Special district executive recruitment, evaluation, and compensation

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Recruiting executives has become increasingly difficult for public agencies. Special districts are constantly trying to fill executive level positions, but are frequently hindered by limits on compensation, including those imposed by the California Public Employees' Pension Reform Act of 2013 ("PEPRA"). To address these challenges, special districts may need to consider other strategies for enhancing executive compensation post-PEPRA, such as how to make salary, bonuses, and other enhancement terms more competitive, supplemental defined contribution plans, and nonqualified deferred compensation plans, and how to avoid the federal tax and state law traps along the way.

PEPRA LIMITS ON PENSIONS

PEPRA mandates uniform, generally lower, benefit formulas, a minimum final compensation averaging period of at least three years, limits on pensionable compensation, and contributions of 50 percent of the pension normal cost for "new members." In addition, PEPRA generally prohibits new replacement benefits plans, new supplemental defined benefit plans, retroactive benefit enhancements, and "airtime" purchases after 2012. These limits on retirement benefits, traditionally one of public employment's attractive benefits, make it more difficult for special districts to compete with the private sector for executive talent. To address this, special districts may need to consider other strategies to attract and retain executive talent.

TRADITIONAL COMPENSATION

One strategy that special districts may want to consider to try to bridge the gap left by PEPRA is how to more effectively use salary, bonuses, and other traditional forms of compensation to attract and retain executives. While not new, these more traditional forms of compensation have become an even more important component of public agency executive compensation because they are not limited by PEPRA.

In doing so, however, employers should consider internal and external alignment and publication and transparency of public employees' salary. Bonuses should be tied to specific performance goals to avoid implicating California's gift of public funds doctrine, and employers should have an annual evaluation process in place. Also, care should be taken to structure traditional enhancements, such as relocation, housing, vehicle, professional development and travel allowances and reimbursements, to avoid adverse tax consequences to executives and special districts under IRS rules.

SUPPLEMENTAL DEFINED CONTRIBUTION PLAN

Special districts may also want to consider establishing a qualified supplemental defined contribution plan for executives. While PEPRA

prohibits new supplemental defined benefit plans, it does not prohibit new supplemental defined contribution plans. PEPRA does, however, limit employer contributions to a supplemental defined contribution plan for new members who also participate in a defined benefit plan.

Under these rules, a public employer may contribute to a defined contribution plan for new members based on compensation in excess of the pensionable compensation limit that applies to the defined benefit plan ($117,020 for members participating in Social Security, and $140,424 for members not participating in Social Security, as adjusted, for 2016). But this contribution must be limited to the employer's contribution rate, as a percentage of pay, required to fund the defined benefit plan, subject to the IRS limit on annual compensation in section 401(a)(17) of the Internal Revenue Code ($265,000, as indexed for 2016).

Further, a public employee must not have a vested right to continue receiving the employer contribution. Finally, the Internal Revenue Code limits total allocations on behalf of a participant to a defined contribution plan to the lesser of (1) 100 percent of compensation, or (2) $53,000. Care should be taken, therefore, to design a supplemental defined contribution plan that will not exceed these limits.

NONQUALIFIED DEFERRED COMPENSATION PLANS

Another option may be a nonqualified deferred compensation plan. There are, however, several potential issues for nonqualified deferred compensation plans of state and local governments.

First, nonqualified deferred compensation plans of state and local governments are generally subject to restrictions under sections 457(f) and 409A of the Internal Revenue Code. Under section 457(f), deferrals are generally subject to tax upon vesting. Nonqualified deferred compensation is also subject to restrictions on timing of elections, changes to time and form of payment, and permissible payment triggers under section 409A.

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While certain types of arrangements are excepted from these rules, these arrangements may lack the desired flexibility. For example, under the "short-term deferral rule," deferred compensation that is paid within 2½ months after the calendar year in which the executive vests isn't subject to the rules under section 409A. Certain bona fide separation pay plans also aren't subject to these rules, but only if the plan (1) provides for separation pay upon an involuntary separation from service; (2) limits the separation pay to two times the lesser of (a) the employee's annualized compensation based on his rate of pay

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for the calendar year preceding his separation from service, or (b) the annual compensation limit under section 401(a)(17) of the Internal Revenue Code in effect for the year in which the employee separates from service; and (3) provides for payment by the end of the second calendar year after separation from service. In addition, California law generally limits severance pay to 18 months.

Failure to comply with these rules can result in immediate taxation of deferred compensation and additional taxes, including an additional 20 percent tax under section 409A. Therefore, care should be taken in designing nonqualified deferred compensation plans to avoid violating these tax rules.

Second, nonqualified deferred compensation plans generally don't offer the same level of benefit security for executives as qualified plans because contributions to these plans must, under the tax rules, be held either as part of the plan sponsor's general assets, or in a grantor "Rabbi Trust" subject to the claims of the plan sponsor's general creditors in the event of its insolvency. While a Rabbi Trust may offer marginally better benefit security to executives, the California Constitution's investment restrictions on public agencies may prohibit investing trust assets in equities. This is because nonqualified deferred compensation plans may not qualify for the public retirement system exception to these restrictions, which requires that plan assets be used for the exclusive benefit of participants and their beneficiaries.

For more information about how to approach executive compensation post-PEPRA, and how to avoid federal tax law and state law traps along the way, please sign up to attend our presentation at the 47th CSDA Annual Conference in San Diego, October 10-13, 2016. ■