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GENERAL MEMORANDUM

Number: 367

Date: August 3, 1992

To: All Authorized Agents

Subject: IMRF earnings and Section 125 plans

What is a cafeteria plan?

A cafeteria plan is an employer-sponsored benefit package authorized by Section 125 of the Internal Revenue Code. Under a cafeteria plan, participants may choose employer provided benefits among two or more options consisting of cash and qualified benefits, such as accident and health coverage or group term life insurance. Cash compensation paid under the cafeteria plan is subject to federal, state and Social Security taxes and IMRF contributions. The compensation paid under the cafeteria plan used for health insurance and other qualified benefits is not included in the salary on which the member pays federal and state income taxes. It is not reported as Social Security wages and no Social Security contributions are made on it. Under the new, as well as the old, IMRF definition of earnings, you do not report to IMRF qualified nontaxable benefits selected through the cafeteria plan or flexible spending plan.

An exception

An exception to the basic rule allows individual units of government to report such compensation to IMRF if its governing body passes a resolution to include this compensation in IMRF earnings. The decision whether or not cafeteria plan contributions are reported to IMRF is thus the choice of each unit of government. Before making this choice, each unit of government should carefully consider the effects on member benefits and employer costs.

IMRF's general rule

Under our general rule, contributions to a cafeteria plan are not considered earnings. When member money is used to purchase health insurance through a cafeteria plan, earnings reportable to IMRF are lowered. This also lowers the IMRF contribution required of the member and the employer. For example, if a member earns $10,000 and places $1,000 into a cafeteria plan to purchase health insurance, $9,000 is reported to IMRF.

Note, however, that lowering a member's reportable earnings can also lower the IMRF benefits. This is due to the fact that the amount of IMRF benefits is based on the earnings of individual members. A decrease in earnings subject to IMRF contributions will, therefore, decrease the amount of IMRF benefits paid.

Retirement planning

An IMRF member who is planning for retirement will benefit by withdrawing from the cafeteria plan four years before the expected date of retirement. This is because retirement benefits are based on a formula using service credit and final rate of earnings (FRE). FRE is the average of the highest 48 consecutive months of earnings in the last 10 years. By withdrawing from the cafeteria plan, the member will increase the rate of

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earnings on which the pension will be calculated. For example, the member earning $10,000 and placing $1,000 into a cafeteria plan and paying IMRF contributions on $9,000 will want to get out of the cafeteria plan so his IMRF earnings go back to $10,000.

The unfunded pension liability of the employer will increase with each member who does this. That is because the contributions made by both the member and the employer during the member's career were less because they were based on lower reported earnings than will actually be used to calculate the pension. The member is not making the 4 1/2 percent contribution on his/her "real" compensation, and the employer is funding for a lower pension amount than will actually be paid.

This inadequate funding will result in an increase in the contribution rate for the employer. The actuary averages the higher contributions required over future years. In this new rate, the employer will make up for the contributions not made earlier by the member and the employer as well as the interest not earned on those contributions.

Employers allowed a choice

The new definition of earnings allows an individual unit of government to choose to report compensation paid under a cafeteria plan. This is accomplished by resolution of the unit's governing body. A sample resolution is attached to this memo. After the resolution is passed, all compensation which is otherwise included in IMRF earnings is reported to IMRF, even if that compensation is paid under a cafeteria plan. This will allow members to take advantage of the tax benefits of the cafeteria plan without jeopardizing IMRF benefits. The employer will, of course, continue to pay IMRF contributions on the member's gross salary. Because the employer is adequately funding for the actual pension that will be paid, there will be fewer long term rate fluctuations for the employer.

Diminishment of benefits not allowed

Once a unit of government has passed a resolution to include cafeteria plan compensation in IMRF earnings, that resolution may not be rescinded for continuing members, but may only be rescinded for new IMRF members. This is because the Illinois Constitution prohibits the diminishment of any of the terms and conditions of the IMRF pension.

For more information

Cafeteria plans offer both employers and members several attractive benefits. The effects of these plans on the IMRF benefits of members and funding of employers should be carefully studied before a determination is made regarding whether or not to include the compensation paid under the plan to IMRF. For further information on this subject, call your IMRF field representative or IMRF legal counsel Kathy O'Brien at 312/346-6722.

Sincerely,

Robert L. Cusma
Executive Director

Enclosure