Background Information on
Thrift Programs (403(b) and Section 457 Plans), and
Supplemental Plan Authority in Minnesota Statutes, Section 356.24

1. Tax-Sheltered Savings Programs: General Overview of Section 457 Deferred Compensation Plans and Section 403(b) Tax-Sheltered Annuities

   This section contains a general overview of Section 403(b) and Section 457 plans as authorized in federal law. Section 403(b) investments were first authorized in federal law in 1962. Initially, insurance company annuities were the only form of investment permitted under this federal law program, leading to the term "tax-sheltered annuities." More recently, with the passage of the federal Employee Retirement Income Security Act (ERISA) in 1974, mutual fund providers are permitted to offer Section 403(b) investments, but a tendency remains to refer to all Section 403(b) plans as tax-sheltered annuity plans. Unless specified otherwise in the remainder of this background piece, the term "tax-sheltered annuity" is used to refer both to insurance company tax-sheltered annuities and to mutual fund investments sold under Section 403(b) programs. Section 457 plans are commonly referred to as deferred compensation plans.

   Under federal law, employees authorized to participate in tax-sheltered annuity plans are employees of school districts, colleges and other higher learning facilities, religious organizations, and nonprofit corporations. Employees of state and local government units and nonprofit corporation employees are eligible to participate in deferred compensation plans. Teachers can participate in tax-sheltered annuity plans, deferred compensation plans, or a combination of the two. Teachers are eligible for Section 457 deferred compensation plans since they are public employees of local government units for purposes of qualifying for that type of plan.

   For both plan types the employee contributions, up to the legal limits, are sheltered from current taxation. That sheltering is achieved in different ways. Tax-sheltered annuity contributions and investment earnings on the account are declared under law to be exempt from current taxation. Section 457 deferred compensation plans create tax sheltering by avoiding constructive receipt of a portion of employee salary, that portion of salary which is directed to the deferred compensation investment. Until recently, contributions and the investment earnings on deferred compensation plan assets were legally retained as employer assets until paid out to the employee, and the assets of these plans could be used to meet the employer's outstanding obligations. Several years ago, when Orange County, California, and various other jurisdictions suffered heavy financial losses from investing government assets in questionable derivative investments, federal law was revised to safeguard employee deferred compensation plan investments. As of 1999, these deferred compensation investment assets must be held by the governmental employer in trust for the employee, and they cannot be used to satisfy employer debts.

   The following chart further describes elements of tax sheltered annuity plans and deferred compensation plans. Since teachers qualify under law for both types of plans, for them the maximum amount they could defer is the sum of the maximum deferral for a 457 plan and a 403(b) plan.

Comparison of Defined Contribution Plans

Issue	457 Plans	403(b) Plans
Eligible employees	Employees of state and local governments and nonprofit organizations.	Employees of nonprofit organizations, school districts, and institutions of higher education.
Role	Supplemental retirement savings plan.	Supplemental retirement savings plan.
Contributions and earnings	Made by employee, but may include some employer contribution.	Employee, but may include some employer contribution.
Ownership of assets	Assets are held in trust for employee.	Assets are owned by the employee.
Typical acceptable investments	Mutual funds, insurance company annuities, separately managed portfolios, and commingled funds.	Mutual funds, insurance company annuities.
Maximum deferral amount	$16,500. If age 50 or older, $22,000.	$16,500. If age 50 or older, $22,000.
Catch-up provision	Allowed for last three years before normal retirement, with a maximum of $15,000 per year.	Allowed after 15 years of service. May not exceed $3,000 per year or $15,000 in total.

Issue	457 Plans	403(b) Plans
In-service withdrawals	Allowed for unforeseeable financial emergencies only.	Allowed for financial emergency.
Loans	Allowed if permitted by the plan.	Allowed if permitted by the plan.
Rollover to IRA or other plan.	Permitted.	Permitted.

2. Summary: Current Version of Minnesota Statutes, Section 356.24

Minnesota Statutes, Section 356.24, enacted in 1971, prohibited state agencies, school districts, and other governmental subdivisions from contributing public moneys to supplemental pension plans, including tax-sheltered annuity or deferred compensation plans, except for a few exceptions listed in the statute. Plan arrangements already in existence before the law was enacted were grandfathered in.

However, particularly in recent years, the Legislature has authorized additional exceptions which permit employer contributions, again shifting the balance between supplemental and primary plans.

Due to these amendments, the list of exceptions is now quite long. The Individual Retirement Account Plan (IRAP), which provides primary pension coverage to higher education faculty who select that defined contribution plan coverage in lieu of Teacher Retirement Association (TRA)'s defined benefit plan coverage, is listed in the law as one of the exceptions. It is unclear why it is listed in current law, since that plan is not a supplemental plan. Rather, it provides primary coverage for higher education faculty and administrators who elect that coverage. The remaining exceptions listed in the current statute are:

a. pre-May 6, 1971, supplemental pension plans;

b. plans that solely provide group health, hospital, disability, or death benefits;

c. plans that solely provide severance pay as permitted by Minnesota Statutes, Section 465.72;

d. an employer matching contribution not to exceed $2,700 per employee to the Minnesota State Colleges and Universities System (MnSCU) Supplemental Retirement Plan on behalf of employees eligible for Supplemental Retirement Plan coverage;

e. an employer matching contribution to any 403(b) or 457 plan, not to exceed one-half of the employee elective deferral maximum to the 403(b) or 457 plan, for covered employees of any Minnesota public plan including city managers but excluding MnSCU employees eligible for the Supplemental Retirement Plan, if the investment's fees and three-, five-, and ten-year rates of return are disclosed in an easily understood document;

f. to a supplemental plan or government trust to save for post-retirement health care expenses qualified for tax-preferred treatment;

g. to a laborers national or local industrial pension fund for governmental employees covered by a collective bargaining agreement providing for coverage by that fund, with an employer contribution not to exceed $5,000 per employee;

h. to a plumbers and pipefitters national or local pension fund for governmental employees covered by a collective bargaining agreement providing for coverage by that fund, with an employer contribution not to exceed $5,000 per employee;

i. to the international union of operating engineers pension fund for governmental employees covered by a collective bargaining agreement providing for coverage by that fund, with an employer contribution not to exceed $5,000 per employee;

j. to the International Association of Machinists national pension fund for governmental employees covered by a collective bargaining agreement providing for coverage by that fund, with an employer contribution not to exceed $5,000 per employee;

k. to a supplemental plan organized and operated under Internal Revenue Code that is solely funded by the employee's accumulate sick leave, vacation leave, and accumulated severance pay;

l. United Hospital District, Blue Earth, may make an employer contribution to the Minnesota State Retirement System (MSRS) deferred compensation plan on behalf of its employees not to exceed the employer contribution and additional employer contribution specified for that salary under the General Employees Retirement Plan of the Public Employees Retirement Association (PERA-General); and

m. to alternate retirement plans established by the Hennepin County Medical Center.

The employer contributions specified above for MnSCU to the Supplemental Retirement Plan, and on behalf of all other public employers authorized to contribute to 403(b) and 457 plans, are employer contributions matching the amount the employee contributes up to the specified maximum. In contrast, the employer contributions to the various industrial pension funds specified above are amounts or percentages specified in collective bargaining agreements and are not necessarily matching contributions.

3. Historical Development, Minnesota Statutes, Section 356.24

a. In 1971 (Laws 1971, Ch. 222, Sec. 1), Minnesota Statutes, Section 356.24, was enacted to prevent some governmental employers from establishing supplemental pension plans to augment the pension coverage provided by the statewide Minnesota public pension plan providing the primary coverage. The statewide plans generally provided uniform pension benefit coverage to most Minnesota public employees, although there was an expanding recognition that this primary coverage was not adequate. The statewide plans, at that time, were career-average salary plans, rather than the high-five average salary plans now in effect.

   The 1971 legislation was recommended by the Legislative Commission on Pensions and Retirement, then operating under the name of the Legislative Retirement Study Commission, following a study of the issue of supplemental pension coverage by the Commission during the 1969-1971 interim and the receipt of testimony from teacher groups, school boards, and other interested parties. The 1971 legislation largely followed the Commission recommendations. The Commission was concerned that supplemental pension plans lessen the emphasis and importance of the primary pension plan coverage, lessen the commitment of employers and employees to those primary plans, increase pension differentials across the state, decrease employment mobility and pension portability, add another competitive factor between governmental subdivisions, and generally cause an increase in the diversity and confusion of the complicated Minnesota public pension system.

   After passing the 1971 law which generally prohibited development of new supplemental plans, while grandfathering in those already in existence, the 1973 Legislature strengthened the primary plans by changing these career-average salary plans to high-five average salary plans, and by providing ad hoc pension benefit increases to those already retired.

b. In 1988 (Laws 1988, Ch. 605, Sec. 9) the employer matching contribution authorization was added to Section 356.24, but was initially restricted to deposits in the Minnesota Deferred Compensation Plan, operating under federal Internal Revenue Code Section 457. The 1988 addition of the employer matching contribution authorization was done at the principal request of the Minneapolis Federation of Teachers, implementing a collective bargaining agreement provision, and was generally intended by the Legislature to provide a vehicle for public employees to save for health insurance coverage during retirement. The legislative change arose during the course of conference committee deliberations on proposed legislation that related to public employment, post-retirement health insurance coverage, collective bargaining over retiree medical insurance coverage, and allowable severance pay. The 1988 authorization of the employer matching contributions to supplemental retirement coverage apparently was not the result of any extensive legislative study of the topic, was not the subject of extensive public testimony, and was not considered prior to enactment by the Legislature.

c. In 1992 (Laws 1992, Ch. 487, Sec. 4) the employer matching contribution authorization in Section 356.24 was subsequently expanded beyond the Minnesota Deferred Compensation Program to include a limited set of federal Internal Revenue Code Section 403(b) tax-sheltered annuity insurance companies. Judging from testimony presented to the Commission on the proposed legislation during the 1992 legislative session, the legislative intent of this expansion apparently was to better accommodate the retirement savings practices of school district employees, who typically utilize tax-sheltered annuities rather than deferred compensation plans for retirement savings, and to accommodate other retirement investment vendors, who are not included in the marketing or investment of the State Deferred Compensation Program. To the best of the Commission staff's determination, the implications of the different regulatory aspects of the federal Internal Revenue Code, Sections 403(b) and 457, were not extensively discussed by the Commission in 1992.

d. In 1995 (Laws 1995, Ch. 141, Art. 3, Sec. 16), a revision to Section 356.24 resulted from a mandated 1994 Commission study which required the Commission to determine whether pension plan regulatory provisions in federal income tax laws apply to investments undertaken through the tax-sheltered annuity employer match provisions. The testimony provided to the Commission was varied and at times conflicting, leading to less than full clarification. Due to this study, the Commission recommended that language be added to law which placed responsibility on the employing unit to ensure compliance with all applicable federal regulation. The new language added to law continued the employer match authority to tax-sheltered annuities providing that the employing unit complies with applicable federal law and regulation. The Commission concluded that with this new requirement in place, school districts and other educational employing units will be more aware of their responsibility to formulate and operate these partially employer-financed supplemental retirement programs in a manner consistent with the applicable federal laws and that there will be fewer future potential problems.

e. In 1999 (Laws 1999, Ch. 222, Art. 18, Sec. 1), the Legislature clearly included mutual fund investment options in the tax-sheltered annuity employer match program, and expansion of the program to more insurance company providers. Rather than a maximum of ten insurance company providers, the revised statute permits the State Board of Investment to select up to 20. In addition to these companies, the revised statute requires that the State Board of Investment select up to five mutual fund providers. These mutual fund providers must be licensed to do business in the state, be in sound financial standing, and provide competitive net returns. The State Board of Investment must determine the revised or expanded group of tax-sheltered annuity employer-match program providers by July 1, 2000, and must periodically review the providers thereafter.

f. In 2000 (Laws 2000, Ch. 461, Art. 12, Sec. 15; Art. 13, Sec. 1-4) the maximum employer match by the Minnesota State Colleges and Universities (MnSCU) to the supplemental retirement plan under Chapter 354C increased from $2,000 to $2,700. The revisions made in 1999 were partially reversed. Authority to receive employer matching contributions to 403(b) products was expanded to all investment companies, rather than being restricted to no more than 20 providers (see Paragraph (e) above), and the mandatory State Board of Investment review was made permissive. Any provider of 403(b) investments eligible to receive an employer match may, rather than must, request a review by the State Board of Investment and Department of Commerce to review the investment company's financial standing, the competiveness of its products, and the level of its charges and fees.

g. In 2001 (1st Spec. Sess. Laws 2001, Chap. 10, Art. 7, Sec. 2), employer contributions were authorized to a supplemental plan or government trust to save for post-retirement health care expenses qualified for tax-preferred treatment, and to a laborers national industrial pension fund for governmental employees covered by a collective bargaining agreement providing for coverage by that fund, with an employer match not to exceed $5,000 per employee.

h. In 2002 (Laws 2002, Ch. 392, Art. 10, Sec. 1) employer contributions were authorized to a plumbers and pipefitters national pension fund and to the international union of operating engineers pension fund for governmental employees covered by a collective bargaining agreement providing for coverage the applicable fund, with an employer match not to exceed $2,000 per employee. Employer contributions were also authorized to a supplemental plan organized and operated under the Internal Revenue Code that was solely funded by the employee's accumulate sick leave, vacation leave, and accumulated severance pay.

i. In 2003 (1st Spec. Sess. Laws 2003, Ch. 12, Art. 7, Sec. 1), the employer contribution authority established in 2002 to a plumbers and pipefitters' national pension fund was extended to include a plumbers and pipefitters local pension fund.

j. In 2006 (Laws 2006, Ch. 271, Art. 3, Sec. 40; Art. 7, Sec. 1), city managers were added to the provision permitting an employer match not to exceed $2,000 to any 403(b) or 457 plan. Employer contributions were authorized to the International Association of Machinists national pension fund for governmental employees covered by a collective bargaining agreement providing for coverage by that fund, with an employer match not to exceed $5,000 per employee. The employer match to a laborers national industrial pension fund for governmental employees covered by a collective bargaining agreement providing for coverage by that fund, with an employer match not to exceed $5,000 per employee, was expanded to also include a laborers local industrial pension fund. The maximum employer match was increased from $2,000 to $5,000 to a plumbers and pipefitters national pension fund or to the international union of operating engineers' pension fund for governmental employees covered by a collective bargaining agreement providing for coverage by the applicable fund.

k. In 2008 (Laws 2008, Ch. 349, Art. 11, Sec. 6), the provision permitting an employer matching contribution on behalf of public employees other than MnSCU, not to exceed $2,000 to any 403(b) or to the MSRS deferred compensation plan, was expanded to permit a match to any deferred compensation plan by:

- increasing the maximum matching contribution from $2,000 to one-half of the employee elective deferral maximum to the 403(b) or 457 plan;
- adding a requirement that any investment eligible for a match must disclose fees and investment returns for three-, five-, and ten-year periods in an easy-to-understand presentation; and
- permitting United Hospital District, Blue Earth, to make an employer contribution to the MSRS deferred compensation plan on behalf of its employees not to exceed the employer contribution and additional employer contribution specified for that salary under PERA-General.

l. In 2010 (Laws 2010, Ch. 359, Art. 2, Sec. 15; Art. 15, Sec. 4), a provision prohibiting employer units from making a contribution to a 457 deferred compensation plan in lieu of Social Security coverage on behalf of volunteer or on call firefighters was eliminated. Language stating that employer contributions are permitted to alternate retirement plans established by the Hennepin County Medical Center was moved to this provision from another chapter of statutes.

4. <u>Shifting Policy Goals Underlying Minnesota Statutes, Section 356.24</u>

Over the history of its development, the legislative intent underlying Minnesota Statutes, Section 356.24, reflects a shifting focus. Initially, the statute reflected an effort to promote and maintain pension uniformity. When initially enacted in 1971, Section 356.24 was intended to end a growing practice in local government (primarily school districts) of creating supplemental employer-funded pension plans beyond the regularly applicable statewide pension plan for that type of public employee. At that time, public pension benefits were considerably more modest than they are currently (career average salary plans rather than final average salary plans) and more affluent jurisdictions were attempting to readjust their employees' pension coverage by local action, without the approval of or notice to the Legislature. The Commission and the Legislature decided that this practice was inappropriate and that the creation of additional pension plans was an unwise public policy. The Commission and the Legislature also apparently felt that pension benefits should be as uniform as possible throughout public employment.

Later amendments, in contrast, again moved in the direction of more local jurisdiction discretion and personal choice. These amendments permitted and encouraged collectively bargained defined-contribution-plan-like retirement savings arrangements with matching employer financing to the Supplemental Retirement Plan, deferred compensation plans, and tax-sheltered annuities. Employer contributions to industrial pension funds were also authorized. These actions created a relatively large range of tax-sheltered investment opportunities for participants, with considerable individual choice and local variation.

More recent changes can upset the relationship between the primary pension plan and the plan or plans which are supposedly supplemental. Starting in 2006, maximum permitted employer contributions to supplemental plans were increased considerably. The employer contributions authorized to various industrial pension plans were increased to $5,000 from $2,000. The statute was further revised to permit employer matches to 403(b) plans and 457 plans of up to one-half of the maximum employee contributions authorized under federal code, rather than $2,000. The employee maximum contribution to 403(b) and 457 plans is currently $16,500, and possibly higher for employees nearing retirement, resulting in a maximum employer matching contribution of $8,250. These recently revised maximums can result in employer contributions to so-called supplemental plans which are in excess of employer contributions made to the primary plan.

Consider a situation where the employee contributes $8,250 to a 457 plan, and a collective bargaining agreement specifies an employer match. If the employee is covered by PERA-General, the employer contribution specified in law to PERA-General is 6.25% of salary, with an employer additional contribution of 1.0% of pay, for a total of 7.25% of pay. If the employee makes $40,000 per year, the total employer contribution to PERA-General on behalf of this employee is only $2,900. The $8,250 match to the 457 plan would be 2.84 times the amount the employer is contributing to the primary plan, PERA-General. Consider that same employee, except the employee is covered by TRA. The employer contribution rate to TRA is currently 5.5% of pay, escalating to 7.5% of pay after June 30, 2014. At the current 5.5% rate, on behalf of the teacher making $40,000 per year the employer would pay an employer contribution of $2,200 to TRA. At a 7.5% rate the TRA employer contribution would be $3,000. Either is much less than the $8,250 the employer could be contributing to either a

457 or 403(b) plan to match the employee. At a 5.5% employer contribution rate, the teacher would have to have a salary of $150,000 per year before the employer contribution to TRA would equal the $8,250 employer match contributed to the supplemental plan. At any salary less than that, the $8,250 employer match contributed to the supplemental plan would exceed the amount that the employer is contributing to TRA. At the 7.5% TRA employer contribution rate applicable as of June 30, 2014, and later, at a salary of $110,000 the amount the employer is contributing to TRA and the supplemental plan would be the same. At salaries below $110,000, the employer would be contributing more to the supplemental plan than to TRA. Results for other plans are similar.