State of Minnesota | LEGISLATIVE COMMISSION ON PENSIONS AND RETIREMENT

H.F. 3436 (Nelson) *in the form of delete-all A08-1290* **S.F. 3136** (Betzold)

Executive Summary of Commission Staff Materials

Affected Pension Plan(s):	MSRS, PERA
Relevant Provisions of Law:	Minnesota Statutes, Section 43A.346
General Nature of Proposal:	Revise Postretirement Option Program for federal compliance
Date of Summary:	April 3, 2008

Specific Proposed Changes

- Prohibiting, for those under age 62, any agreement to take part in program until after termination.
- Requiring a 30-day break in service to ensure true termination.

Policy Issues Raised by the Proposed Legislation

1. Proper current action; consideration of available courses of action, including study.
2. Lack of clarity regarding actions needed to ensure compliance with federal prohibitions against in-service distributions of retirement assets.
3. In-service distributions, whether to permit for those at least age 62.
4. Question of whether individuals will use the postretirement option program given proposed prohibition against discussing any offer of a position in the program until after the individual terminates from service.
5. Disagreement between MSRS, PERA, and the Department of Employee Relations about proper course of action; inconsistent proposals.
6. Interaction with other existing programs, and with proposals in other bills creating uncertainty about the need for this program and its proper design.
7. Need for further study.

Potential Amendments

H3436-1A causes the program to expire on July 1, 2009, which would give the Commission some time to study the program and its broader context.

H3436-2A incorporates the proposed changes to the program contained in delete-all amendment A08-1290 and also makes technical changes.

H3436-3A, an alternative to H3436-2A, restricts the program to those who are at least age 62, removes the 30-day separation requirements, and removes the prohibition against agreements prior to termination. This alternative is based on language suggested by PERA, but it is not supported by the Department of Employee Relations.

H3436-4A, an alternative to amendments H3436-2A and -3A, requires everyone in the program, including those who are age 62 or older, comply with a 30-day separation requirement, and prohibits all offers or agreements while the individual is employed. This approach is likely to be the least problematic by not permitting anyone to receive in-service distributions, including those age 62 or older.

H3436-5A adds a July 1, 2009, expiration date to the postretirement option program by adding an expiration provision to amendments H3436-2A, -3A, or -4A.

H3436-6A, an alternative to all of the previous amendments, terminates the postretirement option program on July 1, 2009, and creates a new program based on the voluntary hour reduction program. The new program expires on July 1, 2012.

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TO: Members of the Legislative Commission on Pensions and Retirement

FROM: Ed Burek, Deputy Director EB

RE: H.F. 3436 (Nelson); S.F. 3136 (Betzold), in the form of Delete-All Amendment A08-1290: MSRS/PERA: Modification of State Employee Postretirement Options Program

DATE: March 14, 2008

Summary H.F. 3436 (Nelson); S.F. 3136 (Betzold)

H.F. 3436 (Nelson); S.F. 3136 (Betzold), in the form of delete-all amendment A08-1290, revises Minnesota Statutes, Section 43A.346, Subdivisions 5 and 6, provisions of the state employee post-retirement option program, by requiring that if the individual is under age 62, no initial offer of employment under the postretirement option program and no offer of renewal of a postretirement option program position can be offered until at least 30 days after the termination of employment.

Discussion and Analysis

The postretirement option program (Laws 2005, Chapter 156, Article 3, Section 2) was enacted as one of a few programs intended to allow state employees to transition into full retirement while meeting employer workforce needs. It was based on provisions contained in 2005 Session H.F. 1953 (Cornish); S.F. 1845 (Larson) and was passed as part of an Omnibus State Government Finance Bill, which also contained a voluntary hour reduction provision and a voluntary unpaid leave of absence provision. At the present time, 70 individuals are in postretirement option program positions, 51 of whom are under age 62.

For purposes of this program, "state employee" means "a person currently occupying a civil service position in the executive or legislative branch," or the staff of the Minnesota State Retirement System (MSRS) or the Public Employees Retirement Association (PERA), the Office of the Legislative Auditor, or the Metropolitan Council. PERA staff was added to this provision in 2007 (Laws 2007, Chapter 134, Article 11, Section 4).

Under the postretirement option program, state employees who worked at least half-time during the prior five years, who terminate from state service and qualify for an unreduced annuity (including a "Rule of 90" annuity), can agree to accept a postretirement option position with the same or different appointing authority under which the individual will reduce hours at least 25 percent or to half-time, whichever is the greater reduction. While in the program, reemployed annuitant maximum exempt earnings limitations do not apply. The appointments are for one year but can be renewed for up to five years. The appointing authority has sole discretion to determine whether positions under this program are to be offered. Any offer of a position in this program must be made in writing by the appointing authority to the employee, on a form provided by the Department of Employee Relations and MSRS or PERA (Minnesota Statutes, Section 43A.346, Subdivision 5).

As this program currently operates, the agreements between the individual and the state employer to enter the program must be reached while the individual is an active employee, before termination of service and commencement of a retirement annuity. Eligible individuals are state employees "currently occupying" state employment positions. Any individual who has already terminated is not "currently occupying" the position. The provision further states that any offer of a postretirement option position must be made in writing by the appointing authority to the employee. Deferred retirement plan members and retirees are not employees.

MSRS and PERA plan administrators are concerned that the postretirement option program as currently operated is not compliant with federal requirements. In general, a qualified plan must prohibit in-service distributions. An in-service distribution is a distribution of plan assets to a plan member prior to true termination of service or retirement. Because under the postretirement option program active employees are entering into arrangements to return to employment with the employing unit following a "termination," the federal government may contend these are invalid, sham terminations. If the terminations are invalid, the retirement benefits these individuals are receiving are in-service distributions, causing the plan to be out of compliance with qualified plan requirements.

One way to address this problem is to limit the postretirement option program to individuals who are age 62 or older. The federal Pension Protection Act of 2006 amended the qualified plan provision, Section 401(a) of the Internal Revenue Code, effective for plan years after December 31, 2006,, by adding the following paragraph:

> A trust forming part of a pension plan shall not be treated as failing to constitute a qualified trust under this section solely because the plan provides that a distribution may be made from such trust to an employee who has attained age 62 and who is not separated from employment at the time of such distribution.

Thus, the federal government has created an exception to its in-service distribution prohibition if the individual is at least age 62. A drawback to utilizing this option is that the Legislature has never knowingly permitted in-service distributions, and may wish to give careful study to this issue prior to permitting them on any basis.

A second approach to the in-service distribution problem is to revise the program to require a true separation from service, to eliminate or at least reduce the risk that the program could be viewed as violating federal in-service distribution prohibitions. Unfortunately, according to plan administrators the federal government has not defined what it considers to be a true separation. Given that absence, plan administrators, lawyers, and auditors have attempted develop reasonable standards to follow. An attachment, an article from GAP News published by the Institute of Internal Auditors, entitled "*The Retire and Rehire Controversy: What it Means for the Public Sector*," declares that "if the payment of a retirement benefit from a plan is not to be viewed as an in-service distribution, there must be a bona fide termination of employment in which the employer and employee relationship is completely severed." The document indicates that any arrangement in which the individual promptly returns to employment in the same position or for the same department would raise concerns. Particularly problematic is any agreement or understanding, oral or in writing, for the individual to return to work after terminating and commencing receipt of the annuity.

Given the lack of specific criteria from the federal government regarding what constitutes a true separation from service, another alternative is to avoid the issue altogether by ending the existing postretirement option program and replacing it, if there is sufficient need, with a voluntary hours reduction program based on the 2005 voluntary hour reduction plan (Laws 2005, Chapter 156, Article 3, Section 3). That program, which expired on June 30, 2007, covered employment provided before, rather than after, termination and commencement of an annuity. Under that program the employee and employer could enter into agreements under which the employee would reduce hours, working no more than the equivalent of a half-time position, but contributions to the retirement plan could be made as though the individual was employed full-time. That protected the individual's high-five average salary for pension purposes, so that when the individual eventually terminated service and commenced drawing a benefit, the half-time employment at the end of the individual's career did not harm the pension.

The delete-all amendment attempts to address the in-service distribution concern of the postretirement option program by requiring a minimum 30-day break in service for all individuals under age 62, and by using the exemption provided in recent federal law regarding in-service distributions to those age 62 or older. Problems with this approach are the lack of full assurance that the 30-day break requirements are sufficient to qualify as a true and complete termination of service, and that the Legislature will be knowingly providing in-service distributions to those at least age 62 who are in the postretirement option program. Although such treatment for those persons age 62 or older is permitted under federal law, the Commission and Legislature have not considered the broad implications of the procedure, including, but not limited to, double-dipping concerns. There may not be adequate time to devote to these issues during the 2008 Legislative Session. If the practice becomes widespread, there may be unforeseen cost implications for the plans.

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

1. Proper Current Action. It would appear that the creation of this program in 2005 inadvertently created in-service distribution problems for the pension funds of the employees who take part in the program. The existing law appears to be out of compliance with federal requirements. The issue is what to do about that problem. Some alternatives the Commission could consider are:

    a. Do nothing until there is a clear statement from the federal government regarding what constitutes a true termination of service;
    b. Terminate the program completely, or phase out the program by not permitting any new entrants;
    c. Keep the existing program, but limit it to those who are at least age 62;

d. Modify the existing program to require all individuals in the program, including those at or over age 62, to have a minimum 30-day break in service and prohibit employees to be offered or enter into contracts prior to a minimum 30-day break;
e. Terminate the program and replace it with a voluntary hour reduction program; or
f. Take no action until there has been thorough study of the various transition-to-full-retirement programs including early-retirement programs, the implications of reemployed annuitant provisions, the interaction between these various programs, federal law, or rule that may impact program design, and public employer workforce needs.

In considering the alternatives, the Commission may wish to review the policy concerns that follow.

2. Federal Requirement Compliance. The issue is whether the program as revised by the proposal would be viewed as effectively satisfying federal requirements if reviewed by the Internal Revenue Service. It is hoped that requiring a 30-day break in service and prohibiting agreements while individuals remain employed (at least those under 62), will be sufficient to avoid a plan qualification problem, but there is no certainty given the lack of federal guidance in this matter. The explicit purpose of this program is to rehire employees who retired and commenced receipt of annuities, which immediately raises the possibility of sham terminations and resulting in-service distributions. Auditors might be concerned about the inability to effectively enforce the proposed prohibition against any oral agreements to return to employment. If any program is deemed necessary, a program allowing individuals to reduce employment hours prior to the termination of service (rather than after, through a termination-rehire agreement) may be less problematic.

3. In-Service Distribution Issues. The issue is whether the Commission and Legislature want to knowingly permit in-service distributions (to those who are at least age 62), at least on a limited basis to individuals who are in this particular program. Permitting in-service distributions to individuals in this program is likely to create pressure to permit this treatment for a much larger group, any members of our public pension plans who are at least age 62. While in-service distributions may be permitted under federal law for those who are age 62 and older, the Commission may wish to address the question of whether this reflects good pension policy. This is not a subject the Commission has previously addressed.

   The Commission should be aware that the Teachers Retirement Association (TRA), in H.F. 3798 (Murphy, M., by request); S.F. 3324 (Betzold), a bill containing a mix of benefit provisions and administrative provisions, is proposing to permit in-service distributions to any TRA member who is at least age 62 if the individual submitted a termination notice, even individuals who immediately return to the same employment on a full-time basis. Permitting in-service distributions is contrary to the core concept that the purpose of retirement plan benefits is to support individuals who are truly retired. Double-dipping concerns are raised, which may lead Minnesotans to question why they are taxed to cover the salaries of public employees who are already drawing a public pension. Also, rehiring annuitants but not giving them further pension plan coverage for the reemployment may lead to pressure or a mandate from the courts that these individuals be provided with additional pension coverage, possibly leading to a requirement that the annual annuity amount these reemployed annuitants are receiving must be recomputed every year to incorporate additional earned service credit.

4. Employee Willingness to Participate in a Revised Program. The issue is the willingness of employees to take part in the revised postretirement option program under the terms in the proposal, given that no written or oral agreement can be offered until after the individual terminates from employment. The proposal creates considerable uncertainty for the employee. The risk to the individual is that he or she might terminate and then not be offered a postretirement option program position. Given that risk, individuals are likely to simply continue in full-time employment for a few more years; or, if they wish to move from full-time to part-time employment toward the end of their careers, make plans for a part-time job outside of state employment before terminating from state employment, which is a more certain outcome than terminating and hoping that a postretirement option program position is offered.

5. Lack of Consensus Regarding Appropriate Changes. Various legislative proposals have been introduced to address federal compliance concerns about the postretirement option program, and these proposals take different approaches, suggesting a lack of consensus regarding a solution. One approach is reflected in the current bill as introduced (requiring all individuals entering or in the program to have a 30-day separation of service), and the delete-all amendment, A08-1290 (requiring all individuals entering or in the program who are under age 62 to have a 30 day separation of service). Another alternative is found in H.F. 3798 (Murphy, M., by request); S.F. 3324 (Betzold), which restricts the program to those who are at least age 62.

6. Scope of the Proposed Change. The issue is the appropriate scope of the proposed change, whether to limit change to this one program or whether similar changes are needed in other programs. For example, there are numerous provisions in law which permit Minnesota State Colleges and Universities System (MnSCU) employees to terminate service and return to work under an agreement under which they will not earn more than $46,000 and will be employed on a one-third to two-thirds of full-time basis. These provisions can be construed as requiring, or certainly permitting, these employee/employer agreements to be reached prior to the individual terminating service for purposes of commencing the annuity. If the postretirement option program under Section 43A.346 has an in-service distribution problem worthy of addressing, it would seem that these MnSCU employee provisions share the same flaw. The MnSCU provisions are found in several different defined benefit plans which might provide coverage to some MnSCU employees: MSRS (Section 352.1155), TRA (Section 354.445), and the first class city teacher plans (Section 354A.31, Subdivision 3a).

7. Interaction with Other Provisions. There are other provisions of law that interact with this provision; changes in those provisions may impact the need for this program or alter how to best structure the program.

   - MSRS, PERA, and TRA law contain provisions which subsidize early retirement, and there are several proposals to extend subsidized early retirement to post June 30, 1989, hires. One can question policies which subsidize individuals to retire at young ages, only to have other programs encouraging them to return to employment after commencing receipt of a retirement annuity. This combination can be deemed costly and counterproductive, and it has resulted in the present concern with the postretirement option program, that its operation conflicts with federal in-service distribution prohibitions.

   - There are also various bills proposing to revise the treatment of reemployed annuitant savings accounts, permitting a retiree to access those accounts far sooner following the end of the reemployment period. Other proposals alter maximum exempt earnings amounts before portions of the annuity are transferred to the savings account, while MSRS proposed eliminating the use of savings accounts and returning to the approach in law until several years ago, forfeiting all or part of annuity payments once the exempt income limit is reached. These proposals include the current bill as introduced (MSRS had proposed to return to a forfeiture of MSRS annuity amounts once the exempt income limit was reached); H.F. 3798 (Murphy, M., by request); S.F. 3324 (Betzold), which includes increasing the TRA exempt income limit to $46,000, which might by amendment be extended to other plans; and H.F. 1001 (Carlson); S.F. 1238 (Rest), which would modify reemployment exempt income limits for substitute teachers.

   - The law establishing the postretirement option program includes a waiver exempting individuals in postretirement option program positions from being impacted by reemployed annuitant exempt income limit provisions. Another postretirement option program provision requires a cutback in service, with no individual in the program being permitted to work more than 50-percent time. If MSRS and PERA reemployed annuitant law were to be revised to use a $46,000 exempt income limit, few, if any, state employees who are reemployed annuitants working part-time would earn as much as $46,000, whether or not they were in the postretirement option program. Thus, the exemption in postretirement option program may not be needed, or the postretirement option program itself may not longer be needed.

8. Potential Need for Further Study. Whether or not the Commission feels a need to make some short-term changes in this program for federal compliance, the Commission may also wish to study the general issue of transitioning into full retirement. Currently, there are programs which require individuals to terminate service, commence benefits, and be rehired on a less than full-time basis. There are programs (qualified part-time teacher programs in teacher plans) which permit individuals to start part-time employment several years before they submit a resignation without negatively impacting their high-five average salary when they do terminate and commence benefits. There are reemployed annuitant exempt earnings provisions (which differ from plan to plan, and with some plans having no provision) which probably impact if and where retirees will seek at least partial employment. Finally, there are many provisions which encourage early retirement, at ages when individuals are still quite productive, at the same time that federal government policies are discouraging early withdrawal from the workforce. There may be overlap between programs, there may also be gaps in coverage, and there are inconsistent treatments between similar groups, and early retirement policy as reflected in Minnesota law is in conflict with federal retirement policy. Perhaps further study is needed about government labor force needs and how to best meet those needs while remaining in compliance with federal code requirements.