

Allan Ritter
Chairman
Barry Telford
Vice Chairman
Ruth Jones McClendon
Budget and Oversight Chairman



RECEIVED
JAN 23 2004
OPEN RECORDS DIVISION

Committees Members
Kent Grusendorf
Trey Martinez Fische
Aaron Pena
Patrick Rose

Texas House of Representatives
Committee on Pensions and Investments

RQ-0172-GA

January 21, 2004

RECEIVED
JAN 27 2004
OPINION COMMITTEE

The Honorable Greg Abbott
Attorney General
State of Texas
PO Box 12548
Austin, TX 78711-7548

FILE # ML-43458-
I.D. # 43458

RE: Application of Texas law to IRS 401(a) Plan

Dear General Abbott:

On behalf of the City of Houston (the "City"), I am requesting your opinion whether the City's establishment of a defined contribution plan that is intended to qualify for favorable tax treatment under section 401(a)¹ of the Internal Revenue Code of 1986, as amended, (the "Code") (the "Proposed Section 401(a) Plan") is permitted under Art. XVI, § 67 of the Texas Constitution and certain State laws.

The background of this request is as follows:

- Under the City's established sick leave and vacation policies, the City allows an employee to accumulate unused sick and vacation benefit days. These unused days are accumulated over the employee's entire term of service with the City. Following the employee's departure from City employment, within certain limits, the employee is entitled to receive a lump sum payment of the value of all or a portion of his or her unused benefit days (the "Lump Sum Payment").
- The Lump sum payment the employee receives is subject to federal unemployment tax under section 3101² of the Code ("FICA"). Both the employee and the City are liable for the FICA tax on the Lump Sum Payment. The employee is also subject to federal income tax on the Lump Sum Payment, which is taxable in the tax year in which it is received.

¹26 U.S.C. § 401(a).

²*Id.* § 3101.

- The City proposes to the Proposed Section 401(a) Plan to require that all or a portion of the Lump Sum Payment would be contributed to the Proposed Section 401(a) Plan. By contributing all or a portion of the Lump Sum Payment to the Proposed Section 401(a) Plan, the City and the terminating employee would not be liable for FICA tax on the contributed amounts and the terminating employee would not be subject to federal income tax on the contributed amount until such time as the amount is distributed to the employee under the terms of the Proposed Section 401(a) Plan.
- Thus, under the terms of the Proposed Section 401(a) Plan, contributions would be made to the Proposed Section 401(a) Plan as of the date an employee terminates employment and would be made out of the lump sum termination benefit to which the employee is otherwise already entitled. Funds representing unused benefit days would not be contributed to the Proposed Section 401(a) Plan from time to time while employees are actively employed by the City.
- The employees who would be included in the Proposed Section 401(a) Plan are the so-called "municipal" employees of the City. Employees classified as police officers or fire fighters would not be eligible to participate in the plan at this time. The eligible employee group currently participates in a pension plan created under TEX. REV. CIV. STAT. ANN. art. 6243(h) (Vernon 2003) that is known as the Houston Municipal Employees Pension System (HMEPS).
- The eligible employees would be at all times fully vested in the amounts contributed on his or her behalf to the Proposed Section 401(a) Plan. In addition, it is contemplated that each employee would be allowed to direct the investment of his or her account among several investment options.

The Board of Trustees of HMEPS is questioning whether the adoption of the Proposed Section 401(a) Plan would violate Art. XVI, § 67(2) of the Texas Constitution, which states that "[a] person may not receive benefits from more than one system for the same service." The Board of Trustees of HMEPS has also questioned whether the City has the power to create a section 401(a) plan under State law. See TEX. GOV'T CODE ANN. § 810.001 (Vernon 2003). Essentially there are two issues:

- Is the City permitted to create the Proposed Section 401(a) Plan under State law? For background purposes, the attorney general has found that a home-rule municipality is authorized to establish a section 401(a) retirement plan without voter approval pursuant to Government Code section 810.001. See Attorney General Letter Opinion No. 98-070 (1998).
- Assuming the City is statutorily authorized to establish the Proposed Section 401(a) Plan, would the plan be unconstitutional under Art. XVI, § 67(2) of

the Texas Constitution? That is, would a municipal employee who receives a benefit under the Proposed Section 401(a) Plan and a benefit under HMEPS be receiving benefits from more than one retirement system *for the same service*? The City believes that a review of the language and intent of Art. XVI, § 67 of the Texas Constitution will reveal that the actual constitutional prohibition is against a person receiving benefits under two different defined benefit plans that are based on formulas that utilize the employee's same years of service in computing benefits under each plan (e.g., an employee cannot receive a benefit from HMEPS and the police defined benefit plan based upon the same years of service).

- If the Proposed Section 401(a) Plan is a retirement system that may violate the provisions of the Texas Constitution, does the fact that an employee is not entitled to the distribution until after he or she terminates service with the City cure the State law issues? As noted above, the Proposed Section 401(a) Plan would be exclusively funded with termination pay that would otherwise be payable as a severance check.

If it is your opinion that the Texas Constitution or State law prohibits the City from establishing and administering the Proposed Section 401(a) Plan, then your assistance is further requested with respect to whether the issues could be resolved under the "meet and confer" provisions of Ch. 40, § 2, 78th Leg. R.S., eff. May 15, 2003. Under this Act, the City and HMEPS are permitted to enter into agreements regarding HMEPS. Theoretically, all or a portion of the Lump Sum Payment of the value of all or a portion of a terminating employee's unused benefit days could be contributed to HMEPS as an additional benefit under HMEPS. In essence, the Board of Trustees of HMEPS would administer this plan as an adjunct to HMEPS.

The City is in the process of submitting requests for a determination letter from the Internal Revenue Service and a private letter ruling from the Internal Revenue Service concerning the qualified and exempt status of the Proposed Section 401(a) Plan and its related trust under sections 401(a) and 501(a)³ of the Code. This inquiry is limited to the State law issues addressed herein. Your assistance regarding the issues posed above will be appreciated.

Sincerely,



Allan B. Ritter
Chairman

³*Id.* §§ 401(a) & 501(a).

**Hon. Greg Abbott
January 21, 2004
Page 4**

**cc: Mr. David L. Long
Executive Director
Houston Municipal Employees Pension System
1111 Bagby
Houston, TX 77002-2555**

**Anthony W. Hall, Jr.
City Attorney
City of Houston
PO Box 1562
Houston, TX 77251-1562**