

## January 2010

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 website at [www.gabrielroeder.com](http://www.gabrielroeder.com).

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### **AFSCME Releases Best Practices Guide for Trustees and Pension Systems**

On December 15, 2009, the American Federation of State, County and Municipal Employees (AFSCME) released its report *Enhancing Public Retiree Pension Plan Security: Best Practice Policies for Trustees and Pension Systems*. The report is designed to facilitate and improve the governance of public pension plans by helping pension systems review their existing policies, identify disparities, and revise or develop new policies as appropriate.

The report reviews best practices and recommends policy language for pension systems to adopt in the following key areas:

- Board member responsibilities and core competencies;
- Board member education; and
- Ethical and fiduciary conduct.

AFSCME developed its recommendations after reviewing the policies of major public pension funds. Additionally, it used research on best practices for fund governance presented in the 2007 Clapman Report released by the Committee on Fund Governance of the Stanford Institutional Investors' Forum which is accessible at: [http://www.law.stanford.edu/program/executive/programs/Clapman\\_Report-070316v6-Color.pdf](http://www.law.stanford.edu/program/executive/programs/Clapman_Report-070316v6-Color.pdf).

The AFSCME report is available at: <http://www.afscme.org/docs/AFSCME-report-pension-best-practices.pdf>

### **U.S. Treasury/IRS Issue Rulings on Contributions of Unused PTO to Profit-Sharing/401(k) Plans**

On September 5, 2009, the U.S. Treasury and IRS issued two revenue rulings describing the circumstances under which unused paid time off (PTO) may be contributed to a 401(k) plan contained within a profit-sharing plan. Generally, the rulings conclude that an amendment made to such a profit-sharing/401(k) plan that permits the value of unused PTO to be contributed to the 401(k) plan on the participant's behalf would not disqualify the plan under Code § 401(a), provided certain conditions are met. Moreover, the value of the unused PTO would not be

taxable to the participant until distributed by the profit-sharing/401(k) plan. The rulings come in the wake of efforts by the Obama administration to help increase U.S. retirement savings.

Revenue Ruling 2009-31 presents two examples of plan amendments allowing unused PTO to be contributed to a profit-sharing/401(k) plan on an annual basis. In the first example, the employer maintains a PTO plan in which no unused PTO may be carried over to the following year. In this example, the employer amends the profit-sharing/401(k) plan and PTO plan to allow the value of unused PTO to be contributed to the profit-sharing/401(k) plan as a “nonelective” employer contribution. The IRS concludes such an amendment would not disqualify the profit-sharing/401(k) plan under Code § 401(a), provided the nonelective contribution, together with other contributions made by the plan, meet the non-discrimination requirements of Code § 401(a)(4).

In the second example, the employer maintains a PTO plan in which participants may carry over unused PTO up to a certain “carryover limit” with the dollar value of amounts above the limit paid to participants early in the following year. In this example, the employer amends the profit-sharing/401(k) plan and PTO plan to allow participants to elect to contribute unused PTO above the carryover limit to the profit-sharing/401(k) plan. The IRS concludes such an amendment would not disqualify the profit-sharing/401(k) plan under Code §§ 401(a) and 401(k), provided the elective contribution, together with other contributions to the plan, satisfies the non-discrimination requirements of § 401(k) and does not exceed the elective contribution limit under § 401(a)(30).

Revenue Ruling 2000-32 presents examples in which unused PTO may be contributed to a profit-sharing/401(k) plan at termination of employment. In these examples, the employer maintains a PTO plan under which participants may carry over hours up to the carryover limit. Additionally, upon termination of employment, any unused PTO remaining at termination is paid to the participant within 60 days of termination. The employer amends both the profit-sharing/401(k) plan and PTO plans to provide that unused PTO at the time of termination is forfeited under the PTO plan and contributed to the profit-sharing/401(k) plan. Generally, the IRS concludes that such an amendment would not disqualify the profit-sharing/401(k) under Code § 401(a), provided the contributions of unused PTO satisfy the non-discrimination requirements of Code §§ 401(a)(4) and § 401(k) and also satisfy the contribution limits of Code §§ 415(c) and 401(a)(30).

The rulings specifically discuss the deferral of unused PTO in the context of private-sector profit-sharing/401(k) plans. The rulings may also apply to state and local governments, at least to the extent they sponsor 401(k) plans established before May 6, 1986. However, although the rulings extend the circumstances in which unused PTO may be contributed to 401(k) retirement plans on a tax-deferred basis, the underlying details are complex. Employers interested in implementing these amendments should obtain assistance from qualified legal counsel.

Revenue Ruling 2009-31 is available at: <http://www.irs.gov/pub/irs-drop/rr-09-31.pdf>

Revenue Ruling 2009-32 is available at: <http://www.irs.gov/pub/irs-drop/rr-09-32.pdf>

### **Department of Labor Updates Computerized System for Filing Forms 5500 and 5500-SF**

On January 8, 2010, the U.S. Department of Labor’s Employee Benefits Security Administration (EBSA) announced the conversion of its EFAST computerized filing system to EFAST2, allowing for the “all electronic” filing of Form 5500 and the new Form 5500-SF (for small filers). As a result, filers must now submit the 2009 and 2010 forms and schedules electronically through EFAST2.

Under Titles I and IV of the Employee Retirement Income Security Act (ERISA), private-sector pension plans and certain other employee benefit plans are required to file annual returns/reports regarding the plan’s financial condition, investments, and operations using Forms in the 5500 series. (Note: governmental pension plans are not required to file these forms.) Under the original computerized ERISA Filing Acceptance System (EFAST), filers chose between (1) “machine print” forms completed using software from EFAST-approved vendors and (2) “hand

print” forms completed by hand (or typewriter). Hand print forms could only be filed on paper and sent using U.S. mail or approved delivery services.

Under EFAST2, filers prepare and submit Form 5500 and Form 5500-SF using either software from EFAST2-approved vendors or the EFAST2 web-based filing system (referred to as IFILE). However, to sign or submit forms using EFAST2, electronic credentials must first be obtained by registering on the EFAST website at: [www.efast.dol.gov](http://www.efast.dol.gov). To help filers use EFAST2 the site also provides:

- An EFAST2 Tutorial: <http://www.efast.dol.gov/training/EFAST2%20Tutorial%20Menu.html>
- EFAST2 FAQs: <http://www.dol.gov/ebsa/faqs/faq-EFAST2.html>

Interestingly, the EFAST website also allows public access to the 5500 forms submitted by private-sector employee benefit plans. According to Phyllis Borzi, Assistant Secretary of EBSA, “Now that the EFAST2 system is operational, the Federal government and the public will for the first time have real time online access to financial information about private-sector employee benefit plans.”

### **Wisconsin Legislative Council Publishes 2008 Public Retirement Systems Study**

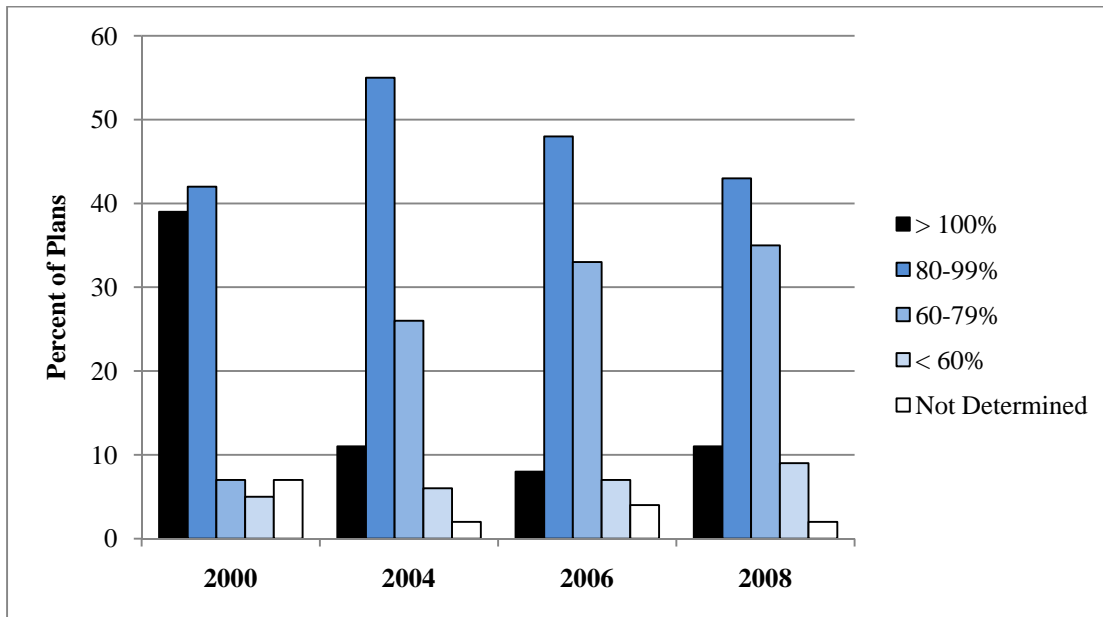
In December 2009, the Wisconsin Legislative Council published its “2008 Comparative Study of Major Public Employee Retirement Systems.” The biennial survey covers retirement benefits for general employees and teachers in 87 large public retirement systems. Conducted since 1982, the study provides information about retirement benefits, employer and employee contributions, actuarial methods and assumptions, plan funding, and other relevant topics. In previous reports, 85 public retirement systems were compared. However, in 2008, two systems were added to account for larger systems that have split.

The systems in the 2008 survey covered 12 million active employees and 6 million retirees, for a total of 18 million participants. Between 2006 to 2008, the number of active participants decreased 0.5%, while the number of retirees increased 6.3%, causing the ratio of active members to retirees to fall from 2.14 in 2006 to 2.00 in 2008. In 2008, the average funded ratio was 81% and funded ratios for the group were distributed as follows:

- 11% of the plans had funded ratios of 100% or more;
- 43% had funded ratios of 80 to 99%;
- 35% had funded ratios of 60 to 79%;
- 9% had funded ratios of less than 60%; and
- 2% had funded ratios that were not determined.

The following graph illustrates the distribution of funded ratios over the period from 2000 to 2008. Significantly, the percent of plans with high funded ratios (i.e., ratios over 100%) fell from 39% in 2000 to 11% in 2008, while the percent of plans with relatively low funded ratios (i.e., ratios between 60-79%) rose from 7% in 2000 to 35% in 2008. The graph also shows that the percent of plans with funded ratios between 80-99% remained relatively stable from 2000 to 2008.

**Figure 1: Plan Funded Ratios**



The study is available on the Wisconsin State Legislature website at:  
[http://www.legis.state.wi.us/lc/PUBLICATIONS/crs/2008\\_retirement.pdf](http://www.legis.state.wi.us/lc/PUBLICATIONS/crs/2008_retirement.pdf)

### **Pension Obligation Bonds May Pose Serious Risks for State and Local Governments**

On January 14, 2010, the Center for Retirement Research at Boston College (CRR) released an issue brief titled: *Pension Obligation Bonds: Financial Crisis Exposes Risks*. The report is part of a series of studies related to state and local pension plans that CRR is conducting for the Center for State and Local Government Excellence.

According to the authors, state and local governments are facing a “perfect storm” of problems due to the financial crisis. As a result of the sharp decline in equity markets, state and local government unfunded pension liabilities have increased. CRR researchers found that funded levels for public pensions have dropped below 80% and will require an additional \$200 billion over the next five years to offset the shortfall. Additionally, the economic recession has lowered state and local tax revenues, greatly limiting the ability of governments to compensate for the shortfall. According to the U.S. Census Bureau, tax revenues fell over 12% from the second quarter of 2008 to the second quarter of 2009.

In the past, some governments have tried to fund their pension shortfalls by issuing pension obligation bonds (POBs). However, the CRR report finds the use of POBs to be controversial, noting that some find them unduly risky and potentially unfair to future generations. During periods of economic stress, governments might consider POBs to be attractive for budget relief or cost savings because they offer “an actuarial arbitrage opportunity.” This opportunity potentially results from borrowing at a rate below the actuarial assumed rate of return and investing in securities expected to earn higher returns. However, the report cautions that POBs pose the following risks for state and local governments:

- Over the duration of most POB debt (15-20 years), the interest costs on the debt can exceed the actual investment returns.

- Proceeds from the origination of a POB are invested immediately, preventing investment on a dollar-cost averaging basis and creating considerable timing risk.
- POBs are debts which require inflexible periodic payments as compared with more flexible pension contributions.
- If the pension plan becomes fully funded as a result of the POB, there may be pressure to increase benefits.

The report is available at: [http://crr.bc.edu/images/stories/slp\\_9.pdf](http://crr.bc.edu/images/stories/slp_9.pdf)

### **CMS Reports U.S Health Care Spending Drops to Record Low in 2008**

On January 5, 2010, the Office of the Actuary for the Centers for Medicare & Medicaid Services (CMS) reported that U.S. health care spending grew at a historically low rate of 4.4% in 2008, down from 6.0% in 2007. CMS indicated that the decreased growth in national health care spending was due in part to the economic recession. However, despite the slower growth rate, total U.S. health care spending reached \$2.3 trillion, or \$7,681 per person. Additionally, health care spending rose to 16.2% of gross domestic product (GDP) in 2008, up from 15.9% in 2007, a rapid increase compared with recent years. CMS explained that rapid increases in health spending as a percent of GDP generally occur during or just after periods of economic recession. The report notes: “Despite the overall slowdown in national health spending growth, increases in this spending continue to outpace growth in the resources available to pay for it.”

The report also found that personal health care spending (i.e., spending on health care goods and services) grew 4.6% in 2008. This increase can be disaggregated into two broad components: (1) growth in prices and (2) all other growth (including growth in population, utilization, intensity of services, etc.) Price growth accounted for 3.1 percentage points of the increase and all other growth accounted for the remaining 1.5 percentage points.

While spending for nearly all health care goods and services slowed, federal spending accelerated. Federal Medicaid spending grew mainly due to an increase in the federal share under the American Recovery and Reinvestment Act (ARRA). Medicare spending increased due to increased hospital spending and a shift in enrollment to Medicare Advantage plans. The growth in Medicare spending was dampened somewhat by slower growth in spending for prescription drugs.

Private health insurance premiums and benefits grew at 3.9% in 2008, their slowest rate since 3.1% in 1967. This was largely due to the recession, which triggered a decline in private insurance coverage partly as a result of unemployment. CMS also reported that out-of-pocket spending was 2.8% in 2008, down from 6.0% in 2007. This may also be due to the recession, possibly as a result of individuals reducing their health care spending and foregoing medical treatment - especially for those who lost health insurance due to unemployment.

The report is available for a fee in the January 2010 issue of *Health Affairs* at:  
<http://content.healthaffairs.org/cgi/reprint/29/1/147>

### **GAO Studies State and Local Government Efforts to Address Retiree Health Liabilities**

On December 23, 2009, the U.S. Government Accountability Office (GAO) released its report *State and Local Government Retiree Health Benefits: Liabilities are Largely Unfunded, but Some Governments Are Taking Action*. The report reviews data on other postemployment benefits (OPEB) presented in recent comprehensive annual financial reports (CAFRs) for the 50 states and 39 large local governments in 2008 and 2009. Typically, retiree health care benefits are the largest OPEB costs that governmental employees earn while working. The GAO found that the total unfunded OPEB liabilities for the studied state and local governments currently exceed

\$530 billion, with \$405 billion attributable to the states and \$129 billion attributable to the large local governments.

Historically, most governmental plans have funded retiree health benefits on a pay-as-you-go basis rather than an accrual basis. However, accounting standards issued in 2004 by the Governmental Accounting Standards Board (GASB) require governments to account for OPEB costs on an accrual basis. Under GASB Statement No. 45, state and local governments are required to measure and report the actuarial value of OPEB obligations in their financial reports.

The GAO report finds that some state and local governments have taken action to address retiree health liabilities by allocating assets to prefund the OPEB liabilities. By prefunding, governments can reduce the unfunded liability reported in their financial statements. In addition, prefunding allows investment income to be earned on the plan's assets and helps to provide greater benefit stability for employees and retirees. According to the GAO, 35% of the 89 governments have allocated assets totaling \$25 billion for their OPEB liabilities.

Another approach to addressing health care costs is to change benefits. For the governments studied, the changes made to retiree health care benefits were most often applied to newly hired or currently active employees. In some cases, the governments made more than one change, which include:

1. **Changing the level of government contributions** – such as reducing the amount or proportion of health insurance premiums paid by the state and local government. This was the most common change.
2. **Changing the type of retirement health benefit plan** – including converting from a defined benefit to a defined contribution health plan (where the benefit is based on the individual account value at and during retirement).
3. **Changing benefit eligibility requirements** – such as increasing the years of service required to qualify for health benefits after retirement.

The GAO also simulated the fiscal outlook for state and local governments, including projections of health care costs. According to GAO, if there are no major changes to current policies, by 2050 the size of the projected operating budget imbalance for state and local governments could be 4.7% of gross domestic product (GDP). This would be mainly due to increases in health care spending. Moreover, by 2050 projected spending on state and local government retirees' health care benefits would double as a share of total operating revenues, increasing from 0.9% to 2.1%.

The GAO report is available at: <http://www.gao.gov/new.items/d1061.pdf>

### **CRS Report Finds Proposed Social Security Reforms May Alter Retirement Savings**

On December 30, 2009, the Congressional Research Service (CRS) released its report *Social Security, Saving, and the Economy*. The report examines the effects of several Social Security reform proposals on household and national savings. It finds that different reforms could have considerably different effects on savings.

The paper updates a 2008 report to reflect more current data and the growth in personal saving. Generally, the report finds that Social Security might affect savings in the following ways:

- Reduce household savings by reducing household income, to the extent the income is used to pay Social Security payroll taxes;
- Reduce household savings by reducing the need to save for retirement and thereby allowing households to reduce precautionary savings;

- Increase household savings by making it easier for participants to retire earlier, thereby encouraging them to save more for a longer retirement; and
- Reduce total savings by creating an intergenerational transfer of savings from relatively high savers (i.e., workers) to relatively low savers (i.e., retirees).

The report goes on to examine the impact of two major Social Security reform proposals: (1) funding the program more fully; and (2) converting the program (at least partially) to a defined contribution plan. The report concludes that funding Social Security more fully could lead to a reduction in household savings, but could also lead to a net increase in national savings. This is because each generation would have to contribute enough to fully provide for their own retirement benefits. While the increased contributions would reduce household savings, it would also tend to reduce the intergenerational transfer of savings, and make participants more confident about the availability of their future benefits. This, in turn, could increase national saving, investment, and economic growth.

Conversely, the report finds converting Social Security to a defined contribution program could reduce national savings. This is because the transfer of Social Security taxes into individual defined contribution accounts would cause federal government surpluses to fall, due to the diversion of tax revenues. If the defined contributions were not mandatory, it is possible that the increase in household savings would not offset the decline in the federal savings rate. If so, national savings would decline. However, if the defined contributions were mandatory, the increase in household savings would offset the decrease in federal government savings, and there would be no net effect on national savings.

The report also examines the reform proposal to invest some of the Social Security Trust Fund in private securities rather than exclusively in U.S. Treasury securities, as is currently done. The report finds no evidence that households would increase or reduce their saving merely as a result of a shift in relative rates of return on selected financial assets. Furthermore, it finds that investing the Trust Fund in private securities would likely have little effect on national saving.

Source: BNA, *Pension & Benefits Reporter*, 1/5/2010.

### **Second Circuit Holds Pension Benefit Reduction Does Not Violate Due Process Clause of U.S. Constitution**

On January 13, 2010, the U.S. Court of Appeals for the Second Circuit found that the City of Waterbury, Connecticut, did not violate the due process clause of the U.S. Constitution in negotiating a collective bargaining agreement that reduced pension benefits for city firefighters (*Walker v. Waterbury*, 2d Cir., No. 09-2104-cv, unpublished 1/13/10).

The case arises from a 2001 collective bargaining agreement (CBA) negotiated between the Waterbury Firefighters Association Local 1339, the city, and an oversight board established by the state legislature. At the time, the city had declared itself to be in financial emergency and the oversight board was established to approve the city's budget and oversee collective bargaining agreements. The new CBA was approved for 2001-2004 and included provisions to reduce benefits to city firefighters, including reducing the firefighters' annual pension accrual rate from 2.5% in the previous CBA to 2.0%.

In 2004, a group of active firefighters brought suit against the city, oversight board, and firefighters association, charging that the 2001-2004 CBA deprived them of vested benefits and so violated the due process clause of the U.S. Constitution. In hearing the case, the district court held that to prove their due process claim, the firefighters would have to show (1) that the vested benefits represented a fundamental right protected by the U.S. Constitution and (2) that the city's conduct was "arbitrary, outrageous, or conscience-shocking." In 2009, the district court granted summary judgment to the city.

The firefighters appealed to the Second Circuit Court. In deciding the case, the Circuit Court held that substantive due process protections extend only to those interests that are “implicit in the concept of ordered liberty” and “so rooted in traditions and conscience ... as to be ranked as fundamental.” Moreover, the Court held that employment rights are “state-created rights” and that “simple, state-law contractual rights” are not protected under the Constitution’s due process clause. In addition, the Court held that substantive due process standards are violated “only by conduct that is so outrageously arbitrary as to constitute a gross abuse of government authority.” Finding that the city did not act in such a manner, the Circuit Court affirmed the district court’s summary judgment.

The Second Circuit Court’s opinion is at: [http://op.bna.com/pen.nsf/id/jmer-7znlpp/\\$File/EB11199.pdf](http://op.bna.com/pen.nsf/id/jmer-7znlpp/$File/EB11199.pdf)