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# Municipal Pension Handbook

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# Municipal Pension Handbook

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# Municipal Pension Handbook

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As of the last count, there are 2,540 municipal pension plans in Pennsylvania: 970 police plans, 75 firefighter plans, and 1,495 non-uniformed employee plans. This number is exclusive of municipal authorities, counties, school district, and other “political subdivisions.” Of those municipal plans, 67% had 10 or fewer active members, 19% had 11 to 25 members, and only 14% had more than 25 active members.

## Constitutional Issues

The Pennsylvania Supreme Court has applied the state constitutional ban against the passage of laws which impair the obligation of contracts to the rights of public employees in their pensions. Specifically, the judicial analysis is that pension benefits constitute a form of deferred compensation, earned today but to be paid in the future. As such, once a public employee has worked even a single day, he or she has not only earned that day’s pay but also the guaranteed right to such future pay (i.e. retirement benefits) that formed part of the employer’s promise of compensation. *Wright v. Retirement Board of Allegheny County*, 390 Pa. 75, 134 A. 231 (1957). Thus, pension benefits cannot be taken away unilaterally, whether by statute, ordinance, or similar action. *Police Pension Fund Association Board v. Hess*, 127 Pa.Cmwlth.Ct. 498, 562 A.2d 391 (1989).

Retirement benefits can be voluntarily relinquished, however, either expressly or by implication. Express relinquishment includes a bargained for exchange as part of a collective bargaining agreement, voting to join or withdraw from the Pennsylvania Municipal Retirement System, or similar voluntary action.

Implied relinquishment occurs as a result of the performance, or nonperformance, of an act that carries legal repercussions, which may not have been intended. An example would include the commission of a crime subject to the Public Employee Pension Forfeiture Act, 1978, July 8, PL 752, No. 140, as amended, 43 P.S. § 1311, et seq., which disqualifies any elected or appointed member or employee of the state or any political subdivision who is convicted of a listed crime relating to public office or employment from receiving any pension benefit, except the return of contributions without interest.

## Types of Pension Plans

Basically, there are three types of pension plan: defined contribution, defined benefit, and multi-employer. The distinction between them turns on the identity of the party that bears the risk of loss, and benefits from gains.

In a defined contribution plan, the employer’s sole financial responsibility is to make a predetermined contribution to the pension fund on behalf of each employee. That contribution may be a fixed percentage of pay or a fixed dollar amount. Either way, the employer only promises to make the contribution, it does not promise any specific level of benefit. The employee’s pension benefit is based upon the amount in the account at the time of retirement, so investment gains and losses can cause substantial fluctuation. The employee usually has control of the choice of investments, although a specific provider may be appointed by the employer to administer the funds.

In a defined benefit plan, the employer promises a definite benefit, usually a percentage of compensation, and funds the plan accordingly. Investment losses may result in higher employer contribution requirements, while investment gains may reduce, or even eliminate, the need for employer contributions to the plan.

In a multi-employer plan, usually sponsored by a labor union, the employer makes a fixed contribution based upon a collective bargaining agreement, without regard to the nature of the benefit promise. Whether the labor organization guarantees a defined pension based on percentage of compensation, or simply accumulates

contributions to the account of the employee has no impact on the municipality. The multi-employer plan is just a form of defined contribution plan from the employer's perspective.

Statutory pension schemes in Pennsylvania are generally of the defined benefit sort. Where the law does not regulate the nature of a municipal pension plan, however, defined contribution plans are not uncommon.

## **Statutory Structures**

Depending on the class of municipality and the nature of the employment, various statutory provisions govern the creation and maintenance of employee pension plans. Philadelphia, the only City of the First Class, applies the act of May 20, 1915, PL 566, as amended, 53 P.S. §§ 13431-13449. Pittsburgh is subject to the Second Class City Code, act of April 15, 1917, PL 39, as amended, 53 P.S. §§ 23641-23666. Scranton is governed by the Second Class A City Code, act of July 3, 1947, PL 1242, as amended, 53 P.S. §§ 30491-30515.1 (for police and firefighters); and the acts of Sept. 23, 1959, P.L. 970, and May 7, 1965, P.L. 48, as amended, 53 P.S. §§ 30551-30594 (for non-uniformed employees). The force and effect of these laws have been mitigated by the establishment and maintenance of home rule charters, which grant broad powers to act within constitutional limitations.

While police pension plans are almost always controlled by statute, as are firefighter plans in the cities, non-uniformed employee plans and those for firefighters in boroughs and townships are largely unregulated and are governed solely at the municipal level.

In boroughs and townships employing fewer than three full time police officers and not opting to be governed by Act 600, the respective municipal codes control. Only the First Class Township Code mandates that any plan be established. In boroughs and second class townships, even the existence of a police pension is discretionary.

The Borough Code, Act of February 1, 1966, PL 1656, No. 581, as amended, 53 P.S. § 46131-46137, allows a police pension plan to be established. Age and service requirements must be set, but what they are is unspecified. All benefits are to be determined by the ordinance, and no contribution rate is mandated.

The Second Class Township Code, Act of May 1, 1933, PL 103, No. 69, as amended, 53 P.S. § 65595-65599, is the other non-mandatory plan. Neither age nor service requirements need be set, but if a service requirement is established it must be at least twenty years. Contributions cannot exceed 3% of pay. All benefits are subject to local determination.

The First Class Township Code, Act of June 24, 1931, PL 1206, No. 331, as amended, 53 P.S. § 56409-56415, mandates the creation of a police pension plan with superannuation benefits not to exceed one-half of monthly pay. Work-related disability and survivors' benefits are required, but the amount is not established. Age and service requirements are optional, but service of at least twenty years must be set if any service requirement is created. Contributions to the plan are limited to 4% of compensation.

The Pennsylvania Municipal Retirement System, Act of February 1, 1974, PL 30, No. 15, as amended, 53 P.S. § 891.101, et seq., is something of a pension system, to the extent that the municipality elects to utilize the statutory frameworks for its benefit plans (under Chapters 2 or 3 of the law), and something of a pension plan administrator where the municipality opts to establish its own benefit structure (a Chapter 4 plan).

## **Summary of Plan Provisions**

PMRS offers a variety of alternative pension plans. Municipalities may design their own pension benefit structures. Most municipalities select this option and work with PMRS to create a combination of benefits that

meet the individual needs of the municipality and its employees. Additionally, PMRS has two basic benefit plans designed by the law: one for municipal employees (Chapter 2) and one for police and firefighters (Chapter 3).

## **Superannuation and Early Annuity Eligibility Benefits**

Under the basic plans, the minimum normal retirement age is 65 for municipal employees and 55 for police and firefighters. A member may retire early at any age after 24 years of service. Under an optional plan design, a municipality may choose any age or service requirement permitted under its particular municipal code. Early retirement under the optional plan may also be designed to meet the needs of the municipality. There are two approaches to accumulating retirement benefits. Under the defined contribution approach, the benefit accrues based on the level of contributions and the investment earnings credited to the fund. The defined benefit approach depends upon the individual's age, years of credited service, and an actual benefit formula which usually includes a salary factor.

## **Disability Annuity Eligibility Benefits**

A member who is unable to work because of serious injury or illness may apply for a disability annuity. PMRS defines disability as the inability to engage in any form of gainful employment. The application and required medical documentation will be reviewed by medical examiners appointed by PMRS to determine whether the member is eligible for the disability benefit. A disability that results directly from doing one's job is classified as a service-connected disability. A disability that is not caused by one's work is termed a non-service disability. The basic plans provide for (1) a service connected disability annuity of 50% of the disabled individual's final average salary offset by worker's compensation, and (2) a non-service disability with a minimum of 10 years' service and a 30% final average salary annuity.

## **Vesting Annuity Eligibility Benefits**

Conditions for vesting are defined in the municipality's contract. The basic plans have a 12-year service requirement for vesting. A member who terminates service before retirement may elect to leave the member's accumulated contributions in PMRS and defer receipt of benefits until normal retirement age. Then when the member receives the vested benefits, checks will include the member contributions and the municipal contributions.

## **Benefit Payment Options**

Depending on the municipality's contractual agreement, employees may choose individual alternatives for the monthly retirement allowance or may select one from a list of options. Typical options are as follows:

1. **Single Life Annuity:** Provides a continual income throughout the annuitant's lifetime with no beneficiary benefit
  - a. Option 1: Reduced lifetime benefit with remaining lump sum value of account to beneficiary
  - b. Option 2: Joint and 100% survivorship annuity
  - c. Option 3: Joint and 50% survivorship annuity

## Death Benefit Eligibility

A death benefit provides some continuation of payment or presentation of benefits to a beneficiary given certain eligibility requirements of the covered individual. If an active member or vested member with minimum years of service dies, the death benefit goes into effect provided the municipality has included this feature in its plan.

## Termination of Service

A member always receives the accumulated deductions and interest earned at the regular rate of interest, as determined by PMRS. Depending upon the municipality's contract structure, the member might also receive excess investment monies upon withdrawal. If a member terminates employment and goes to work for another municipality which is a member of PMRS, the employee may transfer the service credits unimpaired to the new municipal employer.

The Home Rule Charter and Optional Plans Law, act of April 13, 1972, PL 184, No. 62, as amended, 53 Pa.C.S. § 2901, et seq., was previously the subject of some disagreement and ensuing litigation concerning the extent of authority granted to municipalities to govern their own pensions. It has been determined now that Home Rule Municipalities are prohibited from enacting provisions “inconsistent with any statute heretofore enacted prior to April 13, 1972, affecting the rights, benefits or working conditions of any employee of a political subdivision.” 53 Pa.C.S. § 2962(c)(5). Since a separate provision bars the impairment of pension benefits, the quoted language precludes any variation from pre-1972 legislation. See, *Monroeville Police Department Wage Policy Committee v. Municipality of Monroeville*, 767 A.2d 596 (Pa.Cwmlth., 2001), petition for allowance of appeal denied.

The Act of May 29, 1956, PL (1955) 1804, No. 600, as amended, 53 P.S. § 767-778, is generally referred to simply as Act 600.

Act 600 governs police pensions in all boroughs, towns, and townships employing three or more full time police officers. If adopted by the municipality, it may also govern smaller departments. Act 600 was also amended by the Act of May 10, 1996, PL 162, No. 33, effective immediately, to include all regional police departments, regardless of the nature of the participating municipalities: if a Third Class City were to join a regional department, the pension would be governed by Act 600. However, benefit structures in place on May 10, 1996, are grandfathered and continue in full force and effect.

The mandatory provisions of Act 600 are relatively simple. An age and service benefit of one-half final average salary must be provided for the remainder of the retiree's life. The mandated service requirement is twenty-five years as a police officer, in that municipality. Time spent in active military service which interrupts employment also counts toward the service requirement, so long as the employee returns to the police department within six months of separation from active duty. If a member leaves employment before becoming pension eligible, contributions are to be refunded with interest.

The age requirement must be at least fifty, but may range up to fifty-five. Final average salary must be calculated over at least the last three years of employment, ranging up to the last five. Payroll contributions to the pension “must” be 5%, but can range up to 8%, or be reduced or totally eliminated. The term “final average salary” has been judicially interpreted to be “the fixed amount of compensation paid at regular, periodic intervals” (such as base pay, longevity, shift differentials, and educational bonuses, but excluding overtime, premium pay for working a holiday, etc.), the courts have also recognized the right to base benefits on the same compensation from which contributions are deducted. *Borough of Dormont v. Dormont Borough Police Department*, 654 A.2d 69 (Pa. Cmwlth.1995); *Palyok v. Borough of West Mifflin*, 526 Pa. 324, 586 A.2d 366 (1991).

A member who is permanently disabled as a result of injuries incurred in the service is to receive a disability retirement benefit of no less than 50% of salary at the time of disability (less any Social Security disability benefits paid on account of that injury). The family of an member who is killed in the performance of duty receives a benefit of 100% of the member's time of death salary. Disability or death not arising from employment are not compensable through the pension plan, unless the member is otherwise eligible to receive age and service benefits.

A superannuation (i.e., age and service) retirement benefit may be partially offset by Social Security old age benefits, but also reduces the maximum pension contribution rate. Service beyond 25 years may be compensated with a monthly increment, which cannot exceed \$500.

Non-intervening military service may be purchased in accordance with the following formula: 10% of the member's average annual compensation during the first three years of employment, times the number of years or fractional years of military service being purchased, plus 4<sup>3</sup>/<sub>4</sub>% interest compounded annually from the date of employment by the municipality to the date of purchase. This military service credit can only be used for one government pension, except that it may also be used for an age and service pension for service in the Reserves or National Guard. A service credit will only effect the service requirement for the pension. It does not affect age requirements, entitlement to service increments for employment over twenty-five years, longevity pay, or seniority. Summer training, weekend drills, and similar activities are not subject to purchase, although a reservist's initial period of active duty would be. With so many variables, and the substantial cost that can result from the compound interest requirement, each individual must analyze his or her specific situation to determine if the military service purchase is economically beneficial.

Cost of living allowances which do not impair the actuarial soundness of the pension fund may be provided at a rate equal to the annual increase in the Consumer Price Index, but "in no case shall the total pension benefits exceed seventy-five percent (75%) of the compensation for computing retirement benefits"...or "thirty percent (30%), whichever is lesser." The Act does not indicate to what the 30% refers, but the grammatical rule of "last antecedent," and reference to the deferred partial benefit available upon vesting, strongly suggests that the 30% applies to "compensation for computing retirement benefits." That reading is grammatically sound, and recognizes the distinction between those who leave early and reach the 30% cap versus those who work until full retirement and are subject to the 75% maximum.

Act 600 allows vesting after twelve years of police service. After vesting, an member may resign prior to completion of the age and service requirements for a superannuation retirement, and receive a reduced benefit at the time when the superannuation benefit would have become payable: when both age and service requirements would have been met if employment had continued. That reduced benefit is based on the percentage which actual years of service bear to the years of service which would have been rendered until superannuation, times final average salary during the appropriate last three to five years of actual employment.

Another amendment to Act 600 allows the immediate receipt of a reduced vested benefit if a member has twenty years of service before leaving. The Act of February 18, 1998, No. 24, allows the payment of "the actuarial equivalent of a partial superannuation retirement benefit" beginning with the date of separation from service or making the election, whichever is later. Because Act 24 requires the use of the actuarial assumptions from the most recently filed Act 205 report in making the calculation, there is no significant actuarial cost to the pension plan if 12-year vesting is already provided. With each calculation dependent upon so many factors, it is impossible to provide general recommendations regarding the benefit to exercising an Act 24 option. It must be examined on a case by case basis, with the actuary's calculation in hand.

## **Act 600 Summary**

### **1. Normal Retirement**

- a. 25 years of service and age 50 – 55
- b. Longevity: \$100 per month times each year of service beyond 25 to maximum \$500
- c. Possible Social Security offset (with contribution reduction)

### **2. Member Contributions**

- a. 0 to 8%, 5% as default

### **3. Calculation**

- a. 50% of average salary during last 3 to 5 years
- b. “Salary” means “the fixed amount of compensation paid at regular, periodic intervals”
- c. 12 year vesting, with reduced benefit deferred to normal retirement date

### **4. Retirement Options**

- a. No options: benefit is one-half final average salary

### **5. Disability – Work related**

- a. Disability defined as unable to perform police duties
- b. 50 % final average salary; optional Workers’ Compensation offset

### **6. Disability – Not work related**

- a. None

### **7. Death Benefits**

- a. Killed in service: 100% of member’s pay to the surviving spouse for life
- b. Non-work death: 50% of the pension that the member was receiving or would have been receiving had he been retired at the time of his death

### **8. COLA’s**

- a. Optional: CPI increases from year last worked; total pension benefits cannot exceed 75% of final average salary or 30% of such compensation in total cost of living increases, whichever is lesser.

### **9. Service Credits**

- a. Intervening military service is credited
- b. Up to 5 years of non-intervening military service can be purchased

### **10. Miscellaneous**

- a. No portability
- b. No remarriage restriction
- c. No return of contributions unless ineligible for pension

## **Section 1105 of the Borough Code**

Under Section 1105 of the Borough Code (53 P.S. § 46105), relating to compensation to aged employees, a borough may provide by ordinance for compensation to an employee who has at least 10 years of satisfactory service and who is at least 60 years old. This compensation, including benefits under the Social Security Act of 1935, if any, may not exceed 50 percent of the compensation last paid the employee. The intent of this section is to allow a borough to provide benefits to an employee who is too old to join advantageously another type of retirement system. No similar provision exists in either township code.

## **Third Class City Code,**

The Third Class City Code, Act of June 23, 1931, PL 932, as amended, provides for both “standard” (mayor and council) and “optional” (strong mayor, strong council, city manager, etc.) forms of government, which can also effect the statutory restrictions on the pension plan. Within the Third Class City Code is the Optional Third Class City Charter Law, 53 P.S. § 41101, et seq. This must be distinguished from the Home Rule Charter and Optional Plans Law discussed elsewhere in this manual.

## **Optional Third Class City Charter Law**

The Optional Third Class City Charter Law allows unfettered local control of pension benefits, as the only restrictions on the exercise of municipal power are those imposed by the constitution. 53 P.S. § 41304; *Greenberg v. City of Bradford*, 432 Pa. 611, 248 A.2d 51 (1968); *City of Allentown v. FOP, Queen City Lodge #10*, (C.C.P. 2/26/97). The Third Class City Code, on the other hand, provides for certain specific provisions, some mandatory and some discretionary: 53 P.S. § 39301-39309 (police); §§ 39320-39328 (firefighters); §§ 39340-39353 (non-uniformed employees) and 39371-39384 (Optional Retirement System for Officers and Employees).

## **Code Provisions for Police Officers and Firefighters**

Under the Code Provisions for Police Officers and Firefighters, superannuation retirement is available upon completion of not fewer than 20 years of service. There is no age requirement, but if one is set it must be age 50. The monthly pension benefit is the higher of one-half of a member’s last month’s pay, or his highest annual salary averaged over any five years of employment. “Salary” for calculating pension benefits is statutorily defined as “the fixed amount of compensation paid at regular, periodic intervals and from which pension contributions have been deducted.” Service increments in addition to the basic pension are mandated at the rate of 1/40 of the pension times total years of service, to a maximum of \$500 per month.

Benefits to the surviving spouse or minor children of a retired or retirement eligible member are mandated at one-half the member’s pension and may be provided at the full amount of the member’s benefit. The surviving spouse does not forfeit benefit entitlement upon remarriage.

Members are required to contribute 4% of pay to the pension plan, plus 1% for survivors’ benefits and one dollar per month for each \$100 of service increments (to a five dollar total for a \$500 monthly increment). The city is required to contribute from ½% to 3% of all tax revenues except those levied for debt reduction. It is arguable as to whether this provision was superseded by Act 205 of 1984.

Twelve-year vesting with a deferred benefit is provided the same as in Act 600, but with no Act 24 immediate payment provision. Upon separation from service with no retirement eligibility, contributions are refunded without interest. Non-intervening military service may be purchased by paying both the member and employer contributions at the rate applicable to the period of service. Cost of living increases can be provided up to

one-half the current salary of an active patrolman/fireman at the highest grade (which can create some consternation when a high-ranking member is the retiree).

Disability benefits for police officers who are permanently disabled as a result of a service injury are mandatory, and not to exceed the 50% benefit of a regular retirement. Workers' Compensation benefits must be offset to reduce the pension benefit, but the Workers' Compensation Law amendments made by Act 57 of 1996 (effective 8/23/96) grant the compensation carrier an offset for any pension benefits paid. This dichotomy has yet to be resolved.

Disability benefits for firefighters are not defined by the statute. Instead, "the amount and commencement of pensions shall be fixed by regulations of the board." Consideration of workers' compensation benefits also payable is specifically barred. Payments to surviving spouses are at "the amount payable to the member or which would have been payable had he been retired at the time of his death."

Non-service disability benefits for police officers are permitted under the Code, to a maximum of 25% of annual compensation for those with less than 10 years of service, or 50% for those with 10 years or more. Notably, the firefighter pension provisions allow full benefits to be paid for non-service related injuries.

## **Third Class City Code Summary**

### **Police & Firefighters**

1. **Normal Retirement**
  - a. At least 20 years of service; age 50, if any
  - b. Higher of one-half of last month's pay, or highest annual salary averaged over any five years
2. **Member Contributions**
  - a. 4% + 1% for survivors and \$1 for each \$100 of monthly service increment
3. **Calculation**
  - a. Service increments at 1/40 of the pension times total years of service, to a maximum of \$500 per month.
  - b. Fixed compensation paid at regular, periodic intervals and subjected to pension contributions
  - c. 12 year vesting, reduced benefit deferred to normal retirement date
4. **Retirement Options**
  - a. Police
    - i. Mandatory joint and 50 % survivor
    - ii. Optional joint and 100% survivor.
  - b. Firefighters: joint and 100% survivor
5. **Disability - Work**
  - a. Disability defined as unable to perform police/firefighter duties
  - b. Police: not more than 50% final average salary, less Workers' Compensation
  - c. Firefighters: as set by the municipality, but no Workers' Compensation offset

6. **Disability – Non-Work**

- a. Permitted but not required for police
- b. Less than 10 years of Service: 25% of final average salary
- c. 10 or more years of Service: 50% of final average salary
- d. Same as work-related for firefighters

7. **Death Benefits**

- a. Police:
  - i. Killed in service: not more than same as retiree survivor's benefit (50% or 100% of pension)
  - ii. Non-work benefit is based on vested benefit if 12 years of service, or return of contributions
- b. Firefighters: surviving spouse receives the full benefit that would have been payable to the member, if retired.

8. **COLA's**

- a. Optional; can be up to one-half the current salary of an active patrolman/fireman at the highest grade
- b. Service Credits
- c. Intervening military service is credited
- d. Up to 5 years of non-intervening military service can be purchased

9. **Miscellaneous**

- a. No portability
- b. No lump sum except leave payouts and DROP, if any
- c. No remarriage restriction for police survivors

The Third Class City Code provisions for pensions of non-uniformed elected or appointed officers and employees are permissive, rather than mandatory, to the extent of whether or not to establish such a pension. If such a plan is established, however, the Code requires attainment of 60 years of age and 20 years of service. The benefit is calculated at 50% of compensation of the last year of employment or any five years, whichever is higher. Survivors may receive 50% of the retiree's benefit.

Payments for total and permanent disability are payable after 10 years of employment, without regard to age, calculated the same as an ordinary pension.

Once retired, no benefit recipient may be employed by the city. A beneficiary can serve in elected office, but must choose between pension and pay during the term of office.

The Optional Retirement System for Officers and Employees provides for a 50% of the average of any five years of compensation or final monthly pay, whichever is higher, payable at 20 years of service and 55 years of age. A full disability pension is payable after 15 years of service, without regard to age. A deferred vested benefit is available after 12 years of service, payable at the normal retirement date.

An additional service increment can be provided, calculated 1/40 of the normal retirement benefit multiplied by each year of service in excess of 20. Service performed after attaining age 65 is not counted.

Post-retirement adjustments may not exceed one-half of the current salary of non-uniformed employees of the highest pay grade.

Employee contributions are determined at 3% of compensation, plus 1% for survivors' benefits and 1/2 of 1% for service increments.

Special Ad Hoc Municipal Police and Firefighter Postretirement Adjustment Acts, act of December 14, 1988, PL 1192, No. 147, as amended by December 18, 1996, P.L. 993, No. 152, 53 P.S. § 896.101, et seq., and the act of June 19, 2002, P.L. 434, No. 64, 53 P.S. § 896.401, et seq.

Act 147 provided a one time cost of living increase, offset by any COLA provided by a municipal pension plan. To be eligible, a participant must have been receiving pension benefits before January 1, 1985. The benefit, however, was based upon years retired as of January 1, 1989, and calculated as follows: 5-10 years, \$25; 10-20 years, \$75; over 20 years, \$150. A benefit of \$50 was also provided to disability retirees with less than 10 years on pension.

Act 64 provided an additional postretirement adjustment beginning with annuity payments after June 30, 2002, to retired municipal firefighters and police officers who began receiving a retirement benefit before January 1, 1996, with the reimbursement amount payable by the Commonwealth to municipal pension systems based on the amortization contribution requirement attributable to the postretirement adjustment.

Both statutes provided for State funding of the cost of living increases from the proceeds of the taxes assessed on premiums of foreign (out-of-state) casualty and fire insurance companies, before those funds were deposited in General Municipal Pension System State Aid Program revenue account.

## **Pension Funding**

The Municipal Pension Plan Funding Standard and Recovery Act, 1988, December 18, PL 1005, No. 205, as amended, 53 P.S. § 895.101, et seq., was the first legislation which mandated and enforced actuarial funding of municipal pension plans in Pennsylvania. Exempt from ERISA, many political subdivisions operated on a pay-as-you-go basis, with no financial ability to ensure the long-term solvency of their pension systems, while others amassed substantial surpluses from State aid allocated under the Foreign Casualty Insurance Premium Tax Allocation Law, 1943, May 12, PL 259, No. 120, as amended, 72 P.S. § 2263.1-2263.3, and Foreign Fire Insurance Premium Tax Allocation Law, act of June 28, 1895, P.L. 408, No. 289, as amended, 72 P.S. § 2262.

Act 205 does not address pension benefits or operations. It does control funding issues and the actuarial reporting which determines the level of funding necessary. The intent and purpose of Act 205 is to bring all municipal pension plans to the point where plan assets are sufficient to fund all future benefits, and the primary method that it utilizes is the allocation of State aid on the basis of need.

There are two official reports, required to be submitted to the State under Act 205. The first is the biennial actuarial valuation report, which is filed with the Public Employee Retirement Commission by the end of March in each even numbered year and reflects the plan's financial status as of January 1st of the immediately preceding, odd numbered year. (Eg., the report for January 1, 2005, was due by March 31, 2006). It is this report which establishes the underlying figures upon which all contribution requirements and state aid are based for the next two years (Eg. 2006 and 2007 in the example). The second report is also filed by the end of March, but this one is filed every year with the Department of the Auditor General, and certifies the number of eligible employees and their payroll for pension aid purposes. It is important to have some understanding of how these reports are used to determine state aid, and ultimately the required levels of member and municipal contributions.

To determine a plan's funding requirements, Act 205 requires that the annual normal cost and administrative expenses be combined to determine the total annual financial requirement. From this amount, expected member contributions are deducted. An adjustment is made to the remainder based upon the existence of a plan surplus or deficit. Plan deficits must be amortized by future payments which are added to the amount due. Plan surpluses are applied against plan costs at the rate of 10% of the surplus per year, and are deducted from the amount due. The result is called the "net financial requirement" of the plan.

State aid is calculated and paid based upon that net financial requirement, because no plan will be allocated any funds in excess of that amount. Nor will any plan receive funds in excess of the amount payable under the unit value allocation formula, which credits each active police officer and firefighter as two units and each non-uniformed employee as one. The unit value itself is based upon the revenues generated by the tax on premiums collected in Pennsylvania from out-of-state fire and casualty insurance companies, divided by the total units certified in the annual report of employees and payroll.

The next consideration that must be addressed is the calculation of the Minimum Municipal Obligation, or "MMO." This is a budgetary issue that must first be presented to the governing body of the municipality by the end of each September, and finalized with the adoption of the municipal budget by the end of December.

Returning momentarily to the biennial actuarial valuation report, note that it calculates the normal cost of the plan in two forms: first as a real number, and second as a percentage of payroll. That percentage figure is the one that is utilized in the MMO calculation, and applied to the current payroll that was included in the annual report to determine each year's normal cost.

In preparing the actuarial report, the actuary must make certain assumptions, chief among which are the interest and salary assumptions, called the economic assumptions. It is an actuary's job is to predict the future, based upon statistical analyses of market trends, life expectancies, etc. This is not an exact science. When a plan exceeds the actuary's expectations, it incurs an actuarial gain. When it fails to achieve the assumed returns, it sustains an actuarial loss. Over the long term, actuarial calculations are expected to achieve a level of accuracy that is not possible, or expected, in the short term. The Public Employee Retirement Commission, which oversees Act 205, has directed by regulation that the interest rate assumption must be not less than 5% nor more than 9%, while the salary assumption cannot be more than the interest assumption nor less than 3% below it.

In determining contribution requirements, the actuarial assumed rates are less important than the spread between them. Because the interest assumption is concerned with projected plan earnings, a high number anticipates high earnings. The salary assumption relates to expected payroll increases, so a high number anticipates high costs. A wide spread indicates expected earnings well above expected cost increases, while a small spread anticipates little improvement in the overall financial condition of the plan.

## **Qualified Domestic Relations Orders and Police and Firefighter Pension Funds**

Except in rare circumstances, police and firefighter pensions in Pennsylvania are governed by very specific statutes. Thus, while a member's retirement benefits are subject to equitable distribution in a divorce proceeding, that distribution order must be fashioned so as to comply with the underlying legislation, which does not, at the local level, make allowances for domestic relations orders. In fact, Act 600 and the Third Class City Code specifically preclude the attachment or assignment of any pension funds before distribution to the retiree.

Our courts recognize two methods of distributing the value of retirement benefits at the time of a divorce. The first is the "immediate offset method," by which the present value of the pension benefits attributable to the period of marriage (the "coverture share") is immediately paid. Obviously, this method can only be used when there are sufficient other assets to pay the obligation, or the member is able to obtain a loan. The second

method, called the “deferred distribution method,” requires the court to reserve jurisdiction over the pension distribution until such time as benefit payments begin. Once the member retires, the court will order a portion of the retirement benefits to be paid to the former spouse. Because most police members and firefighters have limited assets, this latter method is frequently utilized.

Problems frequently develop because the lawyers handling the divorce are unfamiliar with the underlying statutory provisions that govern the pension plans. A police or firefighter pension plan cannot lawfully make lump sum or accelerated distributions to the former spouse. In fact, a divorced spouse can only receive payments while the retired member is still alive, since an ex-spouse is not a “surviving spouse” under the laws. Payments cannot begin until the member retires, which can be problematic if there is no mandatory retirement age in effect. If the member has remarried at the time of his death, his new wife would be the surviving spouse entitled to benefits: a factor which can lead to considerable acrimony.

These issues are certainly not insurmountable obstacles, but do require care in the drafting of the QDRO so that the municipal pension plan can lawfully implement its terms.

## **Deferred Retirement Option Plans (DROPs)**

The acronym “DROP” refers to “Delayed Retirement Option Plan” or “Deferred Retirement Option Plan.” DROPs are optional payment forms under defined benefit plans similar to the traditional or partial lump-sum options that allow participants to elect to receive a lump sum in exchange for a reduced monthly benefit for life.

Under a regular DROP, a participant who has attained eligibility for retirement can sign a binding agreement to cease employment with the employer after completing an additional period of service. This DROP period is typically two or three years, but in some plans may be as long as five years.

At the conclusion of the DROP period, the participant will be paid a monthly benefit based on his or her age, salary, service and plan formula in effect on the date of entry into the DROP. This is, in effect, an agreement to accept a lower monthly benefit in retirement. Participants who select the DROP, also receive a lump-sum equal to the accumulation of the DROP monthly benefit, with some interest, from the date they entered the DROP until they retire.

While some jurisdictions allow for other forms of DROP (eg., immediate or retroactive), the State aid system established under Act 205 precludes the use of those structures in Pennsylvania.

## **Fiduciary Investments**

In governmental investing, there are four issues to be considered: legality, quality, liquidity, and return. Under generally accepted accounting principles, a public employee pension trust fund is a fiduciary fund type and is subject to fiduciary standards. The legality of investments by most public employee pension trust funds is controlled by Chapter 73, relating to fiduciaries investments, of the Probate, Estates and Fiduciaries Code (20 Pa. C. S. §§ 7301-7319), as well as by public employee pension plan statutes, home rule charters, and creating ordinances. For example, section 1804.1(d)(7) of The Third Class City Code (53 P. S. § 36804.1(d)(7)), section 1316(c)(vii) of The Borough Code (53 P.S. § 46201(c)(vii)), section 1705.1(d)(vii) of The First Class Township Code (53 P.S. § 56705.1(d)(vii)), and section 3204(d)(7) of The Second Class Township Code (53 P.S. § 68204(d)(7)) all authorize any investment authorized by Chapter 73 for any pension or retirement fund of the municipality, and section 9 of the County Pension Law (16 P.S. § 11659) makes county pension trust fund investments subject to the terms, conditions, limitations, and restrictions imposed by law upon fiduciaries. In determining the legality of pension trust fund investments, Chapter 73 gives fiduciaries two options: a specified list of allowed investments or the application of the “Prudent Person Rule.”

**Sections 7303-7316** list the specific forms of permitted investments. Section 7302(b) defines a “Prudent Person Rule,” which also provides guidance on the degree of judgment and care required in determining quality, liquidity, and return. Section 7302(b) provides that:

Any investment shall be an authorized investment if purchased or retained in the exercise of that degree of judgment and care, under the circumstances then prevailing, which men of prudence, discretion and intelligence exercise in the management of their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income to be derived therefrom as well as the probable safety of their capital. The authorization to make and retain investments pursuant to this subsection shall be in addition to, and independent of, authorizations to make investments pursuant to other provisions of this chapter and requirements applicable under other provisions of this chapter shall not affect investments also authorized by this subsection.

However, see, *Potter v. Springfield Township*, 681 A.2d 241 (Pa.CmwltH.Ct. 1996), petition for allowance of appeal denied, which held that no liability for breach of this fiduciary duty attached because of the doctrine of official immunity. (The decision does indicate that liability may attach for a direct theft by municipal officials).

## **Pension Forfeiture Act**

July 8, 1978, PL 752, No. 140, as amended, 43 P.S. § 1311, et seq.

1. Applies to all elected or appointed members or employees of the State or any political subdivision.
2. Disqualifies anyone who is convicted or pleads guilty or no defense to a crime related to public office or employment from receiving any pension benefit, except return of contributions without interest. Payments are also suspended during appeal.
3. A crime related to public employment is a violation of certain Crimes Code provisions, or the federal equivalent, when committed through public employment or when the employment places him in a position to commit the crime.
4. The specified crimes are:
  1. Section 3922 - theft by deception (M1)
  2. Section 3923 - theft by extortion (M1)
  3. Section 3926 - theft of services (M1)
  4. Section 3927 - failure to make required disposition of funds (M1)
  5. Section 4101 - forgery
  6. Section 4104 - tampering with records
  7. Section 4113 - misapplication of property (M2)
  8. Section 4701 - bribery
  9. Section 4702 - improper influence
  10. Section 4902 - perjury
  11. Section 4903(a) - false swearing
  12. Section 4904 - unsworn falsification to authorities
  13. Section 4906 - false reports to law enforcement

14. Section 4909 - bribery of witness or informant
15. Section 4910 - tampering with evidence
16. Section 4911 - tampering with public records
17. Section 4952 - witness intimidation
18. Section 4953 - retaliation against witness
19. Section 5101 - obstructing administration of law or government
20. Section 5301 - official oppression
21. Section 5302 - speculating or wagering on official action
22. Violation of PA Personal Income Tax Law
23. Sections 3121-3129 - Sexual Offenses, when committed by school employee

## Statutory Citations

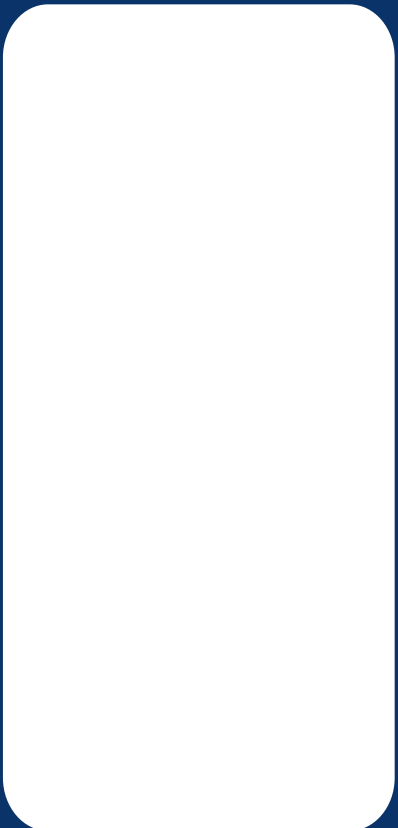
1. First Class City Code, act of May 20, 1915, PL 566, as amended, 53 P.S. §§ 13431-13449
2. Second Class City Code, act of April 15, 1917, P.L. 39, as amended, 53 P.S. Sections 23641-23666
3. Second Class A City Code, act of July 3, 1947, PL 1242, as amended, 53 P.S. §§ 30491-30515.1 (for police and firefighters); and the acts of Sept. 23, 1959, P.L. 970, and May 7, 1965, P.L. 48, as amended, 53 P.S. §§ 30551-30594 (for non-uniformed employees)
4. Third Class City Code, act of June 23, 1931, P.L. 932, as amended; Police: Sections 4301-4307, 53 P.S. Sections 39301-39309; Firefighters: Sections 4320-4328, 53 P.S. §§ 39320-39328; non-uniformed employees: Sections 4340- 4353, 53 P.S. §§ 39340-39353 and the act of May 23, 1945, P.L. 903, as amended, 53 P.S. §§ 39371-39384 (Optional Retirement System for Officers and Employees)
5. Boroughs, Towns and Townships with 3 or more full-time police members: Act of May 29, 1956, P.L. (1955) 1804, No. 600, as amended, 53 P.S. Section 767-778.
6. Boroughs and Townships with less than 3 full-time police members:
  - a. Borough Code, act of February 1, 1966, P.L. 1656, No. 581, as amended, Sections 1131-1137, 53 P.S. Sections 46131-46137.
  - b. 1st Class Township Code, act of June 24, 1931, P.L. 1206, No. 331, as amended, Sections 1409-1415, 53 P.S. Sections 56409-56415.
  - c. 2nd Class Township Code, act of May 1, 1933, P.L. 103, No. 69, as amended, Sections 595-599, 53 P.S. Sections 65595-65599.
7. Pennsylvania Municipal Retirement System, act of Feb. 1, 1974, P.L. 30, No. 15, as amended, 53 P.S. Section 891.101, et seq.
8. Home Rule Charter and Optional Plans Law, act of April 13, 1972, P.L. 184, No. 62, as amended, 53 P.S. Section 1-101, et seq.
9. Special Ad Hoc Municipal Police and Firefighter Postretirement Adjustment Acts, act of Dec. 14,

1988, P.L. 1192, No. 147, 53 P.S. Sections 896.101, et seq., and as amended by the act of December 18, 1996, P.L. 993, No. 152, 53 P.S. § 896.101, et seq.; and the act of June 19, 2002, P.L. 434, No. 64, 53 P.S. § 896.401, et seq.

10. Municipal Pension Plan Funding Standard and Recovery Act, act of Dec. 18, 1984, P.L. 1005, No. 205, as amended, 53 P.S. Section 895.101, et seq. (Act 205 of 1984).
11. Foreign Casualty Insurance Premiums Tax Distribution Act, act of May 12, 1943, P.L. 259, No. 120, as amended, 72 P.S. Sections 2263.1-2263.3.
12. Foreign Fire Insurance Premium Tax Allocation Law, act of June 28, 1895, P.L. 408, No. 289, as amended, 72 P.S. § 2262
13. Public Employee Pension Forfeiture Act, act of July 8, 1978, P.L. 752, No. 140, as amended, 43 P.S. Section 1311, et seq.

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