

Background Information on Service Credit Purchases

1. **Introduction.** Most major Minnesota public pension plans are defined benefit plans. In essence, this means that a benefit is promised in law, with that benefit being dependent upon five-year averaging of salary near retirement, referred to as the “high five,” and years of service credit. Under law, the individual receives a benefit of a certain percentage of the high-five average salary for each year of service.

For Teachers Retirement Association (TRA) Coordinated Plan members, this percentage of high-five average salary per year of service credit, referred to as the accrual rate, is currently 1.7% for individuals retiring at the normal retirement age of 65 for service provided before June 30, 2006, and 1.9% per year thereafter. Thus, if a coordinated TRA-covered teacher retired at age 65 and all the service was prior to June 30, 2006, with a high five of \$40,000 and 35 years of service credit, the annuity at the time of retirement was \$23,800 per year. If some service was after June 30, 2006, the annuity would be marginally higher because of the higher accrual rate applicable to the post-June 30, 2006, service.

TRA and other teacher and general public employee plans also have certain early retirement provisions applicable to employees who entered service before July 1, 1989. The most common is the Rule of 90. Under this provision, the plan member can retire without any penalty for early retirement when the age plus years of service credit in the plan total at least 90.

It is not uncommon for individuals to request authority purchase service credit in the plan when individuals are approaching retirement or eligibility for the Rule of 90. The additional service credit will boost the retirement benefit and permit them to qualify for the Rule of 90 or other subsidized early retirement provisions earlier than would otherwise be the case.

Buybacks or purchases of service credit for prior service are legislatively authorized opportunities for current or former public pension plan members to acquire service and salary credit in the applicable pension plan for a prior period of time that was not contemporaneously covered by the plan. Typically, buybacks or service credit purchases require the payment of an amount in place of the omitted funding. Buybacks arise in connection with optional membership periods, temporary employment periods without pension coverage, omitted pension plan contribution periods, government acquisition of quasi-public sector entities, extensions of plan coverage to quasi-public sector entities, periods of military service or other leave, and periods of service for other governmental employers.

2. **General Law Service Credit Purchases.** Many plans have leave of absence provisions in applicable general law. The Minnesota State Retirement System (MSRS) plans and the Public Employees Retirement Association (PERA) rely heavily on generalized leave of absence provisions permitting service credit purchase, up to one year, for leaves of absence authorized by the employer. Most general law leave provisions require payment shortly after the conclusion of the leave, with a purchase payment equal to the contribution the member and employer would have paid if he or she had remained on the payroll during the leave. If the payments are somewhat delayed, interest is generally charged. If the delay is longer, a full actuarial value payment is generally required instead of contributions plus interest.

Teacher plans tend to have many general law leave provisions with each covering a specific type of leave (such as medical leave, parental leave, sabbatical leaves, extended leaves), with purchase of service credit procedures similar to that used by MSRS and PERA. Sabbatical leaves in the TRA plan are a little different. Law requires that the teacher receive at least one-third pay while on the leave, and full-time equivalent employee contributions are deducted from this pay and transmitted to TRA, along with full-time equivalent employer contributions with the normal payroll billing cycle.

Virtually all plans also have general law provisions to permit purchase of service credit in the applicable Minnesota plan for leaves or breaks in service to provide military service. These provisions, which cover the period of initial induction without voluntary extension, include a provision compliant with the federal Uniformed Services Employment and Reemployment Rights Act (USERRA). Under USERRA-compliant provisions, if the employee pays the employee contributions that would have been made if the leave or break in service had not occurred, the employer must pay the corresponding employer contributions and any applicable interest on both the employee and employer contributions.

3. **Special Law Service Credit Purchase Provisions.** In addition to general law provisions, over the years the Legislature has passed many special law purchase of service credit provisions. Regarding these special law provisions, it is established Legislative Commission on Pensions and Retirement policy to consider those requests on a case-by-case basis and to be guided by the following considerations:

- a. Public Employment Period. The period to be purchased must be public employment or substantially akin to public employment.
- b. Minnesota Connection. The period to be purchased must have a significant connection to Minnesota, either occurring in the state, or occurring during a leave from, and with a return to, Minnesota public service.
- c. Full Actuarial Value Payment. The purchase price must be based on the pension liability incurred by the pension fund in permitting the service credit, without a subsidy provided by the pension plan, although a subsidy can be provided by the public employer involved.
- d. Equitable Considerations Are Met. The buyback must not offend notions of equity.

The above indicates that the Commission generally uses different payment terms for special law purchases of service credit than is used in general law provisions. General law purchases, when payment is timely, require the equivalent member and employer contributions amounts, while special law purchase authorizations require a payment equal to the full actuarial value of the additional benefit obtained by the purchase.

From a policy standpoint, the different payment requirements for special law requests stem from timing issues and concern about adverse selection. Most general law purchase authorizations require the purchase payment (employee and employer contribution amounts) within a short period following the leave period. If there is a minor delay, interest is charged. If the delay is more than a year or two, a full actuarial value payment is required. With special law purchase of service requests, a full actuarial value payment is nearly always specified in the law, because virtually all special law purchase authorizations are requested many years after the uncredited period. When payment does not occur for many years following the period of service in question, the purchase is inconsistent with the risk pooling nature of pension plan financing, since one or more public pension plan members are permitted to enhance their benefits at their own election, without the use of any averaging population. The phenomenon is known as adverse selection or selection against the fund, since the individual making the purchase has remained in the public employment, is approaching retirement, and fully intends to draw pension benefits from the fund. If this was not the case, that member would not request permission to make the purchase.

Since it is assumed that the member requesting the purchase of service credit fully intends to retire under the system, the purchase payment requirement is the full actuarial value of the additional expected lifetime retirement benefits that result from the purchase. In other words, the required payment to receive the service credit is equal to the additional liability that the service credit places on the system. The purpose of this requirement is to avoid any subsidy of this purchase by other covered employees and employers. A subsidy from these groups would only be appropriate if the lack of existing service credit for the individual is due to some error or harm done to the individual by the pension plan administration. In that case, there is an argument for the employees and employer groups to pay part of the cost of redressing the harm, by permitting a purchase at less than full actuarial value.

Purchases of service credit at full actuarial value generally provide no net benefit to the individual making the purchase unless some third party is willing to cover part of the cost. The employer may be willing to cover part of the cost if the employee was harmed due to employer error or employer omission, and most special law service credit purchase provisions permit, but do not mandate, that the employer cover part of the purchase cost. Perhaps the employer harmed the individual by failing to enroll him or her in the pension plan, or mishandled contributions, or missed deadlines, which caused the individual to be ineligible to receive service credit. If the employer pays a portion of the full actuarial value, it is worthwhile for the individual to make the purchase. The purchase provides value to the employee greater than the amount contributed by the employee, but the pension fund is held harmless because it does receive the full actuarial value from the combined employee and employer contribution amounts. If the total were less than the full actuarial value, the pension plan would be covering part of the cost of someone else's error.

Any special purchase request takes up considerable Commission time, often on proposed language affecting only a single individual, and forces the Commission to act more as a judicial body than a legislative group. The Commission is not well equipped to hear testimony from various parties, review and weigh evidence, and determine a monetary award for damages. Authority permitting the employer to pay part of the service credit purchase cost has the effect of directing the situation back to the employer, permitting the employer to review the situation and to voluntarily provide restitution if that employer determines that restitution is appropriate.

In some cases, however, the employer has acknowledged through testimony or written materials presented to the Commission that the employer erred, or there is other strong evidence of employer-created harm. In these situations the Commission has sought to mandate that the employer cover part of the service credit purchase cost.

Efforts to mandate employer payments have been problematic, although in recent years the Commission appears to have found a solution. Special law having a financial impact on a unit of local government generally requires a local approval clause. Thus, in practice, language mandating a payment by a local unit of government is actually permissive, because the local unit of government must approve the legislation for it to be effective. In a few cases, the Commission attempted to mandate employer payment and did not include a local approval clause, but this led to law suits or threatened suits from cities or counties based on the contention that such legislation, by its nature, must include a local approval clause. A solution which the Commission has used since the late 1990s is to allow the employing unit voluntarily to make the payment, but if that does not occur, language in the special law provision requires the necessary amount of money to be deducted from the next round of state aid that would otherwise be sent to the employing unit, and the amount is instead directed to the applicable pension fund.