News Scan

GRS
Gabriel Roeder Smith & Company
Consultants & Actuaries

January/February 2011

The following news summaries were developed by Gabriel, Roeder, Smith & Company to inform clients and other benefit professionals of news in the benefits industry. Our thanks to Mary Ann Vitale for her diligent work on this issue. To receive this publication electronically, send an email to web.admin@gabrielroeder.com with "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.

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IRS Corrects Covered Compensation Tables for 2011

On February 7, 2011, the Internal Revenue Service (IRS) released Announcement 2011-16, identifying a typographical error in the 2011 Covered Compensation Tables presented in Revenue Ruling 2011-3, published on January 24, 2011. According to the Announcement, the error appears in the third column of Attachment I, which provides the 2011 Covered Compensation Table II. The dollar amount in column three for the 1966 Calendar Year of Birth was erroneously shown as $100,220; however, the correct amount is $101,220.

The corrected version of Revenue Ruling 2011-3 is available at: http://www.irs.gov/pub/irs-drop/rr-11-03.pdf

IRS Modifes Rules for Tax-Exempt Group Trusts

On December 16, 2010, the Internal Revenue Service (IRS) issued Revenue Ruling 2011-1, addressing the conditions under which assets may be pooled in a group trust for qualified plans under Internal Revenue Code (IRC) § 401(a), § 408 individual retirement accounts (IRAs), and eligible § 457(b) governmental plans. Group trusts allow the assets of multiple plans to be pooled without violating the IRC's exclusive benefit rule. If certain requirements are met, the ruling also permits group trusts to include: custodial accounts under 403(b)(7), retirement income accounts under 403(b)(9), and governmental retiree benefit plans under § 401(a)(24). The guidance clarifies that § 401(a)(24) applies to all governmental retiree plans, including those providing retiree medical or other welfare benefits.

Rev. Rul. 2011-1 modifies the general rules for group trusts described in Rev. Rul. 81-100 (as clarified and modified by Rev. Rul. 2004-67). Under the new guidance, each entity adopting the group trust must abide by the requirements in Rev. Rul. 81-100, as amended, and must:

- Be tax exempt under IRC § 501(a) or not subject to federal income tax; and
- Be part of a plan that satisfies the exclusive benefit rule.

Additionally, Rev. Rul. 2011-1 requires the group trust to maintain a separate accounting for each entity adopting the group trust. Moreover, each plan that adopts the group trust must state in its governing documents that the

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plan's assets will be used for the exclusive benefit of plan participants and their beneficiaries. If a plan must be amended to include the exclusive benefit requirement, such amendment may be made anytime during 2011, retroactive to the effective date of the ruling (January 10, 2011). The amendment must also be consistent with the plan's operations.

Rev. Rul. 2011-1 also provides two model amendments that can be used by group trusts to comply with the new provisions. Model Amendment 1 provides language that trusts can use to satisfy the separate accounting requirement, if the trust received an IRS determination letter before January 10, 2011. Model Amendment 2 also provides language to satisfy the separate accounting requirement but, in addition, permits custodial accounts under IRC § 403(b)(7), retirement income accounts under § 403(b)(9), or § 401(a)(24) governmental retirement plans to participate in the group trust. Group trusts should adopt both model amendments if: (i) they do not satisfy the separate account requirement and (ii) intend to permit other group trust retiree benefit plans to participate in the group trust.

The IRS has also requested comments by April 11, 2011 regarding whether annuity contracts and/or other tax-favored accounts held by § 401(a) or § 403(b) plans should be permitted to invest in group trusts.

Rev. Rul. 2011-1 is available at: http://www.irs.gov/pub/irs-drop/rr-11-01.pdf

A brief summary of Rev. Rul. 2011-1 is also available on Ice Miller's website at:
http://www.icemiller.com/benefits/Tax-Exempt_Group_Trusts.htm

Groom Law Group Requests Extension of Cycle E Filing Deadline for Governmental Plans

On December 28, 2010, the Groom Law Group submitted a letter to the Internal Revenue Service (IRS) requesting a one-year extension of the Cycle E determination letter deadline for governmental pension plans. The letter requested that the deadline be extended from January 31, 2011 to January 31, 2012 to allow governmental plan sponsors more time to deal with the following issues:

- **Budgetary constraints:** As discussed in the letter, concerns over state and local government budgets have slowed the internal reviews of documents and materials required for the IRS's determination letter process and voluntary correction program (VCP). The one-year extension would give governments time to review the documents and also allow the determination letter costs to be spread over several budget years, facilitating determination letter filings.
- **Plan language requirements:** Plan language requirements have raised concerns for some governmental plans about the extent to which the IRS will allow the cross-referencing of tax code sections in the plan rather than including specific language. In addition, penalties for plan document errors may also discourage governmental plans from applying for determination letters, even though the errors may be resolved through the determination letter process. The extension would allow more time for governmental plans to resolve plan language concerns.
- **Regulatory uncertainties:** Unresolved regulatory issues have also caused governments to be apprehensive about filing determination letter and VCP applications. For example, further guidance related to normal retirement age for governmental plans could encourage more determination letter filings. The extension would allow time to clarify the issues and help promote the interests of all stakeholders in the determination letter process.

The Groom Law Group's letter is available at: http://op.bna.com/pen.nsf/r?Open=foln-8csuur

NASRA Issues Brief on State and Local Government Spending for Public Employee Retirement Systems

On January 18, 2011, the National Association of State Retirement Administrators (NASRA) released an issue brief titled, "State and Local Government Spending on Public Employee Retirement Systems." The brief finds that while growing attention has been focused on public plans, a relatively small portion of total state and local government spending goes to fund the plans. According to the brief, less than 3% of total state and local government spending was used to fund public pension benefits in 2008. This percentage has remained relatively stable since 1995.

Moreover, public retirement systems distributed over $175 billion in pension benefits in 2008, which was paid by the pension trusts. Since the trusts are used to accumulate contributions and investment earnings, the annual amounts that governmental employers (i.e., taxpayers) paid into the trusts in 2008 was only about half of the amount paid out. Additionally, most public employees are required to make annual contributions to their pension plans, ranging from 5% to 10% of their salaries. In some public plans, employers and employees share pension costs equally.

The issue brief also reports that public pension costs have risen, and will likely rise further, due to the 2008 decline in capital markets and the resulting investment losses. However, it argues public pension costs should be considered from the perspective that:

1. State and local retirement systems distribute monthly benefit payments to over 7.5 million retired members, beneficiaries and surviving spouses; and
2. The monthly benefit payments generate positive economic effects in state and local economies.

In addition, the brief notes that 30% of state and local government employees do not participate in Social Security, including about one-half of public school teachers and two-thirds of firefighters and police officers. Typically, these employers and employees make contributions to the pension plan rather than to Social Security. By doing so, the costs to state and local taxpayers are reduced by an estimated $15.6 billion per year.

The issue brief is available at: http://nasra.org/resources/ERContributions.pdf

State and Local Government Organizations Issue Pensions Fact Sheet

On January 25, 2011, the National Association of State Administrators (NASRA), National Council on Teacher Retirement (NCTR), Government Finance Officers Association (GFOA) and seven other organizations representing public sector officials and employees published a fact sheet titled, "Facts on State and Local Government Pensions." The fact sheet is intended to help state and local retirement system officials inform the media and policymakers regarding public pension issues. The stated facts include:

- Retirement systems remain a small portion of state and local government budgets.
- Public pension plans are not in crisis.
- State and local governments are already taking steps to secure their pensions for the long-term.
- Public employees share in the financing of their pension, which in many cases is in lieu of Social Security.
- Pension dollars help the economy of every jurisdiction.
- Long-term investment returns of public funds continue to exceed assumptions.
- State and local government retirement systems do not require, nor are they seeking, Federal financial assistance.

The fact sheet is available at: http://www.nasra.org/resources/PublicPensionFactSheet110125.pdf

CBPP Reports on Misunderstandings Regarding State and Local Government Debt and Pensions

On January 20, 2011, the Center on Budget and Policy Priorities (CBPP) released its report, "Misunderstandings Regarding State Debt, Pensions, and Retiree Health Costs Create Unnecessary Alarm." The report addresses the misconceptions that have arisen from recently published articles regarding the financial status of state and local governments. According to the CBPP, numerous articles have created the mistaken perception that immediate, drastic measures are needed to avoid a fiscal crisis in state and local governments. Generally, these articles have erroneously lumped together both the *current* fiscal budgetary challenges and *longer-term* issues relating to debt, pension obligations, and retiree health costs.

In fiscal year 2012, most state and local governments are projecting large operating deficits mainly due to the weak national economy. Since 2008, however, state and local governments have successfully reduced their recession-induced deficits by using both reserve funds and federal stimulus funds, combined with budget cuts and tax increases. The report considers these deficits "a cyclical problem that ultimately will ease as the economy recovers."

According to the report, the longer-term issues related to bond indebtedness, pension obligations, and retiree health insurance can be addressed over the next several decades rather than requiring near-term solutions. The report also warns that, "it is not appropriate to add these longer-term costs to projected operating deficits…nor should the size and implications of these longer-term costs be exaggerated…such mistakes can lead to inappropriate policy prescriptions."

The report is available at: http://www.cbpp.org/cms/index.cfm?fa=view&id=3372

NASI Issues Policy Brief on Social Security's Long-Term Adequacy and Solvency

On November 10, 2010, the National Academy of Social Insurance (NASI) issued a new policy brief titled, "Strengthening Social Security for the Long Run." According to NASI, Social Security could be strengthened with a 75-year financing plan and targeted benefit improvements. Specifically, the policy brief:

- Describes Social Security reforms enacted in 1983;
- Examines the growing concern about future Social Security inadequacy;
- Provides public support for maintaining and improving the program;
- Recommends benefit adequacy approaches; and
- Summarizes a sample 75-year financing plan to strengthen Social Security.

Additionally, the brief presents three reasons for concern over the future adequacy of Social Security benefits:

- Social Security benefits are the main income source for the majority of the elderly, providing an average annual benefit of about $14,000 in 2010;
- Social Security benefits are projected to decline as a percent of prior earnings in the future; and
- Other sources of retirement income are becoming less adequate and more insecure.

The brief states that, "making modest improvements to address these concerns and covering Social Security's projected long-term shortfall would require revenue increases equal to slightly more than 2% of taxable payroll over 75 years." The report also discusses various alternative approaches to help raise revenues, such as scheduling future FICA tax increases or raising the cap on taxable compensation from $106,800 (the current limit) to 90% of all earnings in covered employment.

The report is available at: http://www.nasi.org/sites/default/files/research/SS_Brief_035.pdf

U.S. Health Care Spending Declines to a 50-Year Low

On January 5, 2011, the U.S. Department of Health and Human Services (HHS) released its report on the 2009 National Health Expenditure Accounts (NHEA). The NHEA are the official estimates of total health care spending in the United States. According to the report, the rate of growth in U.S. health care spending declined from 4.7% in 2008 to 4.0% in 2009, making this the lowest rate of growth in 50 years. The decline was mainly due to the recession and high unemployment which caused demand for medical goods and services to slow or decline. Despite the deceleration, total public and private health expenditures reached $2.5 trillion in 2009, and averaged $8,086 per person. Moreover, total health spending increased as a percent of U.S. Gross Domestic Product (GDP), up from 16.6% in 2008 to 17.6% in 2009. This was the largest one-year increase as a percentage of the GDP since the federal government began tracking national health expenditures. Other findings include:

- Hospital care accounted for $759.1 billion or about 31% of overall health expenditures.
- Prescription drug spending increased 5.3% to $249.9 billion, driven by accelerated growth in prices and utilization.
- Medicare enrollment decreased 1.3% as more beneficiaries enrolled in private Medicare Advantage plans.
- Medicaid enrollment increased 7.4% due to increases in the Federal Medical Assistance Percentages (FMAP) resulting from passage of the 2009 American Recovery and Reinvestment Act (ARRA).
- Private health insurance premiums increased 1.3%, the slowest one-year growth rate in history, down from 3.5% in 2008.

The report was prepared by economists and statisticians at HHS's Centers for Medicare and Medicaid Services (CMS). The NHEA report has measured annual U.S. expenditures for health care goods and services since 1960, including expenditures related to public health activities, government administration, health insurance, and research. The data are presented by type of health care service, sources of funding, and type of sponsor.

The report is available at: http://bit.ly/hM9pqb

NGA/NASBO Survey Finds State Spending and Revenues Remain Lower Than Pre-Recession Levels

In November 2010, the National Governors Association (NGA) and National Association of State Budget Officers (NASBO) released their semi-annual report, *The Fiscal Survey of States: Fall 2010.* The report updates information on the states' fiscal conditions and presents aggregate and individual data on the states' general fund receipts, expenditures, and balances. The survey was conducted by NASBO and completed by the governors' state budget officers in all 50 states from August 2010 through October 2010.

After one of the most challenging periods for state budgets since the Great Depression, fiscal conditions in 2011 are projected to improve slightly over fiscal 2010. However, in fiscal 2012, a significant amount of state funding from the American Recovery and Reinvestment Act of 2009 (ARRA) will be depleted. As a result, states will likely be faced with continued fiscal stress and further spending cuts.

State general fund spending declined in both fiscal years 2009 and 2010. General fund expenditures are estimated to be $612.9 billion in fiscal 2010, down 7.3% from $660.9 billion in fiscal 2009, the largest decline in state spending since the reports were first issued in 1979. In fiscal 2011, the governors' project general fund expenditures to be $645.1 billion, up 5.3% over fiscal 2010, but still lower than the fiscal 2009 levels.

According to the report, the reduction in general fund spending is due to significant decreases in state revenues, including revenues from sales, personal income, and corporate income tax collections, which comprise about 80% of state general fund revenues. The governors estimate that tax revenues will decline 10.4% from $680.2 billion in fiscal 2008 to $609.7 billion in fiscal 2010. (Fiscal 2008 is used as a benchmark because it was the last year in which the states were not affected by the recession.) In fiscal 2011, revenues are projected to decrease by 4.4%

compared to fiscal 2010 and 6.5% compared to fiscal 2008. As a result of declining revenues, 39 states made mid-year budget cuts totaling $18.3 billion in fiscal 2010. Additionally, 14 states have enacted $4.0 billion in budget cuts for fiscal 2011. In fiscal 2009, 42 states made mid-year budget cuts totaling $41.6 billion.

In fiscal 2010, 29 states enacted net revenue increases while 9 states enacted net decreases. As a result, tax and fee revenues increased about $23.9 billion, and other revenues increased an additional $7.5 billion. In fiscal 2011, 23 states recommended net increases while 6 states recommended net decreases, resulting in a projected net increase of $6.2 billion in taxes and fees and an additional $2.9 billion in other revenues.

The survey also reported on "total balances" which include year-end balances and any budget stabilization funds that the states have set aside for use during a financial downturn. In fiscal 2010, total balance levels are estimated to be 6.4% of general fund expenditures and are expected to decrease to 5.6% in fiscal 2011. The report suggests that many states are reluctant to deplete current balances based on the expectation that the economic downturn may last at least into 2012.

The survey report is available at: http://www.nga.org/Files/pdf/FSS1012.pdf

Overview of State and Local Pensions Funding Issues and Challenges

In January 2011, the Center for State and Local Government Excellence (SLGE) released a pension primer titled "State & Local Pensions: An Overview of Funding Issues and Challenges." The primer provides key facts about public pension plans, how they compare with the private sector, and what types of reforms are being enacted to help restore their fiscal health. Specifically, the report examines the effects of the financial crisis and economic downturn which, in many cases, resulted in substantial pension funding shortfalls in 2008-2009.

The primer discusses a wide range of topics related to state and local pension plans, including: the value of plan assets, funded ratios, employer and employee contributions, plan design, and actuarial assumptions. With regard to actuarial assumptions related to investment returns, the report finds that the major public pension plans have generally exceeded their assumed investment returns over the long-term. As of December 31, 2009, the median annualized investment return over one year was 19.9%, over 10 years was 3.9%, over 20 years 8.1%, and over 25 years 9.3%.

With regard to plan funding, the report finds that the aggregate pension liability for the major plans totaled $3.4 trillion in 2009, of which $2.7 trillion was funded by assets and the remaining $0.7 trillion was unfunded. At that time, 10% of the public plans were 100% funded; 33% were 80-99% funded; 47% were 60-79% funded; while 11% were 40-59% funded. The primer indicates that a key benchmark used to evaluate the viability of a public pension plan is the history of actual employer contributions compared with the annually required contribution (ARC). Another important benchmark is the history of the ARC as a percent of pay .

The report also refers to the Government Finance Officers Association's (GFOA) 2010 advisory on *Responsible Management and Design Practices for Defined Benefit Pension Plans*. The advisory recommends improving governments' financial management related to pensions by:

- Making annual required contributions;
- Establishing appropriate full-retirement ages;
- Being realistic about investment assumptions;
- Avoiding retroactive benefit increases; and
- Avoiding pension formulas that allow extraordinary income to be included in benefits.

Additionally, the Center advises governments to use a long-term view in retirement plan design and to fully consider the complexities of workforce planning and retirement security.

The pension primer is available at: http://www.slge.org/vertical/Sites/%7BA260E1DF-5AEE-459D-84C4-876EFE1E4032%7D/uploads/%7BDE913A11-1C4F-475D-BF0E-1662B0C67612%7D.PDF

The GFOA advisory is available at:
http://www.gfoa.org/downloads/GFOA_ADV_ResponsiblemanagementofDBplans.pdf

Moody's Modifies States' Credit Analysis by Combining Debt and Pension Liabilities

On January 26, 2011, Moody's Investors Service released its report "Combining Debt and Pension Liabilities of U.S. States Enhances Comparability." Historically, Moody's credit analysis of state governments has examined the value of outstanding tax-supported bonds separately from unfunded pension liabilities. Under a new methodology, Moody's will combine outstanding tax-supported bonds with unfunded pension liabilities to evaluate the leverage position of state governments.

Moody's believes the new approach will help increase transparency and enhance comparisons among states and corporate entities. However, it also continues to recognize the differences between bonded debt and unfunded pension liabilities. While pension debt is similar to bonded debt, in that it is irrevocable and long-term in nature, the report acknowledges that states can alter various factors that go into valuing pension liabilities. In addition, states can pass legislation granting relief from scheduled contributions. By contrast, bond payments are not subject to change.

The report measures combined tax-supported debt and unfunded pension liabilities in relation to state personal income, gross domestic product, population and operating fund revenues. In general, the states' rankings for combined debt and unfunded liabilities were equivalent to their ranking for debt alone, with some variations. The report notes that, given the fiscal stress being felt by most states and the prospects for a slow revenue recovery, "pension funding pressures will continue to have a negative impact on state credit quality and state ratings." The report also notes that, "pension liabilities may be understated because of current governmental accounting standards." However, the report acknowledges that states are responding to the growing fiscal challenges by increasing pension contributions, raising minimum retirement ages, and implementing other pension reforms.

The report also acknowledges certain limitations to the new measures. The measures do not adjust for differences in actuarial assumptions (e.g., interest rates) or for differences in actuarial cost methods. In addition, many states participate in cost-sharing, multiple-employer plans, which include substantial liabilities that are applicable to local governments rather than the state. In the future, Moody's expects to more accurately reflect the states' portions of cost-sharing, multiple-employer plans. Additional Moody's reports in the coming months will address the effect of pension obligations on state and local government credit ratings.

Moody's report is available on NASRA's website at: http://www.nasra.org/resources/Moodys1101.pdf