



Senate Fiscal Agency
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BILL



ANALYSIS

Telephone: (517) 373-5383
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Senate Bill 547 (as reported without amendment)
 Senate Bill 548 (as reported without amendment)
 Senate Bill 549 (as reported with amendments)
 Senate Bill 550 (as reported without amendment)
 Senate Bill 551 (as reported with amendment)
 Senate Bill 552 (as reported without amendment)
 Sponsor: Senator Glenn D. Steil
 Committee: Finance

Date Completed: 9-13-95

RATIONALE

Under the Internal Revenue Code (IRC), public and private retirement system investments and certain benefits are tax exempt; however, to obtain or retain tax-exempt status each retirement system's "plan document" must include provisions required by the IRC. In Michigan, various retirement Acts constitute the "plan documents" for public retirement systems administered by the State. In recent years, changes have been made to the IRC regarding rollovers of eligible distributions of employee contributions, and requiring that public retirement systems be operated as a trust and abide by certain limitations in employer-financed benefits. It has been suggested that various State retirement statutes be amended to conform with the requirements of the IRC, and thus avoid the possibility that those systems could lose their tax-exempt status.

CONTENT

The bills would amend six public retirement Acts to place in each Act provisions that conform to the Internal Revenue Code regarding direct trustee to trustee rollovers of eligible distributions of employee contributions; and further would amend three of the Acts to conform to IRC requirements that a public retirement system be operated as a trust, and abide by limitations in employer-financed benefits.

Senate Bills 547, 548, 549, 550, 551, and 552 would amend the State Police Retirement Act, the Municipal Employees Retirement Act, the Michigan Legislative Retirement System Act, the Judges Retirement Act, the State Employees' Retirement

Act, and the Public School Employees Retirement Act, respectively.

Rollover Distribution

The IRC provides that a trust cannot constitute a qualified trust (and thus remain tax exempt) unless the plan provides for rollover distribution in the form of direct trustee to trustee transfer to the eligible retirement plan, as specified in the IRC (Section 401(a)(31)). The bills would amend the various retirement Acts to comply with IRC provisions as follows:

- Notwithstanding any other provision (under the retirement Acts) to the contrary that would limit a distributee's election, a distributee could elect, at the time and in the manner prescribed by the retirement board, to have any portion of an eligible rollover distribution paid directly to an eligible retirement plan specified by the distributee in a direct rollover, for distributions made on or after January 1, 1993.
- "Direct rollover" would mean a payment by the retirement system to the eligible retirement plan specified by the distributee. "Distributee" would include a member, vested member, or deferred member; the member's, vested member's, or deferred member's surviving spouse; or the member's or deferred member's spouse or former spouse under an eligible domestic relations order, with regard to the interest of the spouse or former spouse.
- "Eligible retirement plan" would mean an individual retirement account described in IRC Section 408(a), an individual retirement

annuity described in IRC Section 408(b), an annuity plan described in IRC Section 403(a), or a qualified trust described in IRC Section 401(a), that accepted the distributee's eligible rollover distribution. In the case of an eligible rollover distribution to a surviving spouse, however, eligible retirement plan would mean an individual retirement account or an individual retirement annuity.

- An "eligible rollover distribution" would be a distribution of all or any portion of the balance to the credit of the distributee in a qualified trust. Eligible rollover distribution would not include any of the following: a distribution made for the life or life expectancy of the distributee or the joint lives or joint life expectancies of the distributee and the distributee's designated beneficiary; a distribution for a specified period of 10 years or more; the portion of any distribution that was not includable in Federal gross income, determined without regard to the exclusion for net unrealized appreciation with respect to employer securities; or a distribution to the extent that the distribution was required under IRC Section 401(a)(9).

(Section 401(a)(9) provides that a trust cannot constitute a qualified trust unless the plan for the trust follows the distribution requirements specified in the section. In general, the section prescribes when distributions must begin, what must be done if a distributee dies before his or her interest is distributed entirely, and the requirements for distributions when an employee dies before his or her distribution has begun.)

The bills provide that the required beginning date for retirement allowances and other distributions could not be later than April 1 of the calendar year following the calendar year in which the employee attained age 70-1/2, or April 1 of the calendar year following the calendar year in which the employee retired.

Senate Bills 548, 550, 551, and 552 provide that for purposes of determining actuarial equivalent retirement allowances, the actuarially assumed interest rate would have to be 8% with utilization of the 1983 group annuity and mortality table. Under the various retirement Acts, retirement allowances are equated on an actuarial basis for persons who retire before age 65. Under Senate Bill 549, the interest rate would have to be 7% with utilization of the 1971 group annuity and mortality table.

(Senate Bill 547 does not contain either of these provisions.)

Trust Requirements

Currently, the IRC mandates that public retirement systems be operated as trusts for the sole benefit of their members, and that they abide by limitations in employer-financed benefits as specified. The Municipal Employees Retirement Act, Judges Retirement Act, and Public School Employees Retirement Act each contains language that complies with the IRC requirements. The State Police Retirement Act, the Michigan Legislative System Retirement Act, and the State Employees' Retirement Act do not have these provisions. Senate Bills 547, 549, and 551, respectively, would amend those Acts as described below.

Purpose. The bills provide that the section containing the following provisions would be enacted pursuant to Section 401(a) of the IRC, which imposes certain administrative requirements and benefit limitations on qualified governmental plans. The bills also specify that the State "intends that the retirement system be a qualified pension plan created in trust" under the Internal Revenue Code's provisions on qualified pensions, and that the trust be exempt from Federal taxes under the Code.

Employer-Financed Benefits. Under Senate Bills 549 and 551, except as otherwise provided, employer-financed benefits provided by the retirement system could not exceed the lesser of \$90,000 or 100% of the member's average compensation for "high 3 years", as described in the IRC provisions on average compensation, for retirement at age 62 or older. These limitations would apply unless the application of other provisions in the bills produced a higher limitation (described below).

Under Senate Bill 547, except as otherwise provided, employer-financed benefits provided by the retirement system could not exceed \$50,000 per year for a retirant who was a full-time employee of a police department or fire department and who had 15 or more years of credited service as a police officer, fire fighter, or public safety officer at retirement. These limitations would apply unless the application of other provisions in the bill produced a higher limitation, in which case the higher limitation would apply. If a member retired at age 62 or older, employer-financed benefits provided by the

retirement system could not exceed the lesser of \$90,000 or 100% of the member's average compensation for high three years as described in the IRC.

Under all three bills, if a member retired before age 62, the amount of \$90,000 would be actuarially reduced to reflect payment before age 62. The retirement system would have to use an interest rate of 5% per year compounded annually to calculate the actuarial reduction. If the reduction produced a limitation of less than \$75,000 at age 55, the limitation at age 55 would have to be \$75,000, and the limitations for ages under 55 would have to be calculated from a limitation of \$75,000 at age 55.

Cost of Living. Section 415(d) of the IRC requires the Commissioner of Internal Revenue to adjust the \$90,000 limitation (or the \$50,000 limitation under the State Police Retirement Act) to reflect cost-of-living increases. The bills' cost-of-living provisions would have to be administered using the limitations applicable to each calendar year, as adjusted under IRC cost-of-living provisions. The retirement system annually would have to adjust the benefits subject to limitation to conform to the adjusted limits.

Assets. The retirement system's assets would have to be held in trust and invested solely for meeting the system's legitimate obligations, and could not be used for any other purpose. The assets could not be used for or diverted to a purpose other than the exclusive benefit of the members, deferred members, retirants, and retirement allowance beneficiaries before satisfaction of all retirement system liabilities.

Return of Contributions. The retirement system would be required to return to a member upon his or her retirement any post-tax member contributions received by the system pursuant to Internal Revenue Service regulations and approved IRS exclusion ratio tables.

Discontinuance of System. If the retirement system were discontinued, interest in the system of the members, deferred members, retirants, and retirement allowance beneficiaries would be nonforfeitable to the extent funded, as described in the IRC provisions concerning a plan's termination or partial termination and discontinuance of contributions, and the related IRS regulations applicable to governmental plans.

Compliance with Internal Revenue Code. Notwithstanding the bills' other provisions, the retirement system would have to be administered

in compliance with IRC provisions on limitations on benefits and contributions under qualified plans that were applicable to governmental plans. If there were a conflict between the bills and another section of the Acts or any other State act, the bills' provisions would prevail.

MCL 38.1603 et al. (S.B. 547)

38.1502a et al. (S.B. 548)

Proposed MCL 38.1007a et al. (S.B. 549)

MCL 38.2104 et al. (S.B. 550)

38.1 et al. (S.B. 551)

38.1304 & 38.1408 (S.B. 552)

ARGUMENTS

(Please note: The arguments contained in this analysis originate from sources outside the Senate Fiscal Agency. The Senate Fiscal Agency neither supports nor opposes legislation.)

Supporting Argument

The bills would ensure that State-administered public retirement systems would maintain their current tax- exempt status. The IRC requires retirement systems to include provisions specified in the Code for those systems to constitute a qualified trust (and thus remain tax exempt). Recent changes in the IRC regarding rollovers of distributions of employee contributions, and requirements that retirement systems be operated as a trust and abide by limitations on employer-financed benefits, have not yet been incorporated into the various statutes that govern Michigan's retirement systems. The bills would accomplish this and avoid the imposition of stiff Federal taxes on those systems, while having no effect on the structure of the State's retirement systems or the benefits derived from them.

Legislative Analyst: G. Towne

FISCAL IMPACT

Passage of Senate Bills 547 through 552 would have no fiscal impact on State or local resources. Failure to enact this legislation, however, could result in the State's retirement systems' losing their tax-exempt status. This would result in the State's having to pay a 35% tax on both the contributions made to the retirement systems and the investment income earned by each system. These taxes would have to be paid by either a lump sum payment equal to the taxes, or an increase in the contributions made by the State to cover the taxes. Listed below is the estimated amount of taxes that would be paid for each retirement system based on fiscal year 1993-94 data:

- State Employees: \$136.4 million for contributions, \$115 million for investments.
- Public School Employees: \$307.1 million for contributions, \$389.4 million for investments.
- State Police: \$12.6 million for contributions, \$11.8 million for investments.
- Judges: \$2.3 million for contributions, \$4.2 million for investments.
- Legislative: Data unavailable.
- Municipal: Taxes would be paid by the municipalities; data also unavailable.

Fiscal Analyst: J. Carrasco

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This analysis was prepared by nonpartisan Senate staff for use by the Senate in its deliberations and does not constitute an official statement of legislative intent.