HF 4298 (Nelson, M.); SF 4203 (Rosen): Modifying Public Employees Retirement Association (PERA) Police & Fire Plan Disability Benefits

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Introduction

Affected Plan: Public Employees Police and Fire Retirement Plan (PERA P&F)

Laws Amended: Minnesota Statutes, Section 353.656

Brief Description: The bill makes the following changes:

- Reduces the value of the disability benefit for certain members who are age 55 or older and are:
  - Eligible for a duty disability and have less than 20 years of service
  - Eligible for regular disability and have between 1 and 15 years of service
- The disability benefits are changed by:
  - Replacing the minimum duty disability benefit of 60% of salary with a disability benefit equal to being fully vested in the member's retirement benefit
  - Replacing the minimum regular disability benefit of 45% of salary with a disability benefit equal to being fully vested in the member's retirement benefit
  - Removing the 60-month period of tax free disability benefit

Staff Concerns: Staff has identified the following issues raised by the bill:

- Uniformity of benefits – other plans provide disability benefits until the later of age 55 or 60 months after the start of the benefit.
- Age discrimination – bill results in a reduction in disability coverage for some employees after age 55.

Background

Categories of Disability Benefits

The PERA P&F plan has four categories of disability benefits:

1. **Duty disability.** A duty disability is a physical or psychological disability arising out the performance of inherently dangerous duties that are specific to the member's job (police officer or firefighter). The disability prevents the member from preforming the normal duties of a member of the P&F Plan and the duration of the disability is expected to last at least 12 months.

2. **Total and permanent duty disability.** A total and permanent disability is a duty disability except that the disability prevents the member form engaging in any substantial gainful activity and the duration of the disability is expected to be of a long-continued and indefinite duration.

3. **Regular disability.** A regular disability is a physical or psychological disability that arises from non-work activity or from performing work duties that are not inherently dangerous duties specific to public safety employees. The disability prevents the member from performing the normal duties of a member of PERA P&F and the duration of the disability is expected to last at least 12 months.

4. **Total and permanent regular disability.** A total and permanent regular disability is a regular disability except that the disability prevents the member form engaging in any substantial gainful activity and the duration of the disability is expected to be of a long-continued and indefinite duration.

If PERA determines that a member is eligible for a duty disability benefit or a total and permanent duty disability benefit, then the member is also eligible for employer-paid healthcare insurance coverage until age 65.[1]

Calculation of Disability benefits.

Due to the hazardous nature of public safety employment, PERA P&F offers generous disability benefits. The table below describes current disability benefits:

Type of Benefit	Calculation of the Benefit	Duration of the Benefit[2]
Duty disability	60% of high-five salary plus 3% of salary for each year of service in excess of 20 years	• Until age 55 • Members who become disabled when older than 55 and with fewer than 20 years of service, for 60 months
Total and permanent duty disability	Same as duty disability	For the lifetime of the member or until the member ceases to be totally and permanently disabled
Regular disability	45% of high-five salary	• Until age 55 • Members who become disabled when older than 55 and with fewer than 15 years of service, for 60 months
Total and permanent regular disability	Same as regular disability	For the lifetime of the member or until the member ceases to be totally and permanently disabled

[1] Minn. Stat. § 299A.465

[2] If the disability benefit ceases at or after age 55 (normal retirement age), the benefit converts to a retirement annuity of the same amount. In effect, the benefit amount is often for the lifetime of the member.

Taxation of disability benefits.

The portion of a duty disability or total and permanent duty disability benefit that is equal to 60% of the member's high-five salary is not taxable under the Internal Revenue Code.[3] The remainder of the disability benefit, if any, is taxable. In the case of a duty disability, the benefit is non-taxable until the benefit converts to a retirement annuity. In the case of a total and permanent duty disability, the benefit remains non-taxable for the lifetime of the member. Regular disability and total and permanent regular disability benefits are taxed as annuities.

Description of the Bill

Duty disability.

Section 1 of HF 4298 (Nelson, M.); SF 4203 (Rosen) adds a new category of disability benefits for members who are duty disabled and are older than age 55 but have fewer than 20 years of service. Under current law, an eligible member who becomes eligible for a disability benefit at age 55 or older but has fewer than 20 years of service is entitled to 60% of the member's high-five salary for a period of 60 months. During the 60-month period, the benefit is not taxable to the member. Following the 60-month period, the benefit remains the same amount, but converts to a retirement annuity and is taxable to the member. Under current law, PERA requires a member to terminate employment before the member can qualify for this benefit.

Under the bill, the same member is instead entitled to, and is fully vested in, a smaller benefit that is equal to 3% of the member's high-five salary times the number of years-of-service (i.e., 3% x high-five salary x years-of-service). The benefit is the same as a regular retirement annuity except that the member is fully vested in the benefit and thus is eligible to receive the benefit regardless of the member's years of service. Under current law, members hired after 2010, vest under a graded vesting schedule (e.g., 50% vested after 10 years of service and 100% vested after 20 years of service).[4] Under the bill, those members would be 100% vested in the new benefit. The new benefit is taxable to the member as an annuity. Under the bill a member does not need to terminate employment before the member can apply for this benefit.

For examples of the changes in the bill, see Attachment A.

Regular disability.

Similarly, section 4 of the bill adds a new category of disability benefits for members who are eligible for a regular disability and are older than age 55 but have fewer than 15 years of service. Under current law, the member is entitled to 45% of the member's high-five salary for a period of 60 months. Because

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[3] For a description of the tax law, see Attachment B;
see also Internal Revenue Code § 104(a)(1); Treas. Reg. 1.104-1(b).

[4] There are two different graded vesting schedules: one for members between June 30, 2010, and June 30, 2014, and one for members hired after June 30, 2014. See Minn. Stat. § 353.01, Subd. 47.

regular disability benefits are not in the nature of worker's compensation benefits, and thus are taxable to the member as an annuity. PERA requires a member to terminate employment before the member can qualify for this benefit.

Under the bill, the same member is instead entitled to, and is fully vested in, a smaller benefit that is equal to 3% of the member's high-five salary times the number of years-of-service (i.e., 3% x high-five salary x years of service). The benefit is the same as a regular retirement annuity except that the member is fully vested in the benefit and thus is eligible to receive the benefit regardless of the member's years of service. The new benefit remains taxable to the member as an annuity. Under the bill a member does not need to terminate employment before the member can apply for this benefit.

For examples of the changes in the bill, see Attachment A.

Discussion and Analysis

Who is affected?

This bill affects a small percentage of members who become eligible to receive a duty disability or regular disability after the effective date of the bill. Specifically, it affects such members who are older than age 55 and have fewer than 20 years of service. There are approximately 240 members in the plan that are older than age 55 but who have fewer than 20 years of service.[5] PERA estimates that based on current rates of use of the disability benefit, between one and two members per year will become eligible for the reduced benefit under the bill.

What is the financial impact on the plan?

PERA estimates that between one and two people will receive a smaller benefit than they might otherwise have received under the plan. This will result in a very small savings for the plan. The savings is likely too small to be noticeable in future valuations.

Taxation of benefits.

In proposing this legislation, it appears that PERA intended that no disability benefit paid after age 55 would be reported as non-taxable. In fact, that is what this bill accomplishes. Whether a benefit is taxable has a significant effect on the value of that benefit to the member. In some cases, the amount of a tax-free disability benefit can exceed the take-home pay that the member would have received if the member had continued working. The value of a tax-free disability benefit usually exceeds the value of a taxable retirement annuity. However, whether the disability benefit is taxable does not affect the cost borne by the PERA P&F plan to pay the benefit.

There may be some hidden cost to PERA P&F due to the tax-free nature of the disability benefit if it causes some people to apply for a disability benefit who otherwise would not. Commission staff is not aware of any evidence of that occurring.

[5] PERA Police & Fire Plan July 1, 2019, Actuarial Valuation, p. 13.

Should the plan provide 60 months of disability benefits for those near retirement age?

The PERA Local Government Correctional Service Retirement Plan (PERA Correctional) and the Minnesota State Retirement System (MSRS) Correctional State Employees Retirement Plan and the MSRS State Patrol Plan provide a duty disability benefit until the later of 60 months following the start of the benefit or age 55.

PERA has reported that until 2019, and despite law to the contrary, PERA was paying a disability benefit until the later of 60 months or age 55. Commission materials from 2007 indicate that the intent of the legislature was that duty disability benefits would be non-taxable until the later of 60 months or age 55.

It is notable that the PERA duty disability benefit provides workers' compensation to members injured at their jobs and is coordinated with workers' compensation. Worker's compensation also provides 60 months of total and permanent benefits for a person injured within 5 years of retirement age (72) or later.

Age discrimination.

Because the bill was introduced only recently, Commission staff has not had sufficient time to adequately research this issue. The federal Age Discrimination in Employment Act (ADEA) generally prohibits a reduction in employee benefits due to age. A number of exceptions apply to pension plans and there may be an exception that applies in this case.

Under the bill, a member with 15 years of service who is age 54½ and becomes duty disabled is entitled to 60% of the member's high-five salary *(see Attachment A)*. If that same member becomes disabled one month later, the member is entitled to 45% of the member's high-five salary. This may create the perception of discrimination due to the age of the member. Additional research on this topic may be appropriate.

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Attachment A

PERA P&F Disability Benefits
Comparison of Current vs. Proposed in HF 4298; SF 3547

Duty Disability

Current law: Duty disability = 60% of high 5 salary + 3% for each year of service over 20 years.

Proposed in the bill: Duty disability = 60% of high 5 salary + 3% for each year of service over 20 years; for members with less than 20 years of service and who are older than age 55 = 3% for each year of service.

If person becomes eligible for a duty disability at:	Then benefit = this % of high-five salary		And the benefit is non-taxable until age:		Duration of favorable tax treatment:	
	Current	Proposed	Current	Proposed	Current	Proposed
Age 25 with 1 day of service	60%	60%	55	55	30 years	30 years
Age 50 with 25 years of service	75%**	75%**	55	55	5 years	5 years
Age 54½ with 15 years of service	60%	60%	55	55	6 months	6 months
Age 54½ with 20 years of service	60%	60%	55	55	6 months	6 months
Age 55 with 15 years of service	60%	45%	60	Not eligible	5 years	0
Age 55* with 20 years of service	60%	60%	Not eligible	Not eligible	0	0
Age 60 with 19 years of service	60%	57%	65	Not eligible	5 years	0
Age 60* with 20 years of service	60%	60%	Not eligible	Not eligible	0	0

* *A person is not eligible for a duty disability benefit if 55 or older and with more 20 or more years of service, but is instead eligible for a retirement annuity in the same amount.*

** *The portion of a disability benefit that exceeds 60% of high-five salary is taxable as an annuity.*

Regular Disability

Current law: Regular disability = 45% of high 5 salary

Proposed in the bill: Regular disability = 45% of high 5 salary; for members with less than 15 years of service and who are older than age 55, benefit = 3% for each year with no reduction for vesting percentage.

If person becomes disabled at:	Then benefit = this % of high-five salary		And the benefit is non-taxable until age:	
	Current	Proposed	Current	Proposed
Age 25 with 1 year of service	45%	45%	Not eligible	Not eligible
Age 50 with 20 years of service	60%	60%	Not eligible	Not eligible
Age 54½ with 13 years of service	45%	45%	Not eligible	Not eligible
Age 54½ with 25 years of service	45%	45%	Not eligible	Not eligible
Age 55 with 13 years of service	45%	39%	Not eligible	Not eligible
Age 55*** with 15 years of service	33.8%	33.8%	Not eligible	Not eligible
Age 60 with 14 years of service	45%	42%	Not eligible	Not eligible
Age 60*** with 15 years of service	33.8%	33.8%	Not eligible	Not eligible

*** *A person is not eligible for a regular disability benefit if 55 or older and with 15 or more years of service, but is instead eligible for a retirement annuity reduced by the vesting percentage.*

Attachment B

Background Information on the Federal Income Tax Treatment of Disability Benefit Coverage

Section 61(a) of the federal Internal Revenue Code provides that, except as otherwise provided by law, gross income means all income from whatever source derived, including compensation for services.

Section 104(a)(1) of the federal Internal Revenue Code provides that gross income does not include amounts received under workers' compensation acts as compensation for personal injuries or sickness. Specifically, Section 104(a)(1) of the federal Internal Revenue Code provides the following:

> *Section 104. Compensation for injuries or sickness*
> *(a) In General*
> *Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include—*
> *(1) amounts received under workmen's compensation acts as compensation for personal injuries or sickness; ….*

Section 1.104-1(b) of the federal Income Tax Regulations states that section 104(a)(1) of the federal Internal Revenue Code excludes from gross income amounts received by an employee under a workers' compensation act or under a statute in the nature of a workers' compensation act that provides compensation to the employee for personal injury or sickness incurred in the course of employment. Section 104(a)(1) also applies to compensation which is paid under a workers' compensation act to the survivor or survivors of a deceased employee. Section 104(a)(1) does not apply to a retirement pension or annuity to the extent it is determined by reference to the employee's age or length of service, or the employee's prior contributions, even though the employee's retirement is occasioned by an occupational injury or sickness. Section 104(a)(1) also does not apply to amounts which are received as compensation for a non-occupational injury or sickness nor to amounts received as compensation for an occupational injury or sickness to the extent that they are in excess of the amount provided in the applicable workers' compensation act or acts.

Thus, if the public retirement plan has a duty- or occupational-based disability benefit and are in the nature of workers' compensation, the duty- or occupational-based disability benefits are excludable from the gross income of the recipients under section 104(a)(1) of the federal Internal Revenue Code to the extent that the benefit amount is not determined by reference to the disabilitant's age, length of service credit, or prior contributions.

The federal Internal Revenue Code, Section 104(a)(1), disability income exclusion replaced the pre-1977 "sick pay" provisions and is more restrictive than the pre-1977 law.