

## **SAN JOSE POLICE AND FIRE DEPARTMENT RETIREMENT PLAN**

### **CHANGES TO SERVICE-CONNECTED DISABILITY RETIREMENT BENEFITS FOR MEMBERS WITH SEPARATE ACCOUNT ALTERNATE PAYEES**

**Date: March 2, 2023**

The Office of Retirement Services (ORS) recently discovered that it had erred in calculating some members' service-connected disability retirement allowances, and in reporting those allowances to the Internal Revenue Service (IRS). We are in the process of notifying affected members and correcting our calculation and reporting of their benefits. Here are some frequently asked questions to help explain this development in greater detail.

#### **FREQUENTLY ASKED QUESTIONS**

##### ***Which members are affected by this correction?***

Only members who meet all three of the following conditions are affected:

1. If you retired on a service-connected disability;
2. If you have an Alternate Payee (an ex-spouse or ex-domestic partner) who was awarded a portion of your retirement benefit under a Separate Account Domestic Relations Order (SADRO); and
3. If your Alternate Payee applied to receive a monthly allowance.

##### ***What were the errors in calculating and reporting affected members' benefits?***

As of the effective date of an affected member's service-connected disability retirement, ORS calculated the member's benefit as the greater of (a) 50% of their Final Average Salary or (b) a service retirement based on the years-of-service formula found in the San Jose Municipal Code. Under federal tax law, ORS reported 50% of a member's Final Average Salary paid as a benefit as tax-exempt on the member's annual Form 1099R, and any benefit in excess of that amount was reported as taxable income.

However, when their Alternate Payee applied to start receiving their benefit, ORS failed to recalculate the member's benefits under a different formula required by the Code, which required the use of a service retirement formula instead of the disability formula. In addition, ORS failed to recognize that the new formula would change the tax-exempt portion of the member's benefit to taxable. Consequently, ORS misreported the status of a portion of the recalculated benefit to the IRS on the member's annual Form 1099R.

##### ***How long has this been going on?***

ORS just recently discovered this error; the law requiring us to recalculate the affected members' benefits has been in the Municipal Code since at least 2000.

***What is the Municipal Code provision that requires the benefit recalculation?***

Municipal Code Section 3.36.3660 provides (key language in **bold**):

***3.36.3660 Disability retirement of participant.***

- A. ***If the participant retires for disability, the combined benefit payments to both the participant and the alternate payee shall not exceed the amount that would otherwise have been paid to the participant alone.***
- B. *In the case where the alternate payee has been awarded a separate account, no payment shall be made to the alternate payee until such time as the participant would have been eligible for a service retirement had the participant continued working. Disability benefits shall be allocated between the participant and the alternate payee as follows:*
  - 1. *Until the date the participant would have been eligible for a service retirement or the date the alternate payee applies to receive a monthly allowance, whichever date is later, disability retirement benefits shall be paid to the participant without regard to the service credit awarded to the alternate payee.*
  - 2. ***Once the participant would have been eligible for a service retirement had the participant continued working and the alternate payee applies to receive a monthly allowance from the retirement fund, the amount of the monthly allowance payable to each party shall be determined as though the participant had retired for service.***

***Why was this provision put into the Municipal Code and was the tax consequence considered?***

We do not know why the City put this provision into the Municipal Code, or why the City singled out only retired members with disability retirement benefits who have Alternate Payees with SADROs. Nor do we know if the City understood and intended the adverse tax consequences of its action. Whether or not we agree with its logic or consequences, however, the Board and the Plan are duty-bound to follow the law as written. We erred in not following it for several years, but we have no right to perpetuate the error now that we know of it.

***What is the federal tax law that says a portion of the benefit is no longer tax-exempt?***

Under Treasury Regulation §§ 1.104-1(a)-1(b) and Rev. Rule 85-105, any provision that is not based in the nature of a workmen's compensation act and requires a pension benefit formula based on the member's age, contributions and/or length of service is taxable under IRS' rules. Municipal Code § 3.36.3660 meets these two requirements, even if the member's retirement was occasioned by disability resulting from occupational injury or sickness.

***What changes will be made to the benefit amounts?***

For an affected member who retired on a service-connected disability but had enough years of service to retire on a service retirement, there will generally be no change in the total benefit

amount<sup>1</sup>, however, as discussed above the taxability will change. That amount, however, must be split between the member and their Alternate Payee as apportioned by the SADRO. The combined benefits cannot exceed what the member would have received in total benefits absent the SADRO.

For an affected member who did not have enough years of service to retire on a service retirement, they will have their benefit recalculated as of the date the Alternate Payee applied to receive their monthly allowance. ORS will recalculate the amounts owed to the member using a service retirement formula, as if the member had service retired. In this situation, ORS will cease using the 50% of Final Average Salary formula and instead going forward will use the service retirement formula based on the member's earned years of service and age. The result of that change is likely to reduce the member's benefit amount paid: ORS will no longer pay the member 50% FAS *plus* an additional amount to the Alternate Payee.

***Will ORS seek to recover any of the overpaid benefits to affected members?***

The Board of Administration will consider this issue during its March 2023 public meeting and possibly subsequent meetings. Affected members are encouraged to attend and express your views.

***What changes will be made in the tax reporting of the benefit payments?***

For all members with an Alternate Payee with a Separate Account, the benefits become taxable once the Alternate Payee applies for their share of the benefit. This is because the Municipal Code requires the use of a service retirement formula not based in the nature of worker's compensation to recalculate the member's benefit when the Alternate Payee claims their share of benefit, thus requiring ORS to report the benefits as fully taxable. Our tax counsel has advised that the IRS will not exempt any portion of a benefit calculated using a service retirement formula in that circumstance.

Since we discovered these errors right before the January 31, 2023 deadline for issuing Form 1099Rs, ORS decided it was best to bring the Plan into compliance as soon as possible. Therefore, we are in the process of issuing the corrected 1099Rs for tax year 2022 and for 2021, 2020 and 2019 (the open tax years). This may cause revisions to taxes paid in those years, as the IRS may seek to recover taxes that were due but not paid on a portion of the affected members' benefits.

We encourage affected members to seek tax advice once you receive your corrected 1099Rs from this office.

For further information, please contact us:

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<sup>1</sup> In this instance, it may be that the member's option election at retirement may affect the amount calculations due to annual mortality rate table changes.