JOSH GREEN, M.D.
GOVERNOR

THOMAS WILLIAMS
EXECUTIVE DIRECTOR

KANOE MARGOL
DEPUTY EXECUTIVE DIRECTOR

STATE OF HAWAII
EMPLOYEES' RETIREMENT SYSTEM

TESTIMONY BY THOMAS WILLIAMS
EXECUTIVE DIRECTOR, EMPLOYEES' RETIREMENT SYSTEM
STATE OF HAWAII

TO THE HOUSE COMMITTEE ON FINANCE
SENATE BILL NO. 211 S.D. 2 H.D. 2

March 31, 2023
3:00 P.M.
Conference Room 308 & Videoconference

RELATING TO THE EMPLOYEES' RETIREMENT SYSTEM

Chair Yamashita, Vice-Chair Kitagawa, and Members of the Committee,

S.B. 211 S.D. 2 H.D. 2 proposes to add a new section which provides that service or compensation awarded to an employee by a final court decision, arbitration award, or court-approved settlement shall be considered "service" under Hawaii Revised Statutes (HRS) § 88-21 or "compensation" under HRS § 88-21.5.

The Employees' Retirement System's (ERS) Board of Trustees would support S.B. 211 S.D. 2 H.D. 2, **as currently written**, since it contains the City and County of Honolulu's and the ERS's proposed amendments to S.B. 211 S.D. 2 H.D.1. Absent these current provisions, the ERS and its Board of Trustees would have to oppose.

1. ERS's concerns about S.B. 211; Proposed amendments

The ERS had opposed the original S.B. 211 because of concerns about the bill, including: (1) negative impacts on the ERS's tax-qualified status, due to violation of the "definitely determinable" requirement, the exclusive benefit rule and other IRS requirements; (2) pension spiking; (3) administrative burden; and (4) unwarranted increases in the ERS's Unfunded Actuarial Accrued Liability (UAAL).

In the alternative, the ERS had requested proposed amendments to S.B. 211, which contain safeguards intended to protect the ERS's tax qualified status and prevent negative impacts on the ERS's unfunded liability. See ERS's testimony submitted to Senate Committee on Labor and Technology, dated February 10, 2023.

At a hearing on February 10, 2023, the Senate Committee on Labor and Technology recommended that S.B. 211 be passed with amendments, and the committee adopted the ERS's proposed amendments. See S.S.C.R. No. 342 and S.B. 211 S.D. 1.

On recommendation of its outside tax counsel, the ERS submitted proposed further amendments to S.B. 211 S.D. 1, for compliance with the IRC and protection of the ERS's tax qualified status. At a hearing on March 1, 2023, the Senate Committees on Ways and Means and Judiciary recommended that S.B. 211 S.D. 1 be passed with amendments. However, the committees did not adopt the ERS's proposed amendments. See S.S.C.R. No. 1084 and S.B. 211 S.D. 2.

The ERS submitted proposed further amendments to S.B. 211 S.D. 2, for compliance with the IRC and protection of the ERS's tax qualified status. At a hearing on March 14, 2023, the House Committee on Labor and Government Operations (LGO) recommended that S.B. 211 S.D. 2 be passed with amendments. However, the committee did not adopt the ERS's proposed further amendments, as it was concerned that the City needed more time to review them. See H.S.C.R. No. 1313 and S.B. 211 S.D. 2 H.D. 1.

The ERS and the City have since agreed on proposed amendments to S.B. 211 S.D. 2 H.D. 1. At a hearing on March 21, 2023, the House Committee on Judiciary & Hawaiian Affairs (JHA) recommended that S.B. 211 S.D. 2 H.D. 1 be passed with amendments. The committee adopted the City's and ERS's joint proposed amendments. See H.S.C.R. No. 1511 and S.B. 211 S.D. 2 H.D. 2.

2. ERS's ongoing concerns about the ERS's tax qualified status.

a. ERS's tax qualified status.

The ERS is a tax-qualified governmental plan under the Internal Revenue Code ("IRC"). To maintain its qualified governmental plan status, the ERS plan must be administered according to its "plan provisions" or "plan documents" set forth at HRS Chapter 88 (including HRS § 88-22.5), as well as IRC § 401(a). § 88-22.5 provides that "the [ERS] shall be administered in accordance with the requirements of section 401(a)… of the Internal Revenue Code of 1986, as amended." ERS membership, service credit, compensation, retirement eligibility, and other ERS benefits are governed by, and therefore may only be provided pursuant to, HRS Chapter 88 and ERS administrative rules.

As long as the ERS continues to meet the qualification requirements, the members of the ERS will receive favorable federal income tax treatment of their ERS benefits, and the ERS will receive favorable tax treatment on its investment earnings. Should the ERS be administered in a manner that is inconsistent with HRS Chapter 88

and IRC § 401(a), the ERS's status as a qualified governmental plan would be placed at risk.

The ERS risks disqualification if it fails to follow its plan provisions, including HRS Chapter 88 and ERS administrative rules. *See* 26 C.F.R. § 1.401-1(b)(3) (stating "The law is concerned not only with the form of a plan but also with its effects in operation"); Rev. Proc. 2021-30 at 19-20, 2021-31 I.R.B. 172 (July 16, 2021), § 5.01(2)**.** *See also DNA Pro Ventures, Inc. Emp. Stock Ownership Plan v. Comm'r of Internal Revenue*, 856 F.3d 557, 559 (8th Cir. 2017) ("A plan may be disqualified for operational failures, which occur if a plan fails to operate in accordance with § 401(a) statutory requirements or fails to follow the terms of the plan document"). *See, e.g., Forsyth Emergency Servs., P.A. v. Comm'r of Internal Revenue,* 68 T.C. 881, 891 (1977) (plan that operated in variance with its terms was disqualified by the IRS).

The Legislature has recognized the importance of "[protecting] the status of the Employees' Retirement System (ERS) as a tax-qualified retirement plan" and that disqualification of the plan would negatively impact ERS members and the State of Hawaii:

> Hawaii's ERS is currently a tax-qualified retirement plan under the IRC. Loss of this status would be detrimental to both the ERS and its members, resulting in the pre-tax treatment on member contributions to be eliminated and requiring ERS members to pay federal income taxes annually on the value or increase in value of a member's account without receiving a distribution. This could amount to thousands of dollars in taxes for members.

H.S.C.R. No. 343 (2011).

b. <u>Violation of definitely determinable requirement</u>.

The ERS's tax concerns about S.B. 211 included violation of the IRS's **"**definitely determinable" requirement.

IRC § 401(a)(25) provides that "[a] defined benefit plan shall not be treated as providing **definitely determinable benefits** unless, … the amount of any benefit is to be determined … in a way which **precludes employer discretion**." (emphasis added)

"A pension plan within the meaning of section 401(a) is a plan established and maintained by an employer primarily to provide systematically for the payment of **definitely determinable benefits** to his employees over a period of years, usually for life, after retirement. Retirement benefits generally are measured by, and based on, such factors as years of service and compensation received by the employees." *See* Treas. Reg .§ 1.401-1(b)(1)(i). (emphasis added).

"[I]f, in the case of a defined benefit pension plan, the benefits on behalf of each participant are determined in accordance with a stipulated formula that is **not subject to the discretion of the employer**," the definitely determinable benefit requirements of

§ 1.401-1(b)(1)(i) of the regulations are satisfied. Rev. Rul. 74-385, 1974-2 C.B. 130 (1974) (emphasis added). On the other hand, if the terms of the plan specifically allow the employer to vary the employee's compensation used in the benefit formula, the plan would violate the definitely determinable rule. *See id.*

The ERS must comply with the IRC's "definitely determinable benefit" rule. The definition of compensation in HRS § 88-21.5 was intended to "satisfy the Code's requirement that a member's benefit be 'definitely determinable.'" *See Fratinardo v. ERS*, 129 Hawai'i 107, 114-15, 295 P.3d 977, 984–85 (App. 2013). In 2004, the Legislature made several amendments to HRS Chapter 88 to conform to the requirements of IRC § 401(a). *See* S.S.C.R. 2692, S.S.C.R. 2143, and C.C.R. 122-04 in 2004 Senate Journal.

The ERS's testimony on S.B. 211 provided examples of how S.B. 211, as written, would allow an employer to vary an employee's compensation used in the benefit formula, which would cause the ERS plan to violate the definitely determinable rule.

c. Violation of exclusive benefit rule.

The ERS's tax concerns about S.B. 211 also included violation of the IRS's exclusive benefit rule. The "exclusive benefit rule" is set forth at IRC § 401(a)(2) and HRS.§ 88-22.5(a)(1). IRC § 401(a)(2) provides that a tax qualified plan must make it "impossible, … for any part of the corpus or income to be … used for, or diverted to, purposes other than for the exclusive benefit of his employees or their beneficiaries." IRC § 401(a)(2) and HRS § 88-22.5(a) require the ERS to make it impossible for ERS monies to benefit counties and other State agency employers.

The ERS should not be bound by the employer's and employee's characterization of back pay as compensation. To the extent that a settlement does not include compensation as defined in HRS § 88-21.5, the ERS should not have to assume a portion of the employer's liability for its alleged wrongful conduct (discrimination, suspension, termination of claimant, etc.). The exclusive benefit rule bars any mandate by S.B. 211 that the ERS's corpus and income be used for the benefit of the employer by assuming a portion of the employer's liability for its alleged wrongful conduct. To the extent that S.B. 211 requires the ERS to confer service, credited service and other retirement benefits in a manner that is not authorized by HRS Chapter 88 and ERS administrative rules, this would place the ERS's tax qualified status at risk with potentially severe negative consequences for the ERS and ERS members and beneficiaries.

d. Impermissible Cash or Deferred Election.

A governmental defined benefit plan generally will not satisfy the requirements of IRC § 401(a) if it includes a cash or deferred arrangement. See Treas. Reg. § 1.401(k)-1(a)(1). A cash or deferred arrangement is any direct or indirect election by an employee to have the employer either provide an amount to the employee in cash that

is not currently available or contribute an amount to a trust or provide an accrual or other benefit under a plan deferring the receipt of compensation. See Treas. Reg. § 1.401(k)-1(a)(3)(i).

A settlement between an employee and an employer could provide an employee with discretion as to how a monetary award should be structured. For example, a settlement could be structured to provide the employee with ERS compensation and service as proposed under S.B. 211. Also, a settlement could be structured to provide the employee with a lump sum award that is considered damages and would not result in service or compensation under ERS statutes.

As indicated in the ERS's testimony on S.B. 211, the ERS consulted with its tax counsel regarding the potential impact of S.B. 211 on the ERS's tax qualified status and they indicated in writing that they shared our concerns.

3. ERS's ongoing concerns about unwarranted increases in the ERS's UAAL.

The ERS's testimony on S.B. 211 expressed concern that compliance with awards and settlements as provided in S.B. 211 may result in the ERS's loss of actuarial value should there be untimely/retroactive employer and employee contributions, or employee accrual of benefits. Compliance with such awards and settlement may result in unanticipated and unjustified increases to the ERS's unfunded liability.

The ERS's testimony on S.B. 211 provided examples from the ERS's actuary that illustrated the potential increase in actuarial loss to the ERS.

4. Proposed amendments to S.B. 211 S.D. 2 H.D. 1, which were incorporated into S.B. 211 S.D. 2 H.D. 2.

On recommendation of tax counsel, the ERS submitted proposed further amendments to S.B. 211 S.D. 1, for compliance with the IRC and protection of the ERS's tax qualified status, including compliance with the IRS's definitely determinable requirement.

The House JHA Committee adopted the ERS's and City's proposed further amendments to S.B. 211 S.D. 2 H.D. 1. These proposed further amendments included the following:

(1) Section 3 - definition of "Final resolution of claims."

An effective date was added in the new definition of "Final resolution of claims." After (6), the words "that became final on or after [the effective date of this Act]" were inserted. These words were aligned with the left margin, so that they apply to (1) through (6):

(6) A settlement or [~~Other~~] other final resolution of an appeal or challenge from which no appeal may be filed or from which no appeal has been filed within the time allowed,

that became final on or after [the effective date of this Act].

This effective date was recommended by tax counsel. According to tax counsel, the bill should only apply to final adjudications of a court of competent jurisdiction that are final **on or after** the effective date of the Act. Without this provision, the ERS's tax qualified status would be placed at risk.

The House JHA committee moved this definition of "final resolution of claim," including the effective date, to Section 2 of the bill. **If this effective date does not remain in the bill, the ERS would be required to oppose S.B. 211 S.D. 2 H.D.2.**

(2) Section 2, Section (2)

The amendment to Section 2, Section (2) is intended to protect the ERS's tax qualified status in view of the ERS's deletion of a provision that LGO and the City had concerns about. See discussion in Section 5(2) of the ERS's testimony dated March 21, 2023 (attached) regarding the deletion of Section 2, Section 1(B)(iii) in the proposed amendments to S.B. 211 S.D. 2.

(3) Section 2 - sections (3), (5), and (6)

The amendments to Section 2, Sections (3), (5), and (6) regarding employee contributions, employer contributions, and amounts received by employees, respectively, reflect the recommendations of tax counsel, as well as concerns about the ERS's UAAL and administrative burden.

(4) Section 2 - Sections 1(A) and (B)

The amendments to Section 2, Sections 1(A) and (B) reflect the recommendations of tax counsel.

(5) Section 2 – Section (7).

The new Section (7) reflects the recommendations of tax counsel.

The ERS's and City's proposed further amendments also addressed concerns raised by LGO and the City. See ERS testimony to House JHA committee, attached, at pages 7-8.

5. ERS's position regarding S.B. 211 S.D. 2 H.D. 2

The City is proposing to amend Section 6 to state that this Act shall take effect "upon approval." The ERS concurs with this amendment. Besides this amendment to

Section 6, the ERS strongly requests that S.B. 211 S.D. 2 H.D. 2 be passed unamended. The ERS believes that S.B. 211 S.D. 2 H.D. 2, **as currently written**, addresses the ERS's concerns about protecting the ERS's tax qualified status and avoiding unwarranted increases in the ERS's UAAL. The introduction of other substantive amendments may inadvertently pose unacceptable risks to the ERS's tax qualified status.

Attachments:
1. ERS testimony on S.B. 211 S.D. 2 H.D. 1, dated March 21, 2023

JOSH GREEN, M.D.
GOVERNOR

THOMAS WILLIAMS
EXECUTIVE DIRECTOR

KANOE MARGOL
DEPUTY EXECUTIVE DIRECTOR

STATE OF HAWAII
EMPLOYEES' RETIREMENT SYSTEM

TESTIMONY BY THOMAS WILLIAMS
EXECUTIVE DIRECTOR, EMPLOYEES' RETIREMENT SYSTEM
STATE OF HAWAII

TO THE HOUSE COMMITTEE
ON JUDICIARY & HAWAIIAN AFFAIRS

SENATE BILL NO. 211 S.D. 2 H.D. 1

March 21, 2023
2:00 P.M.
Conference Room 325 & Videoconference

RELATING TO THE EMPLOYEES' RETIREMENT SYSTEM

Chair Tarnas, Vice-Chair Takayama and Members of the Committee,

S.B. 211 S.D. 2 H.D. 1 proposes to add a new section which provides that service or compensation awarded to an employee by a final court decision, arbitration award, or court-approved settlement shall be considered "service" under Hawaii Revised Statutes (HRS) § 88-21 or "compensation" under HRS § 88-21.5.

The ERS Board of Trustees would support S.B. 211 S.D. 2 H.D. 1 with further proposed amendments, which are attached. Absent the proposed amendments, the ERS and its Board of Trustees would have to oppose.

1. ERS's concerns about S.B. 211; Proposed amendments

The ERS had opposed the original S.B. 211 because of concerns about the bill, including: (1) negative impacts on the ERS's tax-qualified status, due to violation of the "definitely determinable" requirement, the exclusive benefit rule and other IRS requirements; (2) pension spiking; (3) administrative burden; and (4) unwarranted increases in the ERS's Unfunded Actuarial Accrued Liability (UAAL).

In the alternative, the ERS had requested proposed amendments to S.B. 211, which contain safeguards intended to protect the ERS's tax qualified status and prevent

negative impacts on the ERS's unfunded liability. See ERS's testimony submitted to Senate Committee on Labor and Technology, attached.

At a hearing on February 10, 2023, the Senate Committee on Labor and Technology recommended that S.B. 211 be passed with amendments, and the committee adopted the ERS's proposed amendments. See S.S.C.R. 342 and S.B. 211 S.D. 1.

On recommendation of its outside tax counsel, the ERS submitted proposed further amendments to S.B. 211 S.D. 1, for compliance with the IRC and protection of the ERS's tax qualified status. At a hearing on March 1, 2023, the Senate Committees on Ways and Means and Judiciary recommended that S.B. 211 S.D. 1 be passed with amendments. However, the committees did not adopt the ERS's proposed amendments. See S.S.C.R. 1084 and S.B. 211 S.D. 2.

The ERS submitted proposed further amendments to S.B. 211 S.D. 2, for compliance with the IRC and protection of the ERS's tax qualified status. At a hearing on March 14, 2023, the House Committee on Labor and Government Operations (LGO) recommended that S.B. 211 S.D. 2 be passed with amendments. However, the committee did not adopt the ERS's proposed amendments. See H.S.C.R. 1313 and S.B. 211 S.D. 2 H.D. 1.

2. <u>ERS's ongoing concerns about the ERS's tax qualified status.</u>

a. <u>ERS's tax qualified status.</u>

The ERS is a tax-qualified governmental plan under the Internal Revenue Code ("IRC"). To maintain its qualified governmental plan status, the ERS plan must be administered according to its "plan provisions" or "plan documents" set forth at HRS Chapter 88 (including HRS § 88-22.5), as well as IRC § 401(a). § 88-22.5 provides that "the [ERS] shall be administered in accordance with the requirements of section 401(a)… of the Internal Revenue Code of 1986, as amended." ERS membership, service credit, compensation, retirement eligibility, and other ERS benefits are governed by, and therefore may only be provided pursuant to, HRS Chapter 88 and ERS administrative rules.

As long as the ERS continues to meet the qualification requirements, the members of the ERS will receive favorable federal income tax treatment of their ERS benefits, and the ERS will receive favorable tax treatment on its investment earnings. Should the ERS be administered in a manner that is inconsistent with HRS Chapter 88 and IRC § 401(a), the ERS's status as a qualified governmental plan would be placed at risk.

The ERS risks disqualification if it fails to follow its plan provisions, including HRS Chapter 88 and ERS administrative rules. *See* 26 C.F.R. § 1.401-1(b)(3) (stating "The law is concerned not only with the form of a plan but also with its effects in operation");

Rev. Proc. 2021-30 at 19-20, 2021-31 I.R.B. 172 (July 16, 2021), § 5.01(2) (defining "Qualification Failure" to mean "**any failure that adversely affects the qualification of a plan**") and § 5.01(2)(b) (defining "Operational Failure" to mean "a Qualification Failure ... that arises solely from **the failure to follow plan provisions.**" *See also DNA Pro Ventures, Inc. Emp. Stock Ownership Plan v. Comm'r of Internal Revenue*, 856 F.3d 557, 559 (8th Cir. 2017) ("A plan may be disqualified for operational failures, which occur if a plan fails to operate in accordance with § 401(a) statutory requirements or fails to follow the terms of the plan document"). *See, e.g., Forsyth Emergency Servs., P.A. v. Comm'r of Internal Revenue,* 68 T.C. 881, 891 (1977) (plan that operated in variance with its terms was disqualified by the IRS).

Public pension plans such as the ERS risk disqualification for noncompliance with their governing statutes and/or IRS requirements. *See, e.g., Zilberberg v. Bd. of Trustees, Teachers' Pension & Annuity Fund*, 468 N.J. Super. 504, 510–11, 260 A.3d 45, 49 (App. Div. 2021) ("Repayment of interest to [the pension fund] is crucial to maintain the pension plan's tax-qualified status. ... [T]he pension system and its members could face challenges to their status"); *Robertson v. Pennsylvania Pub. Sch. Employees' Ret. Sys.,* 162 A.3d 569, 574 (Pa. Commw. Ct. 2017) (the retirement system, "as a tax-qualified plan under 26 U.S.C. § 401(a), must ensure that a distribution is not only consistent with the terms of the Retirement Code, but also complies with the Internal Revenue Code.")

The Legislature has recognized the importance of "[protecting] the status of the Employees' Retirement System (ERS) as a tax-qualified retirement plan" and that disqualification of the plan would negatively impact ERS members and the State of Hawaii:

> Hawaii's ERS is currently a tax-qualified retirement plan under the IRC. Loss of this status would be detrimental to both the ERS and its members, resulting in the pre-tax treatment on member contributions to be eliminated and requiring ERS members to pay federal income taxes annually on the value or increase in value of a member's account without receiving a distribution. This could amount to thousands of dollars in taxes for members.

H.S.C.R. No. 343 (2011).

b. <u>Violation of definitely determinable requirement</u>.

The ERS's tax concerns about S.B. 211 included violation of the IRS's **"**definitely determinable" requirement.

IRC § 401(a)(25) provides that "[a] defined benefit plan shall not be treated as providing **definitely determinable benefits** unless, … the amount of any benefit is to be determined … in a way which **precludes employer discretion**." (emphasis added)

"A pension plan within the meaning of section 401(a) is a plan established and maintained by an employer primarily to provide systematically for the payment of

definitely determinable benefits to his employees over a period of years, usually for life, after retirement. Retirement benefits generally are measured by, and based on, such factors as years of service and compensation received by the employees." *See* Treas. Reg .§ 1.401-1(b)(1)(i). (emphasis added).

"[I]f, in the case of a defined benefit pension plan, the benefits on behalf of each participant are determined in accordance with a stipulated formula that is **not subject to the discretion of the employer**," the definitely determinable benefit requirements of § 1.401-1(b)(1)(i) of the regulations are satisfied. Rev. Rul. 74-385, 1974-2 C.B. 130 (1974) (emphasis added). On the other hand, if the terms of the plan specifically allow the employer to vary the employee's compensation used in the benefit formula, the plan would violate the definitely determinable rule. *See id.*

The ERS must comply with the IRC's "definitely determinable benefit" rule. In *Fratinardo v. ERS*, 129 Hawai'i 107, 114-15, 295 P.3d 977, 984–85 (App. 2013). The definition of compensation in HRS § 88-21.5 was intended to "satisfy the Code's requirement that a member's benefit be 'definitely determinable.'" In 2004, the Legislature made several amendments to HRS Chapter 88 to conform to the requirements of IRC § 401(a). *See* S.S.C.R. 2692, S.S.C.R. 2143, and C.C.R. 122-04 in 2004 Senate Journal.

The ERS's testimony on S.B. 211 provided examples of how S.B. 211, as written, would allow an employer to vary an employee's compensation used in the benefit formula, which would cause the ERS plan to violate the definitely determinable rule.

c. <u>Violation of exclusive benefit rule.</u>

The ERS's tax concerns about S.B. 211 also included violation of the IRS's exclusive benefit rule. The "exclusive benefit rule" is set forth at IRC § 401(a)(2) and HRS.§ 88-22.5(a)(1). IRC § 401(a)(2) provides that a tax qualified plan must make it "impossible, … for any part of the corpus or income to be … used for, or diverted to, purposes other than for the exclusive benefit of his employees or their beneficiaries." IRC § 401(a)(2) and HRS § 88-22.5(a) require the ERS to make it impossible for ERS monies to benefit counties and other State agency employers.

The ERS should not be bound by the employer's and employee's characterization of back pay as compensation. To the extent that a settlement does not include compensation as defined in HRS § 88-21.5, the ERS should not have to assume a portion of the employer's liability for its alleged wrongful conduct (discrimination, suspension, termination of claimant, etc.). The exclusive benefit rule bars any mandate by S.B. 211 that the ERS's corpus and income be used for the benefit of the employer by assuming a portion of the employer's liability for its alleged wrongful conduct. To the extent that S.B. 211 requires the ERS to confer service, credited service and other retirement benefits in a manner that is not authorized by HRS Chapter 88 and ERS administrative rules, this would place the ERS's tax qualified

status at risk with potentially severe negative consequences for the ERS and ERS members and beneficiaries.

d. Impermissible Cash or Deferred Election.

A governmental defined benefit plan generally will not satisfy the requirements of IRC § 401(a) if it includes a cash or deferred arrangement. See Treas. Reg. § 1.401(k)-1(a)(1). A cash or deferred arrangement is any direct or indirect election by an employee to have the employer either provide an amount to the employee in cash that is not currently available or contribute an amount to a trust or provide an accrual or other benefit under a plan deferring the receipt of compensation. See Treas. Reg. § 1.401(k)-1(a)(3)(i).

A settlement between an employee and an employer could provide an employee with discretion as to how a monetary award should be structured. For example, a settlement could be structured to provide the employee with ERS compensation and service as proposed under S.B. 211. Also, a settlement could be structured to provide the employee with a lump sum award that is considered damages and would not result in service or compensation under ERS statutes.

As indicated in the ERS's testimony on S.B. 211, the ERS consulted with its tax counsel regarding the potential impact of S.B. 211 on the ERS's tax qualified status and they indicated in writing that they shared our concerns.

3. ERS's ongoing concerns about unwarranted increases in the ERS's UAAL.

The ERS's testimony on S.B. 211 expressed concern that compliance with awards and settlements as provided in S.B. 211 may result in the ERS's loss of actuarial value should there be untimely/retroactive employer and employee contributions, or employee accrual of benefits. Compliance with such awards and settlement may result in unanticipated and unjustified increases to the ERS's unfunded liability.

The ERS's testimony on S.B. 211 provided examples from the ERS's actuary that illustrated the potential increase in actuarial loss to the ERS.

4. Proposed amendments to S.B. 211 S.D. 2 H.D. 1.

On recommendation of tax counsel, the ERS submitted proposed further amendments to S.B. 211 S.D. 1, for compliance with the IRC and protection of the ERS's tax qualified status, including compliance with the IRS's definitely determinable requirement. The Senate Committees on Ways and Means and Judiciary did not adopt the ERS's proposed further amendments to S.B. 211 S.D. 1. The House committee on LGO did not adopt the ERS's proposed further amendments to S.B. 211 S.D. 2.

The ERS now requests that the House Committee on Judiciary & Hawaiian Affairs adopt the attached proposed further amendments to S.B. 211 S.D. 2. These proposed further amendments include the following:

(1) Section 3 - definition of "Final resolution of claims."

An effective date should be added in the new definition of "Final resolution of claims." After (6), the words "that became final on or after [the effective date of this Act]" should be inserted. These words should be aligned with the left margin, so that they apply to(1) through (6):

> (6) A settlement or [~~Other~~] other final resolution of an appeal or challenge from which no appeal may be filed or from which no appeal has been filed within the time allowed,
>
> that became final on or after [the effective date of this Act].

This effective date was recommended by tax counsel. According to tax counsel, the bill should only apply to final adjudications of a court of competent jurisdiction that are final **on or after** the effective date of the Act. Without this provision, the ERS's tax qualified status would be placed at risk. **If this amendment is not added to the bill, the ERS would be required to oppose S.B. 211 S.D. 2 H.D.1.**

(2) Section 2, Section (2)

The proposed amendment to Section 2, Section (2) is intended to protect the ERS's tax qualified status in view of the ERS's deletion of a provision that LGO and the City had concerns about. See discussion in Section 5(2) of this testimony below regarding the deletion of Section 2, Section 1(B)(iii) in the proposed amendments to S.B. 211 S.D. 2.

(3) Section 2 - sections (3), (5), and (6)

The proposed amendments to Section 2, Sections (3), (5), and (6) regarding employee contributions, employer contributions, and amounts received by employees, respectively, reflect the recommendations of tax counsel, as well as concerns about the ERS's UAAL and administrative burden.

(4) Section 2 - Sections 1(A) and (B)

The proposed amendments to Section 2, Sections 1(A) and (B) reflect the recommendations of tax counsel.

(5) Section 2 – Section (7).

The proposed new Section (7) reflects the recommendations of tax counsel.

5. LGO's and City's concerns

(1) LGO wanted to give the City more time to review the proposed amendments.

Response: The City and ERS have developed and agreed on a joint version of proposed amendments to S.B. 211 S.D. 2 H.D. 1, which is attached to this testimony.

(2) LGO asked whether the bill would apply to settlements without court adjudication,

Response: The original bill applies to decisions in administrative proceedings and arbitrations, in addition to court decisions and court-approved settlements. See definition of "Final adjudication of a court of competent jurisdiction" in Section 3, parts (1), (5), and (6) in SB211, SB211 SD1, and SB211 SD2.

Now the ERS's and City's joint version of proposed amendments expressly includes non-court approved settlements. See Section 3, definition of" final resolution of claims," parts (3) and (6).

(3) LGO was concerned about the following provision, which referred to "sole discretion":

> Additionally, the system shall have sole discretion to determine whether the terms of a final adjudication of a court of competent jurisdiction meet the requirements herein and are considered service or compensation as provided in this Chapter.

(Second sentence in Section 2, Section 7 in proposed amendments to S.B. 211 S.D. 2).

Response: The ERS has deleted this provision.

(4) LGO asked whether a member will have an opportunity to resubmit in order to conform to ERS requirements.

Response: The bill does not preclude the opportunity to resubmit if there are corrections, revisions, or new documents to be reviewed. It is not necessary to amend the bill to state this, since it is part of the administrative review process. No other ERS statute has such a provision.

(5) LGO and the City were concerned about the following provision:

> (iii) The final resolution of claims allocates and designates the amount, purpose and nature of back pay or retroactive pay differentials to each monthly period in which it would have been earned;

(Section 2, Section 1(B)(iii) in proposed amendments to S.B. 211 S.D. 2)

Response. Upon further consideration, the ERS has deleted this provision. This provision was intended to protect the ERS's tax qualified status, but the ERS has instead made revisions to Section 2(2), which the ERS believes would meet the ERS's tax concerns.

The ERS will continue to work with the City to develop and clarify the language in the bill as needed.

The ERS would support S.B. 211 S.D. 2 H.D. 1 with these proposed further amendments.

Attachments:
1. Proposed amendments to S.B. 211 S.D. 2 H.D. 1
2. ERS testimony on S.B. 211, dated March 14, 2023, with proposed amendments to S.B. 211 S.D. 2
3. ERS testimony on S.B. 211, dated February 10, 2023, with proposed amendments to S.B. 211

Proposed amendments to S.B. 211 S.D. 2 H.D. 1

SECTION 1. The purpose of this Act is to ensure that employment, work, and pay eligible for the purpose of calculating retirement benefits includes retroactive reinstatement, retroactive rescission of suspension[~~,~~] and retroactive [~~pay differential, and back pay~~] payments that are restored to an employee as part of an administrative, arbitral, or judicial proceeding[~~.~~], or pursuant to a settlement of claims, subject to certification by the system that the retroactive reinstatement, retroactive rescission of suspension, and retroactive [~~pay differential, and back pay~~] payments that are restored otherwise satisfy the requirements of chapter 88, Hawaii Revised Statutes, including:

(1) The definition of "service" in section 88-21, Hawaii Revised Statutes;
(2) The [~~computation~~] calculation of credit for a year of service in section 88-50, Hawaii Revised Statutes;
(3) The definition of "compensation" in section 88-21.5, Hawaii Revised Statutes, to prevent significant non-base pay increases;
(4) Compliance with the employer reporting requirements of section 88-103.7,
(5) Payment of the actuarial value of employee contributions; and
(6) Payment of the actuarial value of employer contributions.

SECTION 2. Chapter 88, Hawaii Revised Statutes, is amended by adding a new section to part II, subpart B, to be appropriately designated and to read as follows:

"§88- Retroactive reinstatement; retroactive rescission of suspension; retroactive [~~pay differential; back pay~~] payments. Upon certification by the system, the retroactive reinstatement, retroactive rescission of suspension, and retroactive [~~pay differential, or back pay~~] payment [~~awarded~~] provided to an employee pursuant to [~~the final adjudication of a court of competent jurisdiction~~] a final resolution of claims, as. defined in section 88-21, shall be considered service under. section 88-21, compensation under section 88-21.5, or both; provided that:

(1) For the reinstatement, rescission of suspension, [~~pay differential, or back pay~~] or payments to be considered:

(A) Service under section 88-21, the employee shall appeal the employee's involuntary termination or unpaid suspension, be retroactively reinstated to employment or have the suspension rescinded in whole or in part, and be [~~awarded~~] provided back pay, pursuant to [~~the final adjudication of a court of competent jurisdiction~~] a final resolution of claims; provided further that:

(i) The [~~days~~] dates of retroactive employment or retroactive rescission of suspension for which back pay is [~~awarded~~] provided pursuant to [~~the final adjudication of a court of competent jurisdiction~~] a final resolution of claims and paid by the State or county [~~shall be considered service;~~], do not precede or succeed the dates the employee would have provided service if the individual had not been suspended or terminated;

(ii) [~~The days of service shall not exceed the number of days that~~] A final resolution of claims specifies the dates of retroactive employment or retroactive rescission of suspension, and the amount, purpose and nature of retroactive payments for each monthly period in which the employee would have provided service if the individual had not been suspended or terminated; [~~and~~]

(iii) The dates of retroactive employment or retroactive rescission of suspension provided pursuant to a final resolution of claims would otherwise have been considered service as provided in this I chapter; and

[(~~iii~~)] (iv) The service shall be credited to the extent [~~that the service satisfies the requirements for credit~~] it would otherwise have been credited as provided in this chapter; [~~or~~] and

(B) Compensation under section 88-21.5, the employee shall challenge an involuntary termination, unpaid suspension, or the employee's compensation and be subsequently [~~awarded~~] provided a retroactive [~~pay differential or back pay~~] payment pursuant to [~~the final adjudication of a court of competent jurisdiction~~] a final resolution of claims; provided further that:

(i) The amount, purpose and nature, and duration of a retroactive [~~pay differential awarded~~] payment provided pursuant to [~~the final adjudication of a court of competent jurisdiction~~] a final resolution of claims and paid by the State or county [~~shall be considered a differential and shall not exceed the amount and type of differential~~] do not exceed the amount, purpose, nature, and duration of compensation available to [~~other similarly situated~~] comparable employees[~~,~~] (including but not limited to employees with similar positions, class, title, pay range or wage scale, step, bargaining unit, contract type, function, job category and pay rate code through the same employer, department or agency, available by pay schedule, or comparable to the employee's own history of [~~pay differential;~~] compensation), less any compensation actually paid to the employee and reported to the system by the State or county, where applicable; do not exceed the compensation attributable to the number of workdays for which retroactive payment is owed; and when added to the compensation actually paid to the employee by the State or County and reported to the system (if any), results in compensation to the employee that does not exceed the compensation that the employee would have earned had the

employee not been suspended or terminated, or had the employee received the compensation available to comparable employees~~;~~

~~(ii) The amount of back pay awarded pursu ant to the final adjudication of a court of competent jurisdiction and paid by the State or county shall be considered pay and shall not exceed either the amount and type of pay under normal salary adjustments available to other similarly situated employees, available by pay schedule, or comparable to the employee's own history of compensation; the pay attributable to the number of workdays that occurred between the date that the employee's absence began until the employee's date of reinstatement; or the pay that the employee would have received had the employee not been suspended or terminated; and~~

[~~(iii)~~] (ii) [~~Differential or pay~~] Retroactive payments provided pursuant to a final resolution of claims [~~shall be considered~~] would otherwise have been considered compensation, ~~to the extent the type of differential or pay meets the requirements of section 88-21.5;~~ as provided in section 88-21.5 (a) or (b), respectively, depending on when the employee became a member, and this chapter; and

(iii) Any amounts provided to the employee for damages, attorney's fees, interest or penalties, payments for failure to hire or payments made as part of an agreement for the employee to resign or otherwise terminate employment shall not be considered compensation for purposes of the system;

(2) The requirements of section 88-103.7 and this chapter shall be satisfied with respect to any retroactive reinstatement, retroactive [~~recission~~] rescission of suspension, retroactive pay differential, or back pay [~~awarded~~] pursuant to [~~the final adjudication of a court of competent jurisdiction~~] a final resolution of claims and paid by the State and county[~~;~~], including but not limited to an allocation of the amount, purpose, and nature of a retroactive payments to each monthly period in which it would have been earned had the employee not been suspended or terminated, or had the employee received the compensation available to comparable employees, subject to the retroactive payments provided pursuant to a final resolution of claims and paid by the State or county as set forth in subsections (1)(A) and (1)(B).

(3) The [~~employee~~] employer [~~shall make~~] has made a lump sum payment to the system in the amount of the actuarial present value, as determined by the system, of contributions that the employee would have contributed, as provided in this chapter, for the service and compensation to be certified pursuant to this section, [~~and~~] which shall include compound interest thereon at the assumed rate of return; provided further that class C service shall be credited at no cost; provided further that any portion of the

lump sum payment in excess of the actuarial present value, as determined by the system, of contributions that the employee would have contributed, as provided in this chapter, for the service and compensation certified pursuant to this section, shall be returned to the employer;

(4) As a condition of the employer's obligation under subsection (3), the employee has paid to the employer the contributions the employee would have contributed, as provided in this chapter, for the service and compensation to be certified pursuant to this section.

[(4)] (5) The employer [shall make] has made a lump sum payment to the system in the amount of the actuarial present value, as determined by the system, of contributions that the employer would have contributed, [pursuant to sections 88-123 through 88-126 had the employee's employment not been suspended or terminated,] as provided in this chapter, for the service and compensation to be certified pursuant to this section, [along with] which shall include compound interest thereon at the assumed rate of return; provided further that any portion of the lump sum payment in excess of the actuarial present value, as determined by the system, of contributions that the employer would have contributed, as provided in this chapter, for the service and compensation certified pursuant to this section, shall be returned to the employer;[and]

(5) If the employee was terminated, the employee shall repay:
(A) The actuarial present value, as determined by the system, of any amount in employee contributions that were refunded to the employee; and
(B) The actuarial present value, as determined by the system, of any service or disability allowance that was paid to the employee, at the time of the employee's termination."

(5) (6) An employee who appeals an involuntarily termination, is retroactively reinstated to employment pursuant to a final resolution of claims, and:

(A) Has been paid their accumulated contributions or hypothetical account balance after the involuntary termination date and as a result of the involuntary termination, has made a lump sum payment to the system in the amount of the actuarial present value, as determined by the system, of the accumulated contributions or hypothetical account that were paid to the employee; or

(B) Has received an allowance on service retirement, ordinary disability retirement or service-connected disability retirement after the involuntary termination date and as a result of the involuntary termination, has made a lump sum payment to the system in the amount of the actuarial present value, as determined by the

system, of any allowance on service retirement, ordinary disability retirement or service-connected disability retirement received by the employee;

(7) Notwithstanding anything herein, if the system determines that a contribution exceeds the limits of any Internal Revenue Code requirements that apply to the system, the system will not accept the contributions and shall return the contributions.

SECTION 3. Section 88-21, Hawaii Revised Statutes, is amended as follows:

1. By adding a new definition to be appropriately inserted and to read:

[~~""Final adjudication of a court of competent jurisdiction"~~] "Final resolution of claims" means:

(1) The final decision of a court, an administrative proceeding, or an arbitration proceeding from which no appeal may be filed or which no appeal has been filed within the time allowed;
(2) A stipulated judgment;
(3) A settlement of claims, including but not limited to a settlement of a labor grievance, that is in writing, signed, and dated by the parties to the settlement, and a court-approved settlement;
(4) A settlement adopted by court order or referenced in an order of dismissal;
(5) A third-party arbitrator decision from which no appeal may be filed or from which no appeal has been filed within the time allowed; or
(6) A settlement or [~~Other~~] other final resolution of an appeal or challenge from which no appeal may be filed or from which no appeal has been filed within the time allowed,

that became final on or after [the effective date of this Act]."

2. By amending the definition of "service" to read:

"Service": service as an employee paid by the State or county, and also:

(1) Service during the period of a leave of absence or exchange if the individual is paid by the State or county during the period of the leave of absence or exchange;

(2) Service during the period of an unpaid leave of absence or exchange if the individual is engaged in the performance of a governmental function or if the unpaid leave of absence is an approved leave of absence for professional improvement; provided that, for the period of the leave of absence or exchange without pay, the individual makes the same contribution to the system as the individual would have made if the individual had not been on the leave of absence; and

(3) Service pursuant to section 88-

Cafeteria managers and cafeteria workers shall be considered as paid by the State, regardless of the source of funds from which they are paid."

SECTION 4. Section 88-21.5, Hawaii Revised Statutes, is amended to read as follows:

"**§88-21.5 Compensation.** (a) For a member who became a member before July 1, 2012[, ~~unless~~]:

(1) Unless a different meaning is plainly required by context, "compensation" as used in this part, means:

(A) Normal periodic payments of money for service the right to which accrues on a regular basis in proportion to the service performed;

(B) Overtime, differentials, and supplementary payments;

(C) Bonuses and lump sum salary supplements;

(D) Elective salary reduction contributions under sections 125, 403(b), and 457(b) of the Internal Revenue Code of 1986, as amended; and

(E) Retroactive [~~pay differentials or back pay of those~~] payments of those purposes and nature authorized in [~~subparagraphs (A) through (D),~~] subsections (a)(1)(A), (a)(1)(B), (a)(1)(C) and (a)(1)(D), and certified as compensation pursuant to section 88- ;

(2) Bonuses and lump sum salary supplements shall be deemed earned when payable; provided that bonuses or lump sum salary supplements in excess of one-twelfth of compensation for the twelve months prior to the month in which the bonus or lump sum salary supplement is payable, exclusive overtime, bonuses, and lump sum salary supplements, shall be deemed earned:

(A) During the period agreed-upon by the employer and employee, but in any event over a period of not less than twelve months; or

(B) In the absence of an agreement between the employer and the employee, over the twelve months prior to the date on which the bonus or lump sum salary supplement is payable; and

(3) Retroactive payments shall be deemed earned when it would have been earned, as determined by the system pursuant to section 88-.

(b) For a member who becomes a member after June 30, 2012, unless a different meaning is plainly required by context, "compensation" as used in this part:

(1) Means:

(A) The normal periodic payments of money for service, the right to which accrues on an hourly, daily, monthly, or annual basis;

(B) Shortage differentials;

(C) Elective salary reduction contributions under sections 125, 403(b), and 457(b) of the Internal Revenue Code of 1986, as amended;

(D) Twelve-month differentials for employees of the department of education; and

(E) Retroactive [~~pay differentials or back pay of those~~] payments <u>of those purposes and nature of payments</u> authorized in [~~subparagraphs (A) through (D),~~] <u>subsections (b)(1)(A), (b)(1)(B), (b)(1)(C) and (b)(1)(D),</u> and certified <u>as compensation</u> pursuant to section 88- ; [~~and~~]

(2) Shall not include any other additional or extra payments to an employee or officer, including overtime, supplementary payments, bonuses, lump sum salary supplements, allowances, or differentials, including differentials for stand-by duty, temporary unusual work hazards, compression differentials, or temporary differentials, except for those expressly authorized pursuant to [~~subparagraphs (l)(B) through (l)(E)."~~] <u>subsection (b)(1)(B), (b)(1)(C), and (b)(1)(D), and (b)(l)(E)"; and</u>

<u>(3) Retroactive payments shall be deemed earned when it would have been earned, as determined by the system pursuant to section 88-.</u>

SECTION 5. Statutory material to be repealed is bracketed and stricken. New statutory material is underscored.

SECTION 6. This Act shall take effect on January 1, 2050.

JOSH GREEN, M.D.
GOVERNOR

THOMAS WILLIAMS
EXECUTIVE DIRECTOR

KANOE MARGOL
DEPUTY EXECUTIVE DIRECTOR

STATE OF HAWAII
EMPLOYEES' RETIREMENT SYSTEM

TESTIMONY BY THOMAS WILLIAMS
EXECUTIVE DIRECTOR, EMPLOYEES' RETIREMENT SYSTEM
STATE OF HAWAII

TO THE HOUSE COMMITTEE
ON LABOR AND GOVERNMENT OPERATIONS

SENATE BILL NO. 211 S.D. 2

March 14, 2023
9:30 A.M.
Conference Room 309 & Videoconference

RELATING TO THE EMPLOYEES' RETIREMENT SYSTEM

Chair Matayoshi, Vice-Chair Garrett and Members of the Committee,

S.B. 211 S.D. 2 proposes to add a new section which provides that service or compensation awarded to an employee by a final court decision, arbitration award, or court-approved settlement shall be considered "service" under Hawaii Revised Statutes (HRS) § 88-21 or "compensation" under HRS § 88-21.5.

While the ERS Board of Trustees has not had the opportunity to review the bill, the ERS staff believes that the Board would support S.B. 211 S.D. 2 with further proposed amendments, which are attached.

1. ERS's concerns about S.B. 211; Proposed amendments

The ERS had opposed the original S.B. 211 because of concerns about the bill, including: (1) negative impacts on the ERS's tax-qualified status, due to violation of the "definitely determinable" requirement and other IRS requirements; (2) pension spiking; (3) administrative burden; and (4) unwarranted increases in the ERS's Unfunded Actuarial Accrued Liability (UAAL).

In the alternative, the ERS had requested proposed amendments to S.B. 211, which contain safeguards intended to protect the ERS's tax qualified status and prevent

negative impacts on the ERS's unfunded liability. See ERS's testimony submitted to Senate Committee on Labor and Technology, attached.

At a hearing on February 10, 2023, the Senate Committee on Labor and Technology recommended that S.B. 211 be passed with amendments, and the committed adopted the ERS's proposed amendments. See S.S.C.R. 342 and S.B. 211 S.D.1.

On recommendation of tax counsel, the ERS submitted proposed further amendments to S.B. 211 S.D. 1, for compliance with the IRC and protection of the ERS's tax qualified status. At a hearing on March 1, 2023, the Senate Committees on Ways and Means and Judiciary recommended that S.B. 211 S.D. 1 be passed with amendments. However, the committees did not adopt the ERS's proposed amendments. See S.S.C.R. 1084 and S.B. 211 S.D. 2.

2. ERS's ongoing concerns about the ERS's tax qualified status.

a. ERS's tax qualified status.

The ERS is a qualified governmental plan under the Internal Revenue Code ("IRC"). To maintain its qualified governmental plan status, the ERS plan must be administered according to its "plan provisions" or "plan documents" set forth at HRS Chapter 88 (including HRS § 88-22.5), as well as IRC § 401(a). § 88-22.5 provides that "the [ERS] shall be administered in accordance with the requirements of section 401(a)… of the Internal Revenue Code of 1986, as amended." ERS membership, service credit, compensation, retirement eligibility, and other ERS benefits are governed by, and therefore may only be provided pursuant to, HRS Chapter 88 and ERS administrative rules.

As long as the ERS continues to meet the qualification requirements, the members of the ERS will receive favorable federal income tax treatment of their ERS benefits, and the ERS will receive favorable tax treatment on its investment earnings. Should the ERS be administered in a manner that is inconsistent with HRS Chapter 88 and IRC § 401(a), the ERS's status as a qualified governmental plan could be at risk.

The ERS risks disqualification if it fails to follow its plan provisions, including HRS Chapter 88 and ERS administrative rules. *See* 26 C.F.R. sec. 1.401-1(b)(3) (stating "The law is concerned not only with the form of a plan but also with its effects in operation"). *See also DNA Pro Ventures, Inc. Emp. Stock Ownership Plan v. Comm'r of Internal Revenue*, 856 F.3d 557, 559 (8th Cir. 2017) ("A plan may be disqualified for operational failures, which occur if a plan fails to operate in accordance with § 401(a) statutory requirements or fails to follow the terms of the plan document"). *See, e.g., Forsyth Emergency Servs., P.A. v. Comm'r of Internal Revenue,* 68 T.C. 881, 891 (1977) (plan that operated in variance with its terms was disqualified by the IRS).

The Legislature has recognized the importance of "[protecting] the status of the Employees' Retirement System (ERS) as a tax-qualified retirement plan" and that disqualification of the plan would negatively impact ERS members and the State of Hawaii:

> Hawaii's ERS is currently a tax-qualified retirement plan under the IRC. Loss of this status would be detrimental to both the ERS and its members, resulting in the pre-tax treatment on member contributions to be eliminated and requiring ERS members to pay federal income taxes annually on the value or increase in value of a member's account without receiving a distribution. This could amount to thousands of dollars in taxes for members.

H.S.C.R. No. 343 (2011).

b. <u>Violation of definitely determinable requirement</u>.

The ERS's tax concerns about S.B. 211 included violation of the IRS's **"**definitely determinable" requirement.

IRC § 401(a)(25) provides that "[a] defined benefit plan shall not be treated as providing **definitely determinable benefits** unless, … the amount of any benefit is to be determined … in a way which **precludes employer discretion**." (emphasis added)

"A pension plan within the meaning of section 401(a) is a plan established and maintained by an employer primarily to provide systematically for the payment of **definitely determinable benefits** to his employees over a period of years, usually for life, after retirement. Retirement benefits generally are measured by, and based on, such factors as years of service and compensation received by the employees." *See* Treas. Reg. section 1.401-1(b)(1)(i). (emphasis added).

"[I]f, in the case of a defined benefit pension plan, the benefits on behalf of each participant are determined in accordance with a stipulated formula that is **not subject to the discretion of the employer**," the definitely determinable benefit requirements of § 1.401-1(b)(1)(i) of the regulations are satisfied. Rev. Rul. 74-385, 1974-2 C.B. 130 (1974) (emphasis added). On the other hand, if the terms of the plan specifically allow the employer to vary the employee's compensation used in the benefit formula, the plan would violate the definitely determinable rule. *See id.*

The ERS must comply with the IRC's "definitely determinable benefit" rule. In *Fratinardo v. ERS*, 129 Hawai'i 107, 114-15, 295 P.3d 977, 984–85 (App. 2013). The definition of compensation in HRS § 88-21.5 was intended to "satisfy the Code's requirement that a member's benefit be 'definitely determinable.'" In 2004, the Legislature made several amendments to HRS Chapter 88 to conform to the requirements of IRC § 401(a). *See* S.S.C.R. 2692, S.S.C.R. 2143, and C.C.R. 122-04 in 2004 Senate Journal.

The ERS's testimony on S.B. 211 provided examples of how S.B. 211, as written, would allow an employer to vary an employee's compensation used in the benefit formula, which would cause the ERS plan to violate the definitely determinable rule.

c. Violation of exclusive benefit rule.

The ERS's tax concerns about S.B. 211 also included violation of the IRS's exclusive benefit rule. The "exclusive benefit rule" is set forth at IRC § 401(a)(2) and HRS section 88-22.5(a)(1). IRC § 401(a)(2) provides that a tax qualified plan must make it "impossible, … for any part of the corpus or income to be … used for, or diverted to, purposes other than for the exclusive benefit of his employees or their beneficiaries." IRC § 401(a)(2) and HRS § 88-22.5(a) require the ERS to make it impossible for ERS monies to benefit counties and other State agency employers.

The ERS should not be bound by the employer's and employee's characterization of back pay as compensation. To the extent that a settlement does not include compensation as defined in HRS § 88-21.5, the ERS should not have to assume a portion of the employer's liability for its alleged wrongful conduct (discrimination, suspension, termination of claimant, etc.). The exclusive benefit rule bars any mandate by S.B. 211 that the ERS's corpus and income be used for the benefit of the employer by assuming a portion of the employer's liability for its alleged wrongful conduct. To the extent that S.B. 211 requires the ERS to confer service, credited service and other retirement benefits in a manner that is not authorized by HRS Chapter 88 and ERS administrative rules, this would place the ERS's tax qualified status at risk with potentially severe negative consequences for the ERS and ERS members and beneficiaries.

d. Impermissible Cash or Deferred Election.

A governmental defined benefit plan generally will not satisfy the requirements of IRC § 401(a) if it includes a cash or deferred arrangement. See Treas. Reg. § 1.401(k)-1(a)(1). A cash or deferred arrangement is any direct or indirect election by an employee to have the employer either provide an amount to the employee in cash that is not currently available or contribute an amount to a trust or provide an accrual or other benefit under a plan deferring the receipt of compensation. See Treas. Reg. § 1.401(k)-1(a)(3)(i).

A settlement between an employee and an employer could provide an employee with discretion as to how a monetary award should be structured. For example, a settlement could be structured to provide the employee with ERS compensation and service as proposed under S.B. 211. Also, a settlement could be structured to provide the employee with a lump sum award that is considered damages and would not result in service or compensation under ERS statutes.

As indicated in the ERS's testimony on S.B. 211, the ERS consulted with its tax counsel regarding the potential impact of S.B. 211 on the ERS's tax qualified status and they indicated in writing that they shared our concerns.

3. ERS's ongoing concerns about unwarranted increases in the ERS's UAAL.

The ERS's testimony on S.B. 211 expressed concern that compliance with awards and settlements as provided in S.B. 211 may result in the ERS's loss of actuarial value should there be untimely/retroactive employer and employee contributions, or employee accrual of benefits. Compliance with such awards and settlement may result in unanticipated and unjustified increases to the ERS's unfunded liability.

The ERS's testimony on S.B. 211 provided examples from the ERS's actuary that illustrated the potential increase in actuarial loss to the ERS.

4. Proposed amendments to S.B. 211 S.D. 2.

The ERS has heard further from its tax counsel. On recommendation of tax counsel, the ERS submitted proposed further amendments to S.B. 211 S.D. 1, for compliance with the IRC and protection of the ERS's tax qualified status. The Senate Committees on Ways and Means and Judiciary did not adopt the ERS's proposed further amendments to S.B. 211 S.D. 1.

The ERS now requests that the House Committee on Labor and Government Operations adopt the ERS's proposed further amendments to S.B. 211 S.D. 2. These proposed further amendments include the following:

(1) Section 3 - definition of "Final adjudication of a court of competent jurisdiction"

After "(6), the words "that became final on or after [the effective date of this Act" should be inserted in the new definition of ""Final adjudication of a court of competent jurisdiction." These words should be aligned with the left margin, so that they apply to (1) through (6):

> (6) Other final resolution of an appeal or challenge from which no appeal may be filed or from which no appeal has been filed within the time allowed,
>
> that became final on or after [the effective date of this Act].

This proposed amendment was recommended by tax counsel. According to tax counsel, the bill should only apply to final adjudications of a court of competent jurisdiction that are final **on or after** the effective date of the Act. Without this provision, the ERS's tax qualified status would be placed at risk. **If this amendment is not added to the bill, ERS would oppose S.B. 211 S.D. 2.**

(2) Section 2 - sections (3), (4), and (5)

The proposed amendments to Section 2, Sections (3), (4), and (5) regarding employee contributions, employer contributions, and amounts received by employees, respectively, reflect the recommendations of tax counsel, as well as concerns about the ERS's UAAL and administrative burden.

(3) Section 2 - Sections 1(A) and (B)

The proposed amendments to Section 2, 1(A) and (B) reflect the recommendations of tax counsel.

(4) Section 2 - Sections (6) and (7).

The proposed amendments to Section (6) reflect the recommendations of tax counsel and concerns about the ERS's administrative burden. The proposed amendments to Section (7) reflect the recommendations of tax counsel.

The ERS has been communicating with City, and will continue to work with the City, to develop and clarify the language in the bill.

The ERS would support S.B. 211 S.D. 2 with these proposed further amendments.

Attachment:
1. Proposed amendments to S.B. 211 S.D. 2
2. ERS testimony on S.B. 211, dated February 10, 2022

Proposed amendments to S.B. 211 S.D. 2

SECTION l. The purpose of this Act is to ensure that employment, work, and pay eligible for the purpose of calculating retirement benefits includes retroactive reinstatement, retroactive [~~recission~~] rescission of suspension, retroactive pay differential, and back pay that are restored to an employee as part of an administrative, arbitral, or judicial proceeding, subject to certification by the system that the retroactive reinstatement, retroactive [~~recission~~] rescission of suspension, retroactive pay differential, and back pay that are restored otherwise satisfy the requirements of chapter 88, Hawaii Revised Statutes, including:

(l) The definition of "service" in section 88-21, Hawaii Revised Statutes;

(2) The calculation of credit for a year of service in section 88-50, Hawaii Revised Statutes;

(3) The definition of "compensation" in section 88-21.5, Hawaii Revised Statutes, to prevent Significant non-base pay increases;

(4) Compliance with the employer reporting requirements of section 88-103.7, Hawaii Revised Statutes;

(5) Payment of the actuarial value of employee contributions; and

(6) Payment of the actuarial value of employer contributions.

SECTION 2. Chapter 88, Hawaii Revised Statutes, is amended by adding a new section to part II, subpart B, to be appropriately designated and to read as follows:

"§88- Retroactive reinstatement; retroactive [~~recission~~] rescission of suspension; retroactive pay differential; back pay. Upon certification by the system, the retroactive reinstatement, retroactive [~~recission~~] rescission of suspension, retroactive pay differential, or back pay awarded to an employee pursuant to the final adjudication of a court of competent jurisdiction, as defined in section 88-21, shall be considered service under section 88-21, compensation under section 88-21.5, or both; provided that:

(l) For the reinstatement, [~~recission~~] rescission of suspension, pay differential, or back pay to be considered:

(A) Service under section 88-21, the employee shall appeal the employee's involuntary termination or unpaid suspension, be retroactively reinstated to employment or have the suspension rescinded in whole or in part, and be awarded back pay, pursuant to the final adjudication of a court of competent jurisdiction; provided further that:

(i) The [~~days~~] dates of retroactive employment or retroactive rescission of suspension for which back pay is awarded pursuant to the final adjudication of a court of competent jurisdiction and paid by the State or county [~~shall be considered service;~~],do not precede or succeed the dates the employee would have provided service if the individual had not been suspended or terminated;

(ii) The [~~days of service shall not exceed the number of days that~~] final adjudication of a court of competent jurisdiction specifies the dates of retroactive employment or retroactive rescission of suspension, and the amount, purpose and nature of back pay, for each monthly period in which the employee would have provided service if the individual had not been suspended or terminated; [~~and~~]

(iii) The dates of retroactive employment or retroactive rescission of suspension awarded pursuant to the final adjudication of a court of competent jurisdiction would otherwise have been considered service as provided in this chapter; and

[~~(iii)~~] (iv) The service shall be credited to the extent [~~that it meets the requirements for credit~~] it would otherwise have been credited as provided in this chapter; [~~or~~] and

(B) Compensation under section 88-21.5, the employee shall challenge an involuntary termination, unpaid suspension, or the employee's compensation and be subsequently awarded [~~a~~] retroactive pay differential or back pay [~~differential~~] pursuant to the final adjudication of a court of competent jurisdiction; provided further that:

(i) The amount, purpose and nature, and duration of a retroactive pay differential awarded pursuant to the final adjudication of a court of competent jurisdiction and paid by the State or county [~~shall be considered a differential, not to exceed the amount and type of differential~~] do not exceed the amount, purpose, nature, and duration of differential available to [~~other similarly situated~~] comparable employees[~~,~~] including but not limited to employees with similar positions, class, title, pay range or wage scale, step, bargaining unit, contract type, function, job category and pay rate code through the same employer, department or agency, available by pay schedule, or comparable to the employee's own history of pay differential; do not exceed the differential attributable to the number of workdays between the date the employee's absence began until the employee's date of reinstatement; and do not exceed the differential that the employee would have earned had the employee not been suspended or terminated;

.(ii) The amount, purpose, nature, and duration of back pay awarded pursuant to the final adjudication of a court of competent jurisdiction and paid by the State or county [~~shall be considered pay and shall~~], do not [~~to~~] exceed the amount, purpose, [~~and type~~] nature, and duration of pay under normal salary adjustments available to [~~other similarly situated~~] comparable employees[~~,~~], including but not limited to employees with similar positions, class, title, pay range or

wage scale, step, bargaining unit, contract type, function, job category and pay rate code through the same employer, department or agency, available by pay schedule, or comparable to the employee's own history of compensation ; do not ~~to~~ exceed the pay attributable to the number of workdays that occurred between the date that the employee's absence began until the employee's date of reinstatement[~~, or~~]; and do not exceed the pay that the employee would have received had the employee not been suspended or terminated;

(iii) The final adjudication of a court of competent jurisdiction allocates and designates the amount, purpose and nature of back pay or retroactive pay differentials to each monthly period in which it would have been earned;

[~~(iii)~~] (iv) Retroactive [~~Differential~~] differential or back pay awarded pursuant to the final adjudication of a court of competent jurisdiction [~~shall be~~] would otherwise have been considered compensation [~~the extent the type of differential or pay meets the requirements of section 88-21.5~~;] as provided in section 88-21.5 (a) or (b), respectively, depending on when the employee became a member, and this chapter; and

(v) Any amounts awarded to the employee for damages, attorney's fees, interest or penalties, payments for failure to hire or payments made as part of an agreement for the employee to resign or otherwise terminate employment shall not be considered compensation for purposes of the system;

(2) The requirements of section 88-103.7 and this chapter shall be satisfied with respect to any retroactive reinstatement, retroactive [~~recission~~] rescission of suspension, retroactive pay differential, or back pay awarded pursuant to the final adjudication of a court of competent jurisdiction and paid by the State and county[~~;~~];

(3) The [~~employee~~] employer [~~shall make~~] has made a lump sum payment to the system in the amount of the actuarial present value, as determined by the system, of contributions that the employee would have contributed, as provided in this chapter, for the service and compensation to be certified pursuant to this section, [~~and~~] which shall include compound interest thereon at the assumed rate of return; provided further that class C service shall be credited at no cost; provided further that any portion of the lump sum payment in excess of the actuarial present value, as determined by the system, of contributions that the employee would have contributed, as provided in this chapter, for the service and compensation certified pursuant to this section, shall be returned to the employer;

(4) The employer [~~shall make~~] has made a lump sum payment to the system in the amount of the actuarial present value, as determined by the system, of contributions that the employer would have contributed, [~~pursuant to sections 88-123 through 88-126 had the employee's employment not been suspended or terminated,~~] as provided in this chapter, for the service and compensation to be certified pursuant to this section, [~~along with~~] which shall include compound interest thereon at the assumed rate of return; provided further that any portion of the lump sum payment in excess of the actuarial present value, as determined by the system, of contributions that the employer would have contributed, as provided in this chapter, for the service and compensation certified pursuant to this section, shall be returned to the employer;[~~and~~]

(5) ~~If the employee was terminated, the employee shall repay:~~

~~(A) The actuarial present value, as determined by the system, of any amount in employee contributions that were refunded to the employee; and~~

~~(B) The actuarial present value, as determined by the system, of any service or disability allowance that was paid to the employee, at the time of the employee's termination."~~

(5) An employee who appeals an involuntarily termination, is retroactively reinstated to employment pursuant to the final adjudication of a court of competent jurisdiction, and:

(A) Has been paid their accumulated contributions or hypothetical account balance after the involuntary termination date and as a result of the involuntary termination, has made a lump sum payment to the system in the amount of the actuarial present value, as determined by the system, of the accumulated contributions or hypothetical account that were paid to the employee; or

(B) Has received an allowance on service retirement, ordinary disability retirement or service-connected disability retirement after the involuntary termination date and as a result of the involuntary termination, has made a lump sum payment to the system in the amount of the actuarial present value, as determined by the system, of any allowance on service retirement, ordinary disability retirement or service-connected disability retirement received by the employee;

(6) The employee or former employee is living on the effective date of the final adjudication of a court of competent jurisdiction; and

(7) Notwithstanding anything herein, if the system determines that a contribution exceeds the limits of any Internal Revenue Code

requirements that apply to the system, the system will not accept the contributions and shall return the contributions. Additionally, the system shall have sole discretion to determine whether the terms of a final adjudication of a court of competent jurisdiction meet the requirements herein and are considered service or compensation as provided in this Chapter.

SECTION 3. Section 88-21, Hawaii Revised Statutes, is amended as follows:

1. By adding a new definition to be appropriately inserted and to read:

""Final adjudication of a court of competent jurisdiction" means:

(1) The final decision of a court, an administrative proceeding, or an arbitration proceeding from which no appeal may be filed or which no appeal has been filed within the time allowed;
(2) A stipulated judgment;
(3) A court-approved settlement;
(4) A settlement adopted by court order or referenced in an order of dismissal;
(5) A third-party arbitrator decision from which no appeal may be filed or from which no appeal has been filed within the time allowed; or
(6) Other final resolution of an appeal or challenge from which no appeal may be filed or from which no appeal has been filed within the time allowed,

that became final on or after [the effective date of this Act]."

2. By amending the definition of "service" to read:

"Service": service as an employee paid by the State or county, and also:

(1) Service during the period of a leave of absence or exchange if the individual is paid by the State or county during the period of the leave of absence or exchange;

(2) Service during the period of an unpaid leave of absence or exchange if the individual is engaged in the performance of a governmental function or if the unpaid leave of absence is an approved leave of absence for professional improvement; provided that, for the period of the leave of absence or exchange without pay, the individual makes the same contribution to the system as the individual would have made if the individual had not been on the leave of absence; and

(3) Service pursuant to section 88-

Cafeteria managers and cafeteria workers shall be considered as paid by the State, regardless of the source of funds from which they are paid."

SECTION 4. Section 88-21.5, Hawaii Revised Statutes, is amended to read as follows:

"**§88-21.5 Compensatio**n. (a) For a member who became a member before July 1, 2012[, ~~unless~~]:

(1) Unless a different meaning is plainly required by context, "compensation" as used in this part, means:

(A) Normal periodic payments of money for service the right to which accrues on a regular basis in proportion to the service performed;

(B) Overtime, differentials, and supplementary payments;

(C) Bonuses and lump sum salary supplements;

(D) Elective salary reduction contributions under sections 125, 403(b), and 457(b) of the Internal Revenue Code of 1986, as amended; and

(E) Back pay or retroactive pay differentials of those purposes and nature of payments authorized in [~~subparagraphs (A) through (D),~~] subsections (a)(1)(A), (a)(1)(B), (a)(1)(C) and (a)(1)(D), and certified as compensation pursuant to section 88- ;

(2) Bonuses and lump sum salary supplements shall be deemed earned when payable; provided that bonuses or lump sum salary supplements in excess of one-twelfth of compensation for the twelve months prior to the month in which the bonus or lump sum salary supplement is payable, exclusive overtime, bonuses, and lump sum salary supplements, shall be deemed earned:

(A) During the period agreed-upon by the employer and employee, but in any event over a period of not less than twelve months; or

(B) In the absence of an agreement between the employer and the employee, over the twelve months prior to the date on which the bonus or lump sum salary supplement is payable; and

(3) Back pay or retroactive pay shall be deemed earned when it would have been earned, as determined by the system.

(b) For a member who becomes a member after June 30, 2012, unless a different meaning is plainly required by context, "compensation" as used in this part:

(1) Means:

(A) The normal periodic payments of money for service, the right to which accrues on an hourly, daily, monthly, or annual basis;

(B) Shortage differentials;

(C) Elective salary reduction contributions under sections 125, 403(b), and 457(b) of the Internal Revenue Code of 1986, as amended;

(D) Twelve-month differentials for employees of the department of education; and

(E) Back pay or retroactive pay differentials of those purposes and nature of payments authorized in [~~subparagraphs (A) through (D),~~] subsections (b)(1)(A), (b)(1)(B), (b)(1)(C) and (b)(1)(D), and certified as compensation pursuant to section 88- ; [~~and~~]

(2) Shall not include any other additional or extra payments to an employee or officer, including overtime, supplementary payments, bonuses, lump sum salary supplements, allowances, or differentials, including differentials for stand-by duty, temporary unusual work hazards, compression differentials, or temporary differentials, except for those expressly authorized pursuant to [~~subparagraphs (I)(B) through (I)(E)."~~] subsection (b)(1)(B), (b)(1)(C), and (b)(1)(D), and (b)(I)(E)"; and

(3) Back pay or retroactive pay shall be deemed earned when it would have been earned, as determined by the system.

SECTION 5. Statutory material to be repealed is bracketed and stricken. New statutory material is underscored.

SECTION 6. This Act shall take effect on January 1, 2050.

JOSH GREEN, M.D.
GOVERNOR

THOMAS WILLIAMS
EXECUTIVE DIRECTOR

KANOE MARGOL
DEPUTY EXECUTIVE DIRECTOR

STATE OF HAWAII
EMPLOYEES' RETIREMENT SYSTEM

TESTIMONY BY THOMAS WILLIAMS
EXECUTIVE DIRECTOR, EMPLOYEES' RETIREMENT SYSTEM
STATE OF HAWAII

TO THE SENATE COMMITTEES ON LABOR AND TECHNOLOGY

ON

SENATE BILL NO. 211

February 10, 2023
3:00 P.M.
Conference Room 224 & Videoconference

RELATING TO THE EMPLOYEES' RETIREMENT SYSTEM

Chair Moriwaki, Vice Chair Lee and Members of the Committee,

S.B. 211 proposes to add a new section which provides that service or compensation awarded to an employee by a final court decision, arbitration award, or court-approved settlement shall be considered "service" under Hawaii Revised Statutes (HRS) section 88-21 or "compensation" under HRS section 88-21.5.

While the ERS Board of Trustees has not had the opportunity to review the bill, the ERS staff believes that the Board would strongly oppose the measure.

1. Negative Impact on ERS's Tax Qualified Status

a. ERS's Tax Qualified Status

The ERS is a qualified governmental plan under the Internal Revenue Code ("IRC"). To maintain its qualified governmental plan status, the ERS plan must be administered according to its "plan provisions" or "plan documents" set forth at HRS Chapter 88 (including HRS section 88-22.5), as well as IRC section 401(a). Section 88-22.5 provides that "the [ERS] shall be administered in accordance with the requirements of section 401(a)… of the Internal Revenue Code of 1986, as amended." ERS membership, service credit, compensation, retirement eligibility, and other ERS benefits

are governed by, and therefore may only be provided pursuant to, HRS Chapter 88 and ERS administrative rules.

As long as the ERS continues to meet the qualification requirements, the members of the ERS will receive favorable federal income tax treatment of their ERS benefits, and the ERS will receive favorable tax treatment on its investment earnings. Should the ERS be administered in a manner that is inconsistent with HRS Chapter 88 and IRC § 401(a), the ERS's status as a qualified governmental plan would be placed at risk.

The ERS risks disqualification if it fails to follow its plan provisions, including HRS Chapter 88 and ERS administrative rules. *See* 26 C.F.R. sec. 1.401-1(b)(3) (stating "The law is concerned not only with the form of a plan but also with its effects in operation"). *See also DNA Pro Ventures, Inc. Emp. Stock Ownership Plan v. Comm'r of Internal Revenue*, 856 F.3d 557, 559 (8th Cir. 2017) ("A plan may be disqualified for operational failures, which occur if a plan fails to operate in accordance with § 401(a) statutory requirements or fails to follow the terms of the plan document"). *See, e.g., Forsyth Emergency Servs., P.A. v. Comm'r of Internal Revenue,* 68 T.C. 881, 891 (1977) (plan that operated in variance with its terms was disqualified by the IRS).

The Legislature has recognized the importance of "[protecting] the status of the Employees' Retirement System (ERS) as a tax-qualified retirement plan" and that disqualification of the plan would negatively impact ERS members and the State of Hawaii:

> Hawaii's ERS is currently a tax-qualified retirement plan under the IRC. Loss of this status would be detrimental to both the ERS and its members, resulting in the pre-tax treatment on member contributions to be eliminated and requiring ERS members to pay federal income taxes annually on the value or increase in value of a member's account without receiving a distribution. This could amount to thousands of dollars in taxes for members.

H.S.C.R. No. 343 (2011).

b. <u>Violation of Definitely Determinable Requirement</u>

IRC § 401(a)(25) provides that "[a] defined benefit plan shall not be treated as providing **definitely determinable benefits** unless, … the amount of any benefit is to be determined … in a way which **precludes employer discretion**." (emphasis added)

"A pension plan within the meaning of section 401(a) is a plan established and maintained by an employer primarily to provide systematically for the payment of **definitely determinable benefits** to his employees over a period of years, usually for life, after retirement. Retirement benefits generally are measured by, and based on, such factors as years of service and compensation received by the employees." *See* Treas. Reg. section 1.401-1(b)(1)(i). (emphasis added).

"[I]f, in the case of a defined benefit pension plan, the benefits on behalf of each participant are determined in accordance with a stipulated formula that is **not subject to the discretion of the employer**," the definitely determinable benefit requirements of section 1.401-1(b)(1)(i) of the regulations are satisfied. Rev. Rul. 74-385, 1974-2 C.B. 130 (1974) (emphasis added). On the other hand, if the terms of the plan specifically allow the employer to vary the employee's compensation used in the benefit formula, the plan would violate the definitely determinable rule. *See id.*

In *Fratinardo v. ERS*, 129 Hawai'i 107, 114-15, 295 P.3d 977, 984–85 (App. 2013), the court acknowledged that the ERS must comply with the I.R.C.'s "definitely determinable benefit" rule. The court stated that the definition of compensation in HRS section 88-21.5 was intended to "satisfy the Code's requirement that a member's benefit be 'definitely determinable.'" The court noted that "[i]n 2004, the Legislature made several amendments to HRS Chapter 88 to conform to the requirements of section 401(a) of the Internal Revenue Code of 1986 (Code). Stand. Comm. Rep. No. 692, in 2004 Senate Journal, at 1358-59." *See* Act 182, 2004 Haw. Sess. Laws. *See also* C.C.R. 122-04, S.S.C.R. 2143, and S.S.C.R. 2692 in 2004 Senate Journal.

S.B. 211 applies to court-approved settlements, as well as judgments and arbitration awards. Even if a settlement is court-approved, it is up to the employer to decide whether to enter into a settlement and whether to agree to specific settlement terms. It appears that S.B. 211 may give employers discretion to vary the employee's service credit or compensation used in the benefit formula by arbitrarily designating the dates, nature, and amounts of payments. An employer doing so would violate the definitely determinable requirement, especially in the absence of personnel and payroll records required by the employer reporting requirements of HRS section 88-103.7, which enable the ERS's calculation of monthly service and monthly compensation in remuneration therefor.

Example 1 (compensation): Proposed section (1)(B)(i) provides that if the employee challenges compensation and is subsequently awarded a retroactive pay differential, then "the pay differential that is awarded shall constitute compensation."

For Tier 1 employees, compensation includes "differentials" without restriction. *See* HRS section 88-21.5(a)(2). For Tier 2 employees, compensation only includes shortage differentials and twelve-month differentials for Department of Education employees. See HRS section 88-1.5(b)(1)(B), (b)(1)(D), and (b)(2).

If an employer agrees to a settlement for a Tier 2 member that purports to include a differential that is prohibited for Tier 2, this would be a prohibited exercise of discretion by the employer. S.B. 211 would allow the employer to vary the employee's compensation used in the benefit formula, in violation of the definitely determinable requirement.

Example 2 (compensation): Proposed section (1)(B)(ii) provides that if the employee challenges compensation and is subsequently awarded back pay, then "the

amount of back pay that constitutes compensation shall include normal salary adjustments and shall be based on the number of workdays between the date the employee's absence began until the employee's date of reinstatement and shall not exceed what the employee would have received had the employee not been suspended or terminated."

(c) Under the employer reporting requirements of HRS section 88-103.7(a), employers must "[a]llocate payments, including bonuses, salary adjustments, payments for compensatory time, and workers' compensation, to monthly or other periods as requested by the system."

If an employer agrees to a settlement that purports to include salary adjustments or pay raises, this may be a prohibited exercise of discretion by the employer, to the extent there is no (1) information about class, position upon which membership is based, pay type, payment dates (which month); (2) personnel and payroll records, and/or (3) indicia of compensation available to other similarly situated employees, available by pay schedule, or comparable to the employee's own history of compensation. S.B. 211 would allow the employer to vary the employee's compensation used in the benefit formula, in violation of the definitely determinable requirement.

(2) Overtime, bonuses, and lump sum salary supplements are included in Tier 1 compensation but are not included in Tier 2 compensation. See HRS section 88-21.5(a)(2), (a)(3) and 88-21.5(b)(2).

If an employer agrees to a settlement for a Tier 2 employee that purports to include overtime, bonuses, and lump sum salary supplements, these items are not authorized Tier 2 compensation. This would be a prohibited exercise of discretion by the employer. S.B. 211 would allow the employer to vary the employee's compensation used in the benefit formula, in violation of the definitely determinable requirement.

If an employer agrees to a settlement for a Tier 1 employee that purports to include overtime, bonuses, and lump sum salary supplements, this would require speculation as to (1) whether the employee would have worked overtime, when, and how much; (2) whether the employee would have received bonuses, when, for what purpose, and how much; or (3) whether the employee would have received supplemental payments, when, for what purpose, and how much. This would be a a prohibited exercise of discretion by the employer. S.B. 211 would allow the employer to vary the employee's compensation used in the benefit formula, in violation of the definitely determinable requirement.

Example 3 (compensation): If settlement provides a retroactive lump sum for back pay, the employer could arbitrarily designate the timing and amounts of pay (including overtime for Tier 1), so that more of the back pay falls within the employee's last three/five years. This would appear to be in contemplation of retirement and would artificially inflate the average final compensation and the retirement allowance. This would be a prohibited exercise of discretion by the employer. S.B. 211 would allow the

employer to vary the employee's compensation used in the benefit formula, in violation of the definitely determinable requirement. As discussed below, S.B. 211 may also encourage pension spiking.

Example 4 (service; credited service): Proposed section (a)(1)(A) provides that service awarded to an employee shall be considered service under HRS section 88-21. Section (a)(1)(A)(a)(i) provides that if the employee appeals an involuntary termination or unpaid suspension and is subsequently awarded back pay and is retroactively reinstated to employment or has the suspension rescinded, then service credit shall be for the period of retroactive employment for which back pay is awarded and the amount of service credited to the employee shall not exceed the period of absence that the employee would have worked but for their suspension or termination.

Service is distinct from credited service. Credited service reflects length of service and is measured in terms of months and years of service. Credited service is used in determining eligibility for service retirement (vesting). *See, e.g.*, HRS section 88-73(a). Credited service is also part of the formula for calculating the retirement allowance (average final compensation and the number of years of credited service). *See* HRS section 88-74(b).

If an employer agrees to a settlement agreement that states that the employee will be reinstated and awarded back pay for 18 months, this does not automatically entitle the employee to 18 months of credited service. In the calculation of credited service pursuant to HAR section 6-21-4, the employee would not be entitled to credited service for any fractional month of employment where the employee worked less than 15 days during the month (or 14 days for February). Absent personnel and payroll records showing whether the employee actually worked at least 15/14 days in a particular month, it would be arbitrary and speculative to assume that all of the 18 months qualify for credited service. This would be a prohibited exercise of discretion by the employer. S.B. 211 would allow the employer to vary the employee's years of credited used in the benefit formula, in violation of the definitely determinable requirement.

c. Violation of Exclusive Benefit Rule

The "exclusive benefit rule" is set forth at IRC section 401(a)(2) and HRS section 88-22.5(a)(1). IRC section 401(a)(2) provides that a tax qualified plan must make it "impossible, … for any part of the corpus or income to be … used for, or diverted to, purposes other than for the exclusive benefit of his employees or their beneficiaries." HRS section 88-22.5(a) provides that "[t]he system shall be administered in accordance with the requirements of section 401(a)… (2) … of the Internal Revenue Code of 1986, as amended." HRS section 88-22.5(a)(1), in turn and consistent with the IRC section 401(a)(2) "exclusive benefit rule," also clearly provides that "no part of the corpus or income of the system shall be used for or diverted to purposes other than for the exclusive benefit of members and their beneficiaries." IRC section 401(a)(2) and HRS

section 88-22.5(a) therefore require the ERS to make it impossible for ERS monies to benefit counties and other State agency employers.

The ERS should not be bound by the employer's and employee's characterization of back pay as compensation. To the extent that a settlement does not include compensation as defined in HRS section 88-21.5, the ERS should not have to assume a portion of the employer's liability for its alleged wrongful conduct (discrimination, suspension, termination of claimant, etc.). It appears that the exclusive benefit rule bars any mandate by S.B. 211 that the ERS's corpus and income be used for the benefit of the employer by assuming a portion of the employer's liability for its alleged wrongful conduct.

Thus, S.B. 211 may require the ERS to confer service, credited service and other retirement benefits in a manner that is not authorized by HRS Chapter 88 and ERS administrative rules. This would place the ERS's tax qualified status at risk with potentially severe negative consequences for the ERS and ERS members and beneficiaries.

The ERS has consulted with its tax counsel regarding the potential impact of S.B. 211 on the ERS's tax qualified status and they have indicated in writing that they share our concerns.

d. Impermissible Cash or Deferred Election.

A governmental defined benefit plan generally will not satisfy the requirements of Internal Revenue Code section 401(a) if it includes a cash or deferred arrangement. See Treas. Reg. section 1.401(k)-1(a)(1). A cash or deferred arrangement is any direct or indirect election by an employee to have the employer either provide an amount to the employee in cash that is not currently available or contribute an amount to a trust or provide an accrual or other benefit under a plan deferring the receipt of compensation. *See* Treas. Reg. section 1.401(k)-1(a)(3)(i).

A settlement between an employee and an employer could provide an employee with discretion as to how a monetary award should be structured. For example, a settlement could be structured to provide the employee with ERS compensation and service as proposed under S.B. 211. Also, a settlement could be structured to provide the employee with a lump sum award that is considered damages and would not result in service or compensation under ERS statutes.

2. Pension Spiking

HRS section 88-100 was enacted to address pension spiking, which the statute calls "significant non-base pay increases." *See* C.C.R. No. 115-12 (2012). Section 88-100 was intended to place a certain level of responsibility and accountability on employers whose employees' compensation is spiked in the immediate years prior to retirement. *See* S.S.C.R. No. 3008 (2012).

S.B. 211 may facilitate settlements made in contemplation of retirement and retirement benefits. It may encourage pension spiking because it would allow an employer and employee to arbitrarily allocate the timing (year/month) and amounts from a lump sum so that more of the back pay falls within the employee's last three/five years.

S.B. 211 does not preclude the imposition of the remedies provided in HRS section 88-100.

3. Administrative Burden

S.B. 211 would impose an administrative burden on the ERS. To the extent that a judgment or settlement does not comply with the reporting requirements of HRS section 88-103.7, the ERS is hindered in calculating monthly service credits and compensation, average final compensation, and retirement allowance. The ERS needs the required information (class, position, pay type, which month, etc.).

4. Actuarial Concerns (Increases in the ERS's Unfunded Liability)

Compliance with awards and settlements as provided in S.B. 211 may result in the ERS's loss of actuarial value should there be untimely/retroactive employer and employee contributions, or employee accrual of benefits. Compliance with such awards and settlement may result in unanticipated and unjustified increases to the ERS's unfunded liability, should there be ex post facto adjustments of purported service, purported compensation, or other factors influencing ERS benefit eligibility and calculations, made in anticipation of the employee's retirement and/or receipt of ERS retirement benefits under the terms of an award or settlement, so as to have the ERS bear the cost of resolving disputes between employees and employers.

The ERS asked its actuary, Gabriel, Roeder, Smith & Company ("GRS"), about the potential impact of the bill on the ERS. GRS indicated that the regular contributions required under the bill may be reasonable for a mid-career employee, but not for one who is near retirement.

For example, a police or fire employee was terminated after approximately 10 years of service but 5 years later was reinstated and awarded back pay and service.

Example 1: The employee is not close to retirement. GRS indicated that the regular contributions required under the bill may be reasonable for a mid-career employee, but not for one who is near retirement.

Example 2: The employee is in his early 50s and has 23 years and 3 months of service, and eligible for retirement with 25 years of service. If the employee is near retirement, GRS estimates the cost to the ERS if the 5 years of service were restored to be approximately $90,000, which is roughly 50% of this employee's compensation of $170,262.36.

Example 3: If an employee has his service reinstated retroactively to a period that occurred 12-17 years ago, GRS estimates that the expected actuarial loss to the ERS would be approximately $213,000. Even though interest would be charged on the employer contributions from the date they should have been made to the date they are actually received by the ERS (12 to 17 years later), this does not cover the cost to the ERS because the member will go from not being eligible to retire to for another 21 months to being eligible to retire immediately.

In these examples, GRS used the current contribution rates to the ERS. In the third example, if the employer contribution rates from 2005-2010 were used, this would increase the actuarial loss to the ERS even more, since those rates were significantly lower than the current 41% of pay employer rates for police and fire employees.

Accordingly, employer and employee contributions should be based on the actuarial value of such contributions, rather than as proposed in sections (2) and (3) of Section 2 of S.B.211. Settlement may be years after the time to which the back pay is designated, with a corresponding negative impact on the ERS's unfunded liability.

The ERS respectfully requests that S.B. 211 be deferred. In the alternative, the ERS requests that the Committee consider the attached proposed amendments to S.B. 211, which contain safeguards intended to protect the ERS's tax qualified status and prevent negative impacts on the ERS's unfunded liability.

Thank you for this opportunity to provide testimony.

Attachment (5 pages): Proposed amendments to S.B. 211

Proposed amendments to S.B. 211

SECTION 1. The purpose of this Act is to ensure that [~~compensation~~] employment, work and pay eligible for the purpose of calculating retirement benefits [~~and service time~~] includes [~~pay and service~~] retroactive reinstatement, retroactive rescission of suspension, retroactive pay differential, and back pay that are restored to an employee as part of an administrative, arbitral, or judicial proceeding[~~.~~], subject to certification that the retroactive reinstatement, retroactive rescission of suspension, retroactive pay differential and back pay that are restored otherwise satisfy the requirements of Chapter 88, Hawaii Revised Statutes, including (1) the definition of service in section 88-21; (2) the calculation of credit for a year of service in section 88-50; (3) the definition of compensation in section 88-21.5 (as enacted by Act 182 (2004) to prevent significant non-base pay increases) (and as amended in this Act); (4) compliance with the employer reporting requirements of section 88-103.7; (5) payment of the actuarial value of employee contributions; and (6) and payment of the actuarial value of employer contributions.

SECTION 2. Chapter 88, Hawaii Revised Statutes, is amended by adding a new section to part II, subpart B, to be appropriately designated and to read as follows:

"§88- Service credit and compensation; back pay. (a) [~~Service or compensation~~] Retroactive reinstatement, retroactive rescission of suspension, retroactive pay differential or back pay awarded to an employee pursuant to the final adjudication of a court of competent jurisdiction, as defined in section 88-21, shall be considered service under section 88-21 and/or compensation under section 88-21.5, respectively, ~~under the following conditions:~~ upon certification by the system that:

(1) For:

(A) Service, the employee appeals an involuntary termination or unpaid suspension, [~~and is subsequently awarded back pay and~~] is retroactively reinstated to employment or has the suspension rescinded in whole or in part, and is awarded back pay, pursuant to the final adjudication of a court of competent jurisdiction; provided that:

[~~(i)~~ ~~The service credit shall be for the period of retroactive employment for which back pay is awarded; and~~]

[~~(ii)~~ ~~The amount of service credited to the employee shall not exceed the period of absence that the employee would have worked but for their suspension or termination; or~~]

(i) The days of retroactive employment for which back pay is awarded pursuant to the final adjudication of a court of competent jurisdiction and paid by the State or county shall be considered service;

(ii) The days of service shall not exceed the number of days the employee would have provided service if the individual had not been suspended or terminated; and

(iii) The service shall be credited to the extent it meets the requirements for credit provided in this chapter; or

(B) Compensation, the employee challenges compensation and is subsequently awarded[~~.~~] a retroactive pay or back pay differential pursuant to the final adjudication of a court of competent jurisdiction; provided that:

(i) The amount of a [~~A~~] retroactive pay differential awarded pursuant to the final adjudication of a court of competent jurisdiction [~~then the pay differential that is awarded shall constitute compensation;~~] and paid by the State or county shall be considered a differential, not to exceed the amount and type of differential available to other similarly situated employees, available by pay schedule, or comparable to the employee's own history of pay differential; and

(ii) The amount of [~~Back~~] back pay awarded pursuant to the final adjudication of a court of competent jurisdiction [~~then the amount of back pay that constitutes compensation shall include normal salary adjustments and shall be based on the number of workdays between the date the employee's absence began until the employee's date of reinstatement~~] and paid by the State or county shall be considered pay, not to exceed the amount and type of pay under normal salary adjustments available to other similarly situated employees, available by pay schedule, or comparable to the employee's own history of compensation, not to exceed pay attributable to the number of workdays between the date the employee's absence began until the employee's date of reinstatement, and [~~shall~~] not to exceed [~~what~~] the pay that the employee would have received had the employee not been suspended or terminated; and

(iii) Differential or pay shall be considered compensation to the extent the type of differential or pay meets the requirements of section 88-21.5;

(2) The requirements of section 103.7 are met with respect to any retroactive reinstatement, retroactive rescission of suspension, retroactive pay differential or back pay awarded pursuant to the final adjudication of a court of competent jurisdiction and paid by the State or county.

(~~2~~) (3) The employee makes [~~contributions~~] lump sum payment to the system [~~based on the applicable ate set forth in section 88-45 and~~] in the amount of the actuarial present value, as determined by the system, of contributions that the employee would have contributed had the employee's employment not been suspended or terminated[;],and compound interest thereon at the assumed rate of return, provided that service shall be credited at no cost for class C service;

(~~3~~) (4) The employer makes lump sum payment to the system [~~based on the contribution rate or rates in effect for the plan during the period of service covered by the back- pay award, and~~], in the amount of the actuarial present value, as determined by the system, of contributions the employer would have contributed pursuant to sections 88-123 through 88-126 had the employee's employment not been suspended or terminated. along with compound interest [~~at the actuarial valuation rate for contributions payable from the date the contribution was due until paid~~] thereon at the at the assumed rate of return; and

~~(4)~~ (5) If the employee was terminated, the employee repays:
(A) [~~Any~~] The actuarial present value, as determined by the system, of any amount in employee contributions that were refunded to the employee; and
(B) [Any] The actuarial present value, as determined by the system, of any service or disability allowance that was paid to the employee, at the time of the employee's termination.

[~~(b) Upon satisfaction of the requirements under subsection (a), the employee shall be entitled to all the membership rights and service credit that would have accrued but for the member's challenged suspension or involuntary termination upon receipt by the system of the full amount due."~~]

SECTION 3. Section 88-21, Hawaii Revised Statutes, is amended by:
1. Adding a new definition to be appropriately inserted and to read as follows:
"Final adjudication of a court of competent jurisdiction" means:
(1) The final decision of a court, an administrative proceeding, or an arbitration proceeding from which no appeal may be filed or which no appeal has been filed within the time allowed;
(2) A stipulated judgment;
(3) A court-approved settlement;
(4) A settlement adopted by court order or referenced in an order of dismissal;
(5) A third-party arbitrator decision from which no appeal may be filed or from which no appeal has been filed within the time allowed; or
(6) Other final resolution of an appeal or challenge from which no appeal may be filed or from which no appeal has been filed within the time allowed."

2. Amending the definition of [~~"base pay" and~~] "service] to read as follows:

[~~"Base pay" means the normal periodic payments of money for service, the right to which accrues on a regular basis in proportion to the service performed; recurring differentials; [and] elective salary reduction contributions under sections 125, 403(b), and 457(b) of the Internal Revenue Code of 1986, as amended[.]; back pay pursuant to section 88- ; and pay differential pursuant to section 88- ;~~]

"Service": service as an employee paid by the State or county, and also: [~~service~~]
(1) Service during the period of a leave of absence or exchange if the individual is paid by the State or county during the period of the leave of absence or exchange; [~~and service~~]

(2) Service during the period of an unpaid leave of absence or exchange if the individual is engaged in the performance of a governmental function or if the unpaid leave of absence is an approved leave of absence for professional improvement; provided that, for the period of the leave of absence or exchange without pay, the individual makes the same contribution to the system as the individual would have made if the individual had not been on the leave of absence~~[.]~~; and

(3) Service pursuant to section 88- . Cafeteria managers and cafeteria workers shall be considered as paid by the State regardless of the source of funds from which they are paid."

SECTION 4. Section 88-21.5, Hawaii Revised Statutes, is amended to read as follows:

"**§88-21.5 Compensatio**n. (a) For a member who became a member before July 1, 2012[, ~~unless~~]:

(1) Unless a different meaning is plainly required by context, "compensation" as used in this part[~~, compensation~~] means:

[~~(1)~~] (A) Normal periodic payments of money for service the right to which accrues on a regular basis in proportion to the service performed;

[(~~2~~)] (3) Overtime, differentials, and supplementary payments;

[(~~3~~)] (C) Bonuses and lump sum salary supplements;

[~~and~~]

[(-~~4~~)] (D) Elective salary reduction contributions under sections 125, 403(b), and 457(b) of the Internal Revenue Code of 1986, as amended[--]; and

(E) Back pay or retroactive pay differentials [~~considered as compensation pursuant to section 88~~] of those payments authorized in subsections (a)(1)((A), (B), (C) and (D), and certified pursuant to section 88- ; and

(2) Bonuses and lump sum salary supplements shall be deemed earned when payable; provided that bonuses or lump sum salary supplements in excess of one-twelfth of compensation for the twelve months prior to the month in which the bonus or lump sum salary supplement is payable, exclusive overtime, bonuses, and lump sum salary supplements, shall be deemed earned:

[~~(1)~~] (A) During the period agreed-upon by the employer and employee, but in any event over a period of not less than twelve months; or

[(~~2~~)] (B) In the absence of an agreement between the employer and the employee, over the twelve months prior to the date on which the bonus or lump sum salary supplement is payable.

(b) For a member who becomes a member after June 30, 2012, unless a different meaning is plainly required by context, "compensation" as used in this part:

(1) Means:

(A) The normal periodic payments of money for service, the right to which accrues on an hourly, daily, monthly, or annual basis;

(B) Shortage differentials;

(C) Elective salary reduction contributions under sections 125, 403(b), and 457(b) of the Internal Revenue Code of 1986, as amended; [~~and~~]

(D) Twelve-month differentials for employees of the department of education; and

(E) Back pay or retroactive pay differentials [~~considered as compensation pursuant to section 88-~~] of those payments authorized in subsections (b)(1)(A), (b)(1)(B), (b)(1)(C) and (b)(1)(D), and certified as compensation pursuant to section 88- ; and

(2) Shall not include any other additional or extra payments to an employee or officer, including overtime, supplementary payments, bonuses, lump sum salary supplements, allowances, or differentials, including differentials for stand-by duty, temporary unusual work hazards, compression differentials, or temporary differentials, except for those expressly authorized pursuant to subsection (b) (1) (B), (b)(1)(C), [&~8] (b)(1)(D)[.], and (b)(l)(E)."

SECTION 5. Statutory material to be repealed is bracketed and stricken. New statutory material is underscored.

SECTION 6. This Act shall take effect upon its approval.

DEPARTMENT OF HUMAN RESOURCES

CITY AND COUNTY OF HONOLULU

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ASSISTANT DIRECTOR

March 30, 2023

The Honorable Kyle T. Yamashita, Chair
The Honorable Lisa Kitagawa, Vice Chair
and Members of the Committee on Finance
House of Representatives, Room 308
State Capitol
415 South Beretania Street
Honolulu, Hawaii 96813

Dear Chair Yamashita, Vice Chair Kitagawa, and Members of the Committee:

SUBJECT: Senate Bill No. 211 SD 2 HD2
Relating to the Employees' Retirement System

Senate Bill No. 211, SD 2, HD 2 ("SB 211") ensures that employment, work, and pay eligible for the purpose of calculating Employees' Retirement System (ERS) retirement benefits includes retroactive reinstatement, retroactive rescission of suspension, and retroactive payments that are restored to an employee as part of an administrative, arbitral, or judicial proceeding.

The City and County of Honolulu ("City") is in strong support of this measure, which is part of the Mayor's legislative package.

Since the introduction of SB 211, the City and County of Honolulu, Department of Human Resources and the ERS have been working collaboratively on the language of the bill and making amendments that the parties believe will satisfy the purpose and intent of the bill while protecting the ERS' tax qualified status. We are very appreciative of the ERS' understanding of the issue and willingness to work with the City on the complicated language of this bill.

We are pleased to inform you that, on or about March 21, 2023, the City and the ERS reached an agreement on the language of SB211. The agreed upon version of the bill was attached to the parties' testimonies submitted to the House Committee on Judiciary and Hawaiian Affairs (JHA), dated March 21, 2023. The JHA referred SB211 to your committee and incorporated the parties' proposed amendments into the current SB211.

As background, when employees and/or their unions avail themselves of their right to challenge employee suspensions, terminations, and/or compensation through the judicial, administrative (including grievance), or arbitral process, the issues are frequently resolved with either awards or settlements. These awards and settlements may require the provision of "make whole" relief involving the rescission of a suspension or termination and/or payment of back pay. In such cases, the City remits its employer contribution and the employee contribution (deducted from the back pay) to the ERS. The City does so with the understanding that the ERS would include the employee's retroactive service as creditable service and the back pay as compensation for the purpose of determining the employee's pension eligibility and benefits. We note that a number of other jurisdictions require, to differing degrees, their respective employees' retirement system to base their pension calculation on retroactive service credits and/or back pay that are provided through such settlements and awards.

On December 17, 2021, the ERS issued a memorandum advising the State and County employers that "ERS benefit eligibility determinations and calculations may not be made, and ERS benefits may not otherwise be provided, pursuant to awards and settlement agreements that resolve claims between employees and employers…." According to the ERS, because its laws and rules did not address the crediting of such service, doing so could have been contrary to the Internal Revenue Code and jeopardized the ERS' tax-exempt status. These concerns resulted in the ERS' advisory to the employers.

The ERS memorandum was a departure from the ERS' long-standing past practice of crediting awards and settlements for service credits and benefits determination purposes. The bill codifies and authorizes this practice with modifications to better ensure compliance with tax laws and the health of the system. The modifications remove uncertainty as to how service time and back pay from settlements and awards will be counted and credited when specific requirements are met.

As indicated above, after multiple discussions between the parties, SB211 (in its current form) is the version the City and the ERS have agreed upon. The City asks that an additional amendment be made to the effective date of the bill in Section 6. We ask that it become effective upon approval. Aside from the change to Section 6, the City requests that SB211, SD2, HD2 be passed unamended.

Based on the foregoing, we ask for your support in advancing this measure.

Thank you for the opportunity to provide testimony in strong support of this measure.

Sincerely,

Nola N. Miyasaki
Director

The Thirty-Second Legislature, State of Hawaii
The House of Representatives
Committee on Finance

Testimony by the Hawaii Fire Fighters' Association, Hawaii Government Employees Association, AFSCME Local 152, AFL-CIO, Hawaii State Teachers Association, State of Hawaii Organization of Police Officers, University of Hawaii Professional Assembly, and United Public Workers

March 31, 2023

S.B. 211, S.D.2, H.D. 2 — RELATING TO THE EMPLOYEES' RETIREMENT SYSTEM

The Hawaii Fire Fighters' Association, Hawaii Government Employees Association, AFSCME Local 152, AFL-CIO, Hawaii State Teachers Association, State of Hawaii Organization of Police Officers, University of Hawaii Professional Assembly, and United Public Workers strongly support the purpose and intent of S.B. 211, S.D. 2, H.D. 2 which ensures that employment, work, and pay eligibility for the purpose of calculating retirement benefits includes retroactive reinstatement, retroactive rescission of suspension, and retroactive payments that are restored to an employee as part of a judicial, administrative, or arbitral proceeding, or pursuant to a settlement of claims.

Contrary to long standing policy, practice and procedure, the State of Hawaii Employees' Retirement System ("ERS") recently took an about-face on its decades long position and is refusing to appropriately credit members who were wrongfully terminated and reinstated through a final and binding arbitration decision achieved through the grievance procedure with service credits. The ERS's refusal to properly credit a reinstated member, who should never have been suspended or terminated in the first place, is reckless and appalling, especially when the members and employers upon reinstatement paid in their full contributions to the ERS, which the ERS accepted, maintained in its possession for years, and assumingly used to invest and perpetuate the retirement fund.

The ERS's new position also contravenes and runs afoul of the law and its obligation as an arm of the State, which is a party and signatory to our collective bargaining agreements.

Thank you for the opportunity to testify in strong support of S.B. 211, S.D. 2, H.D. 2.

Sincerely,

Bobby Lee, President
Hawaii Fire Fighters Association

Christian Fern, Executive Director
University of Hawaii Professional Assembly

Randy Perreira, Executive Director
Hawaii Government Employees Association

Kalani Werner, State Director
United Public Workers

Robert Cavaco, State Director
State of Hawaii Organization of Police Officers

Ann Mahi, Executive Director
Hawaii State Teachers Association

S H P O

STATE OF HAWAII ORGANIZATION OF POLICE OFFICERS

" A Police Organization for Police Officers Only "
Founded 1971

March 30, 2023

VIA ONLINE

The Honorable Kyle T. Yamashita
Chair
The Honorable Lisa Kitagawa
Vice-Chair
House Committee on Finance
Hawaii State Capitol, Rooms 306, 435
415 South Beretania Street
Honolulu, HI 96813

Re: **SB 211 SD2 HD2 – Relating to the Employee's Retirement System**

Dear Chair Yamashita, Vice-Chair Kitagawa, and Honorable Committee members:

I serve as the President of the State of Hawaii Organization of Police Officers ("SHOPO") and write to you on behalf of our Union in **strong support** of SB 211 SD2 HD2 with comments suggesting two further amendments for your consideration regarding the effective date and applicability of the act, and the specificity of information required by an Arbitrator (or decision-maker) to satisfy "service" requirements.

As originally intended, this bill was promulgated to ensure that compensation eligible for the purpose of calculating retirement benefits and service time includes pay and service that are restored to an employee as part of an administrative, arbitral, or judicial proceeding. As initially drafted, this bill sought not only to reconfirm the long standing interpretation and application of the current statutes,[1] but also assured fundamental fairness for employees who are deemed innocent of the allegations raised against them and/or when charges against an employee are ruled to be unfounded, without support, or excessive, and the decision-maker selected by the parties makes the employee "whole" pursuant to the authority the employer and union bestowed on the decision-maker pursuant to the CBA and due process rights the State of Hawaii negotiated with the unions.

[1] This Counties and the ERS have been following the long-established practice of reinstating service credits for over 20 years whenever an employee wrongfully discharged has been subsequently reinstated. This was confirmed by the testimony of the Director (Nola Miyasaki) (dated 2/10/23) of the City and County of Honolulu's Department of Human Resources in "strong support" of SB 211 ("The ERS memo presented a significant departure from what the City understood as the ERS' long-standing past practice of crediting awards and settlements for service credits and benefits determination purposes. As noticed above, the ERS' practice is consistent with their counterparts in other states.").

However, since first being introduced, there have been many amendments to this bill, many of which were added just recently as a result of a joint effort by the ERS and the City & County of Honolulu to come to an agreed upon version of the bill. See March 21, 2023 Testimony of Nola N. Miyasaki, Director of City & County of Honolulu Department of Human Resources. Although SHOPO's members with prior awards/judgments/settlement agreements are directly impacted by the language of this bill, SHOPO was not invited to and did not participate in the recent discussions between the City and ERS that resulted in their joint proposal.

After its 3/14/23 hearing, LGO stated in HSCR 1313:

> Your Committee notes that it considered several amendments proposed by the Employees' Retirement System in its written testimony, but had concerns that the City and County of Honolulu's Department of Human Resources and other state and county departments had not had the chance to adequately review and opine on these proposed amendments. At the time this committee report was filed, the Employees' Retirement System also did not provide sufficient justification for its claims that these amendments were necessary under Internal Revenue Service rules and regulations.

HSCR 1313. In the same report, LGO requested that JHA deliberate on this measure to consider language to: (1) Include settlement agreements made in good faith without any kind of final adjudication by a court of competent jurisdiction; and (2) Allow second or third good faith opportunities, if correct information is not included in the court order or settlement agreement, to conform to the requirements of the ERS.[2] SHOPO fully supported the insertion of language that would achieve those ends. Fortunately, SB 211 SD2 HD2 now includes language making the Act applicable to settlement agreements.

However, without any further explanation or justification offered by the ERS except the representation that the City & County of Honolulu supports its amendments, JHA appears to have rubber stamped ERS' proposed amendments and significantly narrowed the applicability of SB 211 SD2 HD2 to our members. In particular, the definition of the new term "final resolution of claims," the current version of this bill includes the qualifying phrase **"that became final on**

[2] Although SB 211 SD2 HD2 does not include language allowing for additional good faith opportunities if correct information is not included in the court order or settlement agreement to conform to the requirements of the ERS, the ERS' 3/21/23 testimony stated: "The bill does not preclude the opportunity to resubmit if there are corrections, revisions, or new documents to be reviewed. It is not necessary to amend the bill to state this, since it is part of the administrative review process."

or after [the effective date of this Act]." This amendment effectively cuts out any and all members that ERS has denied service credit to in the last year or so when it changed its policy and position abruptly. The ERS (and apparently the City) is perfectly fine advocating for a result that makes this bill inapplicable to the unfortunate and inequitable situation currently faced by our members who have already been found by an independent Arbitrator and/or court of competent jurisdiction to have been wrongfully terminated and/or disciplined, including one particular member discussed in more detail below who has been waiting to retire for three years and others in the same situation. Moreover, this language creates a class of members who were reinstated before the effective date of this act, but decided to retire after the ERS suddenly changed its long-standing practice to credit service time to reinstated members (*circa* 2020-2021) but before the effective date of this act, who are inequitably and unjustly treated as compared to other members in the same situation who decided to retire before or after this period. For these reasons, **SHOPO strongly urges this committee to remove this language.**

Further, SHOPO suggests that Section 2, subsection (1)(A)(ii) of the current version of this bill requiring that final resolution of claims specify the "dates of retroactive employment or retroactive rescission of suspension, and the **amount,** purpose, and nature of retroactive payments **for each monthly period** in which the employee would have provided service if the employee had not been suspended or terminated[,]" be **further amended to eliminate the underlined language**. Under SHOPO's CBA, an Arbitrator is authorized to make an employee "whole," which means that the Arbitrator is empowered to return any and all lost pay and benefits as if the employee had never been terminated in the first place. To that end, when appropriate, arbitrators' awards typically will state that the terminated employee is entitled to be made "whole" by restoring to them any and all benefits denied to them since their termination, including but not limited to lost pay, retirement credits and benefits, time in grade, and any and all promotions and privileges due to them. While the amount and nature of such benefits are usually undisputed and straightforward because pay and benefits are typically detailed in the CBA or in other writings or practices, requiring the Arbitrator to make a definitive ruling on the specific "amount" of these benefits is an unnecessary use of the Arbitrator's and parties' time and resources. In the rare occasion where a dispute as to pay or benefits arises, the parties may return to the Arbitrator for a ruling. The use of the make "whole" language requires the parties to work out the amount of benefits that an employee would have received had he or she not been wrongfully terminated or disciplined, and such benefits are paid out or provided to the employee which will typically conclude the matter. Requiring the Arbitrator to provide additional specificity, including a specific amount of pay or benefits, in his or her decision and award invites error and unnecessary disputes and is a waste of time and resources. Likewise, requiring an Arbitrator to detail the amount, purpose, and nature of benefits for each monthly period when benefits are generally the same for all periods, is unduly burdensome on the decision-maker and does not reflect the customary way in which arbitration awards are worded.

Re: **SB 211 SD2 HD2 – Relating to the Employee's Retirement System**

These are the changes SHOPO strongly urges the Committee to make to the existing bill. As for the remainder of the bill, SHOPO stands in strong support. The changes to HRS chapter 88 as indicated in SB 211 are urgently needed as they will make clear to the ERS' Executive Director that pay and service that are restored to an employee as part of an administrative, arbitral, or judicial proceeding or settlement of claims qualifies as compensation eligible for the purpose of calculating retirement benefits and service time.

As stated in previous SHOPO testimony, the Employer and Union negotiated a CBA wherein an arbitrator is empowered and authorized to issue a final and binding decision as to whether the Employer has violated, misinterpreted, or misapplied any of the sections of the agreements between the Union and the Employer. In addition, Hawaii law provides that "an arbitrator may order such remedies as the arbitrator considers just and appropriate under the circumstances of the arbitration proceeding." See HRS § 658A-21. As stated previously, where deemed appropriate, arbitration awards in this context will often include provisions stating that the wrongfully terminated member is entitled to be made whole by restoring to them any and all benefits denied to them since their termination, including but not limited to lost pay, retirement credits and benefits, time in grade, and any and all promotions and privileges due to them. This is the employee's primary avenue of recourse as negotiated by the parties which avoids lawsuits and unnecessary litigation and resolves these types of matters through private arbitration. As you may also know, the collective bargaining rights between a union and the employer are constitutionally protected rights that arise under Article 13 of the Hawaii Constitution.

Until recently, the long-established policy, practice and procedure of the ERS recognized and complied with final and binding arbitration decisions by calculating and crediting service credits for employees/members who have been reinstated after being wrongfully terminated. This has been the status quo for over 30 years. However, the ERS abruptly and without warning overturned decades of its own established policy, practice and procedure, and now refuses to appropriately credit members with service credits who were wrongfully terminated and subsequently reinstated through the grievance procedure agreed to by the Employers. This refusal to properly credit a reinstated member, who should have never been terminated in the first place, is alarming, especially when the members and employers upon reinstatement have paid their full contributions into the ERS, which the ERS accepted, held in its possession for years, and presumably used such funds to invest and perpetuate the retirement fund. Moreover, this position contravenes and runs afoul of the law and the ERS' obligations as an arm of the State, which is a party and signatory to our and many other public employee CBAs. See HRS § 26-8 (stating that the ERS as constituted by chapter 88 is placed within the Department of Budget and Finance ("DBF"), State of Hawaii, for administrative purposes). By refusing to abide by and comply with arbitration decisions and orders that mandate retirement and service

credits be restored to make a wrongfully terminated member whole, the State is in essence depriving a member of being made whole and penalizing the member for having been wrongfully terminated due to no fault of their own. Respectfully, this position is without valid grounds, inequitable, and violates the applicable CBAs and lawful arbitration decisions (and court orders where confirmed). Unfortunately, despite our best efforts to convince the ERS's Executive Director, he refuses to reconsider his position on service credits or to reinstate the ERS' decades long application of its prior rule. Instead, he has dug in his heels leaving a wrongfully terminated member at risk of suffering the financial retirement consequences of their Employer's initial erroneous termination decision.

As one example, over a decade ago a court confirmed an arbitration award that ruled a police officer had been wrongfully terminated after he was targeted by an arrestee who made false accusations against him. The arbitrator ordered that the officer be made whole by restoring any and all benefits that he lost after being wrongfully terminated, including retirement benefits and credits. The police officer was accordingly reinstated and the ERS promptly collected the County's retirement contribution for the officer and the officer's retirement contribution which were used by the ERS for its investments over the last 10 years. After 25 years of service as a police officer and after the ERS accepted and used the County's and the officer's retirement contributions for investment purposes, the officer attempted to retire in 2020. In response, the ERS flipped 180 and claimed the officer had no credit and zero contributory service for the time he was wrongfully terminated and thus, did not meet eligibility requirements to retire because he did not have 25 years of service. The ERS has provided no valid basis for this highly inequitable position. Moreover, we suspect that the ERS' board of trustees may not even be aware of the position being asserted by its Executive Director. What makes the ERS's position egregious and highly disturbing is that after the ERS took this unequitable position in 2020, it only attempted to return the officer's contributions several weeks ago, on or about March 13, **2023**, or more than three (3) years after telling the officer they would not credit all of his service years. To add insult to injury, the ERS called it an "erroneous contribution" although it had no problem accepting the contribution and applying it toward its investments over the last 10 years. In other words, the ERS is essentially saying thank you for letting us have your money which deprived the officer of the use of his money over the last decade, but now it was going to give it back to him and deny him retirement service credits. This gross mismanagement and abuse by the ERS must be stopped.

Re: **SB 211 SD2 HD2 – Relating to the Employee's Retirement System**

We thank you for allowing us to be heard on this very important issue and we hope your committee will consider and adopt our suggested amendments to SB 211 SD2 HD2.

Respectfully submitted,

ROBERT "BOBBY" CAVACO
SHOPO President

RC jmo