



H.F. 3221
(Murphy, M., by request)

S.F. 2655
(Betzold)

Executive Summary of Commission Staff Materials

Affected Pension Plan(s): MSRS Deferred Compensation Plan
Relevant Provisions of Law: Minnesota Statutes, Section 352.96
General Nature of Proposal: Clarification of existing provision and request to offer Roth 457 and Roth IRA
Date of Summary: March 26, 2008

Specific Proposed Changes

- Clarification of existing provision by recodification
- Requesting authority to offer Roth 457 and Roth IRA
- Requesting authority to provide investment advice to plan participants

Policy Issues Raised by the Proposed Legislation

1. Sufficient need to offer Roth plans.
2. Request to offer Roth 457 plan premature; federal legislation authorizing these plans not yet enacted.
3. Need to clarify "after tax deferred compensation plan" references.
4. Justification for changing required implementation time from 30 days to 60 days.
5. Need to correct subdivision 5 so that it is operational.
6. Lack of statement for allocating cost.
7. Legal implications of providing investment advice; risk of suits.

Potential Amendments

H3221-1A removes the authority to establish Roth plans.

H3221-2A, which can be used if H3221-1A is not used, would permit MSRS to operate a Roth 457 plan if authorized under the Internal Revenue Code, and removes language which would permit MSRS to offer a Roth IRA.

H3221-3A, which can be used if H3221-1A and -2A are not used, would permit MSRS to operate a Roth 457 plan if authorized under the Internal Revenue Code, and offer a Roth IRA.

H3221-4A change the time limit for an employer to provide access for its employees to the MSRS deferred compensation plan from 60 days to a number to be set by the Commission. Existing law allows 30 days.

H3221-5A corrects subdivision 5, by deleting "when selecting consultants," on line 4.20.

H3221-6A adds authority allowing the SBI to charge a proportional share of all costs related to the periodic review to each company currently under contract, and a share of all costs relating to soliciting and evaluating bids.

H3221-7A removes the authority to have a third-party investment consultant to provide investment advice to plan participants.



TO: Members of the Legislative Commission on Pensions and Retirement
FROM: Ed Burek, Deputy Director *EB*
RE: H.F. 3221 (Murphy, M., by request); S.F. 2655 (Betzold): MSRS Deferred Compensation Plan; Recodification and Offering Roth Plans
DATE: March 26, 2008

Summary of H.F. 3221 (Murphy, M., by request); S.F. 2655 (Betzold)

H.F. 3221 (Murphy, M., by request); S.F. 2655 (Betzold) contains the following provisions:

1. The existing Minnesota State Retirement System (MSRS) deferred compensation plan (Minnesota Statutes, Section 352.96) is recodified as new Section 352.965, and conforming changes are made;
2. The deferred compensation plan administration is clarified;
3. The MSRS board is authorized to establish and administer an after-tax deferred compensation or Roth IRA plan;
4. The MSRS board is permitted to retain a third-party investment consultant to provide investment information and advice; and
5. The existing MSRS Deferred Compensation Plan provision and related Minnesota Rules are repealed.

Background Information

- Attachment A contains information on the MSRS Deferred Compensation Plan.
- Attachment B contains information on Roth IRA and Roth 457 Plans.

Discussion and Analysis

David Bergstrom, Executive Director, MSRS, has indicated that much of the bill is a technical recodification. Currently, items dealing the governance and administration of the plan are spread between statutes, rules, and the plan document, and Mr. Bergstrom indicates that MSRS wishes to eliminate the rules, specifying the plan in law and the plan document. But there are a few new items. One identified is that the bill includes authority for MSRS to offer Roth IRAs and/or a Roth 457 plan. A second change is the inclusion of specific authority for MSRS to retain a third-party investment consultant to provide investment advice to participants. These, and several other changes, are discussed below.

The proposed legislation raises several pension and related public policy issues for Commission consideration and potential discussion, as follows:

1. Sufficient Need for Change. The issue is whether there is sufficient need for change. Much of the bill is a restatement of the MSRS Deferred Compensation Plan specified in Minnesota Statutes Section 356.96. While the bill does add some clarification, there may not be sufficient need at this time to recodify this provision, and it is unclear why MSRS needs the few items in the bill that represent any substantive change. The Commission may wish to have brief testimony from MSRS regarding why this bill is needed and what MSRS seeks to accomplish.
2. Roth Issue: Sufficient Need to Offer These Investments. The bill includes a request to permit MSRS to offer a Roth IRA product and/or a Roth 457 plan. The issue is why one or both of those products should be offered, and whether they should be offered by MSRS. The Commission may wish to determine through testimony why MSRS wants to offer these products. Anyone with earned income that does not exceed the limits established by the federal government can create and contribute to a Roth IRA; they do not need MSRS to access this product. There is no clear reason why MSRS should be providing a product which is already so widely available.
3. Roth 457 Issue: Premature Request. The issue is whether this request for Roth 457 plan authority is premature. Mr. Bergstrom has indicated that federal legislation permitting Roth 457 plans is pending in Congress, but has not yet been approved. It is uncertain whether that authority will be provided, and if it is, it is too early to know how Minnesota law will need to be written or revised to create and

administer such a plan. If the Commission does allow MSRS to set up such a plan, MSRS would be taking that action without any specific language in law stating how that plan is to be administered. The Commission may wish to consider whether it would be better to wait until after federal approval has been given to these plans before authorizing MSRS to set up such a plan. The only language specific to Roth plans is found on page 2, lines 30 to 32, which would authorize MSRS to create a Roth IRA and/or Roth 457 plan. At a minimum, the Commission may wish to consider adding some language stating that authority to create a Roth 457 plan is contingent upon the federal government passing legislation authorizing this type of investment plan.

4. Roth 457 Issue: Need for Clarification. Page 2, line 30 to 32, authorizes the MSRS Board to administer an “after tax deferred compensation plan or individual retirement account as defined under section 408A of the Internal Revenue Code.” Presumably, “after tax deferred compensation plan” is intended as a reference to a Roth 457 plan. However, “deferred compensation” plans generally refer to pre-tax plans where the tax deferral is achieved by avoiding constructive receipt of that portion of salary. An “after tax deferred compensation plan” is literally an after-tax pre-tax plan. The Commission may wish to clarify this wording.
5. Roth Issue: Compatibility with Section. The issue is whether the request for authority to provide Roth investment plans, as stated on page 2, line 30 to 32, is compatible with the remainder of the section. The section deals specifically with deferred compensation plan matters, and a Roth plan is not a deferred compensation plan. For example, subdivision 2, on page 3, lines 11 to 13, requires the “appointing authority to defer the payment of part of the compensation of the public officer or employee through payroll deduction.” That is appropriate for a deferred compensation plan to avoid constructive receipt, but it will not work as stated for a Roth 457 plan, where the contributions to the plan must come from after tax income. More language will be needed in this section, or in some other new section, to specify procedures and treatment needed for a Roth 457 plan, and to maintain adequate separation for the two types of 457 plans.
6. Implementation Timing. Page 3, lines 18 to 20, states that a public employer must provide access to the MSRS deferred compensation plan within 60 days of a request by an employee that access to the plan be permitted. Much of the language on page 3, lines 9 to 27, is borrowed from the existing MSRS deferred compensation provision, Minnesota Statutes, Section 352.96, except that the time requirement is 30 days in that existing law, not 60 days. The Commission may wish to inquire why MSRS proposes to change from 30 days to 60 days.
7. Drafting Problem, Subdivision 5. Much of the language of subdivision 5, paragraph (a) on page 4 is borrowed from a Higher Education Individual Retirement Account provision, Minnesota Statutes, Section 354B.25, Subdivision 3. However, an apparent error has been made. The list on page 4, lines 22 to 28, is referring to selection of investment products which the State Board of Investment may offer in the deferred compensation plan. As drafted in this bill, that list is to be used to select investment consultants. It does not work as drafted. The Commission may need to delete “when selecting consultants,” on page 4, line 20.
8. Allocation of Cost. Much of the language of subdivision 5, paragraph (b), is borrowed from the existing Section 352.96, but Section 352.96 includes a sentence allowing the State Board of Investment to charge a proportional share of all costs related to periodic reviews of investment companies to each company currently under contract. The proposed new section lacks that language. The issue for the Commission is why that language is missing, and whether similar language should be added to the proposal.
9. Provision of Investment Advice. Page 5, lines 26 to 30, authorize MSRS to authorize a third-party investment consultant to provide investment information and advice to plan participants. This is new authority. The issue is whether that is appropriate, and whether MSRS is exposing itself to potential lawsuits by providing that service.

Potential Amendments for Commission Consideration

1. Amendment H3221-1A removes the authority to establish Roth plans.
2. Amendment H3221-2A, which can be used if Amendment H3221-1A is not used, would permit MSRS to operate a Roth 457 plan if authorized under the Internal Revenue Code, and removes language which would permit MSRS to offer a Roth IRA.

3. Amendment H3221-3A, which can be used if Amendments H3221-1A and -2A are not used, would permit MSRS to operate a Roth 457 plan if authorized under the Internal Revenue Code, and offer a Roth IRA.
4. Amendment H3221-4A can be used to change the time limit for an employer to provide access for its employees to the MSRS deferred compensation plan from 60 days to a number to be set by the Commission. Existing law allows 30 days.
5. Amendment H3221-5A corrects subdivision 5, by deleting “when selecting consultants,” on line 4.20.
6. Amendment H3221-6A would add authority (found in the existing law but not in this proposal) to allow the State Board of Investment to charge a proportional share of all costs related to the periodic review to each company currently under contract, and a share of all costs relating to soliciting and evaluating bids.
7. Amendment H3221-7A would remove the authority to have a third-party investment consultant to provide investment advice to plan participants. This could be used if the Commission is concerned that providing that function would expose MSRS to lawsuits when individuals follow the advice and poor returns occur.

Attachment A

Background Information on the Minnesota State Retirement System Deferred Compensation Plan, Minnesota Statutes, Section 356.24

- a. In General. The State Deferred Compensation Program is an Internal Revenue Code Section 457 deferred compensation plan. The State Deferred Compensation Program is governed by Minnesota Statutes, Section 352.96. The State Deferred Compensation Program is the sole government sponsored retirement thrift or savings program for most public employees by virtue of a restriction on supplemental retirement plans and employer-funded deferred compensation programs under Minnesota Statutes, Section 356.24. Although the plan is administered by the Minnesota State Retirement System (MSRS), public employees throughout the state are authorized to participate. For purposes of the State Deferred Compensation Program, public employment includes volunteer firefighters. The State Deferred Compensation Program, akin to the somewhat similar Internal Revenue Code Section 403(b) plans, function to encourage additional saving for retirement, supplementing income during retirement from the primary public pension plan, Social Security, or other income sources.
- b. Historical Development of Minnesota Statutes, Section 356.24. Minnesota Statutes, Section 356.24, when initially enacted in 1971 (Laws 1971, Chapter 222, Section 1), was intended to end a growing practice in local government (primarily by school districts) of creating supplemental employer-funded pension plans beyond the regularly applicable statewide pension plan for that type of public employee. At that time, public pension benefits were considerably more modest than they are currently and some of the more affluent jurisdictions were attempting to readjust their employees' pension coverage by local action, without the approval of or notice to the Legislature. The Legislature decided that this practice was inappropriate and that the creation of additional pension plans was an unwise policy. The Legislature also apparently felt that pension benefits should be as uniform as possible throughout public employment. In 1973, the Legislature considerably improved pension benefits payable under the public employees primary pension coverage by moving from career average salary plans to pensions that were based on the average salary of the individual close to retirement. The intent at the time was to provide an adequate benefit through the primary pension plan and eliminate the need, or the ability, to create supplemental plans. Those supplemental plans that were in effect prior to 1971 were grandfathered. Substantial benefit increases occurred in 1980, 1989, 1992, and 1997.
- c. State Deferred Compensation Program. The State Deferred Compensation Program was established in 1971, by Extra Session Laws 1971, Chapter 32, Section 19. The program was established without any specific Federal Internal Revenue Code authority, initially depending instead on a federal IRS Revenue Ruling implementing the notion of the lack of actual or constructive receipt of salary when a portion of an employee's salary is deferred and the amount invested by the employer is subject to claims of the employer's general creditors.

The program initially was open only to state employees and was administered by the Minnesota State Retirement System (MSRS), with rules, regulations and procedures established by the Commissioner of Administration, and invested by the State Board of Investment in a state operated investment fund substantially similar to a mutual fund, known then as the Minnesota Supplemental Retirement Fund. The program specifically prohibited an employer contribution initially and provided that the state employee was to bear the full risk of any investment loss incurred.

In 1975 (Laws 1975, Chapter 273), the State Deferred Compensation Program was broadened in its coverage, with access to the program extended to any political subdivision employee or any public pension plan member. The applicable governing law was also moved from Minnesota Statutes 1974, Chapter 16A (governing the Department of Finance) to Minnesota Statutes, Section 352.96. The power to establish rules, regulations, and procedures for the State Deferred Compensation Program was also transferred to the Executive Director of MSRS.

In 1977 (Laws 1977, Chapter 300, Sections 1-3), the State Deferred Compensation Program was broadened in its investment options. The 1977 legislation authorized fixed and variable annuity products of insurance companies as investment options for the State Deferred Compensation Program in addition to the various investment account approaches provided through the Minnesota Supplemental Retirement Fund operated by the State Board of Investment. The insurance company products were required to be selected through open bidding procedures.

In February, 1978, the Internal Revenue Service promulgated proposed regulations that would have prevented deferred compensation plans for state and local government employees, in part, because of the virtually unlimited potential as to amount for deferrals to deferred compensation plans. The Congress reversed the Internal Revenue Service in the Revenue Act of 1978 by enacting Internal Revenue Code

Section 457, which authorizes state and local government employee deferred compensation plans, but which places specific limitations on the amounts available for deferral.

In 1980, the State Board of Investment implemented the 1977 State Deferred Compensation Program legislation and formally requested insurance company annuity option proposals. After analysis by a consultant and review by the Board, the State Board of Investment selected a proposal submitted by the Great-West Life Assurance Company, marketed by National Benefits, Inc., and a proposal submitted by the Minnesota Mutual Life Insurance Company and the Northwestern National Life Insurance Company, marketed by the Ochs Agency. Also in 1980 (Laws 1980, Chapter 607), the Minnesota Supplemental Retirement Fund was renamed the Minnesota Supplemental Investment Fund.

- d. State Deferred Compensation Program Employer Contribution Match Feature. From 1977 to 1987, the State Deferred Compensation Program was amended periodically, but the amendments had little substantive importance. In 1988, the Program was modified to include a matching employer contribution in addition to the member's deferred compensation amount. The matching employer contribution, authorized under Minnesota Statutes, Section 356.24, was required to be made to the State Deferred Compensation Program, was required to be provided for in either a personnel plan or a collective bargaining agreement, was required to be a dollar for dollar match, and was limited to \$2,000 per year per employee. While not restricted in use to fund retiree health insurance premiums, the employer matching contribution authorization was part of a broader legislative enactment pertaining to retiree health benefits, and the conferees on Laws 1988, Chapter 605, discussed the potential for the savings promoted by the employer matching contribution authorization to be used in part to defray post-retirement health insurance premium costs.
- e. Tax-Sheltered Annuities with Employer Matching Contribution Feature. In 1992 (Laws 1992, Chapter 487, Section 4), similar authority for an employer matching contribution feature for teacher tax-sheltered annuity insurance contracts under federal Internal Revenue Code, Section 403(b), was established. Initially, the number of providers was restricted to no more than 10 companies. In 1999, the number of providers was increased to 20 (Laws 1999, Chapter 222, Article 18, Section 1), and the restriction on the number of providers was removed in 2000 (Laws 2000, Chapter 461, Article 13).

Internal Revenue Code Section 403(b) tax sheltered annuity plans are vehicles for teachers, church workers, and certain other personnel of charitable institutions, to save on a tax deferred basis. These plans are not any public employee's primary retirement coverage; rather they act to supplement the primary plan. This permits eligible employees to have some individual control over their eventual retirement income. Internal Revenue Code Section 403(b) investments are generally referred to as tax-sheltered annuities, although Internal Revenue Code Section 403(b) appears to permit investments in mutual funds in addition to annuities, providing the mutual fund investments are held by a custodian and contributions and disbursements are made only as permitted under Internal Revenue Code Section 403(b). Generally, the maximum permitted employee contribution to Internal Revenue Code Section 403 (b) plans in a year is \$15,500 in 2008, indexed for inflation. For those ages 50 and over, the limit in 2008 is \$20,500. Taxes are due when the money is withdrawn. Withdrawals may begin as early as age 59 and one half and must begin by age 70 and one half. The purpose of these age restrictions is to help ensure that the account is used for retirement purposes rather than intergenerational transfers.

- f. 1997 Deferred Compensation Program Amendments. Laws 1997, Chapter 241, Article 3, Sections 1, 2, and 3, modified the investment options available to be provided by the State Deferred Compensation Program and changed the legal status of the program in conformity with a recently enacted federal law, the Small Business Protection Act/Minimum Wage Bill. The investment options and investment providers to the state deferred compensation plan were expanded to include mutual fund companies, investments managed by registered investment providers, and investments managed by banks and bank holding companies deferred compensation accounts also will be required to be held in trust. The authority of the State Board of Investment was expanded to solicit bids to include the expanded group of providers.
- g. General Comparisons between Internal Revenue Code Section 403(b) and Internal Revenue Code Section 457 Plans. Internal Revenue Code Section 403(b) tax sheltered annuity plans are similar to Internal Revenue Code Section 457 deferred compensation plans in their basic effect to encourage saving by delaying taxes. The tax deferral is achieved, however, differs under the two plan types. Under an Internal Revenue Code Section 403(b) plan, the tax is declared, under law, to be deferred. In contrast, Internal Revenue Code Section 457 deferred compensation plans achieve tax deferral by removing constructive receipt of the deferred income. The deferred income is deemed to be retained by the employer. Since the income is not received by the state employee, no tax is currently due on the deferred amounts or on any investment gain on the deferred amounts. Under current federal law, the deferral limits on Internal Revenue Code Section 403(b) and 457 plans is identical.

Attachment B

Background Information on Roth IRA and Roth 457 Plans

A Roth Individual Retirement Account (Roth IRA) permits individuals to invest after tax income in an account which accumulates tax free and is not taxable upon withdrawal, if withdrawn after age 59.5. The maximum contribution in 2008 is \$5,000, or \$6,000 if the investor is at least 50 years of age. There are income limits for eligibility. As of 2007, single taxpayers were eligible to contribute the maximum permitted amounts if modified adjusted gross income was less than \$99,000. Partial eligibility was permitted with modified adjusted gross income between \$99,001 and \$114,000. Single taxpayers with modified adjusted gross income above \$144,000 were not eligible. Couples filing jointly with adjusted gross income of less than \$156,000 were fully eligible, those with incomes between \$156,000 and \$166,000 were partially eligible, and those with income above \$166,000 were ineligible.

Roth IRAs differ from regular of traditional IRAs. With a Roth IRA the individual pays income tax on the amounts contributed, all investment earnings accumulate tax free, and amounts distributed from the account are also not taxable (providing minimum age and other requirements are met). With a traditional IRA, the contributions are not taxed, all investment earnings accumulate tax free, but all amounts distributed from the plan are taxable as ordinary income when received.

Some years ago, federal legislation passed which permitted private employers to allow employees to contribute to a Roth 401(k) plan, bearing some similarity to a traditional 401(k) plan. With a Roth 401(k) the maximum employee contribution is the same as a 457 deferred compensation plan or a 403(b) plan, currently \$15,500 for most employees, which is much higher than the maximum contribution permitted to a Roth IRA. With a Roth 401(k), the contributions are after tax, but the investments accumulate tax free, and withdrawals are not taxed.

The federal House and Senate are considering legislation to authorize Roth 457 plans, similar to the Roth 401(k). According the MSRS executive director, federal legislation permitting Roth 457 plans has not passed but is pending.

Ed Burek

From: Dave Bergstrom [Dave.Bergstrom@state.mn.us]
Sent: Tuesday, March 25, 2008 7:18 AM
To: Ed Burek
Subject: Re: H.F. 3221; S.F. 2655: MSRS Deferred Compensation Plan Amendments

Yes, the IRS requires we maintain a plan document. Currently, we have things in law, rules and a plan document. We want to get that down to two, law and a plan document.

While most of the bill is technical, the proposal allows us to offer investment advice and offer a Roth IRA or 457 (federal legislation pending to offer a Roth 457 plan). Many private companies and public plans offer investment advice. Computer programs ask the participant to answer questions, and base the advice based on the person's age, etc. using long-standing investment advice principles. The investment advice would be voluntary by the participant.

>>> Ed Burek <edward.burek@lcpr.leg.mn> 03/24 4:41 PM >>>
I am starting to work on H.F. 3221; S.F. 2655: MSRS Deferred Compensation Plan Amendments. I am assuming that this was an MSRS initiative. This recodifies the MSRS deferred compensation plan as a new section, proposed coding as Minnesota Statutes, Section 352.965, and repeals the existing provision, section 352.965, but very little is new. Why is this needed? Was it felt that these changes are needed for the IRS review of your plan?

