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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.

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GRS in the News: California OPEB Liabilities Range Between \$31 Billion and \$48 Billion

On May 7, 2007, California State Comptroller John Chiang announced that the retiree health care liabilities for California state employees range between \$31.28 billion and \$47.88 billion over 30 years, depending on the funding policy used. Gabriel, Roeder, Smith & Company (GRS) prepared the actuarial valuation as of July 1, 2007, in accordance with Governmental Accounting Standards Board (GASB) Statement No. 45, relating to Other Postemployment Benefits (OPEB). The valuation applied the following three alternative funding policies and assumed rates of investment return:

- **Pay-as-you-go funding with a 4.5% rate**, assuming the State will continue to finance retiree health benefits from assets available in the general fund, which produced an actuarial accrued liability of \$47.88 billion over 30 years and an "annual required contribution" (ARC) of \$3.59 billion for the fiscal year ending June 30, 2008;
- **Partial funding with a 6.125% rate**, assuming the State contributes 50% of the excess of the full funding annual required contribution over the pay-as-you-go costs, which produced an actuarial accrued liability of \$38.24 billion and an ARC of \$2.98 billion for FY 2008; and
- **Full funding with a 7.75% rate**, assuming the State will establish a trust fund to prepay and fully fund the benefits, which produced an actuarial accrued liability of \$31.28 billion and an ARC of \$2.59 billion for FY 2008.

In presenting the analysis, Comptroller Chiang explained the information would help the state "move quickly to begin crafting a responsible plan to honor our promises to state employees and protect future budgets." He also encouraged state policymakers to develop options to contain health care costs and determine the appropriate authority responsible for overseeing the trust used to pre-fund the benefits. He added that the mechanism must not overburden the state's annual budget, but must be sufficient to maintain the state's bond and credit ratings.

Currently, a bill (A.B. 554) is awaiting action in the Assembly Appropriations Committee to allow *all* public employers to participate in the trust fund administered by the California Public Employees' Retirement System (CalPERS) rather than only public employers who contract with CalPERS.

The actuarial report is available on the California State Controller's website (www.sco.ca.gov) by selecting the "Publications" tab and then selecting "State of California Retiree Health Benefits Program – Actuarial Valuation Report" in the "Special Reports" section.

IRS Releases Final Rules Regarding In-Service Distributions After Attaining Normal Retirement Age

On May 22, 2007, the Treasury Department and IRS released final regulations (TD 9325) providing guidance related to in-service distributions to pension plan participants after attaining normal retirement age. These regulations constitute the first of two regulations to be issued by the Treasury Department and IRS related to phased retirement benefits.

Generally, a pension plan (i.e., a defined benefit or money purchase plan) may not make in-service distributions prior to normal retirement age. Pension Protection Act (PPA) § 905(b) added new Internal Revenue Code § 401(a)(36) under which, for plan years beginning after December 31, 2006, "a pension plan does not fail to qualify under § 401(a) solely because the plan provides that a distribution may be made to an employee who has attained age 62 and who has not separated from employment at the time of distribution." Consequently, upon attaining age 62, an employee may begin receiving his or her full pension benefits while continuing to work, so long as it is provided by the plan.

The final regulations require that a pension plan's normal retirement age be an "age that is not earlier than the earliest age that is reasonably representative of the typical retirement age for the industry in which the covered workforce is employed." The regulations establish age 62 as the "safe harbor age" deemed to be reasonably representative of normal retirement age for all plans. For normal retirement ages between 55 and 62, the IRS will give deference to the plan that a good faith determination has been made, assuming reasonable facts and circumstances. However, except for qualified public safety employees, a normal retirement age that is lower than age 55 will be presumed to be earlier than the earliest reasonably representative age. For qualified public safety employees, a normal retirement age of 50 or later is deemed to be reasonably representative.

Generally, the regulations are effective as of May 22, 2007. However, special effective dates apply to governmental and collectively bargained plans. The final rules will apply to governmental plans beginning on or after January 1, 2009. For collectively bargained plans the rules apply for the first year beginning after the last current agreement terminates, or if earlier, May 22, 2010.

The final rules are available at: http://www.mhco.com/pdf/files/2007/Reg_NRA_Dist_052107.pdf

IRS Issues Proposed Regulations for Mortality Tables Used in Present Value and Funding Calculations

On May 29, 2007, the Treasury Department and IRS issued proposed regulations (REG-143601-06) related to mortality tables used in present value calculations and in calculations applying certain pension funding requirements. The Pension Protection Act of 2006 (PPA) substantially changed the minimum funding requirements that apply to private-sector, single-employer defined benefit plans, adding Internal Revenue Code § 430, which establishes new rules for minimum contributions to such plans. Under § 430(h)(3), the Secretary of the Treasury must prescribe mortality tables to be used for present value calculations and other calculations under § 430.

Although § 430 does not apply to governmental plans, the newly released § 415 final regulations require that the mortality table used for § 415 purposes after January 1, 2008, be based on a modified version of the mortality table used for minimum funding purposes. Since the final § 415 regulations apply to governmental plans, a modified version of these mortality tables will likely apply to governmental plans for the purpose of testing benefits for § 415 purposes after 2007.

The proposed regulations provide guidance on the new mortality tables and additionally, the framework for using substitute mortality tables. Specifically, the proposed rules would:

- Base the new mortality tables on tables contained in the RP-2000 Mortality Tables Report, i.e., expected mortality as of 2000, along with projection factors for expected mortality improvements;
- Permit plan sponsors to apply projected mortality improvements in annually updated static tables or by using generational tables;
- Establish separate mortality rates for annuitants and non-annuitants, with projection data;
- Provide guidance on the permitted use of static mortality tables; and,
- Provide guidance on the permitted use of substitute mortality tables that must reflect the actual and credible mortality experience separately for each gender of the pension plan.

Under the proposed regulations, substitute mortality tables may be used, provided they comply with certain requirements including (but not limited to): (1) they are based on credible mortality experience; (2) they are established for separate populations within each gender, such as annuitants and non-annuitants; and, (3) they are requested by the plan sponsor in a written request to the IRS that demonstrates the substitute tables comply with the applicable requirements. On May 31, 2007, the IRS issued Revenue Procedure 2007-37 to specify the procedures for petitioning the IRS for the use of substitute mortality tables.

Written or electronic comments on the proposed regulations and requests for a public hearing are due by August 27, 2007. The proposed regulations are available at:

<http://a257.g.akamaitech.net/7/257/2422/01jan20071800/edocket.access.gpo.gov/2007/pdf/07-2631.pdf>

Treasury Reverses Its Position on HELPS Retirees Act Exclusion of Self-Funded Health Plans

On May 15, 2007, the U.S. Department of Treasury agreed to interpret the term “qualified health insurance” as used in § 845 of the 2006 Pension Protection Act (PPA) to include self-funded health plans. The agreement was stated in a letter to Rep. Jim McCrery, Ranking Member of the House Ways and Means Committee. The IRS letter was in response to a letter from Rep. McCrery indicating that § 845 was intended to apply to premiums for both insured and self-funded plans, as clarified in a technical corrections bill currently being developed.

Rep. McCrery’s letter was related to IRS Notice 2007-7, issued January 10, 2007, providing implementation guidance on several provisions of the PPA including § 845. This section of the PPA, also referred to as the “Healthcare Enhancement for Local Public Safety (HELPS) Retirees Act,” allows an annual pre-tax disbursement of up to \$3,000 from a governmental defined benefit plan, 403(b) or 457 plan, if the disbursement is paid directly by the plan to an insurer as “qualified health insurance” premiums for an eligible retired public safety officer and his or her spouse or dependents. In Notice 2007-7, the IRS ruled that the term “qualified health insurance” referred only to plans “providing insurance issued by an insurance company regulated by a State...” and therefore excluded self-funded plans. [Notice 2007-7, Q&A-23]

In its recent letter to Rep. McCrery, however, the Treasury Department agreed to defer to the legislative intent of § 845 and interpret “qualified health insurance” to include employer-provided coverage under insurance or self-funded health plans.

The Treasury Department’s letter is available on the NCPERS website at: www.ncpers.org by clicking on “Treasury Backtracks on HELPS Retirees Interpretation.”

GAO Reports on Efforts to Control Employer Costs for Retirement and Health Care Benefits

On April 30, 2007, the Government Accountability Office (GAO) released a report titled *Employer Sponsored Health and Retirement Benefits: Efforts to Control Employer Costs and the Implications for Workers* (GAO-07-355). The GAO examined the current and emerging practices used by employers to control costs for retirement

and health care benefits, and the effects of these changes on workers. In a previous report, released in February 2006, the GAO found that the costs for retirement and health care benefits increased by 34% between 1991 and 2005, compared with a 10% increase in wages.¹

In its current report, the GAO found that active participation in private-sector defined benefit plans declined from 29 million in 1985 to 21 million in 2003 due to employers terminating existing plans or freezing benefits for active employees. During the same period, active participation in defined contribution plans grew from 33 million to 52 million with more employers offering such plans. The GAO noted this change affects workers' roles in retirement planning, requiring them to assume greater responsibility for retirement risks and for managing their investments.

The GAO also found that the number of employers offering health care benefits dropped from 2001 to 2006 due to an 8% decrease in small employers offering benefits. Moreover, many employers are requiring workers to pay more out-of-pocket costs or participate in consumer-directed health plans with lower premiums, but higher deductibles. In addition, greater shares of retiree health benefit costs are being shifted to retirees and many employers have terminated future retiree health benefits. The report indicated that the greatest challenges will be faced by low-wage workers who are less able to afford higher out-of-pocket costs and less healthy workers who use more health care benefits.

According to the GAO, some employers are also restructuring their workforce through the use of contingent workers who are not employed full time or year round. Since they are not full-time workers, contingent workers often do not have access to benefit plans. The GAO found that in 2005, 64% of all full-time workers participated in employer provided pension plans and 72% participated in health plans, compared to only 17% and 13% of contingent workers, respectively. However, the report noted that experts disagree on whether employers are restructuring their workforce to reduce benefit costs or to become more competitive.

The GAO report is available at: <http://www.gao.gov/new.items/d07355.pdf>

NEA Publishes Results of Large Public Education Pension Plan Survey

Recently, the National Education Association (NEA) posted the results of its 2006 survey: *Characteristics of Large Public Education Pension Plans*. The survey presents key data from 99 retirement systems, of which 79 offer pure DB plans, 19 provide various combinations of DB and DC plans, and one offers a pure DC plan. The survey report shows each system's data individually, including: plan membership, assets, retirement eligibility, vesting, state taxation of benefits, employee and employer contribution rates, benefit formulas, actuarial methods, funding, and board membership. The key findings include:

- About 11.3 million active members are covered by the surveyed retirement plans, with median active membership of about 66,600 and the largest covering over 800,000 active members;
- Total retirement system assets exceed \$2.0 trillion with CalPERS holding the largest amount of assets at \$190.6 billion;
- Two-thirds of the defined benefit plans use an entry age normal actuarial cost method. The average actuarial assumption for investment return is 8% and the average inflation assumption is 3.5%.
- The median funded ratio for the plans was 86%, and ranged from a low of 43% to a high of 153%.

The NEA report is available at: <http://www.nea.org/takenote/images/char2006.pdf>. (Note: the file is about 16 megabytes and may take some time to download.)

¹ GAO, *Employee Compensation: Employer Spending on Benefits Has Grown Faster Than Wages, Due Largely to Rising Costs for Health Insurance and Retirement Benefits*, GAO-06-285.

Social Security Trustees Release 2007 Report

On April 23, 2007, the Social Security Board of Trustees released their annual report on the program's financial and actuarial status. As was the case last year, the report projects that benefit payments and administrative expenses are expected to exceed Social Security's tax revenues in 2017. This will mainly be due to the rapid increase in the number of baby boomers who will leave the workforce and begin receiving benefits. Initially, interest on the trust fund assets will be sufficient to cover the shortfall, but beginning in 2027, government securities held by the trust funds would need to be redeemed to generate sufficient cash to pay benefits. The report projects that Social Security's trust fund reserves will be exhausted by 2041, one year later than indicated in the 2006 report. If this happens, Social Security would be able to pay only 75% of scheduled annual benefits after 2041, and 70% in 2081.

The report presents Social Security's financing shortfall in dollar terms, as well as in percents of taxable payroll and gross domestic product (GDP). The projected actuarial deficit in Social Security's trust funds is \$4.7 trillion (\$100 billion higher than estimated last year) when measured over the next 75 years and \$13.6 trillion when measured on a perpetual basis. Expressed in relation to the GDP, the annual cost of Social Security benefits is projected to increase from 4.3% of GDP in 2007 to 6.2% in 2030, and 6.3% in 2081.

In the 2007 report, several assumptions were revised reflecting disability and methodological factors that affect Social Security's financial condition. First, the ultimate age-adjusted disability incidence rates were changed to reflect the incidence levels experienced since 1970 (which decreased 10% for males and increased less than 1% for females). This change decreased the program's actuarial deficit and unfunded obligations. Second, the projections also reflect two significant methodological changes which included (i) expanding the sample of newly entitled disabled workers and (ii) reallocating total taxable earnings for workers with earnings near, or above, the taxable maximum. These changes lowered the projection of average benefit levels and decreased the actuarial deficit and unfunded obligations. The net result of the changes in assumptions, methods, and long-range valuation period decreased the 75-year actuarial deficit from 2.02% of taxable payroll in 2006 to 1.95% in 2007.

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

- Raising the combined employee-employer payroll tax rate immediately by 1.95 percentage points from the current 12.40% to 14.35%;
- Reducing benefits for all current and future recipients immediately by 13.0% on a permanent basis;
- Transferring general revenues equivalent to \$4.7 trillion (in present value) during the period; or
- Adopting some combination of these approaches.

The trustees urged that the trust fund deficits be addressed soon in order to gradually phase-in the necessary changes and protect future generations. The 2007 Social Security Trustees' Report is available at: <http://www.ssa.gov/OACT/TR/TR07/tr07.pdf>

401(k) Fee Litigation Emphasizes Need to Track and Monitor Fee Reasonableness and Transparency

On April 27, 2007, speakers at the American Bar Association's Real Property and Estate Planning Symposium in Washington, D.C., emphasized the importance for pension plan sponsors and fiduciaries of properly tracking, monitoring and disclosing fees associated with plan administration. Specifically, the speakers discussed recent 401(k) class action suits against pension plan sponsors and fiduciaries in which plaintiffs alleged breach of fiduciary duty connected with service providers charging excessive and improper fees to the participants. Many cases involved investment-related revenue sharing in which indirect payments were made to service providers

by mutual funds. The discussion chairperson, Peter Kelly of Blue Cross Blue Shield Association in Chicago, offered the following advice to plan fiduciaries in evaluating 401(k) fees for plan services:

- Retain outside advice to analyze costs and assess fee reasonableness; and,
- Compare fees with other plans.

Currently, the U.S. Department of Labor is considering new 401(k) fee disclosure requirements and is conducting the following four projects related to plan fees and disclosures:

- Investigating plan consultants and advisers to ensure they are not using their authority to enrich themselves;
- Writing regulations to clarify plan fiduciaries' duties in determining whether arrangements with and compensation paid to service providers are reasonable;
- Disclosing plan administrative and investment-related fee and expense information to participants and beneficiaries in individual account plans; and
- Changing Form 5500 to require plan administrators to disclose indirect plan fees, such as revenue sharing fees collected by service providers from mutual funds.

Source: BNA, *Pension & Benefits Reporter*, May 1, 2007.

Rhode Island Supreme Court Rules City Council Cannot Alter Retirees' COLAs

On April 12, 2007, the Rhode Island Supreme Court affirmed in part and reversed in part the trial court's judgment in a case spanning several years of litigation (*Arena v. Providence, R.I.*, No. 2005-207-Appeal, 4/12/07). At issue is whether the Providence City Council could alter the pension cost-of-living adjustments (COLAs) *after retirement* for police officers and firefighters.

In collective bargaining agreements with the Fraternal Order of Police and International Association of Firefighters, the city agreed to increase pensions by a 5% compounded COLA for police and firefighters who retired after July 1, 1991. This agreement was adopted by the city in Ordinance 1991-5. Subsequently, in Ordinance 1995-17, the city decreased pension COLAs for city employees and retirees to a 3% simple COLA and later reduced it to a 3% non-compounded COLA applying only to the first \$10,000 of pension benefits. Nearly five years later, in 2001, the plaintiffs filed a state court lawsuit seeking monetary damages for the loss of benefits.

The State Supreme Court held that the COLA benefit contained in Ordinance 1991-5 was a bargained benefit that vested at the time the plaintiffs retired. Consequently, the city was not authorized to amend the plaintiff's COLA benefit in a future ordinance. However, the court found no justification for the five-year delay before the plaintiffs' decision to seek declaratory judgment. Therefore, the court based its decision on the "doctrine of laches" (meaning negligence due to an unreasonable lapse of time) and ordered the city to reimburse the plaintiffs for the missed 5% compounded COLA payments, without interest, consistent with the terms of Ordinance 1991-5 *only* from the 2001 date they filed the action and thereafter.

The court opinion is available at:

<http://www.courts.state.ri.us/Supreme/publishedopinions2006-2007.htm> by scrolling down to *John R. Arena et al v. City of Providence et al, No. 05-207 (April 12, 2007)*.

IRS Issues Letter Ruling on Rollover from Qualified Plan to Nonspouse Beneficiary's IRA

On February 1, 2007, the IRS issued its first private letter ruling detailing the tax rules related to a rollover from a qualified plan to a nonspouse beneficiary's inherited IRA (PLR 200717023). "Inherited IRA" is defined in

Internal Revenue Code § 408(d)(3)(C)(ii) as an IRA maintained for the benefit of an individual by reason of the death of another individual, where the acquiring individual is not the surviving spouse of the deceased.

The ruling pertains to a decedent who died: i) prior to age 70-1/2 and ii) before completion of a rollover of his interest from a terminating retirement plan into an IRA. The IRS found that the decedent's nonspouse beneficiary may transfer the decedent's remaining plan interest into her IRA through a trustee-to-trustee transfer as allowed by the 2006 Pension Protection Act (PPA).

Effective for distributions made after December 31, 2006, § 829 of the PPA allows nonspouse beneficiaries to directly roll over an eligible rollover distribution from a "qualified retirement plan" to an "inherited" individual retirement account (or individual retirement annuity) specifically established to receive the distribution, provided the rollover is made through a trustee-to-trustee transfer. Qualified retirement plans include governmental defined benefit and defined contribution plans, as well as 403(b) annuities and governmental 457(b) plans. IRS Notice 2007-7 provides additional guidance for several PPA provisions, including distributions to inherited IRAs of nonspouse beneficiaries. As provided in Notice 2007-7:

- A plan is not required to offer a direct rollover to a nonspouse beneficiary. Rollovers to nonspouse beneficiaries are not subject to the rollover requirements of IRC § 401(a)(31), the rollover notice requirements of § 402(f), or the mandatory 20% withholding requirements of § 3405(c). If an amount distributed from a plan is received by a nonspouse beneficiary (rather than made through a trustee-to-trustee transfer), the distribution is not eligible for rollover. [Q&A-14, Q&A-15]

In the private letter ruling, the IRS also found that the beneficiary may receive minimum required distributions from that IRA using her remaining single life expectancy, beginning no later than December 31, 2008, in accordance with IRC § 401(a)(9)(B). The IRS added that the beneficiary's IRA will be retitled to include her name as beneficiary of the decedent and will constitute an inherited IRA under the PPA.

It should be noted that private letter rulings are directed only to the taxpayers requesting them and may not be used or cited as precedent. The ruling can be downloaded at: <http://www.irs.gov/pub/irs-wd/0717023.pdf>

IRS Allows Transfers from a 457 Plan to a Governmental DB Plan for Purchasing Additional Benefits

On May 11, 2007, the Internal Revenue Service issued a private letter ruling (PLR 200719014) related to transfers from a 457 plan to a governmental defined benefit (DB) plan for purchasing additional benefits under the DB plan. The ruling pertains to a city which maintains both a qualified governmental DB plan for police employees and an eligible deferred compensation 457 plan for police and other city employees. The 457 accounts of the police employees involved in this ruling are "frozen" accounts and are no longer allowed to receive future contributions to the 457 plan. However, the DB plan provides for an increase in the normal monthly retirement benefit accruing for each year of service after October 1, 1997. A police employee who is entitled to this benefit may also purchase additional DB plan benefits for service prior to October 1, 1997, using cash or a transfer or rollover from the 457 plan.

In ruling, the IRS found that a direct trustee-to-trustee transfer from a 457 plan to a governmental DB plan for the purchase of additional benefits is a permissible transfer under § 457(e)(16) and is not includable in gross income at the time of the transfer, provided the eligible rollover provisions are met. Additionally, the IRS ruled that a rollover within 60 days of an eligible distribution from the 457 plan to the governmental DB plan is permissible.

It should be noted that private letter rulings are directed only to the taxpayers requesting them and may not be used or cited as precedent. The letter ruling can be downloaded at: <http://www.irs.gov/pub/irs-wd/0719014.pdf>