# EL DORADO LAFCO

LOCAL AGENCY FORMATION COMMISSION

## *AGENDA OF MARCH 27, 2013*

## *REGULAR MEETING*

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| **TO:** | **Don Mette, Chair, and**<br>**Members of the El Dorado County Local Agency Formation Commission** |
| **FROM:** | **José C. Henríquez, Executive Officer** |
| **AGENDA ITEM #6:** | **RECEIVE INFORMATION REGARDING RETIREMENT BENEFITS, AUTHORIZE EXECUTIVE OFFICER TO FILE NECESSARY PAPERWORK WITH THE IRS AND CONTRACT FOR 457(b) RETIREMENT PLAN WHILE CALPERS CONTRACT IS ADOPTED AND IMPLEMENTED AND PROVIDE DIRECTION TO STAFF ON THE CONTRACT EFFECTIVE DATE** |

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### RECOMMENDATION

Staff recommends that the Commission:

- Receive the following information regarding the CalPERS contract;
- Authorize the Executive Officer to contract for a 457(b) retirement plan while the CalPERS contract is adopted and implemented; and
- Provide direction to staff regarding the effective date of the CalPERS contract

### REASON FOR RECOMMENDED ACTION

Statutory and regulatory context surrounding the CalPERS contract is provided to the Commission about both the need for a contract, as well as the determination of an effective date. In addition, a retirement vehicle must be offered to staff to be in compliance with Federal Internal Revenue Code laws. While a CalPERS retirement contract is recognized as a viable alternative to Social Security, to date this agency has gone 14 months without offering a retirement plan to its employees. A 457(b) is another alternative that can tie the agency over until the CalPERS plan is adopted and implemented.

## BACKGROUND

Recap of Events

When El Dorado LAFCO became independent, it either did not or could not pursue its own contract with the California Public Employees Retirement System. Instead, an arrangement was entered with the County of El Dorado and CalPERS whereby LAFCO sent its contributions to the retirement system under the County's employer code. Funds were differentiated from the County funds by LAFCO having its own "office code." So when LAFCO assumed payroll functions in 2005, it utilized a manual reporting process listing both the County's employer code and LAFCO's office code.

To that end, the Commission and the County signed two Memoranda of Understanding allowing LAFCO employees to participate under the County's CalPERS contract. The first MOU was signed in 2002 when LAFCO's operations were still embedded with the County and a second MOU in 2005 when LAFCO was fully independent from the County. The 2005 MOU replaced the 2002 MOU. The language pertaining to the ability to participate in the County's CalPERS contract is the same across both Memoranda. Subsection C6 of the 2005 MOU reads in part, "LAFCO employees shall be treated as County employees for the purpose of membership in CALPERS retirement programs *as allowed by law*" (emphasis added, refer to Attachment A).

In the fall of 2011, CalPERS implemented a new reporting system called myCalPERS. This new system is intended to be 100% automated; however, myCalPERS also no longer recognized office codes. The LAFCO retirement funds were automatically deposited with the County funds. When LAFCO asked CalPERS for advice on the situation, its staff's response was for LAFCO to enter into its own contract with CalPERS. In addition, the recommendation was for LAFCO to stop making payments into the system, which it did so in mid-November 2011.

*Is a LAFCO Contract with CalPERS Warranted?*

In an e-mail dated February 27, 2013 (please refer to Attachment B) and at the February meeting, the El Dorado County Auditor-Controller said that staff's February report to the Commission was inaccurate when it was stated there was no other choice but for LAFCO to pursue its own contract. He indicated LAFCO could have provided "a summary of employee compensation each payday to the Auditor-Controller's Office and my staff could easily key the payroll data into the myCalPERS system." Setting aside the costs associated with the manual workaround, both in backoffice as well as direct charges, the question is whether LAFCO's continued participation under the County's retirement contract is still feasible.

To answer that question, some background in retirement plan law is necessary. The CalPERS defined benefit plan is a qualified plan under Section 401(a) of the Federal Internal Revenue Code (IRC). The CalPERS plan is exempt from the more rigorous requirements under Section 401(a) due to its status as a "governmental plan" as defined under Section 414(d). To maintain its status as a governmental plan, the CalPERS plan can only permit the State, political subdivisions, and "agency or instrumentalities of the State or political subdivisions" to participate (refer to Attachment C). LAFCO and the County can participate in a CalPERS plan because both are political subdivisions of the State, albeit their police powers vary.

The implementation of MyCalPERS coincided with IRS Notice issued November 8, 2011 (refer to Attachment D), a couple of weeks before LAFCO staff contacted CalPERS. Under the draft regulations, to maintain its qualified status, the CalPERS plan must be established and maintained by the employer for the exclusive benefit of the employer's employees or their beneficiaries (refer to the last paragraph of the first column on page 2 of Attachment D). Failure to operate in compliance with this rule would disqualify the entire CalPERS plan and render all accrued benefits taxable. CalPERS staff further clarified that "an employee must have a relationship with a contracting agency for that agency to report payroll and membership for the employee. A contracting agency can only report its employees to CalPERS" (refer to Attachment E).

LAFCO employees are not County employees. Consequently, LAFCO cannot continue to "piggyback" on County's contract as suggested by the Auditor-Controller, both in his e-mail and at the February 27 Commission meeting. The new regulations also prevent LAFCO employees from being reported through the County while LAFCO's own contract is adopted and implemented. Indeed, CalPERS "New Agency Questionnaire," which starts the contract negotiation process, has been enhanced with the following language: "Therefore, if you are applying for our retirement plan, you should not withhold CalPERS retirement contributions from any employees of the Employer in anticipation of eligibility to participate in the CalPERS Plan, <u>nor should you report the Employer's employees under any other agency currently participating in the CalPERS Plan</u>" (emphasis added, refer to Attachment F).

*Status of LAFCO Employees Within the 2005 MOU*

The 2005 MOU states that "LAFCO employees will be treated as County employees for the purpose of membership on the CALPERS retirement programs." The question is whether that provision satisfies the relationship between a contracting employer and employee in the new regulations. As far as CalPERS is concerned, the answer is no since the County has no control over the hiring or firing of the LAFCO employees. Not only does the 2005 MOU itself state that the responsibility lies exclusively with LAFCO, but CalPERS staff effectively said so in Attachment E. Since CalPERS views the reporting of any non-County employee under the County's contract as risking CalPERS' qualified status as a government plan, it is highly unlikely CalPERS staff would reconsider their position nor does CalPERS have any legal or financial incentive to do so.

*Why Does the LAFCO Contract Have to Be Retroactive?*

Most CalPERS contracts are prospective, meaning they are effective from a certain date forward. Since the initial call in November 2011, CalPERS instructions to LAFCO staff have been clear: The effective date of the contract will be retroactive going back to the date in which LAFCO became independent from the County. According to CalPERS staff, these instructions came from an internal policy, which they have failed to produce despite repeated requests by LAFCO staff for a copy.

LAFCO Counsel believes that the direction for a retroactive contract stem from the new draft regulations. If a retirement plan should only benefit its employees and their beneficiaries, then the presence of LAFCO employees reported amongst County employees introduces an element of error into CalPERS. This error, in turn, puts the

CalPERS system out of compliance. Consequently, the LAFCO contract must go back in time to be effective from the date of its independence in order to eliminate the error.

The problem is that in order to implement a contract with a retroactive date there has to be two new pieces not ordinarily found in a prospective contract. The first is the establishment of an effective date (see discussion below) and the second is called a Reallocation Agreement. The latter document must be approved by the Commission, the County Board of Supervisors, and CalPERS. As the Commission is aware, the County objects to certain language in the agreement relating to a supposed historically incorrect reporting of LAFCO employees as County employees. LAFCO staff agrees with the County's concern that there was no error since the County and LAFCO were acting in compliance with the regulations in effect at the time. Nevertheless, as Attachment E indicates, the LAFCO CalPERS contract will not be implemented until the Reallocation Agreement is signed by the three parties. That will delay the implementation by an unknown period of time.

*Delays in the Process and Social Security Payments*

Social Security coverage is mandatory for state and local government employees who are not qualified participants in a public retirement system maintained by their employer and who are not covered under a Section 218 Agreement. Attachment G contains the IRS regulations surrounding IRC3121(b)(7)(F), the Federal statute covering this mandate [refer to paragraph (b) on page 2]. A public retirement system can be a pension, annuity, retirement, or similar fund or system established and maintained by a State, local government or district that provides retirement benefits to its employees. These benefits should be comparable to the benefits provided under the "Old-Age" portion of the "Social Security" part of the Federal Insurance Contributions Act (FICA). Participation in the CalPERS system qualifies as providing a comparable retirement system to Social Security.

As the Commission knows, the adoption and the implementation of the CalPERS contract has experienced numerous delays. A summary of dates through mid-January 2013 is provided in this report as Attachment H in the form of a memo sent to CalPERS protesting CalPERS' move to void the contract the Commission adopted in December 2012. As it can be seen in this timeline, CalPERS delayed the process for approximately 10 months through a slow turnaround of paperwork and by stopping the processing of new contracts between July and September 2012.

Since then, the Commission is aware that ongoing discussions with the County over the Reallocation Agreement and the effective date of the contract have dominated 2013. Proposed language addressing the County's concerns has been submitted to CalPERS, but LAFCO has been advised it may take as long as 8 weeks for CalPERS' legal to review. Even if the Commission were to adopt the contract in the next few months, as indicated immediately above, CalPERS staff has indicated it will not implement the LAFCO contract until the Reallocation Agreement is received. If CalPERS legal rejects the suggested changes, or if they return with other language County staff finds equally objectionable, then it becomes difficult to establish that the contract will be implemented within a short timeframe after the Commission adopts it.

Had the LAFCO CalPERS contract been adopted and implemented within a short timeframe, LAFCO would not have gone long without retirement benefits. However, now it has been 14 months without benefits. Unfortunately, IRC3121(b)(7)(F) is a black-and-white statute: it contains no exceptions for public agencies attempting to implement a retirement plan. The longer no retirement benefit situation continues, the more likely an audit by the Internal Revenue Service becomes a possibility, almost assuredly accompanied by fines and penalties. The prudent fiscal courses of action are two-fold:

- Submit revised Form 941 tax reporting documents to the IRS for Fourth Quarter 2011 and all of 2012 to reflect Social Security obligations with a payment by LAFCO that is sufficient to cover the requirements under IRC3121(b)(7)(F).
- Authorize the Executive Officer to contract with a qualified retirement management company to implement a 457(b) plan for all employees. This 457(b) plan meets the needs of IRC3121(b)(7)(F) and will cover LAFCO until the CalPERS contract is implemented. Upon implementation of the CalPERS contract, the assets of the 457(b) plan will transferred over to CalPERS.

The cumulative impacts will be approximately $28,463, with an estimated $22,384 going to meet the Social Security obligations for 2011 and 2012 and the remainder going towards the 457(b) plan from January 2013 through June 2013. There will also be costs associated with LAFCO's accounting firm, Terrie Prod'Hon, to prepare and file the necessary documents. There are sufficient salary savings and operating cost savings in the budget to cover all of these costs.

It must be reiterated and emphasized that the Social Security obligations required by IRC3121(b)(7)(F) became present the moment CalPERS instructed LAFCO to stop making payments into its system. Given the long delay in implementing the CalPERS contract, the cumulative cost of the Social Security payment would have been the same even if LAFCO had started paying into Social Security in November 2011.

*Would the Payment of Social Security Become Permanent?*

No because agencies that have an alternative retirement plan and also contribute to Social Security do so under a voluntary agreement known as a "Section 218 Agreement." Once an agency agrees to be bound by Section 218, they can never revoke that agreement.

In this instance, LAFCO's contributions to Social Security would not be under the voluntary agreement rules. Instead, it would be under the mandatory Social Security rules of Section IRC3121(b)(7)(F).

*Effective Date*

As discussed above, CalPERS is requiring that the new contract with LAFCO be retroactive to the date in which LAFCO became independent from the County. As indicated at the February meeting, independence from the County was a process spanning many years with no set date. The following are some milestone dates in the process:

- January 1, 2001 – LAFCOs received statutory permission and authority from the Legislature to become independent from their home county governmental structure through the adoption of the Cortese-Knox-Hertzberg Act.

- January 24, 2001 – LAFCO approves Resolution L-01-01, containing an MOU arranging for LAFCO to continue receiving facilities (office space, equipment and supplies) and services from County despite the then newly-enacted Cortese-Knox-Hertzberg Act's authorization for LAFCOs to become independent.
- January 29, 2002 – The County and LAFCO enter into an agreement that, among other things, gives LAFCO the ability to hire and fire its staff (Attachment I).
- June 26, 2002 – LAFCO approves Resolution L-02-06, which continues the arrangement contained in Resolution L-01-01 for facilities.
- July 1, 2003 – The budget for the fiscal year beginning on this date contains funds to move outside of the County Complex.
- July 2003 – A Federal Employer ID number (FEIN) is obtained.
- October 2003 – LAFCO signs a lease for office space outside of the County Complex.
- November 2003 – LAFCO physically moves out of the County Complex.
- December 2003 – According to a note in the employee file for the previous Executive Officer, LAFCO employees are designated as "terminated" in the El Dorado County Human Resources system.
- January 2004 – LAFCO obtains a California Employment Development Department (EDD) employer ID number.
- May 2004 – LAFCO opens a bank account with Western Sierra Bank (now Umpqua Bank).
- June 2004 – LAFCO partially withdraws funds from the County Treasury and assumes accounts payable functions in June 2004. Payroll functions remain with the County for six more months.
- January 2005 – LAFCO became responsible for its own payroll for the pay period beginning in December 25, 2004 and made its first reports to CalPERS directly.
- February 2005, LAFCO and the County adopted an MOU formalizing the relationship between the two agencies. The MOU specified which benefits LAFCO would contract with the County, including health benefits, liability insurance and participating under the County's PERS contract.

When negotiating a contract, the date of independence was set at December 2003 because that was the date in which LAFCO employees were presumably terminated from the County system. The January Actuary Report the Commission considered at the February meeting is set with the contract start date of December 2003.

At a meeting with LAFCO staff on March 4, 2013, CalPERS staff indicated their preference for the LAFCO contract to be February 2005 date because that is when LAFCO was both responsible for hiring and firing its staff and had the administrative pieces in place (control of its funds, FEIN and EDD employer number, etc.) to carry out payroll independent from any other entity. At their request, another actuarial report was commissioned in case this date is used.

The LAFCO contract start date has been controversial with the County. While County staff has not provided an alternative date, at a March 13, 2013 meeting with LAFCO staff, Assistant CAO Kim Kerr and Deputy County Counsel Judith Kerr stated their concern is not so much of having a "preferred" start date for the contract but more of the lack of information regarding the impact to the County if other alternative dates are used. To settle the matter, another actuarial report was commissioned for a January 2002 date. As stated immediately above, this date coincides with the date in which an MOU was signed between LAFCO and the County giving LAFCO the ability to hire and fire its own staff. While LAFCO was still embedded with the County physically and administratively (please recall that in 2002 LAFCO relied on the County for accounts payable and payroll and LAFCO did not have an FEIN or an EDD employer number), LAFCO Counsel indicates that the ability to control the hiring of staff can be the minimum criterion for determining an agency's independence. It is unknown whether CalPERS would ultimately accept this date; however, they have not been quick to dismiss it.

At the February meeting, Auditor-Controller Harn testified that he believed that the list of employees covered by the LAFCO contract incomplete and should be expanded to include everyone who had worked for LAFCO. While Mr. Harn did not specify a time period he had in mind, presumably his statement could cover any period in time ranging from the staff under the previous executive officer, who started in 1996, to going as far back to 1963 when LAFCOs were created.

This is a misreading of State Law as it existed before 2001. Please recall that LAFCOs did not have the authorization to become independent until the adoption of the Cortese-Knox-Hertzberg Act (CKH). A comparison of the language in some key government code sections between CKH and the Cortese-Knox Act of 1985 is provided as Attachment J of this report. The previous LAFCO governing statute had LAFCOs completely dependent on their home county government for funding (56380 and 56381), facilities and staffing (56380, 56384).

Further, if LAFCO's sole source of labor was the County, then the employees who worked on LAFCO were like other County employees working on a County assignment or department. In addition, until 1997, LAFCO's executive officer reported to the director of the County Planning Department and employees working on LAFCO were covered under County labor agreements and enjoyed County civil service rights (refer to the discussion relating to the then-Commission clerk on Agenda Item #6 in Attachment K). Finally, the Auditor-Controller unilaterally reduced the LAFCO Budget from Fiscal Year 2001-2002, an action presumably taken under the old provisions of Government Code Section 56381(c). Such an action would not have occurred to a truly independent agency, and the Auditor was able to do it because LAFCO had no administrative control over its funds prior to 2001 (refer to Attachment L).

This information is provided to the Commission so that it can review it and provide direction to staff on the effective date it prefers for the LAFCO contract:

- January 2002 – Effective date of the first LAFCO-County MOU where LAFCO assumed the responsibility for the hiring and firing of staff.
- December 2003 – LAFCO employee "termination" from County and the date closest to the date in which its administrative office relocated from the County Complex.

- February 2005 – Effective date of the second LAFCO-County MOU, which is currently in effect and is the closest to December 25, 2004, the first pay period in which LAFCO assumed payroll functions for its employees.

Determining the Commission's preference allows for more effective advocacy when discussing this issue with CalPERS and the County. While CalPERS has not committed to a timeframe for the completion of the two other actuarial reports, they will be made available to the Commission if they are received prior to the March meeting.

<u>Attachments:</u>

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| Attachment A: | 2005 Memorandum of Understanding Between LAFCO and the County of El Dorado |
| Attachment B: | February 27, 2013 E-mail from Auditor-Controller Joe Harn |
| Attachment C: | Internal Revenue Code Section 414(d) |
| Attachment D: | IRS Regulations on the Determination of Governmental Plan Status |
| Attachment E: | March 5, 2013 E-Mail from CalPERS Staff to LAFCO |
| Attachment F: | Copy of CalPERS New Agency Questionnaire |
| Attachment G: | IRS Regulations on IRC3121(b)7 |
| Attachment H: | January 14, 2013 Letter from LAFCO to CalPERS staff |
| Attachment I: | 2002 Memorandum of Understanding Between LAFCO and the County of El Dorado |
| Attachment J: | Comparison of Government Code Sections Between the Cortese-Knox Act of 1985 and the Cortese-Knox-Hertzberg Act of 2000 |
| Attachment K: | Minutes of the November 13, 1997 LAFCO Meeting |
| Attachment L: | October 29, 2001 Letter from LAFCO Special Counsel P. Scott Browne to Auditor-Controller Harn |