

April/May 2008

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GFOA Publishes Recommended Practices on Retirement and Benefit Administration

On February 22, 2008, the Executive Board of the Government Finance Officers Association (GFOA) approved new recommended practices on essential design elements for public-sector defined benefit plans, defined contribution plans, and hybrid plans. The documents can be downloaded from the GFOA website for the following types of retirement plans:

- Defined benefit plans: <http://www.gfoa.org/downloads/DBPlansFINAL.pdf>
- Defined contribution plans: <http://www.gfoa.org/downloads/DCPlansFINAL.pdf>
- Hybrid plans: <http://www.gfoa.org/downloads/HybridPlansFINAL.pdf>

They are meant to be used in conjunction with a broader GFOA recommended practice, *Developing a Policy for Retirement Plan Options*, available at: <http://www.gfoa.org/downloads/corbapolicyforretirementplandesign.pdf>.

Additionally, GFOA's Executive Board approved a recommended practice on fee disclosures and monitoring for defined contribution plans, available at: <http://www.gfoa.org/downloads/FeeDisclosureFINAL.pdf>

IRS Conducts Governmental Plans Roundtable on Tax Compliance

On April 22, 2008, the Internal Revenue Service (IRS) held a roundtable discussion in Washington, D.C., regarding the tax qualification requirements for governmental plans. Sponsored by the IRS's Tax Exempt and Government Entities (TE/GE) Division, the roundtable was limited to 52 participants representing the governmental plans community, including public plan compliance officers and general counsels. The roundtable discussion focused on a range of issues, including:

- Importance of tax compliance;
- Timely amendment requirements for determination letter submissions under the staggered remedial amendment program;
- Voluntary compliance program requirements for helping plan sponsors find, fix and avoid plan errors;
- Enforcement efforts and methods;

- Pertinent technical and compliance issues; and
- Development of tools and programs to assist with achieving compliance.

According to TE/GE Division Commissioner Steven Miller, the IRS intends to increase its scrutiny of governmental pension plans. As reported in BNA's April 29th *Pension & Benefits Reporter*, Miller explained that the IRS wants to ensure governmental plans succeed while meeting the IRS requirements. This would be done through education, compliance (including self-correction), and enforcement.

To better understand governmental plans, the IRS intends to survey plans beginning with a small sample of 20-39 plans followed by a more comprehensive survey of 200 plans in 2009. At the meeting, governmental plan representatives expressed concerns that the IRS would use the survey information to bring enforcement actions. While the IRS representatives assured participants that the corrections program could be used to address any problems, they also cautioned that failure to respond to the survey could result in an IRS compliance check. The governmental plan representatives also emphasized that their plan provisions are legislatively enacted and subject to legal protections. Consequently, any corrective action would take time. The IRS representatives indicated they were willing to work with governmental plans regarding IRS regulation and enforcement.

Andrew Zuckerman, IRS Director, EP Ruling and Agreements, urged governmental plans to submit a request for an IRS determination letter to ensure their plan satisfies the applicable tax qualification requirements. He explained that disqualification could result in the immediate taxation of all or part of the plan participants' benefits under the plan. Under the new staggered determination letter process, governmental plans would generally file their determination letter requests during Cycle C, which began on February 1, 2008, and will end on January 31, 2009. The applications will be reviewed for compliance with the qualification requirements and guidance published in the "2007 Cumulative List of Changes in Plan Qualification Requirements" (Notice 2007-94), available at: <http://www.irs.gov/pub/irs-drop/n-07-94.pdf>.

The IRS has also established a webpage for governmental plans with guidance, news and other resources related to compliance with the federal tax-qualification requirements. The site's recent news section features the April 2008 roundtable presentations including:

- Navigating the Staggered Remedial Amendment Period
- Requirements Relating to Section 414(d) Governmental Plans

In the future, the webpage will also include questions and answers from the roundtable discussion. Also, a special e-mail option is being established for governmental plans to "Ask the IRS" questions. The webpage is available at: <http://www.irs.gov/retirement/article/0,,id=181779,00.html>.

IRS Releases Private Letter Ruling on Disability Benefits for Firefighters and Public Safety Officers

On February 29, 2008, the IRS released a private letter ruling (PLR 200809011) related to the treatment of disability benefits paid to firefighters and public safety officers. The request for the ruling came from a governmental plan after a state court held that a state statute (referred to in the ruling as "Statute A") created a "rebuttable presumption" that an employee's heart condition "arises out of or in the course of his or her employment."

Under the rules governing the plan, a member who retires due to a service-connected disability will receive an annuity equal to one-half of final compensation. However, when the member becomes eligible for normal service retirement, the member will receive the service retirement allowance, if greater. Under Statute A, if a public safety member completes 5 years or more of pension service and develops any heart condition, it is presumed to arise out of and in the course of employment. The court ruling clarified that the statute creates a "rebuttable presumption" that an employee's heart condition arises as a result of employment.

IRC § 104(a)(1) generally provides that gross income does not include amounts received under workmen's compensation acts as compensation for personal injuries or sickness. Treasury Regulation § 1.104-1(b) further explains that § 104(a)(1) does not apply to "a retirement or pension annuity to the extent that it is determined by reference to the employee's age or length of service, or the employee's prior contributions" or to "amounts received as compensation for a nonoccupational injury or sickness to the extent they are in excess of the amount provided in the applicable workmen's compensation act..." However, in Rev. Rul. 85-105, the IRS found that a pension received by a disabled firefighter under a state statute that created a rebuttable presumption that the disability was service-connected was held to be excludable from gross income.

In this private letter ruling, the IRS found that for those participants who retired with a service-connected disability under Statute A's presumption, the statute is in the nature of a worker's compensation act under § 104(a)(1) and so the disability benefit is excludable from gross income. However, once the member begins receiving normal service retirement benefits, only one-half of final compensation is excludable from income under § 104(a)(1) and the remainder is includable in gross income.

It should be noted that private letter rulings are directed only to the taxpayers requesting them and may not be used or cited as precedent. The letter ruling can be downloaded at: <http://www.irs.gov/pub/irs-wd/0809011.pdf>

Senate Committee Publishes Report on Aging of the American Workforce

On February 14, 2008, the Senate Special Committee on Aging released its *Report of the Taskforce on the Aging of the American Workforce*. In recognition of the demographic transition due to the aging and retirement of the Baby Boomers, a federal government interagency taskforce was established in 2006 to analyze the aging of the American workforce and its impact on society. This Taskforce on the Aging of the American Workforce is composed of senior representatives from nine federal agencies, including the Departments of Commerce, Education, Health and Human Services, Labor, Treasury and the Social Security Administration, among others. The Taskforce's primary goals include: 1) enhancing the ability of older Americans to remain in or re-enter the labor market, and 2) enabling businesses to take full advantage of this skilled labor pool.

The report finds that many aspects of American society will be affected by the aging of the U.S. population, including the health care system and financial markets. Moreover, as the population ages and more workers retire, many industries may face labor market and skill shortages. According to the U.S. Census Bureau, by 2030, 19.7% of the U.S. population (71.5 million) will be age 65 or older compared to 12.4% in 2000. In the decade ending in 2014, the Bureau of Labor Statistics (BLS) projects that 18.9 million jobs will be added to the U.S. economy, about 2.6 million more than in the previous decade. Over the same time period, nearly 36 million workers are expected to permanently leave their jobs and will need to be replaced.

Due to shortages in skilled workers, some employers are recruiting and retaining older workers. Often, older workers have more institutional knowledge, a broader range of experience, more productive work habits, and greater adherence to workplace safety rules and regulations than younger workers. However, some employers may offer fewer training opportunities to older workers and may discriminate against them. According to a 2002 AARP survey of workers ages 45 to 74, nearly two-thirds reported having witnessed or experienced age discrimination in the workplace.

The Taskforce's report also provides a broad overview of the legal and regulatory environment affecting older American workers. Some federal and state laws, regulations and institutional practices that influence the work decisions of older workers include: Social Security, Medicare, the Employee Retirement Income Security Act (ERISA), and the Age Discrimination in Employment Act (ADEA). According to the report, many of the current laws and regulations that govern pensions, Social Security, health care, and taxes continue to encourage retirement at earlier ages. However, Americans' retirement expectations are also evolving in accordance with U.S. demographics and global economic position. The Taskforce cautioned that any proposed legal or

regulatory changes must be considered with regard to their cost implications and possible effects on individuals, employers, retirement security programs, and the U.S. economy.

In a collaborative effort, the Taskforce agencies developed strategies to facilitate the increased participation of older workers in the labor market with regard to a broad range of issues, including: legal and regulatory issues, outreach and education, facilitating self-employment, flexible work arrangements, technical assistance, and retirement and financial literacy education. The report relied on information from the Congressional Budget Office (CBO), U.S. Government Accountability Office (GAO), Bureau of Labor Statistics (BLS), AARP and Employee Benefits Research Institute (EBRI), among others. A copy of the report is available at: <http://www.aging.senate.gov/letters/agingworkforcetaskforcereport.pdf>

Social Security Trustees Release 2008 Report

On March 25, 2008, the Social Security Board of Trustees released their annual report on the program's financial and actuarial status. As projected since 2006, benefit payments and administrative expenses are expected to exceed Social Security's tax revenues starting in 2017. This will be mostly due to the aging and retirement of the Baby Boomers combined with increasing life expectancy. The report indicates that the interest on trust fund assets will initially be sufficient to cover the shortfall, but beginning in 2027, government securities held by the trust funds would need to be redeemed to generate sufficient cash to pay benefits. The report projects that Social Security's trust fund reserves will be exhausted by 2041, unchanged from last year. Should this occur, Social Security would be able to pay only 78% of scheduled annual benefits after 2041, and 75% by 2082. The long-range status over the next 75 years has improved from last year's projection (70% in 2081) principally due to changes in certain methods and immigration assumptions.

The report presents Social Security's financing shortfall in dollar terms, as well as in percents of taxable payroll and gross domestic product (GDP). The projected actuarial deficit in Social Security's trust funds is \$4.3 trillion (\$0.4 trillion less than estimated last year) when measured over the next 75 years and \$13.6 trillion when measured on a perpetual basis. Expressed in relation to the GDP, the annual cost of Social Security benefits is projected to increase from 4.3% of GDP in 2008 to 6.0% in 2030, and decline to 5.8% in 2082. In the 2008 report, changes were made to several assumptions reflecting mortality and immigration and methodological factors that affect Social Security's financial condition. The net result of these changes was to decrease the 75-year actuarial deficit from 1.95% of taxable payroll in 2007 to 1.70% in 2008.

Under current law, Social Security's annual cost will likely grow faster than the program's income due to the aging of the baby-boom generation, continuing low fertility, and increasing life expectancy. However, the report indicates that the program could remain solvent throughout the 75-year projection period, if one or more of the following changes were made:

- Immediately raising the combined employee-employer payroll tax rate by 1.70 percentage points from the current 12.40% to 14.10%;
- Immediately reducing benefits for all current and future recipients 11.50% on a permanent basis;
- Immediately transferring general revenues equivalent to \$4.3 trillion; or
- Adopting some combination of these approaches.

If no action is taken until the trust funds are exhausted in 2041, the following changes would keep the program solvent for the 75-year period:

- Raising the combined employee-employer payroll tax rate from the current 12.40% to 15.94% in 2041 and to 16.60% by 2082; or
- Reducing benefits for recipients by 22% in 2041, and to 25% by 2082.

The report also indicated that Social Security's solvency beyond 2082 would likely require further changes due to the increasing average age of the population. The trustees urged that the trust fund deficits be addressed soon in order to gradually phase-in the necessary changes and protect future generations. The report is available at: <http://www.ssa.gov/OACT/TR/TR08/tr08.pdf>

Medicare Trustees Release 2008 Report on Financial Status of Medicare Funds

On March 25, 2008, the Medicare Trustees released their annual report on the financial status of the Medicare funds. According to the trustees, Medicare's long-term liability, based on a 75-year actuarial projection, is estimated to be \$36.3 trillion. Total annual Medicare expenditures, which were \$432 billion in 2007 or 3.2% of Gross Domestic Product (GDP), are expected to grow to 7.0% in 2035, and 10.8% in 2082. The report warns that, after 2007, projections of Medicare expenditures are understated due to projections of substantial reductions in physician payments currently scheduled under current law but which are unlikely to occur.

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 Trustee's report, the financial status of the HI Trust Fund has deteriorated and is projected to be insolvent in 2019, unchanged from last year. After the HI Trust Fund is exhausted, payroll tax revenues would cover only 78% of projected HI expenses in 2019, and only 30% by 2082. The drop in solvency is due to:

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

The financial outlook for the SMI program is better than 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 created new tools to monitor the program, including the "45-percent threshold." 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. The 2008 Trustees' Report is the third consecutive report that projects that the 45-percent threshold will be reached within the next seven years, i.e., 2014. This triggered a Medicare funding warning for the second consecutive year and requires the President to respond with proposed legislation.

The report is available on the CMS web site at: <http://www.cms.hhs.gov/ReportsTrustFunds/downloads/tr2008.pdf>

CMS Actuary Testifies on Medicare's Financial Outlook

On April 1, 2008, Richard S. Foster, F.S.A., Chief Actuary for the Centers for Medicare & Medicaid Services (CMS), testified at the House Ways and Means Health Subcommittee hearing on the financial outlook for the Medicare program. Based on the 2008 Trustees' Report, Foster reported that the financial outlook has

improved slightly with actual costs of \$432 billion in 2007, which were 1.5% lower than previously estimated. This difference is mostly due to slower growth in inpatient hospital expenditures than previously projected.

Foster also reported that 2008-2017 projected expenditures for Medicare's Part D prescription drug program are expected to be significantly lower than estimated in the 2007 Trustee's Report. According to Foster, projected Part D spending over the 10-year period would be reduced by \$129 billion or about 17% due to the following factors: i) lower than estimated actual benefit costs in 2006; ii) greater than expected drug manufacturer rebates (8.6% compared to the assumed 5%); and iii) a slightly lower trend in projected cost growth over the next several years.

In verbal comments during the hearing, Foster also noted that reducing payments to Medicare managed care plans to the same level as those for fee-for-service providers would extend the Medicare Part A Trust Fund until the end of 2020, about 18 months longer than currently projected. He added that Part B premiums would also be reduced by about \$3 per month since the premiums are based in part on projected Medicare spending. On average, Medicare pays managed care plans 12% more than fee-for-service providers.

Foster's testimony is available at: <http://waysandmeans.house.gov/media/pdf/110/RSFTestimony.pdf>

Kaiser Releases Reports on Trends in Medicare Drug Benefit Program

On April 1, 2008, the Kaiser Family Foundation (KFF) released a series of eight reports analyzing key elements of the Medicare Part D prescription drug program. Each report, called a "Data Spotlight," focuses on a major feature of the drug plans and examines trends in drug costs and coverage that occurred since Part D took effect in 2006. Topics analyzed include: benefit design, gap coverage, formularies, subsidies, premiums, and utilization management.

Beginning in 2006, Medicare beneficiaries have had access to prescription drug benefits available from private plans through either stand-alone prescription drug plans (PDPs) or Medicare Advantage prescription drug plans (MA-PD plans). Additionally, the government provides Medicare-subsidized drug coverage to enrolled beneficiaries. As of January 2008, more than 25 million Medicare beneficiaries are enrolled in Medicare drug plans, including 17.4 million in stand-alone prescription drug plans and 8.0 million in Medicare Advantage drug plans.

As reported in KFF's Summary of Findings report, changes since 2006 include:

- **Plan Availability:** In 2008, there were 1,824 PDPs compared to 1,429 in 2006. About 25% of all PDPs are plans that qualify to enroll low-income beneficiaries receiving the full subsidy with no monthly premium payments required.
- **Coverage Gap:** In 2008, the majority of Part D plans have a gap in drug coverage (often called the "doughnut hole") where enrollees have to pay 100% of total drug costs before catastrophic coverage begins (after \$2,510 in total drug costs in 2008). In 2008, about 25% of PDPs and 50% of Medicare Advantage plans offer some type of gap coverage, mainly for generic drugs.
- **Premiums:** In 2008, the weighted average monthly premium for PDPs is projected to be \$31.99 compared to \$25.93 in 2006, a 17% increase. As in previous years, monthly PDP premiums vary widely ranging from \$9.80 to \$72.00 based on different benefit features, such as gap coverage.
- **Benefit Design and Cost Sharing:** Typically, PDPs use tiered, flat-dollar copayments as incentives for enrollees to use less expensive generic and "preferred" brand-name drugs. Cost sharing for generic drugs has remained fairly stable since 2006. However, the average cost sharing for "preferred" brand-name drugs has increased from \$26.87 in 2006 to \$29.86 in 2008 (an increase of 11%) while "non-preferred" brand-name drugs increased from \$55.36 to \$71.31 (an increase of 29%).
- **Specialty Tiers:** In 2008, almost 90% of national PDPs place some relatively expensive drugs on a specialty tier (where they can charge a higher coinsurance rate), whereas only 60% had specialty tier

drugs in 2006. Generally, cost sharing for specialty tier drugs is limited to 25% coinsurance, but CMS allows plans to have higher coinsurance if offset by a lower deductible. The number of PDPs charging 33% coinsurance on specialty tier drugs has increased substantially since 2006.

- **Formularies and Utilization Management:** In 2008, 91% of PDPs cover at least 90% of generic sample drugs, while only 28% cover a similarly high share of brand-name sample drugs. Also, in 2008, utilization management restrictions are more common with 30% of the 169 sample drugs being subject to some use restriction compared with 20% in 2006.

Since 2006, there has been relatively little change in PDP formularies, but increases in cost sharing and utilization management restrictions could have significant implications for beneficiaries' drug access and out-of-pocket expenses. The report emphasizes the need for consumers to carefully compare plans annually and make informed decisions about required medications in light of increasing premiums, changes in plan offerings, benefit design, coverage and costs.

The reports were prepared by a team of researchers from the KFF, Georgetown University, and the National Opinion Research Center (NORC) at the University of Chicago. The analyses was based on data from the Centers for Medicare and Medicaid Services (CMS) for the 47 unique, national stand-alone PDPs in 2008 representing 88% of all national PDPs.

The reports are available at: <http://www.kff.org/medicare/med102507pkg.cfm> and the Summary of Findings is available at: <http://www.kff.org/medicare/upload/7762.pdf>