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GASB Proposes New Pension Disclosure Requirements for Governmental Plans

On December 15, 2006, the Governmental Accounting Standards Board (GASB) issued an Exposure Draft (ED) titled *Pension Disclosures*. Generally, the ED would change certain state and local government financial disclosure requirements for pensions to better conform to the disclosure requirements for other postretirement benefits (OPEBs). Specifically, it would require state and local defined benefit pension plans, and governments participating in sole and agent defined benefit pension plans, to:

- Disclose the plan's current funded status in the notes to the financial statements as of the most recent actuarial valuation date. This would be in addition to disclosing the plan's funding progress in the financial report's required supplementary information (RSI). Defined benefit plans would disclose actuarial methods and significant assumptions in the notes to the financial statements, rather than in the notes to the RSI.
- Governments that use the aggregate actuarial cost method to determine annual contributions must use the entry age actuarial cost method to disclose the plan's funded status in the notes to the financial statements and in the RSI schedule of funding progress. The disclosure should also explain that the purpose of doing so is to provide an approximate measure of the plan's funded status and funding progress.
- Disclose additional information about the actuarial measurement process and provide a reference linking the note disclosure of funded status to the schedule of funding progress in the RSI.
- If applicable, disclose any legal or contractual limits on maximum contribution rates in the notes to the financial statements. If relevant, disclose whether such maximum contribution rates have been explicitly included in the projection of pension benefits for financial accounting purposes.

For governments participating in cost-sharing pension plans:

- Disclose the contractually required contribution rate in the notes to the financial statements, including the dollar amount and the actual percent contributed for the current year and previous two years. This should also include disclosure of how the contractual contribution rate is determined (e.g., by statute, actuarial valuation, etc.)

- Disclose funding information about the cost-sharing plan as a whole, if the cost-sharing plan does not issue a report compliant with generally accepted accounting principles (including the RSI), or if the plan is not included in the publicly available financial report of another entity.

In addition, the ED would require state and local defined benefit pension plans (and defined contribution plans) to disclose in the notes to the financial statements the methods and assumptions used to determine the fair value of investments, if the fair value is not based on quoted market prices. This applies to the value of investments reported in the statement of plan net assets, rather than to the actuarial value of plan assets (which is already subject to disclosure).

The GASB intends the new disclosures to improve the transparency and usefulness of financial information about state and local governmental pension plans. The proposal would be effective for periods beginning after June 15, 2007, with early implementation encouraged. The GASB's deadline for written comments on the ED is February 28, 2007.

The ED is available at: http://www.gasb.org/exp/ed_pension_disclosures.pdf

IRS Issues Guidance to Implement Pension Protection Act Provisions for Plan Distributions

On January 10, 2007, the U.S. Treasury Department and Internal Revenue Service (IRS) released Notice 2007-7 providing guidance on several provisions of the Pension Protection Act (PPA) as enacted on August 17, 2006. The notice answers over 40 questions regarding implementation of certain PPA provisions governing various qualified plan provisions effective in 2007 or earlier, including:

- interest rate assumptions for lump sum distributions;
- hardship distributions;
- rollovers for nonspouse beneficiaries;
- early distributions to public safety employees;
- distributions to pay for accident or health insurance for public safety officers;
- vesting of nonelective contributions;
- notice and consent period for distributions; and
- distributions from IRAs to charitable organizations.

Not all of these provisions apply to governmental plans. A summary of the provisions that do apply is provided in a new GRS research memo on the subject, available at <http://www.gabrielroeder.com>. Key items include:

- **Waiver of 10% Early Distribution Penalty for Public Safety Employees** - PPA § 828 added Internal Revenue Code § 72(t)(10) which provides that early distributions from qualified plans to public safety employees who separate from service after age 50 (previously age 55) are exempt from the 10% early withdrawal penalty effective after August 17, 2006. The Notice defines a public safety employee as an employee whose principal duties must include "services requiring specialized training in the area of police protection, firefighting services, or emergency medical services."
- **Tax-Free Distributions for Health Insurance Premiums of Retired Public Safety Officers** - PPA § 845 added § 402(l) which provides that eligible retired public safety officers may elect to exclude from taxable income up to \$3,000 of annual distributions paid from an eligible governmental plan to a health insurance plan for qualified health (or long-term care) insurance premiums. The Notice states that the accident or health insurance plan receiving the health insurance premiums may **not** be a self-insured plan, but rather must be a plan providing insurance issued by an insurance company regulated by a State.

IRS Notice 2007-7 is available at: <http://www.irs.gov/pub/irs-drop/n-07-07.pdf>

IRS Requests Comments on PPA Provision Allowing In-Service Distributions at Age 62

On December 22, 2006, the U.S. Treasury Department and Internal Revenue Service (IRS) issued Notice 2007-8 requesting comments on a provision of the Pension Protection Act of 2006 (PPA) permitting in-service distributions to participants upon attaining age 62. Under new Internal Revenue Code § 401(a)(36), for plan years beginning after December 31, 2006, “a pension plan does not fail to qualify under § 401(a) solely because the plan provides that a distribution may be made to an employee who has attained age 62 and who has not separated from employment at the time of distribution.” Consequently, upon attaining age 62, an employee may begin to receive his or her full pension benefits while continuing to work, so long as it is provided by the plan.

In November 2004, the IRS issued proposed rules, which have not been finalized, to permit phased retirement distributions to employees after attaining age 59½. Under the proposed rules, a qualified pension plan with a phased retirement program could make in-service pension distributions to an employee proportional to the reduction in the employee’s workload. For example, if an employee switched from working full-time to working three-quarters time under the program, the pension plan could pay 25% of the employee’s accrued benefit while the employee continued to work. The proposed rules also include rules for: accruing benefits during the phased retirement period; adjusting phased retirement benefits in cases where the employee works more hours than expected; and offsetting the employee’s full retirement benefit by any phased retirement benefits.

Notice 2007-8 requests comments on both the in-service and phased retirement provisions, including:

- Should an in-service distribution to a participant who is at least age 62, but has not yet reached normal retirement age, be limited to the actuarial equivalent of benefit at normal retirement age?
- Should the proposed phased retirement rules be finalized, given the new in-service distribution rules under § 401(a)(36)?

The IRS deadline for written comments regarding Notice 2007-8 is April 16, 2007.

Notice 2007-8 is available at: <http://www.irs.gov/pub/irs-drop/n-07-08.pdf>

U.S. House Passes Medicare Prescription Drug Negotiation Act

On January 12, 2007, the U.S. House passed the Medicare Prescription Drug Negotiation Act of 2007 (H.R. 4) requiring the Department of Health and Human Services (HHS) to negotiate lower drug prices with drug manufacturers on behalf of Medicare beneficiaries. However, the bill would prevent HHS from establishing particular formularies (i.e., lists of covered medications), thus limiting HHS’ leverage with drug manufacturers during negotiations.

The bill passed with a vote of 255-170, which was short of the 260 votes needed to override President Bush’s threatened veto. According to a Bush administration statement, “Both the Congressional Budget Office and the Department of Health and Human Services actuaries estimate that H.R. 4 would have negligible or no effect on Federal spending and provide no substantial savings to the government or Medicare beneficiaries.” HHS Secretary Leavitt has said the bill would “limit the availability of medications because plans would drop drugs from their formularies if the negotiated price was too low.”

On January 10, 2007, Senators Ron Wyden (D-OR) and Olympia J. Snowe (R-ME) introduced the Medicare Enhancements for Much Need Drugs (MEND) Act (S. 230). The bill would allow HHS to negotiate prescription drug prices, but also prevents HHS from price-setting or establishing uniform formularies (i.e., lists of covered medications). The bill would generally give the HHS Secretary discretion in determining when such negotiations were necessary, but would require the HHS to negotiate with drug manufacturers if:

- a drug is a single source medication without a therapeutic alternative;
- a drug was created with substantial taxpayer funding for research and development;
- a private insurance plan requests assistance; or
- for any “fallback” drug plan that HHS must provide.

The legislation would require HHS to provide a fallback drug plan that eliminates the coverage gap (i.e., the “donut hole”) if such coverage is not otherwise available. Key members of the Senate Finance Committee oppose the legislation and hope to prevent the Senate leadership from gaining the 60 votes needed to ensure passage.

The text of H.R. 4 is available at: <http://www.govtrack.us/data/us/bills.text/110/h/h4.pdf>

U.S. House and Senate Introduce Bills Providing Grants to States Expanding Health Care Coverage

On January 17, 2007, the U.S. House and Senate introduced bills to provide federal grants to states for initiatives to expand health care coverage to uninsured Americans, which totaled 47 million in 2005 according to the Census Bureau. Under the proposed legislation, a State Health Innovation Commission would be established to review state health reform proposals. The proposals would then be subject to approval by Congress.

Recently the Robert Wood Johnson Foundation issued a report, *State of the States 2007, Building Hope, Raising Expectations*. According to the report, while there has not been much movement toward a national solution for providing health insurance to the uninsured, state initiatives are seeking to expand coverage. Forces driving these initiatives include:

- continued increases in the number of uninsured;
- decreases in employer-sponsored health insurance;
- improved economic outlooks among the states as a result of increased state revenues; and
- lack of comprehensive national health care reform.

The report summarizes many of the state initiatives enacted in 2006. Legislation for comprehensive state health care reform was enacted in three states: Massachusetts, Vermont and Maine. Public-private partnerships to improve coverage for the uninsured were established in other states, including: Arkansas, Montana, New Mexico, Oklahoma, Rhode Island, Tennessee and Utah. Additionally, Illinois and Pennsylvania implemented initiatives to cover all children, and other states are considering similar programs.

More state-based health care reforms are expected in 2007. For example, in January, California Governor Arnold Schwarzenegger proposed a comprehensive health care reform plan requiring all 6.5 million uninsured state residents to be covered by health insurance, with funding coming from state and local governments, individuals, employers, providers, and hospitals. The Governor describes his proposal as a “systems approach” incorporating three essential building blocks: 1) prevention, health promotion, and wellness, 2) coverage for all Californians, and 3) affordability and cost containment. A summary of the proposal is available at: http://gov.ca.gov/pdf/press/Governors_HC_Proposal.pdf

The *State of the States 2007* report is available at: <http://www.statecoverage.net/pdf/stateofstates2007.pdf>

California Governor Establishes Commission to Study Retiree Pension and Health Costs

On December 28, 2006, Governor Schwarzenegger issued an executive order establishing the Public Employee Post-Employment Benefits Commission to examine pension and health care costs for retired state employees.

By January 1, 2008, the 12-member commission must deliver a report to the Governor and the Legislature proposing ways to address the state's increasing pension and retiree health care obligations. The report will:

- Identify the full amount of post-employment health care and dental benefits for which state and local governments in California are liable (including the extent to which they are unfunded);
- Evaluate and compare various approaches to address the unfunded obligations; and
- Propose a plan to address the state's unfunded retiree health care and pension obligations.

Although the state has not yet published a full actuarial valuation of retiree health care benefits, a February 2006 Legislative Analyst Office (LAO) report estimated the state's unfunded liabilities for retiree health care benefits to be between \$40 billion and \$70 billion. The LAO recommended that up to \$6 billion per year be allocated for the unfunded liability in addition to current expenditures of about \$1 billion per year.

The executive order is available at: <http://gov.ca.gov/index.php?/press-release/5012>.

Federal Appeals Court Rules Spouse of Traffic Officer Not Entitled to Federal Death Benefit

On December 1, 2006, the U.S. Court of Appeals for the Federal Circuit ruled that the spouse of a special school zone police officer was not entitled to a federal duty death benefit when his wife was fatally injured while directing traffic (*Cassella v. United States*, Fed. Cir., No. 06-5035, 12/1/06). Under the Public Safety Officers' Benefits Act (PSOBA), a one-time cash benefit is provided to survivors of public safety officers who die in the line of duty.

Under the Act, a "public safety officer" is defined as one serving a public agency as a law enforcement officer, firefighter, or member of a rescue squad or ambulance crew. A "law enforcement officer" is further defined as "an individual involved in crime and juvenile delinquency control or reduction, or enforcement of the laws, including, but not limited to, police, corrections, probation, parole, and judicial officers." The Act is administered by the U.S. Justice Department's Bureau of Justice Assistance (BJA), which is also responsible for issuing regulations related to the Act. Under 28 CFR § 32.2(m), the BJA further defined "law enforcement officer" as an "individual involved in crime and juvenile delinquency control or reduction, or enforcement of the criminal law."

The plaintiff first filed his claim with the BJA, which dismissed the claim on the grounds that the plaintiff's spouse did not have "a duty to control or reduce crime and juvenile activity or to enforce criminal law," and therefore did not meet the definition for public safety officer. The plaintiff then appealed to the U.S. Court of Federal Claims, which invalidated 28 CFR § 32.2(m) on the grounds that it restricted the definition of "law enforcement officer" to only those who enforce criminal law. Since the statutory phrase "enforcement of laws" includes laws related to non-criminal activity, the claims court ruled that the regulatory interpretation was an "invalid restriction of the statute." Finding that Mrs. Cassella's responsibilities included the enforcement of non-criminal laws (i.e., traffic laws), the claims court ruled in the plaintiff's favor. The U.S. Justice Department, in turn, appealed.

The U.S. Court of Appeals for the Federal Circuit overturned the claims court's decision on the grounds that the BJA's regulatory interpretation was consistent with Congressional intent in passing the PSOBA to "benefit the families of those involved in crime control and reduction." To support this finding, the appellate court referred to *Hawkins v. United States* (Fed. Cir., No. 06-5013, 11/17/06), where it reached a similar conclusion. The court also noted that none of the lower court or agency decisions held that Mrs. Cassella was "appointed for, trained for, authorized, assigned, or obligated to fight crime or perform criminal law enforcement duties." Consequently, the court found her position did not qualify her husband for PSOBA benefits.

The appellate court opinion is available at: <http://fedcir.gov/opinions/06-5035.pdf>

U.S. Supreme Court Lets Stand Ruling that Early Retirement Payments Are Subject to FICA Taxation

On January 16, 2007, the U.S. Supreme Court left standing a U.S. Sixth Circuit Court of Appeals ruling that early retirement payments made to Michigan school teachers constitute wages subject to taxation under the Federal Insurance Contributions Act (FICA) (*Appoloni v. United States*, U.S. No. 06-334, cert. denied 1/16/07).

In June 2006, the Sixth Circuit ruled that early retirement payments made to Michigan teachers who relinquished their tenure rights constituted “wages” subject to FICA taxes (*Appoloni v. United States*, 6th Cir., No. 04-2068, 6/7/06). The appeal consolidated two cases that had been heard in separate federal district courts (*Appoloni v. United States*, W.D. Mich., 94 AFTR 2d 2004-5356, 7/21/04, and *Klender v. United States*, E.D. Mich., No. 02-10082-BC, 8/2/04). In *Appoloni*, the Western Michigan district court found that early retirement payments were “remuneration for employment” and so subject to FICA taxes. In *Klender*, the Eastern Michigan district court found that the early retirement payments were made in exchange for the teachers’ right to continued tenured employment and so constituted a property right not subject to FICA taxes.

The Sixth Circuit affirmed *Appoloni* and reversed *Klender*. It reasoned that Internal Revenue Code § 3121(a) defines “wages” as “all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash.” In both *Appoloni* and *Klender*, the teachers were eligible for early retirement benefits after attaining a minimum number of years of service. The Sixth Circuit found that because eligibility for early retirement payments was based on services performed (rather than relinquishment of tenure rights) the payments constituted wages. Furthermore, because the early retirement payments were not made “in exchange solely for tenure rights, but rather in exchange for early retirement” they were essentially severance payments. Under IRS Revenue Ruling 75-44, severance payments fall within the definition of FICA wages as “all remuneration for employment.”

Source: *BNA Pension & Benefits*, January 23, 2007.

The Sixth Circuit’s June 2006 ruling is at: <http://www.ca6.uscourts.gov/opinions.pdf/06a0190p-06.pdf>

American Academy of Actuaries Releases Monograph Analyzing Social Security Reforms

On January 18, 2007, Ron Gebhardtshauer, senior pension fellow at the Academy of Actuaries, announced the release of *Social Security Reform Options*, the Academy’s new monograph on Social Security reform. In announcing the release, Gebhardtshauer urged policy-makers to act “sooner rather than later” since doing so would reduce the severity of needed reforms and allow the reforms to be phased-in over time.

The monograph is intended to provide objective, factual information, without favoring any specific reform. After describing the key features of Social Security and reviewing the program’s financial status, the monograph summarizes the impact and effectiveness of a wide range of reform options, including:

- Increasing the limit on taxable earnings;
- Increasing taxation of benefits;
- Expanding Social Security coverage;
- Raising normal retirement age;
- Changing the benefit formula (including progressive price indexing);
- Reducing cost-of-living adjustments;
- Investing trust fund assets;
- Financing with general revenues; and
- Including individual accounts (both “carve-outs” and “add-ons”).

The monograph provides a clear and concise view of the major options for Social Security reform, and places them in the context of the program’s overall objectives. It is directly available at:

http://www.actuary.org/pdf/socialsecurity/reform_07.pdf