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REPORT

DATE: For the Agenda of December 14, 2001 **ITEM 103**

REPORT NO.: HCR01-133

SUBJECT: Section 457 Deferred Compensation Plan Revision

SUMMARY

Issue: Should the Housing Commission authorize the Chief Executive Officer to implement required and selected optional changes to the San Diego Housing Commission Section 457 Deferred Compensation Plan, effective January 1, 2002, pursuant to the Economic Growth and Tax Relief and Reconciliation Act of 2001?

Recommendation: Authorize the Chief Executive Officer to implement the legislative modifications to the San Diego Housing Commission Section 457 Deferred Compensation Plan, as described in the Attachment, to include: 1) Mandatory Cash-out of Small Account Balances and the following optional changes: 1) Elective Deferral and Catch-up Limits, 2) Additional Contributions for Participants Age 50 and Over, 3) Flexible 457; Required Minimum Distributions, and 4) Qualified Domestic Relations Order language.

Fiscal Impact: None.

Previous Related Action(s): In July 1988, the Housing Commission authorized the Chief Executive Officer to negotiate and implement a voluntary Section 457 Deferred Compensation Plan and execute an investment contract for assets of the Plan. In July 1991, a separate, mandatory Section 457 Deferred Compensation Plan was implemented in lieu of Social Security for non-permanent employees providing a 3.75% match of the employee's required contribution. In February 1998, the Housing Commission granted the Chief Executive Officer authority to implement administrative and legislative changes pursuant to the Small Business Job Protection Act of 1996.

Future Related Action(s): If approved by the Board of Commissioners, this item will be scheduled for the next available Housing Authority meeting.

BACKGROUND

In 1979, the Housing Commission established an IRS approved Defined Contribution Pension Plan providing tax qualified retirement benefits to covered employees. The Plan also allowed employees to voluntarily contribute up to a maximum of 10% of salary on an after-tax basis. Following exclusion of public employers from participating in 401(k) plans, the Chief Executive Director received authorization to negotiate and implement a Section 457 Deferred Compensation Plan with plan assets to be invested similarly to the Pension Plan. In November 1988, a Section 457 Plan was implemented providing employees the opportunity to voluntarily contribute a maximum of one-third of salary up to $7,500 annually on a tax-deferred basis, with plan assets invested through Great-West Life and Annuity Insurance Company. These limits were raised under subsequent legislation.

In February 1998, the Housing Commission authorized the Chief Executive Officer to implement required changes pursuant to the Small Business Job Protection Act of 1996 to provide for automatic future increases in deferral limits for cost of living adjustments (deferral limit increased from $7,500 to $8,000), to comply with the Conforming Equitable Distribution Orders for former spouses and dependents, amend the group annuity contract, and implement recommended administrative modifications, and optional changes to: 1) amend Normal Retirement from 65 to age 62, 2) retain provision for in-service distribution for unforeseeable emergency, 3) retain provision permitting 457 Plan to Plan transfers, and 4) allow a one-time delay in payment by benefits from previous employee-selected benefit commencement date.

In January 2000, the Tax Codes increased the maximum 457 Plan contribution limit from $8,000 to $8,500. This increase and any subsequent legislative increases will continue to be implemented by the Chief Executive Officer in accordance with authorization previously approved by the Housing Commission.

DISCUSSION

The Housing Commission’s Group Benefits and Pension Consultant, Ken Murray of Watson Wyatt Worldwide, has reviewed recommended changes to the San Diego Housing Commission Section 457 Plan proposed by Great West, the Housing Commission’s 457 Deferred Compensation Plan administrators, to comply with the Economic Growth & Tax Relief & Reconciliation Act (EGTRRA) of 2001.

The proposed Plan changes refer to compliance and administrative matters, and do not involve the investment of plan assets nor do they impact the IRS Private Letter Ruling issued for this Plan. Most of the legislative changes described in the Attachment are optional and enhance the capability under the Plan to employees and are positively recommended. (The increase in the permitted contribution rate is not currently deductible under California Income Tax law.) Other EGTRRA changes impact the Housing Commission's Pension Plan document and will be addressed in a separate report for Pension Plan document revisions or apply to a Defined Benefit Pension Plan and are not applicable. The recommended and optional changes are described in the Attachment, in addition to provisions not recommended.

Despite its potential popularity with some employees, the adoption of a loan provision in the Section 457 Plan is not recommended at this time because there is no current Internal Revenue Code provision permitting 457 Plan loans and the IRS will not issue Private Letter Rulings to 457 plans with a loan provision. Loans under qualified plans have long been the single largest reason for lost retirement savings due to the loans becoming a distribution when the employee terminates employment. A distributed loan is subject to California and federal income tax consequences and penalties that may cause additional hardship and lost savings. The Housing Commission will consider adding a Section 457 Plan loan provision if permitted by the Treasury in the future.

A summary of provisions of the Act was discussed with the Pension Investment Committee for compliance and administrative information purposes. The Housing Commission's legal advisor has also reviewed the proposed Plan changes. All employees have been notified of the proposed changes, effective January 1, 2002.

ALTERNATIVES

Approve only the mandatory changes. Do not approve the Optional changes or selectively approve one or more. However, it should be noted that recommendations are made considering the best interests of the Housing Commission and employees, with Pension Investment Committee concurrence including Union representation from S.E.I.U., Local 535. Recommended changes must be approved to comply with the Economic Growth and Tax Relief and Reconciliation Act of 2001.

Respectfully submitted, Signature on File With Original Document Approved by,

Kadee Gonzalez
Human Resources Manager

Elizabeth C. Morris
Chief Executive Officer

Attachment(s):
Summary of Changes

ATTACHMENT

SUMMARY OF CHANGES

Section 457 Deferred Compensation Plan
Economic Growth & Tax Relief & Reconciliation Act (EGTRRA) of 2001

RECOMMENDED CHANGES – Effective January 1, 2002

Mandatory Legislative Change:

1. **Mandatory Cash-out of Small Account Balances**
   To adopt direct rollover language for small account balances greater than $1,000, but less than $5,000.

   The Section 457 Plan has previously been amended to allow for small balance cash-outs. This new language complies with a requirement under EGTRRA to make the cash-out in the form of a rollover to an IRA to avoid forcing a tax consequence on the affected employee.

Optional Changes:

1. **Elective Deferral and Catch-up Limits; Repeal of Coordination**
   To raise contribution limits and eliminate existing offsets for pre-tax contributions to 401(k) and 403(b) plans.

   This change enhances employee deferral capabilities through increased dollar and percentage of compensation limits at no cost to the Housing Commission. Delete Plan reference of $7,500 and replace with "the applicable dollar amount" to reflect automatic index changes; and the legislated dollar increases as follows: $11,000 in 2002, increasing $1,000 per year until the limit reaches $15,000 in 2006, then indexed in $500 increments. Catch-up contributions already available during the three-year period prior to normal retirement age may be increased from $15,000 to twice the regular elective deferral limit and will be changed in the Plan.

2. **Additional Contributions for Participants Age 50 and Over**
   To enhance contribution capabilities for employees 50 years of age and older by the end of the Plan Year. These employees will have an additional $1,000 contribution capability in 2002, increasing $1,000 each year until the catch-up contribution reaches $5,000 in 2006. This amount is then indexed in $500 increments based on cost of living. This change further enhances employee contribution capabilities at no cost to the Housing Commission and will be stated in the Plan.

3. **Flexible 457 Distribution; Required Minimum Distributions**

To adopt EGTRRA's more flexible minimum distribution allowance to permit greater flexibility in the payment of benefits.

This change eliminates tax issues when funds are deemed "made available" and provides greater benefit flexibility for non-spousal beneficiaries at no cost to the Housing Commission. The participant's account balance is no longer taxable when made available. Adopting this provision requires deleting plan language taxing a participant's 457 account balance at separation of service prior to an amount being paid to the participant and beneficiary.

4. **Qualified Domestic Relations Order (QDROs)**
   To substitute new language regarding Qualified Domestic Relations Order for existing Conforming Equitable Distribution Order.

   This will allow employees to select the Pension Plan, Section 457 Plan, or both plans when deciding how to split account balances under a court order in a divorce settlement. It also allows for more uniform language to divide property under one or both plans. This is an administrative issue that should have no cost impact to the Housing Commission and may reduce an employee's attorney's fees in divorce proceedings.

NOT RECOMMENDED

Optional:

Rollovers From Employer-Sponsored Plans and IRAs
To accept rollovers from a 403(b) plan or a qualified plan under Section 401(a) as provided for by the Internal Revenue Code (includes 401(K) plans).

Permitting Section 401(a) rollover under the Pension Plan, but not both plans is recommended. The Pension Plan has enhanced investment options through the self-directed Schwab One Account option. Limiting rollovers to a single plan will eliminate explanation of plan differences regarding plan provisions, benefit options, and investment performances.

457 Plan Loans
Commission staff and consultants strongly recommend against adopting any provision allowing employees to borrow against their Section 457 Plan accounts due to the fact that there is no current Internal Revenue Code provision explicitly permitting 457 Plan loans.