



**POLICY ISSUE #4, cont'd**

Other school employees who are STRS members (e.g. psychologists, reading specialists, language specialists, and resource teachers) and who are employed to perform creditable service that, while common to all employers, may be unique within the individual employment setting would also be impacted by the prohibition against a class of one. The Plan Design Task Force questions whether it is appropriate to require employees who perform unique duties to be grouped with other employees who do not share job similarities related to the nature of the work being performed.

The second concern with the definition of "class of employees" is that the definition was not intended to apply to the determination of creditable compensation. The definition was added to the Law to facilitate the determination of "full-time". While it was not intended that the definition of "class of employees" would apply to the determination of creditable compensation, the Plan Design Task Force finds that the definition nevertheless will apply. Since a class of one is not currently prohibited in the Law for creditable compensation purposes, the new definition represents an unintended change in policy.

**POLICY ISSUE #5 - RESTRUCTURE OF COMPENSATION**

**Recommendation:**

Salary increases resulting from the restructure of compensation should be creditable compensation based on the same criteria that are applied to any other salary increase. However, salary increases that result from the restructure of compensation during a member's final compensation period if the member is in a class of one should be excluded from the definition of "creditable compensation" under a rebuttable presumption that the salary increase was granted for the purpose of enhancing ("spiking") benefits.

**Discussion:**

A salary increase that is provided by the employer to an entire class of employees may be considered creditable compensation under the authority of Section 22114(a)(1)&(4) regardless of the source of funding. The relevant issue regarding an increase in salary is whether the amount of the increase is really "salary", or whether it actually retains the characteristics of benefits or expenses provided by the employer. The Plan Design Task Force has developed a list of suggested guidelines to assist in making this determination. The list of guidelines is included with this Board item as Exhibit I.

**POLICY ISSUE #5, cont'd**

Fringe benefits paid for by the employer in lieu of salary and money paid, allocated, or reimbursed for job-related expenses are not creditable compensation under the current provisions of Section 22114(b)(7) of the TRL. The Law, however, does not currently address the situation that occurs when an employer stops providing these benefits or expenses and restructures employee compensation to provide an increase in salary comparable to the amount that was previously used to provide fringe benefits or job-related expenses.

Such salary increases have previously been determined not to be creditable compensation primarily because of a perceived negative impact on funding. However, in discussions with the System's consulting actuary the Plan Design Task Force was advised that funding of the plan is achieved on a long-term basis. Salary increases are routinely included in actuarial assumptions when an experience analysis is performed. Salary increases are expected to occur periodically throughout a member's career, and the source of funding for a salary increase is not a critical element in the determination of whether or not any particular increase is creditable compensation. The actuary indicated that it is not necessary to treat a salary increase one way or another based on the source of funding. For these reasons, it is likely that an attempt by STRS to exclude from creditable compensation all salary increases that result from the restructure of compensation even if done for an entire class of employees would be considered inappropriate.

The actuary has advised that as employers react to changing tax law and attempt to contain costs by making changes in their compensation arrangements with employees, it is appropriate for the System to recognize and address these resulting changes. If a restructure of compensation is implemented for an entire class of employees, and if the group is not age or service biased, a salary increase that results from the restructure would not have an adverse effect on the integrity of the fund regardless of the size of the class of employees for whom the restructure is implemented.

Inclusion of a rebuttable presumption in the amendment of "creditable compensation" would permit a salary increase resulting from the restructure of compensation during the final compensation period to be included in creditable compensation for a member who is in a class of one if it is proven that the salary increase was not granted for the purpose of enhancing benefits. It would be assumed that a "class of employees" comprised of more than one employee would, by definition, not constitute benefit enhancement or "spiking" if a salary increase resulting from the restructure of compensation were provided in a member's last three years of employment.

**POLICY ISSUE #5, cont'd**

It should be noted, however, that it would be an inefficient use of resources for the System to monitor all salary increases on each report submitted by every employer because a member's final compensation period is not known until a benefit becomes payable and employees in a class of one are not known to the System. Therefore, the review of salary increases should be done on an audit basis. The audit method is similar to how PERS is addressing the same issue. This would permit the System to review salary increases as a normal part of the audit process, and to require employers to correct employee compensation that has been reported in a manner inconsistent with the provisions regarding creditable compensation. The System does routinely monitor salary increases for members who earn more than a specific salary annually or for salary increases that exceed a specific percentage in any school year. This process may identify some cases of inappropriate compensation reported to STRS, however, it should not be relied on as the primary monitoring process.

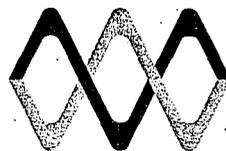
**CLOSING** - Again, it should be noted that the Plan Design Task Force did not find evidence of widespread pension abuse or intentional misreporting of compensation, the Task Force did discover some inconsistent application of the Law on the part of both employers and STRS staff regarding several of the issues discussed herein. Implementation of these policies and the policies on which the Committee has already taken action is important to ensure that the intent of the Law is preserved, that inappropriate salary increases are not included in the calculation of benefits, that all members of the System are treated equitably, and that sound funding principles are maintained.

GUIDELINES FOR DETERMINING "SALARY"

The Plan Design Task Force suggests the following list of criteria be used as a basis for determining whether a salary increase that is derived from funds formerly used to provide fringe benefits or job-related expenses should be included in creditable compensation:

- \* Will the salary increase be paid systematically to an entire classification of employees?
- \* Will the salary increase be paid for the performance of creditable service?
- \* Will the salary increase be added to the applicable salary schedule or contract salary base?
- \* Will the salary increase be included for purposes of calculating future salary increases, COLA adjustments, employer and employee contributions, etc.? (Note: If not, the dollar amount of the former benefit may still be considered creditable compensation even if given on a systematic basis to an entire class of employees.)
- \* Is the target classification of employees for which the employer restructured compensation age or service biased?
- \* Will the target classification of employees have full discretion as to how the increase arising out of the restructured compensation will be spent?
- \* Will the salary increase continue to be included in salary for an indefinite period?
- \* Is the salary increase being granted for the purpose of enhancing retirement or other benefits?
- \* Is the salary increase arising out of the restructured of compensation being paid as an incentive for retirement?

This list is by no means intended to be exhaustive, but rather is merely an indication of the type of inquiry which must take place in order to determine whether the former benefit or expense has actually been restructured to salary.

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March 25, 1996

Ms. Jennifer Morrill  
State Teachers' Retirement System  
PO Box 15275-C  
Sacramento, California 95851

**Re: Creditable Compensation**

Dear Jennifer:

I have been working with you and the actuarial staff for some time on issues related to the definition of creditable compensation. My exposure to the subject has included discussions with staff, reviewing written material developed by the Plan Design Task Force, and written and oral testimony in related litigation on pension spiking.

The Retirement Board has asked for my written comments on Policy Issue #5, Restructure of Compensation, as reported to the Board on March 7, 1996. The following comments are consistent with my previous advice.

1. The System should continue to diligently monitor unusual increases in compensation during a member's final compensation period. There are established procedures already in place to accomplish this review.
2. The System should recognize that employers may wish to react to changing tax law or attempt to contain costs by making changes in their compensation arrangements with employees. For example, the creation of IRC §125 "cafeteria" plans brought on elective salary deferrals which altered the way many pension plans define compensation. For example, employers do not necessarily want pensions reduced simply because an employee chooses to pay for health insurance with pre-tax wages.
3. Most compensation restructuring will be permanent, effectively creating a one-time salary increase. The actuarial valuation treats this no differently than any other salary increase. Because the actuarial valuation is based on assumptions that reflect the actual and projected emerging experience of the System and its members, compensation restructuring

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does not have an adverse effect on the integrity of the funding, regardless of the size of the class of employees for whom the restructuring is implemented. To the extent that restructuring has occurred in the past, we have observed the impact on the assumed salary scale, and are projecting increases into the future.

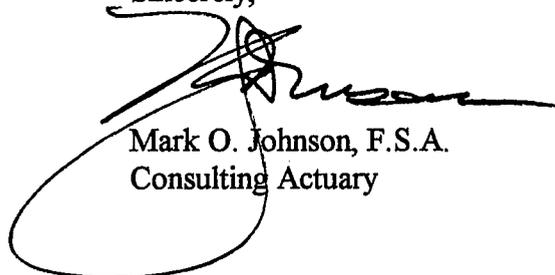
4. Even though compensation restructuring does not, in our opinion, have an adverse impact on the integrity of the funding, it may have a cost impact. This cost impact can be measured by analyzing the benefits a member receives compared to the benefits that would have been received without the compensation restructuring.

However, it is very difficult to assign an absolute cost. Compensation restructuring may come during a contract negotiation and may, for example, be in lieu of an across the board wage adjustment. In addition, to the extent the restructuring occurs in mid-career instead of in the final compensation period, there will be some time to collect and invest contributions on the increased wages.

5. We have identified potential discrimination problems if compensation restructuring is granted to a select group based on age or service criteria. As in the past, we suggest you consult legal counsel on issues related to the continued qualification of the trust.

If you have any questions, please let me know.

Sincerely,



Mark O. Johnson, F.S.A.  
Consulting Actuary

MOJ;j

cc: Bill Rogers

**\*\*\*DRAFT ADMINISTRATIVE DIRECTIVE\*\*\***

**NOTE:** THIS DRAFT ADMINISTRATIVE DIRECTIVE (AD) IS INTENDED TO PROVIDE THE COMMITTEE WITH A CONCEPTUAL VIEW OF INFORMATION THAT WOULD BE PRESENTED IN AN ACTUAL AD ON THIS SUBJECT. THIS DRAFT IS BASED ON THE ASSUMPTION THAT THE COMMITTEE ADOPTS THE RECOMMENDATIONS OF THE PLAN DESIGN TASK FORCE ON THE POLICY ISSUES REGARDING CREDITABLE COMPENSATION.

**SUBJECT:** Restructure of Compensation

**PURPOSE:**

The purpose of this directive is to establish the System's policy regarding the restructure of compensation and to clarify application of the policy to a "class of employees" as defined in Section 22112.5 of the Teachers' Retirement Law (TRL) and stated below.

"Class of employees" means a number of employees considered as a group because they are employed to perform similar duties, are employed in the same type of program, or share other similarities related to the nature of the work being performed. In no event shall one employee be considered a class or group.

**DISCUSSION:**

Section 22114 of the TRL defines "compensation" and "salary" for purposes of determining benefits and contributions. Within that definition, fringe benefits paid for by the employer in lieu of salary are specifically excluded from creditable compensation. The section also states the intent for consistent treatment of compensation throughout the career of the individual member and consistent treatment of compensation for an entire classification of employees.

In the past, System policy has excluded from creditable compensation a salary increase that results from the restructure of compensation to include in salary an amount formerly used to provide fringe benefits. The policy was based on the System's understanding that to permit such an amount to be included in creditable compensation would have an adverse impact on the funding of the State Teachers' Retirement System.

The System has recently reviewed the policy on the restructure of compensation because there has been a significant increase in the number of employers who are taking or considering such action. Previously, a restructure of compensation was limited to the negotiation of individual contracts or to groups of individuals within a class who met an age or service threshold. However, the trend now is for a restructure to be implemented for entire classes of employees who are covered by collective bargaining agreements.

The System's consulting actuary has advised that a salary increase resulting from the restructure of compensation to include in salary an amount formerly used to provide fringe benefits would not have an adverse impact on the integrity of the Teachers' Retirement Fund under the following conditions:

- \* the restructure is implemented for an entire class of employees;
- \* the class of employees for whom the restructure is implemented is not age or service biased; that is, the group is comprised of individuals who share job similarities without regard to the age or the length of service of individual members of the group;
- \* the restructure is not done for the purpose of enhancing benefits payable by the System;
- \* the restructure represents a change in the employer's business practice and is intended to be permanent;
- \* the restructure is not implemented at the member's discretion under an optional provision in his or her contract which allows a restructure of compensation to be requested by the member.

The conditions listed above will provide guidance for staff in determining creditable compensation relative to a restructure of compensation that is implemented for an entire "class of employees." Under the System's policy on application of the definition of "class of employees," creditable compensation will include a salary increase that results from the restructure of compensation for a class of employees when all of the conditions listed above are demonstrated.

When a salary increase results from a restructure of compensation for an individual who cannot be grouped in a class of employees, the salary increase will be excluded from creditable compensation if the restructure occurs within a member's final compensation period and based on STRS determination that the salary increase was granted for the purpose of increasing benefits payable from this System. As such, the salary increase is not creditable compensation.

**ACTION:**

Employers must comply with the System's policy on the restructure of compensation and application of the definition of "class of employees" when implementing a restructure of compensation on and after July 1, 1996. Restructures that occurred prior to that date may be submitted to the Compliance Unit of the Office of Audits for review on a case-by-case basis to determine whether or not prior decisions were consistent with existing statutes.

## CREDITABLE COMPENSATION

A variety of tools are utilized by the System for educating employers and monitoring compliance with the statutory provisions relative to the definitions of "compensation/salary" and "class of employees". These tools are briefly described below. The administrative responsibility for monitoring would be within the usual scope of the initial review of employer reporting by the STRS Reporting Section. This would provide the earliest and most efficient identification of potential problem situations.

The Compliance Unit within the Office of Audits would continue to review employment contracts to monitor and ensure employer compliance with statutory requirements regarding the reporting of compensation and to identify certain conditions in employer reports that necessitate closer review. The System would continue to perform regular audits; however, considering the number of employers who report to STRS, the finite resources available for the audit process at any given time, and the fact that auditing is less timely than reviewing employer reports as they are received, the Office of Audits would play a role in the System's overall monitoring effort.

COMMUNICATION DIRECTED TO EMPLOYERS

**Administrative Directive** - Conveys statutory requirements and prohibitions and documents STRS' policy for employers and STRS staff.

**Employer Circular** - A brief written communication from STRS to employers which provides informal information on a single topic. Typically, this communication is utilized to provide employers with immediate information regarding the particular subject and may precede a more detailed discussion and policy statement in an Administrative Directive.

**Reporting parameters and edits** - Establish administrative guidelines and prescribe technical format for employer reporting purposes and provide automated means of reviewing every report of earnings and contributions submitted by every employer.

**County/District Procedures Manual** - Contains detailed instructions on the appropriate reporting of contributions and service for STRS members. Serves as resource for employers during preparation of monthly reports and can be used by employers in training staff.

**Field visits** - On-site discussions between employers and STRS' Reporting staff to review policy and resolve reporting difficulties.

**Telephone contact** - Staff in the STRS Reporting Section and the Compliance Unit are always available by telephone to respond to employers questions regarding appropriate reporting of earnings and contributions.

**Employer Institute** - A training forum presented annually in the northern and southern areas of the State which permits STRS to inform employers of various requirements on the full range of benefits available from the System and permits employers to obtain clarification and direction regarding reporting issues and other matters of concern.

**Contract review** - A function performed by the STRS Compliance Unit. Through the contract review process STRS can identify actions that are inconsistent with statutory or administrative requirements and resolve problems before earnings and contributions are reported to STRS. This function can also encompass review of salary schedules which would further enable STRS to determine whether or not employer practice is consistent with established statutes and guidelines.

#### COMMUNICATION DIRECTED TO SYSTEM MEMBERS

**STRS Bulletin** - A publication distributed semi-annually to provide members with information on a variety of topics regarding their membership in the STRS Defined Benefit Plan.

**Retirement counseling interviews** - Formal discussions between one System member and one trained counselor through the Regional Counseling Services program.

**Pre-retirement Workshops** - Presentations by Regional Counselors to relatively large groups of System members.

#### OTHER MEASURES

**TRL** - Legislation will be proposed to amend provisions of the Teachers' Retirement Law regarding the definition of "class of employees" and "creditable compensation". These legislative changes will provide needed clarification and more specific statutory authority for the System in administering the intent of the law.

**Training** - Internal Policy Memoranda will be drafted to clearly inform STRS staff of Board policy regarding application of the definition of "class of employee" and "creditable compensation". To supplement the written notifications, training sessions may be held with staff in the Reporting Section and the Compliance Unit to provide a forum wherein staff may ask questions and receive verbal responses to resolve any potential misunderstandings. Training could also include preparation of a simple "job-aid" to which staff could routinely refer during performance of assigned tasks.

**Member Outreach** - The effort to inform members of STRS policies could include development of a "Creditable Compensation" pamphlet which would address the most common situations that are likely to occur throughout a member's career. A more informed membership may enhance compliance with statutory provisions and may minimize the need for post-audit reporting changes.

## DISCUSSION

Effective monitoring of employer compliance with the provisions on "class of employees" would rely predominantly on 1) the Administrative Directive and the County/District Procedures Manual to convey and provide written documentation of statutory requirements and STRS policies, and 2) on reporting parameters and edits to identify situations where there is a necessity for more direct intervention.

Administrative Directives are sent to all County Superintendents of Schools, District Superintendents of Schools, Community College Districts, and other employers. An Administrative Directive is a formal document that states the purpose of the directive, identifies the scope of the directive, sets forth the required action, and discusses STRS policy on the subject of the directive.

The County/District Procedures Manual is intended to be a guide for county and district staff responsible for reporting member earnings and contributions to STRS. The manual covers the main areas of STRS operations and provides an explanation of the most frequently asked questions regarding STRS. The manual includes basic instructions for employer reporting as well as technical detail on the entire monthly report format. Employers are encouraged to make the manual available to all appropriate staff for reference and to instruct staff on use of the manual.

Among the technical detail included in the County/District Procedures Manual are the requirements and specifications applicable to the monthly employer reports. The data reported to STRS must pass an edit exception logic that has both a "history" and a "parameter" check. Data that meets the edit checks is reviewed by a STRS reporting technician and, when necessary, is returned to the report source for correction.

Employers are encouraged to incorporate STRS criteria for determining creditable compensation into the employer data processing programs that produce the monthly reports. When employers incorporate STRS criteria for coding, limits, and logic, errors are minimized and there is a greater chance of the employer submitting acceptable report data. As previously reported to the Committee, STRS monitors changes in member compensation earnable from month to month and year to year. An increase in compensation that exceeds STRS parameters would be detected the first time it is reported.



**BACKGROUND, cont'd**

**Sample Case:** A former Superintendent, who retired from STRS in July of 1987, signed a contract with a third-party consulting firm to perform superintendent duties in a small rural school district from July of 1988 through June of 1994. The Superintendent earned approximately \$60,000 per year for 6 years, without any of the service being reported to STRS and without any monitoring of earnings for compliance with the post-retirement earnings limit. When the case was brought to the attention of STRS, the Superintendent's retirement allowance from STRS had been overpaid by \$213,000.

**PROBLEM**

The current STRS policy regarding earnings from post-retirement employment does not treat retired STRS members equitably. Retired members who are able to enter an agreement to work for a third-party consulting firm, or who become independent contractors, are not subject to the post-retirement earnings limit. At the same time, retired members who perform service as employees of the school district are subject to the earnings limit. This policy was based on the former wording of the law which made the earnings limit applicable to retired members who were "employed by a school district." Since the law was amended by AB 948 (Chap. 394, Stats. 1995) to make the earnings limit applicable to all STRS retired members whether or not the retired member is an "employee" of the school district, the current policy is no longer consistent with the provisions of the law.

In addition to changing the wording of the earnings limit provisions, AB 948 also added a definition of "creditable service" to the TRL. Inclusion of this definition in the law requires STRS to more closely review the type of service performed by retired members when applying the earnings limitation. The law also now provides for exemptions from the earnings limit under specified circumstances to assist financially troubled districts in retaining the services of a retired member with unique critical skills for a limited period of time.

The current law does not exempt persons who are not STRS members and who are retained as true independent contractors from the mandatory STRS membership requirements. The law also is silent with regard to the treatment of persons who are retained as independent contractors, but who are actually "employees" of the district. This discovery is sometimes made by the Internal Revenue Service (IRS). More frequently, however, the discovery is made through the STRS audit process and is often disputed by the audited district.

**RECOMMENDATIONS**

1. Revise STRS' policy regarding independent contractors to be consistent with the definition of "creditable service" and the provisions of Education Code Section 24214. Apply the earnings limitation to all members who are retired for service regardless of whether or not the retired member is an "employee" of the school district effective July 1, 1995.
2. Amend the TRL and continue to exempt persons who are not STRS members and who are retained as true independent contractors from the mandatory STRS membership requirements.
3. With regard to persons hired by independent contractors who are not retired or active members, clarify STRS procedures regarding independent contractors to rely upon the employer's declaration of the person's independent contractor status subject to an IRS finding to the contrary. If the IRS determines that a person retained as an independent contractor is actually an employee, STRS will apply the mandatory membership requirements consistent with the IRS finding.