SANTA BARBARA COUNTY
EMPLOYEES' RETIREMENT SYSTEM

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Gregory E. Levin, CPA
Chief Executive Officer

AGENDA OF THE BOARD OF RETIREMENT
SPECIAL MEETING UNDER G.C. 54956
March 17, 2017

Goleta Library
500 N. Fairview Avenue
Goleta, CA 93117

Persons may address the Board of Retirement in person or by using the remote video testimony system located at the Goleta Library at 500 N. Fairview Avenue, Goleta CA 93117 or at the Santa Maria Radisson at 3455 Skyway Drive, Santa Maria CA 93455.

Persons may address the Board on any matter listed on the agenda by completing and delivering to the Clerk a speaker slip before the item is considered. Matters not listed on the agenda may be addressed during the public comment period.

The Santa Barbara County Employees' Retirement System is committed to:

- *fulfilling its fiduciary responsibility by providing the highest quality of service to all members and plan sponsors; and*
- *protecting promised benefits through prudent investing; and*
- *ensuring reasonable expenses of administration.*

In compliance with the Americans with Disabilities Act, if you need special assistance to participate in the meeting, or if translation assistance is requested, please contact the Clerk of the Board of Retirement at 805-568-2940.

Roll Call at **11:00 a.m.**

Pledge of Allegiance led by Chair

PUBLIC COMMENT

Receive public comment

BOARD

1. Internal Revenue Service Reporting – Staff

Presentation by Gregory Levin, CPA CEO on the System's 1099-R reporting for the calendar year ending December 31, 2016 and potential future payroll calendar changes.

DISCUSSION

RECOMMENDATION: 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 2018, payment payable on January 2, 2018 or other appropriate action.

Next regular meeting dates are March 22-23, 2017

SBCERS

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 12^{th} 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 down sides, 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**

SBCERS
www.sbcers.org

Santa Barbara County Employees' Retirement System

Gregory E Levin, CPA
Chief Executive Officer

March 13, 2017

Members and Beneficiaries:

I am writing this letter to provide you with information regarding the reporting of income on your calendar year 2016 Form 1099-R information return. The Board of Retirement will be considering this matter at a special meeting on March 17, 2017 at 11:00 am.

The meeting will be held at the **Goleta Library at 500 N. Fairview Avenue, Goleta CA 93117**. For those of you who live in the North County and don't wish to commute to Goleta, you can participate in the meeting by attending via remote video-conferencing at the **Santa Maria Radisson at 3455 Skyway Drive, Santa Maria CA 93455**. SBCERS staff will be on hand at both locations to coordinate public comment opportunities and answer questions that members may have about this matter. You will be able to find the Board of Retirement's agenda materials for this meeting at www.sbcers.org.

Please be advised that the income reported to you for 2016 is higher than in past years due to a requirement that we report income to you in 2016 for a direct deposit made to your account on December 30, 2016. In prior years, dating back to the 1980s, direct deposits initiated by SBCERS at the end of December had been reported as income for the subsequent year. Although you had received a total of 12 monthly payments in each full year, the payments reported to you and to the IRS for prior years were for 11 deposits initiated by SBCERS in each calendar year (February 1 through December 1) and one payment for which a direct deposit transaction had been initiated in the previous year. This practice dated back to the year of your retirement, or the year you converted from receiving paper warrants to direct deposit. Accordingly, in the year of retirement (or conversion), you were disbursed a payment in December that was not reported on your 1099-R until the subsequent tax year.

SBCERS discovered the practice of deferring payments in January of this year, after funds had already been deposited to member and beneficiary accounts on December 30, 2016. The practice was deeply ingrained in the business logic of our computerized pension administration system, and therefore not readily apparent absent the conduct of a thorough investigation of SBCERS internal controls over tax reporting. After consulting with SBCERS' tax counsel, we were 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. For that reason, consistent with our obligation to comply with the law, we included the December 30, 2016 direct deposit on your 2016 Form 1099-R. The inclusion of this payment resulted in one additional month of distributions being reported on your 1099-R form for 2016.

This issue only affected our members who receive funds via direct deposit. We chose to include the additional disbursement over other alternatives for correction because we believed it was the most effective means of achieving tax code compliance without the necessity of issuing restated

1099-Rs to all of our retirees for a period of several prior years. Restating 1099-Rs for the years 2013-2016 would have been confusing to all, and for recent retirees would have simply moved an additional payment from 2016 to a prior tax year for which tax returns had already been filed.

We believe that the reporting of the additional payment for 2016 was the best alternative available for retirees, beneficiaries and the System. Along with the extra reported payment, an extra month's withholdings have also been reported. These withholdings will reduce the amount you are required to pay the IRS upon filing your taxes. In addition, we are recommending to the Board of Retirement that it approve a payroll schedule for 2017 with only 11 monthly payments. The recommendation means that the January 2018 payment will be disbursed on January 2, 2018 and reported in the 2018 tax year. If the recommendation is adopted, there will be 12 payments included on your 1099-R information return for every year after 2017.

We apologize for our lack of communication on this matter. We had very little time to correct this issue prior to the January 31, 2017 filing deadline for 1099-R information returns. We have provided education to our staff regarding these issues and they are ready and willing to answer your questions. If you require further information, we encourage you to call us at 1-877-568-2940.

You are welcome and encouraged to attend our meeting on March 17, 2017. Regardless of whether or not you attend, you will be fully informed of any action the Board may take via a follow up letter. In the coming months, you will also be receiving further communications from us at SBCERS. We hope that you will be patient with us in that regard, as we have much further work to do in order to modernize our systems, improve our website, and expand the capacity of our team to provide you with the high level of customer service that you expect.

In closing, I want to impart to you my regret that any of you may feel that your interests have been overlooked or disregarded. I hope this letter clarifies our past actions and demonstrates our commitment to making open and clear communication with our retired members and beneficiaries a priority.

Sincerely,

Greg Levin

Gregory Levin, CPA
Chief Executive Officer