

**INTEROFFICE COMMUNICATION
COUNTY OF MILWAUKEE**

DATE: December 1, 2014

TO: Willie Johnson Jr. & Theodore Lipscomb Sr., Co-Chairs,
Committee on Finance, Personnel and Audit,
Milwaukee County Board of Supervisors

FROM: Paul Bargren, Corporation Counsel
Mark A. Grady, Deputy Corporation Counsel
Steven Huff, Reinhart, Boerner, Van Deuren s.c.

SUBJECT: **Informational Report on Issues related to Purchases of Pension Service Credit**

The Committee has previously received information about errors that occurred in the administration of ERS related to purchases of pension service credit by members (known as “buy ins and buybacks: BIBB). This report provides information for consideration, prior to any policy action being presented. As set forth below, additional information is still being sought and will be provided at a later date.

IRS VCP Process

After the Pension Board discovered errors in the administration of purchases of service credits, Milwaukee County notified the IRS in June of 2007 through a filing under the IRS’s Voluntary Compliance Program (VCP). The VCP encourages tax qualified plans such as Milwaukee County’s to self-report errors in plan operation and documentation and to propose correction methods. VCP allows plan sponsors to self-report and correct errors before the IRS may discover them during an audit which would result in correction, in addition to the imposition of higher penalties based on plan assets (rather than the VCP's more reasonable compliance fees based on participant count). Under VCP, the IRS reviews the errors and proposed correction methods, modifying the methods as it deems necessary, and issues a compliance statement detailing the required action to be taken. The Pension Board and County continue to have communications with the IRS concerning the details of any possible corrections and have not yet received final guidance from the IRS. This memo is based on informal information received from the IRS at this point in time.

Two Alternative Correction Methods

The VCP filing proposed two alternative correction methods relating to the purchase of service credits. One correction method proposed adopting pension plan ordinance amendments that would retroactively correct the errors associated with the administration of purchases of service

credit. The other correction method proposed recalculating pension benefits for affected individuals to eliminate the erroneously granted pension service credits and to attempt to recover overpayments of benefits. Under the second method, ERS proposed adjusting future pension benefits and making ERS whole for any previously paid erroneous benefits. Also under the second method, the IRS may allow ERS or the County to offset the amounts paid by members to purchase service from amounts owed for overpayments of benefits. The IRS has indicated it will accept either of these two alternative correction methods. It had been hoped that the IRS would recommend one of the correction methods to the County as the IRS's preference, but the IRS has recently indicated that it would like the County to recommend its preferred method to the IRS.

Adoption of retroactive ordinance amendments would minimize the administrative burdens on the Pension Board and on ERS, as it will not require recalculation of benefits and collection of overpayments and avoids most of the litigation risk that exists if the benefits are not retroactively confirmed. Because the administration of ERS is the primary consideration of the Pension Board, the Pension Board is on record seeking to follow this correction method.

If ordinance amendments are adopted, the actuary's report dated July 7, 2014 indicates that there would be no cost to the system *greater than currently calculated costs*, and thereby would not require increased County contributions to ERS other than those currently calculated. This is because the actuary previously assumed that the purchases of service credits were valid and has already included the related benefits in the calculation of ERS's liabilities and has already included the purchase payments made by members in the calculation of ERS's assets.

On the other hand, if retroactive amendments are not adopted and the second correction method is chosen, the pension benefits associated with the purchases of service credits would need to be eliminated because they would be deemed to be mistaken or incorrect payments not authorized by the pension plan. Future benefits would be reduced, or terminated completely if appropriate, to reflect the reduced service credit and any change in ERS membership date. The member would be asked to repay overpaid past benefits. The money the member paid to purchase the service would be used either to offset the member's responsibility to repay the overpaid benefits or would be refunded to the member, as appropriate. In addition, any continuing future benefits may be reduced further to offset and collect any remaining overpaid past benefits.

The actuary has begun calculating the specific effect on the benefits for each of the potentially affected individuals. It is anticipated that those calculations will be completed by the end of the year.

In this correction scenario, the actuary would also recalculate and reduce the liabilities of ERS due to the reduced benefits. The actuary's report dated July 7, 2014 details the reduction in liabilities and the resulting reduction in required contributions associated with the elimination of these purchased service credits and the recalculation of benefits. However, the report does not provide an allocation between the County and active employees of any decreased future contributions.

If this correction policy is chosen, the IRS will require that ERS be made whole for any mistaken benefits that were paid. To do so, ERS may attempt to collect overpayments from affected

members and beneficiaries, through the methods set forth above (offsetting refunded purchase payments and offsetting future benefits) and through other collection efforts, which could include suits against members. Assuming that, for a number of reasons, something less than one hundred percent (100%) of the overpayments will be recovered from members, Milwaukee County will ultimately be required to make ERS "whole" for any uncollected overpayments. Thus, Milwaukee County is fiscally responsible for any incorrectly paid benefits that were not authorized by the pension plan and that are not collected back from members.

It should be noted that similar purchases of service have been completed by several hundred other members, within the ERS rules, without any IRS or legal issues associated with them. Those members are or will be receiving the increased pension benefits associated with their purchases. Adopting retroactive ordinance amendments is not required to authorize those purchases; those purchases will be honored by ERS regardless of how the VCP is resolved or which correction method is chosen for those members with errors associated with their purchases.

Addressing uncollected, incorrectly paid benefits

It is virtually certain there will remain some uncollectible overpayments, either due to practical or legal difficulties in collection (see below). Alternatively, it may be possible for the County to make a policy choice not to seek recovery of some or all of the past incorrect payments. Normally, upon the determination that uncollected overpayments exist, the IRS requires payment by the plan sponsor to the plan within 150 days. We are continuing to explore with the IRS whether the County may instead make the required "make whole" payment to ERS over a period of a few years, with interest.

Furthermore, the IRS may allow the County to take credit for previous excess pension contributions that the County made to ERS during the period that the violations occurred rather than making additional payments to make ERS whole for any uncollected overpayments. Because of the pension obligation bonds ("POB") that were issued and that provided funding to ERS in 2009, the County appears to have made substantial excess contributions that remain to be amortized in ERS. We are exploring the issue of unamortized excess POB contributions with the actuary. We are also continuing to explore whether the IRS will allow the County to use the POB excess contributions to meet its make whole obligation for any uncollected overpayments.

If the County is able, and elects, to use the excess POB-related contributions to meet its make whole obligation to ERS for the uncollectible overpayments, it is anticipated that the actuary would be required to adjust the future ERS amortization schedules to reflect the reduced remaining POB amortization credit for the POB excess contributions. We have requested an actuarial report on the effect were the County to make such a choice.

As a rough illustration of this concept, if Milwaukee County's make whole obligation to ERS for the uncollectible overpayments is ultimately determined to be, for example, \$20M, instead of the IRS requiring the County to contribute \$20M on a one-time basis (or over several years if the IRS agrees), the IRS may allow the County to take credit against the excess POB contributions to cover that amount. In that event, the County would not be required to find \$20M for the make

whole payment. However, the excess POB contributions are already included in the actuarial valuation as part of the amortization tables. As noted, we have requested an actuarial analysis of the effect of utilizing the excess POB contributions to address the possibility of uncollected overpayments of benefits.

The actuary has provided a report dated July 7, 2014 (attached) detailing the amount of past benefit payments in question, the amounts paid by members to purchase service credits and the value of the future benefit payments at issue.

Legal issues with collection

Questions have been raised regarding legal issues that could impact collection. One of the issues that might be raised relates to the statute of limitations on collecting any prior incorrect payments. Many of the incorrect payments have been made to members for many years, sometimes decades. Wisconsin law is not absolutely clear on this issue. However, we would anticipate a member arguing that the statute of limitations for such collection is six (6) years. For example, in the case of *Jensen v. Janesville Sand & Gravel*, 141 Wis.2d 521 (Ct. App. 1987), the claimant sued to recover past due pension payments. The court found that the employer's action was not a total repudiation of its contract obligation which required the claimant to sue within 6 years of such a repudiation. Rather, the court held that "[b]ecause the right to receive periodic payments under a pension is a continuing right, the statute of limitations runs from the time when an installment is due under the pension." *Id.* at p. 527. There are arguments on both sides of this question in the context of a potential claim by ERS for mistaken payments and a court would have to resolve this issue. There are other arguments that could also be raised by a member in defense of collection litigation.

Without conceding that a 6 year statute of limitations applies, the actuary has calculated in a supplemental report dated July 7, 2014 (attached) that of the \$25.8M in incorrect payments (net present value), \$20.5M of those are from more than 6 years ago.

Pending Litigation Issues

A lawsuit has been filed by a member who was not allowed by ERS to use his purchased service credit to retire (*Angeles v. Milwaukee County et al.*, 14-CV-6674). The lawsuit also seeks class action status on behalf of all members who purchased service credits with associated operational errors. In general terms, it alleges, among other things, that the members have a vested right to the purchased service credits, which they further allege cannot be taken away, regardless of whether the purchases were consistent with IRS Code and regulations, that ERS made misrepresentations regarding the purchases of service and resulting benefits and that members were entitled to rely, and did detrimentally rely, on those statements. The suit alleges that the members are entitled to the service credit benefits even if receiving the benefits causes ERS to lose its tax-qualified status. The suit also seeks recovery of attorneys' fees.

One consideration associated with this suit is the possibility that the County could choose to correct and revise members' benefits and have the IRS accept that methodology, but could receive an adverse result from the suit requiring payment of the benefits. This would result in

inconsistent and conflicting legal directions from the IRS and the court. In a worst case scenario, this could possibly result in the pension benefits in question being paid directly by the County from tax levy funds.

As part of any litigation, the County or its insurer will incur defense attorney fees. Prior large lawsuits against the County following the 2000 adoption of the pension enhancements resulted in attorneys' fees being paid by the County's insurer in excess of \$1M. As a result of its self-insured retention, ERS is expected to sustain attorneys' fees of \$150,000 in the *Angeles* case.

Encl.

cc: County Executive Chris Abele
Comptroller Scott Manske
Kelly Bablitch
Raisa Koltun
Janelle Jensen
Steve Cady