

Deferred Compensation and Final Average Salary

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Final Average Salary

Discussion topics

- “457(f)” deferred compensation
- IRS limits on annual contributions
- IRS limits on annual benefits

Final Average Salary

Compensation, salary and final average salary

- Pension benefits are based on the formula
Final Average Salary X Years of Service X Multiplier = Annual retirement benefit
- Final average salary is based on average of three to five years of “compensation” or “salary”
 - Depends on member’s plan (e.g., KPERS or KP&F), tier, and membership date
 - Somewhat different statutory definitions of “compensation” and “salary”
 - Both “compensation” and “salary” definitions include all salary and wages payable to a member for personal services performed for a participating employer

Definitions

Treatment of tax-deferred benefits

- Statutory definitions of “compensation” and “salary” specifically include deferred compensation
 - Compensation is defined in K.S.A. 74-4902(9) to include amounts under sections 403(b) and 457 of the federal internal revenue code
 - Salary is defined in K.S.A. 74-4902(33) to include any amounts for tax sheltered annuities or deferred compensation plans and amounts under sections 403(b) and 457 of the federal internal revenue code
- 403(b) and 457 plans are voluntary personal savings vehicles offered by governmental and school employers on a tax-deferred basis

Deferred Compensation

457 plans

- A **457(b)** plan offered by a governmental employer typically covers most, if not all employees
 - Any individual receiving a state paycheck is eligible for the KPERS 457 plan
 - Local employers may offer a 457(b) plan
- A **457(f)** plan is used by employers to retain certain employees
 - Usually limited to particular key employees
 - The employer establishes and funds the plan in a contract with the employee
 - The employee does not receive any income until the end of the contract period

Deferred Compensation

457(f) plans

- Under KPERS' statutory definition of compensation and salary, 457(f) funds received at the end of the contract period are included
- Use is extremely rare – out of about 90,000 retirements in the past 20 years, KPERS is aware of a maximum of 3 times in which 457(f) benefits were included in final average salary
- “Cap law” limits the effect of the 457(f) benefits on final average salary
 - If a member's compensation used in calculating his or her final average salary is more than 15% higher than the preceding year, the amount which exceeds the 15% is not included in compensation (7.5% for KPERS 2 members)
 - Therefore, the increase in a member's final average salary due to 457(f) benefits would be capped at 15% for KPERS 1 members and 7.5% for KPERS 2 members

Deferred Compensation

457(f) plans

- 457(f) benefits would have smaller impact on KPERS 3 cash balance plan benefits
 - KPERS 3 benefits are calculated based on account balances, rather than final average salary
 - KPERS 3 accounts reflect compensation earned throughout career – not the highest three to five years
 - Contributions on 457(f) benefits paid at or near retirement would earn interest for very limited period of time

Salary Limitations

IRS limits compensation subject to contributions

- The IRS sets a contribution limit based on annual earnings and membership date
 - Caps earnings on which contributions are made
 - Does not cap actual earnings
 - Higher limit if membership date is before July 1, 1996
- The IRS sets the limits for each calendar year
- Kansas has adopted the IRS limitation levels by statute

Salary Limitations

IRS limits compensation subject to contributions

| Year | Membership date on or after July 1, 1996 | Membership date before July 1, 1996 |
|------|--|-------------------------------------|
| 2015 | \$265,000 | \$395,000 |
| 2014 | \$260,000 | \$385,000 |
| 2013 | \$255,000 | \$380,000 |
| 2012 | \$250,000 | \$375,000 |
| 2011 | \$245,000 | \$360,000 |
| 2010 | \$245,000 | \$360,000 |
| 2009 | \$245,000 | \$360,000 |
| 2008 | \$230,000 | \$345,000 |
| 2007 | \$225,000 | \$335,000 |
| 2006 | \$220,000 | \$325,000 |
| 2005 | \$210,000 | \$315,000 |
| 2004 | \$205,000 | \$305,000 |
| 2003 | \$200,000 | \$300,000 |
| 2002 | \$200,000 | \$295,000 |
| 2001 | \$170,000 | \$285,000 |
| 2000 | \$170,000 | \$275,000 |

Benefit Limitations

IRS limitation on benefits

- The IRS also sets a maximum limitation on the gross annual **benefit** amount for a member
- The 2015 limit is \$210,000
- This does not include a lump sum payment as it is based on the single life annuity maximum