Tier 2 Pensions and Safe Harbor Explained

This policy brief explains the history of Tier 2 pensions in Illinois, the Safe Harbor issue, and potential solutions for ensuring compliance with federal regulations going forward. It is for policy discussion purposes only and should not be interpreted as legal or tax advice.

What is Tier 2 and Why Was it Created?

Illinois has 663 pension funds for government employees: five State of Illinois funds; 10 funds for major local governments based in Chicago, including four City of Chicago pension funds; one fund for employees of local governments outside of Chicago; and 647 funds for police officers and firefighters in municipalities outside of Chicago. The workers who participate in these pension funds are promised pension benefits earned throughout their employment. Per a ruling of the Illinois Supreme Court under the Illinois Constitution, once an individual begins employment, the pension benefit provisions in place on their date of hire cannot be reduced. All of the public pension funds in Illinois, whether for local government employees or state employees, are governed by State law enacted by the Illinois General Assembly.

Over time, the financial health of most public pension funds in Illinois has deteriorated due to a combination of factors (for example, at the end of FY22, the State's pension funds were only about 44% funded and the City of Chicago's funds were roughly 24% funded).[1] One factor is that there have been inadequate minimum contributions paid into the funds (as set in statute) by government bodies to keep up with benefit levels. In an effort to curb growth in pension costs, the Illinois General Assembly created a new tier of pension benefits in 2010, which significantly lowered pension benefits for state and local government employees hired after January 1, 2011. The new tier of benefits, known as Tier 2, has slowed (and will continue to slow) the growth in pension liabilities as Tier 2 employees become a greater portion of the government workforce and retired population. As the number of Tier 2 employees hired since 2011 grows to represent a larger share of the workforce, governments' pension costs are expected to decline over time.

Key changes to Tier 2 benefits included the following:

- Increased the retirement age to qualify for full benefits to 67.
- Reduced the final average salary on which a pension is based.
    - Changed from the average of the highest four of the last ten years of service to the average of the highest eight of the last ten years of service.
- Imposed a limit on the amount of earnings used to calculate final average salary.

[1] The State's fiscal year runs from July 1st to June 30th while the City's runs from January 1st to December 31st.

    - The salary cap was originally set at $106,800, which was the Social Security wage base in 2010. The cap grows at a rate of one-half of the increase in the Consumer Price Index (CPI), not exceeding 3%. This salary cap has since increased to $123,489 as of 2023.
- Changed the calculation for annual pension benefit increases.
    - Tier 2 workers receive annual benefit increases of 3% or one-half of the increase in the CPI, whichever is less, on a non-compounded basis. By comparison, most Tier 1 employees' benefits increase by 3% annually on a compounded basis.[2]

Despite the lower benefits for Tier 2 employees, employee contributions were not lowered to compensate for the reduced benefits, so Tier 2 employees contribute the same percentage of their salary to their pension fund as Tier 1 employees.

Although Tier 2 is less costly than Tier 1, it still provides valuable retirement income benefits to covered employees. In addition, enacting Tier 2 for new employees over a decade ago was crucial and necessary to slow the growth of pension liabilities. The Commission on Government Forecasting and Accountability (CGFA) in 2011 estimated the State would have saved $976 million in pension contributions within the first full fiscal year due to the Tier 2 reforms. Through 2045, which the statutory pension funding formula targets as the year for reaching 90% funding, CGFA estimated a whopping $71 billion reduction in state pension contributions. These figures do not account for the savings realized by local pension plans, including local police and fire pension plans.

Tier 2 reforms were a critical cost-controlling measure that have helped to manage the trajectory of Illinois' pension liabilities over time. Had the reforms not been enacted, the State's finances would be in much worse shape today and local governments' pension costs would have been much higher, which likely would have manifested as higher property taxes or other local taxes, as well as reduced public service levels.

The Safe Harbor Issue

In Illinois most public employees do not have to pay into Social Security (and their employers do not have to pay Social Security taxes) because they are covered by pension plans that provide certain minimum benefits that are deemed equivalent to Social Security benefits. A plan that meets this equivalency standard is referred to as a Social Security replacement plan. Pension systems whose members also pay into Social Security do not have to provide a minimum benefit, as they are not Social Security replacement plans.[3]

The IRS provides standards to determine whether plans satisfy the requirements for Social Security replacement plans. The simplest standard, known as the Safe Harbor test, looks at key plan features to determine whether a plan is an adequate Social Security replacement plan. The key plan features that are assessed are:
- The compensation "multiplier" (the percentage of final pay per year of service);
- The number of years used to determine final average compensation under the plan; and

[2] Some examples of Tier 1 employees whose benefits do not increase by 3% annually on a compounded basis include members of the Illinois Municipal Retirement Fund (IMRF), the Policemen's Annuity and Benefit Fund of Chicago (PABF) and the Firemen's Annuity and Benefit Fund of Chicago (FABF).
[3] Some examples of public employees who are covered by pension plans as well as Social Security include employees of the Chicago Transit Authority (CTA), most members of the State Employees' Retirement System (SERS), and most members of the Illinois Municipal Retirement Fund (IMRF). Because these employees are also covered by Social Security, there is no federal compliance issue with respect to Tier 2 benefits.

- The definition of compensation used by the plan.

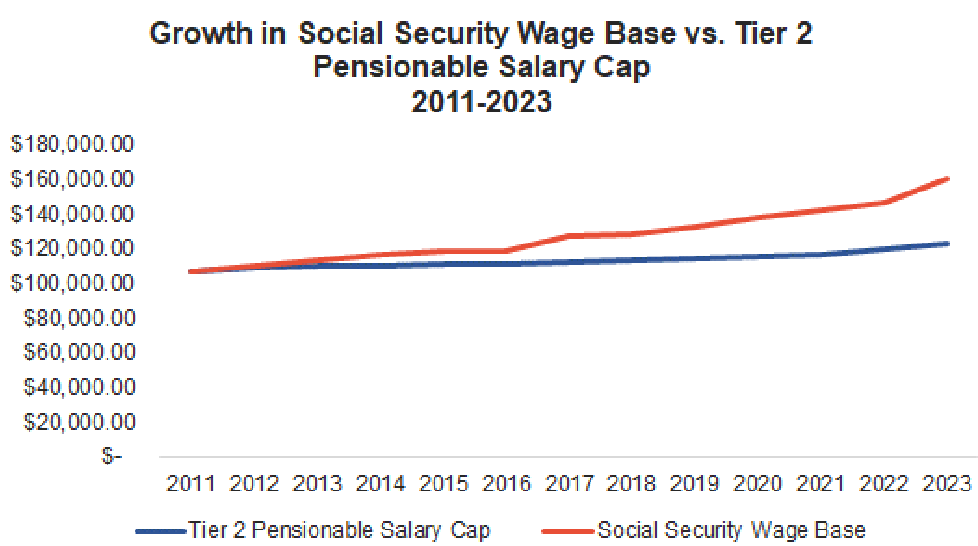
If a plan design does not meet the IRS Safe Harbor, IRS guidance requires that the benefit provided to each individual employee must be reviewed to determine if the employee is receiving a benefit that is equivalent to Social Security. In the case of a system as vast as the Illinois state system, it is impractical to assess the benefit of each individual employee to determine whether Social Security equivalency is met. Accordingly, it is imperative that the Illinois plans continue to meet the plan design based on Safe Harbor.

Tier 2 Compliance with Safe Harbor Rules

Safe Harbor guidance looks at key parameters of a retirement plan: the compensation multiplier, number of years used to determine final average compensation, and the definition of compensation. Under IRS guidance, the baseline multiplier is 1.5% of final average pay, the baseline averaging period is three years, and the baseline definition of compensation is the Social Security wage base, the maximum salary upon which Social Security benefits can be calculated. If a plan varies from any of these baselines as Tier 2 does, the other baselines can be adjusted, and a plan can still meet Safe Harbor.

For example, Tier 2 calculates final average compensation based on the highest eight years of compensation compared to the baseline of three years. Since the averaging period is higher under Tier 2, the compensation multiplier the plan must meet is increased from the baseline (1.5% of final pay) to at least 1.75% of final compensation. Since Tier 2 uses a 2.2% multiplier, it can still pass the Safe Harbor test despite having a longer averaging period for final compensation.

Tier 2's averaging period and compensation multiplier are well within the IRS test's guidelines, but Tier 2's status as a Social Security replacement plan is jeopardized because of its definition of compensation. Specifically, the issue is the growing difference between the maximum pensionable salary under the Social Security wage base (SSWB) and the Tier 2 pay cap. The graph below shows how the SSWB and Tier 2 pay cap have diverged since 2011.



Both of these figures were $106,800 in 2011 but as of 2023 the SSWB is $160,200 while the Tier 2 pay cap is only $123,489. The two salary caps diverged because the SSWB grows faster than the Tier 2 pay cap: the SSWB grows at a rate close to the Consumer Price Index (CPI), while the Tier 2 pay cap grows at a rate of one-half of CPI, but no more than 3%. The growing difference between the two means that pension funds will eventually fail the mathematical test that demonstrates compliance with Safe Harbor.

How Safe Harbor Compliance Is Determined: A Deep Dive

To evaluate whether a retirement plan provides sufficient benefits, it requires legal interpretation of IRS revenue procedures. To ensure compliance, retirement plans are subject to up to three levels of tests laid out in IRS regulations: 1) the Basic Safe Harbor Formula, which tests at the pension plan level; 2) the Modified Safe Harbor Formula, which tests at the plan or employer level; and 3) the Equivalent Safe Harbor Formula, which tests at the individual level.

The Basic Formula test simply looks at whether a plan provides an age 65 pension equal to 1.5% times average compensation times credited service, where average compensation and credited service are defined the same way as under Social Security. If a plan uses different definitions for these parameters than Tier 2 does, it will not pass the Basic Formula test and will next be tested using the Modified Formula test.

The Modified Formula test makes adjustments to account for differences in a plan's definitions of various parameters. For example, a plan with a different definition of compensation than the definition under Social Security (e.g., Tier 2, which caps pay at a level lower than Social Security does) would have a multiplier applied to determine an adjusted benefit threshold that must be met. If the plan or the employer does not pass the Modified Formula test, it will be subject to the Equivalent Formula test.

The Equivalent Formula test is the final level of Safe Harbor testing and looks at whether an individual member's pension benefit is greater than or equal to what is laid out in the Basic Safe Harbor Formula. *It is important to note that Safe Harbor compliance is not determined at an individual level unless the plan or employer has failed the Basic Safe Harbor Formula and the Modified Safe Harbor Formula tests first.*

If a plan's benefits fall out of compliance with IRS rules and fail to meet the Safe Harbor tests, the affected employee(s') wages are mandatorily covered by Social Security and are subject to Social Security withholding. The employee in this scenario would have to pay 6.2% of their salary (up to the SSWB) and the employer must also pay 6.2% of the employee's salary up to the SSWB in taxes. This would be far more costly than proactively adjusting Tier 2 plans to ensure continued compliance.

Potential Tier 2 Solutions

To ensure continued compliance with Safe Harbor rules, the Illinois legislature will need to pass legislative changes to the statutes that govern each of the public pension funds in Illinois (except for those whose employees are already covered by Social Security). However, with varying proposals out there for how to "fix" Tier 2, it is important to keep in mind that ***the only change necessary to specifically correct this issue with federal guidelines is to adjust the Tier 2 pay cap.***

If the State were to simply change the Tier 2 pay cap to match the SSWB, pension plans across the State would no longer be at risk of falling out of compliance. Matching these two levels of pay will remove the mathematical hurdle that will arise if they grow too far apart in the future. This approach was taken by Cook County in Public Act 103-0529, which was passed during the spring 2023 legislative session and became law on August 15, 2023.

This approach is a targeted approach to compliance. Most employees' pensionable salaries do not exceed the current Tier 2 pay cap, so any increase to the Tier 2 cap (to the SSWB, for example) will not have a significant impact on Illinois State and local government pension costs or employees' benefit levels.

Another approach that has been proposed is to adopt more substantial benefit increases for all Tier 2 members such as those proposed for Chicago's Firefighter Annuity Benefit Fund (FABF) in the spring 2023 session. SB1629 and SB1630, which did not pass before the session ended, were purported as Safe Harbor "fixes" but would have substantially increased benefits for all Tier 2 employees. The bills would have changed final average pay calculations for Tier 2 Chicago Firefighters and increased the rate at which the Tier 2 maximum pensionable salary can grow, which would have increased pension obligations by $3.3 billion through 2055 according to City estimates. This approach, however, overshoots what is required for Safe Harbor compliance. Increasing benefits across the board in this manner is far more expensive than the simple compliance fix of setting the Tier 2 pay cap equal to the SSWB.

Any proposed solution should be thoroughly vetted, actuarially sound and the most cost effective of all possible options before the Illinois General Assembly takes any binding action on Safe Harbor "fixes." Benefit enhancements will be necessary to meet Safe Harbor requirements at some point, and addressing the issue deserves proactive consideration. However, Tier 2 changes should be focused on compliance, not benefit enhancement, as pension systems across the State are already facing serious financial challenges. The State cannot afford to take a step backward by unnecessarily increasing Tier 2 pension benefits beyond what is necessary to bring pension benefits into compliance with IRS rules.

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