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IRS Issues Private Letter Ruling on Deferred Retirement Option Plan

The Internal Revenue Service recently issued a private letter ruling (PLR 200721022) regarding various features of a deferred retirement option plan (DROP). DROPs are used by a significant number of governmental defined benefit (DB) plans to encourage participants to continue working beyond normal retirement age by allowing a portion of their benefits to be paid into a DROP account and later distributed when they leave employment.

The DROP in question was established within a statewide governmental defined benefit (DB) plan for police officers and firefighters of local governments, pending a favorable IRS ruling. Under the DROP provisions, a DB plan member may make an irrevocable election to enter the DROP after attaining the DB plan's age and service requirements for unreduced retirement benefits (age 55 with at least 22 years of service). In making the election, the member must specify a DROP termination date that is either three, four, or five years after the member's DROP commencement date.

After electing the DROP, the member remains a participant in the DB plan. However, the member's retirement benefit is frozen (except for certain cost-of-living adjustments) as of the DROP participation date and a DROP account is established for the member. The account is credited with the member's monthly retirement benefit multiplied by an "applicable percentage" equal to 52% plus 2% for each month between the date the member is eligible for unreduced benefits and the date the member begins participating in the DROP. The applicable percentage may not exceed 100%. No interest is paid on the DROP account.

All active DB plan members are required to make contributions to the DB plan, and DROP members must continue making contributions to the DB plan during the DROP period. However, all member contributions are considered "picked-up" by local government employers pursuant to IRC § 414(h)(2). The picked-up contributions are treated as employer contributions for federal and state income tax purposes and, therefore, are not subject to income tax when contributed (although benefits are subject to tax when distributed). Member contributions are made through salary reductions.

When DROP members reach their DROP termination date, they must leave employment and begin receiving their monthly retirement benefits plus

the money credited to their DROP account. The DROP can only be taken as a lump sum distribution or rolled over into an eligible retirement plan. In replying to the ruling request, the IRS responded to the following issues.

Is the DROP a Defined Contribution (DC) Plan?

The characterization of a DROP as either a DB or a DC plan has important implications concerning how the IRC § 415 limits apply. Generally, if the DROP is characterized as a DC plan, the amounts credited to a member's DROP account could be subject to the IRC § 415(c) limits, restricting annual additions to the lesser of the annual dollar limit (\$45,000 in 2007, indexed to inflation) or 100% of compensation.

Regarding the DROP in question, the IRS noted that a DC plan is defined under IRC § 414(i) as a plan that provides "an individual account for each participant and for benefits based solely on the amount contributed to the participant's account, and any income, expenses, gains and losses ... which may be allocated to such participant's account." Consequently, the IRS ruled that since "the DROP benefit is based solely on amounts contributed to the participant's DROP account, which is not adjusted for income, expenses, gains and losses of the invested assets, it is not a separate DC plan."

How Is the DROP Benefit Tested Under IRC § 415?

Rather than being a DC plan, the IRS ruled that this DROP is an optional form of benefit provided by the DB plan. Moreover, since the DB plan does not provide any benefits based on a separate account of the

participant, the limits under IRC § 415(b) apply.

For governmental plans, IRC § 415(b) limits the annual benefit that can be paid by the plan to an established dollar limit (\$180,000 in 2007, indexed to inflation) and adjusted for age at retirement. In determining the benefit tested under the 415(b) limit, the IRS ruled that "the annuity equivalent of the DROP single sum plus the normal annuity benefit under the Plan will be tested for purposes of section 415(b)."

May Member Contributions be Picked-Up During the DROP Period?

As described earlier in this article, members who elect the DROP continue to make contributions to the DB plan during the DROP period. While it is well-established that governments are allowed to "pick-up" member contributions while the member is active, it was unclear whether this could continue after the member elected the DROP.

The IRS ruled that the contributions could continue to be picked-up during the DROP period. Because the member contributions apply equally to those who participate in the DROP and those who do not, and because the contributions are credited to DB plan assets rather than individual accounts, the IRS ruled that "the DROP did not result in contributions being ineligible for pick-up."

Are Benefits Credited to the DROP Considered Distributions?

During the DROP period, a member's DROP account is credited with the member's retirement amount multiplied by the applicable percentage. This raised concerns regarding

whether the IRS would characterize such amounts as distributions to the member (and potentially subject to early distribution penalties or considered ineligible in-service distributions).

The IRS ruled that because the benefits credited to the DROP account are held as assets of the system and are not available to the member until the member terminates participation in the DROP, the credited amounts were not distributions. Accordingly, prior to distribution, the DROP benefit would not be subject to income taxation nor to early distribution penalties under IRC § 72(t).

May DROP Benefits be Rolled Over?

Under the plan's DROP provisions, when members reach their DROP termination date, they must terminate employment, begin receiving their DB plan annuity benefits, and take the DROP either as a lump sum distribution or roll it over to a retirement plan qualified to receive the rollover. This raises the question of whether the DROP distribution is eligible for rollover.

The IRS ruled that because the DROP benefit is paid as a lump sum distribution, it is independent from, and significantly larger than, the participant's retirement annuity. Consequently, it conforms to the "eligible rollover" requirements under IRC § 401(a)(31).

In concluding, it should be noted that IRS private letter rulings, by law, apply only to the entity requesting them and may not be used or cited as precedent. Nevertheless, the rulings can offer useful insights into the IRS's reasoning.

OPEB Management: The Credit Rating Perspective

The accounting and reporting standards for Other Postemployment Benefits (OPEBs) issued by the Governmental Accounting Standards Board (GASB) require large governments to start reporting their OPEB costs for fiscal years beginning in 2007. Medium and smaller governments must begin reporting for fiscal years 2008 and 2009, respectively. Retiree health care benefits are the predominant form of OPEB; however, other types of non-pension, postemployment benefits such as life insurance and long-term care are also included.

Prior to the GASB OPEB standards, governments accounted for retiree health care on a pay-as-you-go basis, reporting annual claims and payments in the current year. Under the new standards, governments that sponsor OPEBs must measure their related long-term costs and liabilities on an accrual basis. As a result, OPEB costs and liabilities reported by governments in their financial statements will increase significantly.

This situation has generated discussion about how the standards are implemented and enforced. The GASB is not a federal agency and does not have enforcement power. Rather, it is a non-profit organization responsible for determining the generally accepted accounting principles (GAAP) that apply to state and local governments.

Generally, the GASB's standards are enforced through audits and credit ratings. Auditors apply GAAP when evaluating a government's financial documents. If the documents do not conform to the GASB

requirements, the auditor states this in the audit letter that accompanies the government's annual financial report and other public financial disclosures.

Credit Rating Agencies

Typically, governments borrow by issuing securities, such as government bonds. When governments issue public debt, they often obtain an evaluation of their creditworthiness from one or more credit rating agencies. The credit rating helps to inform lenders of the risks associated with the government's ability to repay the debt and helps to price the bonds accordingly. The higher the risks the more expensive it will be for a government to borrow money.

In judging creditworthiness, the rating agencies take a wide range of factors into account, including the amount of debt outstanding, local commercial growth, the tax base, etc. In developing this analysis, the government's annual financial statements and other financial documents play a key role. For a government not to follow GAAP would be viewed by the rating agencies as a negative factor in evaluating its credit quality.

Given this, it is useful to understand the rating agencies' perspective with regard to GASB OPEB. Several rating agencies have issued reports discussing their approach to evaluating credit quality in light of the OPEB disclosures, including:

- Standard & Poor's, *Reporting & Credit Implications of GASB 45 Statement on Other Postemployment Benefits*, December 2004;

- FitchRatings, *The Not So Golden Years: Credit Implications of GASB 45*, June 2005; and
- Moody's Investors Service, *Other Post-Employment Benefits (OPEB)*, July 2005.

General Approach

All three agencies indicate they will evaluate OPEB obligations in the same way they evaluate pension obligations, although this differs to some extent for each agency. For Standard & Poor's, unfunded actuarial accrued liabilities are "tantamount to bonded debt." For Fitch, OPEB and pension liabilities are "soft liabilities" which, unlike bonded debt, are likely to fluctuate based on actuarial assumptions and experience. For Moody's, OPEB and pension liabilities are also treated differently from bonded debt, but still included in the "overall credit assessment of the issuer."

Initial Credit Ratings

All three rating agencies indicate they recognize there will be difficulties in implementing the OPEB standards and that the process will likely evolve over time. Recognizing this, the agencies appear willing, at least initially, to take a tempered approach in assessing the impact of the standards on a sponsor's credit rating.

For example, Moody's indicates it does not expect the OPEB disclosures to have an immediate impact on credit ratings and that it would be "premature to prescribe a dogmatic treatment." Fitch reports that it will initially focus on "understanding each issuer's liability and its plans

for answering it.” Fitch also notes that it expects many governments to respond by “steadily ramping up contributions to actuarially determined levels” and realizes that “a rising net OPEB obligation in the short-term may be a product.”

However, for sponsors to maintain their credit ratings, all three rating agencies stress that governments should measure their OPEB liabilities and establish a plan to manage them.

Quantitative and Qualitative Measures

The rating agencies use both quantitative and qualitative factors to evaluate a jurisdiction’s credit risk with regard to OPEB. Although different agencies may use somewhat different factors, there appear to be several key quantitative measures they are likely to use. As discussed in the Moody’s article, these include:

- The absolute size of the unfunded accrued liability (UAL);
- The relative size of the UAL compared to the tax base;
- The relative size of the annual required contribution (ARC) compared to the budget;
- The difference between the ARC and actual employer contributions;
- The rate of growth of the net OPEB obligation (if any); and
- The reasonableness of the actuarial assumptions, especially the investment return assumption and the health care cost trend assumption.

In addition to quantitative measures, the agencies will apply qualitative measures. A key qualitative measure is whether the OPEB sponsor is

developing a plan to address OPEB funding issues. This includes taking steps to (1) measure the OPEB costs and liabilities, (2) evaluate funding vehicles, (3) examine possible benefit changes, and (4) find ways to control health care costs. While recognizing that it may take time to find satisfactory answers to these issues, the rating agencies will look for serious initial efforts.

OPEB Bonds

The rating agencies also understand some governments may consider issuing bonds as a way of funding their OPEB liabilities. These would be similar to pension obligation bonds that some governments have issued to fund their pension liabilities. Although not opposed to OPEB bonds, the credit rating

GFOA Advises Caution Regarding OPEB Bonds

Earlier this year, the Government Finance Officers Association issued a Recommended Practice (RP) on issuing bonds to finance Other Postemployment Benefits (OPEBs). The RP is titled “Need for Considerable Caution in Regard to OPEB Bonds” and advises governments to consider this approach carefully, given the significantly higher risks associated with such debt.

For example, overall health care costs are difficult to predict given the uncertainties surrounding health care cost trends. Moreover, changes in plan design and federal health initiatives can also change the cost of benefits. Because of these and other factors, the amount of the OPEB liability is uncertain. Issuing more OPEB bonds than necessary could

agencies’ support for such bonds is conditional. Fitch notes that OPEB bonds could be a useful tool, “if used moderately and in conjunction with a prudent approach to investing.... However, failure to follow balanced and prudent investment practices could expose the sponsor to market losses.”

Conclusions

Initially, it appears the rating agencies will apply a tempered perspective when factoring OPEB costs into state and local government credit ratings. While they will treat OPEB liabilities as similar to pension liabilities, they will give governments time to develop plans for managing the costs. However, the agencies will likely view the lack of action as a negative factor in their ratings.

use up a jurisdiction’s debt capacity and tie up future revenue streams for an extended time.

The RP recommends that OPEB bonds only be issued after consultation with a knowledgeable financial advisor who is not serving, or planning to serve, as an underwriter for the bonds. Potential issuers should compare this independent analysis of any proposed bond issuance with the costs of funding the OPEB liabilities through contributions. Finally, governments should refrain from issuing the bonds until all questions related to the proper establishment of a qualified trust fund and related investments have been resolved.

The RP is available on the GFOA’s web site at www.gfoa.org.

California Court Awards CalSTRS \$700 Million

In September 2007, the California State Teachers' Retirement System (CalSTRS) received \$500 million from the State of California as partial payment for a skipped contribution to the system's Supplemental Benefit Maintenance Account (SBMA).

The payment comes after California's Third District Court of Appeal ruled that withholding the funds violated the state's contractual obligation (*Teachers' Retirement Board v. Genest*, Super. Ct. No. 03CS01503). The appellate court also awarded interest on the skipped contribution, amounting to about \$200 million.

Background

The issue dates back to 2003 when the state legislature passed Senate Bill 20 (SB 20), which amended state statutes to decrease the state's 2004 contribution to the SBMA from \$559 million to \$59 million. SB 20 also provided that the shortfall would only be made up from state appropriations if periodic actuarial valuations showed that SBMA funds were insufficient to provide purchasing power protection through FY 2036.

The Teachers' Retirement Board (TRB), as manager of CalSTRS, sued the state's Department of Finance (DOF) claiming SB 20 was unconstitutional on grounds that it: (i) violated the contract clause of both the state and federal Constitutions and (ii) interfered with TRB's authority to administer the system.

The trial court ruled that SB 20 did violate the contract clause of both the state and federal Constitutions, but did not rule with regard to impairment of TRB's authority. The DOF

appealed, arguing the trial court erred in finding SB 20 unconstitutional.

On cross-appeal, the California Retired Teachers Association (CRTA) joined TRB in arguing the trial court had erred in awarding interest on the skipped contribution at an annual rate of 7% rather than 10%. AARP and several retired teacher organizations provided friend-of-the-court briefs supporting TRB's and CRTA's position.

The SBMA

As described by the appellate court, CalSTRS retirees receive benefits in three parts: (1) a retirement benefit from the defined benefit plan; (2) an annual adjustment of 2%; and (3) a supplemental payment intended to protect retirement benefits from inflation when they fall below 80% of their original purchasing power.

The supplemental benefit is funded by the SBMA which, in turn, is funded by contributions from the state's general fund. Supplemental payments are made to retirees on a quarterly basis, but only to the extent funds are available in the SBMA.

Prior to 1998, the purchasing power supplement provided by the SBMA was not a vested benefit. Statutory language governing the SBMA explicitly stated that no contractual right existed to the benefit and that the legislature reserved the right to reduce or terminate the state's contributions to the SBMA at any time.

This changed in 1998, when Assembly Bill No. 1102 (AB 1102) was passed, revising the statutory

language related to the SBMA. As a result, after July 1, 1999, a continuous annual appropriation was to be made from the state's general fund to the SBMA equal to 2.5% of members' creditable compensation in order to fund the supplemental benefits.

Moreover, AB 1102 specified that the legislative intent was to establish the supplemental payments as vested benefits pursuant to a contractually enforceable promise to make the annual contributions from the general fund to the SBMA, in order to provide a continuous source of revenue for the supplemental payments.

The Appellate Court's Decision

In appealing the trial court's decision, the DOF argued that the vested right created by AB 1102 was limited to the transfer of "up to 2.5% of creditable compensation," to the extent the funds were needed to make the benefit protection payments. Consequently, if the SBMA was capable of providing the supplemental benefit payments, there was no vested right to the transfer.

However, the appellate court found that the language of AB 1102 explicitly expressed the 1998 legislature's intent to establish the state contributions for supplemental payments as "vested benefits pursuant to a contractually enforceable promise to make annual contributions" from the general fund to the SBMA. In doing so, the legislature created a contractual right to annual state contributions of a specific amount paid to the SBMA.

The appellate court also discussed the tension between constitutional

contract protections and state sovereignty. The court observed that although the state and federal Constitutions limit a state's ability to modify its own contracts, the constitutional prohibition "does not exact a rigidly literal fulfillment" but rather "demands contracts be protected according to their just and reasonable purport."

While noting that not every change in retirement law constitutes an impairment of contracts, the court also observed that the scope of a government's power is more limited for retirees, since they are entitled to the fulfillment of a contract for which they have finished performing service. Noting that under SB 20, the state had no obligation to return the \$500 million if it was not needed before 2036, the court found the statute "substituted a fixed payment for a deferred payment for a limited period of time" and, therefore, increased members' risks.

The TRB's Authority

In its cross-appeal, TRB asked the appellate court to rehear the issue of TRB's authority, since the trial court had not resolved the state's potential ability to interfere. However, the appellate court declined, noting that courts "simply may not render advisory decisions on controversies the parties fear will arise, but do not presently exist."

Interest Payments

In its cross-appeal with the CRTA, TRB argued that the trial court had wrongly awarded an annual interest rate of 7% on skipped contributions, rather than 10%. The appellate court agreed. As a result, the interest payment is expected to increase from \$155 million to about \$200 million.

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