

DEFERRED COMPENSATION PLAN BOARD REPORT 09-34



Date: June 8, 2009
To: Board of Deferred Compensation Administration
From: Staff
Subject: Pre-Audit Testing

Members
Eugene K. Canzano, Chairperson
Richard Kraus, First Provisional Chair
Shelley Smith, Second Provisional Chair
Maggie Whelan, Third Provisional Chair
Sangeeta Bhatia
Sally Choi
Michael Perez
Kurt A. Stabel

Recommendation:

That the Board of Deferred Compensation Administration receive and file the following information regarding pre-audit testing for the Deferred Compensation Plan.

Discussion:

As indicated in prior communications to the Board, staff has begun a process of pre-audit testing of the City's Deferred Compensation Plan to better prepare the Plan in the event of an audit by the Internal Revenue Service (IRS). Section 457 plans were rarely if ever audited by the IRS until the early part of this decade. However, the IRS developed an audit program and now routinely conducts audits.

The City's Plan is probably not high on the list of potential audit targets because our Plan structure is relatively simple and thus less susceptible to major errors. State/county plans with multiple payroll centers or multiple bundled providers, for example, may be more likely targets due to their complexity. However, the potential for an audit of the City's Plan exists and the Plan should take reasonable steps to prepare for that possibility. Moreover, being proactive in researching potential audit inquiries provides us with opportunities to improve our work processes and reporting, regardless of whether an audit ever takes place.

IRS audits are generally focused on contribution limits and payroll processes to ensure that taxes are being deferred and remitted appropriately. The City's Plan is relatively strong in this area because we work with only two payroll centers and use a single Plan administrator (contrasted with, for example, a State or county plan that might have significantly more payroll centers or where contributions-limit controls are monitored by multiple contracted vendors). The City's two payroll systems, with the City Controller and Department of Water and Power (DWP) Payroll, each have programming in place to automatically prevent individuals from over-contributing beyond the three absolute contribution limits (the under-age 50 limit of \$16,500, the over-age 50 limit of \$22,000, and the Catch-Up limit of \$33,000). However, Catch-Up contributions include additional layers of complexity. As a result, the first phase of our pre-audit research has focused on Catch-Up contributions.

Background on Catch-Up

Catch-Up is a provision within Section 457 plans allowing participants to take advantage of higher contribution limits for individuals who have reached or passed the point of being within three years of being able to retire without penalty. To participate in Catch-Up a participant must have an “unused balance” upon which to “catch up.” The unused balance represents the total amount that an employee was eligible to contribute in prior years but did not. As an example, an employee who started working with the City in 1985 but did not begin contributing to the Plan until 1987 would have a minimum unused balance of \$15,000 because the contribution limit in effect in 1985 and 1986 was \$7,500. If this same employee contributed \$2,500 in 1987, an additional \$5,000 would have been added to his/her unused balance for that year, and the unused balance would be increased by any subsequent contribution below an annual maximum thereafter.

Catch-Up thus has two contribution limits: an absolute limit and a relative limit. The absolute limit is established by law and is always double the pre-age 50 annual contribution limit. In 2009 this limit is \$33,000 (normal limit of \$16,500 x 2 = \$33,000). The relative limit is the size of the individual employee’s unused balance, which is a unique number. The effective limit is always the lower of the two limits.

In addition to the fact that each individual’s unused balance is unique, other complexities are associated with Catch-Up. These complexities result from the fact that participation in Catch-Up is spread out over three years and the absolute limits often change from one year to the next (because they are indexed to inflation).

As an example of this complexity, consider the case of a hypothetical participant who has an unused balance of \$27,000 and wants to participate in Catch-Up. When the employee enrolls she intends to reduce her unused balance by \$9,000 each year using the following schedule:

	Year 1	Year 2	Year 3
Starting Unused Balance	\$ 27,000	\$ 18,000	\$ 9,000
Regular Contribution Limit	\$ 16,500	\$ 17,000	\$ 17,500
Catch-Up Contribution	\$ 9,000	\$ 9,000	\$ 9,000
Total Annual Contribution	\$ 25,500	\$ 26,000	\$ 26,500
Ending Unused Balance	\$ 18,000	\$ 9,000	\$ -

However, there are several unknown factors and options that will exist for this employee over the course of three years which may change this plan and create opportunities for over-contributions. For example:

- In Year 1, the participant does not know what future year contribution limits will be;
- The participant may within the three year period elect to increase or lower her contribution amount for personal reasons;
- She might decide to “front-load” contributions in Years 1 and 2 and stop them in Year 3, but then forget to change her bi-weekly contribution in Year 3;
- Depending on her contribution schedule, she might decide to only do Catch-Up in Year 1 and use the age-50 limits in Years 2 and 3, but not inform the Plan to delete her from Catch-Up in Years 2 and 3.

One tool for preventing these errors would be the ability to establish a participant’s unused balance within the payroll system as a one of the limit controls such that contributions would not exceed the unused balance. DWP’s payroll system has this capacity, but the City’s “Paysr” payroll system presently does not. This is an enhancement request for Paysr but it has not yet been implemented. For the time being we rely on manual processes to prevent and/or correct Catch-Up over-contributions.

One of our controls is annual reporting from the Plan Administrator, Great-West, of those individuals who need to be deleted from Catch-Up on the City’s payroll system. This prevents most over-contributions but cannot prevent all of them because some individuals over-contribute prior to the end of their Catch-Up period.

Catch-Up Pre-Audit Testing Results – The primary focus of staff’s Catch-Up pre-audit testing was to determine:

- (a) If eligibility had been properly determined;
- (b) If the documentation completed by the participant properly reflected eligibility; and
- (c) If the participant’s contribution history and payroll status were consistent with eligibility.

It is important to note that the audit was not focused simply on over-contributions. Staff reviews and corrects over-contributions on an annual basis. The fact of an over-contribution is not a problem by itself from the perspective of an IRS audit; but rather the failure to correct an over-contribution, or faulty determination of eligibility to begin with, that would be problematic.

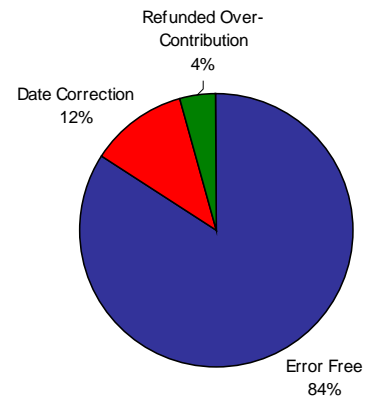
For its testing staff reviewed all 197 participant records with Catch-Up ending dates in 2008. Staff reviewed each Catch-Up enrollment form for these participants to verify the following pieces of information:

- *Normal Retirement Age* - Were the employee’s elected normal retirement ages (i.e date the participant could retire without penalty) and entry/exist dates into Catch-up consistent with the contribution history?
- *Documentation of Over-Contribution Corrections* - Did over-contributions occur and, if so, do we have sufficient documentation of the correction of the over-contribution?

The results of this audit are summarized in the chart to the right. →

Election of Normal Retirement Age - In 2008, 12% of the participants reviewed had incorrect dates recorded on their Catch-Up forms. As staff reviewed these forms we determined that a procedural error was occurring which needed to be addressed. The forms were indicating a “retirement date” when they should have included designation of a “normal retirement age,” the latter of which is an entirely different concept from the perspective of Federal rules.

2008 Catch-Up Audit Results



In general, participants are eligible to participate in Catch-Up in the three years prior to the year designated as their “normal retirement age,” and (importantly) *may not contribute in the same year designated as the normal retirement age*. Designation of the normal retirement age is at the discretion of the participant and need not be the age at which the employee retires. It simply needs to be a date that would be within three years of being able to retire without penalty.

As an example, suppose a participant signing up for Catch-Up in calendar year 2009 is 54 and has 29 years of service. Further suppose that this participant plans to retire in 2010 when he is 55 and has 30 years of service. If the participant designated 2010 as his “normal retirement age” he would only be eligible to participate in Catch-Up in 2009. But if the participant elects his normal retirement age as being in either 2011 or 2012 (which the law allows him to do) he could participate in Catch-Up in both 2009 as well as 2010, and thus be able to contribute more to his account.

On the Catch-Up forms our participants were sometimes indicating their expected *retirement date* rather than the appropriate *normal retirement age*. In some cases, if left uncorrected, this would have required refunds of over-contributions. As a result of our forms audit, all of those dates were corrected and a new process implemented to prevent this error from occurring in the future. Moreover, now that the process has been corrected, going forward all of our forms are reflecting the correct normal retirement ages. A review of over 100 forms with Catch-Up ending dates following 2008 demonstrated 100% accuracy with respect to designation of the appropriate normal retirement age and ending/exit dates

Documentation of Over-Contributions – As previously indicated, over-contributions are not problematic so long as they are corrected. In staff’s review we determined that we were not maintaining centralized records of over-contributions such that, for a given tax year, we could easily produce documentation of how the error had occurred and how it had been corrected. As a result, for the eight (8) Catch-Up over-contributions which were identified in 2008, staff created separate files for each correction. Going forward, for tax years including 2008 and beyond, in the event of an audit we will be able to

provide the IRS with a complete set of files for every over-contribution and all the backup information regarding how it was resolved.

Catch-Up Code Deletion – Staff performed one additional inquiry as part of its pre-audit testing efforts for Catch-Up. A report from the City Controller’s Office was requested which indicated every individual in the payroll system with an active Catch-Up Code (special coding is required in payroll in order to establish a higher contribution limit for the participant).

233 participants had active Catch-Up codes, but staff determined that twelve individuals should have been previously deleted, due to either a lack of available balance or an expired Catch-Up ending date. Of the twelve participants, however, none had over-contributed.

For future monitoring of Catch-Up staff has developed a new spreadsheet tracking system (see attachment). The file maintains a record of all balances and dates and will help us minimize over-contributions. We expect that the incidence of over-contributions should decline markedly when we conduct our next Catch-Up review following the end of the 2008 calendar year.

Future Pre-Audit Testing

The Catch-Up review effort was conducted by staff member Natasha Zuvich and was extremely labor-intensive, requiring approximately 75-100 hours of staff time. Staff will conduct future pre-audit testing as we are able to devote the resources. Our next target for future inquiry will be examination of contribution limit adherence for employees transferring between the City and DWP.

Submitted by:

_____ Steven Montagna

_____ Natasha Zuvich

Approved by:

_____ Alejandrina Basquez