Senate Fiscal Agency
P. O. Box 30036
Lansing, Michigan 48909-7536

BILL ANALYSIS

Telephone: (517) 373-5383
Fax: (517) 373-1986

Senate Bill 549 (as enrolled) **PUBLIC ACT 175 of 1995**
Senate Bill 551 (as enrolled) **PUBLIC ACT 176 of 1995**
Senate Bill 552 (as enrolled) **PUBLIC ACT 177 of 1995**
House Bill 4869 (as enrolled) **PUBLIC ACT 191 of 1995**
House Bill 4870 (as enrolled) **PUBLIC ACT 192 of 1995**
House Bill 4871 (as enrolled) **PUBLIC ACT 193 of 1995**
Sponsors: Senator Glenn D. Steil (S.B. 549, 551, & 552)
Representative Kim Rhead (H.B. 4869-4871)
Senate Committee: Finance (S.B. 549, 551, & 552)
Appropriations (H.B. 4869-4871)
House Committee: Appropriations

Date Completed: 8-8-96

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 was 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 amended 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 amended 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 549, 551, and 552 amended the Michigan Legislative Retirement System Act, the State Employees' Retirement Act, and the Public School Employees Retirement Act, respectively. House Bills 4869, 4870, and 4871 amended the Michigan Employees Retirement Act, the State Police Retirement Act, and the Judges 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 amended 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 may 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" means a payment by the retirement system to the eligible retirement plan specified by the distributee. "Distributee" includes 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" means 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 accepts the distributee's eligible rollover distribution. In the case of an eligible rollover distribution to a surviving spouse, however, eligible retirement plan means an individual retirement account or an individual retirement annuity.

-- An "eligible rollover distribution" is a distribution of all or any portion of the balance to the credit of the distributee in a qualified trust. Eligible rollover distribution does 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 is 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 is 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 may not be later than April 1 of the calendar year following the calendar year in which the employee attains age 70-1/2, or April 1 of the calendar year following the calendar year in which the employee retires.

Senate Bills 551 and 552 and House Bills 4869 and 4871 provide that for purposes of determining actuarial equivalent retirement allowances, the actuarially assumed interest rate must 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 must be 7% with utilization of the 1971 group annuity and mortality table. (House Bill 4870 does not contain either of these provisions.)

<u>Trust Requirements</u>

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 did not have these provisions. House Bill 4870 and Senate Bills 549 and 551, respectively, amended those Acts as described below.

<u>Purpose</u>. The bills provide that the section containing the following provisions is 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.

<u>Employer-Financed Benefits</u>. Under Senate Bills 549 and 551, except as otherwise provided, employer-financed benefits provided by the retirement system may 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 apply unless the application of other provisions in the bills produces a higher limitation (described below).

Under House Bill 4870, except as otherwise provided, employer-financed benefits provided by the retirement system may not exceed $50,000 per year for a retirant who is a full-time employee of a police department or fire department and who has 15 or more years of credited service as a police officer, fire fighter, or public safety officer at retirement. These limitations apply unless the application of other provisions in the bill produces a higher limitation, in which case the higher limitation applies. If a member retires at age 62 or older, employer-financed benefits provided by the retirement system may 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 retires before age 62, the amount of $90,000 will be actuarially reduced to reflect payment before age 62. The retirement system must use an interest rate of 5% per year compounded annually to calculate the actuarial reduction. If the reduction produces a limitation of less than $75,000 at age 55, the limitation at age 55 is $75,000, and the limitations for ages under 55 must 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 must be administered using the limitations applicable to each calendar year, as adjusted under IRC cost-of-living provisions. The retirement system annually must adjust the benefits subject to limitation to conform to the adjusted limits.

Assets. The retirement system's assets must be held in trust and invested solely for meeting the system's legitimate obligations, and may not be used for any other purpose. The assets must 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 is 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 is terminated, interest in the system of the members, deferred members, retirants, and retirement allowance beneficiaries will 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 must be administered in compliance with IRC provisions on limitations on benefits and contributions under qualified plans that are applicable to governmental plans. If there is a conflict between the bills and another section of the Acts or any other State act, the bills' provisions will prevail.

MCL 38.1007a et al. (S.B. 549)
38.1 et al. (S.B. 551)
38.1304 & 38.1408 (S.B. 552)
38.1502a et al. (H.B. 4869)
38.1603 et al. (H.B. 4870)
38.2104 et al. (H.B. 4871)

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 will ensure that State-administered public retirement systems will maintain their 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). 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, had not been incorporated into the various statutes that govern Michigan's retirement systems. The bills 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 the bills will have no fiscal impact on State or local resources. Failure to enact this legislation, however, could have resulted in the State's retirement systems' losing their tax-exempt status. This could have resulted 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 have been 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 have had to 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 have had to be paid by the municipalities; data also unavailable.

Fiscal Analyst: J. Carrasco

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