

STATE OF MINNESOTA
OFFICE OF ADMINISTRATIVE HEARINGS

RECEIVED
09 DEC 31 PM 3:03
ADMINISTRATIVE
HEARINGS

FOR THE PUBLIC EMPLOYEES RETIREMENT ASSOCIATION

In the Matter of the PERA Salary
Determinations Affecting Retired and Active
Employees of the City of Duluth,

Allen Johnson, et al., Petitioners.

**MEMORANDUM OF LAW
IN SUPPORT OF
PERA'S MOTION FOR SUMMARY
DISPOSITION**

OAH Docket No. 4-3600-2080902

INTRODUCTION

The Public Employees Retirement Association ("PERA") submits this Memorandum in support of its Motion For Summary Disposition.

At issue in this proceeding is whether certain forms of compensation, collectively characterized as "employer paid deferred compensation contributions" and "insurance supplement payments" are considered "salary". Minn. Stat. § 353.01, subd. 10 (2008). This is an issue of statutory construction and a question of law. *See Stang v. Minnesota TRA Board of Trustees*, 566 N.W. 2d 345, 348 (Minn. Ct. App. 1997)(construction of the teachers retirement statutes is a question of law). The facts needed to apply the statutory definition of "salary" to the payments in question are not complex nor are they in serious dispute.

The PERA status of the payments can be determined based upon the provisions of the collective bargaining agreements between the City of Duluth and its employees, the correspondence between the City of Duluth and PERA, and the language of the law. Moreover, corollary issues which the parties may seek to raise based upon equitable principles and/or statutory limitations of actions are issues beyond the scope of this proceeding and the authority

of the PERA Board. PERA believes that the legal status of the payments at issue can be resolved on a summary basis.

BACKGROUND

I. Pera's Pension Plans:

PERA manages and administers several pension plans for public employees, including the PERA "general" plan and the PERA Police and Fire Plan ("P&F"). Minn. Stat. chapters 353, 356 and 356A set forth the terms and conditions that govern the operations of these plans and are essentially the pension plans' "Plan Document."¹ Both pension plans are "governmental plans" under applicable federal law and are not subject to most of the requirements imposed on private plans under the Employee Retirement Income Security Act of 1974 ("ERISA"). *See Stocke, et al. v. Berryman, et al.*, 642 N.W.2d 242 (Minn. Ct. App. 2001); 29 U.S.C.A. §§ 1003(b)(1) and 1101(a) (1999). However, in order to maintain a tax-deferred "qualified" status, for income tax purposes, a governmental plan must comply with ERISA's income tax requirements, in particular, the provisions of 26 U.S.C. § 401(a). *See generally*, Affidavit of Mary Most Vanek ("Vanek Aff'd"). Tax-qualified status is important because of the favorable tax consequences. Both employer and employee contributions, the income generated thereby and accrued vested benefits are tax deferred: a taxable event does not occur until benefits are actually distributed to the employee. *See AFSCME Council 614, 65 and 96, AFL-CIO v. Sundquist*, 338 N.W.2d 560, 565 (Minn. 1983), appealed dismissed 466, U.S. 9, 33 104 Sup. Ct. 1902 (1984).

¹ The terms of the P&F Plan are set forth in §§ 353.63-68 (2008). Minn. Stat. § 353.68 (2008) states that the general provisions of chapter 353 apply to the P&F Fund, except as otherwise specifically provided.

II. The Importance Of Salary In A Defined Benefit Plan.

PERA is a defined benefit plan under which retirement benefits are determined by a formula utilizing years of service times a percentage factor for each year of service, times the employee's "high five" salary. *See* Minn. Stat. § 353.01, subd. 17(a). The PERA law defines what is, and is not considered "salary" under Minn. Stat. § 353.01, subd. 10 (2008). PERA law defines "salary" so as to reflect a retiring participant's pre-retirement standard of living, so that the pension benefit replaces a portion of that standard of living based on the participant's length of service. *See* Vanek Aff'd., par. 6. Employer and employee contributions to the plan are also based on a percentage of salary. *See* Minn. Stat. § 353.27, subds. 2 and 3 (2008). Since 1982, employee contribution has been treated as being "picked up" by the employer for purposes of obtaining tax deferment for those contributions. Minn. Stat. § 356.62 (2008).

Consequently, "salary" for PERA purposes: 1) it determines the contribution amounts that governmental subdivisions must pay to PERA to fund an employee's pensions; 2) it determines the amount of money available for investment for future benefits, and 3) ultimately determines the specific monthly amount of annuities that public employees will receive.

III. Governmental Subdivisions Must Correctly Report "Salary" and Employer/Employee Contributions To PERA.

Reporting "salary" and the correct employer and employee contributions to PERA is the duty of the governmental subdivisions that participate in PERA. *See* Vanek Aff'd and Affidavits of Cheryl Keating ("Keating Aff'ds"); Minn. Stat. § 353.27, subd. 4 (2008). In the absence of field audits, a process impractical with over 2000 governmental subdivisions participating in PERA, or self-reporting by a governmental subdivision, PERA cannot determine from the routine documents required to be submitted to PERA, whether amounts reported contain ineligible amounts. Keating Aff'd., par. 10.

PERA has established a number of administrative tools to assist governmental subdivisions in the proper reporting of contributions. Those tools include work-shops for governmental employers and employees, periodic newsletters sent to all governmental subdivisions and the publication and distribution of the PERA Employer Reporting Manual. *See Vanek Aff'd.* and attachments thereto. In addition, PERA encourages governmental subdivisions to contact PERA, either through the Internet or by telephone, with questions relating to "salary." PERA employees are designated as contact persons for employer inquiries. PERA receives a substantial number of inquiries on a daily, weekly, or annual basis. *See Vanek and Keating Aff'ds.*; PERA Employer Manual, (Nov. 2002), "Employer Responsibilities" (art. 2-2); "Employer Services" (art. 2-3; "Employer Response Line" (art. 2-6); "Determining PERA-Eligible Salary" (art. 5-15-18); and "Salary not Subject to PERA Withholding" (art. 5-19).

IV. The Duties of the PERA Board of Trustees and Its Executive Director.

PERA's Board of Trustees and its Executive Director are fiduciaries. They are required to conduct their activities in accordance with the law and pension plan documents. *See Minn. Stat. § 356A.05 (2008).* The PERA Board is authorized to "pass upon and allow or disallow all applications for membership in the fund and allow or disallow claims, withdrawals, pensions, or benefits payable from the fund." Minn. Stat. § 353.03, subd. 3(5) (2008). Minn. Stat. § 353.18 (2008) vests the PERA Board with the "final power" to determine the status of public employees for pension purposes. Minn. Stat. § 353.18 (2008). Its decisions "shall not be disturbed unless found to be arbitrary and capricious." *Id.*

Minn. Stat. § 353.03, subd. 2(b) (2008) authorizes the PERA Board to take legal action when necessary to effectively administer the various retirement plans administered by the

association including, but not limited to, the recapture of overpaid annuities, benefits, or refunds, and the correction of omitted or deficient deductions.

Federal law also requires PERA to administer its pension plans in accordance with the pension plans' "plan documents." Revenue Procedure 2008-50, 2008-35 I.R.B. 464, 2008 WL 3522439 (IRS RPR) sets forth the correction procedures that are required of governmental plans when the provisions of the plan have not been followed. Accepting contributions on an invalid "salary" inconsistent with a governmental plan's document is considered to be an "operational failure" under Revenue Procedure 2008-50. The IRS requires corrective action to be taken in such circumstances. See Revenue Procedure 2008-50 at part 3, sec. 5.01 (2)(b).² (1). While applicable IRS law requires certain terms and benefits for governmental plans, it does not directly define what a governmental plan must consider to be "salary" under the terms of its plan. Consequently, the "salary" status of the payments at issue is a question of state law.

Minnesota courts have long recognized PERA's duty to diligently police salaries reported by public governmental subdivisions in order to determine that the amounts reported are consistent with the PERA plan documents. See *In the Matter of the Retirement Benefits of Robert W. Larson*, No. C7-95-2512, 1996 WL 310344 (Minn. Ct. App. (unpublished) June 11, 1996); *Application of Allers*, 533 N.W.2d 646 (Minn. Ct. App. 1995), rev. den. Aug. 30, 1995. In addition, courts generally give great weight to the construction given to public pension laws by the fiduciaries that administer them. *McDermott v. Teachers Retirement Fund*, 609 N.W. 2d 926, 928 (Minn. App. 2000); *In re Twedt*, 598 N.W.2d 11, 13 (Minn. App. 1999).

² For IRS purposes, invalid contributions are considered "excess amounts" and if they result in benefits beyond what is allowed under the plan, the excess amount is considered an "overpayment." In general, authorized correction methods for operational plan failures should be reasonable and appropriate for the failure with a goal toward restoring the plan to the position it would have been in if the failures had not occurred. See Revenue Procedure 2008-50, section 6.02 (1).

FACTS

PERA was first contacted by the City of Duluth regarding “salary” questions in late June of 2007. Wayne Parson, Duluth City Auditor, submitted to Chris Arcand, sections of the City of Duluth’s collective bargaining agreement, asking whether the compensation provided under those articles, characterized as “employer-paid contributions to deferred compensation accounts” and “insurance supplements” were “salary” for PERA purposes. *See Vanek Aff’d*, par. 10 and Exh. 8. Parson and PERA’s representative, Chris Arcand, agreed that the payments in question should not be considered to be eligible “salary” for PERA purposes. *Id.*

By letter dated September 15, 2008, the City of Duluth informed PERA that certain employer paid benefits had been erroneously treated as salary for PERA purposes. This was the first formal correspondence PERA received on these issues. *Vanek Aff’d.*, par. 11, Ex. 9. (PERA subsequently learned that the City of Duluth had ceased reporting employer payments to deferred compensation plans and insurance supplements as PERA eligible salary in July 2007.).

PERA staff reviewed the information provided by Mr. Parson and determined that the compensation at issue was not PERA eligible. After payroll summaries were provided by the City of Duluth setting forth the payments at issue on an annual basis, PERA readjusted the payments it believed Duluth’s retirees should be receiving, the amount of retiree benefits that were overpaid, and the amount of employer/employee contributions that should be refunded. *Vanek Aff’d.*, par. 15. Individual letters were sent to Duluth’s active and retired employees explaining how PERA’s determination would affect them.³ The City of Duluth also sent letters to its active and retired employees explaining the reporting errors. *Id.*, par. 13, Exhs. 9-11. In

³ The letters sent to those employees/retirees who petitioned for review have previously been filed with OAH.

response to its determination letters, PERA received over sixty (60) Petitions For Review, raising various legal issues regarding PERA's determinations.

The process for review of a PERA benefit determination before the PERA Board is set forth in Minn. Stat. § 356.96 (2008). Review before the PERA Board is not generally a "contested case proceedings." See Minn. Stat. § 356.96, subd. 12 (2008). Nonetheless, the PERA Board in its sole discretion may refer a petition to the Office of Administrative Hearings for a contested case proceeding. *Id.*

In this case, the PERA Board referred all petitions to the Office of Administrative Hearings for a contested case proceeding. In their petitions and at a pre-hearing conference before Judge Bruce Johnson, the petitioners raised various objections and defenses to PERA's determinations, including claims to laches and statutory limitations of actions. These issues have not yet been formally raised by the petitioners.

Originally the forms of compensation at issue in this proceeding included the status of payments received by Duluth's firefighters for unused personal days. That issue was addressed by the active firefighters through a motion for summary judgment and has been resolved through a settlement agreement under which PERA's Executive Director will issue new determinations on the status of unused personal leave days. What remains is the status of certain forms of compensation, collectively characterized as "employer paid contributions to deferred compensation plans" and "insurance supplement payments."

The collective bargaining agreements ("CBAs") between the City of Duluth, have provided for "employer-paid deferred compensation" and "insurance supplements," under

clauses that have evolved during the course of the years in question. The following are the articles from the CBAs that PERA looked to in making its determinations:⁴

1. Duluth/Firefighters (“Local 101”).

Article 17 of the 2007-2009 CBA, entitled DEFERRED COMPENSATION provides :

For each employee who has been continuously employed by the Employer for sufficient time as to be eligible for the Employers medical benefit plan, the Employer shall contribute *two hundred twenty-nine dollars (\$229) each month for either contribution to a qualifying and approved deferred compensation plan, and/or for contribution to family-dependent hospital medical premium, whichever is designated by the employee during the open window for insurance selection, or at the time of a life event.*

Duluth/Local 101, 2007-2009 CBA, Article 17.1(c) Ex. 1-a. This provision first appeared in the Duluth/Local 101 2004 CBA;

Article 18, entitled-HOSPITAL-MEDICAL INSURANCE provides:

The employer agrees to hold a special two week open enrollment period for insurance selection within 15 days following City Council approval, by resolution duly passed, of this agreement. For calendar year 2007, due to federal regulations, the first of the month following the end of the special open enrollment period, *the Employer will deposit seventy-five dollars (\$75.00) per month into a qualifying and approved deferred compensation plan, as designated by the employee, for each employee without claimed dependents. Effective January 1, 2008, the employee without claimed dependants shall elect to have the \$75 per month deposited into a flexible benefits spending account and/or a qualifying and approved deferred compensation plan.* Thereafter, the employee may change this designation during the annual open enrollment period for insurance selection, or at the time of a life event.

Id., Art. 18.1(b); Ex. 1a. In the 2004 CBA, this insurance supplement was directed to either a “medical savings type account” or “flexible spending account.” *See* Exh. 1-b.

Prior to 2004, Article 17, entitled HOSPITAL-MEDICAL INSURANCE, provided payments for both those employees with family health coverage and those without. For employees with family coverage the CBA provided a specified dollar amount “*of the monthly*

⁴ Relevant articles from the CBAs are identified and attached to the Affidavit of Jon Murphy filed herein, and are referred to by their Affidavit Exhibit numbers.

employer contribution available for the employee's family-dependent medical coverage premium to be used as a contribution to the monthly cost of a qualifying and approved deferred compensation plan. *Id.*, Exh. 1c. Employees without family-dependent coverage could designate certain dollar amounts that the employer was to contribute to “*a qualifying and approved deferred compensation plan . . .*”. The amounts that could be designated appeared in a chart. *Id.*⁵ The CBA did not state what happened to these amounts if an employee without family coverage did not designate an amount for deferred compensation. PERA believes that similar benefits were first provided under the 1997-1998 CBA.

2. AFSCME.

Article 8.8 of the Duluth/AFSCME 2007-2009 CBA provides:

For each active employee beginning the first day of the month following the date of hire, the *Employer shall contribute two hundred twenty-nine dollars (\$229.00) per month effective upon City Council approval of this contract, by resolution duly passed, for either contribution to a qualifying and approved deferred compensation plan, or for contribution to a city-sponsored family dependant (sic) hospital-medical plan premium, whichever is designated by the employee during the open window for insurance selection or at the time of a life event.*

Duluth/AFSCME 2007-2009 CBA, ARTICLE 8.8.; Exh. 2a. This provision first appeared in the 1999 CBA. Article 21, entitled -HOSPITAL-MEDICAL INSURANCE, provides:

The employer agrees to hold a special two week open enrollment period for insurance selection within 15 days following City Council approval, by resolution duly passed, of this agreement. Effective the first of the month following the end of the special enrollment period, *the Employer will deposit seventy-five (\$75) per month into a flexible benefits spending account and/or a qualified and approved deferred compensation plan as designated by the employee for each employee without claimed dependents.*

⁵ It is noted that the 2003 agreement contains the same dates and dollar amounts set forth in the 2000-2002 CBA.

See Article 21.1(b); Ex. 2. This provision first appeared in the City of Duluth/AFSCME CBA in 2000.

3. POLICE.

Article 23, of The City of Duluth/Police CBA for 2007-2009, titled DEFERRED COMPENSATION provides:

For each employee who has been continuously employed by the Employer for sufficient time as to be eligible for the Employers medical benefit plan, *the Employer shall contribute two hundred twenty-nine dollars (\$229) each month for either contribution to a qualifying and approved deferred compensation plan, and or for contribution to family-dependent hospital medical premium, whichever is designated by the employee during open window for insurance selection, or a the time of a life event.*

Exh. 3a. This provision first appeared in the 2004-2006 CBA. Exh. 3b.

Since 1997, Article 19, titled- HOSPITAL-MEDICAL INSURANCE, has provided benefits similar to the insurance supplements provided under the AFSCME and Local 101 CBAs, requiring the Employer to deposit specified amounts *“into a flexible benefits spending account and/or qualifying and approved deferred compensation plan, as designated by the employee.* Exh. 3a. This provision first appeared in the 1997-1998 CBA. Exh. 3f.

4. CONFIDENTIAL EMPLOYEES.

For employees eligible for the employer’s medical plan, Article 12 titled Pay Period-Deferred Compensation of the 2007-2009 CBA provides for an employer contribution, *to a qualifying and approved deferred compensation plan, and/or for contribution to family-dependent hospital-medical premium, as designated by the employee during the open enrollment period for insurance selection or at the time of a life event.* Art. 12.4, Exh. 4(a). This provision first appeared in 2004 and \$225 per month for employees “enrolled in Plan 3 hospital-medical” (plan) and \$225 per month for other medical plan participants. *Id.*, Exh. 4(b).

Article 13 of the current agreement, titled -Hospital- Medical Insurance, provides a \$75 per month payment for employees without dependents for contribution to a “flexible benefits spending account and/or a qualifying and approved deferred compensation plan as designated by the employee. *Id.*, Exh. 4a.

In 2004, article 13.1(b) provided that \$50.00 per month be added to the compensation of those employees without dependents who were enrolled in the CP3 plan. For the next two years these payments went to flexible benefit accounts. Ex. 4c.

The 2003 CBA did not provide a deferred compensation payment under article 12 but provided for an insurance supplement payment under article 13.5 for employees without dependent coverage. Employees covered under specific medical plans were given a payment, “to be used as a contribution to the monthly cost of a qualifying and approved deferred compensation plan.” Exh. 4c. These payments began under the 1997-1998 CBA, Exs. 4d and 4e.

5. SUPERVISORY EMPLOYEES.

The 2007-2009 CBA provides a \$229.00 per month deferred compensation payment for, “each employee enrolled in plan 3A hospital medical insurance, for contribution to a qualifying and approved deferred compensation plan, and/or for contribution to family-dependent hospital insurance. . .” 2007-2009 CBA, article 12(c); Ex. 5a. This payment began in 1995. *See* 1995-1996 CBA, article 12(c).

For employees without dependent coverage, article 13.1, titled Hospital-Medical Benefit Plan of the 2007-2009 CBA provided a \$75.00 per month payment for, “a flexible benefits spending account and/or a qualifying and approved deferred compensation plan. . . for employees without claimed dependents. *Id.*, Article 13, Ex. 5. A onetime deposit into a post employment health care savings plan of \$12,000.00 was provided to employees with over 3

years of employment. *Id.*, 13.1(c). This benefit began in 2004 but was paid to a flexible benefits account rather than to a deferred compensation account. *See* 1995-1996 CBA, article 13(c).

ISSUES

1. **WHETHER THE EMPLOYER-PAID DEFERRED COMPENSATION AND INSURANCE SUPPLEMENTS PAID UNDER THE CITY OF DULUTH'S CBAs ARE "SALARY" UNDER MINN. STAT. SECTION 353.01, SUBD. 10 (2008).**
2. **WHETHER PERA IS BARRED FROM ENFORCING ITS DETERMINATION THROUGH THE APPLICATION OF EQUITABLE PRINCIPLES OR STATUTORY LIMITATIONS.**

ARGUMENT

The amounts the City of Duluth contributed to employees' deferred compensation accounts and insurance supplements paid principally to employees without dependent insurance coverage, are not "salary" under Minn. Stat. section 353.01, subd. 10 (2008). They are "employer-paid "fringe benefits" which are either specifically, or categorically, excluded from the PERA definition of salary. Equitable principles cannot bar PERA and its Board of Trustees from following the mandates of the PERA law and acting to correct the resulting excess benefits and excess contributions. Since the PERA law does not provide a time limitation within which errors must be corrected, its actions are not time-barred.

I. **EMPLOYER-PAID CONTRIBUTIONS TO DEFERRED COMPENSATION ACCOUNTS AND INSURANCE SUPPLEMENTS ARE FRINGE BENEFITS EXCLUDED FROM PERA SALARY.**

A. **PERA's Definition of "Salary".**

PERA's definition of salary has been set in law for a long time. While some adjustments were made to the definition in 1993 and 1994, *See* *Murphy Aff'd.*, Exs. 6-8, they were made to clarify that employer-paid amounts were not to be treated as salary simply because the employee could make choices regarding such payments, *Vanek Aff'd.*, para. 7. The basic principles of

what is, and what is not, salary for PERA purposes has existed for a long time. In relevant part,

“salary” is defined as:

(a) Subject to the limitations of section 356.611, "salary" means:

(1) the periodic compensation of a public employee, before deductions for deferred compensation, supplemental retirement plans, or other voluntary salary reduction programs, and also means "wages" and includes net income from fees;

.....

Subpart (b) of section 353.01, subd. 10, excludes certain forms of compensation which might otherwise fall within subdivision (a)'s general definition of salary;

(b) Salary does not mean:

(1) the fees paid to district court reporters, unused annual vacation or sick leave payments, in lump-sum or periodic payments, severance payments, reimbursement of expenses, lump-sum settlements not attached to a specific earnings period, or workers' compensation payments;

(2) employer-paid amounts used by an employee toward the cost of insurance coverage, employer-paid fringe benefits, flexible spending accounts, cafeteria plans, health care expense accounts, day care expenses, or any payments in lieu of any employer-paid group insurance coverage, including the difference between single and family rates that may be paid to a member with single coverage and certain amounts determined by the executive director to be ineligible.

.....

(5) the amount of compensation that exceeds the limitation provided in section 356.611.

Minn. Stat. Sec. 353.01, subd. 10(a)(1) and (b) (1), (2) and (5) (2008). The clause, “employer-paid flexible spending accounts, cafeteria plans, healthcare expense accounts, daycare expenses,” was added in 1993. *See*, Murphy Aff's, Ex. 7; Minn. Stat § 353.01, subd. 10 (1993 Supp.). This exclusion was re-written in 1994 primarily to exclude: “employer-paid amounts used by an employee” and “certain amounts determined by the executive director to be ineligible.” *Id.*, Ex. 8; Minn. Stat § 353.01, subd. 10 (1993

Supp.). Subpart 5, referring to section 356.611 was added by Laws 2005, 1st. Sp., ch. 8, art. 1, § 9 and § 10.

The obvious purpose of the 1993 and 1994 amendments was to address the increased acceptance and use of various “cafeteria style” benefits, and assure that all employer paid fringe benefits, regardless of an employees choice or control over where the money would go, were not salary for PERA purposes. Vanek Aff’d., par. 8.

B. Employer paid contributions to deferred compensation accounts is the type of fringe benefits the legislature intended to exclude from PERA “salary.”⁶

The Executive Director’s determined that employer-paid contributions to deferred compensation accounts was not salary, with the authority vested in the Executive Director under Minn. Stat. sec 353.01, subd. 10, (b)(2). A number of reasons support that determination. Foremost is that PERA and a majority of the other state pension funds have excluded it for many years, even before the 1993 and 1994 amendments to the definition of “salary.” See, Vanek Aff’d, par.7.

PERA has interpreted the salary definition for well over 15 years as excluding employer-paid deferred compensation payments and its construction of the statute it administers should be given considerable deference. *Goodnature v. Mower County*, 558 N.W. 2d 19, 21 (Minn. App.

⁶ PERA recognizes that its law does not define the term, “fringe benefit.” However, it knows of no legal authority stating that employer paid deferred compensation is not a fringe benefit. For purposes of public employee collective bargaining, PELRA considers retirement contributions to be a fringe benefit. See, Minn. Stat. § 179A.03, subd. 19 (2008)(terms and conditions of employment" means the hours of employment, the compensation therefore *including fringe benefits except retirement contributions or benefits.* .). In addition, the IRS has published a lengthy booklet on “fringe benefits,” and by way of definition simply states: “a fringe benefit is a form of pay for the performance of services.” See IRS Publication 15B (2010), Employer’s Tax Guide to Fringe Benefits. The IRS publication, Public Employer Tax Guide states that fringe benefits include “any compensation other than cash wages.” IRS, Federal, State and Local Governments, Public Employer Tax Guide (2008), ch 7, Fringe Benefits., (2008).

1997). In 1993 and 1994, the legislature recognized that the only statewide pension plan that did not exclude contributions made by an employer to a deferred compensation plan was the Minnesota State Retirement System (“MSRS”). In a desire to create uniformity, a “salary advisory committee” was created and resulted in the MSRS law being amended in 1995 to specifically exclude employer paid deferred compensation benefits. *See*, Murphy and David Bergstrom Affidavits.

Several reasons support a consistent recognition in this case that employer-paid contributions are not salary:

1. Employer-paid deferred compensation contributions do not satisfy the general definition of salary.

“Salary is defined under Minn. Stat. § 353.01, subd. 10(a)(1) as:

the periodical compensation of a public employee before deductions for deferred compensation, supplemental retirement plans, or other voluntary salary reduction programs and also means wages and includes net income from fees.

Minn. Stat. § 353.01, subd. 10(a)(1). Employer-paid amounts are not treated as compensation in the employees’ paychecks, do not result in “deductions” from an employee’s pay check, and are they part of a voluntary salary reduction program. Moreover, these payments do not further the legislative pension goal of providing a retirement benefit replacing the employee’s cost of living since it is not money otherwise available to the employee.

2. Excluding employer-paid deferred compensation from the definition of salary is consistent with Minn. Stat § 356.611 and applicable federal pension law.

Salary is subject to the limitations of section 356.611. Section 353.01, subd. 10(a) (2008), Federal law places restrictions on the amount of benefits that can be earned each year and the month of benefit that can be paid. The limits are based upon “compensation” In determining “compensation” for pension contributions and benefits, federal law distinguishes between “elective deferrals”, i.e., deferred compensation amounts determined by an employee

under a written agreement, and “non elective deferrals,” i.e., employer-paid amounts where the employee has limited choice. Tracking federal law’s limitations on maximum benefit and contribution limits, Minn. Stat. § 356.611, subd. 4, defines compensation as a member's compensation “actually paid or made available for any limitation year including items described in federal treasury regulation section 1.415(c)-2(b) and excluding items described in federal treasury regulation section 1.415(c)-2(c). It includes elective deferrals, but not employer paid deferrals. *Id.*

Employer contributions to a deferred compensation account are not “actually paid” nor are they made available to an employee., i.e., they cannot choose to have cash instead. In addition, compensation does not include non-elective deferrals. *See* Minn. Stat. § 356.611, subd. 4. Treasury Regulation 1.415(c)-2(b)(c) specifically excludes from compensation contributions made by an employer to a plan of deferred compensation to the extent that the contributions are not includable in the gross income of the employee for the taxable year in which contributed. The requirements of § 356.611 and federal law support finding that employer contributions are not “salary.” Moreover, their inclusion would not further the legislative intent to have a pension benefit replace an employee’s cost of living since it is not money otherwise available to the employee.

3. The deferred compensation contribution is a choice given Duluth’s employees as part of a flexible spending account and/or a cafeteria plan, and is excluded from salary under section 353.01, subd. 10 (b)(2)

State law does not define the terms “cafeteria plan” and flexible spending account.” The IRS defines a cafeteria plan as: “A cafeteria plan, including a flexible spending arrangement, is a written plan that allows your employees to choose between receiving cash or taxable benefits for which the law provides an exclusion from wages. If an employee chooses to receive a qualified

benefit under the plan, the fact that the employee choose a taxable benefit instead, will not make the qualified benefit taxable.” See IRS Publication 15-B, Employer’s Tax Guide to Fringe Benefits.” In layman terms, a cafeteria plan is a way to provide an umbrella for all types of benefits that are generally excludable from income tax under the IRS Code as fringe benefits or health benefits. Benefits that are excludable from the gross income of an employee under a specific section of the Internal Revenue Code may be offered under a cafeteria plan. See IRS Regulation 1.125-2, Miscellaneous Cafeteria Plan Questions and Answers at p. 8, sec. 1.125-2T, Q-1; Publication 15-B (2010), Employer’s Tax Guide to Fringe Benefits. Cafeteria plans generally involve qualified benefits which do not defer the receipt of compensation but the benefit is non-includable in an employee’s gross section by reason of an expressed provision in the IRS Code. *Id.* Regulation 1.125-2, Miscellaneous Cafeteria Plan Questions and Answers.

The employer deferred compensation contributions, particularly those given as a choice within the City of Duluth’s insurance benefit plans, are excluded from “salary” since they are paid under cafeteria/flex benefit styled plans. They fit the intent of the exclusion: to exclude from salary amounts paid by an employer which an employee may choose to direct towards non-taxable or tax-deferred accounts.

4. Excluding employer-paid deferred compensation contributions from salary is consistent with federal and state regulation of deferred compensation plans.

The CBAs in this case do not identify the particular type of “deferred compensation account” that each employee may have, nor do PERA records reflect where such monies were deposited since it does not administer deferred compensation plans for public employees; the Minnesota State Retirement System, its Board of Directors, and its Executive Director administer the state program. See Minn. Stat. § 352.965 (2008). However, certain restrictions are placed upon both the governmental subdivision as the employer and upon the employee in order for any

governmental deferred compensation plan to be tax deferred. Tax deferred “457” plans are governed by 26 U.S.C. § 457. Federal law requires a written agreement between the employee and the employer specifying the amount that is to be deferred. *See* 26 C.F.R. part 1, § 1.457-2(b). Federal law allows for non-elective employer contributions. *Id.*, part 1, sec. 457-2.

Amounts deferred (both elective and non-elective) under eligible plans are generally subject to FICA taxes at the time of deferral (when the services are performed) because at that time the amount are usually not subject to a substantial risk of forfeiture. 26 U.S.C. § 457(a)(b)(4).

There are limitations on the amounts that may be deferred to an eligible plan. The limitation amount established under 26 U.S.C. § 457(e)(15) for the year 2009 is \$16,500. In comparison, in 2004, the maximum amount was \$13,000. These amounts are based upon what the IRS defines as “includable compensation.” Includable compensation does not include contributions made by the employer to the plan, to the extent those amounts are not included in the employee’s income for the year in which contributed. *See* 26 U.S.C. §§ 457(e)(4) (c)(3) and 26 U.S.C. part 1.415(c)-2(c). In meeting the maximum amount that can be deferred, however, non-elective employer contributions are included.

The term “annual deferral” is the amount of compensation deferred whether by salary reduction or by non-elective employer contributions. For example:

Employee A is paid an annual salary \$40,000 from which the employee elects to contribute \$5,000 to a 457 plan. The employer makes what is called a non-elective contribution that matches the \$5,000 amount. Employee A’s includable compensation for determining the maximum contribution amount is \$35,000. The employer contribution is added to the elected deferral in order to determine whether the limitation had been reached.

Since the maximum amount for the year 2009 cannot exceed \$16,500, the contributions of \$10,000 do not exceed limitations. *See Lesser and Powell*, 457 Answer Book, 5th Ed., Aspen Publishers 2007 at 2-34 ? 2.61 and 2-75 ? 2; 160.

State law, other than PERA law, places severe limitations on a governmental entity's ability to contribute to a supplemental pension or deferred compensation plan. Under Minn. Stat. § 356.24, subd. 1(5), governmental subdivisions (state colleges and universities exempted) are authorized to contribute an employer contribution matching the employee contribution on a dollar-for-dollar basis "but not to exceed an employer contribution of 1/2 half of the available elective deferral permitted per year per employee, under the Internal Revenue Code." Prior to 2008, this section limited employer contributions to \$2,000 per year.⁷ The \$2,000 limitation had been the law at least since 1995. The law also limits the type of plans to which contributions may be made. Authorized accounts for employer matching contribution is to the State of Minnesota, Deferred Compensation Plan or "any other deferred compensation plan offered by the employer under section 457 of the Internal Revenue Code." Minn. Stat. § 356.24, subd. 1(5)(i)(iii) (2008).

Consequently, excluding employer contributions from the definition of salary is consistent with the federal and state requirements for governmental deferred compensation plans;

PERA's Executive Director and correctly found that the deferred compensation payments were not eligible salary for PERA pension purposes.

C. Employer paid insurance supplements are fringe benefits and not salary.

Most of the reasons for not including employer paid deferred compensation as salary apply equally to the various insurance supplements provided under the CBAs. Insurance supplements do not fit the general definition and they are not amounts received by or deducted

⁷ See Laws 2008, ch. 349, art. 11, sec. 6. The 2008 law was effective August 1, 2008.

from the employees' pay-checks. They are the types of compensation that in 1993 and 1994 were intended by the legislature to be excluded from the definition of salary.

PERA is not the only public pension fund that found a need to strengthen its definition of salary in the 1990s. In 1992, the Teachers Retirement Association's ("TRA") definition of salary was limited by legislative action. It defined salary as "compensation before reductions for employee selected fringe benefits" and excluded, "payments in lieu of employer paid group insurance coverage." See Minn. Stat. Sec 354.05, subd.35(b) (1992). In *Stang v. Minnesota Teachers Retirement Ass'n Board of Trustees*, 566 N.W.2d 345 (Minn. App. July 15, 1997), a teacher worked under a 1992-93 CBA that provided that a certain amount (\$3,810) would be added to the salary of each faculty member for flexible benefits. At the time, the employer did not offer an insurance program. Stang chose to take the money in cash. TRA claimed the money was "in lieu of employer- paid insurance. The court disagreed, finding that the plain language of the statute excluded payments from salary "in those situations where an employer provides group insurance to all employees, but an employee declines to accept such coverage, and the employer compensates that employee with payments representing the cost differential." *Stang*, 566 N.W.2d at 348.⁸ The court reasoned that in such a situation, an employee who receives the additional funds because he declined coverage should not be able to have a higher salary for the purposes of calculating retirement than those employees who accepted group insurance from the employer. Since the employer did not offer an insurance plan, the statute could not apply. The court's rationale still applies: through choices made on how to spend fringe benefits, an employee should not receive a higher pension than the employee who uses all available payments for the cost of insurance or other flexible benefits. In particular, increased payments to those employees who

⁸ Prior to the *Stang* decision, in 1994 TRA had already amended its definition to provide uniformity with the PERA definition. See Minn. Stat. § 354.05, subd. 35 (2008).

chose single insurance coverage rather than the more costly dependent or family coverage, should not mean they receive higher pensions than those who chose higher insurance coverage's or another form of tax-deferred benefit. Pension benefits are based upon salaries, not fringe benefits. Pension benefits are based on salaries not fringe benefit levels.

Consistent with the Executive Director's authority under Minn. Stat. § 353.01, subd. 10, b(2) (2008), PERA's Executive Director correctly found that the insurance supplements were not eligible salary for PERA purposes.

II. EQUITABLE REMEDIES SUCH AS ESTOPPEL AND LACHES DO NOT BAR PERA FROM FOLLOWING THE REQUISITE OF THE LAW.

A. Pera's statutory duties require it to recover overpayments and reduce benefits that are based on ineligible salary.

PERA pension plans are administered by the PERA Board of Trustees ("PERA Board"). *See* Minn. Stat. § 353.03, subd. 1 (2008). The PERA Board is authorized to "pass upon and allow or disallow all applications for membership in the fund and allow or disallow claims, withdrawals, pensions, or benefits payable from the fund." *See* Minn. Stat. § 353.03, subd. 3(5) (2008). Minn. Stat. § 353.18 provides that the "final power" to determine the status of any individual and the employee of any governmental subdivision, for the purposes of the PERA law, is vested in the board and their determinations shall not be disturbed unless found to be arbitrary and capricious. *See* Minn. Stat. § 353.18 (2008).

Minn. Stat. § 353.27 (2008) directs the PERA Board on the steps it must take when erroneous contributions are received and excess benefits are paid based upon those contributions. When erroneous contributions are made to PERA that result in overpayments to members, PERA's duties are straightforward:

Employer contributions and employee contributions taken in error from amounts that are not salary under section 353.01, subd. 10, are invalid upon discovery by the association and must be refunded as specified in paragraph (d).

Minn. Stat. Sec. 353.27, subd. 7(2)(c) (2008). Subpart (d) of section 353.27 directs PERA to adjust benefits and recover overpayments:

In the event that a retirement annuity or disability benefit has been computed using invalid service or salary, the association must adjust the annuity or benefit and recover any overpayment under subdivision 7b.

Minn. Stat. sec. 353.27, subd. 7(d). (2008). Minn. Stat. § 353.27, subd. 7(b) (2008) provides:

Overpayments to members. In the event of an overpayment to a member, retiree, beneficiary, or other person, the executive director shall recover the overpayment by suspending, or reducing the payment of a retirement annuity, refund, disability benefit, survivor benefit, or optional annuity payable to the applicable person or the person's estate, whichever applies, under this chapter until all outstanding money has been recovered.

Minn. Stat. section 353.27, subd. 7b (2008).⁹

The law is clear: Contributions made on amounts that are not salary must be refunded and PERA must reduce benefits and attempt to recover overpayments that resulted from the inclusion in salary of ineligible amounts such as the payments at issue in this proceeding. The PERA Board are fiduciaries and are required to follow the law. Minn. Stat. § 353.56 (a) .05, subd. a, subp. 3 (b).¹⁰

B. Civil Equitable Remedies Cannot Bar PERA From Following The Law.

Minnesota courts have long held that an estoppel cannot be applied against a public pension plan where the plans or its board of trustees lacks the authority to act. *In the Matter of the Application for PERA Retirement Benefits of Michael McGuire*, 756 N.W.2d 517, 519-20

⁹ These requirements have been part of the PERA law since at least 1994. *See*, Minn. Laws, ch. 353.27, subd. 7 (c) and (d) (1994).

¹⁰ Even if the state law was not straightforward, in order to maintain its status as a qualified plan, PERA believes it has the same obligations under federal IRS law.

(Minn. Ct. App. 2008), *review den.* Dec. 16, 2008. In *McGuire*, McGuire challenged a PERA determination that he was ineligible for retirement benefits because he did not complete a continuous separation for 30 days from employment as required under the PERA law. McGuire claimed that he was never told by PERA about the 30 day separation requirement although he counseled with PERA representatives on a number of occasions. On appeal, McGuire claimed that the PERA Board should be reversed since it refused to hear his equitable estoppel claim. Following the Supreme Court's decision in *Axelsson v. Minneapolis Teachers' Retirement Fund Ass'n*, 544 N.W.2d 297 (Minn. 1996)(promissory estoppel cannot apply where a pension board has no authority to act), the court held that because the retirement benefits McGuire received were unauthorized, estoppel could not be applied to cause PERA to make those unauthorized payments, nor could PERA be estopped from rescinding the erroneous payments.¹¹

Of particular guidance for this issue are several unpublished opinions regarding claims of estoppel or reliance against PERA on salary issues:

¹¹ McGuire characterized his claim as one of "equitable estoppel," though based upon what he claims were misrepresentations of law. Several public pension cases have addressed the terms "equitable" and "promissory" estoppel without distinction. See *In the Matter of the Retirement Benefits of Robert W. Larson*, 1996 WL 310344 (Minn. Ct. App. (unpublished) June 11, 1996); *In Matter of Ogren*, 1007 WL 118254 (Minn. Ct. App. (unpublished) March 18, 1997). In a case not concerning a government agency, *Heidbreder v. Carton*, 645 N.W.2d 355, 371 (Minn. 2002), the court treated equitable and promissory estoppel the same:

A party seeking to invoke the doctrine of equitable or promissory estoppel has the burden of proving (1) that promises or inducements were made; (2) that (he) reasonably relied upon the promises; and (3) that (he) will be harmed if estoppel is not applied.

Heidbreder, *supra*, 645 N.W.2d at 371. Accordingly, Respondent believes the holdings in *Axelsson* and *McGuire* apply, whether the claim is characterized as "promissory" or "equitable" estoppel.

The first is *In the Matter of the Retirement Benefits of Robert W. Larson*, 1996 WL 310344 (Minn. Ct. App. (unpublished) June 11, 1996). In that case, Larson retired and began receiving PERA retirement benefits. PERA subsequently discovered that during his last year of his employment Larson received payments for of what were characterized as “income reserve payments,” reported to PERA as salary. Income reserve payments were based upon Larson’s accumulated unused sick leave. Therefore, PERA claimed they were not eligible salary and sought to reduce Larson’s retirement benefits. Larson claimed PERA was estopped from reducing his benefits. The court noted that under Minn. Stat. § 353.27, subd. 7(b) (1994) the executive director of PERA had the affirmative duty to recover any overpaid benefit amounts. *See Larson* at p. 3. The court applied common law standards of estoppel in rejecting Larson’s claim finding “(1) there was no showing a fault or wrongful conduct on the part of PERA, (2) because Larson was not entitled to the benefit amounts initially awarded him, he suffered no recognizable harm, and (3) there is no detriment when one is not able to retain money that should never have been received in the first place. Therefore, PERA was not estopped from reducing his benefits or from collecting overpayments he had received. *Larson* at p. 5: *See also, Application of Allers*, 533 N.W.2d 646, 651 (Minn. Ct. App. 1995), *rev. den.* (Minn. August 30, 1995).¹²

In a teacher retirement case, *In Matter of Ogren*, 1007 WL 118254 (Minn. Ct. App. (unpublished) March 18, 1997), retirement estimates given Ogren included payments in lieu of “employer paid group insurance coverage” and “employer paid fringe benefits.” Thus, the estimates were calculated improperly and the court found that TRA could not use those amounts

¹² It is noted that the *Axelsson* case was decided by the Supreme Court on March 8, 1996. *Larson*, decided on June 11, 1996, did not cite to *Axelsson* but rather applied common law standards of estoppel to find that PERA could not be estopped.

in calculating Ogren's monthly annuity. Since the retirement association did not have the authority to calculate Ogren's benefits by using a different definition of "salary" from that provided under the TRA law, the court found that neither promissory or equitable estoppel could be employed to "vouch safe" the pre-retirement estimate that Ogren claimed he relied upon. *Ogren*, p. 2. (neither promissory nor equitable estoppel can be employed where the retirement fund has no authority to apply a definition of "salary" different from that provided by statute).

Other cases with similar holdings include; *Wohlwend v. Duluth Teachers' Retirement Fund Association*, 2002 WL 1163620 (Minn. Ct. App. (unpublished) June 4, 2002) (promissory estoppel cannot be used to require the board to take action that is not authorized by statute); *Kath v. Teachers Retirement Association*, 2003 WL 22707503 (Minn. Ct. App. (unpublished) November 18, 2003) *review denied*, January 20, 2004 (promissory estoppel cannot apply where pension board lacks authority to grant credit for a certain kind of leave of absence). Copies of these unpublished opinions are supplied with this memorandum.

Like the issues involved in the afore-cited cases, the PERA Board has no authority to deviate from the statutory definition of salary that is set forth under Minn. Stat. § 353.01, subd. 10 (2008). In addition, even if common law equitable principles of estoppel could apply in this proceeding, the factors that would support application of the doctrine are lacking. PERA had no notice prior to 2008 of the nature of the compensation that the City of Duluth was claiming as salary, *See Vanek Aff'd.*, made no misrepresentations or promises to Petitioners regarding what would constitute salary, and Petitioners have not been prejudiced since they will receive all that the retirement law authorizes them to receive as benefits.

By the same rationale, the doctrine of laches cannot be applied against the Board, estopping it from performing its mandatory duties. The doctrines of estoppel and laches are

similar. *Hanson v. Summers*, 105 Minn. 434, 117 N.W. 842 (1908); *Chevlin v. Chevlin*, 96 Minn. 398, 105 N.W. 257 (1905). The basic purpose of laches is to prevent one who has not been diligent in asserting a known right from recovering at the expense of one who has been prejudiced by the delay.

Laches is an equitable doctrine available to “prevent one who has not been diligent in asserting a known right from recovering at the expense of one who has been prejudiced by the delay.” *Winters v. Kiffmeyer*, 650 N.W.2d 167, 169 (Minn. 2002). In deciding whether laches applies to bar a claim, the question is whether there has been such “unreasonable delay in asserting a known right,” resulting in “prejudice to others,” such that the relief prayed for should be denied. *Id.* at 170. In *State of Minnesota ex rel. Speaker of House of Representatives Honorable Steve Sviggum, et al. v. Hanson in his official capacity as Commissioner of Finance*, 732 N.W.2d 312 (Minn. Ct. App. May 22, 2007), the court stated “the equitable doctrine of laches is available to prevent the granting of relief to a party who has unreasonably delayed the assertion of a legal right and has thereby prejudiced others and made it inequitable for the court to grant the relief requested, citing *Eronovich v. Levy*, 238 Minn. 237, 242, 56 N.W.2d 570, 574 (1953).

The application of a doctrine of laches in civil actions in Minnesota is best summarized in the case of *Morris v. McClary*, 43 Minn. 346, 347, 46 N.W. 238:

“Where only strict legal rights are in controversy, no neglect in asserting the right, short of the time described by the statute of limitations, will bar the appropriate legal remedy. If the holder of the legal title seeks equitable relief, unreasonable delay in asserting his right may, under the equitable rule as to laches, bar his claim to such equitable relief in less time than would, under the statute of limitations, bar his legal remedy. Where there is no estoppel, his legal remedies will be barred only by the statute of limitations. Where a party is seeking a legal remedy upon a legal right, the courts have held that the doctrine of laches has no application and that the remedy sought will only be barred by the statute of limitations.”

See Eronovich v. Levy, at 241, 574, citing *Morris v. McClary*.

The doctrine of laches has no application when a party is seeking a legal remedy upon a legal right and the remedy is not otherwise barred by the statute of limitations. *Bahr v. City of Litchfield*, 404 N.W.2d 381 (Minn. Ct. App. 1987). Laches is strictly an equitable defense as distinguished from the absolute defense of a statute of limitations. *Sinell v. Sharon*, 206 Minn. 437, 298 N.W. 44 (1939).

The PERA Board lacks the authority to apply laches to restrain itself from following the mandates of the law

C. Statutes of Limitation That Apply To Civil Actions In District Court Do Not Apply To This Proceeding.

The PERA law that applies to this proceeding does not bridle PERA with a time limitation within which to correct erroneous contributions and recover the overpaid benefits that result. *See* Minn. Stat. § 353.27, subd. 7(b) (2008). Prior to 1990, § 353.27 contained a three-year statute of limitations but the statute was amended in 1990 to allow erroneously taken deductions to be re-funded “at any time.” Minn. Laws 1990, ch. 570, art. 11, sec. 5 *See In the Matter of the Retirement Benefits of Robert W. Larson*, No. C7-95-2512, 1996 WL 310344 (Minn. Ct. App. (unpublished) June 11, 1996); In 1991, subpart 7(b) was added requiring the suspension of benefits, “until all outstanding money has been recovered.” Act of June 5, 1991, ch. 341, § 11; 1991 Minn. Laws 2534. Moreover, in 2009, the law was again amended to place a three year limitation on the correction of erroneous contributions and deductions and resulting overpayments. Act of May 22, 2009, ch. 169, art. 4, sec. 11; 2009 Minn. Laws 2328-2329.

PERA's discovery of the payments in this proceeding occurred in 2008, and the payments occurred from 1996 through 2007. During this time the law did not provide a time limitation on PERA's actions:

Where the applicable law does not contain a time limitation on administrative action, the Courts have not provided one.

Nicholson v. Independent Sch. Dist. #636, 1992 WL 48113, (Minn Ct. App. (unpublished) 1992).

PERA is not aware of any other statutory limitation of action that would apply. Since at least 1975, the Minnesota courts have ruled that the time limitations in Minn. Stat. § 541.05 apply only to judicial proceedings. *Har-Mar, Inc. v. Thorsen & Thorson, Inc.*, 300 Minn. 149, 153, 218 N.W.2d 751, 754 (1974); *Lucas v. American Family Insurance Co.*, 403 N.W.2d 646, 650 (Minn. 1987). Other jurisdictions have concluded similarly where public pensions are involved. *See, City of Oakland v. Public Employees' Retirement System, et al.*, 95 Cal. App. 4th 29, 47-48, 115 Cal. Rptr.2d 151 (Cal. App. 3rd Dist. 2002)(administrative hearing is not a "civil action" and the California Pension Board is not a "court" even though it exercises a power judicial in nature.): *See also, Hosni Nagib-Fahmy v. Medical Board of California*, 38 Cal. App. 4th 810, 816 (Cal. Ct. App. 2d Dist. 1995)(statute of limitations cannot be created by judicial fiat).

There is no legal basis to assert that the PERA Board should invent or "borrow" from the civil law a time limitation on its duty to correct the mistakes caused by erroneously reported compensation.

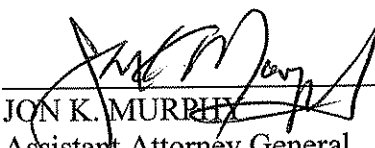
CONCLUSION

The Administrative Law Judge should recommend to the PERA Board of Trustees: (1) that employer-paid deferred compensation payments and insurance supplement payments are not "salary"; (2) that the determinations of PERA's Executive Director are in accord with Minn. Stat. §353.01, subd. 10 (2008); and (3) that neither equitable principles nor statutory time limitations estop the PERA Board from pursuing its duties under Minn. Stat. § 353.27, subd. 7 (2008).

Dated: 12/31/09

Respectfully submitted

LORI SWANSON
Attorney General
State of Minnesota



JON K. MURPHY
Assistant Attorney General
Atty. Reg. No. 0076508
445 Minnesota Street, Suite 900
St. Paul, MN 55101-2127
(651) 757-1385 (Voice)
(651) 296-1410 (TTY)

ATTORNEYS FOR PERA
BOARD OF TRUSTEES