



**House  
Legislative  
Analysis  
Section**

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**ADOPT IRC PROVISIONS FOR  
PUBLIC RETIREMENT SYSTEMS**

**AS ENROLLED**

**House Bills 4869 and 4870 as introduced  
House Bill 4871 with House committee  
amendment**

**Sponsor: Rep Kim Rhead**

**Senate Bills 549, 551, and 552 as passed by  
the Senate**

**Sponsor: Sen. Glenn D. Steil**

**Senate Committee: Finance**

**House Committee: Appropriations**

**First Analysis (9-26-95)**

***THE APPARENT PROBLEM:***

Under the Internal Revenue Code (IRC), public and private retirement system investments and certain benefits are tax exempt as long as a specific system's "plan document" includes 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, while other provisions have been added requiring public retirement systems to be operated as a trust and that they abide by certain limitations in employer-financed benefits. In order to preserve the tax-exempt status of the state's public retirement systems, it has been suggested that various state retirement statutes be amended to conform with the requirements of the IRC.

***THE CONTENT OF THE BILLS:***

The bills would amend six public retirement acts to place in each act provisions that conform to the federal Internal Revenue Code (IRC) regarding direct trustee to trustee rollovers of eligible distributions of employee contributions; and would add to three of these acts provisions conforming to IRC requirements that a public retirement system be operated as a trust and abide by limitations in employer-financed benefits. (Currently, the IRC requires public and private retirement systems to include provisions in each retirement system's "plan document." The various public employee retirement the distributee in a direct rollover, for distributions

acts in Michigan constitute the plan documents for retirement systems administered by the state.)

House Bill 4869 would amend the Municipal Employees Retirement Act (MCL 38.1502a et al.); House Bill 4870 would amend the State Police Retirement Act (MCL 38.1603 et al.); House Bill 4871 would amend the Judges Retirement Act (MCL 38.2104 et al.); Senate Bill 549 would amend the Michigan Legislative Retirement System Act (MCL 38.1001 et al.); Senate Bill 551 would amend the State Employees' Retirement Act (MCL 38.1 et al.); and Senate Bill 552 would amend the Public School Employees Retirement Act (MCL 38.1304 and 38.1408).

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 would amend the various retirement acts to comply with IRC provisions as follows:

\* Notwithstanding any other provision (in the respective retirement acts) to the contrary that would limit a distributee's election, a distributee could 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 made on or after January 1, 1993.

House Bills 4869-4871 and Senate Bills 549, 551 and 552 (9-26-95)

\* "Direct rollover" would mean a payment by the retirement system to the eligible retirement plan specified by the distributee. "Distributee" would include 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" would mean 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 accepted the distributee's eligible rollover distribution. In the case of an eligible rollover distribution to a surviving spouse, however, eligible retirement plan would mean an individual retirement account or an individual retirement annuity.

\* An "eligible rollover distribution" would be a distribution of all or any portion of the balance to the credit of the distributee in a qualified trust. Eligible rollover distribution would 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 ten years or more; the portion of any distribution that was 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 was 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 could not be later than April 1 of the calendar year following the calendar year in which the employee attained age 70 and one-half, or April 1 of the

calendar year following the calendar year in which the employee retired.

House Bills 4869 and 4871 and Senate Bills 551 and 552 provide that, for purposes of determining actuarial equivalent retirement allowances, the actuarial assumed interest rate would have to be eight percent with utilization of the 1983 group annuity and mortality table. Senate Bill 549, however, specifies the interest rate would have to be seven percent with utilization of the 1971 group annuity and mortality table. (House Bill 4870 does not contain either of these provisions.) Under the various retirement acts, retirement allowances are equated on an actuarial basis for persons who retire before age 65.

Trust requirements. 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 Michigan Legislative Retirement System Act, the State Police Retirement Act, and the State Employees' Retirement Act do not have these provisions. House Bills 4869 and 4870 and Senate Bill 551, respectively, would amend those acts as described below.

Purpose. The bills provide that the section containing the following provisions would be 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.

Employer-financed benefits. Under Senate Bills 549 and 551, except as otherwise provided, employer-financed benefits provided by the retirement system could not exceed the lesser of \$90,000 or 100 percent of the member's average compensation for "high three years", as described in the IRC provisions on average compensation, for retirement at age 62 or older. These limitations would apply unless the application of other provisions in the bills produced a higher limitation (described below).

Under House Bill 4870, except as otherwise provided, employer-financed benefits provided by the retirement system could not exceed \$50,000 per year for a retirant who was a full-time employee of a police department or fire department and who had 15 or more years of credited service as a police officer, fire fighter, or public safety officer at retirement. These limitations would apply unless the application of other provisions in the bill produced a higher limitation, in which case the higher limitation would apply. If a member retired at age 62 or older, employer-financed benefits provided by the retirement system could not exceed the lesser of \$90,000 or 100 percent of the member's average compensation for "high three years" as described in the IRC.

Under all three bills, if a member retired before age 62, the amount of \$90,000 would be actuarially reduced to reflect payment before age 62. The retirement system would have to use an interest rate of 5 percent per year compounded annually to calculate the actuarial reduction. If the reduction produced a limitation of less than \$75,000 at age 55, the limitation at age 55 would have to be \$75,000, and the limitations for ages under 55 would have to be calculated from a limitation of \$75,000 at age 55.

Cost-of-living adjustments. 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 would have to be administered using the limitations applicable to each calendar year, as adjusted under IRC cost-of-living provisions. The retirement system annually would have to adjust the benefits subject to limitation to conform to the adjusted limits.

Assets. The retirement system's assets would have to be held in trust and invested solely for meeting the system's legitimate obligations, and could not be used for any other purpose. The assets could 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 would be 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 were discontinued, interest in the system of the members, deferred members, retirants, and retirement allowance beneficiaries would 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 IRC. Notwithstanding the bills' other provisions, the retirement system would have to be administered in compliance with IRC provisions on limitations on benefits and contributions under qualified plans that were applicable to governmental plans. If there were a conflict between the bills and another section of the acts or any other state act, the bills' provisions would prevail.

**FISCAL IMPLICATIONS:**

The House Fiscal Agency says enactment of House Bills 4870 and 4871 and Senate Bills 549, 551, and 552 would not affect state budget expenditures. However, the agency says if these bills were not enacted, the state-administered retirement systems would lose their tax-exempt status. This could subject annual employer contributions to a 35 percent federal tax, while investment income under the various systems would be subject to federal taxes, resulting in a cumulative cost to the state of up to \$1 billion annually.

In addition, the agency says enacting House Bill 4869 would not affect budget expenditures of local governments that participate in the Municipal Employees Retirement System, but failure to enact the bill would subject them to federal taxes. (9-20-95)

**ARGUMENTS:**

**For:**

The bills would ensure the state-administered public retirement systems would maintain their current 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. Recent 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, have not yet been incorporated into the various statutes that govern Michigan's public retirement systems. The bills would accomplish this and enable these systems to avoid imposition of stiff federal taxes, but would not affect the structure of the state's retirement systems or the benefits derived from them.

***POSITIONS:***

The Department of Management and Budget supports the bills. (9-22-95)

The Retirement Coordinating Council, which represents state and school employee retirees, supports the bills. (9-22-95)