

GRS INSIGHT

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New ADEA Cash Balance Rules and Governmental Plans

Section 701 of the 2006 Pension Protection Act (PPA) amended the Age Discrimination in Employment Act (ADEA), adding § 4(i)(10), *Special Rules Related to Age*. Virtually identical additions were made to the vesting and benefit accrual rules in § 411 of the Internal Revenue Code (IRC). The changes apply to cash balance plans and other similar hybrid plans, and determine how benefits in these plans may accrue in ways that are not age discriminatory. The Internal Revenue Service (IRS) has further clarified these changes in Notice 2007-6.

While governmental plans are generally not subject to the vesting and benefit accrual rules of IRC § 411, they are subject to the ADEA. Under the new ADEA rules, a cash balance plan or other "applicable defined benefit plan" will not be treated as age discriminatory if, under the terms of the plan, a participant's "accrued benefit" is equal to or greater than that of a "similarly situated" younger individual. Similarly situated refers to an individual who is identical to the participant in every respect (e.g., period of service, compensation, position, date of hire, etc.) except for age.

Under § 701 of the PPA, an "applicable defined benefit plan" is a defined benefit (DB) plan under which "the accrued benefit (or any portion thereof) is calculated as the balance of a hypothetical account maintained for the participant" or as an accumulated percentage of the participant's compensation.¹(see endnotes) IRS Notice 2007-6 uses the phrase "statutory hybrid plan" to describe an applicable plan and defines it broadly to include "either a lump sum based plan or a plan that has a similar effect to a lump sum based plan."

The Notice goes on to explain that such a plan would include a DB plan "under which the accumulated benefit of a participant is expressed as the balance of a hypothetical account maintained for the participant ... and does not depend on whether the plan provides for an optional form of benefit in the form of a lump sum payment." Representatives of the IRS have stated their belief that deferred retirement option plans (DROPs) are included in this definition, as well as DB plans that credit interest on refunds of "picked-up" employee contributions, or have money purchase or other hybrid features.

The Cash Balance Controversy

These changes stem from a long-standing controversy over whether cash balance plans are age discriminatory. Under the ADEA and ERISA, a DB plan is age discriminatory if, on account of age, an employee's "benefit accrual" is ceased or the rate of benefit accrual is reduced.

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Cash balance plans are defined as DB plans that accumulate benefits in the form of a “hypothetical account” which, upon retirement, is paid as an annuity or a lump sum. Amounts are credited annually to the account based on the participant’s pay plus credited interest. Unlike defined contribution plans, however, the credited interest includes future interest to normal retirement age.

Prior to the PPA, benefits provided by DB plans were defined strictly in terms of the “accrued benefit” – the actuarial value of an annuity payable at normal retirement age. However, when cash balance benefits are expressed as accrued benefits, the rate at which the accrued benefits grow is lower for older employees than for younger employees. Several courts saw this as evidence of age discrimination.

Other courts disagreed, finding that “benefit accrual” is different from “accrued benefit.” Whereas accrued benefit refers to amounts paid out from the plan, benefit accrual refers to amounts paid in. Consequently, under this interpretation, cash balance plans are not age discriminatory so long as the amounts paid into the accounts do not discriminate based on age. Accordingly, the fact that younger employees have more time to accumulate interest on contributions reflects the time value of money rather than age discrimination.

Essentially, the PPA codifies this latter interpretation for periods after June 2005. The new rules broaden the definition of accrued benefits to include benefits expressed as an account balance. In addition, the rules provide that a plan is not age discriminatory if such accrued benefits are the same for all people with essentially the same employment characteristics except for age.

Special Rules for Interest Credits

In addition, the PPA establishes special rules under which an applicable plan would be considered age discriminatory

unless the plan provides that the interest credited for any plan year may not be greater than the “market rate of return.” Moreover, the interest credited may not be so low that the aggregate account balance is less than total contributions.

The Treasury has announced it will provide further guidance in 2007 related to the market rate of return. As safe harbors, IRS Notice 2007-6 provides:

- For plan years beginning prior to January 1, 2008, the market rate will be deemed to include the interest rate on long-term investment-grade corporate bonds; and,
- Thereafter, the market rate will include the “third segment rate” (i.e., the average rate on long-term investment-grade corporate bonds with maturities of 20 years or longer) or the 30-year U.S. Treasury rate.²(see endnotes)

Special Rules for Plan Conversions

Age discrimination may also occur when a traditional DB plan is converted to a cash balance or similar hybrid plan. Typically, accrued benefits for older employees in a traditional DB plan are higher than the benefits they would have accrued in a cash balance plan. Consequently, after conversion, older employees often must wait several years for their cash balance benefits to catch up with their traditional accrued benefits. During this “wear-away” period, they effectively earn no additional benefits. Since this generally affects older workers to a greater extent than younger workers, it has been judged as age discriminatory.

To prevent “wear-away,” the PPA applies special rules when a traditional DB plan is converted to a cash balance (or other applicable) plan. Under the rules, the applicable plan will not be deemed to be age discriminatory if the rate of benefit accrual is at least equal to the sum of:

- A. The participant’s accrued benefit

for years of service before the conversion, under the traditional DB plan’s provisions; plus

- B. The participant’s accrued benefit for years of service after the conversion, under the cash balance (or other similar) plan’s provisions.

This “A + B” approach ensures that participants will continue to accrue benefits throughout their service.

Application to Governmental Plans

State and local government retirement plans have undergone significant design changes over the past decade, including broader application of hybrid plan designs. Some governments have added combination plans, with DB and DC plan features. Others have established cash balance plans or similar hybrids.

At this writing, it is still unclear how the ADEA changes will apply to governmental plans. Since governmental plans are generally not subject to IRC § 411, the IRS’s regulations under Notice 2007-6 arguably would not apply directly to governmental plans.

However, Notice 2007-6 was written by the IRS in consultation with the Equal Employment Opportunity Commission (EEOC), the agency that oversees the ADEA. Moreover, the PPA amendments to the ADEA are identical to the amendments to the Internal Revenue Code. Therefore, for governmental plans that meet the definition of “statutory hybrid plan,” it appears the rules provided in Notice 2007-6 would apply. Consequently, governmental plans should examine their plans carefully in light of the ADEA changes and IRS guidance.

Endnotes

¹ Although not seen in the public sector, some hybrid private-sector plans (referred to as “Pension Equity Plans”) express benefits as an accumulated percentage of the participant’s compensation.

² Market rates also include certain variable interest rates assumed to be no greater than the 30-year U.S. Treasury rate (as listed in IRS Notice 96-8, Part IV).

Congress Reintroduces Bills to Repeal the Social Security GPO and WEP

This article was revised to correct an erroneous reference to Social Security survivor benefits.

On January 4, 2007, U.S. Representatives Howard Berman (D-CA) and Howard "Buck" McKeon (R-CA) reintroduced the Social Security Fairness Act of 2007 (H.R. 82) to repeal the Social Security Government Pension Offset (GPO) and Windfall Elimination Provision (WEP). The bill has broad bipartisan support, with 180 original co-sponsors. On January 9, 2007, an identical bill (S. 206) was introduced in the Senate by Senators Dianne Feinstein (D-CA) and Susan Collins (R-ME), with 10 co-sponsors.

When Social Security was enacted in 1935, governmental employees were excluded from coverage, due mainly to constitutional issues regarding the federal taxation of state and local governments. In the early 1950s, arrangements were made for state and local governments to voluntarily elect Social Security coverage. Currently, about 5 million (25%) of state and local government employees are not covered by Social Security, including roughly half of teachers and two-thirds of police officers and firefighters.

Government Pension Offset

The GPO, created in 1977, was designed to replicate Social Security's "dual entitlement" provision. For a person covered by Social Security, the dual entitlement provision reduces the Social Security spousal or widow(er) benefits that the person can receive by the amount of their Social Security retirement benefits. Similarly, for a person receiving a pension from employment not covered by Social Security, the GPO reduces the amount of Social Security spousal and widow(er) benefits that the person can receive by two-thirds of their pension benefit.

TABLE 1: GPO EXAMPLE	Mary Covered by Social Security	Jane Not Covered by Social Security
(a) Monthly retirement benefit from employment	\$1,200	\$1,500
(b) Monthly Social Security retirement benefit (based on worker's earnings record)	\$900	\$0
(c) Monthly Social Security spousal benefit - before adjustment (based on 50% of spouse's \$2,000 Social Security retirement benefit)	\$1,000	\$1,000
(d) Reduction in Social Security spousal benefit due to dual entitlement	\$900	NA
(e) Reduction in Social Security spousal benefit due to GPO (= 2/3 of (a))	NA	\$1,000
(f) Total monthly income (= (a) + (b) + (c) - (d) or (e))	\$2,200	\$1,500

GPO Examples

The following illustrates how the dual entitlement and GPO provisions work. Assume Mary and Jane are retired teachers. Mary worked for a school system covered by Social Security while Jane did not. Mary's monthly pension from her school system is \$1,200 while Jane's is \$1,500. (Pension benefits are typically somewhat higher for public employees who are not covered by Social Security in order to partially compensate for the lack of Social Security benefits.) Unlike Jane, Mary receives \$900 in monthly retirement benefits from Social Security, bringing her total monthly retirement income to \$2,100. Both have husbands whose employment was covered by Social Security and who receive \$2,000 in monthly Social Security retirement benefits.

Mary and Jane would potentially be eligible for monthly Social Security spousal benefits of \$1,000 (one-half their husbands' monthly Social Security retirement benefits), before adjustment. Because Mary's employment was covered under Social Security, the Social Security dual entitlement provision requires that her Social Security retirement benefits offset her Social Security spousal benefits, reducing her monthly Social Security spousal benefits to \$100 (\$1,000 - \$900). Consequently, she receives her school pension (\$1,200) plus her Social Security retirement benefit

(\$900), plus a portion of the Social Security spousal benefit (\$100). Her total monthly income is \$2,200.

Because Jane worked in employment not covered by Social Security, her Social Security spousal benefits are subject to the GPO and reduced by \$1,000 (two-thirds of her \$1,500 pension), offsetting her Social Security spousal benefits. Her total monthly income remains \$1,500.

These examples are meant to be illustrative, and are not intended to represent any particular employee group. Reductions will depend on each individual's specific circumstances. According to Social Security, the GPO reduced Social Security spousal and survivor benefits for about 367,000 governmental retirees in 2002 by an average of about \$392 per month (\$4,700 per year).¹(see endnotes) Of the government employees affected by the GPO in 2002, 73% were women.

Windfall Elimination Provision

Often, employees in employment not covered by Social Security have worked long enough in employment covered by Social Security to qualify for Social Security benefits. For example, a teacher in a school system not covered by Social Security may have been previously employed in a school system covered by Social Security or in the private sector. The WEP, created in 1983, reduces Social Security retirement or disability

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benefits for people who receive benefits from both covered and non-covered employment.

Social Security benefits are designed to replace a larger percentage of pre-retirement income for lower paid workers than for higher paid workers. This is done through a process that first calculates an employee's average indexed monthly earnings (AIME) for employment covered by Social Security. Then, the employee's primary insurance amount (PIA) is determined through a formula that applies a higher replacement percentage to lower earnings than to higher earnings.

In 2007, the Social Security PIA formula replaces 90% of the first \$680 of AIME, plus 32% of AIME from \$681 to \$4,100, plus 15% of AIME above \$4,100. However, for retirees receiving a pension for work not covered by Social Security, the WEP reduces the replacement percentage for the first \$680 of AIME to 40%, thereby reducing Social Security benefits otherwise payable by \$340 per month (\$4,080 per year).²(see endnotes)

WEP Examples

To illustrate, consider the following examples. Jack and Ray are two retired public employees with average annual earnings from public employment of \$36,000. Jack's public employment was covered by Social Security while Ray's was not. In addition, both worked part-time in employment covered by Social Security, with average annual earnings of \$12,000.

Simplifying somewhat, assume Jack's AIME is \$4,000 (\$48,000 divided by 12) and Ray's is \$1,000 (\$12,000 divided by 12). Applying the current PIA formula, Jack's monthly Social Security benefit would be \$1,674 (90% of \$680 + 32% of \$4,000 - \$680) or 42% of his average monthly Social Security earnings. (Note that Jack's average monthly Social Security earnings are equal to his average monthly total earnings.)

TABLE 2: WEP EXAMPLE	Jack Covered by Social Security	Ray Not Covered by Social Security
(a) Monthly earnings from public employment	\$3,000	\$3,000
(b) Monthly earnings from private employment (part-time)	\$1,000	\$1,000
(c) Monthly earnings covered by Social Security (AIME)	\$4,000	\$1,000
(d) Social Security benefit (based on PIA formula prior to WEP adjustment)	\$1,674	\$714
(e) Social Security benefit (based on PIA formula after WEP adjustment)	NA	\$374
(f) Social Security benefit as % of AIME prior to WEP adjustment	42%	71%
(g) Social Security benefit as % of AIME after WEP adjustment	42%	37%

Applying the PIA formula without the WEP, Ray's monthly Social Security benefit would be \$714 (90% of \$680 + 32% of \$1,000 - \$680) or 71% of his average monthly Social Security earnings. (Note, however, his Social Security benefit is only 18% of his total \$4,000 monthly earnings.) Applying the PIA formula with the WEP, Ray's monthly Social Security benefit would be \$374 (i.e., 40% of \$680 + 32% of \$1,000 - \$680) or 37% of Social Security earnings (9% of his total monthly earnings).

Supporters of the WEP argue that a worker who has spent part of his or her career in employment not covered by Social Security would appear to have lower average lifetime earnings compared to actual earnings. Consequently, without the WEP, such employees would inappropriately receive a "windfall" as a result of the weighted benefit formula. However, it should be noted that the AIME already excludes earnings for employment outside of Social Security. Consequently, the portion of lifetime earnings replaced by Social Security is already limited to Social Security covered earnings without further limitation by the WEP.

According to Social Security, the WEP reduced Social Security benefits for 635,000 retired and disabled workers in 2002.³ (see endnotes)

Prospects for Passage

Legislation to repeal the GPO and WEP has been introduced each year over the past four years, but has been caught up in the debate over Social Security reform and eluded passage. Prospects

are better this year, as evidenced by growing co-sponsorship of the House and Senate bills. At this writing, the National Education Association reported the House bill had 237 bipartisan co-sponsors and the Senate bill had 20.

However, while debate over Social Security reform is less evident this year, there is growing concern over federal deficits. According to Social Security, eliminating the GPO and the WEP would cost Social Security about \$62 billion over a 10-year period, and increase the program's long-term deficit by 0.12% of payroll.⁴ (see endnotes) Given recent Congressional emphasis on PAYGO (the principle that any cost increase or tax reduction must be paid for by an offsetting revenue increase or cost reduction) the prospects for passage are unclear.

Endnotes

¹ Jo Anne B. Barnhart, Commissioner of Social Security, in testimony before the U.S. Senate Committee on Governmental Affairs, September 24, 2003. Average calculated by author based on testimony data.

² For persons who have 20 or more years of Social Security covered employment, the 40% formula is increased by 5 percentage points per year until reaching 90%. Consequently, for a person with 30 or more years of Social Security covered employment, there is no reduction in Social Security benefits resulting from the WEP. Also, under the WEP, the reduction in Social Security benefits can not be more than one-half of the pension benefit based on work not covered by Social Security.

³ Barnhart, 2003.

⁴ Frederick G. Streckwald, Assistant Deputy Commissioner, Social Security Administration, in testimony before the U.S. House Ways and Means Committee, June 9, 2005.

New IRS Determination Letter and Plan Amendment Procedures

The Internal Revenue Service (IRS) has established new procedures for qualified plan determination letters and remedial amendment periods based on a system of 5-year cycles. As a result of these changes, the next determination letter period for governmental plans will end January 31, 2009.

Advantages of Plan Qualification

Defined benefit plan qualification under Internal Revenue Code (IRC) § 401(a) is an essential component of plan design, providing significant tax advantages.

- For participants, plan qualification means that employer contributions and plan investment earnings are not taxable to the participants until distributed.
- For private-sector employers, plan qualification allows employer contributions to be treated as business expenses (up to certain limits) and deducted from business income for tax purposes. (The provision is not applicable to governmental plans, since governments are generally exempt from federal taxes.)
- For governments, plan qualification provides relief from certain qualification rules and offers more favorable treatment with regard to certain benefit limits. Moreover, qualified governmental plans may “pick up” employee contributions and permit service credit purchases.

To maintain these advantages, the plan’s written provisions must conform to the IRC § 401(a) qualification rules applicable to governmental plans and the plan must operate accordingly. Moreover, as Congress amends applicable laws, the plan’s provisions must also be amended to reflect required

changes. However, while plans must operate in accordance with amended laws as of the applicable effective dates, the IRS allows a “remedial amendment period” during which the plan may be amended retroactively to comply with new qualification requirements.

Remedial Amendment Periods

Remedial amendment periods are typically provided when Congress changes qualification provisions or when the U.S. Treasury and IRS change regulations related to qualification provisions. For example, after passage of the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) in 2001, the IRS announced a remedial amendment period ending December 31, 2005, for many of EGTRRA’s provisions.

However, because governmental plan provisions are usually amended by state legislatures (or other legislative bodies) who may not meet annually, the IRS often extends remedial amendment periods for governmental plans. For example, the IRS extended the EGTRRA remedial amendment period for governmental plans to the later of December 31, 2005, or what might be referred to as the “legislative date” (i.e., the “90th day after the opening of the first legislative session of the legislative body with the authority to amend the plan that begins on or after June 15, 2004”).

Determination Letters

To assist plan sponsors determine whether plan provisions conform to IRC § 401(a) qualification rules, the IRS will review plans and issue determination letters. While such letters are not required by the IRS for a plan to be qualified, a favorable determination letter provides reliance that the plan is qualified under IRC § 401(a). Governmental plans applying for deter-

mination letters would use Form 5300, Application for Determination of Employee Benefit Plan, and pay a fee ranging from \$1,000 to \$15,000, depending on the plan’s complexity.

A favorable determination letter expresses the IRS’s opinion that the plan is qualified based on the applicable “Cumulative List of Changes in Plan Qualification Requirements.” The list identifies, on a year-by-year basis, all changes in the qualification requirements resulting from changes in statutes, regulations, or other IRS guidance that must be reflected in the plan document. The IRS usually publishes this list in November.

New Determination Letter Procedures

As noted at the beginning of this article, the IRS has established new submission procedures for determination letters, based on a system of 5-year cycles. Under the new system, sponsors of individually designed plans (including governmental plans) who want to apply for determination letters would submit their application once every 5 years. The determination letter would rule on all plan amendments adopted and made effective during the applicable remedial amendment cycle.

There are five, 5-year cycles, labeled A through E. Generally, the last digit of the employer’s identification number determines which cycle applies to the employer. However, governmental plans are all assigned to Cycle C. For Cycle C plans, the next submission period for determination letters begins January 31, 2008, and ends January 31, 2009, (and every 5 years thereafter).

New Remedial Amendment Cycle

In conjunction with the new determination letter cycle, the IRS has also established a new remedial amendment period cycle. As mentioned earlier in this article, remedial amendment periods were previously announced by

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the IRS after a legislative or regulatory change. However, under Rev. Proc. 2005-66, a plan qualified under IRC § 401(a) will have a remedial amendment cycle that corresponds with its determination letter cycle.

Therefore, for governmental plans, the next 5-year remedial amendment cycle will end on January 31, 2009 (the same as the determination letter cycle). Under this process, a governmental request for determination letter would be submitted between February 1, 2008, and January 31, 2009. The IRS would review the plans' qualification provisions based on the Cumulative List issued in November 2007, including all new Congressional legislation with effective dates affecting qualification rules through October 2007. Therefore, for the plan to receive a favorable determination letter, Congressional legislation enacted and effective through October 2007 would need to have been included in the plan provisions by January 31, 2009, at the latest.

Potential Problems

This creates potential problems for some governmental plans. For state retirement plans, this situation would require the state legislature to act during the 2008 legislative session to amend the state plan to conform to any qualification provisions enacted by Congress in late 2007. However, six state legislatures only meet on a biennial basis in odd-numbered years (and typically only for the first half of the year). Consequently, these states would not be able to act until 2009 and, therefore, would be precluded from obtaining a favorable qualification letter for Congressional changes made to qualification provisions after mid-2007.

Officials at the U.S. Treasury and the IRS recognize this issue and are considering the steps needed to resolve the problem. GRS will continue to monitor this issue and provide additional information as it becomes available.

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