**Public Employee Post-Employment Benefits Commission**
**DRAFT DISCUSSION DOCUMENT FOR OAKLAND HEARING**

Document Overview

Commission discussion at the Oakland hearing will focus on policy issues and areas related to the following concept:

> ***The costs of promised benefits should be fully identified, known, and paid for within the working career of those receiving the benefit. The process for funding those benefits should be clear, easily understood, and actuarially sound.***

In preparation for the hearing, this document provides background information on the following discussion topics:

- Prefunding of OPEB Liabilities
- Mitigation of Market Volatility
- Tax Issues
- Impact of Cost-Containment Strategies

Note

This document summarizes key issues for each discussion item and is not intended to be an exhaustive review of a particular topic. Subject matter experts will be available at the hearing to provide additional detail and answer questions.

# Prefunding of OPEB Liabilities

## 1. Definitions

Pay as you go (pay-go) refers to a strategy where an employer only covers current year expenditures for retiree health care costs. No consideration is given to accumulated or future costs.

Prefunding refers to the deposit of assets in advance of their actual need to cover accumulated and future costs. Typically, prefunding is linked to the deposit of assets into an irrevocable trust account with investment earnings increasing available funds over time.

Intergenerational cost-shift refers to the funding of pension or OPEB liabilities over a period of time that would exceed the working career of the workforce wherein the liability was generated.

## 2. Background

GASB 43 and 45 require public retirement systems and public agencies to disclose their unfunded liabilities for retiree health care, thus bringing more attention to the funding approach used to provide these benefits. Although the new reporting requirements do not require prefunding, they have led many public agencies to discuss the benefits of prefunding.

Retirement and OPEB liabilities can be paid for in three ways: pay-as-you-go (pay-go), prefunding, or a combination of the two.

<u>Pay-Go</u>

- Under the pay-go approach, the employer pays immediate costs out of direct budget allocations. Consequently, the employer pays for the benefits of current retirees, as well as for survivors of employees and beneficiaries.
- This approach constitutes an intergenerational cost-shift.
- Historically, most public agencies have used this approach to pay for retiree health care.

<u>Prefunding</u>

- Under the prefunding approach, the employer and/or current employees contribute now to pay the anticipated future cost of promised benefits.
- At the practical level, while it does not constitute legal vesting, one effect of prefunding is that the promised OPEB benefits are more likely to be delivered since the money is there to fund them.
- In the short term (ten to twenty years), prefunding can be more expensive than pay-go. Over the long term, however, the ability to earn investment income and avoid accrued liabilities reduces costs. Using the performance of California's public retirement systems as a model, the investment returns brought about by prefunding could eventually pay for up to 75% of the money spent on retiree health care benefits.

- The prefunding of the State's OPEB liabilities has been endorsed by both the State Controller and the Office of the Legislative Analyst.

- In addition, prefunding is a way to avoid intergenerational cost shift.

Today, pay-go tends to be the predominate strategy used by public agencies to cover OPEB costs. For many years, the cost of health care and retiree health care was a relatively small portion of an agency's annual expenditures and the pay-go funding strategy created no fiscal hardship for the employer. Although some did decide to do so, very few public employers chose to prefund their promised OPEB benefits. Almost all of those that did prefund did so by setting money aside in an internal service fund rather than an irrevocable trust.

However, the dramatic increases in health care costs in recent years, along with the new reporting requirements of GASB, have focused attention on both the accumulated and future costs of these benefits. As a result, many agencies have begun to reevaluate their current use of pay-go to fund OPEB, and to consider using prefunding.

A case in point is that of the State of California. Since the inception of employer-paid health care for active and retired state workers almost fifty years ago, California has paid for its retiree health care benefits on a pay-go basis. Like other public agencies, the State is now required to report its liability under GASB 43 and 45. In May 2007, it received its first actuarial report on its OPEB liabilities.

- That report identified the State's unfunded OPEB actuarial liability as $47.88 billion over the next 30 years on a pay-go basis. With full prefunding beginning in 2008/09, however, the report noted that the OPEB liability would be reduced to $31.28 billion.

- Under its current pay-go approach, it is estimated that the State will pay $1.36 billion for health care for its retired employees in FY 2007/08. It will also accrue an additional $2.23 billion unfunded liability for the future cost of health benefits earned during FY 2007/08, bringing the total cost of those benefits to $3.59 billion.

- With full prefunding, the State's total retiree health care payment for FY 2007/08 would be increased to $2.59 billion, but with no accrued unfunded liability. Put differently, prefunding would increase current expenditures but would reduce total long-term spending.

<u>GASB Compliant Prefunding</u>

Under GASB guidelines, in order to fully benefit from prefunding, OPEB funds must be protected and be available to cover <u>only</u> retiree health care benefits. GASB compliant prefunding requires that:

- Contributions be irrevocable (until liabilities are expunged);

- Assets be dedicated to providing OPEBs to retirees and dependents in accordance with the terms defined by the health benefit plan; and

- Assets be legally protected from creditors of the plan or of the administrator.

Those agencies which prefund OPEB liabilities can choose from a variety of funding mechanisms. (See separate background document, "OPEB Funding Options," for additional details on various OPEB vehicles.)

Prefunding via a GASB-compliant vehicle allows for a higher discount rate (if assets in the vehicle are diversified), thus reducing long-term liability. Therefore, prefunding through an irrevocable trust both reduces the OPEB liability and guarantees that the funds will not be used for other purposes.

In contrast, a public agency using a revocable OPEB trust or an internal service fund does not receive GASB credit for prefunding its future OPEB liabilities, although such funding may be recognized by the rating agencies as part of a prefunding plan. In addition, the use of a revocable trust could permit an agency to use the funds to address an unforeseen emergency.

**3. Pension Issues**

- California's public retirement plans have been prefunded since their inception, which for many was more than 70 years ago.

- The vast majority of retirement systems have adopted amortization policies that are considered actuarially acceptable and in compliance with GASB guidelines.

- In 1994, GASB issued Statements 25 and 27, requiring accrual accounting for public retirement systems. GASB 43 and 45 were closely modeled on those previous pension standards.

**4. OPEB Issues**

- The decision to prefund cannot be made in a vacuum. Other than in the unusual situation where OPEB can be funded out of "extra" money, OPEB prefunding will have to compete with other fiscal and budgetary needs of the agency.

- Thus, in order to prefund an OPEB liability, the employer may wish to identify a source or sources of funding. Some have identified specific funding sources, while others have made allocations from general funds.

- Although the State of California is facing budget challenges in the coming year, prefunding is part of a prudent fiscal approach which will address the issue of paying for retiree health care over the longer term, and thus should not be delayed. Choosing to not prefund now only costs more money in the long run.

- As the Commission has heard in testimony, benefits which have not been funded may be dropped by the employer in difficult economic times. Setting aside funds can help to reduce the chance of benefits being reduced in the future.
- Many agencies will consider phasing from pay-go into paying the full ARC over time (five to ten years). While some will see this as delaying prefunding, others will see it as a pragmatic alternative.
- Some agencies may delay funding until the Federal government clarifies whether or not they will reimburse OPEB prefunding in a manner similar to pensions.

OPEB Bonds

An employer can issue OPEB bonds to create a source of funds for prefunding. Considerations associated with using this funding vehicle include:

- For pension obligation bonds, the actuaries can predict the various pension factors in order to develop an accurate unfunded liability for which bonds may be issued. In comparison, the future costs of health care are difficult to project and the liability used for an OPEB bond may be a point-in-time calculation with significant future volatility.

- OPEB bonds are basically an arbitrage strategy in which the employer believes that the return on invested funds is greater than the cost of debt. If this is not the case, then the employer has locked in higher costs for the life of the bond.

- Even if changes in public policy or cost shifts to employees and retirees reduce or eliminate the employer's OPEB liability, the debt cost of the bond will continue. In effect, a future estimated OPEB liability will have been converted into a fixed cost.

- OPEB bonds, like pension bonds, are taxable for bond holders, thus increasing the debt costs.

- There are fixed costs to any bond authorization. There are threshold levels below which issuing bonds is prohibitively expensive.

- Public agencies should be aware that the Federal government has not clarified its reimbursement position on OPEB bonds, and should therefore be cautious when considering this funding vehicle.

- Based on the State of California's recent experience with a proposed pension bond, it should be assumed that an OPEB bond would have to be passed by a two-thirds majority of the voters.

## MITIGATION OF MARKET VOLATILITY

### 1. Definition

There are three funding sources for defined benefit plans: 1) employee contributions, 2) employer contributions, and 3) investment returns.

All defined benefit retirement plans have an expected investment rate of return built into their actuarial assumptions. Because of fluctuations in the marketplace, investment returns may be above or below the expected rate of return at any point in time. This variation in investment returns is referred to as “market volatility”.

### 2. Background

Virtually all employer contribution rates are determined by actuaries and periodically adjusted. (One notable exception is CalSTRS, whose contribution rates are established in statute.) Employer contribution rates consist of two components: normal cost and payments toward any unfunded accrued liability.

- Normal cost is the portion of the total present value of benefits that is allocated to the current year of service for active members.

- Actuarial accrued liability is the value today of the past normal costs for active members, plus the full present value of benefits for retired and inactive members, as of the date of the actuarial valuation. In effect, the accrued liability is what would be in the fund if the normal cost had always been contributed and all assumptions had always come true.

- When the actuarial value of the plan’s assets is less than the actuarial accrued liability, the fund is said to have an unfunded actuarial accrued liability (UAAL) and must receive contributions in excess of the normal cost in order to get back on its funding schedule.

- A plan with an actuarial value of assets in excess of the accrued liability is said to have a surplus (or be over funded) and can temporarily reduce contributions below the level of the normal cost.

- With each annual actuarial study, the employer’s contribution rate can be reset to meet the normal cost and to either fund any UAAL or take credit for any surplus.

Employers generally have two main interests with regards to employer contributions: low contributions and stable contributions. The advantage of a low contribution rate is obvious, while a stable contribution rate is important for the purpose of budgeting and better addressing the ongoing costs of the organization.

Market volatility can significantly impact the employer’s contribution rate. Market changes in the assets cause changes in the unfunded accrued liability (or surplus), which in turn cause changes in the employer’s contribution rate.

- When the investment market underperforms and does not meet the expected rate of return, the resulting shortfall increases the unfunded accrued liability, which increases the employer’s contribution rate.

- If investment market returns are above the expected rate of return, those extra earnings reduce the unfunded accrued liability, which reduces the employer's contribution rate.

Market volatility is the primary cause of volatility in a plan's unfunded accrued liability. Experience with respect to other actuarial assumptions (mortality, salary increases, etc.) also causes volatility in the unfunded accrued liability, but generally not as much as from the investment earnings.

The following are some approaches that have been used to minimize fluctuations in the employer contribution rate.

<u>Smoothing</u>

There can be wide swings in investment returns from year to year. To try to stabilize these rates, actuarial methods have been developed to help "smooth" short term variability in the market value of assets.

- The shorter the smoothing period in an upward (or downward) market, the faster gains (or losses) will be recognized, resulting in a more rapid lowering (or raising) of the employer's contribution rate.

- The longer the smoothing period in a downward (or upward) market, the slower losses (or gains) will be recognized, resulting in a more rapid raising (or lowering) of the employer's contribution rate.

The investment gains and losses are often smoothed, or averaged, over three, five, or some other number of years.

- Most retirement systems use a three year smoothing method.

- LACERA (Los Angeles County Employees' Retirement Association) uses three year asset smoothing, which is at the short end of the range of smoothing methods. That means there will still be a relatively large amount of employer contribution rate volatility, but also that the smoothed asset value will stay relatively close to the market value.

- CalPERS uses a 15-year smoothing approach, which is at the long end of the range of smoothing methods. That means there can be relatively large differences between the smoothed value and the market value of its assets...

<u>Amortizing the Unfunded Accrued Liability (or Surplus)</u>

As noted above, in addition to the normal cost, the employer contribution includes a charge or a credit to recognize or "amortize" the UAAL (or surplus). "Gains and losses" are changes in the UAAL due to actual experience different from what was assumed.

- Similar to smoothing, longer amortization periods will reduce employer contribution rate volatility, but increase the chances of shifting costs (or savings) to future generation of taxpayers.

- Shorter amortization periods will mean more employer contribution rate volatility, but also lower chances of shifting costs (or savings) to future generation of taxpayers

There is a wide range of amortization periods and practices for gains and losses. Some systems have separate amortization periods just for gains and losses, while others use a single amortization period for the entire UAAL, including any gains and losses.

- Most systems that separate out their gains and losses now amortize them over at least 15 years. However, in the late 1990s and early 2000s, some systems had gain/loss amortization periods as short as 5 to 10 years.

- LACERA has adopted a rolling 30-year smoothing period for its entire UAAL, including gains and losses. LACERA reports that this is an interim policy and is in the process of developing a long-term funding policy.

- CalPERS has adopted a rolling 30-year smoothing period only for gains and losses, which currently make up most of the CalPERS UAAL.

<u>Employer Contribution Holidays</u>

In the late 1990s, investment returns rose significantly and most defined benefit retirement systems met or exceeded their funding requirements. Pensions were said to be “over funded” or “in surplus” if their assets exceed their actuarial accrued liability. Many systems also had relatively short amortization periods for their surpluses, so it did not take very much surplus to generate credits that offset much or all of the normal cost. As a result, many employers were able to reduce or even stop making contributions to their retirement systems via “employer contribution holidays”.

Starting in March 2000, the investment markets plummeted over a span of 36 months. This period of investment underperformance (along with the addition of new benefits, in many cases) resulted in many defined benefit retirement systems becoming significantly under funded. On the whole, funding ratios dropped into the 80% funding range.

Employers experienced a rapid shift – from being over funded, with contribution holidays, to being under funded, with a resulting demand for immediate contributions. Some employers’ contribution rates went suddenly from zero or near zero to rates including both the normal cost and large UAAL payments. In the case of the State of California, its CalPERS pension contribution went from $156,722,747 in 2000/01, to $2,212,518,481 in 2003/04.

While this jump in contributions has been said by some to be due to the adoption of more expensive benefits, it is really better explained as the result of an extended employer contribution holiday coupled with a dramatic drop in the value of CalPERS assets.

The increase in contribution rates greatly impacted employers’ operating budgets across the state. In some cases, employers reported that they had to redirect funds from other programs in order to meet their pension obligations.

In reaction to their experiences during this period, large numbers of California’s public employers requested that there be a more stable approach to contributions in the future so that they might have more certainty in their fiscal planning.

CalPERS addressed this issue by requiring that surplus be spread over 30 years before being applied to reduce contributions below the normal cost. The reason that CalPERS did not just require that contributions continue at the normal cost level is that the GASB standards require some recognition of surplus, and 30 years is the longest period allowed.

Interest Fluctuation Reserves

Public pension systems in California have a limited ability to take a portion of earnings from any one year of good investment performance and place it into a reserve to be used in future years of underperformance. Such reserves can then be used to help mitigate market underperformance and the resulting upswing in the contribution rate. In effect, this is an early, insurance company form of asset smoothing.

The size of these “interest fluctuation reserves” or “contingency reserve” are limited by law and policy. For example, the CalPERS account is currently limited to 0.2% of the assets of the system.

Interest fluctuation reserves are also part of the 20 county retirement systems under the ‘37 Act, where they are generally called “contingency reserves”. Here, however, their purpose is not necessarily to mitigate contribution rate volatility.

These contingency reserves are excess earnings amounts that must be set aside before any additional excess earnings can be for certain purposes specified in the statute. While one of those purposes is to reduce employer contributions, they can also be used to provide additional benefits or to offset liabilities caused by unexpected or extraordinary events. The minimum required reserve is 1%, or 3% for the three counties that have adopted a special section of the statute.

These excess earnings based benefits and the related contingency reserves will be the subject of a later discussion at the Sacramento hearing.

Asset Smoothing Corridors

Returning to asset smoothing, some systems want to be sure that the smoothed value of assets does not get too far from the market value. Based on this idea, some retirement systems have added a “corridor” to their asset smoothing method.

- This methodology first applies the regular smoothing method, but then restricts the smoothed value to be within some percentage of market value, for example, plus or minus 10% or 20%).

- The only disadvantage to adding the corridor restriction is that, if the smoothed value hits the corridor then future investment volatility is not reduced as much, as the smoothed value “rides” the top or bottom of the corridor...

- CalPERS and several other pensions in California have adopted this methodology.

## 3. Pension Issues

Asset Smoothing

It is generally agreed that longer asset smoothing periods will help to minimize contribution rate volatility. For example, if the longer smoothing periods reserves had been in effect during the up-and-down markets of 1995-2003, the downward-then-upward impact on the employer’s contribution rate changes would have been mitigated.

- While asset smoothing does help to reduce contribution rate fluctuations, perspectives on how this technique should be applied can change based on market performance.

- o Employers often want longer smoothing in “down years”, when it helps them defer losses, and so pay less into the fund.
- o When the market recovers sufficiently, there is pressure for a shorter smoothing period in order to recognize asset gains sooner and reduce the employer contribution.

- In technical terms, this is known as “cherry picking the smoothing method”. To be most effective, smoothing should have the necessary discipline to treat periods of investment gains and losses the same.

<u>Interest Fluctuation Reserves</u>

- California pensions were designed to allow for the establishment of a special reserve to lessen the impact of the down markets. Through law and regulation, this reserve is generally set at 1% of assets for pensions systems under the ‘37 Act, and at .2% for CalPERS. (Note: for the ‘37 Act systems these reserves are not necessarily only a rate stabilization mechanism.)

- This limit was created when public pensions were primarily in fixed income instruments (bonds), and pensions were measured on a book value basis instead of the market value basis used today. Currently, retirement systems have a majority of their investments in equities (stocks). It is not unusual to see market swings of 2% in a business day.

- When public retirement systems were not allowed to invest in equities, these accounts did provide a useful cushion against market volatility. However, with the wide range of volatility now found in the equities market, these reserves are not large enough to cover rapid or prolonged market downswings.

- To the extent that asset smoothing and interest fluctuation reserves are two means to the same end, there is some redundancy in having both. Current practice would favor asset smoothing over interest fluctuation reserves as the preferred way to control the impact of asset volatility.

<u>Employer Contribution Holidays and Normal Cost</u>

- As described above, historically, short amortization periods for surplus have, in effect, led to granting employers rate holidays when the assets of the fund exceed the liabilities.

- Since the normal costs are always present and always accruing, it has been suggested that either employers should always be required to make the contribution for their normal costs, or at least that surplus should be spread over much longer periods when being applied to reduce the contribution below the normal cost. This would provide a much more stable rate base for the employer and would also provide equity to employees who seldom, if ever, receive a contribution holiday.

- It has been suggested that when a pension plan is over funded, so that contributions fall below the level of the normal cost, the contribution savings could be used to prefund OPEB benefits.

- Some systems, especially some ‘37 Act systems, currently use a portion of investment returns in excess of the assumed rate of return to prefund OPEB benefits.
    - Since funds from a pension trust cannot be directly transferred to an OPEB trust, a method of transfer and credits has been used for years by these county systems, using a 401(h) account.
    - While this practice could provide a source of OPEB funding in good years, it would probably not lend itself to being the only source of OPEB funding over time.

**4. OPEB Issues**

- With public plans still determining their OPEB obligations, market volatility has not become an issue. However, as funds are set aside and invested, the techniques discussed above for pensions could have direct application the OPEB funds as well.

## Tax Issues

Following is a brief summary of the federal tax issues that will be discussed during the Oakland hearing. Please see the Appendix section at the end of this document for a more detailed overview of each issue.

### 1. Investment of Assets Used to Fund OPEB

Many California public agencies are now starting to prefund their retiree health care benefit obligations. Under current tax law, it is very difficult to combine for investment purposes assets held for retiree health care benefits with assets held for pension obligations. This raises the following considerations:

- Because the amount of OPEB funds is much smaller than that held for pensions, economies of scale are not now available for investing retiree health funds.
- Therefore, net investment costs will generally be higher, thus reducing the net amount available to pay retiree health care benefits.

### 2. Collectively Bargained Retiree Health Benefits

Collectively bargained, employer-provided health benefits generally are tax free to active and retired employees. However, the IRS has interpreted tax law to limit tax free retiree health care benefits that are collectively bargained and have a "vesting schedule" so the employer provides a higher contribution for longer service employees, unless those benefits are "fully insured".

Fully insured refers to a plan where the employer pays premiums to an insurer and the insurer assumes the risk to pay all health care claims. This is in contrast to a self-insured plan where an employer may retain the use of a third party administrator but the employer assumes the risk of providing benefits and paying all claims.

Many California agencies provide benefits that are not fully insured and that provide a "vesting schedule". The tax law provides that if health benefits are not fully insured, then they are partially or fully taxable for the top 25% of wage earners, if they "discriminate" in their favor.

### 3. Savings for Retirement: Redeposits and Service Purchase

Tax law allows employers to "pick up" the members' contributions for tax purposes only, thereby making them pre-tax. The IRS has also established that pre-tax pick up rules apply to the redeposit of previously withdrawn member contributions, and to the purchase of additional service credit by employees.

The IRS is considering rule changes which would make members pay these contributions on an after-tax basis, thereby making them more expensive for employees.

### 4. Definition of "Government Agency" for Retirement Systems

Governmental retirement plans are exempt from much federal regulation, as well as a number of private sector IRS rules. Without these exemptions, the federal government would regulate California public sector benefits, treating them essentially as private sector benefits, creating a substantial increase in administrative costs and in the cost of the benefits themselves.

The IRS, the Department of Labor and the Pension Benefit Guarantee Corporations are currently working on narrowing the definition of "government agency". This project is being conducted behind closed doors and without local and state input. A very narrow definition could have a negative impact on those public employees whose agencies did not meet its requirements, as they would no longer be allowed to participate in their retirement system or the agency would have to change its benefits, potentially running into conflict with California's vested rights rules.

### 5. Health Benefits - Domestic Partners and All Others

California law requires that domestic partners receive the same benefits as provided to spouses, including retiree health coverage. The IRS has recently ruled that if the domestic partner of a retiree is provided these benefits – and the value of the coverage is not taken into account at the time that the employee worked and earned these benefits – then ALL retirees covered by the plan are taxable on ALL of their health benefits, whether or not they have a domestic partner.

### 6. IRS Determination Letter

It is very important for all public retirement systems be tax qualified. Qualification is the basis for tax exemption of system earnings and the deferral of taxation of members until they actually receive their retirement benefits. The IRS regularly issues letters to private retirement plans on their tax qualified status. Such letters give assurance to members and systems that they are in tax compliance. Few California public retirement systems have these letters and the IRS process for obtaining these letters – which is designed for the private sector - is very difficult for public retirement systems to navigate.

## IMPACT OF COST CONTAINMENT STRATEGIES

### 1. Definition

From the perspective of employer-sponsored health care, cost containment refers to the slowing or reduction of annual premium costs. Cost containment strategies can improve the ability of an employer to address an OPEB liability.

### 2. Background

Cost containment can be accomplished by more effectively using services covered, including: reducing the amount or use of services covered, reducing the reimbursements to providers for services covered, shifting costs to another payor, or some combination of all of the above.

For an employer, this can be accomplished by altering benefit designs, shifting costs to employees/retirees, limiting choices of providers, or moving responsibility for members/retirees to other payors (e.g. Medicare).

### 3. Pension Issues

- N/A

### 4. OPEB Issues

- The expected cost trends for medical expenses and utilization of medical services are key variables when employers determine their OPEB liabilities. Actions that reduce these trends usually result in reduced liabilities.

- It is important to recognize that what an employer may see as cost containment may be viewed as a cost shift to employees and retirees.

- Through benefit design changes, employers can shift costs to members. Changes in co-pays, deductibles, coinsurance (for Preferred Provider Plans - PPO) and a reduction in the number of covered benefits, generally result in lower premiums for both the employer and employees. For example:
    - Co-pays for generic drugs can be reduced while co-pays for brand name drugs can be increased as an incentive to use generics over brand name pharmaceuticals.
    - Co-pays for use of the emergency department can be increased while co-pays for urgent care services can be reduced to provide an incentive to avoid the emergency department.

- Employers can cap their contributions for health care through either “hard caps” (a fixed dollar amount that does not increase) or “soft caps” (a dollar amount, such as percentage of premium, that changes as premium cost changes). Such caps reduce employer costs and shift some cost to employees/retirees as health premiums increase.

- Employers can adjust premiums to provide incentives to members/retirees to more efficiently and effectively use the benefits provided by the employer sponsored health plan.

- For example, premiums can be reduced for members who participate in wellness programs that result in measurable improvements in individual health profiles to avoid chronic diseases (attaining or maintaining a specific BMI, smoking cessation, attaining or maintaining lower cholesterol levels, etc.).
- Similar incentives can be adapted to reward successful participation in chronic disease management programs, after diagnosis of a chronic disease, in order to limit the costs and negative health outcomes associated with chronic conditions.

- Benefit designs can be aligned to provide incentives for “evidence based medicine” or preventive care.
  - Evidence based medicine refers to a shift from management of health care utilization to care management that uses clinical research to determine the most appropriate treatment for a given disease.
  - This approach emphasizes adherence to guidelines linked to empirical clinical studies on diagnosis, treatment, and outcomes. It is believed that clinical based knowledge will assist physicians in making more accurate diagnosis and in coaching patients to remain compliant with treatment protocols.
  - While empirical evidence is mixed, it is anticipated that such an emphasis will slow upward health care cost trends and improve quality of care.

- Employers can limit the choice of providers through selective provider networks. Premiums, co-pays, deductibles, and co-insurance can be increased when members use out-of-network providers.
  - Empirical evidence is limited, in part because this approach is relatively recent. It is anticipated that narrower provider networks will be more efficient (and therefore less expensive) resulting in lower costs over time.

- Public agencies can also investigate participation in larger purchasing arrangements. These options include:
  - Evaluating the trade-offs of participating in the PERS purchasing pool under PEMHCA. A public agency in PEMHCA receives the benefits that comes from being part of a large purchasing pool (more stable rates, relatively low administrative costs, etc.), but largely delegates control of benefit design, premiums, and administrative structure to the PERS Board. Participation in PEMHCA also requires employers to agree to contribution levels for retirees that equal contribution levels for active employees.
  - Joining with other local public agencies through the development of joint powers agreements (JPA). A number of JPAs already exist that address risk management and self-insurance issues for areas other than health care. The concept could be expanded to the provision of health care.
  - Participating in joint purchasing arrangements with private sector employers in the same geographical area. Employers, whether public or private, typically use similar provider networks in a geographic area. They could combine their purchasing power to leverage more stable pricing and creative benefit designs. Employer contributions, risk across benefit designs, and out-of area coverage are examples of issues that would need to be addressed with this arrangement.

## Appendix
## Additional Background on Tax Issues

This appendix provides additional details on the tax issues discussed on page 12 of this document.

### 1. Investment of Assets Used to Fund Retiree Health Benefits

<u>Summary</u>

Many California public agencies are now, or soon will be, prefunding their retiree health care benefit obligations.

- For many years to come, the amounts which are invested for retiree health care will be small relative to the amounts that are held in trust to pay pension obligations.
- Therefore, economies of scale generally will not be available for investing retiree health care funds.
- The net cost of investment (basis points per dollar invested) generally will be higher than it is for pension funds, thus reducing the net amount available to pay retiree health care benefits.

Under the tax laws it is very difficult to combine assets held for retiree health care benefits and those held for pension benefits in order to obtain economies of scale.

<u>Detailed Background</u>

Spurred on by the GASB rules, many California public agencies are now starting to fund their retiree health benefit obligations. Most agencies will amortize their required contributions over time so it will take many years for the funds to build up to substantial size. This is in contrast to the size of existing public retirement funds, which have had many decades to grow.

The cost of investing smaller amounts is usually higher per dollar invested because there are few, if any, economies of scale. This, in turn, reduces the net investment returns on retiree health care funds and reduces the amount of protection for employees and retirees.

Currently, awkward "work arounds" must be followed to try to obtain these economies of scale, including:

- "Parallel investing" (which often does not work well), or
- Establishing a totally separate business entity such as a joint venture or LLC, which can be quite costly.

A simple solution to this problem would be to allow the combination of health care funds which are held in trust for public agency retirees along with public system retirement funds. This would bring instant economies of scale.

However, the IRS has ruled that only limited types of funds can be combined with retirement funds for investment. (Rev. Rul. 81-100.) Some of the allowed combinations are pursuant to statute, such as IRA funds. However, some of the allowed combinations are pursuant to IRS administrative decision, such as "403(b)" funds. Therefore, it is clear that in some circumstances the IRS has the authority to broaden the category of funds that can be combined for investment.

## 2. Collectively Bargained Retiree Health Benefits

<u>Summary</u>

The IRS has interpreted the tax laws to limit the ability to apply a “vesting schedule” (i.e., the employer provides higher benefits to employees with longer service) to tax-free retiree health benefits that are collectively bargained unless the benefits are “fully insured”. Fully insured refers to a plan where the employer pays premiums to an insurer and the insurer assumes the risk to pay all health care claims. This is opposed to a self-insured plan where an employer may retain the use of a third party administrator but the employer assumes the risk of providing benefits and paying all claims.   This is an unusual position in that the IRS normally gives full deference to benefits which are bargained.

<u>Detailed Background</u>

Employer-provided health benefits generally are tax free to retirees as well as to active employees. However, the tax laws also provide that if health benefits are not fully insured, then they are taxable to the top 25% of wage earners if they “discriminate” in their favor. For the IRS, “discrimination” means that this top group receives better treatment than the other employees. In the IRS’ view, this includes providing a higher level of employer contributions to longer service employees.

Discrimination can be difficult to determine, but for example, if the top wage earners include safety employees and they bargain for a higher percentage of health care premium paid by the employer than that for other employees, this can be treated as “discrimination” by the IRS. In addition, the IRS has said that because longer service employees generally earn higher salaries, a “vesting schedule” can be discriminatory on its face.

Many California agencies provide benefits that are not fully insured. Furthermore, bargaining agreements can vary significantly between bargaining units in the agreed upon health care coverage and the employer paid premium. Moreover, it is common to provide longer service employees with a higher percentage of premium payment upon retirement than for shorter service employees. These IRS positions effectively refuse to recognize collective bargaining and also are quite disruptive of standard retiree health care arrangements.

The tax laws provide a way for the IRS to avoid creating these problems. For pensions, the IRS has taken the position that under the Internal Revenue Code, benefits which are collectively bargained generally meet any “non-discrimination” rules.  Similar -- but not the same -- Internal Revenue Code provisions apply to health care benefits and could be used by the IRS to reach the same result. However, this has not yet been done.

### 3. Saving for Retirement: Redeposits and Service Purchase

Summary

The IRS is considering changing its long-established rules in a way that will significantly increase the out-of-pocket cost to members who wish to redeposit previously withdrawn contributions or to purchase additional service credit. IRS is considering making these member contributions after-tax instead of pre-tax.

Making members pay for this on an after-tax basis will immediately increase the cash out-of-pocket purchase price of retirement benefits for California's public employees. This, in turn, will reduce the amount of retirement benefits for many individuals. This is a proposed internal policy change - there has been no change in the federal governing statutes which would warrant such a change.

Detailed Background

The tax laws allow employers to "pick up" members contributions for tax purposes only, thereby making them pre-tax. (Some pick ups occur when the employer actually pays the member contributions. These are real economic pick ups, paid for by the employer, which would not be affected by the pending IRS change of rules

Tax pick ups were enacted in 1974 as part of ERISA, and serve to reduce the member's net cost of belonging to a retirement system. Pick ups were enacted because they were common in public systems and there was no desire to disrupt a program that was working well. There has been no change in the pick up statute (Int. Rev. Code sec l. 414(h)(2)) since it was enacted.

During the approximately 15 years leading up to the end of 2005, the IRS issued hundreds of "private letter rulings" which concluded that:

- Pre-tax pick up rules also apply to the re-deposit of previously withdrawn member contributions to retirement systems.
- Pre-tax pick up rules apply to member contributions used to purchase service credit, such as prior public service time or time served in the armed forces.

These rulings reduced the up front out of pocket cost of retirement benefits.

At the end of 2005, the IRS stopped issuing any such rulings. IRS staff has stated that IRS is considering issuing a ruling that redeposits and service purchase contributions cannot be made on a pre-tax pick up basis. The reason given is that such voluntary pick ups look like deferrals to 401(k) plans and no 401(k) deferrals can be made to defined benefit plans.

However, pick ups are not the same as 401(k) contributions. For example, pick ups are irrevocable after they are made and 401(k) contributions can be changed at intervals effectively set by the plan administrator.

Additionally, the Congress has given no indication that it intended to adversely affect the pick up rules when it approved 401(k) plans, and has given no indication that it wishes such a change to be made.

## 4. Definition of "Government Agency" for Retirement Systems


Summary

Governmental retirement plans are exempt from Department of Labor ("DOL") and Pension Benefit Guarantee Corporation ("PBGC") regulation and from a number of private sector IRS rules. Without these exemptions, the federal government would regulate California public sector retirement systems. Such a development would create substantially increased administrative cost without creating material new protections for system members.

The IRS, DOL and PBGC are working on narrowing the definition of "governmental retirement plan". To date, this project has been behind closed doors. But such a change could severely adversely affect a substantial number of public employees by making it difficult for them to, e.g., participate in CalPERS or in the 37 Act systems.


Detailed Background

Governmental retirement plans are exempt from many IRS regulations which are private sector focused, and also exempt from DOL and PBGC regulation. For example, private sector plans that are as complex as public systems must annually comply with rules designed to avoid "discrimination" in favor of the highly compensated. About a decade ago, IRS tried to figure out how to apply these rules to public sector systems and failed. These private sector rules do not work in the public environment.

The courts have occasionally dealt with the issue of what is a government plan and generally have held that the answer is based on the particular facts and circumstances of each case. This is generally the same rule that is followed by IRS, DOL and PBGC. These 3 agencies have sometimes not agreed on applying the rules to a particular agency. Also, sometimes there have been conflicts within one agency on how to apply the rules.

This lack of uniformity may be the driver for the 3 agencies to agree on a new set of rules. We also understand that not all of the 3 agencies have experience with how local government works, how complex, diverse and innovative it is, and how each agency participates in retirement systems.

If new rules create a definition that excludes some agencies from being "governmental", then the retirement system must exclude them and all of their employees - or risk loss of exemption from regulation and loss of tax-qualified status. Employees would have to be tossed out of the affected systems in order to protect the remainder of the system and all of its members.

Also, if DOL rules applied to them, then California public retirement systems could be sued in federal courts. Further, if PBGC rules applied, then California public systems would have to pay substantial insurance premiums to that agency as do private sector pensions.

## 5. Health Benefits – Retirees, Domestic Partners, and All Others Covered by the Retiree Health Plan

Summary

California law requires that domestic partners receive the same benefits as do spouses, including retiree health care coverage. However, the IRS has ruled that if a domestic partner is provided these benefits – and the value of coverage was not taken into account at the time that the employee worked and earned these benefits – then ALL retirees covered by the plan are taxable on ALL of their health care benefits, whether or not they have domestic partners.

The IRS solution for avoiding this tax problem is to tax the employee currently on the value of domestic partner retiree health care coverage earned in the current year. This “solution” leads to very awkward results which can hurt the retirees as well as the IRS.

Detailed Background

It is common for California employers -- both public and private sector -- to provide the same or similar benefits, including retiree health care benefits, to domestic partners as are provided to a spouse. It is also common for California employers to treat as taxable (to the retiree) at the time of payment any retiree health care benefits paid for coverage of domestic partner.

However, the IRS recently ruled that if any health benefits are paid to anyone other than a spouse, tax dependent or employee (or retiree), then the benefits for everyone covered by the plan are taxable (Rev. Rul. 2006-36). The IRS has made it clear that this applies when domestic partners are covered. However, IRS has ruled that if the employee is taxed during his or her employment on the value of the domestic partner retiree health coverage earned at that time, then the tax-free status of benefits for all covered is preserved.

This IRS “solution” does not work. There is no guidance on how to value retiree health coverage earned every year. Even if this could be valued, it is extremely uncertain whether any domestic partner will ever receive these benefits because there is no way to know whether an employee will have a domestic partner with coverage until a premium or other benefit is actually paid.

Because of this uncertainty, practitioners and administrators are considering imputing very small amounts of income to employees. Under the IRS rules, if this is the correct value then when benefits are actually paid they are tax free. This allows some “gaming of the system”, which cannot be good for the IRS.

## 6. IRS "Determination Letter" for Retirement Systems

Summary

It is very important for all retirement system members and all participating public agencies that their retirement system be tax qualified. Qualification is the basis for tax exemption of system earnings and the delay of taxation of members until they actually receive retirement benefits.

The IRS regularly issues letters to private retirement plans on their tax qualified status. Few, if any, large California public retirement systems have current IRS letters. This is the case for a number of reasons, including the fact that they are "legacy systems" (established long before there was any recognition that the federal tax laws could apply to state systems) and that the IRS process is set up for the private sector. An IRS letter gives assurance to members and retirement systems that they are in tax compliance and gives the same assurance to the IRS.

Detailed Background

Most large California public retirement systems were established over 60 years ago, and were considered part of government agencies. Federal taxes apparently were not considered relevant for these systems, perhaps as a Constitutional interpretation. Also in 1977 the IRS issued a notice that led many systems to reasonably conclude that the IRS would not take any action concerning tax qualification compliance by public retirement systems. (IR 1869, 8/10/77). However, since then it has become clear from actions by the Congress and by the IRS that the tax qualification rules do apply to public systems.

The IRS has established a procedure for obtaining approval ("determination letter") of the tax qualified status of retirement plans. This provides an efficient way for the IRS to assure that plans are written to comply with the ever changing law, and to provide protection for plan members and guidance for plan administrators.

- Most private sector retirement plans have this approval and regularly request it as the laws change.

- Some public systems obtained approval decades ago but have not requested review since then even though the tax laws have had major changes, so these letters are effectively useless.

The IRS determination letter process does not work well for public systems. For example:

- The process requires that any changes to system documentation be made within a 90 day window, which is essentially an impossible time frame to change state statutes.

- If a system does not have a recent IRS letter, retroactive change to governing documents and operations may be required, which is extremely difficult for these systems. Moreover, few IRS reviewers understand public systems so the method of review can be hit or miss.

IRS does have a "correction" process for retirement plans that do not comply with the tax rules (Rev. Proc. 2006-27), but it is cumbersome and not readily navigated by public systems in its current form.

Retirement system governing boards therefore must decide between staying the course of not asking for an IRS letter or asking for a letter with a very uncertain outcome. This is a very uncomfortable situation and most often the decision is to not ask ("better the devil you know").