

Current Status of the PERA Eligible Salary Issue
August 4, 2009

BACKGROUND

The City Auditor, as part of his regular responsibilities, discovered in July 2007 that “certain employer-paid benefits”, primarily the City provided deferred compensation /family health care premium subsidies, had been incorrectly treated as PERA eligible salary since approximately 1995. These amounts are excluded from PERA eligible wages under Minnesota Statutes, §353.01, subd. 10(b)(2). This practice of reporting the additional amount as eligible salary to PERA was corrected in July 2007. The mistake was reported to PERA in a letter dated September 15, 2008 and was reported to employees and benefit recipients in October 2008.

PERA and City staff undertook a process to gather the data necessary for PERA to calculate refunds of employee deductions and employer contributions, and for PERA to determine any benefit overpayments. The City Auditor was able to compile accurate payroll earnings records electronically as far back as January 1, 1997. PERA eligible salaries related to this deferred benefit for 1995 and 1996 are de minimus due to low dollar values per month for this benefit during this period. The total erroneous withheld employee deductions are \$1.137 million, total employer erroneous contributions are \$1.414 million and total net overpayments of excess PERA benefits are \$1.268 million. These numbers are subject to change to the extent we identify any additional adjustments or issues in payroll reporting for those periods.

Minnesota law prior to the end of May 23, 2009 required refunding overpaid employee deductions and employer contributions on any amounts reported that is not considered valid salary. It also requires adjustment of benefits of anyone receiving a retirement, survivor, or disability benefit that was determined using salary that should not have been included.

STATUTE OF LIMITATIONS

Prior to the 2009 Omnibus Pension Bill, there was no statute of limitations for correcting errors attributable to incorrect eligible wage determinations. Overpayments of employee deductions and employer contributions as well as adjustment of retiree benefits, including retirees, survivors and those former employees receiving PERA disability benefits would have to be made for all such payments back to 1995, the first year the City provided deferred compensation benefits were paid.

The 2009 Omnibus Pension Bill provides a new, general statute of limitation for correcting errors attributable to the definition of eligible salary. S.F. 191, Article 4, §11, subds. 7(c) and (g) limits the period of adjustment to the fiscal year of PERA in which the error was discovered, plus the two immediately preceding fiscal years. This provision applies to errors reported on or after May 23, 2009, the enactment date of the legislation.

S.F. 191, Article 4, §49, subd. 1 provides special procedures for the City of Duluth to correct employee deductions and employer contributions attributable to errors in

determining eligible salary reported between January 1, 1997 and October 23, 2008 and to adjust related retiree benefits. The new general statute of limitations does not apply to the City of Duluth's eligible salary errors because these errors were already reported and "in process" prior to enactment of the new legislation.

Another new provision, S.F. 191, Article 4, §50, provides for the election of the new three year statute of limitation if adjustments are "in process" as of the date of enactment. Our error was discovered by PERA as of September 15, 2008, or PERA's June 30, 2009 fiscal year. Thus, if the City elects to apply this provision, the period of adjustment would be July 1, 2006 through June 30, 2009, absent election of the special provisions of §49 of S.F. 191, Article 4.

ALTERNATIVES FOR CORRECTING ELIGIBLE SALARY ERRORS

The City of Duluth has three options to choose from to correct erroneous employee deductions, employer contributions and adjusting overpaid benefits. Each has its own benefits and implications to active employees, the City and retirees. The City will also need to coordinate with and possibly decide which provisions to utilize on behalf of the DECC and the Duluth Airport Authority.

1. *Utilize existing law prior to enactment of the 2009 Omnibus Pension Bill.*

Because our error was "in process" as of the enactment date, absent elections pursuant to §49 or §50, the provisions of the 2009 Omnibus Pension Bill do not apply and any adjustments will be made under the procedures of existing law as follows:

- a. Adjustments go back to the first point of error, January 1, 1995.
- b. Active employees will be refunded their erroneous deductions back to the first instance of erroneously withheld deductions.
- c. The City will be refunded its invalid employer contributions without interest or receive a credit for both the employee and employer portions against future contributions payable by the City. If the credit is applied, the City will be required to refund to the employees any amounts that had been erroneously deducted back to the first instance. PERA will decide whether to refund or apply credits.
- d. Retirees and others receiving benefits impacted by a recalculation of eligible salary will have their benefits suspended or reduced until all overpayments have been recovered.
- e. Under a provision passed in the 2009 Omnibus Pension Bill, interest will be paid on all refunds of employee deductions paid out on or after June 1, 2009.
- f. This option will be the most problematic to retirees, who will face significant reductions or suspensions of their current pension payments or have the obligation to repay past pension overpayments out of pocket. The City will have to spend extensive time and resources to identify eligible salary errors for 1995 and 1996 because those records are not available in our electronic database. Active employees will receive all their erroneous deductions back, with interest and will receive the pension to which they are entitled when they retire.

2. Elect under §49 to apply the Compromise Option. This provision overrides other sections of Minnesota law to provide for a slightly modified statute of limitations and different procedures for correcting prior errors in defining eligible salary.
 - a. Adjustments go back to the later of the first point of error or January 1, 1997.
 - b. Active employees will be refunded invalid deductions previously withheld plus interest.
 - c. Retirees will be adjusted as follows:
 - i. Retirees' benefit payments will be adjusted to the correct monthly amount by reducing the average salary calculation by the invalid salary amounts.
 - ii. Net the amount of overpaid benefit payments with the amount of over withheld deductions on invalid salary, plus interest
 - iii. If the over withheld deductions exceed the overpaid benefits, the net result will be refunded to the retiree.
 - iv. Net overpaid benefits will be repaid by applying the City's erroneous employer contributions to the amount due. The retiree will not be responsible for repayment of any overpayment.
 - d. The City will use its erroneous employer contributions to repay overpaid retiree benefits per 3(c)(iv) above. Any remaining erroneous employer contributions will be credited against future required employer contributions. If the excess employer contribution is insufficient to cover all overpaid retiree benefits, the City must make up the difference. PERA will determine the time and manner for such repayment by the City.
 - e. §49 becomes effective the day after the city council timely approves the application of §49 by resolution passed by majority vote.
3. Elect under §50 to apply the new three year statute of limitations. Because our adjustments are "in process", the new three year statute of limitations does not apply. §50 was enacted to allow the City to take advantage of the new statute of limitations.
 - a. Adjustments go back to the later of the first point of error or July 1, 2006.
 - b. Most disadvantageous to active employees. Active employees will only get back erroneously withheld deductions between July 1, 2006 and July 2007 (the point in time when the City corrected the invalid withholding) but will have the full impact of the reduction for invalid salary on their 5-year average base if retiring more than two years from now.
 - c. The City will get refunds of its excess contributions only from July 1, 2006 to July 2007.
 - d. Most advantageous to retirees. Monthly pensions will increase above the correct level to reflect PERA over calculation of the employee high five by including non-PERA eligible salary for years prior to the new statute of limitations. Retirees will generally have no adjustment to their benefits they were receiving prior to the reductions implemented by PERA on July

- 1, 2009. This option will increase retiree pensions currently being received to a level back to those in place prior to July 1, 2009.
- e. Election must be made by the City Council within 90 days of enactment which is August 21, 2009.

TAX RAMIFICATIONS FOR EMPLOYEES AND RETIREES

The employee's 401(a) PERA deduction was reported as a reduction to gross wages for tax purposes at the time it was originally withheld. Refunded employee deductions will be treated as taxable income in the period received by the employee. Interest paid to active employees on refunded deductions will be subject to income tax. PERA has agreed with the City and the IRS to make those payments directly to the employees and will issue the required 1099s.

There should be no taxable event to retirees as they were already taxed on amounts actually received in prior periods and will only be taxed on their reduced benefits going forward.

Final tax treatment will be determined after PERA files their program changes with the IRS. The City will be assessed a fee based on its pro rata share of the IRS filing fees for the application to IRS for a ruling on the methodology for correcting the prior errors in the retirement plan.

As in all tax matters, employees are encouraged to seek professional tax advice with questions on proper treatment of refunds and pension benefits. The City does not provide individual advice on tax matters.

PARTICIPANT APPEALS AND TIMELINE

Approximately 60 petitions for review have been received by PERA from active and retired employees challenging the PERA staff's determination on the issue of what is included in salary for PERA pension purposes. An Administrative Law Judge, Bruce Johnson, has been assigned to hear the contested case hearing.

The judge has set a pre-hearing conference for Friday, August 21, 2009 at 9:00am in our city council chambers to allow the petitioners to present their case. PERA would like all the petitions consolidated into one collective hearing. PERA will be sending information packets out to all petitioners prior to the pre-hearing conference. After the pre-hearing, a date will be set for the contested case hearing.

The judge has informed PERA he will not be able to conduct the contested case hearing until November due to his full schedule. After that hearing the judge has 60 days to report his recommendations to the PERA Board of Trustees, which puts it into late January or February. There are three possible outcomes:

1. The judge supports the PERA staff determination and the PERA Board votes to accept the judge's report. Petitioners will have 60 days to appeal to the Minnesota Court of Appeals ("MCA"). If the MCA upholds the PERA Board, PERA will then start to issue refunds of invalidly withheld employee deductions.
2. The judge rejects the PERA staff determination but the Board votes to accept the

staff recommendation. The Board is not required to follow the judge's advisory report. Same process with the MCA as #1.

3. The judge rejects the PERA staff position and the Board votes to accept the report by the judge. PERA will reinstate adjusted benefits retroactively to July 1, 2009 (the date PERA started to adjust benefits going forward) and no contribution refunds will be issued. PERA will have to decide how to treat employee deductions and employer contributions going forward by looking to reasoning laid out in the judge's ruling.