James M. Andersen
Retirement Administrator

Telephone: (707) 463-4328
(707) 467-6473
Fax: (707) 467-6472

MENDOCINO COUNTY
EMPLOYEES' RETIREMENT ASSOCIATION
625-B KINGS COURT
UKIAH, CALIFORNIA 95482-5027

Date:	September 21, 2011
To:	Pat Meek, Human Resources Director
	Sue Goodrick, Human Resources Manager
From:	Jim Andersen, Retirement Administrator
Subject:	Remaining Balance in the Retiree Health Insurance Reserve

Introduction

In January of 2011, the Mendocino County Employees' Retirement Association (MCERA) submitted an application for a determination letter and a related voluntary correction program (VCP) filing to the Internal Revenue Service (IRS). The determination letter is a formal "determination" by the IRS that the terms of MCERA (as documented in the County Employees' Retirement Law of 1937 (the '37 Act) and other official MCERA actions) are in substantial compliance with the Internal Revenue Code (IRC).

The IRS has strongly encouraged all public sector retirement systems such as MCERA to file an application for an IRS determination letter on the tax qualified status of the system. As part of such a filing, if the retirement system determines that there are issues about the tax rules as applied to that system, the IRS also encourages the system to file under its VCP procedure. MCERA, as many other public sector systems across the country and many other California county systems operating under the '37 Act, made these filings last January. The IRS has begun its review of applications filed by public retirement systems and under its normal process will respond to MCERA regarding its filings. Hanson Bridgett LLP was retained to represent MCERA in its IRS filings and is representing MCERA in any discussions with the IRS.

In the VCP filing process, MCERA describes areas where we may have compliance issues, and suggests possible corrections for the IRS to consider. This two pronged approach is meant to be a voluntary and cooperative method of securing a determination letter from the IRS, correcting any problematic issues, and retaining the tax qualified status of the plan. As fiduciaries of the pension plan, there is arguably no more critical responsibility than ensuring the tax qualified status of the plan; thereby ensuring all contributions to the plan and earnings on the assets will remain tax deferred. It is critical, therefore, that the MCERA Board work closely with its attorneys to best support discussions with the IRS related to MCERA's filings.

Since filing the application for a determination letter and related VCP, MCERA has entered into agreements with a new actuary, The Segal Company (Segal), and a new external financial auditor, GALLINA LLP (GALLINA). The actuary and external auditor are key advisors regarding the policies and practices of MCERA, and new advisors may offer new perspectives on historical activities of MCERA and the information contained in the application for a determination letter and the VCP filing.

Discussion

In the VCP filing submitted in January of 2011, MCERA made factual statements based on its understanding at that time. MCERA stated that it had provided retiree health benefits based on "excess earnings" determined in a manner that was in compliance with the '37 Act. MCERA also noted that the IRS had issued a favorable determination letter for MCERA's plan document in August of 1987 when the relevant sections of the CERL were in place, indicating that MCERA was "not in noncompliance" at that time with the rules for providing retiree health benefits.

In light of the recent change in actuarial and accounting advisors, MCERA, in consultation with Hanson Bridgett, determined it was appropriate to re-examine statements contained in the VCP application to determine their continued factual correctness. While MCERA implemented historical practices in good faith based upon the advice of its advisors at the time, the following are key findings of the re-examination process conducted over the past two months:

1. The balance of excess earnings that have been set aside to pay for retiree health benefits must be shown as a liability on the actuarial balance sheet in each year's valuation study. Including the funds set aside for retiree health care as a liability will increase Unfunded Accrued Actuarial Liability (UAAL) and the employer contribution rate. While the funds may be used for retiree medical benefits under Government Code Section 31592.4, the best practice would be to calculate UAAL and the employer contribution rate with and without funds set aside for retiree health benefits, and to then allow discussion prior to making an informed decision on whether or not to designate the funds for pension liabilities or retiree health benefits. Staff also found that beginning in the fiscal year ended June 30, 2006, the balance in the retiree health account has not been shown as a liability on the actuarial balance sheet. We believe that this may have resulted in an understatement of UAAL and employer rates from 2007/08 fiscal year forward. Since each new actuarial valuation is a "snapshot in time," any historical understatement of UAAL and rates should be corrected in the June 30, 2011, valuation being prepared by Segal.

2. The use of excess earnings for retiree health benefits is limited (subordinate to funding pension liabilities) per Section 401(h) of the IRC. MCERA has calculated the 401(h) limit, which Segal has reviewed, and determined that the amounts paid for retiree medical benefits through the use of excess earnings has satisfied the 401(h) limit. Nonetheless, best practice would result in the 401(h) limit being calculated each fiscal year, and the results being part of the annual process to determine if excess earnings should be used to fund pension liabilities or retiree health benefits. MCERA staff found in performing the calculations required for the IRS 401(h) limit that the percent of aggregate funds set aside for retiree health benefits compared to funds for pension benefits steadily rose from 13.04% in 1998/99 to 22.18% in 2009/10.

John D
I very much
doubt this.

3. The '37 Act only allows for the recognition and posting of excess earnings when reserve accounts have been posted at the assumed actuarial rate (8%) and a contingency fund of 1% of assets is maintained. In 2005/06, MCERA's records show that $9,557,912 was

3557276.1

recognized as excess earnings, while only 5.1% was posted to employee, employer and retiree reserves. While this posting was done in good faith reliance on actuarial and auditing advisors at the time, it raises the question as to whether or not the '37 Act was complied with in that fiscal year.

Conclusion

As noted in the introduction, MCERA's primary objective is to provide the appropriate support for our attorneys as they begin discussions with the IRS regarding our application for a determination letter and VCP filing, and ultimately, to maintain the tax qualified status of the pension plan. Maintaining the tax-qualified status of MCERA is in the best interests of all concerned. We must communicate completely with the IRS regarding any new findings and continue our on-going efforts to strengthen MCERA's compliance with the '37 Act and the IRC.

Based upon those broader goals, Hanson Bridgett has recommended the following actions:

1. Submitting a supplemental letter to the IRS containing new findings and/or clarification of statements made in the applications for a determination letter and VCP.

2. Implementing best practices (including consideration of certain model policies that have been developed in coordination with other '37 Act systems) for financial reporting and disclosure in decision making processes.

3. Requesting that our new financial advisors, Segal and GALLINA, review the recognition of excess earnings from 1998 forward and provide findings and recommendations.

4. Refraining from distributing the $658,654 (which was determined based on the calculation of excess earnings that will be the subject of the further review) that remains in the retiree health insurance account until the review is completed by our new advisors.

The Board of MCERA is acutely aware that refraining from using the remaining balance of $658,654 for retiree health benefits will impact anticipated financing for retiree health benefits and may result in program changes by the County. However, as stated in the introduction, as fiduciaries, the Board's first commitment must be to ensuring that the pension plan retains its tax qualified status and continues forward with its primary purpose of meeting pension obligations.

JA

Copy Board of Retirement
Carmel Angelo, CEO, Mendocino County
Judith Boyette, Partner, Hanson Bridgett LLP
Andy Yeung, Vice President and Associate Actuary, The Segal Company
Crystal Ekanayake, Partner, CEBS, GALLINA LLP