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September 21, 2011

VIA FACSIMILE

John Old  
Internal Revenue Service-PE  
1111 Constitutional Ave., NW  
SE:T:EP:RA:VC Rm. 4H6  
Washington, DC 20224

Re: Mendocino County Employees' Retirement Association  
EIN: 94-6116617  
Plan Number: 001

Dear Mr. Old:

We represent the Mendocino County Employees' Retirement Association ("MCERA") and submitted a determination letter application and related voluntary correction program filing with the Service on behalf of the Board of Retirement for MCERA in January 2011. Based on our prior interactions with respect to voluntary correction program ("VCP") filing issues for the '37 Act systems for which we made filings, we are assuming that you will be handling MCERA's VCP issues. If that is not the case, we would greatly appreciate your assistance in forwarding this letter to the appropriate representative at the Service.

Since MCERA's filing in January, MCERA has determined that certain factual information in that filing should be supplemented or corrected. Because we understand that Ernest Tichenor of the Service likely is or will be reviewing MCERA's determination letter application, we are also forwarding a copy of this letter to Mr. Tichenor, so that he will be aware of any overlapping issues that may involve MCERA's factual statements included with the filing.

#### **Supplemental Information and Corrections to Tab Q of VCP Filing**

Under Tab Q of the VCP filing made with the Service in January, MCERA described its particular compliance issues, including non-compliance with Internal Revenue Code section 401(h), which allows retiree medical benefits to be provided under a qualified pension plan. (A copy of Tab Q of MCERA's filing is attached for your convenience as Exhibit A.)

Since the filing in January, there have been changes in MCERA's outside advisors. At its February meeting, MCERA's Board of Retirement received information from EFI Actuaries, who had been engaged to perform an actuarial audit. The report by EFI suggested that some areas need to be addressed in the actuarial valuation process, which the Board determined would be done as a part of the valuation for the year ending June 30, 2011. In its meeting of March 16, 2011, the Board approved a contract with a new actuary, The Segal Company, and agreed to notify the current actuary, Buck Consultants, that their contract would be terminated. In its

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meeting of June 15, 2011, the Board approved entering into an agreement with GALLINA LLP for independent financial auditing services. GALLINA LLP replaced V. James Sligh, CPA as the external auditor for MCERA.

**A. Review of MCERA's Compliance With the CERL and Related 401(h) Provisions**

Under Tab Q, based on the facts known to MCERA as of January 28, 2011, MCERA made the following statement.

"From 1998 to the present MCERA has provided retiree health benefits. These benefits were paid from "excess earnings" as provided in the CERL. MCERA has not complied with the requirements of Code § 401(h) and did not pay these benefits from an account structured to comply with 401(h). These benefits were paid from "excess earnings" in accord with the CERL. MCERA has complied with the provisions of the CERL that govern these benefits. Moreover, on August 24, 1987, the Service issued a favorable determination letter to MCERA on the CERL – which is MCERA's plan document – so the Service has effectively ruled that MCERA is not in noncompliance with the qualification rules on account of providing retiree health benefits. MCERA understands, however, that going forward it will most likely have to change its operations to conform to Code § 401(h). (In this respect, please see Tab M and proposed corrections to the CERL for retiree health benefits.)"

Especially in light of the change in MCERA's accounting and actuarial advisors, MCERA undertook a review of the factual information provided. Based on that review, MCERA wishes to inform the Service of the following with respect to the statements made above.

1. Review of determination of "excess earnings". After extensive review of the financial information available, MCERA staff has determined that "excess earnings" were declared and posted to the Retiree Health Insurance Reserve Account in fiscal years 1998/99, 1999/00, 2000/01, 2006/07 and 2007/08. The excess earnings were as described in the CERL—that is, "earnings of the retirement fund at the end of any fiscal year that exceed the total interest credited to contributions and reserves plus 1 percent of the total assets of the retirement fund." (CERL section 31592.4) In each of the fiscal years cited, pension reserves were credited at 8% and a 1% contingency fund was maintained.

MCERA Staff relied on advice from its former actuary and in good faith believed that MCERA had complied with all the applicable requirements under the CERL regarding the treatment of excess earnings. MCERA's current actuary, Segal, has advised MCERA to take the following additional steps to provide information to better support the decision-making process with respect to applying excess earnings:

(a) Funds that have been set aside for retiree medical benefits should not be shown as available for pension liabilities. Segal has advised MCERA that funds posted to a retiree health reserve account cannot also be recognized as a funding source for pension liabilities. In reviewing the valuation reports from 1998 forward, MCERA Staff determined that retiree health account assets were not shown as also available to pay pension liabilities for the years ending June 30, 1998 through June 30, 2005. However, beginning with the fiscal year ending June 30, 2006, MCERA Staff's review indicated that the amounts set aside in the 401(h) account were also shown as available to pay pension liabilities. This has had a potential adverse effect on the calculation of the amount of the unfunded accrued actuarial liability for MCERA. The amount of

underfunding may have been understated and the contribution rates not calculated to cover the amount of that underfunding. Since every actuarial valuation essentially provides a new "point in time" assessment of liabilities, the new valuation being prepared by Segal for the year ended 6/30/11 should address any understatement.

(b) IRS 401(h) limit should be calculated each year. In addition, MCERA Staff has determined that the annual IRS limit was not calculated and provided as a part of the annual actuarial report and decision-making process. MCERA's new actuary, Segal, has verified that MCERA has passed the annual tests. However, MCERA Staff has determined that the information was not being calculated as part of the required annual process in the past.

2. Review of Compliance with the CERL.

The posting of the "excess earnings" amounts on MCERA's books was done in good faith based on advice of MCERA's advisors at the time. Because it appears that reserves were not credited at 8% in 2005/06, this raises a question as to whether there was compliance with the CERL in that year. In addition, while excess earnings were recorded in both 2006/07 and 2007/08, those earnings were applied to increase the balance in the Retiree Health Insurance reserve to approximately 3 years of retiree health care projected expenses to be available for reimbursement, rather than to eliminate \$9,557,912 of "unrecorded earnings". MCERA believes that this accounting treatment should be reviewed at this time. As noted, however, all of these actions were taken by MCERA in good faith reliance on its advisors at the time.

Given the change in MCERA's external auditor and actuary, and the questions that have been raised noted above, MCERA is obtaining a specific review of the actuarial and accounting treatment of the retiree medical account during this period. MCERA will provide the Service with a further update following this review.

MCERA intends to make certain that the appropriate accounting and actuarial adjustments are made such that the pension (and retiree medical) obligations of the employers participating in MCERA are appropriately reflected on MCERA's financial and actuarial statements.

**B. Changes in Other MCERA Statements Regarding Retiree Medical Program**

Under Tab Q, MCERA also proposed that it would take the following actions.

1. "MCERA intends to cease providing any retiree health benefits as of August 1, 2011."

Change in Circumstances: Given MCERA's engagement of a new actuary and external auditor, MCERA felt it must undertake a full review of its actuarial and accounting issues. MCERA has determined to delay distribution of the remaining approximately \$658,654 that is credited to the Retiree Health Insurance Account until it has completed its full review of the accounting and actuarial treatment of the retiree medical account and its operation under the terms of the CERL.

2. "Prior to August 1, 2011, MCERA will adopt the model regulations for a 401(h) account in Tab M. Additionally, the County will contribute to that account in accord with section 401(h) to pay retiree health benefits up to August 1, 2011."

MCERA will also comply with CERL section 31592.4 to facilitate those contributions."

Delayed Adoption of Regulations: The model regulations were proposed to the Service under Tab M of MCERA's VCP filing. MCERA Staff intends to propose formal adoption of regulations substantially the same as those proposed to the IRS at the October 2011 Board meeting. All actions taken since the filing have been in accordance with the requirements of Code section 401(h).

3. "MCERA understands that the Service generally requires that the employer correct payments of retiree health benefits from assets other than those in a 401(h) account. However in this case the Service has ruled, for MCERA specifically, that its plan document met the rules of tax qualification. (The relevant provisions of the Code were enacted prior to the date of the determination letter issued to MCERA and the relevant provisions of the CERL were enacted prior to that date as well.) The determination letter issued by the Service covers the provisions of the CERL concerning paying retiree health benefits. Therefore, it would be inappropriate to require MCERA to make any retroactive change in this regard. "

Further Review is Being Undertaken to Ensure Compliance: As noted previously, the prior and continued review of the MCERA retiree medical program indicates that MCERA's previous actions have been taken in good faith and in reliance on advice of its outside advisors. As noted above, MCERA is undertaking continued review to make certain that all of its actions are in compliance with the CERL and will make any corrections determined to be necessary to ensure that compliance.

4. "If the Service does not wholly agree, then MCERA wishes to point out that the County has already "repaid" to MCERA a substantial part of the amount of retiree health benefits. This is because assets available for pensions have been reduced with payment of these benefits, thereby causing the actuaries to calculate a higher required annual contribution from the County. This has occurred for every year in which retiree health benefits have been paid. MCERA's actuaries have not calculated the amount repaid but can do so if the Service requests."

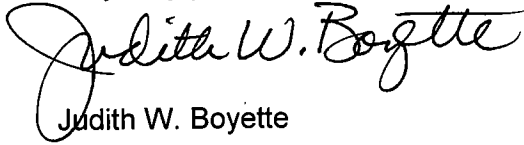
Further Review Required; Statement May Not Be True for All Years: As noted earlier, assets available for pensions may not have been reduced by the amount in the Retiree Health Insurance Account in all years. However, any errors are being corrected and the June 30, 2011 valuation and contribution requirements will reflect the appropriate liabilities.

A copy of the required penalty of perjury statement with respect to this Supplemental information is enclosed.

**Plan Name:** Mendocino County Employees' Retirement Association **EIN:** 94-6116617 **Plan #:** 001

We sincerely appreciate your assistance in helping to see that this information is provided to those who are involved in the review of MCERA's filings. Please do not hesitate to contact me if you have questions or wish to discuss any of these issues. We look forward to continuing to work with you on this matter.

Very truly yours,



Handwritten signature of Judith W. Boyette in cursive script.

Judith W. Boyette

Enclosures: Exhibit A: Copy of Tab Q of MCERA's VCP filing dated 1/28/11  
Required Penalty of Perjury Statement Executed by MCERA's Representative

cc: Ernest L. Tichenor w/encs.  
Via Facsimile

Robert A. Blum

# Exhibit A

**Plan Name: Mendocino County Employees' Retirement Association EIN: 94-6116617 Plan #: 001**

**TAB Q**

**MCERA SPECIFIC ISSUES**

**CALIFORNIA COUNTY EMPLOYEE RETIREMENT SYSTEMS  
ISSUES AND PROPOSED CORRECTIONS**

1. 401(h) Account

From 1998 to the present MCERA has provided retiree health benefits. These benefits were paid from "excess earnings" as provided in the CERL. MCERA has not complied with the requirements of Code § 401(h) and did not pay these benefits from an account structured to comply with 401(h). These benefits were paid from "excess earnings" in accord with the CERL. MCERA has complied with the provisions of the CERL that govern these benefits. Moreover, on August 24, 1987, the Service issued a favorable determination letter to MCERA on the CERL – which is MCERA's plan document – so the Service has effectively ruled that MCERA is not in noncompliance with the qualification rules on account of providing retiree health benefits. MCERA understands, however, that going forward it will most likely have to change its operations to conform to Code § 401(h). (In this respect, please see Tab M and proposed corrections to the CERL for retiree health benefits.)

MCERA proposes the following:

- MCERA intends to cease providing any retiree health benefits as of August 1, 2011.
- Prior to that date, MCERA will adopt the model regulations for a 401(h) account in Tab M. Additionally, the County will contribute to that account in accord with section 401(h) to pay retiree health benefits up to August 1, 2011. MCERA will also comply with CERL section 31592.4 to facilitate those contributions.
- MCERA understands that the Service generally requires that the employer correct payments of retiree health benefits from assets other than those in a 401(h) account. However in this case the Service has ruled, for MCERA specifically, that its plan document met the rules of tax qualification. (The relevant provisions of the Code were enacted prior to the date of the determination letter issued to MCERA and the relevant provisions of the CERL were enacted prior to that date as well.) The determination letter issued by the Service covers the provisions of the CERL concerning paying retiree health benefits. Therefore, it would be inappropriate to require MCERA to make any retroactive change in this regard.
- If the Service does not wholly agree, then MCERA wishes to point out that the County has already "repaid" to MCERA a substantial part of the amount of retiree health benefits. This is because assets available for pensions have been reduced with payment of these benefits, thereby causing the actuaries to calculate a higher required annual contribution from the County. This has occurred for every year in which retiree health benefits have been paid. MCERA's actuaries have not calculated the amount repaid but can do so if the Service requests.
- Finally, we respectfully request that the Service take into account Mendocino County's seriously difficult financial circumstances in considering any additional contribution to the County. The County is responsible for its indigent and underserved residents. Additional contributions will adversely affect the community by reducing the funds available to the poor. The rules of the Service clearly allow this



fact to be taken into account Under I.R.M. 5.8.11.2.2.1, (section 5), the Service takes into account significantly negative effects on the community and in particular to indigent and low income and under-served individuals. (This is in the context of an offer in compromise.)

Mendocino County continues to endure sustained double-digit unemployment figures, currently around 11.3%. The County's labor force has declined by approximately 15% since the financial crisis began. Important revenue sources like the sales tax have declined by 20% since 2008-2009, timber yield tax (once a major funding source) has declined to almost nothing. The County continues to pursue layoffs to balance the budget. All of these extremely serious problems will be exacerbated under the new Governor's budget that proposes to strip a very significant amount from the County. Therefore, it would be extremely adverse to the citizens of the County if additional money had to be diverted from basic human services such as health, police, fire, welfare, mental health to MCERA, based on the errors in the application of the 401(h), especially since the Service has approved the retiree health provisions of the CERL for MCERA under its prior determination letter.

## 2. 402(f) Notices

Code § 402(f) requires the plan administrator of a qualified plan to provide written notice to any member receiving an eligible rollover distribution. The written notice must explain the direct rollover rules, the mandatory income tax withholding rules for distributions not directly rolled over, the tax treatment of distributions not rolled over, and when distributions may be subject to different restrictions and tax consequences after being rolled over. Sections 617 and 657 of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") and Sections 824, 828, 829 and 845 of the Pension Protection Act of 2006 changed the rollover rules and 402(f) notices provided after December 31, 2009 should reflect these law changes. In Notice 2009-68, the IRS provided safe harbor notices that could be used to satisfy the 402(f) notice requirements. MCERA's 402(f) notice does not currently reflect the law changes made by EGTRRA and PPA so the 402(f) notice does not correctly describe the direct rollover rules or the tax treatment of distributions. As soon as administratively practicable, MCERA will begin providing the safe harbor notice provided in Notice 2009-68 for distributions not from a designated Roth account.

## 3. Required Minimum Distribution

Code § 401(a)(9) requires that a member's entire interest must be distributed or begin to be distributed no later than April 1 following the later of the year in which the employee attains age 70½ or the year in which the employee retires. MCERA did not have a process in place to ensure that members timely received their required minimum distribution ("RMD"). MCERA is in the process of determining the extent of this failure. See Tab I for relevant CERL provisions.

MCERA will correct its RMD failure by distributing the required minimum distribution amounts (plus interest) to each affected individual. The interest rate used will be the rate of interest credited to member accounts for the affected plan years. Interest will be credited from the date of the failure up to the date of the corrective distribution.

If any affected individuals cannot be found, MCERA will use either the IRS or DOL location program to complete correction of this failure.

## MENDOCINO COUNTY EMPLOYEES' RETIREMENT ASSOCIATION APPLICANT'S REPRESENTATIONS

### A. Under Examination


To the best of the Board of Retirement's knowledge: (1) the subject plan is not currently under examination of either an Employee Plans Form 5500 series return or other Employee Plans examination, (2) the Plan Sponsor is not under an Exempt Organizations examination (that is, an examination of a Form 990 series return or other Exempt Organizations examination), (3) Neither the Plan Sponsor nor any of its representatives has received verbal or written notification from the Tax Exempt and Government Entities Division of the Internal Revenue Service of an impending examination or of any impending referral for such examination, nor is the plan in Appeals or litigation for any issues raised in such an examination, and (4) The subject plan is not currently under investigation by the Criminal Investigation Division of the Internal Revenue Service.

### B. Abusive Tax Avoidance Transactions

Neither the Plan nor Plan Sponsor have been a party to an abusive tax avoidance transaction as defined in Section 4.13(2) of Revenue Procedure 2008-50.

### C. Penalty of Perjury

Under penalties of perjury, I declare that I have examined this submission, including accompanying documents, and, to the best of my knowledge and belief, the facts presented in support of this submission are true, correct, and complete.

  
Signature

9/21/2011  
Date

James M. Andersen  
Print Name

Administrator  
Title