

## July 2008

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](mailto:web.admin@gabrielroeder.com) with "SUBSCRIBE NEWS SCAN" in the subject line. To stop receiving this publication electronically, send "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](http://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.

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### **IRS Issues Proposed Regulations on Required Minimum Distribution Rules for Governmental Plans**

On July 9, 2008, the IRS and Treasury Department issued proposed regulations (IRS Reg-142040-07), pursuant to § 823 of the Pension Protection Act of 2006 (PPA). The proposed regulations provide that governmental plans are treated as satisfying the required minimum distribution (RMD) rules under Internal Revenue Code (IRC) § 401(a)(9) by complying with a reasonable, good faith interpretation of those rules. When enacted, PPA § 823 required the Secretary of the Treasury to issue regulations implementing a permanent reasonable good faith standard for governmental plans to comply with § 401(a)(9). The proposed rules would affect all tax-qualified governmental retirement plans established by federal, state and local government agencies. Additionally, the proposed regulations would apply to 403(b) contracts that are part of governmental plans and eligible governmental 457(b) deferred compensation plans.

IRC § 401(a)(9) establishes the required minimum distribution (RMD) rules for a qualified trust. In general, the RMD rules require retirement plans to begin distributing each participant's plan assets by April 1 of the calendar year following the later of: (1) the calendar year in which the plan participant reaches age 70-1/2 or (2) the calendar year following the year in which the participant retires. Moreover, the entire interest of the participant must be distributed over the life of the participant or over the lives of the participant and designated beneficiary (or over a period not extending beyond the life expectancy of the participant or life expectancies of the participant and designated beneficiary). Additional RMD rules apply to death benefits.

The proposed regulations would be effective for all years to which § 401(a)(9) applies. Written or electronic comments and requests for a public hearing must be submitted to the IRS by October 8, 2008.

The proposed regulations are accessible at: <http://edocket.access.gpo.gov/2008/E8-15740.htm>

### **IRS Holds Hearing on Proposed Regulations for Cash Balance and Other Hybrid Retirement Plans**

On June 6, 2008, the Internal Revenue Service held a hearing on proposed regulations (REG-104946-07) published by the IRS and Treasury in December 2007 relating to the tax treatment of cash balance and other hybrid retirement plans under the Pension Protection Act of 2006 (PPA). In comments submitted to the IRS, employee benefit practitioners requested changes in the regulations relating to plan conversions, interest rates,

vesting and definitions. However, much of the discussion concerned the proposed rules related to the interest crediting rate and market rate of return.

In 2006, § 701 of the PPA amended the ADEA by adding new rules that determine how benefits may accrue in ways that are not age discriminatory for cash balance plans and similar hybrid plans. The rules were further interpreted by the IRS to include plans where the accumulated benefit of the participant is “expressed as the balance of a hypothetical account maintained for the participant....” Representatives of the IRS have stated their belief that such plans include certain governmental Deferred Retirement Option Plans (DROPs), as well as defined benefit plans that credit interest on refunds of “picked-up” employee contributions, among others.

PPA § 701 also provided special rules for crediting interest on such accounts, under which a plan would be considered age discriminatory unless the plan limited the interest credited to no more than the “market rate of return.” The December 2007 proposed regulations establish a number of restrictions on the market rate of return, including situations where the market rate is defined in relation to both a fixed and variable rate. For example, the regulations indicate that a fixed rate of 4% or 5% would be acceptable if it is the only interest crediting rate under the plan; however, a 3% or 4% rate would be acceptable if combined with a variable rate.

Commentators at the hearing argued that such rules were inconsistent with the statutory language and legislative history of PPA § 701, under which a statutory hybrid plan may provide an interest crediting rate that combines a variable market rate of return and a fixed rate without reductions. Commentators also expressed concern over the proposed treatment of an equity-based rate when combined with a fixed rate.

Source: BNA *Pension & Benefits Reporter*, June 10, 2008.

### **CRR Issues Report on Annual Required Contributions Paid to Governmental Pension Plans**

In May 2008, the Center for Retirement Research at Boston College (CRR) released its report: *Why Don't Some States and Localities Pay Their Required Pension Contributions?* Based on the 2006 *Public Fund Survey* of 126 state and local plans and newly collected data, the study examines the plans' funding status and the reasons why some plan sponsors do not make their annual required contributions.

The study begins with the premise that public plan sponsors are acting responsibly when they establish an actuarially sound funding plan and maintain it over time. With regard to an actuarially sound funding plan, the report suggests that a funding ratio of 80% would be considered adequate, provided that contributions to fund the plan are sufficient to eliminate the shortfall over time. According to the report, 62% of state and local plans met or exceeded the 80% benchmark in 2006.

With regard to maintaining the funding plan over time, the report examined the extent to which plan sponsors contributed the full amount of their annual required contributions (ARC), as defined by the Governmental Accounting Standards Board (GASB). As explained in the report, when a plan sponsor pays the full ARC, funds are allocated to cover benefits earned in that year in addition to amortizing any unfunded liability. However, failure to contribute the full ARC over time will likely result in the deterioration of a plan's funding status. The report found that plan sponsors for 56% of the surveyed plans paid 100% of their ARC in 2006. Of the remaining 44% of plans where plan sponsors did not pay the full ARC, two-thirds were legally constrained by state legislated contributions. The report also found that many states with legal constraints reportedly are in the process of gradually increasing their contribution rates.

For the remaining plans that were not constrained by statutory limits, the report found that lack of funding discipline, plan size, and fiscal pressures on the state government had statistically significant effects on whether the plan sponsor contributed the full ARC.

The report is available at:

[http://crr.bc.edu/images/stories/Briefs/slp\\_7.pdf?phpMyAdmin=43ac483c4de9t51d9eb41](http://crr.bc.edu/images/stories/Briefs/slp_7.pdf?phpMyAdmin=43ac483c4de9t51d9eb41)

## **Twenty National Organizations Send Joint Letter to Congress Defending Public Retirement Plans**

On June 17, 2008, twenty national organizations representing state and local governments, public retirement systems, and public employees and retirees sent a joint letter to Congressman George Miller, Chairman of the House Committee on Education and Labor. The letter was written to set the record straight with regard to the long-term viability of public retirement plans by responding to “incomplete and misleading information” published in recent press articles, intended to “to distort the truth of public pension finance.”

The letter emphasizes that independent sources, such as the U.S. Government Accountability Office and the Center for Retirement Research at Boston College have found public pension plans to be in sound financial condition. Moreover, significant safeguards exist for public pension funding and benefits, including:

- Public pension benefits are publicly adopted and ultimately subject to the oversight of elected governmental bodies.
- Accrued benefits and future accruals are generally protected by state constitutions, statutes or case laws that prohibit elimination or diminution. These benefit protections are often stronger than those for private plans under ERISA and the PBGC.
- Public pension plans are administered by separate public agencies governed by independent boards of trustees. Strict requirements for transparency and public accountability must be followed.
- Public pension assets are professionally managed and invested on a long-term basis in accord with sound investment policies.
- Public pension funding levels and investment performance have been found to exceed those in the private sector.

The letter also notes that state and local government plans have prefunded 90% of their future pension liabilities; accumulated about \$3 trillion in financial assets; and ensured the retirement security of more than 20 million working and retired state and local government employees and their beneficiaries.

The letter is on the National Association of State Retirement Administrators’ web site at: <http://www.nasra.org>

## **NASRA Posts Chart Comparing Features of Large Public-Sector Hybrid Retirement Plans**

In June 2008, the National Association of State Retirement Administrators (NASRA) compiled a chart comparing the retirement benefits offered by the following seven large public-sector hybrid plans: the Employees’ Retirement System of Georgia; Indiana Public Employees’ Retirement Fund, Indiana State Teachers’ Retirement Fund, Ohio Public Employees Retirement System, State Teachers Retirement System of Ohio, Oregon Public Employees Retirement System, and Washington State Department of Retirement Systems. The comparative chart summarizes selected features for both defined benefit (DB) and defined contribution (DC) plans, and includes such items as:

- Applicable covered groups;
- DB plan multipliers;
- Normal retirement eligibility requirements;
- Social Security coverage;
- Employer and employee contribution requirements; and
- DC plan investment and withdrawal options.

The chart is available at: <http://www.nasra.org/resources/Hybrid%20Grid.pdf>

## **NCPERS Announces Bill to Modify the 10% Early Withdrawal Penalty for Public Safety Employees**

On June 5, 2008, the National Conference on Public Employee Retirement Systems (NCPERS) announced that legislation had been introduced by Representative Kendrick Meek (D-FL) in the U.S. House (H.R. 6157) to modify the 10% penalty related to early withdrawals from governmental plans for public safety employees. In 2006, § 828 of the Pension Protection Act (PPA) amended the tax code by waiving the 10% penalty on early distributions made to qualified public safety employees who separated from service at age 50 (instead of age 55, as was the case prior to the PPA). PPA § 828 was enacted recognizing that public safety employees typically retire earlier than other employees due to the demanding nature of their profession and (often) mandatory retirement ages. No change was made to the provisions for all other employees, who may continue to take distributions without penalty beginning at age 55.

As reported by NCPERS, two issues have arisen in the implementation of PPA § 828, which are addressed in the House bill:

- 1) Public safety employees between the ages of 50 and 55 who roll over their distributions into a 457 plan are subject to the 10% early withdrawal penalty on 457 distributions until age 59-1/2. H.R. 6157 would apply the age 50 waiver to any distribution made after enactment of the PPA for public safety employees.
- 2) Public safety employees who retired before enactment of § 828 (and before age 55) who opted to annuitize their benefit to avoid the 10% early distribution tax are now subject to a 10% recapture tax on the previous annuitized distributions. H.R. 6157 would make the recapture tax inapplicable to such annuities.

H.R. 6157 was referred to the House Ways and Means Committee. The bill is available on NCPERS' website at: <http://www.ncpers.org/News/PageText/documents/HR6157.pdf>

## **Policy Report Urges Better Estimates of Federal Revenue Costs Related to Retirement Savings Proposals**

On June 2, 2008, an independent tax policy report was released calling for the federal government to provide more accurate estimates of the federal revenue costs associated with retirement savings legislation. Titled *Revenue Estimates and Retirement Policy: The Need to Consider Present-Value Estimates of Changes in Tax Policy*, the report was sponsored by the U.S. Chamber of Commerce, American Benefits Council, American Society of Pension Professionals & Actuaries, National Association of State Retirement Administrators (NASRA), and National Conference on Public Employee Retirement Systems (NCPERS), among others.

The report highlights the need for better federal revenue cost estimates for proposed legislation related to retirement savings. Generally, current federal budget scorekeeping rules require that changes in tax revenues be measured on a cash-flow basis over a 10-year budget period. Typically, this approach works well for proposals that provide a current tax deduction (or similar tax benefit) which is not offset by future taxable income. However, many retirement savings proposals provide tax deferrals for retirement contributions and investment earnings that are later included in taxable income. As a result, federal revenue costs for retirement savings proposals are overstated. Current budget scorekeeping methods do not reflect taxes paid on retirement income deferred beyond the 10-year budget window.

To remedy this, the report proposes calculating the revenue costs of retirement savings proposals on a present-value basis. For example, under this approach the revenue costs for an IRA contribution in a given year would include (1) the taxes deferred on the amount contributed in the given year, plus (2) the present value of taxes deferred on investment earnings attributable to the current year deferral, offset by (3) the present value of the subsequent income taxes that occur when distributions from the IRA are paid to the retiree.

The report focuses mainly on defined contribution-type arrangements, such as IRAs and 401(k)s, but also advises that present-value estimates could be used for traditional defined benefit plans which provide a federal tax deferral for plan contributions.

The report is available at:

[http://www.americanbenefitscouncil.org/documents/revenue\\_report\\_6-2-08.pdf](http://www.americanbenefitscouncil.org/documents/revenue_report_6-2-08.pdf)

### **California Governor Endorses OPEB Legislation for State and Local Governments**

On May 28-29, 2008, the California Assembly and Senate passed legislative bills (A.B. 1844 and S.B. 1123 respectively) that would implement recommendations from the state's Public Employee Post-Employment Benefits Commission regarding other postemployment benefits (OPEB) for governmental workers. In 2007, Governor Arnold Schwarzenegger and legislative leaders established the 12 member bi-partisan commission to propose ways to address the escalating obligations for postemployment benefits and retiree health care in California state and local governments. According to the commission, of the 338 public agencies that reported unfunded actuarial accrued liability data, the (self-reported) total unfunded OPEB liability is \$118 billion, including \$48 billion for state retirees and \$70 billion for retirees of local governments.

In early January 2008, the commission issued a report with 34 recommendations for funding and improving public sector pensions and health care benefit administration. The recommendations focus on prefunding health care benefits, increasing transparency, and improving guidance. Governor Schwarzenegger endorsed the comprehensive measures recommended by the commission and will seek prefunding newly created liabilities for state retiree health care benefits in fiscal year 2009-10. The two bills would enact several of the recommendations into law as follows:

- 1) A.B. 1844, approved by a unanimous Assembly vote, addresses benefit fraud in public retirement systems by increasing transparency and accountability in the benefits process. The bill would make it a crime for an individual to make false material statements in connection with retirement benefits and applications. Additionally, pension systems would have greater access to information from the state's Employment Development Department and insurers such as workers' compensation.
- 2) S.B. 1123, as approved by the Senate, requires the Legislature to include postretirement health care benefits within the triennial actuarial valuation. Additionally, it would require that future annual costs of postemployment benefits be made public at least two weeks prior to benefit increases and prohibit adoption of postemployment benefit changes by means of a consent calendar for the system's governing body. The bill would also create the California Actuarial Advisory panel to provide impartial and independent information on pensions, other postemployment benefits, and best practices to the Legislature, Governor and public agencies.

The Governor also directed the Department of Finance (DOF) and Department of Personnel Administration (DPA) to propose options, by September 30, 2008, for reducing the state's OPEB obligation without raising taxes or using the state's general fund. In addition, he urged local governments to undertake a similar process for their OPEB obligations.

A.B. 1844 and S.B. 1123 are available respectively at:

[http://www.leginfo.ca.gov/pub/07-08/bill/asm/ab\\_1801-1850/ab\\_1844\\_bill\\_20080611\\_amended\\_sen\\_v96.pdf](http://www.leginfo.ca.gov/pub/07-08/bill/asm/ab_1801-1850/ab_1844_bill_20080611_amended_sen_v96.pdf)  
[http://www.leginfo.ca.gov/pub/07-08/bill/sen/sb\\_1101-1150/sb\\_1123\\_bill\\_20080611\\_amended\\_asm\\_v94.pdf](http://www.leginfo.ca.gov/pub/07-08/bill/sen/sb_1101-1150/sb_1123_bill_20080611_amended_asm_v94.pdf)

### **MSU's Institute for Public Policy and Social Research Issues Report on Retiree Health Care Reforms**

In June 2008, Michigan State University's Institute for Public Policy and Social Research (IPPSR) issued their report, *Balancing Dollars and Health Sense: A Framework for Decision Making on Funding State Retiree Health Care Benefits*. In an effort to address the State of Michigan's estimated \$22.7 billion unfunded retiree

health care obligations, the Michigan House of Representatives' Committee on Retiree Health Care Reforms requested that the IPPSR provide research on state employee retiree health benefits.

Funded by a grant from the Center for State & Local Government Excellence, the IPPSR studied retiree health care funding options and examined practice models utilized in eight states; namely, Michigan, Hawaii, Illinois, Indiana, Massachusetts, Minnesota, Vermont and Wisconsin. Additionally, the IPPSR examined ways to smoothly transition from the state's current pay-as-you-go system to a long-term alternative that would effectively address the unfunded liabilities and escalating retiree health care costs. The information gathered includes opinions, facts and perceptions that decision makers may consider when exploring methods and developing strategies for managing unfunded obligations. Some of the IPPSR's recommendations include:

- 1) Establishing a nonpartisan commission to develop a plan and provide information to employees on the plan's progress.
- 2) Creating an irrevocable trust fund under Internal Revenue Code §115 with various funding options.
- 3) Merging plan administration to unify the purchasing process and increase bargaining power while maintaining separate employee group plans.
- 4) Assuring current retirees that they will receive promised benefits.
- 5) Balancing the need to control costs while keeping plans affordable for employees.
- 6) Providing incentives for employee wellness.

The full report is available at:

<http://www.slge.org/vertical/Sites/%7BA260E1DF-5AEE-459D-84C4-876EFE1E4032%7D/uploads/%7B5D473689-13FB-4EB2-BC23-0FD5BBC1D49E%7D.PDF>

### **West Virginia Teachers Permitted to Transfer from Defined Contribution to Defined Benefit Plan**

In March 2008, the West Virginia Legislature passed H.B. 101, allowing West Virginia teachers in the Teachers Defined Contribution Retirement System (TDC) to transfer to the State Teachers Retirement System (TRS) beginning July 1, 2008. TRS was created in 1941 as a defined benefit plan for state teachers and other school employees. Under the TRS plan, employees contribute 6% of pay and employers contribute 7.5%. The TDC plan was created in 1990 as a defined contribution plan, with mandatory participation for all employees hired after July 1, 1991. TDC participants contributed 4.5% of pay (pretax) with 7.5% contributed by employers.

Over time, concerns were raised about the ability of the TDC to provide adequate benefits for retired teachers. Research done by the state shows that TDC account balances for covered teachers only average \$34,000, and that no teacher has an account balance over \$157,000.

More than 78% of the state's nearly 19,000 school employees have opted to transfer. Because employee contributions to the TDC plan (4.5% of pay) were less than employee contributions to TRS (6.0%), employees transferring from the TDC to TRS will have to make an additional "catch-up" contribution to receive full pension benefits from TRS. The catch-up contributions amount to 1.5% of salary for each year spent in the TDC plan plus 4% interest. Those who do not pay the catch-up amount will be eligible for 75% of the normal TRS pension benefit. To assist employees make the catch-up contribution, the West Virginia Consolidated Public Retirement Board is offering low interest loans up to \$40,000.

The retirement board's actuaries and DC plan administrator will determine the present value of each TDC account individually. Later this year, state lawmakers will set aside funds in a special session for the state's share of transfer and pension costs. In March, lawmakers estimated that \$24.5 million would be needed to cover the state's initial costs. However, due to recent declines in the stock market, the value of the TDC accounts has decreased by about \$65 million.

H.B. 101 is available at: <http://www.wvretirement.com/forms/TDCEnrolledHB101.pdf>

## **DB Plan Investment Returns Outperform 401(k) Plan Returns from 1995-2006**

On June 18, 2008, Watson Wyatt Worldwide released the results of its latest study comparing investment returns earned by defined benefit (DB) retirement plans and 401(k) defined contribution plans. The study found that, on an asset-weighted basis, DB plan investment returns outperformed 401(k) plan returns by an average of 1.09% (109 basis points) per year over the period from 1995 through 2006. Similar results have been shown in recent research conducted by the Center for Retirement Research at Boston College. The report suggests several reasons for the higher DB plan returns:

- DB plans are overseen by trustees who have a fiduciary duty regarding investment performance. Consequently, trustees usually hire professionals with the education, experience, and analytical tools needed to manage the investments.
- 401(k) plan participants must make their own investment decisions even though, when compared with professional investment managers, they may not be as well informed and may react to market changes in a more emotional way.
- 401(k) plans typically have relatively higher administrative expenses than DB plans. These expenses are bundled into the fees and deducted from returns.

In its conclusion, the study notes that the shift from defined benefit to 401(k) plans “has raised concerns about whether today’s workers will have sufficient resources for a secure retirement.” As a result, recent legislation and regulations have established default investment options for 401(k) plans (e.g., life-cycle, target date, and balance funds), intended to mitigate the associated risks and offset the knowledge gap. Future Watson Wyatt studies will investigate how effective these changes are in closing the gap in investment returns.

<http://www.watsonwyatt.com/us/pubs/insider/showarticle.asp?ArticleID=19148>

## **U.S. Supreme Court Finds ADEA Does Not Bar Disability Benefit Disparity Based on Age**

On June 19, 2008, the U.S. Supreme Court ruled that the Age Discrimination in Employment Act (ADEA) does not bar the Kentucky Retirement Systems from adding service credit to benefits for workers who become disabled before reaching the plan’s normal retirement age and not for workers who become disabled after reaching normal retirement age (*Kentucky Retirement Systems v. EEOC*, U.S., No. 06-1037, 6/19/08). The case stems from an age discrimination claim filed by a deputy sheriff in Jefferson County. Upon applying for disability benefits from the Kentucky Retirement Systems (KRS), the deputy was informed that, while he was eligible for normal retirement benefits, he was ineligible for disability benefits because he was older than the plan’s normal retirement age.

Under the plan’s 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 the lesser of 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.

In 1999, after investigating the deputy’s claims, the EEOC filed suit in the U.S. District Court for the Western District of Kentucky. In 2003, the district court ruled in favor of KRS, holding that the EEOC had failed to show how the plan’s age elements were discriminatory. The EEOC appealed to the U.S. Sixth Circuit Court of Appeals, where a panel of three judges affirmed the district court’s opinion in 2005. However, in 2006, the EEOC again appealed to the Sixth Circuit, requesting a hearing by all 14 of the court’s appellate judges. The

full appellate court found the plan "facially discriminatory" and, as a result, ruled it was not necessary for the EEOC to show discriminatory intent to establish an age-discrimination claim.

The U.S. Supreme Court reversed the appellate court, based on its decision in *Hazen Paper Co. v. Biggins*, 507 U.S. 604, 16 EBC 1881 (1993). In *Hazen Paper*, the U.S. Supreme Court held that a disparate treatment claim based on age could not succeed unless the employer, in creating the pension benefit disparity, was actually motivated by age. Extending this to the case at hand, the Court found that the Kentucky plan was not motivated by an age bias, because the disparity "is simply an artifact of Plan rules that treat one set of workers more generously in respect to the timing of their eligibility for normal retirement benefits but which do not treat them more generously in respect to the calculation and amount of their normal retirement benefits."

The Court's decision is available at: <http://www.supremecourtus.gov/opinions/07pdf/06-1037.pdf>