Background Information on the Minnesota State Deferred Compensation Plan

1. In General. The Minnesota State Deferred Compensation Plan is governed by Minnesota Statutes, Section 352.965, and is an Internal Revenue Code Section 457 deferred compensation plan. The Deferred Compensation Plan is the most likely government sponsored retirement thrift or savings program for most public employees due to restrictions, found in Minnesota Statutes, Section 356.24, on supplemental retirement plans and employer-funded deferred compensation programs. However, in recent years restrictions on employer contributions to supplemental plans other than the Deferred Compensation Plan have been considerably lessened.

   Although the Deferred Compensation Plan is administered by the Minnesota State Retirement System (MSRS), public employees throughout the state are authorized to participate, including volunteer firefighters. The Deferred Compensation Plan, akin to the somewhat similar Internal Revenue Code Section 403(b) plans, functions to encourage additional saving for retirement, supplementing income during retirement from the primary public pension plan, Social Security, or other income sources.

   The legislation which created the Deferred Compensation Plan and the restrictions on other government sponsored savings plans both were enacted in 1971. The legislation restricting other government sponsored savings plans passed as Laws 1971, Chapter 222, Section 1, and was coded as Minnesota Statutes, Section 356.24. When enacted, it was intended to end a growing practice in local government (primarily by school districts) of creating supplemental employer-funded pension plans beyond the regularly applicable statewide primary pension plan for that type of public employee. At that time, public pension benefits were considerably more modest than they are currently and some of the more affluent jurisdictions were attempting to readjust their employees' pension coverage by local action, without the approval of or notice to the Legislature. The Legislature decided that this practice was inappropriate and that the creation of additional pension plans was an unwise policy. The Legislature also apparently felt that pension benefits should be as uniform as possible for similar public employees throughout the state.

   In 1973, the Legislature considerably improved pension benefits payable under the public employees' primary pension coverage by moving from career average salary plans to pensions based on the average salary of the individual close to retirement. This considerably improved benefits from the primary plans and, coupled with the 1971 legislation, was intended to eliminate both the need for and ability to create employer-funded supplemental plans. Those supplemental plans in effect prior to 1971 were grandfathered. In addition to the major improvement which occurred in 1973 by moving from using career average salary to high-five average salary, further benefit increases in primary pension plans occurred in 1980, 1989, 1992, and 1997.

2. Development of the Deferred Compensation Plan. The Deferred Compensation Plan was established in 1971 (Ex. Sess. Laws 1971, Ch. 32, Sec. 19). The Deferred Compensation Plan provided a vehicle for additional retirement savings, funded, however, solely by employees. The plan was established without any specific federal Internal Revenue Code authority, initially depending instead on a federal IRS Revenue Ruling regarding lack of constructive receipt. Taxes were deferred on any portion of an employee's salary which was deferred and for which there was no constructive receipt, if that deferred salary was invested by the employer and was subject to claims by the employer's general creditors.

   The plan initially was open only to state employees and was administered by MSRS, with rules, regulations and procedures established by the Commissioner of Administration, and investment by the State Board of Investment in a state-operated investment fund substantially similar to a mutual fund, known then as the Minnesota Supplemental Retirement Fund. Initially, the plan specifically prohibited any employer contribution and provided that the state employee was to bear the full risk of any investment loss incurred.

   Coverage significantly broadened in 1975 (Laws 1975, Ch. 273), by extending the plan to not just state employees, but employees of any political subdivision covered by any Minnesota public pension plan. The applicable governing law was also moved from Chapter 16A (governing the Department of Finance) to Minnesota Statutes, Section 352.96. (In 2008, Minnesota Statutes, Section 352.96, was recodified as Minnesota Statutes, Section 352.965.) The power to establish rules, regulations, and procedures for the Deferred Compensation Plan was also transferred to the MSRS executive director.

   Investment options were expanded in 1977 (Laws 1977, Ch. 300, Sec. 1-3). The 1977 legislation authorized fixed and variable annuity products of insurance companies as Deferred Compensation Plan investment options in addition to the various investments offered through the State Board of

Investment's Minnesota Supplemental Retirement Fund. The insurance company products were required to be selected through open bidding procedures.

Authority for deferred compensation programs was clarified in 1978. In February 1978, the Internal Revenue Service promulgated proposed regulations that would have prevented deferred compensation plans for state and local government employees, in part because of the lack of limitations on amounts that could be deferred. However, the Congress reversed the Internal Revenue Service in the Revenue Act of 1978 by enacting Internal Revenue Code Section 457, which specifically authorizes state and local government employee deferred compensation plans, but with specific limitations on the amounts available for deferral.

In 1980, the State Board of Investment implemented the 1977 Deferred Compensation Plan legislation and formally requested insurance company annuity option proposals. After analysis by a consultant and review by the Board, the State Board of Investment selected a proposal submitted by the Great-West Life Assurance Company, marketed by National Benefits, Inc., and a proposal submitted by the Minnesota Mutual Life Insurance Company and the Northwestern National Life Insurance Company, marketed by the Ochs Agency. Also in 1980 (Laws 1980, Ch. 607), the Minnesota Supplemental Retirement Fund was renamed the Minnesota Supplemental Investment Fund.

In 1997 (Laws 1997, Ch. 241, Art. 3, Sec. 1-3) the Legislature modified the Deferred Compensation Plan investment options and changed the legal status of the plan in conformity with a recently enacted federal law, the Small Business Protection Act/Minimum Wage Bill. The investment options and investment providers to the Deferred Compensation Plan were expanded to include mutual fund companies, investments managed by registered investment providers, and investments managed by banks and bank holding companies. Also, deferred compensation accounts were required to be held in trust. State Board of Investment authority to solicit bids was expanded to include the expanded group of providers.

3. <u>Deferred Compensation Plan Employer Contribution Match Feature, and Similar Feature in Tax-Sheltered Annuity Plans</u>. A significant change occurred in 1988 when the Deferred Compensation Plan was modified to include allowing a limited employer match to employee contributions made to the Deferred Compensation Plan. The matching Deferred Compensation Plan employer contribution was authorized under Minnesota Statutes, Section 356.24, and could be made only if provided for in a personnel plan or a collective bargaining agreement, and not to exceed $2,000 per year per employee. While not restricted in use to fund retiree health insurance premiums, the employer matching contribution authorization was part of a broader legislative enactment pertaining to retiree health benefits, and the conferees on Laws 1988, Chapter 605, discussed the potential for the savings promoted by the employer matching contribution authorization to be used in part to defray post-retirement health insurance premium costs.

   This matching feature lead to requests for similar treatment in tax-sheltered annuity plans (Internal Revenue Code Section 403(b) plans). In 1992 (Laws 1992, Ch. 487, Sec. 4), similar authority for an employer-matching contribution feature for teacher tax-sheltered annuity insurance contracts under Internal Revenue Code Section 403(b) was established. The applicable tax-sheltered annuity insurance contracts were those issued by one of up to ten qualified insurance companies licensed to do business in this state, engaged in the life insurance or annuity business, determined by the Commerce Commissioner to be among the top two rating categories of a national insurance rating entity, and selected by the Minnesota State Board of Investment as providing competitive options and investment returns. Eight qualified insurance companies were designated by the State Board of Investment. These were Aetna, Great West, IDS, Metropolitan, Minnesota Mutual, Nationwide, United Investors, and VALIC.

   Internal Revenue Code Section 403(b) tax-sheltered annuity plans are vehicles for teachers, church workers, and certain other personnel of charitable institutions to save on a tax-deferred basis. These plans were not intended as any public employee's primary retirement coverage; rather they act to supplement the primary plan. Internal Revenue Code Section 403(b) investments are generally referred to as tax-sheltered annuities, although Section 403(b) appears to permit investments in mutual funds in addition to annuities, provided the mutual fund investments are held by a custodian and contributions and disbursements are made only as permitted under Section 403(b). The maximum permitted employee contribution to Internal Revenue Code Section 403 (b) plans is set by federal code or regulation, and is revised each year. Taxes are due when the money is withdrawn. Withdrawals may begin as early as age 59½ and must begin by age 70½. The purpose of these age restrictions is to help ensure that the account is used for retirement purposes rather than intergenerational transfers.

4. Other Subsequently Permitted Employer Contributions. Following the limited employer match permitted under 1988 legislation, numerous other employer contribution or employer match exceptions have been added to Minnesota Statutes, Section 356.24. These have largely reversed the apparent intent of the initial 1971 legislation which sought to prohibit employer contributions to supplemental plans. Indeed, under current law employer contributions to so-called supplemental plans can considerably exceed the employer contribution to the primary plan. Minnesota Statutes, Section 356.24, currently authorizes employer contributions, not to exceed $5,000 per employee, to a national or local industrial pension fund, to a national or local plumbers and pipefitters pension fund, to the Union of Operating Engineers Pension fund, or to the International Association of Machinists pension fund. These are permitted if a fund contribution rate is specified and if a collective bargaining agreement authorizes coverage by the applicable fund. Even more extensive employer contributions are permitted to deferred compensation and tax-sheltered annuity plans (Section 457 and 403(b) plans). The employer contribution permitted to the MSRS Deferred Compensation Plan under the 1988 revisions has been considerably expanded. Rather than a maximum $2,000 employer contribution to the Deferred Compensation Plan if specified in a collective bargaining agreement, currently the employer could make an employer contribution equal to half the maximum permitted contribution as specified by the Internal Revenue Code. This contribution can be made to the Deferred Compensation Plan, or to any other deferred compensation plan offered by a governmental employer if specified in a collective bargaining agreement or similar document. Also, comparable language has been added to Minnesota Statutes, Section 356.24, permitting identical matches to 403(b) plans.

   Over the years, the maximum contributions to Section 457 and 403(b) plans permitted under the Internal Revenue Code have grown considerably. Individuals are permitted to contribute their full salary or the maximum permitted dollar contribution, whichever is less. As of 2012, the maximum permitted contribution to a Section 457 or 403(b) plan is $17,000 per year if under age 50, $22,500 if age 50 or older, and, under a catch-up provision applicable to those within three years of normal retirement age, $34,000 per year. Using the lowest figure, $17,000 per year, Minnesota Statutes Section 356.24, could allow an employer to make an employer matching contribution to a Section 457 or 403(b) plan of $8,500 per employee. Teachers are eligible under federal code to use Section 457 plans, Section 403(b) plans, or both. A teacher could contribute the maximum permitted under a Section 403(b) plan, either alone or in conjunction with the employer, and also contribute up to an identical maximum in a Section 457 plan, again, either alone or in conjunction with the employer.

   The amounts that an employer could contribute to either a Section 457 or a Section 403(b) plan considerably exceed the amounts that the employer is likely to contribute to the so-called primary plan. For instance, for 2012 the General State Employees Retirement Plan of the Minnesota State Retirement System (MSRS-General) employer contribution rate is 5.0% of salary, and the employer contribution rate in the General Employees Retirement Plan of the Public Employees Retirement Association (PERA-General) is 7.25%. Given an employee with a $50,000 salary, the employer contribution to MSRS-General would be $2,500, while the contribution to PERA-General, if that were the plan providing coverage, would be $3,625. But if an employer match to a Section 457 plan is specified in a collective bargaining agreement, the employer could contribute as much as $8,500 to the supplemental plan (and possibly more if the employer were older). Even if the employee’s salary was $100,000 per year, the employer could still be contributing less to the primary plan than to the supplemental plan.