(b)(10) of the Internal Revenue Code of 1986 (IRC).

BACKGROUND

Prior to July 1988 the "final compensation" used to calculate retirement benefits for a member of CERS consisted of the average of the retiree's highest three years of base compensation. San Diego Municipal Code section 24.0103(1). Since July 1, 1988, a safety member's "final compensation" consists of the highest one year of base compensation. On July 1, 1989, general members of CERS received the same benefit.

IRC section 415 was added to the Internal Revenue Code in 1976. It was amended by the Tax Reform Act of 1986 and by the Technical and Miscellaneous Revenue Act of 1988 (TAMRA). It contains rules designed to limit the benefits payable to a retiree under a tax qualified retirement plan. The TAMRA amendments codified at 26 U.S.C. 415(b)(10) contain the "amnesty" or "grandfather" provisions mentioned in your question. The "amnesty" or "grandfather" provisions were adopted when Congress realized that most state and local government plans exceeded the benefit limits of IRC section 415 and therefore could not meet the statutory limits without breaching their contractual obligations to their employees under the pension plan.

CERS has until June 30, 1991, (the close of the first plan year beginning after December 31, 1989) to adopt the "amnesty" or "grandfather" provisions or be forever bound by the private sector limitations found in IRC section 415(b). The "amnesty"

or "grandfather" provisions state that any individual who first became a retirement system member before January 1, 1990, may receive whatever benefit was provided for by the plan under the plan in effect on October 14, 1987, whether or not that benefit exceeds the current IRC section 415(b) limits. The high one year benefit was adopted by CERS after October 14, 1987, and therefore

is not protected by the "amnesty" or "grandfather" provisions. The benefit may still be payable, provided it does not exceed the benefit limitations found in IRC section 415(b) or the benefit level in effect on October 14, 1987, whichever is applicable. CERS will lose its tax qualified status if it violates the maximum limitation on benefits rule. The "amnesty" issue is therefore an important one.

As a condition of "amnesty," all new members of CERS who become participants after January 1, 1990, must meet the new standards. There are special limits for police and firefighters, but lifeguards, who are members of the CERS safety system, are not covered under those special provisions. It should be remembered at this point that the limits set forth in IRC section 415(b) apply to the annual benefit payable under a defined benefit plan that is attributable solely to pre-tax employer contributions, including all IRC section 414(h) "pickups" through the salary ordinance or the Management Benefit Plan (MBP).

You should also be aware that the various definitions of compensation found in the IRC do not comport with the CERS definition of base compensation. For example, deferrals to an IRC section 457 deferred compensation plan do not appear at this time to be eligible for inclusion in the definition of compensation for IRC section 415 formula testing purposes, pursuant to temporary Treasury Regulation 1.415-2. However, almost all forms of compensation, including flexible benefits, management benefits, 414(h) pickups and 401(k) deferrals, are included in temporary Treasury Regulation 1.414(s)-1T for the purpose of discrimination testing under IRC section 401(a). Both of these definitions include other forms of taxable income such as overtime, compensatory time, pay in lieu of vacation or final payoff for sick leave, all of which are not included in the CERS definition of base compensation. However, the CERS definition of base compensation may cause benefits distributed under CERS, in certain circumstances, to exceed IRC section 415 limits when IRC section 457 amounts are used in the calculation of base compensation, even where the employee has received overtime, compensatory time, pay in lieu of vacation or sick leave payments in the employee's last year of employment prior to retirement. The reason for this is that CERS authorizes benefits to be calculated on the highest one year of base compensation but the IRC 415 formula is calculated using the average compensation (as that term is defined in Treasury Regulation 1.415-2) for the employee's highest three consecutive years.

The recent attempt to permit section 457 deferrals to be included in the definition of compensation along with IRC 414(h)

pickups for maximum limitation benefit testing under section 415 was not successful. Unfortunately, the temporary Treasury Regulations 1.414(a)-1T and 1.415-2 published on May 14, 1990, have only caused additional confusion on this point. For the purposes of this discussion, we will assume that the definition of compensation for IRC section 415 testing purposes excludes IRC section 457 deferrals.

ANALYSIS

Congress has given government retirement plans a choice between two different methods of testing the maximum benefits that can be offered by defined benefit plans. Although The City of San Diego is bound by the IRC section 415(e) rule that combines the testing for defined benefit and defined contribution plans and provides a higher combined safe harbor limit, each plan must separately pass the maximum limitation on benefits test in addition to the combined formula test. The testing rules and limits are highly complex but the following discussion should put the issue into perspective for the purposes of answering your concerns.

If The City of San Diego does not elect to be covered by the "amnesty" or "grandfather" provisions, the maximum annual limit payable under CERS at age 62 based solely on employer contributions will be the lesser of:

1. 100 percent of the member's average compensation (does not include amounts deferred under IRC section 457) for the member's highest consecutive three years,
or
2. \$102,582 (adjusted for 1990).

If the employee desires to receive a benefit prior to age 62, the \$102,582 figure will be reduced actuarially but cannot go below \$75,000 (unadjusted) if the benefits under the government plan commence on or after age 55. The maximum reduced benefit cannot go below \$56,990 for police and firefighters with at least fifteen years of service. The key fact to remember is that the \$75,000 limit, unlike the other limits, is not indexed for inflation. The "amnesty" or "grandfather" provisions provide that the limitation with respect to participants who first became participants in the plan before January 1, 1990, shall not be less than the accrued benefit under the plan as of October 14, 1987. The price for this is that, except for police and fire-fighters, all new plan participants after December 31, 1989, will be governed by the new IRC section 415(b) limits for the private sector. In other words, the new plan participants,

except for police and firefighters, will lose the special \$75,000

limit for all government employees and will be bound by the early limit for the private sector (\$102,582 reduced actuarially to age 55).

One of the key factors mentioned previously is that the \$75,000 base will not be adjusted for inflation and will decrease in value in the future. Another factor to remember is that the IRC section 415(b) limits on defined benefit plans speak only to the benefit derived from the employer's contribution. The benefit level in effect for CERS on October 14, 1987 will vary from individual to individual because of the different offsets (IRC section 414(h) "pickups") for each employee group in effect that year and the different IRC section 414(h) individual allocation for each participant from MBP at that time.

As can be seen from the above, the benefit changes instituted in July 1988 and 1989 do not affect CERS' ability to adopt IRC section 415(b)(10) "amnesty" or "grandfather" provisions, but these provisions, if adopted, will only protect the affected employees to the extent that the benefit level in effect on October 14, 1987 is not exceeded. This may or may not occur under a "high one year" formula. One important variable is the impact of amounts deferred under IRC section 457 in the calculation of the "highest consecutive three years" benefit level of IRC section 415. This may be mitigated of course by additional compensation in the form of overtime, compensatory time, pay in lieu of vacation or sick leave payoff in the employee's last year of employment.

Nevertheless, the "amnesty" or "grandfather" provisions will provide a safety net for CERS. Unfortunately, all employees except police and firefighters who become plan participants on or after January 1, 1990 will bear the burden of the safety net by having to comply with the new lower private sector limits. Without the ability to perform IRC section 415 tests on all individual employees, it is difficult to say with certainty that, absent the "amnesty" or "grandfather" provisions, CERS will fail the IRC section 415 test for service retirement benefits, but it is possible under the current rules which exclude IRC section 457 deferred compensation amounts from the formula for that to occur.

CONCLUSION

The benefit changes to CERS providing for "high one year" benefit level do not affect the City of San Diego's ability to adopt the "amnesty" or "grandfather" provisions of IRC section 415(b)(10). If those provisions are adopted into the San Diego Municipal Code, they will provide a safe harbor for city employees who became plan participants in CERS prior to January 1, 1990, at the October 14, 1987 plan level and employees, except

police and firefighters, who become or will become plan participants after December 31, 1989, will be held to the new private sector limits for defined benefit plans. Whether or not CERS adopts the "amnesty" or "grandfather" provisions, all plan participants eligible for "high one year" benefits may receive that benefit only when it does not exceed the individual employee's applicable IRC section 415 limit. If any employee's retirement benefit exceeds the IRC section 415 limit, the tax qualification status of CERS will be threatened.

JOHN W. WITT, City Attorney

By

John M. Kaheny

Chief Deputy City Attorney

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