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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 "SUBSCRIBE NEWS SCAN" in the subject line. To stop receiving this publication electronically, send "UNSUBSCRIBE NEWS SCAN" in the same manner. Copies of this and other benefit-related publications are available on the GRS web site at www.gabrielroeder.com.

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House and Senate Introduce Pension Protection Act Technical Corrections Bills

On August 2, 2007, the "Pension Protection Technical Corrections Act of 2007" was introduced in the U.S. Senate (S. 1974). An identical bill (H.B. 3361) was introduced in the U.S. House of Representatives on August 3, 2007. The bills would correct and clarify provisions of Pension Protection Act of 2006 (PPA), including typographical and grammatical errors. Moreover, several provisions would also clarify legislative intent, address implementation issues, and make similar changes. Action on the bills is expected when Congress returns in early September 2007. Significant provisions would:

- **Allow public safety officers to exclude up to \$3,000 of self-insured health premiums:** Under the PPA, eligible retired public safety officers may elect to exclude up to \$3,000 annually from gross income for certain distributions made from an eligible retirement plan to pay qualified health insurance premiums. However, in January the IRS ruled that the exclusion did not apply to distributions made to self-insured health plans. The Technical Corrections Act would change the law to provide that the exclusion would apply to self-insured plans.
- **Allow nonspouse beneficiaries to elect direct rollovers to inherited IRAs:** Under the PPA, qualified retirement plans under IRC § 401(a) and similar arrangements (such as 403(a), 403(b) or eligible governmental 457 plans) were allowed to let nonspouse beneficiaries elect a direct rollover to an IRA, provided it was treated as an inherited IRA. Under the Technical Corrections Act, such rollovers would be subject to the same rules as other eligible rollover distributions. Consequently, effective for plan years beginning after December 31, 2007, qualified retirement plans and similar arrangements would be required to allow nonspouse beneficiaries to directly rollover eligible funds to an inherited IRA.
- **Allow cash out of small lump sums regardless of plan's funding status:** Under the PPA, private-sector plans that fall below certain funding levels are not permitted to make lump sum payments to participants. The Technical Corrections Act provides that a plan may pay involuntary lump sum distributions under \$5,000, regardless of the plan's funded status.

S. 1974 and H.B. 3361 are available at: <http://www.govtrack.us/congress/billtext.xpd?bill=s110-1974> and <http://www.govtrack.us/congress/billtext.xpd?bill=h110-3361>

The Joint Committee on Taxation's analysis of the bills is at: <http://www.house.gov/jct/x-60-07.pdf>

Treasury and IRS Issue Final 403(b) Regulations

On July 23, 2007, the U.S. Treasury Department and IRS issued comprehensive final regulations for 403(b) tax-sheltered annuity plans, including those offered by non-profit, governmental, and church organizations. The final regulations update the original rules adopted in 1964 and include legislative and regulatory changes under the Employee Retirement Income Security Act of 1974 (ERISA), the Small Business Job Protection Act of 1996 (SBJPA), the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), and the Pension Protection Act of 2006 (PPA). A major effect of these changes is to decrease the differences between 403(b) plans and other tax-deferred, salary-reduction arrangements such as 401(k) and governmental 457(b) plans.

Generally, the final regulations apply to tax years beginning after December 31, 2008. However, certain plans are subject to delayed effective dates and explicit transition rules. For example, arrangements subject to collective bargaining agreements in effect on July 26, 2007 will not have to comply with the new regulations until the earlier of July 26, 2010, or the date the collective bargaining agreement terminates.

In many respects, the final regulations reflect the proposed regulations that were issued on November 15, 2004. Specifically, the following changes and clarifications were adopted in the final regulations:

- **Written plan document:** For plan years beginning in 2009, the 403(b) arrangement must be in writing and describe the material plan provisions, including the allocation of responsibilities between the employer, service providers and participants. The final regulations provide that other documents, such as annuity contracts, may be included by reference. The IRS is expected to publish future guidance on plan documents, including model provisions for plans offered to public school employees.
- **Universal availability and nondiscrimination testing:** Under the universal availability rule of Internal Revenue Code (IRC) § 403(b)(12)(A)(ii), if an employer allows any employee to make elective deferrals to a 403(b) plan, all employees must be allowed to do so (except non-resident aliens, employees eligible to participate in a 457(b) plan, students, and employees who normally work less than 20 hours per week). Previously, under IRS Notice 89-23, 403(b) plans could also exclude collectively bargained employees, certain visiting professors, religious order employees who take a vow of poverty, and employees who make a one-time election to participate in a governmental plan. However, the final regulations clarify that such employees may no longer be excluded.

Elective deferrals to 403(b) plans remain free from nondiscrimination testing. However, employer contributions and after-tax employee contributions continue to be subject to nondiscrimination testing (with exceptions for governmental and certain church plans).

- **Limitations on contributions:** Annual additions to a 403(b) plan may not exceed the IRC § 415 limits. Under the regulations, if an excess contribution is made, the excess will be subject to tax under the rules of IRC § 403(c).
- **Catch-up contribution:** A special catch-up election under IRC § 402(g)(7) allows employees with 15 or more years of service with a qualified employer to make a catch-up contribution to a 403(b) plan in excess of the generally applicable dollar limit. Additionally, employees who will attain age 50 by the end of the tax year may make additional catch-up contributions under § 414(v) up to a specified dollar limit (\$5,000 for 2007) to the 403(b) plan. If an employee is eligible for both the special 403(b) catch-up contribution under § 402(g)(7) and the age 50 catch-up contribution, the special 403(b) catch-up is deemed made first.
- **Plan-to-Plan transfers:** The final regulations provide for three forms of non-taxable transfers: 1) an investment option exchange within the same plan, 2) certain plan-to-plan transfers involving different

employers, and 3) permissive service credit purchases in governmental defined benefit plans. However, transfers to and from qualified plans, 457(b) and other non-403(b) plans are still not permitted.

- **Plan termination:** A 403(b) plan may be terminated and the benefits of all participating employees must be distributed as soon as administratively feasible. Upon plan termination, employees may request distributions to be rolled over to another eligible retirement plan (i.e., a 403(b), 401(k), 457(b) governmental plan, or IRA).

Recently, the IRS has been examining public school district 403(b) plans to determine their compliance with the nondiscrimination provisions of § 403(b)(12)(A)(ii). The IRS is focusing on the “universal availability” requirement, as discussed above. A violation of the universal availability requirement may result in the 403(b) plan losing its tax-favored status and cause the loss of retirement savings and tax benefits for participants.

The final 403(b) regulations are available at: <http://benefitslink.com/taxregs/07-3649.pdf>

IRS Extends Transitional Relief for Indian Tribal Governmental Plans

On August 9, 2007, the IRS issued Notice 2007-67 extending transitional relief provided to Indian tribal governmental plans. Last year, the Pension Protection Act of 2006 (PPA) amended the definition of “governmental plan” under Internal Revenue Code (IRC) § 414(d) to include certain plans of Indian tribal governments (ITGs) and their related entities. The inclusion of ITG plans in the definition of governmental plans allows them certain tax advantages, including the ability for employee contributions to be tax-deferred under IRC § 414(h). To qualify, ITG plans must cover participants who perform essential governmental services, but not commercial activities.

To allow ITG plans time to create separate plans for commercial employees, in 2006 the IRS issued Notice 2006-89, providing transitional relief through September 30, 2007. Under Notice 2006-89, ITG plans would be treated as satisfying the requirements of a governmental plan if the plan complies with the definition based on a reasonable good faith interpretation of its requirements.

Notice 2007-67 extends the transitional relief deadline established in Notice 2006-89 from September 30, 2007, until the date that is six months after the IRS issues broader guidance on the definition of governmental plans (expected in 2008). The extension is conditioned on the plans not being amended, for periods before the extended date, to reduce benefits unless the reduction: (i) does not vary based upon whether the participant is considered an ITG governmental or commercial employee, or (ii) is made to the plan for commercial ITG employees and is the minimum reduction necessary to satisfy the tax code requirements.

Notice 2007-67 is available at: <http://www.irs.gov/pub/irs-drop/n-07-67.pdf>

IRS Publishes Proposed Cafeteria Plan Regulations

On August 6, 2007, the IRS published comprehensive proposed regulations for cafeteria plans under Internal Revenue Code § 125 which allows employees to choose between taxable compensation and nontaxable employee benefits. The new proposed rules clarify and update rules issued over the last 23 years affecting cafeteria plans and flexible spending arrangements (FSAs) for health and dependent care.

The following briefly highlights the new proposed cafeteria plan guidance:

- **Written plan documents:** The requirements were expanded to provide definitions, plan requirements, and rules regarding eligible participants and qualified benefits that can be offered.
- **Nondiscrimination rules:** The rules regarding key employees and highly compensated employees were clarified to provide definitions of key terms, the eligibility test, and contributions and benefits

tests used in determining when the actual election of benefits is discriminatory. A cafeteria plan must give each similarly situated participant a uniform opportunity to elect qualified benefits and highly compensated participants must not disproportionately elect qualified benefits while other participants elect permissible taxable benefits.¹ The proposed regulations provide a new objective test for determining if qualified benefits are disproportionately elected by highly compensated employees. Under the objective test, the aggregate qualified benefits (calculated as a percentage of compensation) that are elected by highly compensated employees cannot exceed those elected by non-highly compensated employees.

- **Flexible spending arrangements:** The proposed regulations restate the previous FSA operating rules as applicable to health, dependent care and adoption expense reimbursement plans. As set forth in the prior rules, the use-it-or-lose-it rule applies to all FSAs. Also, the uniform coverage rule (as previously described) continues to apply to health FSAs, but not to dependent care or adoption assistance FSAs.

The proposed rules replace previous proposed and temporary regulations that were issued since 1984 but never finalized. Generally, the proposed rules would be effective for plan years beginning on or after January 1, 2009. However, employers may immediately rely on the new proposed regulations for guidance pending the issuance of final regulations. Written or electronic comments on the proposed rules are due by November 5, 2007.

The proposed regulations are available at: <http://benefitslink.com/taxregs/reg142695-05.pdf>

SEC Issues White Paper on Disclosure and Accounting Practices in the Municipal Securities Market

On July 26, 2007, Security and Exchange Commission (SEC) Chairman Christopher Cox submitted a white paper titled "*Disclosure and Accounting Practices in the Municipal Securities Market*" to the U.S. Senate Banking Committee and House Financial Services Committee. The white paper discusses the size and importance of the municipal securities market, recent enforcement issues, and possible legislative reform.

According to the white paper, there are currently more than \$2.4 trillion of municipal securities outstanding. In 2006, over \$430 billion in new bonds and notes were issued, and over \$6 trillion in long and short term municipal securities were traded. Currently, individual investors hold 36% (\$861 billion) of municipal securities directly and up to 33% indirectly through money market funds, mutual funds, and closed end funds.

The white paper argues that current laws do not provide the SEC with sufficient authority to ensure municipal security disclosure and protect investors. To remedy this, the white paper proposes a regulatory system for the municipal securities market which would:

- Require official documents and periodic reports provided to municipal security investors contain information similar to what is currently required for all other securities offerings;
- Make information on municipal securities available on a more timely basis;
- Mandate municipal issuers use generally accepted governmental accounting standards;
- Provide SEC oversight and an independent funding mechanism for the GASB, in the same way that the Sarbanes-Oxley Act provided SEC oversight for the FASB;
- Require large, complex, and frequent issuers of municipal securities to have policies and procedures for disclosure;
- Clarify the legal responsibilities of issuer officials, underwriters, bond counsels and other participants; and,
- Ensure that private companies who indirectly access the municipal market through municipal issuers meet the same requirements as corporate issuers.

¹ Including cash compensation for salary, annual leave, sick leave or other paid time off and severance pay.

Although some are skeptical that Chairman Cox will obtain support in Congress for legislative reform, the SEC urged lawmakers to allow the commission to mandate compliance with GASB standards, oversee the standards setting board, and provide independent funding for the board. Cox stated that the SEC will begin conducting focused reviews in the municipal market on broker-dealer compliance with the pay-to-play rule. The rule prohibits brokers from performing business with municipal issuers to which they have made political contributions.

Chairman Cox submitted the white paper to Congress following his speech, "Integrity in the Municipal Market," given on July 18, 2007, at the Los Angeles Town Hall meeting. The speech is available at: <http://www.sec.gov/news/speech/2007/spch071807cc.htm>.

The white paper is available at: <http://www.sec.gov/news/press/2007/2007-148wp.pdf>

CalPERS Reports Record 19.1% Investment Return for FY 2007

On July 23, 2007, the California Public Employees' Retirement System (CalPERS) reported a 19.1% investment return for fiscal year ending June 30, 2007, with assets increasing \$36.5 billion for the year to end at \$247.7 billion. For the fourth consecutive year, the pension fund's annual returns exceeded 10% and, over the past 10 years, annual returns averaged 9.1%. For FY 2007, CalPERS' investments exceeded the industry benchmarks by nearly \$3.8 billion in all major investment portfolios. The highest rates of return were generated in international stocks (29.6%), global equity (23.7%), and U.S. stocks (20.6%).

According to Rob Feckner, President of CalPERS Board of Administration, "...these gains will carry many CalPERS plans to 100 percent full funding of our retirement obligations as of June 30, 2007." He added, "Since investment gains account for 75 cents of every dollar we pay in benefits, these returns represent money saved for employers and taxpayers." Currently, CalPERS benefit payments are funded with approximately 75% paid from investment returns, 12.5% from employee contributions and 12.5% from employer contributions.

The 2007 fiscal year-end asset allocation was comprised of 61.3% in public equities, 23.7% in bonds and other fixed income, 8.2% in real estate, 6.2% in private equities, and 0.6% in cash equivalents.

The CalPERS press release is available at:

<http://www.calpers.ca.gov/index.jsp?bc=/about/press/pr-2007/july/assets-gain-19-percent.xml>

Iowa State Auditor Reports on Early Retirement Programs

On July 13, 2007, Iowa State Auditor David A. Vaudt released a report on early retirement programs for state employees. The review was conducted to determine the state's cost savings resulting from the programs, and to ensure the programs complied with relevant laws, rules and guidelines. Between 2001 and 2006, Iowa offered state employees three Early Out Incentive (EOI) programs and one Buy Out program. The early retirement benefits were paid as five annual payments based on the value of accumulated vacation and sick leave. From 2001 through 2006, 1,019 workers elected the early retirement options, with payments of \$34.2 million made from 2002 to 2006 and an additional \$4.8 million expected to be paid from 2007 through 2009.

The incentives were offered as an alternative to layoffs, as well as a way of reducing the state's wage and fringe benefit costs. While initial estimates of the expected cost savings exceeded \$250 million, the auditor's report showed actual cost savings to be about \$132 million over the period from 2002 through 2009. The difference is largely due to the fact that the costs of replacing employees were excluded from the initial estimate but were included in the auditor's report.

The state auditor also reported that 64 former employees who retired under the early retirement incentives returned to state employment as temporary employees. For fiscal years 2002 through 2006, the costs associated

with these rehiring totaling over \$1.6 million. The state auditor indicated that some of the people rehired functioned as permanent workers, which violated the requirements and intent of the EOI legislation. He recommended that the state include the costs of replacing employees in future estimates of EOI savings and that the state limit the rehiring of those electing the early retirement incentives to comply with the EOI's objectives.

The report is available at: <http://auditor.iowa.gov/specials/specials.htm>

Washington State Expects Significant Reductions in Health Care Cost Growth in 2008

On July 17, 2007, Washington Governor Christine Gregoire announced a significant reduction in the growth rate of health care costs for state employees from 11% in 2005 to 3% in 2008 with projected savings of \$192 million in 2008. According to Steven Hill, Administrator of the Washington Health Care Authority, the savings occurred without benefit reductions by changing the plans offered to employees, improving the health care contract negotiation process, and consolidating more costly plans with an existing health plan.

The Washington Health Care Authority administers the health plans provided by the Public Employees Benefits Board (PEBB) which cover about 325,000 Washington residents including active state employees, retired teachers, retired state employees, and dependents.

Further information is available at: <http://www.pebb.hca.wa.gov/changes.shtml>

Kaiser Family Foundation Releases Health Care Costs Primer

In August 2007, the Kaiser Family Foundation released a primer on health care costs which analyzes the growth in U.S. health care costs and its impact on families, businesses and government agencies since 1970. The paper describes the types and sources of health care spending and associated demographic factors based on spending levels. Additionally, it discusses the factors that influence the growth in health care spending, including new medical technology, population changes, and changes in disease prevalence. The key facts reported were:

- In 2005, U.S. health care spending totaled \$2 trillion, which is about \$6,700 per person or 16% of gross domestic product (GDP).
- Since 1970, health care costs have risen at an average annual rate of 9.8%, or about 2.5 percentage points faster than GDP.
- Increases in health care premiums have consistently outpaced inflation and the growth in workers' earnings. Between 2000 and 2006, health insurance premiums increased 87%, or more than four times the growth in wages.
- In 2004, almost 50% of all health care spending was used to treat only 5% of the U.S. population.
- Prescription drug spending accounts for about 10% of total health expenditures, but contributes 14% of growth in spending.
- In 1996, about 26% of people with incomes below the federal poverty level spent more than 10% of their income on health. In 2003, nearly 33% spent more than 10% of their income on health.
- Many policy experts agree that a large portion of health care spending and its growth is attributable to new medical technology.

The report is accessible at: <http://www.kff.org/insurance/upload/7670.pdf>

CRR Analysis of Retirement Savings Crisis

In August 2007, the Center for Retirement Research (CRR) at Boston College released an issue brief titled, "*Is There Really a Retirement Savings Crisis?*" The brief focuses on the National Retirement Risk Index (NRRI) which measures the percent of U.S. working-age households who are "at risk" of being financially unprepared

for retirement based on the *2004 Survey of Consumer Finances*. According to the issue brief, a retirement savings crisis does exist.

According to the NRRI, upon retirement almost 45% of households will fall more than 10% below their pre-retirement standard of living, even if they work until age 65 and annuitize all their financial assets (including receipts from reverse home mortgages). By comparison, in 1992 only 20% of households age 51-61 were considered “at risk” of being unable to maintain their pre-retirement standard of living. The brief correlates this increase with declining Social Security replacement rates, lower real interest rates, and the continued shift from defined benefit plans to 401(k) plans.

The issue brief is available at: http://crr.bc.edu/images/stories/Briefs/ib_7-11.pdf

NGA Reports on States’ Health Care Reform Initiatives

On August 14, 2007, the National Governors Association (NGA) released an issue brief titled, “*Leading the Way: State Health Reform Initiatives*.” As described in the brief, states are developing health care reforms that encompass both health coverage and system improvements. Perceiving a lack of federal action to improve the current health care system, the states have focused their efforts on health reform initiatives to control costs and improve coverage for those uninsured.

As reported in the issue brief, 19 states have implemented health care reforms and several others are forming task forces to develop reform proposals. Innovative approaches initiated by states include:

- **Expanding health care coverage for children and small business employees:** These programs include expanding state-sponsored Medicaid and the State Children’s Health Insurance Programs (SCHIP). They also include programs to expand coverage for employees through premium rebates and tax incentives for small businesses that offer health coverage.
- **Reforming private insurance:** These programs are designed to make health insurance more affordable and create less expensive health care products. They include mandatory health care coverage in some states, in an effort to spread the insurance pool across a large number of participants. They also include “connector model” programs in which health coverage is offered through a quasi-governmental entity that may negotiate with health insurers to offer benefits within a specified premium range.
- **Improving the health care system:** These programs include efforts to improve the quality of the health care system as well as the overall health of the population. Many states are using quality improvement and measurement approaches to improve patient care. States are also using “pay-for-performance” programs as incentives for health care providers to establish standards of quality in return for a higher reimbursement rate.

Additionally, states are incorporating prevention and wellness programs, and using information technology to improve health care delivery. The report provides brief summaries of implemented and proposed health reform initiatives listed by state. It is available at: <http://www.nga.org/Files/pdf/0707HEALTHREFORM.PDF>