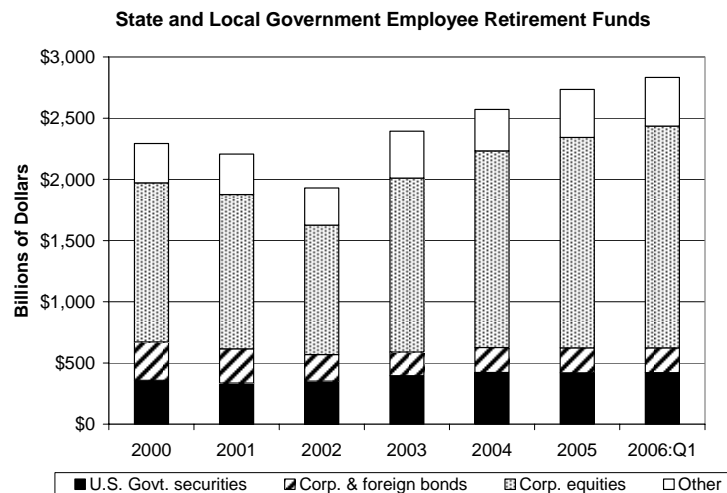


June 2006*

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 the message "SUBSCRIBE NEWS SCAN" in the subject line. To stop receiving this publication electronically, send the message "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.

Federal Reserve Reports Public Pension Assets Nearing \$2.8 Trillion

On June 8, 2006, the Board of Governors of the Federal Reserve released its *Flow of Funds Accounts* statistical report for the first quarter of 2006. On page 76, the report shows that state and local government employee retirement funds totaled \$2.79 trillion on March 31, 2006, up from \$2.54 trillion on March 31, 2005, an increase of \$250 billion over the 12 month period. The funds' 2006 holdings in corporate equities totaled \$1.81 trillion (64 percent of total assets) up from \$1.58 trillion (62 percent) a year earlier. The following graph shows state and local retirement fund assets by major investment type for year-end 2000 to 2005, and the first quarter of 2006. The graph illustrates the significant decline in the value of corporate equities that occurred at the beginning of the decade and the subsequent rebound after 2002.



Source: Board of Governors of the Federal Reserve, *Flow of Funds Accounts*, First Quarter, 2006.

The statistical release is available on the Federal Reserve's web site at:
<http://www.federalreserve.gov/releases/z1/current/default.htm>

* The authors of these news summaries are not attorneys and the statements made are not intended as legal advice or opinion. Qualified legal counsel should be consulted to ensure plan provisions and documents comply with applicable laws and regulations.

Colorado Governor Signs PERA Reform Bill

On May 25, 2006, Colorado Governor Bill Owens signed legislation (S.B. 235), making substantive changes to the Colorado Public Employees' Retirement Association (PERA) designed to return PERA to full funding over time. Currently, the plan is facing a funding shortfall of \$11.3 billion. Key components of Senate Bill 235 include:

For current PERA members:

- Establishing an additional Supplemental Amortization Equalization Disbursement (SAED) payment of 0.5 percent of the employer's total payroll beginning January 1, 2008, and increasing by 0.5 percent of payroll per year until reaching 3 percent in 2013. These increases will be funded by a portion of total payroll that would otherwise have been used for pay increases.
- Reducing benefit "spiking" by setting a 15 percent limit on the annual increase in the salaries used to calculate retirement benefits. This will apply for current members who retire after January 1, 2009.
- Requiring the cost of purchased service credit to reflect the actuarial cost of the service.

For PERA members hired after January 1, 2007:

- Increasing benefit eligibility requirements so that these newly hired employees will need to be at least 55 years old and have at least 30 years of service at retirement to be eligible for full retirement benefits (i.e., when age plus years of service total 85, also known as the "Rule of 85"). For employees hired before January 1, 2007, full benefits are available when age plus years of service total 80 (i.e., "Rule of 80").
- Limiting annual cost-of-living adjustments after retirement to the lesser of 3 percent or the annual rate of change in the Consumer Price Index (CPI), provided sufficient amounts are available to pay the COLA from the newly established COLA reserve fund.

Other changes:

- Reducing the maximum period for amortizing unfunded liabilities from 40 years to 30 years.
- Requiring the legislature to conduct an actuarial valuation before voting to increase retirement benefits.
- Reducing the size of the PERA's governing board from 16 to 15 members, with 11 elected trustees, 3 trustees appointed by the governor, and the State Treasurer being a permanent member.

The changes are expected to increase PERA's funded ratio to almost 75 percent by 2034 and 100 percent by 2051.

The full text of the bill is available at: <http://www.leg.state.co.us/Clics2006A/csl.nsf/MainBills?openFrameset> by entering "235" in the "Go Directly to the Bill Number" window.

Los Angeles County Reduces Contribution Rate Due to Investment Gains

On May 31, 2006, officials of the Los Angeles County Employees Retirement Association (LACERA) announced the County will be able to reduce its overall contribution by approximately \$43 million in the fiscal year beginning July 1, 2006, due to better than expected investment returns. According to a 2002 agreement between the County and LACERA, the county must make annual contributions to amortize any unfunded actuarial accrued liability (UAAL) over a rolling 30-year amortization period. LACERA's most recent actuarial valuation reported that the plan was 86 percent funded with liabilities of \$34.4 billion and assets of \$29.5

billion. The valuation also showed that LACERA received a \$790 million gain due to investment returns that exceeded the plan's expected actuarial rate of return. As a result, LACERA's Board of Investments recommended reducing the County's contribution to \$779 million, down \$43 million from what it would have been otherwise. In the next fiscal year, LACERA's funded level is expected to improve further since the plan has unrecognized gains exceeding \$1 billion.

Source: BNA *Pension and Benefits Reporter*, June 6, 2006.

Michigan Teachers Early Retirement Payments Subject to FICA Taxes

On June 7, 2006, the U.S. Sixth Circuit Court of Appeals ruled that early retirement payments made to Michigan teachers who relinquished their tenure rights constituted "wages" taxable under the Federal Insurance Contribution Act (FICA) (*Appoloni v. United States*, 6th Cir., No. 04-2068, 6/7/06). The appeal consolidated two separate cases filed in Michigan federal courts. In general, both cases involved former teachers who unsuccessfully applied to the Internal Revenue Service for refunds of FICA taxes withheld from early retirement payments. In the first case, *Appoloni v. United States*, the U.S. District Court for the Western District of Michigan ruled that the early retirement payments made to three tenured teachers were wages subject to FICA tax. However, in the second case, *Klender v. United States*, the U.S. District Court for the Eastern District of Michigan came to the opposite conclusion. It found that early retirement payments made to tenured teachers who gave up their right to tenured employment did not constitute wages subject to FICA tax.

According to the Sixth Circuit Court of Appeals, the Internal Revenue Code (I.R.C. § 3121(a)) defines "wages" as "all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash." In both *Appoloni* and *Klender*, the teachers were eligible for early retirement benefits after attaining a minimum number of years of service. The court found that this requirement was for services performed rather than relinquishment of tenure rights and, therefore, constituted FICA wages. Moreover, the majority found the early retirement payments were not made "in exchange solely for tenure rights, but rather in exchange for early retirement, and as such, were essentially severance payments." According to Revenue Ruling 75-44, severance payments fall within the definition of FICA wages as "all remuneration for employment." The appeals court affirmed the *Appoloni* decision and reversed the *Klender* decision.

The full text of the appellate case is available at: <http://www.ca6.uscourts.gov/opinions.pdf/06a0190p-06.pdf>

Tennessee Legislature Approves Bill Allowing Roth 401(k) Plans for State Employees

On May 23, 2006, the Tennessee Legislature passed a bill (H.B. 3287) allowing the state treasurer to offer Roth 401(k) plans to state employees if approved by the State Department of Finance and Administration. Federal provisions for the new Roth 401(k) plan were made under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and became effective for plan years beginning on or after January 1, 2006. The Roth 401(k) plan allows participants to make voluntary contributions to the plan on an after-tax basis, with investment income accumulating on a tax-free basis. In essence, a Roth 401(k) plan combines the investment features of a traditional 401(k) plan with the tax-free distribution of a Roth IRA.

The key elements of Roth 401(k) plans include:

- **Contributions are made on an after-tax basis.** Plan sponsors must withhold applicable federal, state and local taxes on Roth 401(k) contributions.
- **Qualified distributions are tax-free.** Roth 401(k) contributions and earnings on those contributions are not subject to federal income tax (and often state income tax) when distributed after attainment of age 59 ½, death or disability, provided a five-year participation period has been satisfied.

- **No income limits.** Roth contributions may be made available to all plan participants regardless of income level.

The plan sponsor must amend the 401(k) plan in order to allow for the Roth 401(k) feature. It is important to note that if a plan allows for after-tax Roth contributions, then traditional, pre-tax 401(k) contributions must also be allowed. After-tax contributions must be irrevocably designated as Roth contributions before they are made, and the 401(k) plan must account separately for these contributions and earnings. Any matching employer contributions must be made into the traditional 401(k) on a pre-tax basis. Qualified distributions from a Roth 401(k) that are not taxable may only be rolled over to a Roth IRA or another Roth 401(k) account through a direct trustee-to-trustee transfer.

The Roth 401(k) provision is set to expire after December 31, 2010, unless it is extended by Congress. The following table compares features of the new Roth 401(k) and the traditional 401(k).

Roth 401(k) vs. Traditional 401(k)

	Roth 401(k)	Traditional 401(k)
Tax Treatment of Contributions	Contributions are subject to federal income tax and withholding and, if applicable, state and local income taxes as well.	Contributions are not subject to federal income tax and withholding. Often contributions are also excluded from state and local income taxes.
Tax Treatment of Distributions	Qualified distributions* (including investment earnings) are not subject to federal income tax. Depending on state laws, qualified Roth 401(k) distributions may also be exempt from state and local income taxes as well.	Distributions (including investment earnings) are taxed as ordinary income when distributed.
Distribution Penalties	A 10% early distribution penalty applies to distributions made before age 59 ½, unless an exception applies.	Same as Roth 401(k).
Minimum Distributions	Subject to minimum distribution rules.	Same as Roth 401(k).
Rollover Restrictions	Roth 401(k) assets can only be rolled into a Roth IRA or another Roth 401(k).	Traditional 401(k) assets can be rolled into a variety of plans, including 401(k), 403(b), and 457 plans and a traditional IRA, but cannot be rolled into a Roth IRA.
2006 Contribution Limits	In 2006, participants may contribute up to \$15,000, or up to \$20,000 with catch-up contributions if age 50 or older. Plan participants can contribute to a traditional 401(k), Roth 401(k) or a combination of both, but combined annual contributions cannot exceed \$15,000/\$20,000.	Same as Roth 401(k).

*Roth 401(k) distributions are considered "qualified distributions" if the participant is at least age 59 ½ or the distribution is made on account of the participant's death or disability, provided the participant has held the account for at least five years.

The Tennessee bill also includes a provision allowing the distribution of pension benefits to a deceased employee's children if the member's spouse was the sole designated beneficiary and was also deceased. H.B. 3287 is available at: <http://www.legislature.state.tn.us> by clicking on the "Legislation" tab and searching for "HB3287."

CBO Adjusts Social Security 100-Year Projections

On June 14, 2006, the Congressional Budget Office (CBO) issued its report "*Updated Long-Term Projections for Social Security*" offering new 100-year projections of the program's finances. According to the report, currently scheduled program revenues will increase from 4.87 percent of gross domestic product (GDP) in 2005 to 5.10 percent in 2050 and then fall to 4.90 percent in 2100. Currently scheduled benefits, on the other hand, will grow from 4.24 percent of GDP in 2005 to 6.50 percent in 2050 and continue growing to 7.09 percent in 2100. Under the CBO's projections, Social Security outlays will begin exceeding revenues in 2019 and the Social Security trust fund will be exhausted in 2046. (By contrast, the 2006 Social Security Trustees' Report

projected that the program's growing deficits would exhaust the fund in 2040, under current financing arrangements.) Once the trust fund is exhausted, the CBO projects that continuing annual revenues will only be sufficient to pay 79 percent of currently scheduled benefits in 2047, declining to 69 percent in 2100.

In comparison to CBO's March 2005 report, this year's report projected an increase in overall "summary revenues" from 5.20 percent of GDP to 5.26 percent and increase in overall "summary outlays" from 5.77 percent to 6.04 percent. These summary measures are computed as the present value of the revenues (or outlays) projected over 100 years, divided by the present value of projected GDP over the same period. According to CBO, the new projections were based on newly available data, updated assumptions, and improved modeling.

The CBO report is available at: <http://www.cbo.gov/ftpdocs/72xx/doc7289/06-14-LongTermProjections.pdf>

EBRI Reports Social Security Reforms Likely to Reduce Benefits for Younger Workers

On June 16, 2006, the Employee Benefit Research Institute (EBRI) issued a report regarding the effects of several Social Security reform proposals on the value of benefits. The report found that because various proposed Social Security reform options would phase in benefit reductions, the reforms would result in larger benefit reductions for younger workers. In its study, EBRI investigated four alternatives to the current law benefits:

- **Gradual Reduction in Benefits (GRB):** Starting in 2016, the primary insurance amount (PIA) factors would be reduced gradually until benefits reached 67 percent of current law benefits in 2065.
- **Increase in the Normal Retirement Age (INRA):** Currently scheduled increases in normal retirement age (i.e., age 67 for those born in 1960) would continue until reaching age 70 for those born in 1978.
- **Progressive Price Indexing (PPI):** Indexing a portion of average monthly indexed earnings (AMIE) for changes in consumer prices rather than wages. This would reduce the benefits of higher wage earners without affecting the benefits of lower wage earners.
- **Combination of PPI and INRA:** Fully incorporating the combined INRA and PPI changes.

EBRI estimated that the annual benefit reductions resulting from these alternatives for those born in 1962 would range from \$300 for beneficiaries with the lowest benefits to about \$3,000 for those with the highest benefits. These annual reductions would increase progressively across age cohorts. For those born in 1997, the benefit reductions would range from \$2,200 to \$10,370. For those born in 2022, the benefit reductions would range from \$3,790 to \$18,360.

In order to compensate for the reductions in current law benefits, many workers would need additional savings which may still be inadequate to maintain their pre-retirement standard of living. The EBRI study indicated that reform options that reduce Social Security benefits will significantly impact many retirees, particularly those at the lowest income levels who are most dependent on Social Security benefits.

The EBRI report is available at: http://ebri.org/pdf/notespdf/EBRI_Notes_06-20061.pdf

Prescription Drug Spending Declines to Seven Year Low

On May 19, 2006, Medco Health Solutions, Inc., a pharmacy benefits manager (PBM), released its *2006 Drug Trend Report*. The report analyzed prescription drug claims which represented more than 85 percent of Medco's overall client spending. According to the report, the annual rate of growth in prescription drug spending fell from 8.5 percent in 2004 to 5.4 percent in 2005 (about 70 percent lower than the 16.4 percent growth rate in 1999). As a result, 2005 was the fourth consecutive year of declines in drug cost trends. The

report attributed this decline to deceleration in the overall growth rate for drug utilization, decreases in high-use drug categories, and use of less expensive generic drugs. In 2005, prescription drug usage increased only 2.7 percent, which was 50 percent less than the 2004 rate of increase. According to the report, in 2005 only 18 new drugs were approved by the Food and Drug Administration (FDA) which was the lowest number of approvals since 2002 and third lowest in 25 years. Medco predicted that the increasing use of generic drugs will continue, since many top-selling brand-name drugs (totaling \$43 billion in U.S. sales) could lose patent protection in the next four years.

The press release is available at: <http://www.medco.com> by selecting “Latest News.”

South Carolina Supreme Court Holds Statute Requiring Contributions Resulted in Breach of Contract

On May 4, 2006, the South Carolina Supreme Court ruled that a statute requiring retirement plan contributions by certain retired state employees who continued to work for the State resulted in a breach of contract (*Layman v. South Carolina, S.C., No. 26146, 5/4/06*).

In January 2001, the South Carolina General Assembly enacted the Teacher and Employee Retention Incentive Program (TERI). Under the program, teachers and other state employees could choose to retire but continue working for the State for up to 5 years. Although the TERI participants were not paid pension benefits while they continued to work (and did not earn additional service credit), they were paid these accumulated benefits when they ultimately left employment.

Under the original statute, TERI participants did not continue to pay employee contributions to the retirement system. In July 2005, the General Assembly passed the State Retirement System Preservation and Investment Reform Act (Act 153) requiring, among other changes, that TERI participants contribute 6.25 percent of their salary to the South Carolina Retirement System while they continued to work.

In response, a group of TERI participants brought a class action lawsuit against the State and the South Carolina Retirement System on the grounds that requiring contributions after enrollment in the TERI program constituted a breach of contract. They also sought a temporary restraining order seeking to enjoin the State from collecting the contributions. The circuit court granted the motion. The case was appealed to the South Carolina Supreme Court for review.

In deciding the case, the Court examined the question of whether the original TERI statutes created contracts. The Court observed that, under South Carolina law, statutes do not create contracts unless they expressly indicate the legislature’s intent to bind itself contractually to the statute’s provisions. Examining the original TERI statute, the Court found that the legislature used terms indicative of a contract, such as: “A member who is *eligible* [to retire under TERI] ... and *complies* with the *requirements* of this article ... *shall agree*” to continue working. Since the language required affirmative actions by both parties and fixed obligations as a result of the actions, the Court held that the “plain meaning” of the statute created a contract. The Court also found that the State breached the contract by unilaterally altering the agreement and requiring TERI participants to contribute.

However, the Court limited its findings only to persons who elected to participate in the TERI program prior to the Act’s effective date, July 1, 2005. For employees who elected to participate after July 1, 2005, the Court ruled that they must make contributions as required by the Act. “It is fully within the power of the state to make changes to laws that impact future participants, but ... the State breached its contract with the old TERI participants by changing the terms of the existing statutory agreement after participants agreed to those terms by electing to retire.”

The Court also distinguished the TERI program from a similar “working retirees” program. Under the State’s working retirees program, retirement system participants who have been retired for at least 60 days may return to employment covered by the system and earn up to \$50,000 without reduction in their monthly retirement benefits. The Court ruled that the statute establishing this program did not use the same “contractually significant” language and, therefore, did not create a contract. However, the Court also found that some of the older working retirees under this program may have received written contracts detailing the workings of the program, and exempting them from further contributions to the retirement system. The Court remanded these cases to the trial court to be addressed on an individual basis.