

February 2007

The following news summaries were developed by Gabriel, Roeder, Smith & Company to inform clients and other benefit professionals of news in the benefits industry. Our thanks to Mary Ann Vitale for her diligent work on this issue. To receive this publication electronically, send an email to web.admin@gabrielroeder.com with the message "SUBSCRIBE NEWS SCAN" in the subject line. To stop receiving this publication electronically, send the message "UNSUBSCRIBE NEWS SCAN" in the same manner. Copies of this and other benefit-related publications are available on the GRS web site at www.gabrielroeder.com.

Note: The authors of these summaries are not attorneys and the statements made are not legal advice or opinion. Qualified legal advice should be obtained before acting with regard to related laws and regulations.

NASRA Publishes Overview of State and Local Government Defined Benefit Retirement Plans

On January 23, 2007, the National Association of State Retirement Administrators (NASRA) published a one-page summary of *Key Facts Regarding State and Local Government Defined Benefit Retirement Plans*. The overview summarizes the findings of the 2005 Public Fund Survey sponsored by NASRA and the National Council on Teacher Retirement (NCTR). The key facts include:

- **Public pension plans are in favorable financial condition.** As a group, public pension plans have assets amounting to nearly 90% of the liabilities owed. These assets are professionally managed and invested on a long-term basis using sound investment policies. The \$2.89 trillion in real assets invested by the plans are an important source of liquidity and stability for the U.S. financial markets.
- **The majority of public pension funding is not paid by taxpayers.** Over the past 23 years, only 24% of the monies used to fund public pension benefits was provided by taxpayers. Other funding sources included investment earnings (64%) and employee contributions (12%).
- **Public pension plans attract and retain the workforce that provides essential public services.** Ten percent of the U.S. workforce is comprised of active public employees, of whom 67% are employed in education, public safety, corrections, and the judiciary.
- **Public pension plans are an integral component of national, state, and local economies.** Public plans distribute more than \$140 billion in benefit payments annually to about 7 million retirees, beneficiaries and other recipients. These benefit payments help support the local, state and national economies.
- **State and local pension plans are subject to comprehensive oversight.** State and local plans are subject to state constitutional and statutory provisions, as well as case law. Moreover, they are subject to comprehensive accounting standards established for state and local governments.
- **State and local pension funds earn competitive investment returns.** Public pension funds generated investment returns of 8.5% to 9.5% for the 10- and 20-year periods ending 6/30/06.

The summary is available on the NASRA website by selecting "Key Facts on Public Employee Retirement Plans" at: <http://www.nasra.org>. The 2005 Public Fund Survey is accessible at: www.publicfundsurvey.org

Massachusetts Pension Fund Assets Increase 16.7% in 2006

On February 6, 2007, Massachusetts State Treasurer Tim Cahill reported that the state's Pension Reserves Investment Trust (PRIT) increased 16.7% in 2006, with total assets growing to a record \$46.7 billion. The investment performance was double the state's actuarial benchmark of 8.25%, and exceeded the Public Fund Median Return of 14.3%. According to Treasurer Cahill's office, the fund's performance was attributable to diversification and, in part, to a strategy of shifting assets into private equity, emerging markets, hedge funds, and real estate over the past four years. Since 2003, the PRIT fund has grown from \$26 billion to over \$46 billion.

Source: BNA *Pension & Benefits Reporter*, February 13, 2007.

IRS Clarifies Guidance on Direct Rollovers to Nonspouse Beneficiaries

On February 13, 2007, the Internal Revenue Service (IRS) published a special edition of *Employee Plan News* to further clarify guidance relating to direct rollovers from qualified plans to nonspouse beneficiaries. As provided in the 2006 Pension Protection Act (PPA), nonspouse beneficiaries are now allowed to directly rollover an eligible rollover distribution from a qualified retirement plan to an "inherited" individual retirement account or annuity (IRA). Qualified retirement plans include governmental defined benefit and defined contribution plans, as well as 403(b) annuities and governmental 457(b) plans. This change applies to distributions made after December 31, 2006. However, plans are not required to provide such rollovers (i.e., the new PPA provision is permissive rather than mandatory.)

On January 10, 2007, the Treasury Department and IRS issued Notice 2007-7 offering implementation guidance on several provisions of the PPA, including direct rollovers to nonspouse beneficiaries. However, the guidance raised additional questions related to the rollovers, which are addressed in *Employee Plan News*. Specifically, the IRS responded to questions regarding the interaction of a general rule in Q&A-19 of Notice 2007-7 and a special rule in Q&A-17, which is an exception to the general rule. *Employee Plan News* clarifies that the general rule in Q&A-19 was not intended to override the special rule in Q&A-17.

Under the PPA, a rollover to a nonspouse beneficiary is carried out by a direct rollover from the qualified plan to the inherited IRA. The amount must be eligible for rollover, which means that certain required minimum distributions (specified under IRC § 401(a)(9)) may not be included in the rollover. Under the general rule described in Q&A-19, if a participant dies before his or her required beginning date, the required minimum distribution applicable to the nonspouse rollover is determined under either the "5-year rule" or the "life expectancy rule."

However, the special rule in Q&A-17 provides an exception to the general rule. If, under the plan, the 5-year rule applies for determining required minimum distributions, a nonspouse beneficiary may nevertheless treat the plan as using the life expectancy rule, as long as the rollover to the IRA is made before the end of the year following the year of the participant's death (the "end-of-the-year-after-death" rule).

Additional clarifications of these provisions may be forthcoming. In a recent letter to the Treasury, Senators Gordon Smith (R-OR) and John Kerry (D-MA) requested further clarifications of Notice 2007-7. Specifically, the Senators asked the IRS to consider:

- A transition rule to ensure that the distributions to certain nonspouse beneficiaries for participants who died in 2003, 2004, and 2005 are eligible under an end-of-the-year-after-death rule;
- A clarification that retirement plans that only offer the five-year payout option would not preclude a rollover to an IRA that allows the beneficiary to use either the five-year or life expectancy rule; and

- An offer to help Treasury and IRS officials reexamine whether the new rollover rule for nonspouse beneficiaries should be permissive or mandatory.

The special edition of *Employee Plan News* is available at: http://www.irs.gov/pub/irs-tege/se_021307.pdf

IRS Releases Guidance on Rollovers from Health FSAs and HRAs to HSAs

On February 15, 2007, the U.S. Treasury and Internal Revenue Service released Notice 2007-22 providing guidance on rollovers from health Flexible Spending Arrangements (health FSAs) and Health Reimbursement Arrangements (HRAs) to Health Savings Accounts (HSAs). The Tax Relief and Health Care Act of 2006 provides employers may amend their health FSA or HRA plans to allow employees to elect a one-time rollover to an HSA prior to 2012. Notice 2007-22 clarifies the rules and circumstances under which such rollovers may take place.

Generally, in order for a rollover to receive favorable tax treatment under the new rules, the plan must meet all of the following conditions by the end of the plan year:

- The plan must be amended to conform with the rollover requirements;
- The employee must elect the rollover;
- The employee's year-end balance must be frozen; and
- The funds must be transferred by the employer directly to the custodian or trustee of the HSA within 2-1/2 months after the end of the plan year and result in a zero balance in the employee's health FSA or HRA.

The notice also provides a special transition rule for transfers made during the period from December 20, 2006 through March 15, 2007. The transition relief requires, in part, that the amendment, election and transfer must be completed by March 15, 2007.

Additional details are provided in Notice 2007-22, available at: <http://www.irs.gov/pub/irs-drop/n-07-22.pdf>

Moody's Survey Shows OPEB Costs Outpace Inflation in Largest U.S. Cities

On January 30, 2007, Moody's Investor Services released a report titled, "Survey Shows that Cost of Other Post-Employment Benefits (OPEB) for the Largest U.S. Cities Outpacing Inflation." In surveying the 55 largest U.S. cities, Moody's found that the "pay-as-you-go" costs for other post-employment benefits (OPEB) increased by an average of 10% annually from 1999 through 2004. The report states that "consistent with national trends in healthcare inflation, the growth in OPEB costs has slowed over the last few years, but the percentage increase remains notably higher than the general rate of inflation."

The report also states that Moody's believes it is too early to make near-term changes to municipalities' current credit ratings due to pending implementation of the GASB OPEB reporting requirements under Statements No. 45 and No. 43. Prior to implementation, Moody's will monitor municipalities' general framework for providing OPEBs, including benefit eligibility requirements, dependent coverage, statutory requirements, and early efforts to measure related costs and liabilities. After the standards are implemented, Moody's will examine the following factors, among others:

- The projected cost of pay-as-you-go benefits as a percentage of total budget;
- The government's unfunded actuarial accrued liability (UAAL) and annual required contribution (ARC) for OPEBs relative to total payroll and budget (as compared with other cities);
- The actuarial assumptions used to derive OPEB cost and liability measures; and

- The government's financial flexibility for addressing OPEB costs and liabilities relative to operating revenues, benefit changes, pre-funding liabilities, or some combination of these.

To help fund OPEB liabilities, some state and local governments are considering creating dedicated trusts or issuing OPEB bonds (or both). While generally noncommittal on the use of these approaches, the report notes several drawbacks. Regarding OPEB bonds, the report states: "Debt may be viewed somewhat positively if it has a sound financial rationale and is part of an overall strategy for managing an OPEB liability, but these advantages will be weighed against the loss of financial flexibility and increase in market risk inherent in bonding out the liability. Further, debt may be viewed negatively if its structure reveals a lack of willingness to make appropriate, near-term budget adjustments."

The report also notes that establishing a dedicated trust may also raise issues. According to the report, some municipalities have expressed concerns that establishing a dedicated trust might have disadvantages, including (1) loss of control over OPEB assets; (2) ceding control over granting benefits to plan members; or (3) creating political pressure to increase benefits. These concerns have led some municipalities to consider foregoing the use of qualified trusts for pre-funding OPEB liabilities, even in situations where it is currently allowed by state law.

The report also provides an appendix with information on each of the 55 cities' credit ratings, operating revenues, OPEB pay-as-you-go costs, and basis for providing OPEBs (e.g., state statute, union contract, etc.). A free copy of the report (No. 101468) can be obtained by contacting Moody's at 212-553-1658. (Note: the report is also referred to as a "Special Comment.")

EBRI Reports Many Americans Risk Outliving Retirement Assets

On February 6, 2007, the Employee Benefit Research Institute (EBRI) released its issue brief, *How Are New Retirees Doing Financially in Retirement?*, which indicates that a significant percentage of Americans face the risk of outliving their retirement assets. The EBRI study is based on data from the Health and Retirement Study (HRS), sponsored by the National Institute of Aging and the Social Security Administration, and administered by the Institute for Social Research at the University of Michigan. The survey collects data every two years from more than 22,000 Americans over age 50.

The EBRI study examined changes in income and wealth over the period from 1992 to 2004 for U.S. retirees currently between the ages of 65 and 75. The majority were married (67%), in "good" or better health (72%), with total wealth (assets minus debt) of \$100,000 or more (61%). Overall, about 47% experienced a decrease in their household income over the period, and 29% had a decline in total wealth. For those experiencing a decline in total wealth, the annual rate of decline averaged about 5.5% over the period. Retirees with the greatest rate of decline in wealth were females, widows, widowers, and those who never married, were in poor health or had low incomes. The study found that these retirees were at significant risk of running out of money in retirement.

In general, the study advised individuals to adhere to a "5 percent solution." For retirees who do not have annuity income, annual spending in retirement should not exceed 5% of their total wealth. Research has shown that those who do not abide by the 5% solution have a higher likelihood of exhausting their retirement savings within 30 years.

The study also suggests further education is needed to help individuals manage their assets in retirement, especially for those who rely primarily on defined contribution plans, individual retirement accounts, and other fixed savings. This group represented about 60% of the surveyed population.

The issue brief is available at: http://www.ebri.org/pdf/briefspdf/EBRI_IB_02-20071.pdf

CBO Releases 10-Year Federal Budget Projections

On January 24, 2007, the Congressional Budget Office (CBO) released its report, *The Budget and Economic Outlook: Fiscal Years 2008 to 2017*. Intended to provide impartial analysis for both parties in Congress, the report presents 10-year projections of federal revenues, expenditures, deficits, and outstanding debt. It also compares these with projections of Gross Domestic Product (GDP) and other economic indicators.

According to the report, if current laws and policies remain the same, the annual federal deficit will fall from \$248 billion in 2006 (1.9% of GDP) to \$12 billion in 2011 (0.1% of GDP), after which annual surpluses are projected to rise to \$249 billion in 2017 (1.2% of GDP). During this period, total publicly-held federal debt is projected to fall from \$4.8 trillion in 2006 (37% of GDP) to \$4.3 trillion in 2017 (20% of GDP). However, this favorable scenario assumes **none** of the following potential policy changes occurs:

- The tax cuts included in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs and Growth Tax Reconciliation Act of 2003 (JGTRRA) are made permanent for periods after 2010;
- Congress provides relief from the alternative minimum tax (AMT); and,
- Discretionary spending (including military spending) grows at the same or higher rate as nominal GDP (projected at 4.3%) rather than inflation (projected at 2.2%).

If all three occur, the CBO forecasts the annual deficit would increase to \$328 billion in 2012 (1.9% of GDP) and add an accumulated \$4.2 trillion to outstanding federal debt by 2017.

Social Security Projections. The CBO projects Social Security outlays will almost double from \$544 billion in 2006 (20% of total federal outlays and 4.2% of GDP) to \$1.03 trillion in 2017 (26% of total federal outlays and 4.8% of GDP). To a large extent, these increases are driven by two factors: (1) increases in the number of people collecting benefits and (2) Social Security's cost-of-living adjustments. CBO estimates that the number of people collecting Social Security will rise from 49 million in 2007 to 62 million in 2017, and that Social Security COLAs will average about 2.2% per year over the 10-year period. These two factors account for 90% of the CBO's projected increase in Social Security outlays.

Medicare Projections. Annual Medicare outlays are projected to more than double from \$374 billion in 2006 (14% of total federal outlays and 2.9% of GDP) to \$851 billion in 2017 (21% of total federal outlays and 4.0% of GDP). CBO projects Medicare caseloads will increase from 43 million in 2007 to 54 million in 2017, accounting for about 30% of the increase in Medicare outlays.

Medicare payment rates are also adjusted annually to reflect increased medical costs. However, the rate of increase is mitigated through the "sustainable growth rate" (SGR) formula, which sets a cumulative spending target for payments to physicians and for services related to medical visits. The CBO forecast assumes these targets will be met. Other sources of medical cost increases include increased use of medical services (e.g., more frequent doctor's visits, tests, etc.) and increased use of medical technology.

The Medicare Part D prescription drug program is also projected to increase Medicare outlays, although to a lesser extent than previously expected. Payments under the Part D program are projected to total \$46 billion in 2007 and increase to \$142 billion in 2017. These increases are lower than previously estimated for several reasons, including: (1) the competitive bids submitted to provide drug coverage in 2007 are 15% lower than expected, and (2) the eligible population covered by a comparable non-Medicare drug plan is higher than expected, lowering the projected ultimate Part D participation rate from 87% to 78% of Medicare beneficiaries.

The CBO report is available at: <http://www.cbo.gov/ftpdocs/77xx/doc7731/01-24-BudgetOutlook.pdf>