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Treasury and IRS Release Final 415 Regulations

On April 4, 2007, the U.S. Treasury and IRS released final regulations related to Internal Revenue Code (IRC) § 415. The final regulations generally follow the proposed regulations released on May 31, 2005, with some modifications reflecting amendments to § 415 made by the Pension Protection Act of 2006. The regulations consolidate the statutory changes and IRS guidance released since the comprehensive § 415 regulations were last updated in 1981. The final regulations also include conforming changes to additional regulations under §§ 401(a)(9), 401(k), 403(b), and minor corrective changes under § 457.

IRC § 415 limits the benefits that can be paid from defined benefit (DB) plans and the annual additions that can be made to defined contribution plans, including governmental plans. IRC § 415(b) limits the maximum employer-provided benefit that can be paid annually from a DB plan for a benefit commencing between the ages of 62 and 65 (i.e., \$180,000 in 2007). IRC § 415(c) limits the maximum annual additions (including employer and employee contributions) that can be made to a DC plan (i.e., the lesser of \$45,000 in 2007 or 100% of compensation). These limits are adjusted annually for changes in the Consumer Price Index (CPI). The remainder of this article describes several provisions of the final regulations related to public plans.

Definition of Public Safety Employees. Under the IRC § 415(b)(2)(C), the \$180,000 limit on DB benefits is actuarially reduced for retirement before age 62 (for example, about \$108,000 at age 55 and about \$77,000 at age 50). However, the age reduction in the limit does not apply to certain full-time employees in police and fire departments maintained by state, local, and Indian tribal governments who have at least 15 years of service credit. The 2005 proposed regulations clarified that this exemption from the age-reduced limit applied only to full-time employees in police and fire "departments." However, this raised concerns that public safety employees outside of named departments would not be eligible for the exclusion. The final rules clarify that "department" refers to the function performed rather than how the department is named.

Automatic COLAs. Under IRC § 415(b)(2)(B), benefits paid in a form other than a straight life annuity (e.g., period certain annuities) are adjusted to the actuarial equivalent of a straight life annuity for testing under 415(b). Under the 2005 proposed regulations, an annuity with an automatic COLA would be adjusted upward to reflect the additional value of the COLA before testing. Under the final regulations, this adjustment need not be made so long as the plan specifically provides that the benefit paid each year will not exceed the 415(b) dollar limit for that year, applicable to the age at which the benefit commenced.

Multiple Annuity Starting Dates. Under the 2005 proposed regulations, benefits paid over “multiple annuity starting dates” (MASD) would be subject to complicated rules as of the dates the benefit amounts changed. The final regulations postpone implementation of the MASD rules, but still require plans to test past and future distributions with respect to the benefits commencing at the various annuity starting dates. The IRS is continuing to work on the final MASD rules, which may be released in 2007.

Generally, the new regulations apply to limitation years beginning on or after July 1, 2007. For governmental plans, the new regulations apply to “limitation years that begin more than 90 days after the close of the first regular legislative session of the legislative body with authority to amend the plan that begins on or after July 1, 2007.”

The final 415 regulations are available at:

<http://a257.g.akamaitech.net/7/257/2422/01jan20071800/edocket.access.gpo.gov/2007/pdf/E7-5750.pdf>

IRS Office of Chief Counsel Advises Certain 414(h)(2) “Pick-Ups” Are Not Subject to FICA Tax

On April 6, 2007, the IRS Office of Chief Counsel responded to a request for assistance regarding employer contributions paid to a retirement system under IRC § 414(h)(2). According to the Chief Counsel Advice (i.e., written legal advice prepared by the Office of Chief Counsel on matters including tax issues), the employer contributions in question were not paid pursuant to a salary reduction under IRC § 3121(v)(1)(B) and, therefore, are not considered wages for FICA tax purposes (C.C.A. 200714018).

Under § 414(h)(2) of the Internal Revenue Code, governmental employers are permitted to “pick up” mandatory employee contributions to qualified retirement plans established by state and local governments. As a result, the picked-up employee contributions are treated as employer contributions and are not subject to federal income tax when contributed (although they are subject to income tax when later distributed). Under § 3121(v)(1)(B), employer pick-ups are considered wages for FICA tax purposes only if the employer picks up the contribution pursuant to a salary reduction agreement (whether written or otherwise).

The request for assistance was submitted by a public school district that operates a mandatory retirement system as required by statute and picks up employee contributions. The school district did not reduce or offset the employee’s salary for the employer pick-up and did not withhold or pay FICA taxes on those contributions. In examining the facts and circumstances of the case, the CCA found that the employer’s contributions in relation to the pick up:

- Did not reduce or offset any amounts due or owed to the employees;
- Were in addition to, not in lieu of, all remuneration for services owed to the employees under the terms and conditions of employment; and,
- Were in addition to, not in lieu of, salary increases consistent with historical norms.

Consequently, the CCA found the employer did not pay the picked-up contributions in lieu of current or future compensation that would have been included in wages for FICA tax purposes. As a result, the picked-up contributions were not made pursuant to a salary reduction and so were not wages for FICA tax purposes.

The Chief Counsel Advice is available at: <http://www.irs.gov/pub/irs-wd/0714018.pdf>

Medicare Trustees Issue 2007 Report Triggering Medicare Funding Warning

On April 23, 2007, the Medicare Board of Trustees issued their annual report on the financial status of the Medicare funds. Total Medicare expenditures, which were \$408 billion in 2006 or 3.1% of Gross Domestic Product (GDP), are expected to increase to 7.3% of GDP by 2035 under intermediate assumptions and to 11.3% in 2081. However, the Trustees noted that after 2007, Medicare expenditures are understated as a result of

assumptions regarding reductions in physician payments scheduled under current law but which may not materialize.

The Medicare program consists of two component programs for the elderly and disabled: Hospital Insurance (HI) and Supplementary Medical Insurance (SMI). The HI program (Medicare Part A) pays primarily for inpatient hospital care and is financed by a payroll tax of 1.45% of taxable earnings. The SMI program consists of Medicare Parts B and D. Part B is a voluntary program that pays for physician, outpatient hospital, home health, and other services. Part D is a voluntary program providing access to outpatient prescription drug benefits. Approximately one-quarter of the SMI program is financed by beneficiary premiums, with the remainder financed by transfers from the U.S. Treasury's general fund.

According to the Trustees' report, the financial status of the HI Trust Fund continues to deteriorate and is projected to be insolvent in 2019, one year later than projected in 2006. After the HI Trust Fund is exhausted, payroll tax revenues would cover only 80% of projected HI expenses in 2019. The slight improvement in solvency is due to:

- Slightly higher projected payroll tax income; and
- Slightly lower projected benefits than previously estimated.

The financial outlook for the SMI program is better than for the HI program, although rapid expenditure growth remains a serious issue. For both Part B and Part D, revenues are projected to equal expenditures for all future years, but only because beneficiary premiums and general revenue transfers must, by statute, be increased to meet expected costs for each year. However, the rapid growth of health care costs is expected to greatly accelerate the need to finance these benefits.

In an effort to address Medicare's long-term financial challenges, the Medicare Modernization Act of 2003 created new tools to monitor the program, including the "Medicare funding warning." Under this provision, the annual Trustees' report is required to include an estimate of the year in which general revenues will account for more than 45% of Medicare funding. If two consecutive Trustees' reports project that general revenue financing will exceed 45% of total Medicare expenditures within the next seven years, the President is required to propose legislation in the next budget recommending options to reduce this percentage. Some of the options could include decreasing expenditures (e.g., cutting benefits, delaying eligibility, or reducing provider payments), increasing revenues (e.g., raising payroll taxes, or raising beneficiary premiums), or some combination of the two. Congress could then implement the administration's recommendations, but is not required to do so.

The 2006 Trustees' report was the first to find that the 45% threshold would be reached within the seven years, i.e., 2012. The second consecutive finding was issued in the 2007 Trustees' report, which projected the 45% threshold to be exceeded in 2013. Therefore, the "Medicare funding warning" was triggered, requiring the President to respond with proposed legislation within 15 days after the release of the *Fiscal Year 2009 Budget* in early 2008. Congress will then be required to consider the legislation on an expedited basis.

The report is available on the CMS web site at:

<http://www.cms.hhs.gov/ReportsTrustFunds/downloads/tr2007.pdf>

GASB Proposes New Standards for Real Estate Investments Held by Endowments

On March 23, 2007, the Governmental Accounting Standards Board (GASB) issued a new Exposure Draft (ED) titled *Land and Other Real Estate Held as Investments by Endowments*. The proposal would require state and local governmental endowments (e.g., those maintained by state colleges and universities) to report land and other real estate investments at fair value. Currently, the GASB standards require endowments to report these investments at historical cost.

Generally, endowments invest resources to generate income and perform essentially the same investment function as pension and other postemployment benefit plans, external investment pools, and § 457 deferred compensation plans. Under the proposal, state and local endowments would also be required to report any changes in fair value as investment income, disclose the methods and assumptions used to determine fair value, and provide any other information currently reported for other investments at fair value. The proposal is intended to establish consistent standards that enhance the comparability and usefulness of financial reporting for land and other real estate investments held by governmental entities.

The proposal amends Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*. As proposed, the requirements would be effective for financial statement periods beginning after June 15, 2008, with earlier application encouraged. The GASB's deadline for written comments on the ED is June 29, 2007.

A copy of the Exposure Draft is available at: http://www.gasb.org/exp/ed_endowments.pdf

NASRA and NCPERS File Amicus Brief in Support of Kentucky Retirement Systems

On March 15, 2007, the National Association of State Retirement Administrators (NASRA) and the National Conference on Public Employee Retirement Systems (NCPERS) filed an *Amici Curiae* ("friend of the court") brief with the U.S. Supreme Court. In the brief, NASRA and NCPERS argue in support of the Kentucky Retirement Systems' retirement plan formulas (*Kentucky Retirement Systems, et. al. v. Equal Employment Opportunity Commission*, U.S., No. 06-1037). At issue is whether a decision by the U.S. Sixth Circuit Court of Appeals regarding the use of "age" in a retirement plan formula renders the plan facially discriminatory under the Age Discrimination in Employment Act (ADEA).

On October 31, 2006, the Sixth Circuit reversed a district court's summary judgment for the Kentucky Retirement Systems (KRS) on an Equal Employment Opportunity Commission (EEOC) age discrimination claim (*EEOC v. Jefferson County Sheriff's Dept.*, 6th Circuit (en banc), No. 03-6437). In a 10-4 "en blanc" rehearing made before the full court of 14 appellate judges, the majority found that the EEOC had provided sufficient evidence to establish a *prima facie* ("at first view") violation of the Age Discrimination in Employment Act (ADEA).

The case stems from an EEOC claim filed by a deputy sheriff in Jefferson County. Upon applying for disability benefits from the Kentucky Retirement Systems, the deputy was informed he was ineligible for disability benefits because he was older than the plan's normal retirement age. Under the plan's disability provisions, employees who become disabled after normal retirement eligibility (i.e., age 55 for workers in hazardous positions and age 65 for other workers) receive normal retirement benefits based on actual years of service. However, those who are disabled before normal retirement eligibility receive additional years of service credit up to normal retirement age (or 20 years of service), but not more than the number of years already worked. As a result, younger workers who are disabled before becoming eligible for normal retirement can receive higher benefits than older workers who are eligible for normal retirement, even with the same final earnings and actual years of service.

Writing for the Sixth Circuit majority, Judge Karen Nelson Moore found that the KRS Plan was "facially discriminatory on the basis of age" in two ways. First, the plan disqualified employees from receiving disability retirement benefits if they have reached normal retirement age at the time they become disabled. Second, the plan calculated disability retirement benefits using a method that results in an older employee receiving lower monthly benefit payments than a younger employee who is similar in every applicable factor other than age. The judge ruled that, because the plan was found to be facially discriminatory, it was not necessary for the EEOC to show discriminatory intent in order to establish an age-discrimination claim.

In their brief, NASRA and NCPERS argue that the Sixth Circuit's decision merits review by the U.S. Supreme Court for several reasons, including:

- The finding that a plan is facially discriminatory simply because it considers age as a correlating factor in its retirement benefit formula undermines the funding and benefit framework for the nation's public pension plans.
- The use of "age" as a factor in a retirement plan does not, by itself, render the plan discriminatory under the ADEA. The ADEA permits the use of age as the basis for benefit eligibility.
- The Sixth Circuit's decision is contrary to the U.S. Supreme Court's 1993 ruling in *Hazen Paper v. Biggins*. Under *Hazen*, in cases of "disparate treatment" liability, the protected trait (age) must actually have motivated the employer's decision, rather than simply being a correlating factor.
- The U.S. Supreme Court has already held in *Kimel v. Florida Board of Regents* that Congress can not impose substantive requirements on state and local governments when such requirements are disproportionate to any unconstitutional conduct which could be targeted under the ADEA.

The brief is available on NCPERS's website at: http://www.ncpers.org/artman/publish2/article_244.asp

NCPERS and NASCAT File Amicus Brief in *Tellabs v. Makor Issues and Rights*

In another amicus brief, NCPERS and the National Association of Shareholder and Consumer Attorneys (NASCAT) supported shareholder rights in a securities fraud case (*Tellabs, Inc. and Richard C. Notebaert v. Makor Issues & Rights, LTD., et al*, U.S., No. 06-484). In this case, the Seventh District Court of Appeals had determined that when a complaint has sufficiently alleged facts supporting a "strong inference" of intent to commit securities fraud, if the pleading standards governing securities fraud complaints have been met, the complaint should not be dismissed. The Seventh Circuit Court's decision disagreed with several other appeals courts which held that "strong inference" should be weighed against competing inferences. At issue is the proper manner for evaluations of allegations in a securities fraud complaint and whether that includes the weighing of competing inferences.

NCPERS and NASCAT petitioned the U.S. Supreme Court to review the rulings, citing the Seventh Circuit's decision. In the brief, they argue that the Seventh Circuit Court was correct, and there should be no weighing of competing inferences after a complaint has sufficiently alleged a "strong inference" of wrongful intent. The U.S. Supreme Court heard the case on March 28, 2007.

The brief is available on NCPERS's website at: http://www.ncpers.org/artman/publish2/article_244.asp

California LAO Launches Retiree Health Care Website

On April 11, 2007, the California Legislative Analyst's Office (LAO) launched a new website featuring information on public-sector retiree health benefits and costs within the state and throughout the U.S. LAO, the California legislature's non-partisan fiscal and policy advisor, maintains the website to provide information on retiree health issues and policy actions of various types of governments (states, counties, cities, school districts, etc.) for the public, policy makers, and researchers. The site also includes answers to frequently asked questions (FAQs) regarding other postemployment benefits (OPEBs), Governmental Accounting Standards Board (GASB) Statement No. 45, and health care reform.

The LAO website is available at: <http://www.lao.ca.gov/retireehealth>

New Jersey Governor Signs Bill Mandating Pension Forfeitures for Convicted Public Officials

On March 15, 2007, New Jersey Governor Jon S. Corzine signed legislation (S. 14) mandating imprisonment and pension forfeiture for public employees and elected officials convicted of abusing their public office, position or employment for personal gain. The bill specifies 19 crimes that, if such person is convicted, would

result in mandatory imprisonment and retirement benefit forfeiture. Such crimes include bribery in official matters, accepting unlawful benefit for official behavior, tampering with public records or information, and false contract payment claims.

Under the bill, any state or locally administered retirement system is given the following rights and responsibilities:

- The board of trustees has the power to subpoena witnesses and documents.
- The board can order forfeiture of earned service credit and implement pension forfeitures under court order.
- The board can order forfeiture of all or part of earned service credit, pension or retirement benefits of any member in a misconduct case whether or not under court order. The board can also order pension forfeitures for offenses not listed in the statute.
- A public employer that allows an employee to resign in good standing and retain a pension and benefits in an out-of-court settlement of misconduct must reimburse the retirement system for all pension costs incurred by retaining the employee in the system.

The bill is available at: http://www.njleg.state.nj.us/2006/Bills/S0500/14_I1.PDF

Washington Senate Approves Comprehensive Health Care Reform Bill

On March 9, 2007, the State of Washington's Senate unanimously approved a comprehensive health care reform bill (Engrossed Second Substitute S.B. 5930). The bill is intended to provide increased access to high quality, affordable health care for state residents. The 2006 Legislature created the Blue Ribbon Commission on Health Care Costs and Access which was responsible for establishing a five-year plan and recommending strategies for improving access to affordable health care. The commission was co-chaired by Governor Christine Gregoire and former Senator Pat Thibaudeau, and included 12 legislative and state agency leaders. The bill adopted many of the commission's recommendations, such as requiring coverage for employees' unmarried dependents up to age 25.

Additionally, the bill would:

- Provide for reform of the public health system;
- Encourage a process of evidence-based medical decision-making;
- Require the state to use its purchasing power to improve the quality of health care; and
- Support the use of electronic medical records to improve care and reduce medical errors.

Further information is available at: <http://apps.leg.wa.gov/billinfo/>

Commonwealth Fund Examines Congressional Health Care Coverage Bills

On March 19, 2007, the Commonwealth Fund released its report *Congressional Health Care Bills, 2005-2007: Part I Insurance Coverage*. In the first of a two-part series, the report examines significant Congressional health care reform proposals introduced from 2005 to 2007 which were intended to expand health insurance coverage. The study found that many of the bills, if passed, may substantially reduce the number of uninsured Americans (estimated to rise to 48 million in 2007 and 56 million by 2013) and decrease overall health care expenditures.

The study analyzed 10 bills introduced in Congress since 2005 and President Bush's health care reform plan announced in February 2007. According to the study, the bills would provide health care reform using one of the following three approaches: (1) fundamental reform of the health insurance system; (2) expansion of existing public insurance programs through Medicare, Medicaid and SCHIP; and (3) strengthening the

employer-based coverage system (currently covering over 160 million workers and dependents, or about 63% of Americans). Key proposals included:

- Senator Ron Wyden’s “Healthy Americans Act” (S. 334) creating regional insurance exchanges;
- Representative Pete Stark’s “AmeriCare Health Care Act” expanding coverage through Medicare; and
- President Bush’s Health Care Reform proposal providing a health insurance tax deduction and a tax on employers’ contributions.

On March 19th, the Commonwealth Fund’s analysis was presented at a panel discussion sponsored by the Alliance for Health Reform. During the discussion, Henry Aaron, Brookings Institute senior fellow, noted that, “states are taking the lead in adopting health care coverage proposals.” He added, “such moves are the first steps toward national reform.” Part II of the Commonwealth Fund’s series will analyze and compare Congressional bills intended to improve health care quality and efficiency.

The study is available at:

http://www.cmwf.org/publications/publications_show.htm?doc_id=469753

EBRI Releases Retirement Confidence Survey

On April 11, 2007, the Employee Benefit Research Institute (EBRI) released Issue Brief No. 304, titled *The Retirement System in Transition: The 2007 Retirement Confidence Survey*. The results indicate that U.S. workers may be slow to recognize and adapt to ongoing retirement system changes, which could threaten their comfort in retirement. For example, the survey found:

- Nearly 50% of workers report total household savings and investments (excluding their primary residence and any defined benefit plans) of less than \$25,000.
- Approximately 62% of workers expect to receive lifetime benefits from a defined benefit plan, while only 41% are actually covered by such a plan.
- Almost 50% of workers are less confident about pension benefits due to pension plan changes by employers, but many fail to act to better secure their retirement.
- More than 50% of workers indicate they would use professional investment advice offered by companies that manage employer-sponsored retirement plans. However, of these, two-thirds would implement only some of the recommendations.
- About 25% of workers and 33% of retirees report they have long-term care coverage (separate from health insurance, Medicare, and Medicaid). Yet, in 2002, only 10% of Americans age 65 or older are estimated to have private long-term care insurance.

The survey report is available at: http://www.ebri.org/pdf/briefspdf/EBRI_IB_04a-20075.pdf