



Santa Barbara County Employees' Retirement System

DATE: March 17, 2017

Agenda Item # 1

TO: SBCERS BOARD OF RETIREMENT

FROM: Gregory Levin, CPA 

RE: Internal Revenue Service Reporting

Recommended Action:

Receive and accept the report and direct staff to implement a payroll schedule for 2017 consisting of 11 payments, February 1 through December 1, with the January 18, payment payable on January 2, 2018.

Background:

A background memorandum provided to the Board for its March 6, 2017 meeting is attached for reference. To state the issue more succinctly, the circumstances that led to a change in payroll tax reporting for 2017 are as follows.

In prior years dating back to the 1980s, the deposit initiated by SBCERS at the end of December for its direct deposit payees was reported as income for the subsequent year and not in the year that the direct deposit was initiated. Although members and beneficiaries have received a total of 12 monthly payments in each full year after the year of retirement, the payments reported to members and beneficiaries and to the IRS for those years were for 11 deposits initiated by SBCERS in that calendar year (February 1 through December 1) and one payment for which a direct deposit transaction had been initiated in the prior year. This practice, dating back to the year of a member's retirement, or the year that the member or beneficiary converted from receiving paper warrants to direct deposit, was based on the assumption that most members did not receive access to their funds electronically deposited by SBCERS on the last business day of the year until the following day, which was normally in the next calendar year. Staff has concluded that this assumption is no longer defensible and that the System is at significant legal risk if the process remains unchanged. Public comment by retirees at the March 6th meeting, in which many retirees stated that they had received the closing December payment in December each year, reinforces staff's conclusion.

In January of this year, after funds had already been deposited to member and beneficiary accounts on December 30, 2016, the last business day of the year, this reporting practice was questioned by the recently hired SBCERS Controller. After consulting with SBCERS' tax counsel, staff was advised that it would not be in compliance with tax reporting rules to defer the reporting of this payment to 2017 and that it must be reported in 2016, due to the deposit having been initiated by SBCERS on December 30, two days prior to the close of the calendar year. For that reason, consistent with our obligation to comply with the law, we included the December 30, 2016 direct deposit 2016 Form 1099-Rs issued to all members and beneficiaries.

Although staff had no choice but to report the December 30 payment on Form 1099-Rs and could not ignore their legal obligations to do so, a decision still had to be made regarding how the December 31, 2015 payment should be reported, since it had not previously been reported as income to members and beneficiaries due to the lag in reporting caused by the existing tax reporting method. After further consultation with tax counsel, it was concluded that there were only two options available, reporting an additional payment for 2016 (the 12 already scheduled for reporting plus the additional payment for December 30, 2016) or issuing restated 1099-Rs for all open tax years back to 2013. Staff elected the additional payment option over other alternatives for correction based on the advice of tax counsel that it provided the most complete and defensible correction. Additionally, the issuance of restated 1099-Rs to all of our retirees for a period of several prior years would have been confusing to all members and would have caused hardship to those who may be required to file amended tax returns for prior years. Another consideration was that for recent retirees, this method would have simply moved the additional payment from 2016 to a prior tax year for which tax returns had already been filed.

We continue to believe that the reporting of the additional monthly payment for 2016 was entirely proper and the best alternative under the circumstances for the Retirement System and for its retirees and beneficiaries. Along with the extra reported payment, an extra month's withholdings have also been reported to member accounts, which credits will tend to reduce the amount of 2016 taxes retirees will owe, and in many cases may result in the payment of those increased taxes in full. In addition, the implementation of an 11 payment payroll schedule for 2017 with the 12th payment to be disbursed on January 2, 2018 and, reported in 2018, will mitigate tax burdens imposed on some SBCERS members by the 2016 reporting.

Analysis and Alternatives:

Staff Recommendation:

As outlined above, we believe that the action that has been taken to report an additional payment for 2016, coupled with the adoption of an 11 payment payroll schedule for 2017, is the most optimal choice to achieve legal compliance and to permissibly mitigate higher tax liabilities that some members may experience for 2016 as a result of the additional payment reporting method. The upsides of this approach are that, based on advice of tax counsel, it

best achieves tax compliance objectives, and results in the most simple tax reporting for most members, since only one tax year is impacted. Most members we have spoken to one on one, and to whom we have explained the alternatives, have preferred this method over the issuance of multiple re-stated 1099-Rs. In fact, many members have already relied on the 1099-R that was issued and have filed tax returns for 2016. The downsides of this approach are outlined in the prior staff report provided to the Board for its March 6 meeting, and have been voiced by retirees who have been critical of this method. Notwithstanding these downsides, we believe that most negative impacts can be mitigated by the adoption of an 11 payment payroll schedule for 2017. The balance of negative impacts are simply unavoidable given the unacceptable negative impacts of other alternatives.

Alternative 1 – Restate 2016-Rs to omit the December 30, 2016 payment and correct the problem by deferring the December 31, 2017 payment into 2018.

As explained above, this is not an acceptable solution, because it would direct staff to report and file restated 1099-Rs that are not in compliance with the law. In addition, reversing course after having made a correction would expose SBCERS to unacceptable risk of being assessed penalties for having willfully violated IRS reporting requirements.

Alternative 2 – Restate 2016 1099-Rs to omit the December 31, 2015 payment.

Without additional action this is an unacceptable alternative, because it would direct staff to reverse tax reporting of income disbursed to retirees on December 31, 2015 without reporting that income in another period. This option, like alternative 1, would expose SBCERS to unacceptable risk of being assessed penalties for having willfully violated IRS reporting requirements.

Alternative 3 – Restate 2016 1099-Rs to omit the December 31, 2015 payment and restate 1099-Rs for all other open years, 2013-2015, to include payments disbursed by SBCERS in that year, without forward reporting of amounts disbursed on December 31 to subsequent years.

This alternative received serious consideration by staff before implementation of the additional payment option. Unlike Alternatives 1 and 2, it would achieve compliance with federal tax law, since the December 31, 2015 payment would not go unreported; that payment would be reported for 2015, the payment initiated on December 31, 2014 would be reported for 2014 and so forth. The advantages of this approach would have been the mitigation of tax liabilities for some SBCERS retirees. However, the many downsides of this approach caused staff to reject it: (i) there are legal risks associated with this approach that would be inappropriate to disclose in a public session memorandum; (ii) providing four years of restated 1099-Rs to its retirees would have caused considerable confusion and may have caused many retirees to have to file amended tax returns for prior years; (iii) for retirees who have retired in the years 2013 through 2015, restating 1099-Rs would have simply moved the additional payment from 2016 to a prior year for which tax returns have already been filed.

In addition to the downsides that staff evaluated in January, imposing this alternative now would have additional negative consequences, since many retirees have expressed a preference for the additional payment option and some have already filed tax returns in reliance on that option.

Alternative 4 – Give Retirees the Option of Accepting the Additional Payment Option or Requesting Four Years of Restated 1099-Rs

This is an alternative that staff has considered, but not implemented on the advice of tax counsel, due to the potential exposure to legal risk that may be caused by allowing member choices and by reporting income in different ways for members similarly situated.. The details of these risks and legal advice regarding them cannot be provided in a public memorandum. Because not implemented previously, implementation of such an alternative now could also be viewed as inequitable, since many members who may have opted for the receipt of restated 1099-Rs have already filed tax returns on the assumption that such an option is not available to them. If this option were implemented, it would be imperative that SBCERS staff receive sworn certifications that the affected members did in fact receive funds in December of each of the years to be re-stated and that SBCERS cannot be responsible for the costs and tax consequences associated with such an election. For reasons stated above, staff does not recommend that this option be pursued.

Conclusion:

All of the options reflect tradeoffs and cause impacts to the membership. However, in Staff's view, the staff recommendation is the least impactful on the membership of the options available to the Board of Retirement. It is worth noting that none of the options presented fully immunizes the System from further action by the Internal Revenue Service. However, in this context staff believes that the staff recommendation is also the least impactful on the taxpayers and the plan sponsors.

Attachments:

- **March 6, 2016 Special Board Meeting Board Letter**
- **Open Letter to Retired Members Regarding Tax Reporting**