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August 11, 2021

The Honorable City Council
City of Los Angeles
c/o City Clerk
Room 395, City Hall
200 North Spring Street
Los Angeles, CA 90012

Honorable Members:

Subject: **Establishment of Internal Revenue Code Section 115 Trust to Fund
Future LAFPP Retiree Health Benefits**

At its meeting of July 15, 2021, the Board of Fire and Police Pension Commissioners (the Board) directed staff to seek City Council consideration and establishment of an Internal Revenue Code Section 115 Trust to provide an alternative funding mechanism for the Los Angeles Fire and Police Pensions (LAFPP) retiree health benefits program. In order to achieve this objective, the Board requests that the City Council direct the Office of the City Attorney to prepare a draft ordinance which would amend Chapter 11.5 of Division 4 of the Los Angeles Administrative Code (LAAC) to establish the Los Angeles Fire and Police Pension Retiree Health Care Fund (LAFPP Health Care Fund). The proposed LAFPP Health Care Fund is intended to qualify for exemption from federal income tax under Section 115(1) of the Internal Revenue Code, giving LAFPP increased flexibility in its health care funding mechanism. The draft ordinance would also specifically authorize the use of the LAFPP Health Care Fund to pay for LAFPP health and welfare benefits.

Background and Summary of Proposed 115 Trust

As recommended by the Board of Fire and Police Pension Commissioners, the LAFPP Health Care Fund would be created as an alternative funding mechanism for LAFPP health and welfare benefits in place of the LAFPP Health Care Coverage Account established in Section 4.1150 of the LAAC (the Health Care Coverage Account), pursuant to Section 401(h) of the Internal Revenue Code. The draft ordinance would authorize the City and the Board to enter a written trust agreement establishing their roles and responsibilities regarding the administration and investment of the LAFPP Health Care Fund. The trust agreement would name the Board as trustee of the LAFPP Health Care Fund.



The recommended LAFPP Health Care Fund provides increased flexibility compared to the existing Health Care Coverage Account. Because the LAFPP Health Care Fund would not be subject to the subordination requirement that governs the Health Care Coverage Account, it is not at risk of incurring tax liability when the cost of health and welfare benefits surpass the limits that the Health Care Coverage Account requires. The Health Care Coverage Account was established to comply with Section 401(h) of the Internal Revenue Code (Section 401(h)). Section 401(h) allows a pension plan such as LAFPP to provide health benefits for retirees and their dependents on a tax-free basis when certain requirements are satisfied. One of these requirements is that health benefits - combined with life insurance - provided by a pension plan must be subordinate to the retirement benefits the plan provides. In order to be subordinate, the aggregate amount of contributions for health benefits and life insurance must be less than 25% of all aggregate plan contributions. The subordination requirements of Section 401(h) governing the Health Care Coverage Account are similarly codified in LAAC Section 4.1150(b). While to date aggregate LAFPP health benefits contributions fall under the 25% threshold, they are on pace to exceed this limit in the future.

In contrast, the LAFPP Health Care Fund would not be subject to the Section 401(h) subordination requirement. Instead, the LAFPP Health Care Fund is intended to qualify for federal tax exemption under Section 115(1) of the Internal Revenue Code (Section 115). Section 115 has fewer requirements for tax exemption than Section 401(h). Section 115 dictates only that "income derived from any public utility or the exercise of any essential governmental function and accruing to a State or any political subdivision thereof" is not federally taxable. Because health benefits paid out of the LAFPP Health Care Fund are not required to be subordinate to the Plan retirement benefits, the LAFPP Health Care Fund would not become taxable when Plan health benefits surpass the 25% threshold.

It is noted that the City Council previously established a similar 115 Trust account to fund retiree health benefits for the Los Angeles City Employees' Retirement System (LACERS) in November 2018. For similar reasons we humbly request that the City Council now direct the Office of the City Attorney to prepare a draft ordinance which would amend Chapter 11.5 of Division 4 of the Los Angeles Administrative Code (LAAC) to establish the Los Angeles Fire and Police Pension Retiree Health Care Fund (LAFPP Health Care Fund).

If you have any questions regarding this matter, please contact Assistant General Manager Joseph Salazar at (213) 279-3095.

Sincerely,



Raymond P. Ciranna
General Manager

RPC:JS

c: Matt Szabo, City Administrative Officer
Anyia Freedman, Assistant City Attorney