Fixing Tax Barriers

Public Employee Post-Employment Benefits Commission
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Issue and Opportunity

- Public sector retirement systems are the most successful in the country
- California's systems are leaders
- Tax rules set barriers to system operations
- The Commission could lead in removing these barriers
- Fixing the barriers will help all system members

Tax Barriers

- Legacy systems – some history
- Pensions
- Retiree health

Legacy Systems

Legacy Systems & Taxes

- Systems established in the 1930's
- Taxes irrelevant – states are immune?
- 1977 – IR 1869 – IRS "gives a pass" to public retirement systems
- 1982 – discovered tax issues ("415")
- 1988 – special tax legislation
- 1988 – 2007 – uneasy relation with IRS

Pensions

Key Tax Issues - Pensions

- IRS letter of approval
- Re-deposits & service purchase
- Retirement and re-hires
- What is a government agency
- Recruiting

IRS Letter of Approval

IRS Letter of Approval

- IRS letter – system approved as to form
- Problem – Few large California retirement systems have an IRS letter because it is very uncertain what will happen if they ask
  - Very high % of private plans get IRS letter
  - A letter is very valuable for both IRS and system members

IRS Letter – Risk In Asking

- Risk for legacy systems
- Prior years – no statute of limitations
- IRS process not fit public sector
- "Who goes first"?

IRS Letter – How To Fix

- IRS has "fix it" process for private plans
  - Administratively established
  - No revenue loss
  - Congress has endorsed it
- IRS could set up similar program for public systems
  - Acknowledges public sector situation
  - Designed to help public as did for private

IRS Letter – Commission's Role

- Policy– Assure both IRS and systems that they comply with the tax laws
- Recommendation– IRS should develop correction program for public systems
- Commission recommendation will be more effective than any one system

Re-deposits
Re-hires
Government Agency

Redeposits & Service Purchase

- Redeposit
  - Terminating member withdraws contributions
  - Forfeits all benefits from employer money
  - On re-hire wants to "re-deposit" withdrawal + interest to reinstate pension
- Service purchase
  - Government Code allows members to purchase service additional service credit
  - E.g., public service time, military time, "ARC"

Redeposits – Problem

- Problem – cost increase for members
  - Now, redeposit can be pre-tax
  - IRS project will require it be after-tax
  - Cost increased – fewer will have full pensions
- IRS wants change because
  - Looks like "401(k)"
  - Uncomfortable with "pickups" rule
- No law change supports a new IRS position

Redeposits – Commission's Role

- Policy – Encourage employees to provide for their retirement
- Recommendation – IRS should not change its existing position – which would adversely affect all members – so re-deposits and service purchase should remain pre-tax

Retirement and Re-hires

- Problem – civil service rules
  - Because of civil service rules, new retiree returns to train the replacement
  - Tax law – no pension before "normal retirement age" if no "separation from service"
  - High risk issue – affects tax "qualification"
  - Could hurt all members
- IRS aware of similar issue – private plans
  - "phased retirement"

Retirement and Re-hires Commission's Role

- Policy – Tax pension rule should not interfere with sound government operations
- Recommendation – IRS should develop "phased retirement" rules that meet the needs of local government

Government Agency - Defined

- Problem – IRS changing definition of local government agency
  - This will cut out some local agencies from public retirement systems
  - Could adversely affect members in CalPERS, 37 Act systems, etc.
- IRS change because
  - Inter-agency inconsistency (IRS, DOL, PBGC)
  - Texas hospitals

Government Agency – Commission's Role

- Policy – Local government agencies are defined by state law unless strong over-riding tax policy
- Recommendation – IRS should have extensive discussions with the public sector retirement community before making any formal proposals to change the definition of public agency

Recruiting

- Problem – Public sector and private sector tax law hurts recruiting of senior employees
  - “Compensation cap” for qualified plans
  - If move plans, lose “grandfather” status
  - So lose pension with change of employer
- This is a statutory problem
  - A similar issue was fixed by Congress
  - “Replacement benefit plans”

Recruiting – Commission's Role

- Policy — Public sector should not be treated worse than the private sector
- Recommendation — Congress should change the tax law to provide for a replacement benefits plan under the compensation cap in the same way as it did for the "section 415" limitations.

Recruiting – California Law

- California law also sets a barrier to fixing this problem, except for CalPERS agencies (Govt. Code 20894)
- Policy – Treat all agencies the same
- Recommendation – Amend California law to allow all agencies the same ability to fix this problem

Retiree Health

Key Tax Issues – Retiree Health

- Investment of assets
- Collectively bargained benefits
- Public safety officer tax benefit
- Domestic partners

Investment of Assets

- Problem – It is very difficult to invest retiree health assets with pension assets
  - Reducing the net return for retiree health
  - Increasing the cost of benefits
  - Reducing the net assets for members
- This is a historical IRS position
  - But some change in similar areas has occurred

Investment – Commission's Role

- Policy – Best practice investment should not be prevented by IRS unless there is strong overriding tax policy
- Recommendation – IRS should allow retiree health and pension assets to be invested together for sound funding of these benefits

Collectively Bargained Benefits

- Problem – Retirees covered by "self insured" health plans can be taxed
  - PERS Choice and PERS Care
  - IRS ruling position – "vesting" creates taxation
- IRS ruling position
  - Practical issue when IRS rules on trust
  - New position
- No exception if bargained

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Bargained Benefits – Commission's Role

- Policy – Unions and employers should be able to bargain for benefits without IRS roadblocks
- Recommendation – IRS should interpret the tax laws on collectively bargained retiree health benefits in the same manner as it does now for pension benefits

Public Safety Officer Benefit

- Problem – this benefit is very uncertain for many California retired safety officers
  - Retired PSO's can use $3k of pension for health premiums, tax-free
  - IF terminate after "NRA" (or on disability)
  - Many California systems do not have NRA and is hard to fit IRS rules
  - Result: a number of retired safety officers will lose the benefit <u>or</u> take a tax risk

Public Safety Officer Benefit – Commission’s Role

- Policy – IRS rules should not reduce this new benefit or create uncertainty for California retirees
- Recommendation – IRS should revise “NRA” to fit with California systems and allow this benefit for our retirees

Domestic Partners

- Problem – new IRS ruling creates very high tax risk for **all** retirees
  - If misstep re domestic partners, **all retirees** are taxed on all their health benefits
  - IRS "solution" does not make practical or tax sense
    - impute as income to employee the present value of retiree health coverage earned each year
  - This was not created by the Administration's "social policy" but by Rev. Rul. 2006-36 and staff interpretation

Domestic Partners – Commission's Role

- Policy – Tax only those with domestic partners and tax when the value can be determined
- Recommendation – Under existing tax rules, tax the value of retiree health benefits to domestic partners only when paid (per prior rulings)

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Final Note – Your Ability to Create Change

- Your role – good policy & sound solutions
  - You come to the IRS without the "taint" of personal interest
- Most recommendations do not involve "revenue loss"
- Most can be solved by administrative action
- You should get a good hearing