GROOM LAW GROUP

March 2, 2012

Retirement Plans of
State and Local Governments

I. **Key Structural Differences**

A. "Plan Document" may be in state or local law

B. Lots of public information (usually)

C. Internal administration

II. **Key Legal Differences**

A. ERISA benefit standards not applicable – state or local specific

1. Example: State constitution or local law may provide anti-cutback protection instead of ERISA

2. Example: No spousal consent/"QDRO" rules, but some follow ERISA anyway or have comparable alternatives

B. ERISA funding rules not applicable – part of budget process

C. ERISA claims procedures not applicable – usually internal

D. ERISA preemption not applicable – state laws fully applicable unless retirement plan provisions say otherwise

E. ERISA fiduciary rules not applicable – but some apply ERISA either by incorporation or repetition

F. Most IRS Code rules not applicable – see attached IRS summary of applicable requirements

Comment: Be sure it is a "governmental plan" under ERISA/Code

G. No PBGC termination insurance

III. <u>Some Benefits Concepts Unique to Governmental Plans</u>

A. "Tiers"

B. Employee contributions ("414(h) pick-ups")

C. Purchase of service credit

D. Leave conversion

E. "DROPs"

F. FICA alternative plan (IRC § 3121(7)(F))

G. "Spiking" (and other compensation items)

H. Portability/transfers

I. 403(b) (public school/university) and 457(b) (most government entities)

IV. <u>Current Trends/Issues</u>

A. Movement to DC plans – mandated or optional/choice

B. Scaling back key provisions – later early and normal retirement ages, less compensation recognized, lower accrual rates, lower (or no) COLAs

C. Increased mandatory employee contributions

D. Deferred funding – shift to localities or even members themselves

Attachment

"Top 10" Code Section 401(a) Rules –

Governmental Plans

The principal IRS requirements for a tax-qualified governmental plan are that it –

- Be established and maintained by the employer for the exclusive benefit of the employer's employees or their beneficiaries,
- Provide definitely determinable benefits,
- Satisfy the direct rollover rules of sections 401(a)(31) and 402(f),
- Satisfy the limitation on compensation ($250,000 for 2012),
- Comply with the statutory minimum required distribution rules under section 401(a)(9),
- Satisfy the pre-ERISA vesting requirements under section 411(e)(2),
- Satisfy the section 415 limitations on benefits, as applicable to governmental plans ($200,000/$150,000 for 2012), and
- Satisfy the prohibited transaction rules in section 503.
- Be operated pursuant to its terms,
- Be timely amended to include legislative and regulatory changes

Daily Tax Report®

New IRS Regulation Project Tackles Definition of 'Governmental Plan'

BY KIMBERLY DAHM, DAVID LEVINE, AND DAVID POWELL

The Internal Revenue Service in November officially kicked off its initiative to fill a long-standing gap in the vast regulatory scheme that the Employee Retirement Income Security Act has produced—the definition of "governmental plan."[1]

Governmental pension plans are exempt from the reporting, participation, vesting, and fiduciary standards of ERISA, and similarly governmental welfare plans are generally exempt from the ERISA rules that privately sponsored welfare plans must satisfy. Thus, a plan's status as "governmental" is critically important to defining the obligations of the plan sponsor, and the rights of participants and beneficiaries.

[1] Section 414(d) of the Internal Revenue Code of 1986, as amended, provides "the term 'governmental plan' means a plan established and maintained for its employees by the Government of the United States, by the government of any State or political subdivision thereof, or by any agency or instrumentality of any of the foregoing." Sections 3(32) and 4021(b) of ERISA contain substantially identical definitions.

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In broad terms, the ERISA exemption for such plans primarily reflects congressional policy that the federal government should not dictate the rules for the benefit programs of state and local governments.

The recent advance notice of proposed rulemaking (REG-157714-06[1]) has been in the works for at least five years. Although the statutory provisions have existed without regulations for 37 years, concern about the growing number of requests from plan sponsors whose relationships to states or political subdivisions are increasingly remote—and plan sponsors who raise novel issues in arguing that their plans are governmental plans—led to this push for more definitive regulatory criteria.

Although the statutory provisions have existed without regulations for 37 years, the growing number of requests from plan sponsors whose relationships to states or political subdivisions are increasingly remote has raised concerns.

By issuing an advance notice, IRS is demonstrating that it has heard the concerns expressed by the governmental plan community that any new guidance provide ample lead time for comments and transition before it is finalized. As a result, governmental entities have time to review, evaluate, and comment on the proposed guidance—and the governmental plans community will have another bite at the apple when the Section 414(d) governmental plan regulations are formally proposed.

Though the advance notice was issued by IRS, the preamble states that the Department of Labor and Pension Benefit Guaranty Corporation were consulted, and comments on the advance notice will be shared with the other agencies. We understand that the close coordination by the agencies was one of the reasons that this advance notice has taken several years to be issued.

Below, we discuss several key features of the advance notice.

[1] 76 *Fed. Reg.* 69172 (Nov. 8, 2011).

Attempt to Harmonize New Guidance With Existing Authority

IRS's approach in the advance notice is generally based upon existing case law and assorted agency guidance in the area, which the notice discusses, as opposed to creating a new line of analysis. In that vein, the proposed regulations contemplate a facts and circumstances analysis that would draw from factors historically used in governmental plan determinations.

We would assume that this reliance on historical precedent implies that IRS does not intend to force governmental plans maintained by "core" governmental entities, such as states, counties, cities, and towns, to conduct a complex re-evaluation of their governmental plan status.

Definition of 'Agency or Instrumentality'

The most difficult part of the definition of governmental plan is probably what constitutes an "agency or instrumentality" of a state or political subdivision of a state. For example, this issue has commonly been a challenge when a plan is designed to cover employers one or more steps removed from a state, county, city, or town, such as a water district or sanitation authority.

The most difficult part of the definition of governmental plan is probably what constitutes an "agency or instrumentality" of a state or political subdivision of a state.

Here, the proposed regulation would set out a number of major and minor factors, as briefly described below, for a facts and circumstances determination, accompanied by examples. Notably, IRS has expressly asked for comments on whether these factors should be modified, combined, or expanded.

The factors currently proposed as "major" factors are as follows:

- **Control of Governing Board or Body.** The entity's governing board or body is controlled by a state or political subdivision of a state.

- **Membership of Governing Board or Body.** The members of the governing board or body are publicly nominated and elected.

- **State or Political Subdivision Responsibility for Debts and Liabilities.** A state (or political subdivision of the state) has fiscal responsibility for the general debts and other liabilities of the entity (including funding responsibility for the employee benefits under the entity's plans).

- **Treatment of Employees.** The entity's employees are treated in the same manner as employees of the state (or a political subdivision of the state) for purposes other than providing employee benefits (e.g., the entity's employees are granted civil service protection).

- **Delegation of Sovereign Powers.** In the case of an entity that is not a political subdivision, the entity is delegated, pursuant to a statute of a state or political subdivision, the authority to exercise sovereign powers of the state or political subdivision (e.g., the power of taxation, the power of eminent domain, and the police power).

The factors currently proposed as "minor" factors are as follows:

- **Control of Operations.** The entity's operations are controlled by a state (or political subdivision of the state).

- **Source of Funding.** The entity is directly funded through tax revenues or other public sources, but not including services provided by contracts or grants.

- **Enabling Legislation.** The entity is created by a state government or political subdivision of a state pursuant to a specific enabling statute that prescribes the purposes, powers, and manners in which the entity is to be established and operated. Notably, the advance notice does not consider a nonprofit corporation that incorporated under a state's corporate laws as satisfying this factor.

- **Federal Income Taxation of the Entity.** The entity is treated as a governmental entity for federal employment tax or income tax purposes (e.g., the entity has authority to issue tax-exempt bonds under Section 103(a)) or under other federal laws.

- **Applicability of State Laws for State Governmental Entities.** The entity is determined to be an agency or instrumentality of a state (or political subdivision thereof) for purposes of state laws (e.g., the entity is subject to open meetings laws or the requirement to maintain public records that apply only to governmental entities, or the state attorney general represents the entity in court under a state statute that only permits representation of state entities).

- **Judicial Determination of Agency or Instrumentality Status.** The entity is determined to be an agency or instrumentality of a state (or political subdivision of the state) by a state or federal court.

- **Ownership Interest.** A state (or political subdivision of the state) has the ownership interest in the entity and no private interests are involved.

- **Governmental Purpose.** The entity serves a governmental purpose.

Although satisfaction of a particular factor would not be conclusive, the preamble to the advance notice particularly seems to emphasize the element of control of the governing body of the entity by the state or political subdivision, such as control of a majority of the board of directors. Interestingly, the preamble indicates that where there are a number of tiers of intervening corporations between the entity and the state, and in cases in which control is shared among so many governing entities that none can be said to be responsible, there may be a lack of control by the state or political subdivision. Any ownership interest by a private entity would also indicate that the entity is not an agency or instrumentality of a state or political subdivision.

The preamble also discusses and requests comments on a potential safe harbor standard where, if certain

ISSN 0092-6884

factors are met, an entity would be treated as an agency or instrumentality of a state or political subdivision. Multiple safe harbors would help to reduce the burdensome and costly process of evaluating each entity's facts and circumstances—and for requesting DOL advisory opinions and IRS private letter rulings (which may not even be available until after final regulations are issued).

De Minimis Participation By Nongovernmental Employees

For classification as a governmental plan, the proposed regulations generally would not permit participation by any nongovernmental employees (i.e., they do not propose to adopt the "de minimis" rule in certain Department of Labor advisory opinions), except for employee labor union employees described in Section 413(b)(8) (e.g., a teacher who has shifted from active teaching to working for the teachers' union) and plan employees (i.e., system staff).

While the positive guidance with respect to these two groups is very helpful, other arrangements—such as employees who were "privatized" pursuant to contractual arrangements providing for continued participation in a governmental plan—might be suggested to IRS in comments. Specifically, the preamble to the advance notice asks for comments on cases where a small number of private employees participate in what would otherwise be a governmental plan. Some considerations suggested in the preamble include:

- **Privatized Employees.** Whether the private employees were previously employees of the sponsoring governmental entity (e.g., a mental health or hospital system where a private employer has taken over a former governmental institution) and whether the private employees were previously participants in the governmental plan.

- **Limitation on Number.** Whether the number or percentage of such former employees who participate in the governmental plan is de minimis (and, if so, what constitutes a de minimis number or percentage). This item has been the subject of conflicting authority from IRS, DOL, and PBGC.

- **Existing Plan Rules.** Whether the coverage is pursuant to pre-existing plan provisions. Some existing privatization agreements require the continuation of coverage and some plans already provide such coverage.

- **Function of the Private Employer.** Whether the private employer performs a governmental function and has been officially designated as a state entity for plan participation purposes.

- **Types of Plans That Can Be Sponsored by Private Employer.** Whether the employer is ineligible to sponsor the particular type of governmental plan (e.g., whether a private employer is a tax-exempt organization under Section 501(c)(3) that can sponsor a Section 403(b) plan), and whether the private employer sponsors or has sponsored plans that cannot be sponsored by a state governmental entity (e.g., a cash or deferred arrangement under Section 401(k) or an unfunded Section 457(b) plan of a tax-exempt entity).

If a de minimis rule is adopted, the preamble notes that related issues could arise. For example, issues with respect to funding (i.e., applicability of the ERISA funding rules to part of a plan), multiple employer governmental plans (i.e., compliance with the multiple employer plan rules and the extent to which "unaffiliated" entities can participate in the governmental plan), and Section 414(h) governmental pickup plans.

Even if the final regulations do adopt a de minimis rule, it seems likely that a transition period will be provided for those plans unable to utilize any de minimis rule provided. The advance notice specifically requests comments on transitional relief that should be provided.

'Established and Maintained'

The proposed regulations would also address the critical issue of what it means for a plan to be "established and maintained" by a governmental entity, and what happens when a public entity becomes a private entity and vice versa.

The positions proposed in the advance notice are that a privatized employer's plan becomes a private plan at the time of the change and, where a private employer becomes a public employer, the plan becomes a public plan at that time. This approach would generally seem to follow what has been widely perceived to be the current rule, which is that a plan is either governmental or private depending on the facts at a given time, and can conceivably switch back and forth as facts change.

The proposed approach would generally seem to follow what has been widely perceived to be the current rule, which is that a plan is either governmental or private depending on the facts at a given time, and can conceivably switch back and forth as facts change.

Unfortunately, the preamble indicates that a public plan that becomes a private one may have immediate compliance concerns, and also contemplates that, after a privatization, sponsorship of a public plan may remain behind with another governmental employer under a "soft freeze" (i.e., currently covered employees can continue to receive service for vesting and eligibility for early retirement subsidies, and receive final pay adjustments, but apparently cannot earn further benefits attributable to future service with the private entity under the benefit formula) and remain a governmental plan, which is similar to a rule under the Section 457 regulations.

Recognizing the complexities raised by these proposed rules, the advance notice requests comments specifically addressing the following:

- **Transition Relief.** What type of transition relief should be provided to governmental plans that cover privatized employees and that cover employees of a vendor to a governmental entity.

■ **Corrective Relief.** What relief should be made available when an entity, although it believed it was a governmental entity maintaining a governmental plan, is later determined to be a private entity.

'Integral Part'

The proposed regulations would not address what it means to be an "integral part" of a state or political subdivision. The preamble indicates this will be the subject of a separate guidance project that may include stricter criteria than this proposed regulation. Because the concept of "integral part"—which generally has its source under the Section 115 rules—plays a significant role in many governmental plan investment and health care plan designs, significant attention should be given to any potential developments in this area.

Federal Credit Union

The proposed regulations would address whether a federal credit union can have a tax-exempt employer Section 457(b) plan. The proposed answer is "yes," and that federal credit unions will be nongovernmental tax-exempt organizations within the meaning of Section 457(e)(1)(B).

Other Plan Types and Legal Requirements

Although the proposed regulations would be applicable only for purposes of Section 414(d) (i.e., Section 401(a) defined benefit and defined contribution plans), the advance notice indicates it is expected that the principles set forth will apply for parallel terms in Section 403(b) and 457 plans.

In addition, the advance notice specifically recognizes that any guidance under Section 414(d) will affect a number of other tax code requirements (e.g., the Section 503 prohibited transaction rules, the Section 4975 prohibited transaction rules, Section 4980B Consolidated Omnibus Budget Reconciliation Act requirements, and the exclusion of certain "governmental plans" from certain health care requirements under the Patient Protection and Affordable Care Act of 2010 (Pub. L. No. 111-148)), though it does not expressly mention whether it will apply for purposes of Section 218 agreements with the Social Security Administration for Federal Insurance Contributions Act replacement plans.

Indian Tribal Governments

Concurrent with the issuance of the advance notice, a separate advance notice (REG-133223-08) addressing potential proposed regulations on the distinction between Indian tribal plans that are treated as governmental plans and those that are treated as nongovernmental plans due to the commercial activities underlying and performed by the plans' covered employees.

This guidance would follow-up on the interim "reasonable and good faith standard" set forth in Notices 2006-89 and 2007-67. As with the broader-focused advance notice, public hearings will be held on this potential tribal plan Section 414(d) guidance and listening meetings will be held to obtain input from tribal governments.

Comments, Next Steps, and Effective Date

Comments are due to IRS by Feb. 6, 2012. The preamble indicates that IRS will also hold a number of hearings and "town meetings" to be scheduled in the future. These multiple avenues will expand the ability of governmental entities and their advisers to learn more about, and comment on, the proposals.

It is also expected that the effective date of any final regulations would provide sufficient time for any plan amendments to be made through the legislative process.

At this time, governmental entities and plans should review and potentially comment on the advance notice so that any concerns they have may be addressed early in the process.

   ISSN 0092-6884

Bloomberg BNA Pension & Benefits Daily™

Source: Pension & Benefits Daily: News Archive > 2011 > August > 08/10/2011 > BNA Insights > State Pension Plans Step Up Efforts to Adapt to 21st Century Financial Pressures

State Pension Plans Step Up Efforts to Adapt to 21st Century Financial Pressures

By Robert L. Clark and Lee A. Craig

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In recent years, the financial status of public pension plans has been front page news. Policymakers are very concerned about the high cost of current pensions and the large unfunded liabilities associated with future pension promises. Taxpayers and the public at large have focused on the generosity of these plans relative to those in the private sector and the growing tax burden required by public retirement plans. These fiscal concerns have arisen at the same time as public revenues have declined with the lingering economic slowdown. [1]

[1] Material in this article is based on the information in Robert Clark, Lee Craig, and John Sabelhaus, *State and Local Retirement Plans in the United States*, Northampton, Mass.: Edward Elgar, 2011, along with updates from the websites of the various state retirement plans. Readers who are interested in the earliest development of public pension plans in the United States should consult Robert Clark, Lee Craig, and Jack Wilson, *History of Public Sector Pensions in the United States*, Philadelphia: University of Pennsylvania Press, 2003.

Public pension plans are not static entities; they evolved slowly during the 20th century, until, by the end of the century, defined benefit plans were offered to virtually all full-time state and local employees. In many areas, the generosity of the plans allowed career public employees to retire in their early 50s with income replacement rates in excess of 50 percent of their final salaries. For the majority of public employees who are also covered by Social Security, this meant that when retiring they would receive roughly the same level of net income as they did when working. In contrast, pensions in the private sector provide much lower replacement rates and have considerably higher retirement ages.

However, public pension plans are changing in response to the fiscal pressure on governments caused by the economic downturn and the overall cost of these plans. Reform of public pensions is moving steadily but relatively slowly. One constraint is legal prohibitions on reducing benefits for current workers and retirees. Many of the pension reforms can only be applied to new employees; thus the impact of cost-reducing amendments must play out over 30 to 40 years. To understand the current status of public retirement plans and to examine the continued evolution of public pensions, one must know how the current pension structure was developed and how the current financial problems arose. In this article, we provide a brief history of the development of state and local retirement plans up to 2000 and then describe ongoing efforts to reform public pension plans.

Development of Public Pension Plans

Shortly after the onset of the American Revolution, the Continental Congress created pension plans for its army and navy personnel. Initially, the plans were created to provide disability payments and survivors' benefits to widows and orphans, but after the Revolution, they evolved into retirement plans. By the middle of the 19th century, several large municipalities, mainly in the north, began offering plans for their police officers, firefighters, and school teachers.

Although the states and federal government did not provide pension *plans* for their workers (with the exception of military personnel) until early in the 20th century, special legislation enacted by the state legislatures or, in case of federal employees, the U.S. Congress, provided retirement benefits on a case-by-case basis. State governments began creating plans for their employees in the early decades of the 20th century, and Congress created a federal plan for nonmilitary personnel in 1920.

By the middle of the 20th century, the plans offered by the federal government and the majority of the states, as well as the country's largest cities, were traditional defined benefit pension plans. Until the mid-1970s, the development of public pension plans paralleled the dominance of defined benefit plans in the private sector of the economy.

Turning Point

Beginning in the 1970s, employers in the private sector started terminating their defined benefit plans and converting them to defined contribution plans, especially tax code Section 401(k) plans, and new plans were disproportionately defined contribution plans. This process continued during the next 40 years. As a result, the proportion of private-sector workers in defined benefit plans declined, while the percent in defined contribution plans increased substantially.

The Department of Labor reported that in 1992-93, 32 percent of private industry workers were participating in defined benefit plans compared with 35 percent enrolled in defined contribution plans. However, by 2005, participation in defined contribution plans had increased to 42 percent, and participation in defined benefit plans had decreased to 21 percent of all workers.

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In contrast, defined benefit plans still remain the norm among state and local workers, as only a few states have terminated their defined benefit plans and adopted a defined contribution plan as the sole or primary retirement plan for their public employees. The dominance of defined benefit plans in the public sector is generally attributed to differences between the labor markets for public- and private-sector workers.

Public employees tend to be older, have lower turnover rates, and are more unionized than comparable private-sector workers, all factors that tend to be associated with defined benefit plans. In addition, public-sector plans are not subject to federal regulation, such as the Employee Retirement Income Security Act, and thus do not bear the same administrative costs as private-sector plans.

Despite the continued dominance of defined benefit plans in the public sector, during the past decade, state-run pension plans have begun shifting, usually on a piecemeal basis, to defined contribution plans, and many other states are making fundamental changes in their defined benefit retirement plans. In large measure, these changes are in response to the rising cost of relatively generous retirement benefits and concern over unfunded liabilities.

Are public pensions now facing a period of fundamental change that will conclude only after major reductions in benefits have been adopted and/or there has been a shift by many public employers away from traditional defined benefit plans?

21st Century Changes

Broadly speaking, the states that have terminated their traditional defined benefit plans or made major modifications to their plans in recent years can be divided into three categories: (1) those that do not offer defined benefit plans to new employees; (2) those that offer their workers a choice between a defined benefit and defined contribution plan; and (3) those that have developed combination plans.

States that do not offer a traditional defined benefit plan. As of 2011, all but four states offered some type of traditional defined benefit plan to their employees. Those states are Alaska, Michigan, Nebraska, and Utah. In Alaska and Michigan, new state employees are enrolled in a defined contribution plan. In Nebraska, state workers are covered by a cash balance plan; while in Utah, new state employees are offered a choice of either a defined contribution plan or a combination plan that includes a defined benefit and a defined contribution component.

States that have retained a defined benefit plan but offer optional defined contribution plans. Six states now allow some or all of their new employees the option of enrolling in a defined contribution plan instead of being required to participate in the state defined benefit plan. Colorado, Florida, Montana, North Dakota, Ohio, and South Carolina provide new employees the opportunity to select a defined contribution plan instead of the defined benefit plan.

Typically, the defined benefit plan remains the default if the worker fails to choose between the plans. The percentage of newly hired public employees selecting the defined contribution plan ranged from a low of 3 percent in Ohio to a high of 26 percent in Florida. About one-fifth of new employees in Colorado and South Carolina select the defined contribution plan compared with about one-tenth of those in Montana, North Dakota, and Ohio.

States that offer combination plans. Six states have decided that the optimal retirement plan for their employees includes a base defined benefit plan combined with a mandatory defined contribution plan. The defined contribution component is often funded entirely with employee contributions, while the defined benefit part typically relies on employer contributions. States offering such plans include Florida, Georgia, Indiana, Ohio, Oregon, and Washington. With the exception of Indiana, which has long offered a mixed plan, the other states have converted their plans since the late 1990s.

Modifying States' Defined Benefit Plans

During the past five years, state governments have faced severe funding crises, growing liabilities associated with their retirement plans, and declining pension funding ratios. In response, state legislatures have passed legislation aimed at reducing the current and future costs of their pension plans. In addition, a number of states have appointed special commissions to review and evaluate their retirement systems and to make recommendations for modifying their plans in the future.

While many states have considered shifting to defined contribution plans, relatively few have actually converted their retirement plans. Instead, policymakers have attempted to achieve savings by modifying their plans to reduce future costs. In addition, some states have attempted to shift costs to employees by increasing employee contribution rates. The evolution of public retirement plans is not finished and the pace of reform seems to be quickening.

A report by the National Conference of State Legislatures indicates that in 2010 alone 21 states enacted significant retirement system changes and in 2011 the number of states with substantial plan changes increased to 25. [2] The following brief overview of reforms is based on the information presented in the NCSL (2011) report and our own review of plan websites. The reform movement is widespread, covering most of the states, and broad-based, as amendments cover most of the fundamental aspects of public pensions.

[2] The summary data for pension reforms in 2010 and 2011 are from Ronald Snell, "Pensions and Retirement Plan Enactments in 2011 State Legislatures," National Conference of State Legislatures, June 30, 2011, http://www.ncsl.org/?tabid=22763 accessed July 8, 2011.

Increasing years in final average salary. To reduce future retirement benefits, a number of states have made adjustments to their benefit formulas and altered eligibility requirements. Changes include increasing the number of years in the salary averaging period. For example, Louisiana (change made in 2005), Kansas (2007), North Dakota teachers plan (2007), and Rhode Island (2009) increased the number of years used to calculate final average salary, typically increasing the figure to five years. Eight states increased the length of the averaging period in 2010, and another five states followed suit in 2011.

"After a century of expansion in coverage, lower retirement ages, and higher benefit multipliers, the trend of increasingly generous public-sector pension plans appears to have ended in the first decade of the 21st century."

Reducing the benefit formula. Rhode Island also lowered the multiplier for some employees and reduced the maximum replacement ratio from 80 percent to 70 percent. Nevada (2009) lowered the generosity parameter from 2.67 percent per year of service to 2.5 percent.

Raising the retirement age. In 2009, New York increased the minimum age for full or normal retirement from 55 to 62. States increasing the criteria for normal retirement include Colorado, which, in 2006, switched from using the Rule of 80 to the Rule of 85; these are formulas that add age and years of service to determine eligibility for full retirement benefits. North Dakota, in 2007, changed from the Rule of 85 to the Rule of 90 for teachers; and Louisiana, in 2005, increased the normal retirement age from 55 to 60, for teachers. Rhode Island, New Jersey, Kentucky, Nevada, and Texas made similar changes, requiring employees to have more years of service and/or to retire at an older age. In 2010, Illinois raised the normal retirement age for newly hired teachers to 67. Overall, in 2011 alone, 14 states increased age and service requirements for retirement.

Adopting anti-spiking rules. Given the relatively short salary-averaging period in most state plans, a sharp increase in salary near retirement can have a major effect on lifetime benefits and thus the cost of providing retirement benefits to certain workers. In an effort to limit this effect, Colorado, Iowa, Louisiana, Kansas, Nevada, and Georgia adopted anti-spiking rules that capped the increase in salary that could be used in calculating final average salary.

Modifying COLAs. During the past several decades, as matter of course, states have routinely granted retirees cost-of-living adjustments (COLAs) to their pensions. Recently, a number of states have adopted policies limiting or eliminating cost-of-living increases to retirees, eight in 2010 and nine in 2011. A legal question has been whether changes in post-retirement benefit increases represent a reduction in benefits and thus should be precluded by state laws. After reducing these increases, Colorado and Minnesota were sued over this change, with the pensioners arguing that such changes violated the employment contract. In these cases, the states won the suits and were allowed to reduce the COLAs.

Increasing years to vesting. In addition, some states have reduced their future pension liabilities by changing the vesting rules in the plans they offer. For example, Mississippi (in 2007) increased the vesting period from four to five years; North Dakota teachers (2007) raised the vesting standard from three to five years; and New York (2009) imposed a vesting requirement of 10 years, up from a previous five-year requirement. Vesting requirements were raised in five states in 2010 and in seven states in 2011.

Increasing employee contributions. To further offset the increase in the cost of retirement benefits to public employers, some states have increased required employee contributions: 11 states in 2010 and 15 states in 2011.

After a century of expansion in coverage, lower retirement ages, and higher benefit multipliers, the trend of increasingly generous public-sector pension plans appears to have ended in the first decade of the 21st century. In just the past few years, roughly half the states have either converted to defined contribution plans, in part or in whole; have made their pension plans less generous; or are reviewing the possibility of changing their plans.

We now turn to a consideration of the implications of these changes and of national economic events and retirement policies for the future of public-sector pensions.

State Retirement Plans in the 21st Century

Public-sector pension plans are facing considerable economic, financial, and political pressures to reduce the increase in the cost of providing retirement benefits and to improve their funding ratios. After almost a century of expansion in coverage, increases in retirement benefits, and reductions in retirement ages, public-sector pension plans are now confronted with the need to reform and reduce the retirement promises that are made to public employees.

The future development of public pension plans will depend on several key factors. We assess the momentum for pension reform in the public sector and speculate on whether public-sector pension plans will now follow pension trends that have been transforming pensions in the private sector for three decades.

Since the passage of ERISA in 1974, private employers have tended to shift away from defined benefit plans, and there has been increasing utilization of defined contribution plans. Only in the past decade have public-sector employers begun to move in the direction of adopting defined contribution plans. Are these fundamentals changing or are public employers beginning to feel the results of the aging of the population, rising pension costs, and the impact of the financial risk that was imbedded in their retirement plans?

Recent events raise the question of whether public pension plans are at a significant tipping point or whether we are simply observing necessary restructuring to maintain the basic pension structure that is now in place. The weight of the evidence points to a watershed event in which public pension plans will be fundamentally changed in response to the recent financial crisis, population aging, major changes in the labor market, Social Security amendments, and the continuing fiscal pressure on state and local governments.

The movement toward defined contribution plans and combination plans seems strong. In particular, less generous defined benefit plans combined with mandatory defined contribution plans may entice more governments to adopt these types of combination plans. The traditional defined benefit plans that remain will likely be less generous and have older normal retirement ages. As governments consider changes in their retirement plans, they must balance the need for fiscal restraint with the ability to attract and retain quality workers.

Reconsideration of Retirement Benefits

In summary, financial pressures have pushed states to reconsider the generosity and structure of their retirement plans. [3] It appears that increasingly states are willing to consider adopting defined contribution plans, offering workers choices between a defined benefit and defined contribution plan, or developing some type of hybrid plan.

[3] Pension plans are only one component of retirement benefits provided to most public employees. Another major benefit is retiree health insurance. Virtually all full-time public employees are covered by a health plan that extends into retirement. The annual cost and unfunded liability of these plans is also a major fiscal problem for many state and local governments. For a comprehensive overview of public-sector retiree health plans, see Robert Clark and Melinda Morrill, *Retiree Health Plans in the Public Sector: Is There a Funding Crisis?* Northampton, Mass.: Edward Elgar Publishing, 2010.

Those states that are committed to retaining only the traditional defined benefit plan are also making substantial changes in an effort to reduce costs. Many states are increasing the normal retirement ages, increasing years in the final average salary used to calculate benefits, and adopting anti-spiking rules, along with other plan modifications aimed at reducing the employer cost of providing these plans. Workers entering public employment during the next decade will have much different retirement plans compared with workers who were hired in the final decades of the 20th century.

ISSN 1523-5718

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Spousal Inequities in Public Plans

Federal plans

1. CIARDS- Central Intelligence Agency Retirement and Disability System.
    a. Former spouses of employees who began working for the CIA prior to 1984 lose the right to receive an annuity awarded in divorce if s/he remarries before the age of 55. 50 USC §2032
2. CSRS- Federal Civil Service Retirement System-
    a. no spousal protections on the TSP account- no consent requirement on the cash out, and participant can disinherit spouse by naming a non-spouse beneficiary;
    b. no pre-retirement survivor annuity for deferred vested participants;
    c. benefits awarded at divorce will only be paid when the participant actually retires rather than when s/he becomes eligible to retire.
    d. Retirement Spouse Equity Act of 1984 created a "Special Survivor Annuity" but former spouses who had divorced before 9/14/1978 were not entitled to the annuity if the worker remarried so that another spouse was collecting the survivor benefit.
    e. Lots of problems involving the timing of the Court Order Acceptable for Processing (COAP) when it is submitted to OPM. No posthumous orders allowed.
3. Military
    a. Only "disposable pay" is divisible at divorce. Disposable pay is the pension minus several things such as disability pay.
    b. The Uniformed Services Former Spouses' Protection Act of 1981 (USFSPA) requires that a court have special jurisdiction in order to divide a military pension. This special jurisdiction requirement can make it very difficult to find a court with jurisdiction.
4. FERS- Federal Employee retirement System
    a. benefits awarded at divorce will only be paid when the participant actually retires rather than when s/he becomes eligible to retire.
    b. Participant can designate a non-spouse as the beneficiary of the TSP account upon his/ her death thereby disinheriting spouse.
    c. Lots of problems involving the timing of the COAP when it is submitted to OPM. No posthumous orders allowed.
5. Railroad Retirement
    a. Surviving former spouses who remarry before reaching age 60 lose the right to their survivor benefit and they lose regular divorced spouse benefits if they remarry at any age.
    b. Railroad retirement requires that workers have a "current connection" in order for the surviving spouse to receive a benefit.

6. Non-Appropriated Fund Employee plans- These are quasi-federal plans that are exempt from Title 5- mostly covering workers on military bases. The one I worked with was Navy Exchange Service Command Retirement Plan.
    a. Benefits are not divisible at divorce.

State plans

1. Illinois state pension plan-
    a. does not accept QDROs or any other means of dividing benefits at divorce
2. Hawaii state pension plan-
    a. does not accept QDROs or any other means of dividing benefits at divorce
3. Fire and Police Pension Association of Colorado
    a. Former spouses can't receive benefits until worker actually retires.
    b. No survivor annuity for former spouses.
4. Alabama state retirement system
    a. Default form of benefit is single life annuity even for married participants.
5. New Jersey Police and Firefighter plan
    a. No survivor benefits for former spouses
6. District of Columbia Public Teachers Retirement Plan
    a. No spousal consent requirement for participant to elect single life annuity
    b. Plan requires spouses to be married for 2 years (ERISA requires only 1) prior to death of participant before surviving spouse is eligible to receive survivor benefits.
    c. Remarriage penalty prevents remarried surviving spouses from receiving survivor benefits.

Local plans

1. Cook County Illinois 457 plan-
    a. does not accept QDROs or any other means of dividing benefits at divorce
2. Oakland California Police and Fire Retirement System-
    a. Spouses who remarried before Jan. 1, 1985, do not receive survivor benefits.
3. LACERA- Los Angeles County Employee Retirement
    a. Former spouses can receive survivor annuities, but if the participant remarried, the benefit to the former spouse stops upon the death of the surviving spouse.