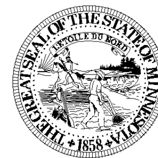
State of Minnesota \ LEGISLATIVE COMMISSION ON PENSIONS AND RETIREMENT



TO: Members of the Legislative Commission on Pensions and Retirement

FROM: Ed Burek, Deputy Director

RE: S.F. 578 (Betzold); H.F. xxx (2009 Administrative Bill); Amendment Replacing PERA Erroneous Receipts and Disbursements, Recovery of Overpayments Language

DATE: February 24, 2009

Summary

Mary Vanek, Executive Director, Public Employees Retirement Association (PERA), has requested that Amendment S0578-24A be used to replace Section 9 in S.F. 578 (Betzold); H.F. xxx. Amendment S0578-24A replaces the erroneous receipts and disbursements language found in the bill with alternative language which Ms. Vanek has said is fully compliant with plan qualification requirements and Internal Revenue Service (IRS) compliance procedures. Ms. Vanek has been working with the IRS on these matters to address plan operational problems due to longstanding overpayment of contributions and overstatement of salary for PERA purposes by Duluth and several other cities.

Amendment S0578-24A

Amendment S0578-24A removes Section 9 of the bill, which revised Minnesota Statutes, Section 353.27, Subdivision 7, PERA's erroneous receipts provision, and replaces it with a somewhat different revision to the erroneous receipts language. S0578-24A also revises Subdivision 7b of the same statute, PERA overpayments of benefits provision. Subdivision 7, PERA's adjustment for erroneous receipts or disbursements provision, is revised by specifying that interest will be paid to employees when excess contributions are refunded to the employee, and an approximate three-year statute of limitations is added to the provision (the adjustment period is limited to the fiscal year in which the error occurred and the prior two fiscal years) unless there is evidence of fraud or abuse, in which case a longer period may apply. All returned employer contributions are without interest and will be done by a credit against future contributions. The provision also includes new language specifying that any fees or penalties assessed by the Internal Revenue Service for any failure by an employer to follow the statutory requirements for reporting eligible members and salary must be paid by the employer. Subdivision 7b is revised for consistency with the changes in the erroneous receipts provision. The provision is revised by stating that when a benefit overpayment results from overpayment of contributions, the amount of the benefit overpayment recapture must be netted against the refund of the contributions.

Discussion and Analysis

The Commission may wish to hear testimony from Ms. Vanek and also review any documentation she can provide regarding why the specific revisions in PERA erroneous receipts provision are necessary, and the extent to which these proposed changes are specifically required by the IRS and plan qualification requirements. Current law does not provide interest on refunds of overpayments of contributions by members; the amendment (and the current bill) provides interest. That imposes a slight cost on PERA. The statute of limitations language in Amendment S0578-24A is unusual because the amount of time that PERA can go back depends on when the error is detected. The adjustment period is limited to the fiscal year in which the error occurred and the prior two fiscal years. If the fiscal year begins in January and an error is found in late January, the plan can go back to the beginning of that month and the prior two fiscal years, or about 25 months in total. If the plan administration finds an error in late December, the plan can go back for that approximate whole fiscal year and the prior two, or about 36 months in total. It seems a bit odd that the amount of the retroactive application depends on when during the year PERA detects the error. Another issue is the proposed language in Amendment S0578-24A requiring the employing unit to pay any fees or penalties imposed by the IRS. The Commission may also wish to hear from representatives from the City of Duluth and other cities that may be impacted to know that they have been informed of this proposed language and to provide the chance to respond.

S.F. 578 (Betzold); H.F. xxx, Section 36, creates an new erroneous receipts provision for the first class city teacher plans. These plans have not previously had such a provision. The language in Section 36 creates a provision modeled, at least approximately, after TRA's provision. However, TRA's provision and this proposed provision are not consistent with PERA's proposal, either as found in the bill as Section 9 or in Amendment S0578-24A.

Consideration of Actions

If the Commission is confident that the requirements specified in Amendment S0578-24A are necessary and appropriate, the Commission may chose to adopt S0578-24A.

Alternatives if S0578-24A is not adopted:

1. Amendment S0578-4A. The current law would remain in effect if the Commission chose to adopt Amendment S0578-4A. That amendment, discussed on page 4 of the staff memo on S.F. 578 (Betzold); H.F. xxx, removes section 9 from the bill.

2. Adopt No Amendment. This allows the language found in Section 9 of the bill to remain. The Commission may wish to review the summary of that provision and policy issues raised on pages 3 and 4 of the staff memo on S.F. 578 (Betzold); H.F. xxx.

If the Commission wishes to work from Section 9 as found in on S.F. 578 (Betzold); H.F. xxx and modify it, the Commission may wish to consider:

1. Amendment S0578-5A. If the Commission wishes to remove the proposed payment of interest on employee overpayments but make no other change to the provision as drafted, Amendment S0578-5A removes the interest language.

2. Amendment S0578-6A. If the Commission wishes to remove the proposed authority to correct operation failures by applying other procedures permitted by the IRS, rather than follow the proposed interest payment procedures, while making no other changes to the drafted provision, Amendment S0578-6A can be use to remove paragraph (g) on page 9.9 to 9.12.

Longer Term Consideration

In recent months and weeks PERA has provided several drafts to revise its erroneous receipts provision to address the situation in Duluth and certain other employing units in a way consistent with IRS requirements. The language found as Section 9 of on S.F. 578 (Betzold); H.F. xxx replaced an earlier version initially submitted, and PERA is again seeking to revise that language through Amendment S0578-24A.

If PERA's most recent effort to revise the PERA erroneous receipts provision is indeed necessary and appropriate to comply with plan qualification requirements and any other requirements imposed by the IRS, it would seem appropriate that comparable changes should be made in the similar provisions of MSRS, TRA, and other plans. Commission staff has not prepared that amendment, although the Commission can certainly direct its staff to prepare such an amendment for later consideration. The issue of expanding the scope of this amendment to include all of the larger plans, or all of the public paid employee plans, may be better left until after this Session, when there is some distance and sufficient time for the plan administrators to work on and agree to uniform language to be added to Chapter 356 to apply to many of the retirement plans. That perhaps is a good issue to address in next year's administrative bill.

From: PERA
February 25, 2009

Amendment to Section 353.27, subdivisions 7 and 7b

The language changes that are being presented accommodate the following:

◊ Authorizes the payment of interest on the refunded employee deductions that were taken in error – required by Internal Revenue Service (IRS)

◊ Directs that the return of any overpaid employer contributions must be through credits against future employer obligations – required by IRS

◊ Institutes a statute of limitations (following the IRS self-correction period) of current plan year in which an error is discovered plus two previous plan years as the "statute of limitations" for correcting future invalid salary discoveries

◊ Institutes a statute of limitations of three years from effective date of benefit payments as the limitation when benefit payments may be corrected.

◊ Sets forth the process for refunding erroneous employee deductions and employer contributions paid, and the recovery of overpaid benefits.

◊ Requires the employer, who didn't follow the statutory reporting requirements, to pay penalties and fees that may be assessed by the IRS – required under Voluntary Compliance Procedures, under IRS Revenue Procedures 2008-50, Section 10.01 – "... requirements ... are satisfied ... if the Plan Sponsor pays the compliance fee ... Defines Plan Sponsor under Revenue Procedure 2008-50, section 5.01(6) as ".. the employer that ... maintains a qualified plan for its employees." Response to question asked of IRS personnel via e-mail "the compliance procedures are clear... the compliance fee should not be coming out of the Plan's assets either directly or indirectly."

The Board took the position that the statute of limitations should only apply to newly discovered errors. Therefore, those corrections already in process, such as the City of Duluth, should be corrected retroactively for the entire period of invalid salary reported. However, given the IRS requirement that interest must be paid to the employees on the deductions reported on invalid salary, that particular change in this amendment will apply to refunds processed for anyone after the effective date. And, since we do not expect to refund anything to the employees of Duluth and the other employers currently in process for adjusting errors until the appeal period has expired – targeted to be in June -- this effective date works. See background below.

Background
On July 31, 2007, a staff member in the PERA Account Information Management Division received an e-mail message from Duluth's city auditor asking us to review some language in the collective bargaining agreements to provide our interpretation as

to whether the arrangement referred to in the (current years') agreement would be considered salary on which PERA employee deductions and employer contributions should be reported. PERA responded that we did not view the arrangement to which we were referred as eligible salary for PERA purposes, but instead viewed it as an "employer-paid fringe benefit." There was no further communication on the issue thereafter between the City of Duluth and PERA until the following.

In September 2008, PERA received a letter from the City of Duluth notifying us employee deductions and employer contributions had been reported on an employer paid contribution that was to be paid as designated by the employee to either deferred comp or health insurance. We were told that this had been going on for many years, dating back into the mid 1990s, and that the city's administration was still researching the extent of the issue. PERA staff contacted the City administration to learn more about the details of this issue and after reviewing all of the collective bargaining and personnel agreements for the City, dating back to 1994, we determined that the provisions of the agreements allowing the employees to direct an employer contribution to either deferred compensation or to dependent health insurance was an "employer-paid fringe benefit" that we do not consider to be salary on which deductions and contributions should be reported and on which pensions should be calculated. Another provision within the insurance section of the agreements authorizes the employer to deposit a specific dollar amount into the employee's deferred comp account or into a flexible spending account, as designated by the employee. PERA again has determined the employer contribution under this provision to not be salary for PERA purposes, as provided under our statutes, section 353.01, subdivision 10, which states in part: "Salary does not mean … employer-paid amounts used by an employee toward the cost of insurance coverage … flexible spending accounts…"

After further review of the various agreements, we found that one or two of the agreements also allowed employees to cash out personal days, which the City included in salary reported to PERA. PERA's governing statutes do not allow contributions to be paid or pensions calculated on any unused annual leave. We classify cashed out personal days or annual leave as "unused." And, we found that in at least one of the agreements, a tool allowance had been reported as salary, which is ineligible for PERA purposes, because in our view this represents a reimbursement for expenses that is specifically excluded from PERA's salary definition.

Staff worked with the City of Duluth administrators directing what we would need to make the necessary adjustments to salary and contributions reported and to recalculate monthly benefit amounts being paid that included the invalid salary in the high-five year average salary.

Within six weeks, we then learned that the Western Lake Superior Sanitary District (WLSSD) had been withholding deductions and reporting contributions on the employer contribution to deferred compensation since 1990. The PERA governing statutes, however, weren't amended to specifically reference "employer-paid fringe benefits" as ineligible salary until July 1, 1994. Therefore, we informed the WLSSD that we would only be correcting reporting errors back to that date, because our law did not reference employer-paid fringe benefits as ineligible prior to that time.

We also heard from the City of Virginia in October 2008 that they had also been reporting contributions to PERA on an employer payment to deferred compensation since July 1, 1997. The number of city employees affected by the Virginia error was limited to supervisory personnel, so has affected only a couple dozen, some already retired, however.

After we sent out a special mailing to employers asking them to come forward if they were similarly misreporting salary to PERA, we heard from the City of Backus, affecting two individuals; the Duluth Entertainment Convention Center for one individual and the Duluth School District. PERA is continuing to work through the issue with the school district at this time.

Internal Revenue Service Consultation re:
Compliance requirements for qualified plans.

When we learned of the extent of the reporting error by Duluth and WLSSD, our attorney consulted with the tax compliance arm of our actuarial consulting firm, Mercer. We were advised to contact the Internal Revenue Service (IRS) about filing a Voluntary Compliance Program (VCP) application for two reasons:

1. PERA submitted an application to the IRS in May 2008 asking for a new determination letter verifying that our plan is operated in compliance with the requirements set forth by the IRS for qualified plan status.
2. The purpose of this application is to notify the IRS of a significant reporting error that has resulted in a plan operational failure. Anytime the provisions of the plan document (statutes) are not properly followed, a plan operational failure occurs. A significant error is generally one that has not been found within about three years since it began. Filing the VCP application notifies the IRS of the issue and provides a detailed description of how we will correct the failure and is recommended in the event the plan is ever audited by the IRS. If the plan were to be audited and an error of this significance first brought to the Service's attention only then, the plan runs the risk of significant penalties and fines. By submitting the VCP application, the IRS is on notice and has had an opportunity to weigh in and guide the plan on the appropriate action to take to correct the error.

On November 6, 2008, PERA staff and legal advisor had a conference call with the IRS' personnel responsible for overseeing the Employee Plans Compliance Resolution System and specifically the 2008-50 Revenue Procedures guiding the VCP application process and other correction methods authorized by the IRS for qualified retirement plans. We were informed that since our plan document (statutes) did not have a limitation on correcting the reported salary and contributions and benefits paid thereon, we had to make the corrections retroactively to the appropriate dates. We were told that the procedures required the payment of interest on the erroneously reported employee deductions, and that a refund of those erroneous deductions, plus interest, had to be paid to the employer who in turn was to get the refund to the currently active members of the plan. A direct payment to current active members would be considered an in-service distribution which is not allowed for qualified plans. We were also told that the erroneous employer contributions paid on the ineligible salary could not be refunded as

a distribution out of the trust, but would have to be counted against future employer obligations. We were told we were absolutely not to take money out of the trust to refund overpaid employer contributions.

We later verified with the IRS personnel what should be done if the deductions and contributions paid on ineligible salary that was included in benefit payments were going to be refunded. We were advised that if contribution refunds were paid, but the benefit payments were not going to be corrected and overpayments collected, the employer would have to pay to PERA the actuarial value of the higher benefit payments. But, if contributions were not refunded and benefit payments were allowed to continue with the invalid salary included in the benefit computation, there was no additional financial requirement from the employer.

We were also advised that there is nothing that prohibits a retroactive amendment to our plan document (statutes) as part of the correction process for this error. (Part III, Section 5.01(b) states in part: "... A plan does not have an Operational Failure to the extent the plan is permitted to be amended retroactively..."

Example of the dollars estimated to be involved with these employee deduction and employer contribution overpayments are as follows:

Name of Employer	Total Employee Contributions (w/o interest)	Total Employer Contribution
City of Duluth	$1,137,164.73	$1,414,340.72
Duluth Airport Authority	$13,729.98	$14,928.55
Western Lake Superior Sanitary District	$21,184.88	$23,160.61
City of Virginia	$13,386.46	$15,917.72
City of Backus	$915.49	$994.14
Total ($2,655,723.28)	**$1,186,381.54**	**$1,469,341.74**

Name of Employer	Number of Active Members	Number of Inactive Members	Number of Benefit Recipients
City of Duluth	742	142	466
Duluth Airport Authority	15	4	15
Duluth Entertainment Convention Center (DECC)	1	0	0
Western Lake Superior Sanitary District	13	8	8
City of Virginia	12	4	4
City of Backus	2	0	0

Overpaid benefit values are still being calculated.

.... moves to amend S.F. No. 578; H.F. No. ...., as follows:

Page 7, delete section 9 and insert:

"Sec. 9. Minnesota Statutes 2008, section 353.27, subdivision 7, is amended to read:

Subd. 7. **Adjustment for erroneous receipts or disbursements.** (a) Except as provided in paragraph (b), erroneous employee deductions and erroneous employer contributions and additional employer contributions for a person, who otherwise does not qualify for membership under this chapter, are considered:

(1) valid if the initial erroneous deduction began before January 1, 1990. Upon determination of the error by the association, the person may continue membership in the association while employed in the same position for which erroneous deductions were taken, or file a written election to terminate membership and apply for a refund upon termination of public service or defer an annuity under section 353.34; or

(2) invalid, if the initial erroneous employee deduction began on or after January 1, 1990. Upon determination of the error, the association shall refund all erroneous employee deductions and all erroneous employer contributions as specified in paragraph (d). No person may claim a right to continued or past membership in the association based on erroneous deductions which began on or after January 1, 1990.

(b) Erroneous deductions taken from the salary of a person who did not qualify for membership in the association by virtue of concurrent employment before July 1, 1978, which required contributions to another retirement fund or relief association established for the benefit of officers and employees of a governmental subdivision, are invalid. Upon discovery of the error, the association shall remove all invalid service and, upon termination of public service, the association shall refund all erroneous employee deductions to the person, with interest as determined under section 353.34, subdivision 2, and all erroneous employer contributions without interest to the employer. This paragraph has both retroactive and prospective application.

(c) Adjustments to correct employer contributions and employee deductions taken in error from amounts which are not salary under section 353.01, subdivision 10, ~~are invalid upon discovery by the association and~~ must be ~~refunded~~ made as specified in paragraph ~~(d)~~(e), except that the period of adjustment must be limited to the fiscal year in which the error is discovered by the association and the immediate two preceding fiscal years.

(d) If there is evidence of fraud or other misconduct on the part of the employee or the employer, the board of trustees may authorize adjustments to the account of a member or former member to correct erroneous employee deductions and employer contributions on invalid salary and the recovery of any overpayments for a period longer than provided for under paragraph (c).

~~(d)~~ (e) Upon discovery of the receipt of erroneous employee deductions and employer contributions under paragraph (a), clause (2), or paragraph (c), the association must require the employer to discontinue the erroneous employee deductions and erroneous employer contributions reported on behalf of a member. Upon discontinuation, the association ~~either~~ must ~~refund~~ :

(1) for a member, provide a refund or credit to the employer in the amount of the invalid employee deductions ~~to the person without interest and~~ with interest on the employee deductions as determined under section 353.34, subdivision 2, and the employer must pay the refunded employee deductions plus interest to the member;

(2) for a former member who:

(i) is not receiving a retirement annuity or benefit, return the erroneous employee deductions to the former member through a refund with interest as determined under section 353.34, subdivision 2; or

(ii) is receiving a retirement annuity or disability benefit, or a person who is receiving an optional annuity or survivor benefit, for whom it has been determined an overpayment must be recovered, adjust the payment amount and recover the overpayments as provided under this section; and

(3) return the invalid employer contributions reported on behalf of a member or former member to the employer ~~or provide~~ by providing a credit against future contributions payable by the employer ~~for the amount of all erroneous deductions and contributions. If the employing unit receives a credit under this paragraph, the employing unit is responsible for refunding to the applicable employee any amount that had been erroneously deducted from the person's salary. In the event that a retirement annuity or disability benefit has been computed using invalid service or salary, the association must adjust the annuity or benefit and recover any overpayment under subdivision 7b~~.

~~(e)~~ (f) In the event that a salary warrant or check from which a deduction for the retirement fund was taken has been canceled or the amount of the warrant or check returned to the funds of the department making the payment, a refund of the sum deducted, or any portion of it that is required to adjust the deductions, must be made to the department or institution.

~~(f) Any refund to a member under this subdivision that is reasonably determined to cause the plan to fail to be a qualified plan under section 401(a) of the federal Internal Revenue Code, as amended, may not be refunded and instead must be credited against future contributions payable by the employer. The employer receiving the credit is responsible for refunding to the applicable employee any amount that had been erroneously deducted from the person's salary.~~

(g) If the association discovers, within three years of the accrual date of any retirement annuity, survivor benefit, or disability benefit that an overpayment has resulted by using invalid service or salary, or due to any erroneous calculation procedure, the association must recalculate the annuity or benefit payable and recover any overpayment as provided under subdivision 7b.

(h) Notwithstanding the provisions of this subdivision, the association may apply the Revenue Procedures defined in the Internal Revenue Service Employee Plans Compliance Resolution System and not issue a refund of erroneous employee deductions and employer contributions or not recover a small overpayment of benefits if the cost to correct the error would exceed the amount of the member refund or overpayment.

(i) Any fees or penalties assessed by the Internal Revenue Service for any failure by an employer to follow the statutory requirements for reporting eligible members and salary must be paid by the employer.

EFFECTIVE DATE. (a) This section is effective the day following enactment except that the statute of limitations under paragraphs (c) and (g) does not apply to any adjustments or corrections already in process.

(b) The interest required on deductions in error as provided in paragraph (e) must be applied to any refunds paid on or after June 1, 2009.

Sec. 10. Minnesota Statutes 2008, section 353.27, subdivision 7b, is amended to read:

Subd. 7b. **Recovery of overpayments~~ to members~~.** (a) In the event ~~of an overpayment to a member, retiree, beneficiary, or other person,~~ the executive director ~~shall recover the overpayment by suspending or reducing the payment of a retirement annuity, refund, disability benefit, survivor benefit, or optional annuity payable to the applicable person or the person's estate, whichever applies, under this chapter until all outstanding money has been recovered.~~ determines that an overpaid annuity or benefit that is the result of invalid salary included in the average salary used to calculate the payment amount must be recovered, the association must determine the amount of the employee deductions taken in error on the invalid salary, with interest as determined under 353.34, subdivision 2, and must subtract that amount from the total annuity or benefit overpayment, and the remaining balance of the overpaid annuity or benefit, if any, must be recovered.

(b) If the invalid employee deductions plus interest exceed the amount of the overpaid benefits, the balance must be refunded to the person to whom the benefit or annuity is being paid.

(c) Any invalid employer contributions reported on the invalid salary must be credited to the employer as provided in subdivision 7, paragraph (e).

4.1 (d) If a member or former member, who is receiving a retirement annuity or
4.2 disability benefit for which an overpayment is being recovered, dies before recovery of
4.3 the overpayment is completed and a joint and survivor optional annuity is payable, the
4.4 remaining balance of the overpaid annuity or benefit must continue to be recovered from
4.5 the payment to the optional annuity beneficiary.
4.6 (e) If the association finds that a refund has been overpaid to a former member,
4.7 beneficiary or other person, the amount of the overpayment must be recovered.
4.8 (f) The board of trustees shall adopt policies directing the period of time and manner
4.9 for the collection of any overpaid retirement or optional annuity, and survivor or disability
4.10 benefit, or a refund that the executive director determines must be recovered as provided
4.11 under this section.

4.12 **EFFECTIVE DATE.** This section is effective the day following final enactment."
4.13 Renumber the sections in sequence and correct the internal references
4.14 Amend the title accordingly