MWDOC

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GOVERNMENT CODE COMPLIANCE

The Municipal Water District of Orange County (MWDOC) conducts periodic reviews for compliance with changes in legislative and regulatory requirements, including retirement plan contributions for directors of the district. Compensation for Directors is governed by a series of often competing government and IRS codes, which are complicated and require ongoing legal analysis. MWDOC has for decades followed the advice of legal counsel and over the years, the requirements and processes have changed.

In recent months, MWDOC has been working with legal counsel to ensure continued compliance with the various government entities including the State of California and the Internal Revenue Service.

Background:

- Prior to 2001, MWDOC treated all Directors as independent contractors (IRS Form 1099), not employees (IRS Form W-2). However in 2001, the guidance of then legal counsel was that directors must be treated as employees under the IRS codes. This change in regulatory status required that MWDOC establish a retirement program for elected directors; either by participating in Social Security or a 401-type program, therefore, MWDOC's 401 plan was modified to include elected Directors. Today, the IRS continues to define both elected and appointed Directors as employees, which means they are required to participate in a retirement plan.

- The 401 plan was established with the advice of legal counsel. The Directors were told by legal counsel that the IRS mandated that they participate.

- Thirteen years later in late 2014, current legal counsel advised the District that there may be an issue with conflicting State and Federal requirements regarding the District making contributions to the Director's retirement plans. Of particular concern was whether the District's contributions to the Directors' federally required retirement plans would be considered compensation to the Directors subject to State Government Code limits.

- In an abundance of caution, the District stopped making contributions to the Director's retirement plans and instead Directors began to make their own contributions to their plans. The Directors also immediately committed to refund all contributions previously made by the District, with interest. To date, all current MWDOC Directors have refunded the payments back to MWDOC.

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- Since mid 2015, MWDOC has provided public access to documents related to this matter at http://opengov.mwdoc. Board meeting minutes, committee meeting minutes and complete annual audits which reference this matter can be located on the District's open government web page.

Current Status:

In March of 2016, California State Senator John Moorlach engaged in the issue asking the State Attorney General's office for an opinion on the matter. MWDOC appreciates the opportunity this request offers to resolve any uncertainty. The legal review is underway now. However, it may take over a year for the Attorney General's office to issue a formal opinion.

Click here for the full text of California State Senator John Moorlach's letter to the Attorney General.

Commitment to Transparency:

The Municipal Water District of Orange County is committed to a culture of transparency and accountability to the communities it serves. As a matter of common practice, the District provides all public documents including agendas, minutes, budget reports and financial audits on its website. Transparency is a core value for MWDOC and a fundamental guiding principle for its elected leaders.

MWDOC continues to be recognized as an organization that promotes and prioritizes open governance. In 2014, MWDOC was specifically recognized for its transparency on finance reporting and was awarded a Transparency Certificate of Excellence by the Sacramento-based Special District Leadership Foundation. MWDOC was again awarded this recognition in September of 2016. In addition, MWDOC received the District of Distinction Award from SDLF in 2015 in recognition of MWDOC's commitment to good governance and to ethical and sound operating practices.

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JUDICIARY
VICE CHAIR
BUDGET & FISCAL REVIEW
GOVERNANCE & FINANCE

SENATOR
JOHN M. W. MOORLACH
THIRTY-SEVENTH SENATE DISTRICT

March 24, 2016

Susan Duncan Lee
Senior Assistant Attorney General
Office of the Attorney General
Opinion Unit, Department of Justice
455 Golden Gate Ave., Suite 11000
San Francisco, CA 94102

Dear Attorney General Kamala Harris:

I am writing to request a legal opinion regarding compensation for Directors of Special Districts on the following questions:

- Whether water districts (as the term is defined in Section 20200 of the California Water Code) may make employer-paid retirement plan contributions ("Contributions") on behalf of governing board members ("Directors") without violating the provisions of the California Water Code regarding the compensation that water districts may pay to its Directors?

- If water districts are not permitted to may make Contributions on behalf of Directors, must Directors return Contributions received in prior years to the water district? If so, in what form must the reimbursement be made?

- If Contributions must be returned by a Director to the water district for prior periods, is there a statute of limitations that would limit the number of years that would be subject to such reimbursement obligation?

The attachment to this letter consists of relevant legal authority for purposes of the opinion requested with respect to the first question. Whether a response is warranted for the remaining questions will depend on the conclusion reached with respect to the first question.

Thank you in advance for your work on their issues. Please feel free to contact David Mansdoerfer (david.mansdoerfer@sen.ca.gov) at my office if you have any questions or need any further information.

Very truly yours,

John M. W. Moorlach
37th District

I. MANDATORY SOCIAL SECURITY RULES

These questions arise as a result of the aggressive stance that the IRS has taken with public agencies, with water districts being a particular focus, to reclassify governing board members as employees rather than independent contractors for federal income tax purposes. While public agencies have the option to challenge the IRS position in the form of an administrative appeal, most public agencies have elected not to do so because of the limited financial impact of such reclassification as compared to the uncertainty of prevailing in such a challenge, the time it would take to get a resolution and the cost of mounting such a challenge.

One of the consequences of the reclassification of Directors as employees is the employing water district's obligation to comply with the mandatory Social Security rules.

Section 3121(a) of the Internal Revenue Code ("Code") provides that, unless specifically excluded, all compensation for *employment* is subject to Social Security taxes. Although Code Section 3121(b)(7) recognizes an exclusion to the mandatory Social Security rules for services rendered to a public entity, this exclusion does not apply if the service is subject to a Section 218 agreement (i.e., voluntary Social Security agreement) or if it is performed by an employee who is not a member of a public retirement system.[1]

Assuming that a public entity is not a party to a Section 218 agreement,[2] service performed by its employees is only exempt from mandatory Social Security if the service is performed by employees who are members of a *public retirement system.*

A public retirement system, as defined in Code Section 3121(b)(7)(F) and Treasury Regulation Section 31.3121(b)(7)-2 is a pension, annuity, retirement or similar fund or system maintained by a state or local government that provides a retirement benefit to the employee that is comparable to the benefit provided under Social Security. However, the term public retirement system is misleading because under the mandatory Social Security rules, a "public retirement system" can be something other than a retirement system such as the state, county or municipal retirement system. In fact, an employee can be exempt from mandatory Social Security if the employee participates in a 457(b) Plan or 401(a) Plan ("Alternative Retirement Plan") which provides the minimum level of benefits required for a public retirement system. For this purpose, Treasury Regulation 31.3121(b)(7)-2(e)(2)(iii) provides that a plan must provide for an allocation to the employee's account of at least 7.5% of the employee's compensation. Contributions from both the employer and the employee may be used to make up the 7.5%. However, an Alternative Retirement Plan with only employee contributions would also satisfy the minimum benefit requirement, provided the total contributions by the employee constitute at least 7.5% of compensation.[3]

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[1] 26 U.S.C. §3121(b)(7)(E), (F).

[2] Section 218 agreements are voluntary. If implemented, the covered employees must pay 6.2% of their wages as a contribution to Social Security and the public entity must pay an equivalent amount. However, it is common for such agreements, if in place, to exclude elected officials such as Directors, from coverage.

[3] *See* Treasury Regulation §31.3121(b)(7)-2(e)(2)(iii)(B).

Directors of water districts that contract with the California Public Employees' Retirement System ("CalPERS") for retirement benefits are barred by statute from participating in CalPERS if they were first elected or appointed to an office on or after July 1, 1994.[4] Thus, employee Directors who are ineligible to participate in CalPERS are subject to mandatory Social Security (e.g., 6.2% employer and 6.2% employee contribution) unless they participate in an Alternative Retirement Plan which provides for a minimum contribution of 7.5% of compensation.

The crux of our question is whether in light of the preceding, state statutory limits on the compensation that Directors may receive require compliance with the mandatory Social Security rules by way of an Alternative Retirement Plan funded solely by Director contributions.

Our review of relevant California law discussed below leads us to a conclusion that the answer to the preceding is unclear and, thus, it is necessary that the Attorney General's Office provide clarity.

II. STATUTORY LIMITS ON DIRECTOR COMPENSATION

Although the statutory limits on the compensation that Directors may receive varies by the principal act of the water district that such Director serves,[5] California Water Code Section 20201, applicable to water districts generally, puts a ceiling of $100 on the maximum amount Directors can receive for each day's attendance at meetings of the board. Specifically, California Water Code Section 20201 provides, in relevant part, that:

> "...the governing body of any water district may, by ordinance adopted pursuant to this chapter, provide compensation to members of the governing board...in an amount not to exceed one hundred dollars ($100) per day for each day's attendance at meetings of the board...and may, by ordinance...in accordance with Section 20202, increase the compensation received by members of the governing board above the amount of one hundred dollars ($100) per day."

However, California Water Code Section 20202 authorizes water district boards to increase the amount of compensation from $100 per day for each day's attendance at a board meeting not to exceed 5% for each calendar year after the last adjustment to compensation, up to a maximum of 10 days in any calendar month. Such, increases are at the board's discretion.

For the purpose of determining what is considered to be compensation, California courts have ascribed a broad interpretation to the meaning of compensation indicating that the term is not restricted to any particular method or mode of payment.[6] In fact, in *Sturgeon v. County of Los Angeles*, when defining the term "compensation," the court stated that the term includes

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[4] California Government Code §20322(c).

[5] *See e.g.*, California Water Code §21166 (irrigation districts), California Water Code §30507 (county water districts), California Water Code §40355 (California water storage districts), California Water Code §50605 (reclamation districts), California Water Code §55305 (county waterworks districts), California Water Code §56031 (county drainage districts), California Water Code §60143 (water replenishment districts), California Water Code §70078 (levee districts), California Water Code §71255 (municipal water districts) and California Water Code §74208 (water conservation districts).

[6] *See e.g.*, Sturgeon v. County of Los Angeles, 167 Cal. App. 4th 630 (2008); In re Marriage of Stenquist, 21 Cal.3d 779 (1978); Waite v. Waite, 6 Cal.3d 461 (1972); Ross v. Board of Retirement, 92 Cal. App. 2d 188 (1949).

employee benefits.[7] Further, in *Ross v. Board of* Retirement, the court stated that retirement benefits are compensation.[8] The Attorney General's Office has also adopted a broad interpretation of the term compensation in various opinions.[9]

Thus, a water district may not provide any additional compensation, whether in the form of cash or other benefits (i.e., retirement benefits), other than the compensation authorized under the California Water Code *unless* an express exception exists that operates to exclude certain benefits from being treated as compensation for purposes of the statutory limits on compensation.

III. LIMITED EXCEPTION TO THE STATUTORY LIMITS ON DIRECTOR COMPENSATION

One such exception exists with respect to "health and welfare" benefits authorized under California Government Code Section 53200 et. seq. which applies broadly to any "local agency" which includes water districts.[10] California Government Code Section 53201(a) provides, in relevant part, that:

> "The legislative body of a local agency, subject to conditions as may be established by it, may provide for any health and welfare benefits for the benefit of its officers, employees, retired employees, and retired members of the legislative body..."

In this respect, California Government Code Section 53208 provides an exception to the statutory limitations on Director compensation provided in California Water Code Section 20202. California Government Code Section 53208 states, in relevant part, that:

> "Notwithstanding any statutory limitation upon compensation or statutory restriction relating to interest in contracts entered into by any local agency, any member of a legislative body may participate in any plan for health and welfare benefits permitted by this article."

The language in California Government Code Section 53208 suggests that in the absence of statutory permission to participate in a plan of health and welfare benefits, the provision of such health and welfare benefits by a local agency, including a water district, would likely be treated as compensation subject to the applicable rules relating to the limitations on the compensation received by governing board members, including Directors.

To our knowledge, no other exception to the statutory limits on compensation exists under the laws applicable to water districts. This is significant because an earlier Attorney General Opinion suggests that statutory authority is necessary for a public agency to extend any form of compensation to those rendering services on its behalf.[11] Thus, unless a benefit is deemed to be a health and welfare benefit as defined in Government Code Section 53200, it would appear that such benefit would not be permitted to the extent that it constitutes compensation in excess of the maximum authorized compensation of Directors. For example,

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[7] Sturgeon at 643, *supra note 7.*
[8] Ross at 193, *supra note 7.*
[9] *See* 89 Ops. Cal. Atty. Gen. 217 (2006); 83 Ops. Cal. Atty. Gen. 124 (2000); 67 Ops. Cal. Atty. Gen. 467 (1984); 62 Ops. Cal. Atty. Gen. 631(1979); 30 Ops. Cal. Atty. Gen. 60 (1957); and 12 Ops Cal. Atty. Gen. 42 (1948).
[10] California Government Code §53200(a).
[11] *See* 32 Ops. Cal. Atty. Gen. 97 (1958).

cash in lieu of health and welfare benefits was deemed to be unauthorized excess compensation in a 2000 Attorney General Opinion on the basis that cash in lieu of health benefits was not a health and welfare benefit as defined under California Government Code Section 53200(d).[12]

For this purpose, California Government Code Section 53200(d) defines the term health and welfare benefit to mean any one or more of the following:

> "[h]ospital, medical, surgical, disability, legal expense or related benefits including, but not limited to, medical, dental, life, legal expense, and income protection insurance or benefits, whether provided on an insurance or a service basis, and includes group life insurance..."

Conspicuously absent from the preceding list of benefits that are treated as health and welfare benefits are retirement plans. In fact, separate articles from the Group Insurance article contained in California Government Code Sections 53200-53210, pursuant to which employers such as water districts are authorized to offer health and welfare benefits, authorize employers to establish a deferred compensation plan or a pension plan for its "officers and employees."[13] This suggests that the Legislature sees deferred compensation plans, e.g., 457(b) Plans, and qualified plans, e.g., 401(a) Plans, as distinct from health and welfare benefits. It should be noted that the authority to establish a deferred compensation plan or a pension plan does not include exclusionary language such as that found in California Government Code Section 53208. Furthermore, while such authority permits officers to participate in deferred compensation plans and qualified plans, the statutes clearly require that such participation be pursuant to the deduction of plan contributions from officers' compensation. That is, there is no authority for such contributions to be made from employer funds as is the case with "health and welfare benefits."

A 2006 Attorney General Opinion ("2006 Opinion") indirectly supports the preceding. In the 2006 Opinion, the Attorney General concludes that city council members of a general law city may elect to contribute the value of health insurance benefits to a retirement plan, such as a 457(b) Plan, without violating the statutory limits on the compensation that such council members may receive.[14] While the 2006 Opinion refers to health and welfare benefits as defined by California Government Code Section 53200(d), it considers retirement benefits to be distinct from health and welfare benefits. It does so by noting that for general law city council members, amounts paid for retirement benefits do not count towards the compensation of city council members in the same way that health and welfare benefits do not count. This exception is codified in California Government Code Section 36516(d) which applies only to general law cities. Notably the exception under Section 36516(d) excludes "*retirement*, health and welfare, and *federal social security* benefits" from being counted for purposes of the statutory limits on

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[12] 83 Ops. Cal. Atty. Gen. 124 (2000). Although the Attorney General opinion relates to school districts, the opinion would also apply to special districts, including water districts, as such entities are governed by the same Government Code sections as school districts with respect to the provision of health and welfare benefits.

[13] California Government Code §§ 53213 and 53216. Although the term "officers and employees" is not defined purposes of the preceding statutes, the term "officers" in the phrase "officers and employees" is defined to include members of the governing board of a public agency under California Government Code Section 53200(e) for purposes of the "Group Insurance" article only. In light of the absence of a definition for purposes of California Government Code §§ 53213 and 53216, it would appear that the Legislature intended for the definition under California Government Code Section 53200(e) to be imported for purposes of California Government Code §§ 53213 and 53216 given the exact use of the phrase "officers and employees."

[14] 89 Ops. Cal. Atty. Gen. 107 (2006).

compensation.[15] In contrast, the statute applicable to water districts which excludes certain benefits from the statutory limits on compensation – California Government Code Section 53208 – excludes only health and welfare benefits from such limitations. Thus, the exclusion of retirement benefits and federal social security benefits from compensation available to council members of general law cities is not available to governing board members of a public agency, including Directors.

Although we are not aware of any statutory provision that applies to water districts generally, in the same fashion that California Government Code Section 52308 applies, to exclude items of compensation other than "health and welfare" benefits from the statutory limits on compensation, we understand that many water districts have relied on the 2006 Opinion for the purpose of extending employer-paid retirement benefits to its Directors. However, if the authority that permits a general law city to provide employer-paid retirement plan contributions on behalf of its council members without including such contributions in compensation for purposes of the statutory limitations on compensation does not extend to other public agencies, including water districts, and it is determined that similar statutory authority would need to be in place for water districts, such clarity is warranted to ensure consistency amongst water districts.

[15] Emphasis added.