

STORAGE NAME: h1103a.go

DATE: April 24, 2000

**HOUSE OF REPRESENTATIVES
COMMITTEE ON
GOVERNMENTAL OPERATIONS
ANALYSIS**

BILL #: HB 1103

RELATING TO: FLORIDA RETIREMENT SYSTEM/Disability or Death Benefits

SPONSOR(S): Representative Putnam and others

TIED BILL(S):

ORIGINATING COMMITTEE(S)/COMMITTEE(S) OF REFERENCE:

- (1) GOVERNMENTAL OPERATIONS YEAS 6 NAYS 0
 - (2) GENERAL APPROPRIATIONS
 - (3)
 - (4)
 - (5)
-

I. SUMMARY:

HB 1103 would require the Division of Retirement to identify, locate, and reimburse from the Florida Retirement System Trust Fund all members of the Florida Retirement System (FLORIDA RETIREMENT SYSTEM) who, prior to 1994, took disability retirement for a disability suffered in the line of duty (or died in the line of duty) and erroneously paid federal income taxes on their benefits.

This bill provides an effective date of upon becoming a law.

The costs of this bill are unknown, so we don't know whether these costs would be actuarially "significant." See OTHER COMMENTS section.

II. SUBSTANTIVE ANALYSIS:

A. DOES THE BILL SUPPORT THE FOLLOWING PRINCIPLES:

- | | | | |
|-----------------------------------|------------------------------|-----------------------------|---|
| 1. <u>Less Government</u> | Yes <input type="checkbox"/> | No <input type="checkbox"/> | N/A <input checked="" type="checkbox"/> |
| 2. <u>Lower Taxes</u> | Yes <input type="checkbox"/> | No <input type="checkbox"/> | N/A <input checked="" type="checkbox"/> |
| 3. <u>Individual Freedom</u> | Yes <input type="checkbox"/> | No <input type="checkbox"/> | N/A <input checked="" type="checkbox"/> |
| 4. <u>Personal Responsibility</u> | Yes <input type="checkbox"/> | No <input type="checkbox"/> | N/A <input checked="" type="checkbox"/> |
| 5. <u>Family Empowerment</u> | Yes <input type="checkbox"/> | No <input type="checkbox"/> | N/A <input checked="" type="checkbox"/> |

For any principle that received a "no" above, please explain:

B. PRESENT SITUATION:

In-line-of-duty disability benefits payable under the FRS. Under s. 121.091(4), F.S., the minimum benefit for total and permanent disability suffered in the line of duty is 42 percent of the disabled retiree's average monthly compensation at retirement. To be considered a disability suffered "in the line of duty," under s. 121.021(13), F.S., the disability must be "an injury or illness arising out of and in the actual performance of duty required by a member's employment during his or her regularly scheduled working hours or irregular working hours as required by the employer." This minimum in-line-of-duty disability benefit is payable to eligible retirees regardless of length of service. However, if an affected retiree qualifies for a higher benefit based on service, he/she is entitled to receive the higher benefit.

In-line-of-duty death benefits payable under the FRS. Under s. 121.091(7)(d), F.S., the minimum benefit payable to a surviving spouse (or if there is no surviving spouse, to the surviving child or children) in the case of a member who is killed in the line of duty is 50 percent of the member's monthly salary at time of death. To be considered a death suffered "in the line of duty," under s. 121.021(14), F.S., it must be a "death arising out of and in the actual performance of duty required by a member's employment during his or her regularly scheduled working hours or irregular working hours as required by the employer." This minimum in-line-of-duty death benefit is payable to eligible survivors regardless of the deceased member's length of service. However, if the deceased member would have qualified for a higher retirement benefit based on service, the survivor(s) are entitled to receive the higher benefit.

Benefit payment options and survivor benefits under the FRS. When applying for retirement, a member must choose a benefit payment option (see s. 121.091(6)(a), F.S.). The four available payment options are generally described below:

Option 1 provides a monthly benefit to the retiree for his/her lifetime.

Option 2 provides a reduced monthly benefit payable to the retiree for the remainder of his/her life or, if the retiree dies within 10 years of retiring, continuing to a beneficiary for the balance of the 10 years.

Option 3 provides a reduced monthly benefit payable to the retiree for his/her lifetime and continuing to his/her joint annuitant for the remainder of the joint annuitant's life.

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Option 4 provides an adjusted monthly benefit payable to the retiree and his/her joint annuitant while both are living; upon the death of either, the benefit is reduced to two-thirds of the former benefit.

If a member chooses payment option 2, 3, or 4 at retirement, his/her surviving beneficiary may be entitled to receive a continuing benefit upon the retiree's death.

Taxability of in-line-of-duty disability/death benefits. Based on a reasonable and good faith interpretation of the applicable federal laws and regulations relating to pension payments and retirement issues, until November 1996, the Division of Retirement treated benefits paid for in-line-of-duty disability or death as taxable income and withheld amounts for payment of taxes as requested by the retirees or required by the IRS. As soon as the Division of Retirement became aware of the *possibility* that in-line-of-duty disability benefits might be excludable from taxable income in the same way that the tax laws permitted exclusion of workers' compensation benefits, it acted. After extensive legal research, the division decided that the application of the federal law was sufficiently uncertain as to require IRS guidance. Therefore, in April 1996, the division filed a formal request for a private letter ruling from the Internal Revenue Service (IRS). At that time, there were about 1,250 persons receiving FRS in-line-of-duty disability benefits (most of whom received the 42% minimum amount). The request to the IRS sought to determine:

whether disability benefits paid under s. 121.091(4), F.S., and/or survivor benefits paid under s. 121.091(7)(d), F.S., are considered income subject to withholding for federal tax purposes; and

whether that portion of the benefit attributable to the annual 3-percent cost-of-living adjustment (COLA) is considered income subject to withholding for federal tax purposes.

IRS private letter ruling. In November 1996, the IRS issued Private Letter Ruling No. 9644017, in which the IRS held that the described disability benefits constituted "benefits in the nature of a workers' compensation act." As such, the IRS found in-line-of-duty disability benefits to be *excludable from taxable income* -- i.e., not treated as wages for purposes of the Federal Insurance Contributions Act (FICA) or the Federal Unemployment Tax Act (FUTA), or for purposes of federal income tax withholding on wages -- as long as the base benefit did not exceed the statutory minimum disability benefit of 42 percent of the member's average final compensation (or "floor benefit"). In addition, the IRS held that the cost-of-living adjustment (COLA) "attributable to an excludable statutory minimum [disability benefit] or floor benefit is also excludable . . ." Benefits paid in excess of the floor benefit (and the associated COLAs) were found to be taxable income, but were not deemed wages for FICA or FUTA purposes.

Similarly, in the case of in-line-of-duty death benefits and option 2, 3, or 4 benefits payable upon the death of a retiree who was receiving an in-line-of-duty disability benefit, the IRS held that the statutory minimum amount of such benefits are also excludable from taxable income, while benefits received in excess of the "floor benefit" are deemed wages for federal income tax purposes (and subject to withholding), but are not deemed wages for FICA or FUTA purposes. As before, the IRS held that the COLAs attributable to an excludable statutory minimum benefit are also excludable, while COLAs on benefits above the floor benefit were taxable income.

Impact of IRS ruling. When the division received the ruling from the IRS, it acted quickly to stop withholding taxes on affected monthly benefit payments and to notify affected

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recipients that they might be eligible for a refund from the IRS for certain prior taxes paid on such benefits and should file a claim with the IRS to obtain the refund. The division was without knowledge as to the individual return treatment of the benefits by the 1,250 members who received such benefits, and could only assume that all or most of the members reported the income as taxable on their individual returns.

However, the IRS only recognizes claims filed within 3 years after the tax return for that year was filed or within 2 years after the tax for that year was paid. Consequently, affected recipients could not claim a tax refund from the IRS for taxes erroneously paid prior to 1994, since these benefits were not determined by the IRS to be excludable from gross income (nontaxable) until November 1996 and, by then, IRS time limits for filing pre-1994 claims had expired.

C. EFFECT OF PROPOSED CHANGES:

The Division of Retirement would be required to identify, locate and reimburse retired members (and presumably surviving beneficiaries) for pre-1994 taxes paid to the IRS "in error" as described in this analysis. The money for the reimbursement would come from the FRS Trust Fund. (The bill directs the division to identify and locate "members" who paid taxes on in-line-of-duty disability or death benefits in error. It does not refer to surviving beneficiaries; however, since a deceased member would not pay taxes on his/her own death benefit, common sense would dictate its application to surviving beneficiaries.)

D. SECTION-BY-SECTION ANALYSIS:

See section above.

III. FISCAL ANALYSIS & ECONOMIC IMPACT STATEMENT:

A. FISCAL IMPACT ON STATE GOVERNMENT:

1. Revenues:

None.

2. Expenditures:

Indeterminate.

B. FISCAL IMPACT ON LOCAL GOVERNMENTS:

1. Revenues:

None.

2. Expenditures:

Indeterminate.

C. DIRECT ECONOMIC IMPACT ON PRIVATE SECTOR:

None.

D. FISCAL COMMENTS:

None.

IV. CONSEQUENCES OF ARTICLE VII, SECTION 18 OF THE FLORIDA CONSTITUTION:

A. APPLICABILITY OF THE MANDATES PROVISION:

This bill does not require a city or county to expend funds or to take any action requiring the expenditure of funds.

B. REDUCTION OF REVENUE RAISING AUTHORITY:

This bill does not reduce the authority that cities or counties have to raise revenue in the aggregate.

C. REDUCTION OF STATE TAX SHARED WITH COUNTIES AND MUNICIPALITIES:

This bill does not reduce the percentage of a state tax shared with counties or cities.

V. COMMENTS:

A. CONSTITUTIONAL ISSUES:

None.

B. RULE-MAKING AUTHORITY:

None.

C. OTHER COMMENTS:

The Division of Retirement raised several concerns in its 2000 Substantive Bill Analysis:

Administration and cost issues. Each individual's income taxes are uniquely based on his/her individual circumstances. The amount of taxes an individual owes in a given year depends on many factors (including the individual's tax bracket, exemptions, deductions, credits, and tax laws in effect in the year the taxes were paid). It is also likely that reimbursements under HB 1103 would be treated by the IRS as taxable income in the year the retiree gets the reimbursements. If so, it is not clear whether the division would be expected to "gross up" the reimbursements to truly make affected individuals whole.

Even rough estimates are impractical since pre-1994 benefit payment records are archived on microfiche and are not readily accessible. Furthermore, it is not possible to predict who or how many would apply for reimbursement, or how many years prior to 1994 such applicants received benefits for which reimbursement may be sought.

Consequently, the cost to provide payments to affected retirees or beneficiaries cannot be known until actual applications for reimbursement are filed, reviewed, and approved.

Funding issues. Florida law requires that significant plan changes must be concurrently funded. Costs can be paid immediately or "mortgaged" and paid over time, provided that the debt is paid within 30 years. Key provisions are set forth below:

112.64 Administration of funds; amortization of unfunded liability.—

(4) The net increase, if any, in unfunded liability under the plan arising from significant plan amendments adopted, changes in actuarial assumptions, changes in funding methods, or actuarial gains or losses shall be amortized within 30 plan years.

121.031 Administration of system; appropriation; oaths; actuarial studies; public records.—

(4) Notwithstanding the provisions of s. 112.64(4) to the contrary, the net increase, if any, in unfunded liability under the system arising from significant system amendments adopted or changes in assumptions shall be amortized within 30 plan years.

The costs of HB 1103 are unknown, so we don't know whether these costs would be actuarially "significant."

Plan qualification issues. It is questionable whether the payments envisioned by HB 1103 would be permissible under state or federal law. Section 401(a) of the Internal Revenue Code establishes the qualification requirements that must be met by all retirement plans. If the qualification requirements are not met, the plan becomes a nonqualified plan, the trust which is a part of the plan becomes a non-exempt trust, and the tax advantages of a qualified plan are not available to the employer and the employees. A key requirement for plan qualification is that the plan must definitely and affirmatively prohibit the diversion of plan assets for purposes other than for the exclusive benefit of the employees or their beneficiaries until all liabilities to employees and their beneficiaries have been satisfied. State law fulfills this federal requirement in s. 121.30(1) and (2), F.S.:

Statements of purpose and intent and other provisions required for qualification under the Internal Revenue Code of the United States.—Any other provisions in this chapter to the contrary notwithstanding, it is specifically provided that:

(1) The purpose of this chapter is to provide pension benefits for the exclusive benefit of the member employees or their beneficiaries.

(2) No part of the principal or income of the trust fund created hereunder shall be used or diverted for purposes other than for the exclusive benefit of the member employees or their beneficiaries and for the payment of administrative cost.

VI. AMENDMENTS OR COMMITTEE SUBSTITUTE CHANGES:

N/A

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VII. SIGNATURES:

COMMITTEE ON GOVERNMENTAL OPERATIONS:

Prepared by:

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