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July 17, 2012

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State Comptroller investigation identifies widespread improper participation in state pension system

Investigation finds local governments failing to comply with state law barring independent contractors from earning pension credits

An Office of the State Comptroller (OSC) investigation has uncovered widespread improper participation in the state pension system among attorneys and other professionals working as independent contractors for local governments.

OSC reviewed 58 municipalities and school districts and found that an overwhelming majority of those local governments failed to comply with a 2007 state law that required all public entities to determine whether their professional service providers were bona fide employees as opposed to independent contractors.

In total, following its review OSC has referred 202 pension enrollees to the state Division of Pensions and Benefits for review and removal of improper pension credits.

The 2007 law made clear that individuals are ineligible for state pension credits if they were retained through a public contracting process or if they otherwise meet the Internal Revenue Service's multi-factor definition of an independent contractor. Individuals ineligible for pension credits were to be removed from the system once their existing contract or annual appointment expired in 2008.

The failure of local governments to properly implement the 2007 law occurred despite guidance letters issued both by the Division of Pensions and Benefits and by the

Department of Community Affairs, directing local officials to review and document the status of all local professional service providers.

OSC's investigation nonetheless found, for example, that 34 professional service vendors continued to be enrolled in the state pension system even though they were retained through a contract awarded under New Jersey's public contracting laws, an unequivocal violation of the 2007 statute.

As to those part time service providers not retained through public contracting, OSC's investigation revealed that none of the surveyed local governments had properly performed and documented the required analysis to support each professional's continued enrollment in the pension system.

The 202 enrollees being referred to the Division of Pensions and Benefits consist of 176 attorneys, 21 engineers, four health care professionals and one auditor. The pension credits of six of those individuals already have been voluntarily removed by local governments based on OSC's inquiries. The 202 enrollees have accrued pension credits that could result in the state paying them a total of approximately $1.9 million per year in pension benefits. OSC conservatively estimates that a review of the remaining 515 municipalities and 597 school districts not included in its survey could uncover hundreds of other inappropriately enrolled individuals and millions of additional dollars in pension savings each year.

State Comptroller Matthew Boxer said OSC decided to conduct its investigation after previous OSC reports had uncovered individual instances of improper pension participation.

"We decided to investigate just how widespread the problem of improper participation in the state pension system is, and what we learned is that the problem is extensive," Boxer said. "Despite the requirements of state law and the guidance issued by state agencies, local governments across the state have not done nearly enough to ensure that only eligible employees receive pension benefits."

The specific reasons underlying the failure to properly implement the 2007 law varied, the OSC report found. Some local governments, without justification, simply failed to perform the required analysis to determine if their professional service providers qualified for pension credits. Other local officials said they kept these individuals in the pension system because they thought they were "grandfathered" in because of their long-standing membership in the system. However, the law contains no grandfathering exception. Other local governments used a skewed analysis that weighed only those factors consistent with employee status while ignoring more significant factors that pointed to independent contractor status.

Perhaps most prominent was these local governments' failure to give appropriate weight to individuals' separate employment in a private professional firm. Guidance from the Internal Revenue Service makes clear that it is unlikely that a professional service provider is a bona fide government employee if that professional simultaneously is engaged in business through a private firm and offers his or her services to the public. Each of the 202 enrollees referred to the Division of Pensions and Benefits appears to be employed at or operating such a private firm.

In some cases, local governments opted to keep their attorney enrolled in the pension system based on the legal advice of the same attorney whose pension eligibility was in question.

"Government officials should not be relying on pension eligibility advice from the very attorney whose eligibility is at issue," Boxer said. "That just flies in the face of common sense."

Pension system participation also has implications for state health care expenses. For example, 16 of the enrollees referred to the Division of Pensions and Benefits have either accrued the 25 years of pension credits needed to receive lifetime state-funded health benefits or are within five years of qualifying. OSC conservatively estimates that the potential cost of health benefits for these 16 professionals alone is $307,111 annually.

Many of the enrollees referred by OSC had multiple questionable enrollments, further boosting their ultimate pension payouts through the "tacking" of multiple pension credits. For example, one attorney is receiving pension credits for two part-time positions: a $191,654-a-year position as borough attorney and a $50,000-a-year position as legal counsel for a school board. The same attorney told OSC that he devotes approximately 50 percent of his work time to his private law practice. A second attorney interviewed by OSC is enrolled in the pension system for his work as public defender in six separate municipalities, despite substantial evidence of independent contractor status in all six of these towns and his operation of a private law practice.

Even those local governments that removed enrollees from the pension system following the 2007 law often failed to carry out the removals retroactive to the proper cut-off date, OSC found. In fact, two employees incorrectly remained in the system long enough after the cut-off to be able to reach the 10 years of credits required to vest in the pension system and become eligible to receive payments upon retirement.

The OSC report recommends that the Division of Pensions and Benefits develop a comprehensive checklist for local governments to use to certify the pension eligibility of each of their professional service providers. The report also recommends that additional state resources be allocated to address questionable pension enrollments.

"We need to work aggressively to ensure that pension credits are received only by those government employees who have earned them," Boxer said.

A 2010 law tightened future entry into the state pension system by requiring all individuals hired after May 21, 2010 to work for the public entity a minimum of 32 hours per week in order to qualify for pension credits. Individuals enrolled prior to that date, however, are not subject to that 32-hour work week requirement. The report released today finds that there are potentially hundreds of such pre-May 2010 enrollees still accruing pension credits improperly.

Boxer thanked the Division of Pensions and Benefits and the Department of Community Affairs for their assistance with the OSC investigation.