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July 19, 2008

Rep. Bette Grande, Chairman
Employee Benefit Programs Committee
c/o Jeff Nelson
ND Legislative Council
State Capitol
600 East Boulevard
Bismarck, ND 58505-0360

Re: Actuarial Analysis: Bill No 109 (90109.0100 – 13th Check)

Dear Rep. Grande:

As requested, we have reviewed and analyzed Bill 109, which provides for a special one-time payment for annuitants of the Teachers' Fund for Retirement (TFFR).

Provisions

Each annuitant—retiree, disabled retiree, or beneficiary receiving a benefit—as of June 30, 2009 would receive a one-time payment equal to the sum of:

- $48.00 times the member's years of service, and
- $36.00 times the number of years the member has been retired

This payment would be made in December 2009.

The bill also provides for an appropriation of $11 million to TFFR, intended to pay for this special benefit.

Analysis

As of June 30, 2007, the date of the last actuarial valuation, there were 6,077 annuitants in TFFR. The average annuitant's benefit was $1,434/month, and the average annuitant had 27.655 years of service. As of June 30, 2009, these annuitants will have been retired on average for 13.9 years.

Based on the bill's formula, TFFR would pay approximately $11,800,000. This is an approximation that takes into account our estimate of the impact of new retirees and deaths between June 30, 2007 and June 30, 2009. We estimate that there will be 6,573 annuitants as of June 30, 2009. (This assumes a 4% annual increase in the number of annuitants.) We believe it is very likely that the actual payment amount will fall between $11.5 million and $12.0 million. This would provide an average one-time payment of about $1,750-$1825 under the bill.

Therefore, it is our view that the $11 million appropriation is too small. If the intent is to pay for this benefit entirely out of appropriated funds, we recommend increasing this to $11,800,000, or if it is desirable to provide a cushion to ensure that all payments are covered, to $12,000,000.

Assuming this is done, there would be no effect on the unfunded actuarial accrued liability (UAAL) for TFFR, and no effect on the funded ratio or margin, since the special payments would be covered by the appropriation.

Technical Comments

The provisions we described above are what we believe is intended. However, the wording of the bill's formula is unclear. The bill actually says the payment is equal to: "an amount determined by taking four dollars multiplied by the member's number of years of service credit plus three dollars multiplied by the number of years since the member's retirement multiplied by twelve." This is subject to misinterpretation, since it could mean ($4.00 x service) + ($3.00 x years retired x 12), rather than ($4.00 x service x 12) + ($3.00 x years retired x 12). For clarity, we recommend rewording this to read: "an amount determined by taking forty-eight dollars multiplied by the member's number of years of service credit, plus thirty-six dollars multiplied by the number of years since the member's retirement." In other words, the "multiplied by twelve" is intended to apply to both pieces of the formula.

One administrative/equity issue we see with the bill is the choice of the June 30, 2009 date to determine eligibility. Traditionally, the summer months are the heaviest months for teacher retirements, with significant number of retirements in June, July and August. Teachers who are considering retirement at that time may feel "stampeded" to make their decision quickly, so that the effective date of their retirement is in June. This will increase the workload on the Retirement & Investment Office (RIO), since they would have to process most of a summer's worth of new retirees by the end of June. There are a couple of ways to overcome this. The effective date could be moved to December 2009, so that all of the annuitants who receive a regular annuity payment in December 2009 would also receive the special one-time payment. Alternatively, the bill could be modified to make the one-time payment available only to members who had retired in 2008 or earlier. This would reduce the total amount paid by perhaps $600,000 - $800,000.

If the gap is left between the effective date for determining who receives the payments (June 30, 2009) and the payment date (December 2009), the bill should clarify what would happen in the event that a member dies between these dates without a survivor annuitant. For example, suppose Rick Shelton is a teacher who retired in 2002. He elected a life annuity, and is still alive on June 30, 2009, but he dies on October 13, 2009. Would a payment be made on his behalf to his estate? Or should the fact that he died without a survivor annuitant cancel his payment?

We also note that, based on past precedent with other cost-of-living legislation, that for annuitants who are beneficiaries, the years of service will be based on the service of the deceased member, and for annuitants who are survivors of deceased retirees, the years of service will be based on the number of years since the member's retirement. In the case of members whose benefits are divided by a qualified domestic relations order (QDRO), the one-time payment would likewise be divided in accordance with the language of the QDRO. We assumed that the Retirement and Investment Office would use exact decimal service in the formula, and that the number of years retired would be determined by subtracting the year of retirement from 2009.

The Rollover Issue

There is one other administrative consequence which should be discussed. Under Internal Revenue Service regulations, a payment that is supplemental to the regular annuity is treated as eligible for rollover to an IRA or another qualified plan, unless it meets an exception under the regulation. Under IRS Regulation 1.402(c)-2, Q&A 6, there is an exception for supplemental payments, if they meet these four requirements:

1. The supplement is a benefit increase for annuitants;

2. The amount of the supplement is determined in a consistent manner for all similarly situated annuitants;

3. The supplement is paid to annuitants who are otherwise receiving payments that would constitute substantially equal periodic payments; and

4. The aggregate supplement is less than or equal to the greater of 10% of the annual rate of payment for the annuity, or $750 or any higher amount prescribed by the Commissioner in revenue rulings, notices, and other guidance published in the Federal Register.

This would exempt payments made as a "13th check," since the amount of a 13th check that is equal to one-month's payment would be less than 10% of the annual distribution. But under Bill 109, over half of the annuitant's would receive a payment larger than both (a) 10% of the annual pension, and (b) $750.00, and therefore the one-time payment would be eligible for rollover.

As a consequence, the RIO will be required to offer a rollover either to (a) just the annuitants who fail the 10%/$750 test, or (b) all annuitants. It is not clear to us whether the failure in this case applies to the entire design of the supplement, or whether the exemption still applies to members whose payments are below the 10%/$750 threshold.

Offering a rollover will require the RIO to provide a Special Tax Notice and a rollover election form to the members eligible to rollover the payment. It will require providing additional educational material and communications explaining this option. If the payment is rollover-eligible, RIO must withhold 20% of the payment for federal income taxes unless it is rolled over, regardless of the withholding required on the member's regular annuity payment. It may be necessary for RIO to provide a separate Form 1099-R to each annuitant to report the special payment, since if it is rollover eligible.

As the Committee is aware, we are not attorneys. We are providing this information not as a legal opinion, but as a suggestion that legal research on this topic may be necessary.

Data and Assumptions

Our calculations were based on the member data used in preparing the June 30, 2007 actuarial valuation, and on the actuarial assumptions and methods used in that valuation.

If you have any questions about our analysis or comments, please do not hesitate to call or write.

Sincerely,

J. Christian Conradi

J. Christian Conradi
Senior Consultant

cc: Ms. Fay Kopp, Deputy Executive Director, North Dakota Retirement & Investment Office

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