



Bureau of Fire & Police Disability & Retirement

Tax Offset Benefit Overpayment and Recovery: Frequently Asked Questions

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1. What is the tax offset benefit? How is it calculated?

Additional pension benefits were mandated by the Oregon State Legislature in 1991 (Senate Bill 656) and 1995 (House Bill 3349) as a result of the State of Oregon's decision to tax these benefits. The benefits are a percentage of your base pension that is calculated as the greater of:

- From 1995: 9.89% times the proportion of creditable service prior to October 1, 1991, or
- From 1991: 0% to 4%, based on years of service (0-9 years, 0%; 10-19 years, 1%, 20-24 years, 2.5%; 25 or more years, 4%)

The 9.89% figure is the result of a calculation that is:

$$1 / (1 - 9\% \text{ Oregon personal income tax rate}) - 1$$

By statute, the tax offset benefit is only available to Members, and their Beneficiaries, who began their service prior to July 14, 1995. It is currently paid regardless of whether or not you pay Oregon income tax on your pension.

See [Oregon Revised Statutes](#) (ORS) 237.625, 238.375, 238.380 and 238.385 for definition of the additional tax offset benefit.

2. How did the overpayment occur? Whose fault is it?

In 1997, FPDR implemented House Bill 3349 that became ORS 238.380. FPDR, however, erroneously calculated the tax offset benefit as a blend of the two percentages described above, instead of the greater of the two. The blended calculation took 9.89% times your percent of service prior to October 1991 and added the years of service percentage (4% for most retired Members) times your percent of service from October 1991 until your retirement or until you reached 30 years of creditable service.

The blended calculation meant that Members who had some, but not all, of their creditable service prior to October 1991 were overpaid relative to what was required to be paid under ORS 238.380 because they got the House Bill 3349 benefit and some of the Senate Bill 656 benefit instead of the greater of the two benefits. FPDR has no authority to pay benefits that are in excess of those provided in Chapter 5 of the City of Portland Charter – known as the Fire and Police Disability, Retirement and Death Benefit Plan (the Plan) – and applicable statutes such as ORS 238.380.

The Fund Administrator and the Board of Trustees are responsible for the proper administration of the Plan.

3. How was the overpayment discovered in 2008? Why had it not been noticed before?

In July 2008, FPDR staff compared two documents that had been in common usage since 1997: the pension estimate form and a cover memo that was sent with estimates. The pension estimate form described the blended calculation, while the cover memo described the correct calculation. We do not know why no one who prepared the estimates and cover memos – or who received them – noticed the discrepancy until 2008.

4. What happened when the overpayment was found?

FPDR staff informed the Board of Trustees of the overpayment at the August 2008 meeting.

At the September 2008 meeting, the Board discussed the potential impact of the overpayment on the Plan's tax qualification status due to the payment of benefits not authorized by the Charter or state law and unanimously passed a motion to seek determination from the Internal Revenue Service that FPDR could address the overpayment by correcting the calculation going forward but not require a recovery of the overpayment.

FPDR staff corrected the tax offset benefit calculation for most Members and Beneficiaries for benefits paid in October 2008. Alternate Payees and some Members with domestic relations orders were corrected for benefits paid in January 2009.

In July 2009, the Board's outside counsel filed with the IRS an application for a determination letter – such a letter would acknowledge the Plan's tax qualification status – and a related Voluntary Compliance Program (VCP) application discussing the calculation error and proposing the prospective-only correction of the overpayment operational error. In addition to the overpayment, some non-amender failures – instances where the Plan had not been updated to reflect new laws – would also have to be addressed via a Council ordinance to secure a determination letter.

See the materials presented to the Board and the minutes of the public session discussions in [August](#) and [September](#) 2008 (under October 2008).

5. What does tax qualification of the Plan mean? Why is it important?

Charter Section 5-402, Tax Qualification, states:

The benefits provided by this Chapter are intended to constitute a tax qualified pension plan that satisfies the requirements of Section 401(a) of the Internal Revenue Code of 1986, or any successor provision, as it may be amended from time to time.

Charter Section 5-403(c) gives City Council authority to change the benefits provided by FPDR by ordinance in order to comply with any changes in the requirements for tax-qualified status.

By providing benefits in excess of the formula provided in Chapter 5 and state law, FPDR violated IRC Section 401(a) because the plan document was not followed. This operational failure put the Plan's tax-qualified status in jeopardy. If any qualified plan were to lose its tax-qualified status, benefits that are now taxable only when they are received would instead become taxable when the participant becomes vested in them.

6. How did the IRS respond to the VCP application?

In April 2010, the IRS replied to the VCP application by stating that they would require some form of correction to address the overpayments and not simply allow for a prospective-only correction. The options the IRS provided were:

- reducing benefit payments until the overpayments were repaid
- seeking a retroactive amendment to the Plan, which would require a ballot measure to be approved by Portland voters, permitting the past overpayments

See the June 2010 Board [materials](#).

7. How did the Board of Trustees decide to answer the IRS, and why?

In addition to its responsibility to administer the Plan according to Chapter 5 and state law, the Board also has a fiduciary responsibility to Portland taxpayers and to current and future FPDR Members, and so the Board did not choose to ask Portland voters to forgive an almost \$3 million overpayment. The Board passed a motion in June supporting the recovery of the overpayments to Members and Beneficiaries in pay status through deferral of cost-of-living adjustments (COLA) where possible. At the same time, they discussed the fairness of not seeking to recover overpayments under any de minimis threshold that the IRS might approve.

The Board's counsel filed an updated VCP application that the IRS accepted in a [letter](#) dated December 21, 2010. Please note that this is a conditional compliance statement, subject to the issuance of a favorable determination letter. The determination letter is still pending.

See the June 2010 Board [minutes](#) (under August 2010).

8. What is the recovery plan?

The recovery plan conditionally accepted by the IRS provides for two recoupment methods:

FPDR One: Actuarial Recoupment

The benefits of overpaid FPDR One Members and Beneficiaries will be permanently reduced by an actuarial reduction amount calculated based on the payee's age, gender and status at the time recoupment begins May 1, 2011 for the benefits paid in June 2011. This date is driven by the IRS requirement to begin recovery within 150 days of the compliance statement date.

FPDR Two: COLA Holdback

The benefits of overpaid FPDR Two Members and Beneficiaries will remain the same until such time as the overpayment has been fully recovered through foregone COLA increases. At that point, the Member's or Beneficiary's benefits will be immediately increased by all of the deferred COLA(s). The first deferred COLA will be the one effective July 1, 2011 for benefits paid in August 2011. This date is determined by the conditional compliance statement date as the first COLA effective date after the conditional compliance statement was issued.

Both recoupment methods are pre-tax recoveries, reflecting the fact that Members and Beneficiaries have already paid taxes on the overpaid benefits. Pre-tax recovery means that the amount of the recovery will not be included in the annual 1099-R you receive from FPDR. Recovery will end at the Member's or Beneficiary's death; benefits for new survivors will not be affected by the recovery.

The recovery plan conditionally approved by the IRS gives FPDR the option to not seek recoupment from:

- estates or survivors of deceased Members or Alternate Payees who died before recovery is to begin
- individuals whose disability benefits were overpaid due to the tax offset calculation error (although any pension benefits overpaid to them will be recouped)
- Members or Alternate Payees whose total overpayments are \$500 or less

Because of fairness concerns expressed by the Board, however, FPDR will seek recovery of overpaid pension benefits under this program from any payee who is alive when recovery is to begin, regardless of the amount of the total overpayment.

9. What is the difference between FPDR One and FPDR Two? Which one am I in?

FPDR One (“Old Plan”) is provided in Article 5 of Chapter 5. FPDR One Members were retired or on disability as of January 1, 1990 when FPDR Two (“New Plan”) was created or did not elect to join FPDR Two.

FPDR Two Members either elected to join FPDR Two or were first sworn at the City of Portland on or after January 1, 1990 but prior to January 1, 2007.

10. How did FPDR calculate my overpayment amount?

For most Members and Beneficiaries, FPDR looked at two kinds of benefit payments.

Regular monthly benefits have a base benefit and an additional tax offset benefit that together make up the gross benefit payable. For these payments, FPDR added all of the tax offset benefits paid during the period the blended formula was in effect and then calculated what the correct tax offset benefit should have been, using the ratio between the correct tax offset benefit percentage and the incorrect, blended percentage.

Example:	Total offset payments	\$10,000
	Blended offset percentage	9.5%
	Correct offset percentage	9.0%
	Ratio of two offset percents	$9.0 / 9.5 = 94.74\%$
	Offset overpayment percent	$100\% - 94.74\% = 5.26\%$
	Offset overpayment amount	$\$10,000 * 5.26\% = \526

Tax offset benefit retro payments were made in 1997 when FPDR implemented the blended tax offset percentage. The retro payments were the difference between what would have been paid had the blended percentage been paid back to 1991 and the 0% to 4% years of service-based tax offset benefit that was already in effect. Again, the correct and blended tax offset percentages were calculated. From each of these was subtracted the years of service-based percentage to get correct and blended retro percentages. The overpayment was the difference between the total retro and the retro multiplied by the ratio of the correct and blended retro percentages.

Example:	Retro payment	\$10,000
	Blended offset percentage	9.5%
	Correct offset percentage	9.0%
	Years of service percentage	4.0%
	Blended retro percentage	$9.5 - 4.0 = 5.5\%$
	Correct retro percentage	$9.0 - 4.0 = 5.0\%$
	Ratio of two retro percents	$5.0 / 5.5 = 90.91\%$
	Retro overpayment percent	$100\% - 90.91\% = 9.09\%$
	Retro overpayment amount	$\$10,000 * 9.09\% = \909

The sum of the overpayment amount from the regular monthly benefits and that, if any, from the 1997 retro payment is the total overpayment. No interest was assessed on the overpayment.

Alternate Payees and some Members with domestic relations orders had to be calculated in greater detail.

11. FPDR One: How did FPDR calculate the actuarial reduction?

FPDR's actuary prepared a life expectancy factor table based on the Member's or Beneficiary's gender and age at the time recovery begins and whether the payee is a Member retired from service, a Member retired from disability or a Beneficiary. FPDR calculated a blended factor based on the factors at the payee's last and next birthdays. The life expectancy factors do not include any interest on the overpaid amount.

Example:	Male Member retired from disability, born August 5, 1940
	Age at May 1, 2011 70.74 years, or 74% of the way to age 71
	Factor at age 70 11.8
	Factor at age 71 11.1
	Blended factor $11.1 * 74\% + 11.8 * (1 - 74\%) = 11.3$
	Total overpayment amount \$150
	Benefit adjustment $\$150 / 11.3 / 12 \text{ months} = \$1.11/\text{month}$
	Current gross benefit \$4,201.76, including tax offset benefit
	Post-adjustment benefit $\$4,201.76 - \$1.11 = \$4,200.65$

The benefit adjustment will be a permanent reduction in the Member's or Beneficiary's benefit payments. Each year when benefits are adjusted effective July 1, the new gross benefit will be calculated, and the benefit adjustment will again be subtracted to get a new post-adjustment benefit.

When an FPDR One Member dies, the Member's survivor's benefit is based on the Member's gross benefit (before the adjustment is subtracted). The new survivor's benefits will not have any adjustment.

12. FPDR Two: How will FPDR calculate the deferred COLA and the recovery period?

FPDR expects to have the 2011 FPDR Two COLA percentage(s) determined by the end of April. Once the COLA is known, staff will calculate the monthly amount of COLA that will be applied to the overpayment recoupment. Most overpaid Members and Beneficiaries will require more than 12 months for the COLA deferral process to fully recover their overpayments, so staff will make assumptions about future COLA percentages.

Example:	Current gross benefit \$6,000/month
	Total overpayment amount \$1,000
	7/11 COLA percentage 1.25%
	Deferred COLA amount $\$6,000 * 1.25\% = \$75.00/\text{month}$
	Recovered after one year $\$75.00 * 12 \text{ months} = \900
	Remaining to recover 7/12 $\$1,000 - \$900 = \$100$, balance after July 1, 2012
	7/12 COLA percentage 1.50%
	New deferred COLA amount $\$6,000 * 1.0125 * 1.0150 - \$6,000 = \$166.13$
	Benefit paid 8/12 $\$6,000 + \$166.13 - \$100 = \$6,066.13$, recovery done
	Benefit paid 9/12 \$6,166.13, including both deferred COLAs

FPDR will send you a letter when your overpayment recovery is approaching completion, including the completion date and your benefit after completion. If your overpayment recovery lasts for more than a year, FPDR will send you an annual update on the status of your recovery.

13. I paid taxes on the overpayment! How do I get that money back?

The pre-tax recovery will essentially offset the taxes you paid on the overpayment by making your taxable income during the recovery less than it would have been without the recovery. Below is a simple example that compares a Member who was not overpaid to one who was overpaid \$1,000 in Fiscal Year (FY) 2008-09, had it recovered in FY 2011-12, and paid 25% in taxes each year.

Example:		No Overpayment		Overpayment & Recovery	
	<u>COLA</u>	<u>Gross Income</u>	<u>Taxes</u>	<u>Gross Income</u>	<u>Taxes</u>
FY 2011-12	1.25%	\$81,000	\$20,250	<i>\$80,000</i>	<i>\$20,000</i>
FY 2010-11	1.40%	\$80,000	\$20,000	\$80,000	\$20,000
FY 2009-10	2.00%	\$78,896	\$19,724	\$78,896	\$19,724
FY 2008-09		<u>\$77,349</u>	<u>\$19,337</u>	<u>\$78,349</u>	<u>\$19,587</u>
Total		\$317,244	\$79,311	\$317,244	\$79,311

Total gross income and taxes are the same in both cases. The overpaid Member paid \$250 more in taxes in FY 2008-09 and will pay \$250 less in FY 2011-12 than the Member who was not overpaid.

14. Do I have the option of a different recovery method?

Yes. If you prefer, you can send a check for the full amount of your overpayment prior to the effective date of your recovery beginning (May 1, 2011 for FPDR One, July 1, 2011 for FPDR Two). Please make the check payable to the City of Portland and send it to FPDR, 1800 SW First, Suite 450, Portland, OR 97201.

15. What authority does FPDR have to recover my overpayment?

The FPDR Fund has a fiduciary duty to follow the Plan's terms for the benefits of all Members, which includes maintaining the Plan's tax qualification under Internal Revenue Code Section 401(a).

16. Can I protest FPDR's recovery of my overpayment?

If you think a factual error has been made, please send a letter to the FPDR Director explaining why you think there is an error.