State of Minnesota | LEGISLATIVE COMMISSION ON PENSIONS AND RETIREMENT

H.F. 3840
(Gunther)

S.F. 3554
(Rosen)

Executive Summary of Commission Staff Materials

Affected Pension Plan(s): Supplemental Retirement Plans
Relevant Provisions of Law: Minnesota Statutes, Section 356.24, Subdivision 1
General Nature of Proposal: Exemption to Restriction for Blue Earth United Hospital District
Date of Summary: March 25, 2008

Specific Proposed Changes

The United Hospital District in Blue Earth, Minnesota, is granted a specific exception to the statutory restriction on supplemental retirement plans to continue to use the Minnesota Deferred Compensation Program as its public pension plan and is permitted to make employer contributions, without an employee match, up to the PERA employer contribution percentage of salary.

Policy Issues Raised by the Proposed Legislation

1. Appropriateness of adding a single employer exception to Minnesota Statutes, Section 356.24, restrictions.
2. Appropriateness of using the Minnesota Deferred Compensation Program as primary pension plan coverage.
3. Appropriateness of Minnesota Deferred Compensation Program employer contribution limit increase.
4. Appropriateness of using PERA-General plan contribution structure, including amortization funding, in setting defined contribution plan contributions.
5. Appropriateness of not requiring dollar-for-dollar member contribution match for employer contributions.
6. Federal tax law compliance; potential discrimination in favor of highly compensated personnel.

Potential Amendments

No Commission staff-suggested amendments.

State of Minnesota \ LEGISLATIVE COMMISSION ON PENSIONS AND RETIREMENT

TO: Members of the Legislative Commission on Pensions and Retirement

FROM: Lawrence A. Martin, Executive Director

RE: H.F. 3840 (Gunther); S.F. 3554 (Rosen): Supplemental Retirement Plans; Exemption to Restriction for Blue Earth United Hospital District

DATE: March 25, 2008

Summary of H.F. 3840 (Gunther); S.F. 3554 (Rosen)

H.F. 3840 (Gunther); S.F. 3554 (Rosen) amends Minnesota Statutes, Section 356.24, Subdivision 1, by adding a subdivision that creates a specific exception for the unnamed public hospital in Senate District 24 to allow the hospital to make an employer contribution equal to the Public Employees Retirement Association General Employees Retirement Plan employer contribution rate to individual accounts of its employees in the Minnesota Deferred Compensation Program who are making member contributions.

Pension Situation of the Blue Earth United Hospital District

The Blue Earth United Hospital District has its roots in the Dr. G. I. Smart Hospital, operating in Blue Earth, Minnesota, from 1886 until 1909, in the Dr. F. N. Hunt Hospital/Dr. Wilson Hospital operating from before 1908 until 1946, and in the Blue Earth Community Hospital, operating from 1950 until 1966. In 1967, ownership of the community hospital was transferred under Minnesota Statutes, Section 447.31, to a hospital district. The Blue Earth hospital expanded in size in 1971, 1982, 1984, 1993, 1999, and 2003. The United Hospital District is accredited by the Joint Commission on Accreditation of Healthcare Organizations, has 43 licensed hospital beds, has 24 adolescent treatment beds, has 200 employees, utilizes 50 physicians and other providers, has approximately 900 annual inpatient admissions, and has about 29,000 annual outpatient registrations.

The Blue Earth United Hospital District is not covered by the General Employees Retirement Plan of the Public Employees Retirement Association (PERA-General), as exempt from mandatory PERA-General coverage under Minnesota Statutes, Section 353.01, Subdivision 6, Paragraph (c). The hospital has been using the Minnesota State Deferred Compensation Program for its pension plan coverage and has been making matching employer contributions to the plan for employees who want the coverage up to the $2,000 annual limit set forth in Minnesota Statutes, Section 356.24, Subdivision 1, Paragraph (a), Clause (5). The hospital is concerned because the $2,000 annual limit is a modest pension contribution for its higher-compensated workforce and it would prefer to have the limit for its contribution set at the same percentage contribution rate that is applicable to PERA-General employees.

Background Information

Background information on the Minnesota State Deferred Compensation Program is set forth in **Attachment A**. Background information on statutory restrictions on supplemental pension plan coverage is set forth in **Attachment B**.

Analysis and Discussion

H.F. 3840 (Gunther); S.F. 3554 (Rosen) permits the Blue Earth United Hospital District to continue to use the Minnesota Deferred Compensation Program for the provision of its defined contribution plan pension coverage, under Minnesota Statutes, Section 356.24, with an increase for the hospital in the authorized employer contribution to the same amount as the employer contribution to the General Employees Retirement Plan of the Public Employees Retirement Association (PERA-General) and by discontinuing the requirement of a dollar-for-dollar match for the employer contribution to be made by the hospital.

The proposed pension legislation will raise several pension and related public policy issues for consideration and possible discussion by the Commission, as follows:

1. Appropriateness of Adding a Single Employer Exception to Minnesota Statutes, Section 356.24, Restrictions. The policy issue is the appropriateness of making an exception to the restrictions on supplemental public pension plans for a single employer rather than a more generalized class of employing units. When Minnesota Statutes, Section 356.24, was enacted in 1971, to curb some prosperous public employers from gaining a market advantage in attracting and retaining public employees by creating separate lucrative supplemental retirement plans, the provision had two broad-

based exceptions, which were preexisting supplemental plans and group health, hospitalization, disability or death benefit plans. The exceptions have grown over to 12, including four private sector multi-employer pension plans which cover some public employees, the laborers union pension funds, the plumbers and pipefitters union pension funds, the international union of operating engineers pension fund, and the international association of machinists pension fund. The addition of exceptions consisting of a single employing unit could lead to a future trend of additional single employer exceptions.

2. Appropriateness of the State Deferred Compensation Program as Primary Pension Plan Coverage; Exclusion from PERA-General Coverage. The policy issue is the appropriateness of the Legislature sanctioning the use of the Minnesota Deferred Compensation Program to provide primary retirement coverage when a better-designed primary retirement coverage arrangement exists, either in the form of the General Employees Retirement Plan of the Public Employees Retirement Association (PERA-General), from which the requesting public hospital apparently is excluded and desires to remain excluded, or the PERA Defined Contribution Plan. The Minnesota Deferred Compensation Program was not designed as anything more than a retirement-oriented savings arrangement to supplement traditional defined benefit-type public pension plans such as PERA-General, although as a defined contribution-type plan, it could be used as a primary plan. Commission files reflect a long and contentious history between PERA and public hospitals, in the 1950s and 1960s, where hospitals resisted PERA-General coverage because they contended that their workforces objected to making the mandatory member contributions and because they objected to having their employer contributions for short-term high turnover employees become PERA-General actuarial turnover gains. The eventual resolution of the past disputes between public hospitals and PERA was an exclusion from PERA-General coverage for hospital districts organized or reorganized before July 1, 1975, under Minnesota Statutes, Sections 447.31 to 447.37, the 1958 general law governing hospital district creation and reorganization. The requesting public hospital apparently believes that some or all of its employees would object to a mandatory PERA-General member contribution and apparently opposes PERA-General coverage because of its impact on those hospital employees.

3. Appropriateness of the State Deferred Compensation Program Employer Contribution Limit Increase. The policy issue is the appropriateness of increasing the annual employer supplemental retirement plan contribution maximum. For most Minnesota public employees, the limit on the matching employer contribution to the State Deferred Compensation Program is $2,000 annually. For employees of the Minnesota State Colleges and Universities System (MnSCU), the supplemental pension plan employer contribution limit is $2,700, accounting in part for the existence of a special 1967 supplemental retirement plan. For employees with coverage by one of the four union pension plans as supplemental retirement plan coverage, the employer contribution limit is $5,000 annually. The proposed limit for the public hospital is an amount equal to the required employer contribution rate for the General Employees Retirement Plan of the Public Employees Retirement Association (PERA-General) applied to the member's salary, or 6.50 percent of salary currently (2008) and 7.00 percent of salary after 2009. The impetus for the increase in the maximum apparently is the nominal percentage of salary that a $2,000 employer contribution represents for medical doctors and other highly compensated hospital employees. The Commission would be well advised to take additional testimony on the number and the compensation amounts of these highly compensated hospital employees.

4. Appropriateness of Including PERA-General Amortization Contribution in Setting Defined Contribution Plan Contribution. The policy issue is the appropriateness of setting the limit on the public hospital's employer contributions to the Minnesota Deferred Compensation Program, a defined contribution-type retirement plan, based on the total employer contribution rate of a defined benefit plan, the General Employees Retirement Plan of the Public Employees Retirement Association (PERA-General), when that total employer contribution includes the amortization contribution needed to pay off the plan's unfunded pension liability. Currently, the total PERA-General employer contribution is 6.5 percent of salary, increasing to 7.0 percent of salary in 2010, which is comprised of a 6.0 percent regular contribution and a 0.5 percent additional contribution (increasing to 0.75 percent in 2009 and to 1.0 percent in 2010). The current financial requirement of PERA-General, after deducting the member contribution of 6.0 percent of salary, is 6.75 percent of salary. If the goal is to give the public hospital's employees the benefit of the same cost to the hospital under the defined contribution plan that the hospital would bear if it were covered by PERA-General, then setting the employer contribution limit in the requested exception to the Minnesota Statutes, Section 356.24, restrictions as the same percentage of salary as the total PERA-General employer contribution is sensible. However, since a portion of total PERA-General contributions pay for past funding departures rather than the average value of the current benefit plan for current members, setting the defined contribution plan employer contribution at the total defined benefit plan contribution structure

provides the public hospital's employees with more pension value than they would receive if they were covered by PERA-General. If the Commission wishes to avoid giving these defined contribution plan members the value of intended amortization contributions as well as ongoing benefit plan contributions, setting the employer contribution limit at the 6.0 percent regular employer contribution would be more appropriate.

5. Appropriateness of Not Requiring Dollar-For-Dollar Contribution Match for Employer Contributions. The policy issue is the appropriateness of the departure from employer contributions being dollar-for-dollar matches of member contributions. The draft proposed legislation requires that the public hospital employee make a member contribution to the Minnesota Deferred Compensation Program in order to have the employer contribution on their behalf, but drops the dollar-for-dollar match requirement to meet the apparent desire not to price low-paid employees out of the coverage and to make the arrangement more likely to comply with federal tax code plan participation requirements (see issue #6). However, by disconnecting the dollar-for-dollar match requirement, the adequacy of the eventual savings amassed will be in doubt because lower-compensated members will trade near-term expenditures for long-term retirement wealth and the arrangement sets a precedent for ending Minnesota's contributory retirement plan design, which places affordability concerns on the plan membership as well as the covered employers.

6. Potential Discrimination in Favor of the Highly Compensated; Federal Tax Law Compliance. The policy issue is the potential that the requested exception to the prohibitions on supplemental retirement plans may function as discrimination favoring the highly compensated, raising potential federal tax law compliance issues. Using the Minnesota Deferred Compensation Program, permitted by Section 457 of the Internal Revenue Code, as a defined contribution plan-type retirement plan vehicle, normally governed by either Section 401 or Section 403(b) of the Internal Revenue Code, raises potential tax qualification difficulties. Employer contributions to retirement arrangements that are tax-qualified arrangements are not taxable to the employer when made and retirement accumulations in tax-qualified arrangements are not taxable to the plan member until withdrawn, rather than as being taxable as they are accumulating. The federal tax code does not permit employer-sponsored qualified retirement plans to discriminate in favor of the highly compensated. Internal Revenue Code Section 457 deferred compensation programs, as voluntary individual savings programs, are not usually subjected to the same discrimination rules. The intricacies of tax code compliance is beyond the expertise of the Commission staff, but if the proposed legislation was enacted for the public hospital and the resulting implementation produces a situation where only the doctors, medical director, and upper-end compensated hospital administrators and personnel make some member contributions and gain the employer contribution to their account, the public hospital would likely be out of compliance with the federal tax code and that lack of compliance could additionally threaten the tax treatment of the entire deferred compensation program.

Attachment A

Background Information on the Minnesota State Deferred Compensation Program

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. The applicable tax-sheltered annuity insurance contracts are those issued by one of up to ten qualified insurance companies licensed to do business in this state, engaged in the life insurance or annuity business, determined by the Commerce Commissioner to be among the top two rating categories of a national insurance rating entity, and selected by the Minnesota State Board of Investment as providing competitive options and investment returns.

Eight qualified insurance companies were designated by the State Board of Investment. The eight insurance companies are Aetna; Great West; IDS; Metropolitan; Minnesota Mutual; Nationwide; United Investors; and VALIC.

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 20 percent of salary or $9,500, which ever is less. 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.

The maximum deferral amounts, the ability to borrow from the account, and other features differ between the two plan types. The maximum deferral amounts under Internal Revenue Code Section 457 plans are less than the amounts that can be set aside under Internal Revenue Code Section 403(b) plans. Internal Revenue Code Section 403 (b) plans also have more lenient provisions on permissible withdrawals prior to retirement, and the state employee is permitted to borrow from the account. Borrowing from an Internal Revenue Code Section 457 plan account is not permitted. For these reasons, although teachers have access to both types of plans, they tend to prefer Internal Revenue Code Section 403(b) plans over Internal Revenue Code Section 457 plans. Public employees other than teachers and other school district employees are not eligible for Internal Revenue Code Section 403(b) plans, but are restricted to Internal Revenue Code Section 457 plans.