

Legislative Commission on Pensions and Retirement

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TO: Members of the Legislative Commission on Pensions and Retirement

FROM: LCPR Staff

DATE: March 24, 2019

RE: H.F. 2489 (Murphy, by request); S.F. xxxx: Minnesota State; Increasing employee contributions to the Individual Retirement Account Plan (IRAP); and Amendment 2489-1A

Introduction and Summary

H.F. 2489 (Murphy, by request); S.F. xxxx increases the contribution rates for employees covered by Minnesota State's Individual Retirement Account Plan (IRAP) to the same rate paid by coordinated members of the Teachers Retirement Association (TRA). This will result in an increase in employee contributions of three percent on July 1, 2019. The current IRAP employee contribution rate is 4.5% of salary. The current TRA employee contribution rate is 7.5% of salary and is scheduled to increase to 7.75% of salary on July 1, 2023.

Background

The increase in the employee contribution rate is intended to bring the IRAP into compliance with federal regulations that govern the option to elect coverage by another plan. The IRS' ruling position is that such an election cannot result in a change in the electing employee's employee contribution rate. When an IRAP-covered employee elects to be covered by TRA, the employee's employee contribution rate changes from 4.5% to 7.5%.

Minnesota Statutes, Section 354B.21 provides participants in the IRAP with the option to elect coverage by TRA at various times during their employment with Minnesota State. All IRAP-covered employees have a chance to elect coverage by TRA within the first year of being hired in an IRAP-covered position. Faculty also have the option to elect TRA coverage upon achieving tenure or its equivalent; this is called a "second chance election." It is this second chance election that has come under scrutiny because the employee contribution rate changes when the election is made and the election is permitted at a time other than when the employee is first hired.

The second chance election is similar to the elections allowed for members of the Unclassified Employees Retirement Plan of the Minnesota State Retirement System (MSRS Unclassified). Members in the Unclassified Plan who are not elected officials may elect coverage by the MSRS General State Employees Retirement Plan (MSRS General) upon completion of ten years of service or prior to seven years of service depending on the hire date of the employee. However, this arrangement does not result

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in a violation of federal regulations because the employee contribution rates for the Unclassified Plan and for the General Plan are the same.

Upon discovering that there are IRS requirements that apply to an election such as the second chance election and that action would be required to correct the non-compliance, Minnesota State administrators and representatives of the bargaining units that cover affected employees had two alternatives to bring the IRAP into compliance:

- Eliminate the second chance election, or
- Increase the employee contribution rate under the IRAP to make it equal to the employee contribution rate under TRA.

The policy rationale for permitting a second chance election is to provide recruitment and retention benefits that match the career patterns of faculty members of the state system. It is generally understood that faculty members often change employment during their initial teaching years. Furthermore, adjunct positions are often part-time and limited to a semester or specific term. As a result, the benefit under the IRAP, which is an individual account and, therefore, more portable, is typically the more attractive benefit to faculty early in their career. Once a faculty member achieves tenure, they are much less likely to change employers, and the guaranteed income of TRA's defined benefit plan becomes the more attractive benefit.

Representatives of the bargaining units expressed interest in retaining the second chance election, even if it meant increasing the employee contribution rate. Accordingly, the bill increases the employee contribution rate to equal the employee contribution rate under TRA. There is no change to the availability of the second chance election.

Policy Considerations

Loss of take-home pay. The three percent increase in contributions required by H.F. 2489 results in a corresponding reduction in take-home pay. While the contributions go directly into employee's individual accounts, the contribution increase may result in hardship for some plan participants.

Scope of solution. H.F. 2489 increases the contribution rate for all IRAP members. However, not all IRAP members are eligible to make a second chance election, either because they already had the opportunity to elect TRA when they achieved tenure and elected to stay in the IRAP or because they are not in a position that will lead to tenure and the second chance election.

Minnesota State estimates that of the 6,456 faculty members participating in the IRAP, 4,678 are no longer eligible for an initial or second chance election. The IRAP contribution rate could remain at 4.5% for those 4,678 employees without violating federal regulations.

Some unclassified administrative employees are also covered by the IRAP. Those employees are not eligible for a second chance election. Minnesota State estimates that some additional 573 unclassified

administrative employees are not eligible for a second chance election. Amendment H2489-1A creates a carve-out for these groups as described below.

Amendment H2489-1A

Amendment H2489-1A carves out two exceptions to the general requirement that the employee contribution rate will be increased to the TRA rate:

- (1) The first group is faculty no longer eligible to make a second chance election.
- (2) The second group is unclassified administrative employees who are no longer eligible to make an initial election and will not be eligible to make a second chance election because they are not in a position that can receive tenure.

Because of the administrative burden of administering different employee contribution rates for different groups of employees, both groups initially retain the current 4.5% employee contribution rate, but are phased up to the TRA rate at 0.65% per year over the next five years. Starting on July 1, 2024, all participants would be subject to the same employee contribution rate.

Additional Explanation of Applicable Federal Requirements

Under the Internal Revenue Code, employee contributions made to a qualified retirement plan are included in income and considered “after-tax” contributions, unless they are made pursuant to a cash or deferred arrangement, such as under section 401(k) of the Code. A governmental employer is not permitted to offer a cash or deferred arrangement as part of a tax-qualified, or section 401(a), plan, unless the plan is a “grandfathered 401(k) plan.”

Governmental plans are permitted to require employee contributions as a condition of employment and because of the “pick-up” provisions under Code § 414(h)(2), these contributions may be deducted pre-tax and will be considered employer contributions for most purposes. When a governmental employer “picks up” contributions which are otherwise considered employee contributions, the contributions are treated as employer contributions. Employer contributions are not taxed to the employee until the benefit is distributed. For governmental defined benefit pension plans, it is important, from a funding perspective, to receive the contributions “pre-tax” to maximize plan assets. Thus, from both a plan qualification perspective and a funding perspective, ensuring compliance with the pick-up rules is critically important.

Section 414(h)(2) states that “... in the case of any [governmental] plan..., where the contributions of employing units are designated as employee contributions but where any employing unit picks up the contributions, the contributions so picked up shall be treated as employer contributions.” It would appear that all the employer needs to do to “pick up” an employee contribution is to include a statement to that effect in the plan document. For governmental plans, the plan document is typically the governing state statutes or city ordinances.

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The IRS, however, has expanded and supplemented the law in a number of revenue rulings and private letter rulings since 1980. Under the IRS' current criteria, published in a 2006 revenue ruling, to satisfy the pick-up requirements, a governmental employer must do the following:

- (1) Specify that the contributions, although designated as employee contributions, are being paid by the employer. For this purpose, the employing unit must take formal action to provide that the contributions on behalf of a specific class of employees of the employing unit, although designated as employee contributions, will be paid by the employing unit in lieu of employee contributions. A person duly authorized to take such action with respect to the employing unit must take such action. The action must apply only prospectively and be evidenced by a contemporaneous written document (e.g., minutes of a meeting, a resolution, or an ordinance); and
- (2) Not permit a participating employee from and after the date of the "pick-up" to have a cash or deferred election right (within the meaning of Code section 1.401(k)-1(a)(3)) with respect to designated employee contributions. Thus, for example, participating employees must not be permitted to opt out of the "pick-up", or to receive the contributed amounts directly instead of having them paid by the employing unit to the plan.

The IRS' second requirement incorporates the requirements of a detailed regulation under section 401(k) regarding what does and does not constitute a cash or deferred election. This 401(k) regulation:

- Defines a "cash or deferred election" to include "any direct or indirect" election;
- States that the cash alternative includes "some other taxable benefit;"
- Specifies timing rules: the election must precede the date on which the pay is "currently available," the services for which pay would have been received must precede the date of the contribution, and the election must precede the date of the contribution; and
- Defines a "one-time irrevocable election" to mean an election made "no later than the employee's first becoming eligible under the plan or any other plan or arrangement of the employer."

As borne out by subsequent private letter rulings, the IRS apparently intends to apply fully this 401(k) regulation in its analysis of governmental pick-up contributions.

To summarize, an employee election between two plans, such as in the case of the second chance election from the IRAP to the TRA, is not permitted under IRS guidance if the election occurs after initial employment; and the result of the election is an increase or decrease in the employee contribution rate.

1.1 moves to amend H.F. No. 2489; S.F. No., as follows:

1.2 Page 1, line 7, before "The" insert "(a) Except for a participant described under paragraph
1.3 (b), "

1.4 Page 1, after line 9, insert:

1.5 "(b) The member contribution rate is the rate described in paragraph (c) for a participant
1.6 in the individual retirement account plan who:

1.7 (1) achieved tenure or its equivalent at a Minnesota state college or university before
1.8 July 1, 2018; or

1.9 (2) is an employee in an eligible unclassified administrative position, is not a faculty
1.10 member, and first contributed to the individual retirement account plan before July 1, 2018.

1.11 (c) The member contribution rate for a participant described in paragraph (b) is the
1.12 following percentage of salary:

1.13	<u>from July 1, 2019, to June 30, 2020</u>	<u>5.15</u>
1.14	<u>from July 1, 2020, to June 30, 2021</u>	<u>5.80</u>
1.15	<u>from July 1, 2021, to June 30, 2022</u>	<u>6.45</u>
1.16	<u>from July 1, 2022, to June 30, 2023</u>	<u>7.10</u>
1.17	<u>from July 1, 2023, to June 30, 2024</u>	<u>7.75</u>

1.18 After June 30, 2024, the member contribution rate is the rate specified in paragraph (a)."

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State of Minnesota
HOUSE OF REPRESENTATIVES

NINETY-FIRST SESSION

H. F. No. **2489**

03/14/2019 Authored by Murphy by request
The bill was read for the first time and referred to the Committee on Government Operations

- 1.1 A bill for an act
- 1.2 relating to retirement; increasing contribution rates in the higher education
- 1.3 individual retirement account plan; amending Minnesota Statutes 2018, section
- 1.4 354B.23, subdivision 1.
- 1.5 BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF MINNESOTA:
- 1.6 Section 1. Minnesota Statutes 2018, section 354B.23, subdivision 1, is amended to read:
- 1.7 Subdivision 1. **Member contribution rate.** The member contribution rate for participants
- 1.8 in the individual retirement account plan is ~~4.5 percent of salary~~ equal to the coordinated
- 1.9 employee contribution rate in section 354.42, subdivision 2.
- 1.10 **EFFECTIVE DATE.** This section is effective July 1, 2019.