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PUBLIC PENSION CHANGES

House Bill 5108 as enrolled
Public Act 100 of 2002
Sponsor: Rep. Jerry Vander Roest

House Bill 5109 as enrolled
Public Act 99 of 2002
Sponsor: Rep. Joanne Voorhees

House Bill 5110 as enrolled
Public Act 94 of 2002
Sponsor: Rep. Sandra Caul

House Bill 5111 as enrolled
Public Act 98 of 2002
Sponsor: Rep. Jim Howell

House Bill 5112 as enrolled
Public Act 95 of 2002
Sponsor: Rep. Alexander C. Lipsey

House Bill 5113 as enrolled
Public Act 96 of 2002
Sponsor: Rep. Cameron Brown

House Bill 5114 as enrolled
Public Act 97 of 2002
Sponsor: Rep. Samuel Buzz Thomas

Second Analysis (4-8-02)
House Committee: Appropriations
Senate Committee: Appropriations

House Bills 5108-5114 (4-8-02)

THE APPARENT PROBLEM:

A number of changes to acts governing public retirement systems have been proposed to address several issues.

- Generally, under an anti-alienation clause of a pension plan, benefits cannot be assigned or “alienated” (transferred), and they are not subject to attachment, garnishment, levy, execution, or other legal process. The federal Internal Revenue Code addresses this issue by providing that benefits under a “qualified” pension plan are, generally speaking, not subject to assignment or transfer. In addition, the federal Employee Retirement Income Security Act

(ERISA) contains an anti-alienation provision, and the U.S. Supreme Court has ruled (*Patterson v. Shumate*, 1992) that an interest in an ERISA-qualified pension plan is not includable in a person’s bankruptcy estate. However, according to public pension specialists, these protections do not apply to governmental pension plans. Many, or most, public pension plans contain their own anti-alienation clauses designed to protect pension assets of governmental employees, assuring that these benefits will be there upon retirement. However, apparently not all public plans contain such a clause, and the effectiveness of those existing in local ordinances has

been called into question in certain bankruptcy proceedings. (In a Chapter 7 bankruptcy proceeding, the most common form of bankruptcy, the debtor's non-exempt assets are liquidated, or sold, and the proceeds distributed to creditors according to priorities established in the federal Bankruptcy Code. Pension benefits may be protected from creditors if they are "excluded" from the debtor's bankruptcy estate, or, if included in the estate, by being "exempted" from liquidation. At issue is whether pension benefits are "excluded" from a person's bankruptcy estate by virtue of an effective anti-alienation clause in the pension plan.)

The statutes governing Michigan's state-administered public pension systems each contain an anti-alienation clause, and also make exceptions for the division of marital assets, payment of child support obligations, and forfeiture of assets due to certain criminal convictions. The Municipal Employee Retirement System Act, under which some municipalities and courts offer retirement plans for their employees, has an anti-alienation clause in its plan document, though the statutory language was repealed when the MERS system was made into an independent public corporation governed by a board of directors. Public Act 156 of 1851, which allows county boards of commissioners to establish retirement systems for county employees, *does not* contain anti-alienation clause language. In addition, local governments have broad powers to establish retirement systems for their employees under their general statutory and charter operating authority. These independent retirement plans *may or may not* contain anti-alienation clauses. It has been suggested that a uniform state statute applying to all state and local pension systems is needed to provide adequate protection of public employee pension benefits in the event of bankruptcy proceedings.

In a related matter, the State Correctional Facility Reimbursement Act states that a prisoner's pension benefits may be subject to his or her statutory obligation to reimburse the state for the costs of incarceration; however, the pension acts do not specifically mention this obligation. The state supreme court has held, in *State Treasurer v. Schuster*, 1998, that the State Correctional Facility Reimbursement Act has priority over the anti-alienation clause of the Public School Employees' Retirement Act, and therefore that pension benefits payable under that act are subject to the reimbursement act. It has been suggested that the pension statutes should specifically address this obligation.

- An additional issue concerns the way in which the major state retirement systems fund health benefits for retirees. Under current law, the retirement for public school employees pays 100 percent of the premiums for health insurance coverage, and 90 percent of the premiums for dental and vision coverage. Funding of these health care benefits is paid on a cash basis; in other words, each year the employer contribution pays only for the health care costs incurred that year for current retirees. This differs from the funding of pension benefits, which are constitutionally guaranteed and are "prefunded" (the employer prepays an amount which, together with investment income, is sufficient to pay for the *future* costs being incurred on behalf of current employees and retirees). According to the financial report of the retirement system for the 1999-2000 fiscal year, if health care benefits were prefunded, the unfunded accrued liability of the system would be \$12.7 billion. The governor has proposed setting up a mechanism to partially address this very expensive proposition, by establishing an account to receive employer contributions toward the goal of prefunding health benefits in years when the basic pension benefit funds are fully funded. (Similar provisions for the State Employees Retirement System have been adopted under House Bill 5732.)

- The Office of Retirement Services also seeks amendments to the various pension statutes to update provisions required by the Internal Revenue Service so that the retirement systems retain tax-exempt status, and changes to implement new provisions allowed by recent federal tax law changes that allow expanded options for "rollover" of retirement accounts into other accounts without incurring tax penalties. (Some of these amendments allow for the recent addition of the option for state employees to use pre-tax payroll deductions to purchase service credit in the retirement system, and likewise to use lump sum amounts in so-called 401(k) retirement savings accounts to purchase service credit.)

- According to the Office of Retirement Services' web site, in rare instances, the Internal Revenue Code limits the pension amount that can be paid to very highly compensated individuals. One section of the IRC restricts the amount of annual compensation that can be used to calculate a pension, and another section sets the maximum amount of pension that can be paid out of pension assets. In order for the various pension systems to be able to pay benefits above these limits ("excess benefits") to individuals who are entitled to them (based on pension formulas), the acts need to be amended to set up an "arrangement and

fund” to pay excess benefits out of nonpension assets, a procedure that is sanctioned by the IRS.

- The Office of Retirement Services faces an enormous administrative challenge in the next several months, to implement the state employees’ early retirement system and to implement the many other changes contained in these bills and in House Bill 5732. An additional appropriation to cover administrative expenses has been proposed.

- Under current law, only supreme court justices, court of appeals justices, and certain other elected and appointed officials receive health care benefits paid by the Judges Retirement System. These individuals contribute 1.5 percent of their salary to fund health benefits. According to the Senate Fiscal Agency, for the past several years the amount available from employee contributions has not been sufficient to pay for health care costs for retirees. The reserve for health benefits is estimated to be in deficit in the amount of \$343,000. It has been proposed that the employee contribution rate be increased and that certain transfers among the pension fund accounts be implemented to correct this problem.

- In addition, several amendments to the Legislative Retirement System Act have been proposed by retirement system staff.

THE CONTENT OF THE BILLS:

Public Employee Retirement Benefit Protection Act. House Bill 5108 would create a new Public Employee Retirement Benefit Protection Act to put in statute an anti-alienation clause that would apply to all public pension systems administered by the state and by local governments in Michigan. House Bills 5109-5114 would amend the statutes governing pension systems for state employees, public school employees, firefighters and police officers, judges, state police, and legislators to eliminate the so-called “anti-alienation” clause in each act, and instead make these retirement systems subject to the provisions of the new act.

House Bill 5108 would create the new act. It would specify that the right of a member (including a current or vested former member, deferred member, designated beneficiary, or refund beneficiary) or retiree to a retirement benefit *could not* be subject to execution, garnishment, attachment, the operation of bankruptcy or insolvency laws, or other process of law, and could not be assigned. A “retirement benefit” would include an annuity, a retirement

allowance, an optional benefit, a postretirement benefit, a benefit received from a defined contribution plan, defined benefit plan, deferred compensation plan, disability plan, life insurance plan, all money, investments and income of the various funds created under a public employee retirement system, and any other right accruing to a member under a retirement system. A “retirement system” would include a public employee retirement system established by the state or a political subdivision of the state.

However, as under current law, the right of a member or retiree to a benefit *would be*:

- subject to forfeiture under the Public Employee Retirement Benefits Forfeiture Act; and

- subject to an award by a court during divorce proceedings, under an eligible domestic relations order, or under any other domestic relations order of a court pertaining to alimony or child support. As under current law, if an award or court order required a retirement system to withhold payment of a retirement benefit or requires the system to make a payment of a retirement benefit for the purpose of meeting the member’s or retiree’s obligations to a spouse, former spouse, or child, the withholding or payment provisions of the order would be effective only against amounts that become payable to the member or retiree, unless otherwise provided by an eligible domestic relations order. However, this limitation would not apply to the accumulated contributions of a person who terminates employment before becoming vested in a retirement system.

In addition, the bill would specifically provide that rights to benefits *would be* subject to claims made under the State Correctional Facility Reimbursement Act.

Further, the bill states that it is not intended to prohibit a member or retiree from receiving a loan from a retirement system if the system concluded that the person was otherwise eligible for a loan.

Finally, nothing in the bill would prevent a retirement system administrator from correcting records and seeking to recover overpayments made to a retiree or member.

House Bills 5109-5114 would amend the acts governing the various retirement systems. It would delete language that specifies that retirement benefits from defined benefit programs and distributions from

defined contribution programs are not subject to execution, garnishment, attachment, the operation of bankruptcy or insolvency laws, or other process of law, and are unassignable except as otherwise provided by law. Instead, the each bill would specify that these benefits and distributions would be subject to the Public Employee Retirement Benefit Protection Act (as proposed in House Bill 5108). The bills would also delete from the respective acts language that specifies that benefits and distributions are subject to court orders in divorce proceedings and eligible domestic relations orders (as that language would be re-enacted in the new act).

House Bill 5109 would amend the State Employees' Retirement Act (MCL 38.31 et al.). House Bill 5110 would amend the Public School Employees Retirement Act (MCL 38.1346 and 38.1385). House Bill 5111 would amend the Fire Fighters and Police Officers Retirement Act (MCL 38.556 and 38.559). House Bill 5112 would amend the Judges Retirement Act (MCL 38.2308 et al.). House Bill 5113 would amend the State Police Retirement Act (MCL 38.1643). House Bill 5114 would amend the Michigan Legislative Retirement System Act (MCL 38.1057 and 38.1080).

Health advance funding subaccount – Public School Employees Retirement System. House Bill 5110 would also amend the Public School Employees Retirement System Act to create a new health advance funding subaccount in the retirement system. Under the bill, in years in which the pension system was fully funded (for payment of basic retirement benefits), employer contributions could be deposited into the health advance funding subaccount, rather than into the other accounts dedicated to funding basic retirement benefits. In those years, the requirements for an annual comparison and reconciliation of actual and budgeted amounts of needed employer contributions would not apply.

Assets and any earnings on the assets in the health advance funding subaccount could not be treated as pension assets for any purpose. Further, assets and earnings in the subaccount could not be expended until the actuarial accrued liability for health benefits was fully funded. However, the bill would allow the Department of Management and Budget to transfer funds from the health care subaccount to the pension fund, if the pension fund was underfunded, but this would require the approval of the House and Senate Appropriations Committees. When the assets in the health care subaccount reached a level sufficient to fully fund health care benefits, money in the subaccount would be used to pay for health care

benefits of retirees. Also at that time, the contribution rate for health care benefits would be computed using an individual projected benefit entry age normal cost method of valuation (i.e., health benefits would be “pre-funded”, meaning that the benefits earned in a given year would be funded for the future in that year), instead of using a cash disbursement method (a “pay as you go” method of funding from year to year).

Internal Revenue Code provisions. The various retirement acts contain several provisions required under federal law in order to maintain the tax-exempt status of the systems. House Bills 5110, 5112, and 5114 would amend the acts governing the public school employees', judges', and legislators' retirement systems to make the following changes:

- The definition of “compensation” would be amended to delete language referring to the compensation limit established in the federal Internal Revenue Code; however, the bills would add language stating that, notwithstanding any other provision of the acts, the compensation of a member of each retirement system would be taken into account for any year under the retirement system only to the extent that it does not exceed the compensation limit established in the Internal Revenue Code, as adjusted by the commissioner of revenue. The new provision would apply to any person who first becomes a member of the retirement system on or after October 1, 1996.
- The bills would add language specifying that, notwithstanding any other provision of the acts, contributions, benefits, and service credit with respect to qualified military service will be provided under the retirement systems in accordance with the Internal Revenue Code. This provision would apply to all qualified military service on or after December 12, 1994.
- Beginning January 1, 2002, the definition of “eligible retirement plan” (for purposes of rollover distribution of eligible distributions of employee contributions) would be amended to include annuity contracts described in section 403(b) of the IRC, or an eligible plan under section 457(b) of the IRC that is maintained by a state or local government, so long as amounts transferred into eligible retirement plans from the state-administered retirement systems are separately accounted for by the plan provider.
- Further, beginning January 1, 2002, with regard to an “eligible rollover distribution”, the bills specify that if a portion of a distribution that is not included

in federal gross income is paid to an individual retirement account or annuity described in sections 408(a) or 408(b) of the IRC or a qualified defined contribution plan described in section 401(a) or 403(a) of the IRC, and the plan providers agree to separately account for amounts paid, the portion of distribution that is not includable in federal gross income would be an eligible distribution under the state-administered retirement systems.

[Note: Identical language was added to the State Employees Retirement System Act under House Bill 5732. House Bill 5111, which amends the State Police Retirement Act, *does not* contain these provisions.]

“Arrangement and fund”. House Bill 5108 also provides that a retirement system could elect by a majority vote of its governing body to establish and administer an “arrangement and fund” out of nonpension assets to pay accrued benefits of its members in excess of the limitations of Section 415 of the Internal Revenue Code. (This is said to be a way for the retirement systems to pay benefits to members that the members are entitled to receive under service credit formulas, but that exceed IRS limits on the amount of pension that may be paid to a retiree out of pension assets.) The bill specifies that an arrangement and fund established under this provision would have to be kept separate from the pension assets of the system. Benefits paid from the fund would be paid out of employer contributions or other eligible assets.

House Bills 5110, 5112, and 5114 would amend the acts governing the public school employees’, judges’, and legislators’ retirement systems to add language specifying that if those retirement systems established such an arrangement and fund, the retirement board would determine the amount of employer contributions or other eligible funds that would be allocated to the fund, and deposit that amount in the fund before it deposited any remaining employer contributions in the pension fund. [House Bill 5732 added similar language to the State Employees Retirement Act; House Bill 5111, which amends the State Police Retirement Act, *does not* contain this language.]

Appropriation for implementing state employees early retirement program. House Bill 5109 would appropriate an additional \$2.1 million in pension trust funds to the Department of Management and Budget, Office of Retirement Services, for administration of the changes created by House Bill 5732 (containing the early retirement program for state employees,

among many other changes). The unexpended portion of this appropriation would be considered a work project. The project is to be accomplished by the use of department personnel and by contracting with private consultants, with an estimated completion date of September 30, 2003.

Public School Employees Retirement System – withdrawal from MIP. The bill would delete language that specifies that a member of the Public School Employees Retirement System may discontinue contributions to the member investment plan and receive a refund of his or her contributions. (Deletion of this provision is said to be a technical amendment, as the provision has never been in effect due to a lack of IRS approval.)

Judges Retirement System – funding for health benefits. Under the Judges Retirement Act, health care benefits are provided only for “Plan 1” and “Plan 2” participants. “Plan 1” participants are the governor, lieutenant governor, secretary of state, attorney general, and auditor general. “Plan 2” participants are supreme court justices, justices of the court of appeals, and the state court administrator. Under current law, the listed individuals participating in the defined benefit plan contribute 5 percent of their salary to the retirement system, and of that 5 percent, 1.5 percent is dedicated to health care costs. House Bill 5112 would increase the amount dedicated to health care benefits from 1.5 percent to 2 percent (but would not increase overall employee contributions). In addition, the bill would require those participating in the defined contribution plan (who currently do not contribute for health care benefits) to contribute 2 percent of their salary to the retirement system for deposit into the reserve for health care.

The bill would also change the way funds from the Court Fee Fund are distributed. Under current law, a portion of certain court fines, fees, and assessments are deposited by the state treasurer into the reserve for employer contributions to pay normal pension costs of the Judges Retirement System. If pension costs are fully funded, this revenue is instead deposited into the Court Fee Fund. An amount not to exceed \$2.2 million is then transferred annually into the Court Equity Fund, and is used to reimburse local trial courts for general operating costs. Under House Bill 5112, funds from the Court Fee Fund would be distributed instead in the following manner:

- First, to pay for “excess benefits” under the provisions of an “arrangement and fund”, if one is established by the retirement system (see above).

- If funds remained in the Court Fee Fund after the payments to cover “excess benefits”, then the state treasurer would be required to transfer a portion of the remaining funds to the reserve for health benefits, to pay for health benefits for the subsequent fiscal year to the extent that health care costs exceeded employee contributions, and to pay, up to \$100,000 each fiscal year, toward health care costs not paid from the reserve for health benefits since fiscal year 1996-97. (According to the Senate Fiscal Agency, there is an estimated \$343,000 deficit in the reserve for health benefits.)

- After payment for excess benefits and health care costs, remaining Court Fee Funds would be transferred (as under current law) in an amount up to \$2.2 million per year to the Court Equity Fund.

Legislative Retirement System – additional changes. House Bill 5114 would also amend the Legislative Retirement System Act in the following ways.

- The bill would add a definition of “surviving spouse”, defined to mean the person to whom a member or retiree is legally married at the time of his or her death.

- Under current law, in the absence of a valid beneficiary designation, refund payments can be made only upon a probate court order; the bill would amend this provision to specify that refund payments could be made to the executor or personal representative of the deceased for the benefit of the estate.

- For purposes of calculating a retirement allowance, the term “salary” currently includes certain amounts added for each year or “major portion” of a year; the bill would amend this provision to refer instead to each year or “portion” of a year.

- The bill would require the retirement board to credit regular interest to the health insurance fund annually, and specify that, except as otherwise provided in the act, member contributions to the health insurance fund would not be refundable.

- The bill would add language specifying that if a deferred vested member has elected to defer receipt of his or her retirement allowance and subsequently dies before retirement, the retirement system would pay 100 percent of his or her deferred benefit to a beneficiary.

- Currently, a member who is not entitled to a regular retirement allowance, or a deferred vested member,

may receive a retirement allowance if he or she presents certain evidence of physical or mental disability. The bill would amend this provision to make it apply specifically to members who meet the service requirements for a retirement allowance but are not yet 55, and to members who do not meet the requirements of a provision that allows for retirement at age 50 and with a combined age and years of service of at least 70.

- In provisions concerning the composition and operation of the retirement board, the bill would add language allowing a deferred vested member serving on the board who becomes a retiree to continue to serve out his or her term of office on the board, and to require that at least 6 concurring votes (rather than 5) would be necessary for any action by the board at a meeting.

- In a provision concerning transfers of membership from Tier 1 (the defined benefit program) to Tier 2 (the defined contribution program), the bill would add language specifying that interest would be added to a member’s contributions when calculating the amount to be transferred to a Tier 2 account.

- In several provisions concerning certain administrative functions, the bill would delete references to the Department of Management and Budget’s role, specifying instead that the retirement board would be responsible for these functions.

Tie-bars. House Bill 5108 is tie-barred to each of the other bills in the package, and House Bills 5109-5114 are each tie-barred to House Bill 5108. House Bill 5109 is also tie-barred to House Bill 5732.

FISCAL IMPLICATIONS:

According to the Senate Fiscal Agency, except for House Bill 5109 and 5112, the bills have no fiscal implications for the state or for local governments. House Bill 5109 would appropriate \$2.1 million to pay for the administrative costs of the early retirement plan for state employees contained in House Bill 5732. House Bill 5112 would create a revenue shortfall in the judiciary budget (which receives appropriations from the Court Fee Fund) to the extent that the bill would create prior set-asides for employee retirement “arrangement and fund” provisions and for the reserve for health care benefits. (4-2-02)

ARGUMENTS:**For:**

Bankruptcy law allows a debtor who is unable to pay his or her creditors to resolve debts through the division of his or her assets under court supervision. Bankruptcy allows a debtor to be discharged of his or her debts, even if they are not paid in full, after the assets have been distributed in the manner provided by federal law. In a bankruptcy proceeding, a bankruptcy trustee supervises the liquidation and distribution of a person's non-exempt assets, so that creditors receive at least some part of what is owed. Generally, pension benefits are excluded from the assets that are distributed under a bankruptcy proceeding; this protection is assured to private sector employees who are participants in ERISA-qualified pension plans by federal statute and case law. However, these protections do not apply to public pension plans. Though the state-administered retirement systems have anti-alienation language, so local systems lack this protection. Pension specialists testified that some public employees in Michigan have had their pension benefits used to satisfy creditors in bankruptcy proceedings, despite attempts by local governments to protect their employees through including anti-alienation clauses in pension ordinances. It is believed that a uniform state law would strengthen the authority and protections of anti-alienation provisions, so that public employees would have the same protection as those in the private sector.

For:

House Bill 5110 would make an important first step toward achieving the laudable goal of prefunding health benefits in the Public School Employee Retirement System. Under the bill, excess employer contributions would be set aside into a health care advance funding subaccount in years that the pension system is completely funded, in order to help pay for future health care benefits. The explosion in health care costs is a trend that is likely to continue, and the current \$12.7 billion unfunded liability for health care benefits is a ticking time bomb that must be addressed. Though the bill would only make a start, it would help to counter the impact of inflation and the growing retiree population by taking advantage of investment earnings.

Response:

While it is good public policy to prefund health care benefits, this proposal falls far short of actually achieving that goal. With an unfunded liability of billions of dollars, it is unlikely that any of today's retirees will be helped by this proposal, as it will take

so many years for the fund to reach the needed balance. In the meantime, the proposal "locks in" all surpluses in the pension system toward this one purpose, so that they will not be available to fund post-retirement increases for older retirees (as has sometimes been the custom).

For:

The bills would update several provisions of the act to reflect recent changes in federal law. These updates are necessary to assure that the retirement system's tax-exempt status will continue.

For:

Though the Judges Retirement System provides health care benefits for only a few elected officials and justices, rising health care costs have outstripped the rate of employee contributions intended to pay those costs. As the pension fund is considerably overfunded, it makes sense to shift some of the employee contributions paid by defined benefit participants toward health care costs. In addition, reportedly due to an error at the time of the implementation of the defined contribution plan, DC participants were not required to contribute toward health care costs as DB plan participants do. House Bill 5112 would correct this by adding a 2 percent health care contribution for DC participants. These changes, and the implementation of a process for paying down the existing deficit in the reserve for health benefits, will address the problem of unfunded health care benefits in the Judges Retirement System.

For:

House Bill 5114 would make several amendments to the Legislative Retirement System Act at the request of the retirement system staff. Several changes would clarify provisions or add specificity where the act is silent, or would bring the statute into conformity with administrative practices. Other changes would be technical in nature, correcting references and errors that were made in earlier amendatory acts.

Analyst: D. Martens

■ This analysis was prepared by nonpartisan House staff for use by House members in their deliberations, and does not constitute an official statement of legislative intent.