San Diego County Taxpayers Association

Taxpayers watchdog since 1945

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House Resolution (H.R.) 205: Amendment to IRS Ruling 2006-43

March 2013

SDCTA Position: **SUPPORT**

Rationale for Position: Cities in California have attempted to address their respective pension problems by introducing innovative solutions that benefit both taxpayers and employees. By allowing current employees to enroll in lower cost pension plans, cities would experience a reduction in pension costs while employees would see an increase in take-home pay. The proposed bill would allow cities that have already adopted this reform to move forward with implementation and clear any barriers for other cities to begin the process of adopting similar provisions to that of Orange County, San Jose and San Diego.

Title: H.R. 205 – Amendment to IRS Ruling 2006-43
Jurisdiction: Federal
Type: Statutory/constitutional amendment/ordinance
Vote: Majority
Status: Referred to House Ways & Means Committee
Issue: To amend the Internal Revenue Code of 1986 to clarify the treatment of certain retirement plan contributions picked up by governmental employers.
Description: Bill would revise IRS Ruling 2006-43 with an amendment authorizing public agency employees to opt-out of their current defined benefit pension plan and enter into lower cost hybrid or defined contribution plans without penalty.
Fiscal Impact: As employees elect to enroll in lower cost pension plans, local governments could experience a reduction in pension costs through lower unfunded liabilities and normal cost contribution rates. Employees electing to enroll in a lower cost pension plan would see an increase in take-home pay. Taxpayers in jurisdictions that offer this option may also see less tax dollars being spent on public employee pensions.

Background:

Orange County Pension Reform

In 2009, the County of Orange and union representatives with the Orange County Employees Associate agreed to give employees the option of enrolling in lower cost pension plans as a means to alleviate the rising contribution rates of their defined benefit pension plans. The lower cost plan is a hybrid plan, which includes a lower defined benefit component as well as a defined contribution component. New employees would also be able to choose between the two plans. Two other unions, the Association of Orange County Workers and the International Union of Operating Engineers, have also agreed to the plan.

Reforms in Other Cities

Voters within the Cities of San Diego and San Jose passed ballot measures in 2012 that included a similar component to that of Orange County's reform. Both Measure B in San Jose, and Proposition B in San Diego, included language that would allow current employees to enroll in lower cost pension plans instead of paying higher costs for their current defined benefit plans.

IRS Ruling 2006-43

IRS Revenue Ruling 2006-43 deals with what actions are required in order for a state or local government employer to "pick up" employee contributions to a qualified plan so that the contributions are treated as employer contributions pursuant to § 414(h)(2) and therefore tax-deferred. The ruling clarifies that in order for employee contributions to be considered made, or picked up, by the employer:

1. Contributions, although designated as employee contributions, are to be paid by the employer pursuant to formal action taken by the employing unit to provide that the contributions on behalf of a specific class of employees of the employing unit, although designated as employee contributions, will be paid by the employing unit in lieu of employee contributions; and
2. A participating employee, from and after the date of the "pick-up", cannot be permitted to have a cash or deferred election right with respect to designated employee contributions. That is, participating employees must not be permitted to opt out of the "pick-up", or to receive the contributed amounts directly instead of having them paid by the employing unit to the plan.

Based on one reading of Ruling 2006-43, Orange County's optional defined benefit plan tier for current employees, because it changes the level of the "picked-up" employee contribution, could be viewed as a prohibited cash or deferred arrangement under the plan. Orange County has been attempting to determine if the second part of this Revenue Ruling requirement would indeed prevent it from offering its new tier as an individual option to its current employees. That is, would the Revenue Ruling not only prohibit any employee from opting out of the pick-up, but also from making any election that would changes the amount of the employee's picked-up contribution since it would result in the employee "electing" to have more current or deferred compensation?

Orange County has been working with the IRS as well as the Treasury Department to seek clarification on this ruling and allow them to move forward with implementing the hybrid pension plan for current employees. Discussions have been unsuccessful and thus attempts to move forward with legislative reforms have proceeded.

SDCTA Past Position

SDCTA supported Proposition B, and the provision that would allow current employees to elect to participate in a lower cost retirement plan as a means to increase take-home pay, if permissible by law.

Proposal:

In January 2013, Congresswoman Loretta Sanchez (CA-46) introduced House Resolution (H.R.) 205 that would amend the Internal Revenue Code to clarify the treatment of certain retirement plan contributions picked up by governmental employers.

H.R. 205 would add section (B), "TREATMENT OF ELECTIONS BETWEEN ALTERNATIVE BENEFIT FORMULAS." The section specifically reads,

> "(i) IN GENERAL. – For purposes of subparagraph (A), a contribution shall not fail to be treated as picked up by an employing unit merely because the employee may make an irrevocable election between the application of two alternative benefit formulas involving the same or different levels of employee contributions.
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> (ii) APPLICATION TO EXITING EMPLOYEES. – Clause (i) shall be applied without regard to whether the employee is already covered by one of the benefit formulas referred to therein."

Congressmen John Campbell and Ed Royce, both representing portions of the County of Orange, have joined as co-sponsors to the bill.

Policy Implications:

H.R. 205 would amend the Internal Revenue Code to allow current government employees to elect to participate in a lower cost retirement plan without the penalty of previous contributions paid for by their employer to be determined as deferred compensation. Passage of the bill would allow not only employees of Orange County to move forward with this reform, but the cities of San Jose and San Diego as well.

Some public employee unions may be concerned with the implications of this reform and the temptation it presents to current employees to waive their constitutional guarantees to their current benefits. Unions may ask the Treasury Department and the IRS to follow a strict interpretation of Revenue Ruling 2006-43 and find that individually elected contributions should continue to be excluded from treatment as employer "pick-up" contributions.

Fiscal Impact:

Local Government
As employees elect to enroll in lower cost pension plans, local governments could a reduction in pension costs through a reduction in their unfunded liabilities and normal cost contribution rates.

Local Taxpayers
Employees electing to enroll in a lower cost pension plan would see an increase in take-home pay. Taxpayers in jurisdictions that offer this option may also see less tax dollars being spent on public employee pensions.

List of Proponents:

- Congresswoman Loretta Sanchex (CA-46)
- Congressman John Campbell (CA-45)
- Congressman Ed Royce (CA-39)
- Orange County Board of Supervisors

Proponent Arguments:

- Reform being pursued by Orange County, San Jose and San Diego will allow for great taxpayer savings by reducing the costs of public employee pensions within those jurisdictions.
- Not only would governments see reductions in pension costs, employees will see greater take-home pay by opting to enroll in these lower cost pension plans.

List of Opponents:

- None listed at this time.

Opponent Arguments:

- Employees may choose to opt-out of defined benefit pension plans in lieu of lower cost defined contribution plans/hybrid plans that provide for less retirement security.