

# CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM

## BILL ANALYSIS

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**BILL NUMBER:** Senate Bill 525 (Torlakson) – As Introduced 2/18/05

### **SUMMARY:**

Senate Bill 525 reduces the time period a member of the California State Teachers' Retirement System (CalSTRS) Defined Benefit Supplement (DBS) Program, or a participant of the Cash Balance (CB) Benefit Program, must wait before receiving a termination benefit under either program.

### **PURPOSE OF THE BILL:**

SB 525 provides members and participants a higher level of customer service by paying termination benefits after a shorter waiting period, while maintaining a clear standard to prevent in-service distributions of benefits in violation of federal law.

### **BOARD POSITION:**

Sponsor. The Teachers' Retirement Board (Board) believes this bill furthers the System's goal to provide the highest level of customer service possible, while simplifying the administration of benefits. In addition, SB 525 meets a goal identified by the Board in the CalSTRS Strategic Plan to "proactively develop benefits and products that meet customer needs" by providing members with requested funds in a timely manner and reducing unnecessary CalSTRS staff workload.

### **SUMMARY OF PROPOSED AMENDMENTS:**

Staff proposes amendments to specify the six-month waiting period and five-year restriction do not apply to a member who has reached the age at which federal law requires a distribution of funds (currently age 70-½), and members who reach that age during the five-year waiting period will receive an immediate distribution, pursuant to the Internal Revenue Code (IRC). In addition, staff proposes amendments to conform the DBS and CB distribution processes for those members and participants who return to perform creditable service during the six-month waiting period.

### **LEGISLATIVE HISTORY:**

Chapter 74, Statutes of 2000 (AB 1509—Machado), establishes the DBS Program and requires 25 percent of a member's contributions to the DB Program be redirected to separate nominal accounts in the DBS Program until December 31, 2010.

Chapter 1021, Statutes of 2000 (AB 2700—Lempert), makes all compensation for creditable service creditable under CalSTRS and credits member and employer contributions for service in excess of 1.000 year of service per school year to the DBS Program.

Chapter 1048, Statutes of 1998 (SB 2085—Burton), merges the CB Benefit Plan and the DB Plan and establishes them both as programs under the Teachers' Retirement Plan (Plan).

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Chapter 592, Statutes of 1995 (AB 1298—Ducheny), establishes the CB Benefit Plan as a qualified alternative retirement plan administered by CalSTRS as an optional plan for public school employers to offer to part-time employees

**PROGRAM BACKGROUND:**

CalSTRS administers the Plan, which consists of the Defined Benefit (DB) Program, the DBS Program and the CB Benefit Program in accordance with Section 401(a) of the IRC. As such, the Plan maintains certain features in order to retain its tax-qualified status. One of these features includes restricting benefit payments to Plan participants who have not terminated service creditable to the Plan.

The means by which funds are distributed after a termination of service, without the participant retiring or being disabled, differ among the programs within the Plan. In the DBS and CB Benefit Programs, the funds in the employee's account, which generally consist of member/participant and employer contributions plus credited interest, are distributed in the form of a termination benefit. The funds can only be distributed if no creditable service is performed under the Plan for 12 consecutive months after the date employment was terminated. If the member or participant performs creditable service during the waiting period, for example as a substitute teacher, the employer reports the service to CalSTRS. Upon receipt of the service information, CalSTRS cancels the application for a termination benefit and issues a letter of explanation to the member or participant, informing the member or participant of his or her right to re-apply for the benefit. CalSTRS members have the option to either stop performing creditable service and re-apply for the termination benefit, in which case the benefit is paid after one year has passed, or continue performing creditable service and not re-apply for a termination benefit. In addition, only one termination benefit can be paid in the CB Program during a five-year period.

The one-year waiting period for distribution of DBS and CB termination benefits was enacted to ensure a bona fide termination of service has occurred before the member can receive a benefit to remain consistent with the IRC. The waiting period also serves to reduce the incidence of "serial refunding", in which members who do not want to participate in a retirement plan terminate their employment after each school year, take a refund and resume employment in the following school year. Because no service can be performed during the one-year waiting period, a person who returns to employment within 12 months is deemed not to have terminated employment and therefore does not receive his or her termination benefit. The DB Program does not require a waiting period because a refund under that program does not constitute payment of a benefit. If the member terminates service, no DB benefit is paid; instead, the funds in the member's DB account, which consist of only the member's contributions plus credited interest, are refunded. These funds are available immediately after termination of service and payment to the member usually occurs within three weeks of the member's application for termination. By comparison, the return of the member and employer's contributions plus interest under the DBS Program make up the actual benefit available under that program.

Existing law requiring a one-year waiting period for distribution of termination benefits conflicts with the provision providing for a DB refund payment "upon termination" of service. The negative impacts of the DBS/CB termination benefit one-year waiting period include:

- Confusion among members terminating membership in the DB Program;
- A lengthy delay in receipt of termination benefits for members and participants who permanently leave the teaching profession; and
- The System canceling the application for a termination benefit when the member returns to the classroom for even a day.

**ANALYSIS:**

## SB 525:

- Reduces the one-year waiting period to a period of six consecutive months for both members of the DBS Program and participants of the CB Benefit Program before receiving a termination benefit under either program;
- Prohibits the payment of more than one termination benefit under the Plan during a single five-year period.

Reducing the waiting period for receipt of a termination benefit under the DBS and CB Benefit Programs will help diminish the hardship felt by former members and participants who might rely upon these funds for financial security. The change would decrease the waiting period for the nearly two-thirds of members and participants who never perform creditable service under the Plan again after seeking a refund, presumably having left CalSTRS for employment in another state or occupation. Changing the waiting period for both the DBS and CB Benefit Programs also maintains consistency among the programs within the Plan.

SB 525 changes the process for distributing a DBS termination benefit by automatically re-starting the waiting period upon receipt of creditable service information reported by employers; however, the bill does not change the process under the CB Benefit Program. Re-starting the waiting period for DBS members who perform creditable service during the waiting period would result in the member receiving a termination benefit when he or she might prefer to continue working, or plans on working again in the future. In addition, the waiting period could restart multiple times if the member continues to perform creditable service on an on-going basis. CalSTRS recommends amendments to conform the proposed DBS distribution processes to the existing CB distribution process for those members and participants that return to perform creditable service during the six-month waiting period.

SB 525 also establishes a five-year waiting period between applications for DBS Program termination benefits, which mitigates the risk of “serial refunding”; the CB Benefit Program already includes this restriction. Multiple refunds comprise approximately five percent of all refunds sought under the Plan and conflict with the spirit of the law providing for refunds and in-service distribution rules imposed by the IRC. Requiring a waiting period between refunds and termination benefits will discourage members and participants from using their retirement funds for current financial needs in between periods of employment.

The IRC currently requires members to receive a pension distribution on or before the calendar year in which the member reaches age 70-½, if the member has terminated employment. Currently, the CB Benefit Program cancels the participant’s request for a termination benefit and issues a retirement benefit payment when the participant reaches age 70-½ during the waiting period to comply with this IRC requirement. The DB Program issues an immediate refund and the DBS Program distributes an immediate termination benefit when a non-vested member

reaches age 70-½; a vested member is still subject to a waiting period before receiving his or her DBS termination benefit. CalSTRS recommends amendments to specify the waiting period does not apply to members who have reached the age at which federal law requires a minimum distribution of funds (currently age 70-½), and members who reach that age during the five-year waiting period will receive an immediate distribution pursuant to the IRC.

An analysis of termination benefit distributions, using a minimum credited interest rate of 5.25 percent applied to DBS and CB Benefit Program accounts for fiscal year 2003-04, indicates the DBS Program paid \$3.1 million in termination benefits, which included \$162,750 in credited interest; while the CB Benefit Program paid approximately \$196,625 in termination benefits, which included \$10,322 in credited interest. If the waiting period that year would have been six months instead of one year, the loss to the Teachers' Retirement Fund (Fund) would have been approximately \$45,000.

### **FISCAL IMPACT:**

**Benefit Program cost/savings:** A cost of less than \$50,000 to the Fund based on the difference of the potential investment earnings minus the credited interest on the money in terminated DBS and CB accounts awaiting distribution.

**Administrative costs/savings:** One-time cost of less than \$150,000 to modify the corporate database and member communication material.

### **SUPPORT/OPPOSITION**

**Support:** Teachers' Retirement Board (Sponsor)

**Opposition:** None known

### **ARGUMENTS**

#### **Pro:**

- Improves customer service and speeds payment of benefits to the nearly two-thirds of members and participants who refund and do not become members of the Plan again;
- Reduces hardship on members and participants awaiting funds after termination of employment;
- Maintains compliance with the IRC;
- Creates consist standards among the various programs within the Plan.

#### **Con:**

- Does not completely eliminate the waiting period or the resulting member/participant inquiries and complaints.