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Illinois Teachers' Retirement System and Tier II Pension Law: An Overview

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Illinois Teachers' Retirement System and Tier II Pension Law: An Overview

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AAOA	American Academy of Actuaries
AAL	Actuarially Accrued Liability
ADC	Actuarially Determined Contribution
COGFA	Commission on Government Forecasting and Accountability
COLA	Cost of Living Adjustment
DB	Defined Benefit
DC	Defined Contribution
FICA	Federal Insurance Contributions Act
FRA	Full Retirement Age
GAO	Government Accountability Office
GARS	General Assembly Retirement System
IRA	Individual Retirement Account
IRC	Internal Revenue Code
IRS	Internal Revenue Service
JRS	Judge's Retirement System
PIA	Primary Insurance Amount
SERS	State Employee's Retirement System
SSA	Social Security Administration
SSWB	Social Security Wage Base
SURS	State University's Retirement System
TRS	Teacher's Retirement System
UAAL	Unfunded Actuarial Accrued Liability

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1. The Fraught History Behind Creation of Tier II and the Fiscal Problems it Creates

Illinois state government has the responsibility to fund five public pension systems: the Teachers' Retirement System ("**TRS**"); the State Employees' Retirement System ("**SERS**"); the Judges' Retirement System ("**JRS**"); the State Universities Retirement System ("**SURS**"); and the General Assembly Retirement System ("**GARS**").

According to the United States Government Accountability Office ("**GAO**"), to be considered financially healthy, many experts believe a public pension system should have a "funded ratio" of at least 80 percent.[1] A "**funded ratio**" is determined by dividing the current monetary value of a pension system's total assets by its total liabilities to pay benefits to current and future projected benefits to members.

The Pension Protection Act of 2006 also uses an 80 percent threshold for rating large private plans as being not at risk of defaulting on their liabilities.[2] Similarly, Standard & Poor's gives a rating of above average to pension systems that have funded ratios of 80-90 percent, while Fitch Ratings "considers a funded ratio of 70% or above to be adequate and less than 70% to be weak.[3]

The American Academy of Actuaries ("**AAOA**"), however, cautions that, because of various outside economic factors, like volatile interest rates and stock market fluctuations, "no single level of funding distinguishes a healthy plan from an unhealthy plan." [4] Instead, funded ratio just gives a snapshot of where a plan stands fiscally at a given moment in time. According to the AAOA, "while funded ratio may be a useful measure, pension plans should have a strategy to reach "100% funded within a reasonable amount of time." [5]

But whether 80 percent or 100 percent is used as the guideline, as things stand today the state's pension systems are decidedly not healthy. As of November 2022, which is the most recent data available, the state's five pension systems collectively had $248 billion in liabilities, but only $109 billion in assets to cover those liabilities.[6] This results in a funded ratio across all five state systems of just 44 percent, or fully 36 percentage points less than the lower, 80 percent threshold many consider the minimum for being healthy. It also means Illinois state government faces a significant, as in $139 billion, aggregate "unfunded liability"—read that as "debt"—owed to its pension systems.

In a poorly conceived attempt to reduce overall costs for the pension systems, legislators passed Public Act 96–0889 in 2010, which modified the Pension Code by creating a new, Tier II category of retirement benefits that were significantly less than the benefits payable under the state's existing, Tier I plan.[7] Among other things, Tier II provides lesser annual retirement benefits and a lesser cost of living adjustment, while imposing a higher retirement age.[8] These lesser benefits are applicable to all workers eligible to participate in any of the state's five public pension plans hired on or after January 1, 2011.[9]

Unfortunately, lowering benefits to reduce pension costs never made sense from either a policy or fiscal perspective, because all the data demonstrates that Tier I benefit levels neither caused the creation of the state's significant unfunded liability in the first place, nor the explosion in that unfunded liability which has occurred over the last three decades.[10] Instead, as shown in **Figure 1,** fully $57.92 billion, or 42 percent, of the growth in the unfunded liability since 1995 resulted from Illinois making woefully inadequate contributions into the pensions. Meanwhile, benefits accounted for just $5.8 billion, or 4.2 percent of that growth.

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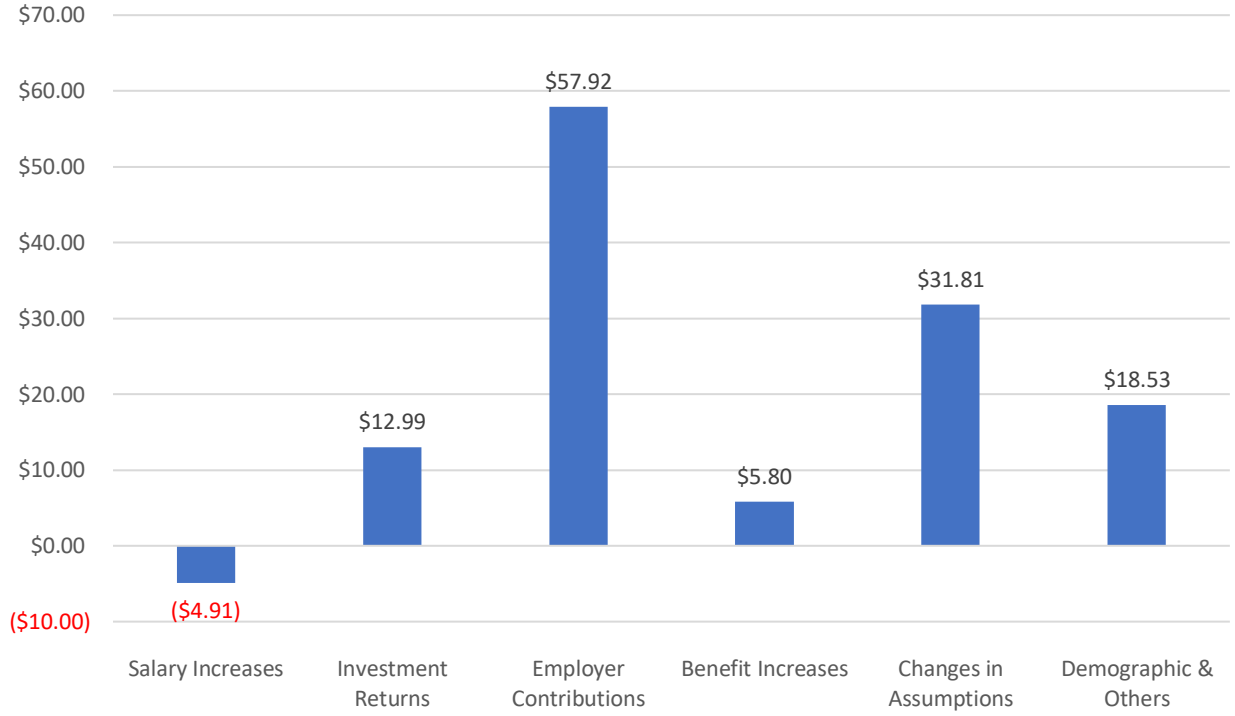
Figure 1
Factors Contributing to the Aggregate Change in Unfunded Liabilities for All Five Illinois State Pension Systems from FY 1996-FY 2021 ($ in Billions)



Source: September 2022 COGFA Financial Condition of Illinois State Retirement Systems

In fact, the fiscal challenges associated with the state's five pension systems have very little if anything to do with the design of the state's pension systems generally, or Tier I specifically. Instead, the real fiscal strain being placed on the state's General Fund today in large part stems from the plan for repaying pension debt that was enacted almost 30 years ago in 1995 and is colloquially known as the "**Pension Ramp**."[11]

Back then, state lawmakers were concerned that after decades of not making adequate contributions into the systems, the state's pensions had a funded ratio of only 54.2 percent, or just over half of the assets needed to cover the benefits owed to workers. So the General Assembly passed, and Governor Edgar signed into law, the Pension Ramp. The Pension Ramp established a 50-year schedule for repaying the significant unfunded liability debt the state had been accruing for years. Supporters of the legislation noted that the Pension Ramp was designed to bring the systems up to a healthy funded ratio of 90 percent by 2045.

But rather than represent a departure from the historical, irresponsible practice of underfunding the annual, actuarially determined contributions that should have gone into the pensions, the 1995 Pension Ramp made things worse. It established a payment schedule that was so inadequate on the front-end, it actually increased the aggregate unfunded debt Illinois owed to its pension systems.

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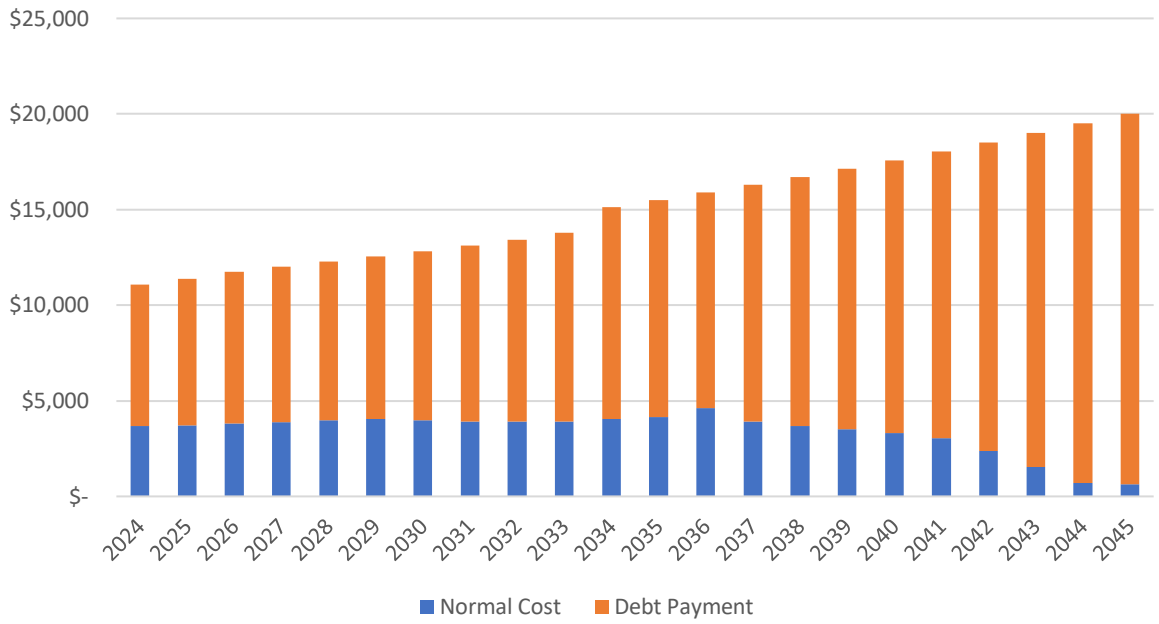
Of course, the only way the Pension Ramp could then get the systems 90 percent funded by 2045 was to backload payments in out years, by making them jump annually in unaffordably high increments, as shown in **Figure 2**

Figure 2
Pension Ramp Payments by Debt Service Versus Normal Cost
FY 2024-2045



Source: CTBA Analysis of 2022 Actuarial Reports for Illinois TRS, GARS, SURS, JRS, and SERS

Indeed, as **Figure 2** makes clear, the normal cost of funding benefits is not in any way driving the fiscal pressure created by the Pension Ramp. Consider that in FY 2024, the total contribution required under the Pension Ramp is $11.066 billion. Of that amount, only $3.697 billion, or 33 percent, is the normal cost, while fully $7.369 billion or 67 percent is the debt service payment going to repaying unfunded liabilities. The Pension Ramp debt service is so backloaded that by 2045 it grows to $19.366 billion, while normal cost drops all the way down to $651 million.

Bottom line: the decision to create Tier II and reduce benefits as a means of saving pension costs was poorly conceived, and failed to address the true drivers of the pension-related funding pressures on the state.

Worse, Tier II not only failed to address the true causes of the state's unfunded liabilities. In fact, it created new pension funding problems for Illinois. Those new problems stem from the very design of the Tier II benefit plan itself.

On the one hand, Tier II provides significantly lesser retirement benefits than pertain under Tier I.[12] For instance, under Tier I, retired workers receive a three percent, annual, cost of living adjustment **("COLA")** to their retirement benefit that provides a real boost to their annual retirement benefit because it compounds over time.[13] Under Tier II, however, the COLA is significantly less valuable than the COLA under Tier I for two reasons. First, the Tier II COLA is calculated using the lesser of either 3 percent or one-half of the Consumer Price Index as of the preceding September.[14]

Second, increases in the COLA under Tier II do not compound from year-to-year. Instead, the Tier II COLA is always computed as a percentage of a retiree's initial, annual pension benefit—meaning no

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compounding and hence a real decline in value and purchasing power over time, that gets worse the longer a Tier II retiree lives.[15] Moreover, the retirement age that qualifies a member to receive full pension benefits is higher under Tier II than Tier I, and the final benefit calculation is averaged over a longer period of time, resulting in a lesser dollar value per year.[16]

Yet despite receiving significantly lesser benefit levels, public workers in the Tier II system pay the same out-of-pocket contributions for their lesser benefits, as do public workers who receive the greater retirement benefits under Tier I.[17] Effectively this means a portion of the contribution made by Tier II workers is not being used to fund their future benefits, but rather to pay unfunded liabilities Illinois owes to Tier I.

Tier II's lesser benefit structure, combined with the requirement that Tier II members pay the same portion of their wages for these lesser benefits as Tier I members pay for their greater benefits, create some significant policy problems for Illinois. For instance, it clearly is not equitable for the state to charge public workers the same contribution rate for lesser benefits than what their peers receive, especially since the workers receiving the lesser benefits are providing the same services to the citizens of Illinois as are their better compensated peers.

Of course, because their benefits are less than what is provided under Tier I, members of the Tier II system have less retirement security than their Tier I peers have. That in turn makes it harder for Illinois to attract and retain public sector workers generally—and teachers specifically—given the significant teacher shortage currently facing the nation.[18]

On top of that, from a purely fiscal perspective, there is a growing consensus that the design of Tier II, which charges its members the same contribution rate as Tier I members but pays a much lower retirement benefit, runs afoul of the exemption created under the Federal Insurance Contributions Act ("**FICA**") that allows states to avoid the cost of enrolling their workers in Social Security.[19] Under the terms of this FICA "**Safe Harbor**," state governments do not have to enroll public sector employees in Social Security—and hence pay into the Social Security system—only for so long as the state's pension benefits are at least functionally equivalent to Social Security.[20]

If in fact Tier II fails to satisfy the Safe Harbor, it seems that Illinois would ultimately be required to enroll its Tier II members in Social Security, and consequently assume the significant cost of making its employer contribution into Social Security for those employees.[21]

The following sections of this report analyze the Safe Harbor issue using data from TRS, which is Illinois' largest pension system by number of enrollees, liabilities, and asset holdings, and provides:

(i) a breakdown of the Safe Harbor requisites established under FICA, and the concomitant Social Security Equivalence standards;
(ii) an overview of TRS;
(iii) a more detailed explanation of why Tier II benefits were created; and
(iv) a basic computation that shows why Tier II benefits do not comport with the Safe Harbor under FICA.

2. The FICA Safe Harbor and Social Security Equivalence Standards

Under the Safe Harbor created in FICA, a state government is exempt from enrolling public sector employees in Social Security for so long as the exempted employees receive a "sufficient pension package" from that state's retirement systems.[22] That begs the question of what qualifies as a "sufficient

pension package." The Internal Revenue Service ("**IRS**") outlined what such a pension package would have to include in the Employment Tax Regulations contained in Section 3121 of the Internal Revenue Code ("**IRC**").[23] Because of the significant design differences between defined benefit or "**DB**" plans, and defined contribution or "**DC**" plans, IRC Section 3121 creates one standard for DBs and another for DCs.[24]

Under a defined benefit plan, members earn a specific monthly retirement payment based on a formula. In general, a DB formula will determine a retiree's monthly benefit payment utilizing some combination of length of employment, retirement age, and a percentage of the retiree's average salary over the last few years of employment. Over time, this benefit is typically increased by a COLA, which can be compound or simple, and continues for the life of the retiree. Under DB plans, retirees are not limited to an individual retirement account with a fixed amount of money that can be exhausted, so the retiree cannot outlive his or her retirement benefit.

DB plans are funded from three sources: the employee's contribution, the employer's contribution, and investment returns earned across all the system's assets. What the employer should contribute to a pension fund in a given year is calculated by actuaries and is typically based on what it would cost annually over the next 30 years to reach a specific funded ratio by the end of said 30-year period.

Under a defined contribution plan, each employee has a separate tax deferred investment account that he or she owns, which is administered and held by the employer. Investment decisions, however, are made by the employee who owns the account in question. This account is typically funded by contributions from the employee and employer, at rates identified in the employment agreement.

When a worker with a DC plan retires, she or he gets whatever assets are in her or his account. Although the employer's contribution into a DC plan is defined, it is not possible to know how much the account will be worth when the employee retires, and in fact all market risks that could cause the value of that account to fluctuate up or down are borne by the employee. The most common DC plans are the Individual Retirement Account or "**IRA,**" and traditional 401(k) account. Although Illinois does offer some DC options, its primary pension plans are DBs.

In pertinent part, the IRS regulations which identify the level of pension benefits that qualify for the FICA Safe Harbor specify that:

- The dominant plan must provide members with an annuity, commencing on or before the Social Security Full Retirement Age ("**FRA**"). The FRA ranges from 65 to 67 years old.[25]
- The annuity provided must equal the value of the Social Security benefit the member would have received at FRA had he or she participated in Social Security.[26]

While that may sound straight forward, it really is difficult to determine, if for no other reason than the benefits payable upon retirement under Social Security on the one hand, and the various state defined benefit pension plans on the other, are calculated in fundamentally different ways, a fact acknowledged by the Social Security Administration itself.[27]

So, to help determine if a defined benefit pension plan meets federal standards, the IRS issued Revenue Procedure 91-40, which outlines distinct "Safe Harbor" formulas a state employer can use to assess its defined benefit and defined contribution plans.

In the DB setting, the formulas focus on whether the benefits being provided to public sector workers who the state claims are exempt from Social Security, qualify as "meaningful" benefits comparable to

those which the employee would have received under Social Security.[28] Essentially, these Safe Harbor formulas set the minimum DB benefit level states have to provide to remain exempt from Social Security, at an amount that is at least equivalent to the Social Security "Primary Insurance Amount" or "**PIA**" for the average wage earner.[29]

The Safe Harbor requisites for defined contribution plans are not incredibly detailed or restrictive, stipulating only that: the total employer and employee contribution must equal at least 7.5 percent of the employee's salary annually, and that certain payout percentage requirements are met (which are detailed more extensively in Section 5 of this Report).[30]

For decades, state pension plans claiming exemption from Social Security, like many in Illinois, easily qualified for the Safe Harbor. However, that is changing. Various economic factors, as well as changes in pension plan design that have been implemented over the last three decades, have all played a role in pushing many state pension plans out of satisfying the Safe Harbor requisites under FICA.[31] These factors have included everything from two, major, stock market downturns—including one that occurred during the Great Recession—to state governments simultaneously reducing the retirement benefits that can be earned by new employees, while failing to make adequate contributions into their respective pension plans.[32]

In fact, a 2020 study ("**2020 SSA Study**") commissioned by the Social Security Administration ("**SSA**") that analyzed a few, select public defined benefit pension plans (including Illinois' TRS) found that 43 percent of the DB benefit formulas sampled for exempt workers, actually fell short of the benefit levels needed to maintain that exemption under Social Security.[33]

According to the 2020 SSA Study, one of the primary reasons formerly exempt state DB plans were now running afoul of the Safe Harbor has to do with how benefit payment amounts are determined and paid. Social Security utilizes a progressive formula tied to wage-indexed earnings.[34] Wage-indexed earnings are defined by the SSA as benefit amounts that are adjusted in line with the Average Wage Index, a method that helps ensure a worker's future benefits reflect the general rise in the standard of living that occurred during his or her working lifetime.[35]

Because of that formula, the benefits payable under Social Security are front-loaded.[36] In contrast, most exempt DB plans use a backloaded formula strongly tilted towards an employee's final-pay. This provides generous benefits to long-tenured workers. Hence most DB plans tend to continue to technically satisfy the Safe Harbor at a member's FRA.[37]

However, because of this backloading, the benefits many state DB plans provide to short- and medium-tenure members are relatively modest.[38] Moreover, state DB plans: frequently require very long vesting periods; are increasingly unlikely to include a full, inflationary COLA; and often allow members to claim full benefits at a younger age than that required to claim full Social Security benefits.[39]

Considered together, the 2020 SSA Study found that these differentials between state DB plans and Social Security in many cases were enough to violate the Safe Harbor requisites for certain employees.[40] So much so, that, as indicated previously, 43 percent of the public plans reviewed by the SSA that claimed exemption from Social Security fell short of the Safe Harbor requisites for members who stayed in their positions for more than a few years, but less than a full career.

This has the potential to be a significant issue nationwide, considering that, according to the 2020 SSA Study, employees who currently make up one-third of the state and local government workforce may no longer be exempt from Social Security.[41]

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3. TRS Overview

TRS is the largest of Illinois' pension systems, by number of enrollees and by asset holdings. As of June 2022, there were 439,000 members in TRS, of which 128,000 are retirees and survivors.[42] TRS also served 992 discreet public sector employers, which included: 851 local school districts; 132 special districts; and nine state agencies.[43]

As of June 2022, TRS had $62.8 billion in assets, determined on a fair market value basis.[44] It also had total liabilities owed to current and future retirees valued at $143.5 billion.[45] This results in a funded ratio of just 43.8 percent.[46]

This means the system does not currently have sufficient assets to cover even half of the sum of the benefits and debt payments it owes. It also means TRS is among the worst funded public employee retirement systems in the United States.[47]

How did the funded ratio for TRS become so abysmally low, especially since TRS members have always contributed their full employee share to the fund?[48] It is because the state's employer contribution has been grossly inadequate for decades. (Read more about Illinois' pension funding crisis in CTBA's report, *Understanding—and Resolving—Illinois' Pension Funding Challenges*).

Moreover, the June 2022 TRS actuarial evaluation highlights numerous actions taken by state decision makers over time that have also resulted in growing the system's unfunded liability, and concomitantly reducing its funded ratio, including:

- Creating the Pension Ramp in 1994, which established a 50-year period over which the Unfunded Actuarial Accrued Liability ("**UAAL**") owed to TRS was amortized;
- Backloading payments under the Pension Ramp's 50-year amortization schedule, in part by establishing artificially low required annual contributions that were less than the full Actuarially Determined Contribution ("**ADC**") for the first 15 years of the Pension Ramp;
- Setting the target for TRS's funded ratio at 90 percent of the Actuarially Accrued Liability (**"AAL**"), as opposed to 100 percent;
- Using the "projected unit cost" method of amortizing the unfunded liability owed to TRS, as opposed to the "entry age normal cost" method. Under the projected unit cost method, each period of service is an additional unit of benefit eligibility, with each unit being measured independently to determine the final obligation. This approach further backloads contributions owed to TRS, resulting in significantly escalating annual payments in out-years. On the other hand, the entry age cost method starts with estimating the full cost of each individual's pension, which it then amortizes on a level percent of payroll basis between the time employment starts (entry age) and the assumed retirement date. So, as opposed to backloading payments, this results in a level dollar payment structure over time. (Note, there are various different pension amortization policies and best practices—for more information see CTBA's report, *Understanding—and Resolving—Illinois' Pension Funding Challenges*);
- Not using all Pension Obligation Bonds proceeds to retire debt payments owed to TRS, but putting TRS on the hook for paying the full POB interest costs associated with those bonds;
- Reducing the annual contributions into the pension systems for the fiscal years ended on June 30, 2006, and 2007, below the amounts initially required under the Pension Ramp;

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- Modifying the method used to value TRS system assets in a manner that reduced the state's contribution to TRS for the fiscal year that ended on June 30, 2011, to an amount below what was initially required under the Pension Ramp, and then further reducing the state's FY 2011 contribution to TRS by requiring TRS to change 2009 liability estimates downward, by assuming Tier II was in effect in 2009, even though it did not pass into law until the following year; and
- Phasing in, rather than immediately recognizing in full, the growth in liabilities caused by changes in actuarial assumptions.[49]

4. Tier II Was Created as a Poorly Conceived Attempt to Save Pension Costs

As indicated previously, in 2010 legislators created Tier II when they passed Public Act 96–0889 into law, in a misguided attempt to reduce overall costs for the pension systems, by creating a second tier of benefits that were significantly less than the benefits payable under the state's existing Tier I plan.[50] As clearly shown in **Figure 1** above, lowering benefits to reduce pension costs never made sense from either a policy or fiscal perspective, given Tier I benefit levels neither caused the unfunded liability in the first place, nor the explosion in that unfunded liability that occurred over the last three decades.

Nonetheless, Tier II was created under P.A. 96-0889, and is the pension plan for any state worker, or TRS eligible employee, hired on or after January 1, 2011. Tier II reduces benefits from what pertain under Tier I in a number of ways, including:

(i) Tier II employees must work five years longer than Tier I employees to be eligible for retirement;[51]

(ii) the final period over which the average final salary is computed is four years longer under Tier II than Tier I, which typically results in a lesser retirement benefit, because more years at lower salaries are included in the computation;[52]

(iii) pensionable salaries under Tier II are currently capped at $119,892, while there is no salary cap for Tier I; and

(iv) the annual COLA adjustment to the retirement benefit earned under Tier II is either 3 percent or one-half of the Consumer Price Index, whichever is less, computed on a simple, rather than compound basis, which results in a lesser COLA adjustment than the 3 percent available under Tier I, which is computed on a compounding, rather than simple basis.[53]

Yet despite receiving significantly lesser benefits, teachers who are members of the of the Tier II system under TRS contribute the same 9 percent of their salary as do teachers in the more generous Tier I system, which is patently unfair. The reason behind the creation of this inequitable contribution scheme is simple: Tier II employee contributions are being used not for the benefit of Tier II members, but to replace state tax dollars that should be used to fund Tier I benefits. Essentially, that portion of a Tier II member's annual, out-of-pocket contribution to the pensions that is not needed to fund his or her lesser Tier II benefits, is being used to replace state dollars that should be going to cover unfunded liabilities created by Illinois' historical failure to make adequate contributions to the systems in the first place.

So how does the subsidy of Tier I benefits being made by Tier II members work numerically? For starters, as of June 2022, the normal cost of funding pension benefits being earned by current Tier I employees

was approximately three times the normal cost of the benefits being earned by current Tier II employees. This reflects both the difference between the benefits being earned by members of Tier I versus Tier II, as well as the relatively older age composition of Tier I versus Tier II members.

As it turns out, the Tier II normal cost in a given fiscal year is currently lower than the aggregate, annual contributions being made into the state pension systems by Tier II members. As a result, a portion of the aggregate dollar contributions being made out of the wages of Tier II members ends up funding both Tier I benefits that are currently being earned, and a portion of the interest on the Unfunded Actuarial Accrued Liability ("**UAAL**")—i.e. pension debt—that the state has incurred to Tier I over decades.[54]

To attain some sense of the scope of this subsidy, it is helpful to disaggregate the funded ratios for Tiers I and II respectively, even though Tier I and Tier II are not typically assessed separately for the purposes of determining funded ratio. However, when the funded ratio is computed separately for the two different Tiers some interesting data emerges.

For instance, as of June 2022, when Tier I of TRS is considered on its own, without inclusion of Tier II, its funded ratio is just 43 percent.[55] That funded ratio value is scheduled to increase to 86 percent by the end of the Pension Ramp on June 30, 2045.[56] By comparison, Tier II was over 100 percent funded in June of 2022, coming in at a funded ratio of 121 percent.[57] Under the Pension Ramp, that funded ratio is reduced over time down to 109 percent by June 30, 2045. While that is still over 100 percent funded, the dollar cost of reducing the funded ratio in Tier II from 121 percent to 109 percent represents the dollar amount diverted from the wages of Tier II members to subsidize Tier I benefits. In economic terms, this constitutes a pay cut for Tier II teachers, since a portion of their wages is being diverted to benefit other employees.

5. The Data Now Indicates that the Tier II Benefit Structure Fails to Comply with FICA's Safe Harbor for Exemption from Social Security

As of today, it appears that the benefits provided under Tier II are not sufficient to continue satisfying the FICA Safe Harbor provisions that allow Illinois to exempt a significant number of public sector workers from being enrolled in Social Security. Recently, the state's Commission on Government Forecasting and Accountability ("**COGFA**") retained the Segal Group, Inc., an independent actuarial consulting firm, to analyze the general benefit formula under Tier II, to determine whether the formula was following the FICA Safe Harbor (the "**Segal Study**").[58]

The Segal Study reviewed various Illinois-state pension plans that now provide Tier II benefits, including TRS, SERS, and SURS. The Segal Study found that the following Tier II formulas do not satisfy the FICA Safe Harbor:

(i) The Tier II benefit formula for SURS Police and Fire Employees with less than 20 years of service; and

(ii) The general Tier II retirement benefit formula for TRS, SERS, and SURS.

To qualify for the Safe Harbor, any pension plan that determines retirement benefits by using a formula predicated on the final average salary paid to a member over a defined number of years prior to retirement—which all these Tier II systems in fact do—must provide its members with a life-long, monthly retirement benefit that is both (a) payable no later than age 65, and (b) at least equal to a dollar amount determined by multiplying a "**Minimum Required Percentage**" (as explained below)

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times the applicable member's final average annual salary as determined under the plan formula (the "**Minimum Qualifying Monthly Retirement Benefit**").[59]

The "**Minimum Required Percentage**" used to determine this dollar amount varies, based on the number of years of employment utilized to calculate the final average annual salary of a member under the defined benefit plan in question. The minimum required percentages used for the different potential terms of employment are delineated in IRS Revenue Procedure 91-50, Section 3 for Safe Harbor formulas.[60]

The Segal Study found that the Tier II benefit packages identified in subparagraphs (i) and (ii) above failed to satisfy this Safe Harbor requirement, because the dollar value of the benefits they provide to members at age 65 are less than the Minimum Qualifying Monthly Retirement Benefit.

Of course, reaching that conclusion involved a somewhat complex series of steps. For starters, under Tier II, the computation of final average salary is based a member's earnings over the last eight years, or 96 months of employment.[61] Under IRS Revenue Procedure 91-50, Section 3, the Minimum Required Percentage used when a member's retirement benefit is determined based on that member's average salary computed over his or her final eight years of employment is 1.75 percent.[62]

So, to be eligible under Safe Harbor, the Minimum Qualifying Monthly Retirement Benefit payable under Tier II had to be equal to at least 1.75 percent of the final average salary of a Tier II member, as determined over that member's last eight years of employment. After running the numbers, the Segal Study found that the final monthly retirement benefit payable to a Tier II member came to 2.2 percent of final average salary (the "**Tier II Monthly Benefit Percentage**"), which is well within the Safe Harbor guidelines.

The problem is that monthly benefit was not payable unless a Tier II member retired at age 67 or older. Under the Safe Harbor, the retirement payment must be available to those who retire at age 65. While Tier II members are eligible to receive retirement benefits at age 65, these benefits are discounted from what they would be if the member in question put off retirement until age 67, at the rate of six percent per year.[63] This in turn required an additional adjustment to determine what the Tier II Monthly Benefit Percentage would be for members who retire at age 65, the maximum retirement age for qualifying under the Safe Harbor.

Doing the math, if a Tier II member retires at age 65, and that member's benefit amount is discounted by six percent per year, her or his monthly retirement benefit will be 12 percent less than what it would have been if retirement was put off until age 67. Reducing the initial Tier II Monthly Benefit Percentage of 2.2 percent of final average salary payable at age 67 by this 12 percent discount, results in a new, adjusted Tier II Monthly Benefit Percentage of 1.936 percent of final average salary payable at age 65. Which is greater than the 1.75 percent threshold required by Safe Harbor, so it is still not an issue.

However, in addition to both establishing a higher retirement age than what is used for the Safe Harbor, and discounting the value of the final monthly retirement benefit for those who retire before age 67, Tier II also caps the dollar value of the salary earned by a member that can be used in the calculation of final average salary. Under Tier II, this cap was $106,800 in annual earnings for calendar year 2011.[64] Thereafter that cap gets increased annually by the lesser of (a) one-half of CPI-U for the prior calendar year, or (b) three percent.[65]

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If the Tier II salary cap on pensionable income excludes compensation that would have been included in the Social Security Wage Base ("**SSWB**"), then yet another adjustment must be made to determine if the final Tier II Monthly Benefit Percentage remains within the Safe Harbor guidelines. As it turns out, for the plan year ending in June 2023, pensionable salary under the Tier II cap is limited to $119,892 per year, which is only 74.8 percent of the corresponding SSWB of $160,200 per year.[66]

To account for this differential, the adjusted Tier II Monthly Benefit Percentage of 1.936 percent derived after accounting for the discount in benefits Tier II imposes for retiring prior to age 67, must be multiplied by the differential between the cap in pensionable salary under Tier II and the SSWB, or 74.8 percent. Multiplying 1.936 percent times 74.8 percent results in a final Tier II Monthly Benefit Percentage of just 1.45 percent—or less than the minimum 1.75 percent required under the Safe Harbor, as shown in **Figure 3.**

Figure 3
Computation of Tier II Monthly Benefit Percentage

Step 1: Multiply the initial Tier II Monthly Benefit Percentage for retirement at age 67 of 2.2 percent times .88 to account for the 6 percent annual benefit reduction Tier II imposes for retiring before age 67, to determine the benefit percentage for members retiring with full benefits at the Safe Harbor age of 65.

This results in a new Tier II Monthly Benefit Percentage of 1.936 percent; and

Step 2: Multiply 74.8 percent—which is the percentage difference between the current annual pensionable salary cap created under Tier II of $119,892 and the Social Security wage base of $160,299—times 1.936 percent, to derive the final Tier II Monthly Benefit Percentage under Tier II of 1.45 percent. This is less than the 1.75 percent required to qualify under the Safe Harbor.

Source: Storm, Matthew. "Impact of Potential Tier II Benefit Formula Change Needed for FICA Exemption," Segal, June 5, 2023

Since the final adjusted Monthly Benefit Percentage under these Tier II plans is less than the minimum required percentage of 1.75 needed to satisfy the Safe Harbor, the Tier II general benefit formulas for TRS, SERS, and SURS members is not sufficient to exempt the state from enrolling employees who receive these benefits in Social Security.

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