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CITY ATTORNEY

REPORT NO. R 18 - 0303
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REPORT RE:

**DRAFT ORDINANCE AMENDING ARTICLE 1 OF CHAPTER 11 OF DIVISION 4 OF
THE LOS ANGELES ADMINISTRATIVE CODE TO ESTABLISH THE LOS ANGELES
CITY EMPLOYEES' RETIREMENT SYSTEM HEALTH CARE FUND AND TO
AUTHORIZE THE USE OF THE HEALTH CARE FUND TO PAY FOR RETIREE
HEALTH AND WELFARE PROGRAMS**

The Honorable City Council
of the City of Los Angeles
Room 395, City Hall
200 North Spring Street
Los Angeles, California 90012

Honorable Members:

This Office has prepared and now transmits for your consideration the enclosed draft ordinance, approved as to form and legality. As recommended by the Board of Administration of the Los Angeles City Employees' Retirement System (the Board), the draft ordinance would amend Article 1 of Chapter 11 of Division 4 of the Los Angeles Administrative Code (LAAC) to establish the Los Angeles City Employees' Retirement System Health Care Fund (LACERS Health Care Fund). The LACERS Health Care Fund is intended to qualify for exemption from federal income tax under Section 115 of the Internal Revenue Code, and thereby give the Los Angeles City Employees' Retirement System (LACERS or the Plan) increased flexibility in its health care funding mechanism. The draft ordinance would also specifically authorize the use of the LACERS Health Care Fund to pay for LACERS health and welfare benefits.

Background and Summary of Ordinance Provisions

The draft ordinance creates the LACERS Health Care Fund as an alternative funding mechanism for LACERS health and welfare benefits in place of the LACERS Health Care Coverage Account established in Section 4.1102 of the LAAC (the Health

Care Coverage Account). The draft ordinance authorizes the City and the Board to enter a written trust agreement establishing their roles and responsibilities regarding the administration and investment of the LACERS Health Care Fund. The trust agreement will name the Board as trustee of the LACERS Health Care Fund.

The LACERS Health Care Fund provides two aspects of increased flexibility compared to the existing Health Care Coverage Account. First, because the LACERS Health Care Fund is not 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 LACERS 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 expenditures for health benefits (along with life insurance contributions) 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 4.1102(b). While to date aggregate LACERS health benefits expenditures fall under the 25% threshold, they are on pace to exceed this limit in the future.

In contrast, the LACERS Health Care Fund would not be subject to the Section 401(h) subordination requirement. Instead, the LACERS Health Care Fund is intended to qualify for federal tax exemption under Section 115 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 LACERS Health Care Fund are not required to be subordinate to the Plan retirement benefits, the LACERS Health Care Fund would not become taxable if the Plan health benefits surpass the 25% threshold.

Second, the LACERS Health Care Fund gives LACERS more flexibility to invest premium surpluses to provide for smoothing should health care premiums considerably increase in the future. The Board has considered the implications of premium smoothing and found that it is in the best interest of LACERS membership to implement this process. Furthermore, the Board noted that LACERS is in a unique position to take advantage of decreased premium amounts next year; and, therefore, it seeks to finalize the creation of the LACERS Health Care Fund before January 1, 2019.

Currently, the Health Care Coverage Account cannot receive full refunds of excess premiums from insurance providers because Section 401(h) strictly limits what

monies can be held in that account. Specifically, Section 401(h) only allows the Health Care Coverage Account to retain funds the City deposits. Because premium refunds are made up of City subsidy payments and LACERS member contributions, the portion of the premium made up of member contributions cannot be returned to the Health Care Coverage Account. As a result, insurance providers currently retain excess premium amounts on LACERS' behalf in a reserve account that earns a nominal interest rate. Similarly, when premiums decrease, LACERS cannot keep member contributions flat and then retain a reserve portion of member contributions in the Health Care Coverage Account for future premium smoothing because these funds did not come directly from the City.

In contrast, the LACERS Health Care Fund faces no such restrictions under the Section 115 requirements. Therefore, it can receive full premium surplus refunds from insurance providers. LACERS can invest these funds at a higher rate of return than the insurance providers' reserve account interest rate. Additionally, LACERS can take advantage of periods of insurance provider premium decreases to keep funded premiums level and invest the difference between funded and charged premiums via the LACERS Health Care Fund. LACERS can use these investment gains to offset future health care premium spikes.

Council Rule 38 Referral

A copy of the draft ordinance was sent, pursuant to Council Rule 38, to LACERS and to the Office of the City Administrative Officer. Their respective comments have been incorporated into the draft ordinance.

If you have any questions regarding this matter, please contact Deputy City Attorney Miguel Bahamon at (213) 978-6800. He or another member of this Office will be present when you consider this matter to answer questions you may have.

Sincerely,

MICHAEL N. FEUER, City Attorney

By



DAVID MICHAELSON
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DM:MB:pj
Transmittal