Governor's Pension Reform Bill and Constitutional Amendment Proposed February 2, 2012

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On February 2, 2012 Governor Brown released the text of a bill and proposed constitutional amendment for his pension reform proposals. The proposals follow his prior announced policy. They include a number of important limits and raise questions about operation. This memo is a first cut analysis of the proposals, limits and questions. As we learn more, and as the Legislature takes action, we will provide more information.

SUMMARY OF PROPOSALS

The Governor's pension reform bill generally would do the following:

- For new hires on and after July 1, 2013, require a mix of defined benefit ("DB") and defined contribution ("DC") plans that target a benefit after a full career of 75% of final compensation, with a cap generally equal to the Social Security wage base. The full benefit would not be payable for a safety member who retires before 57 and a general (miscellaneous) member who retires before 67.
- Eliminate the purchase of airtime for current employees and new hires.
- Require annual DB plan contributions equal to normal cost with the cost split 50/50 between employers and employees.
- Limit return to work by retirees who keep receiving their pensions.
- Prohibit retroactive benefit enhancements.
- Change the composition of the PERS Board, giving the Governor more appointments.

These proposals are discussed below.

DISCUSSION OF PARTICULAR PROVISIONS

1. Hybrid Pension Plan With Capped Benefits

A new mandatory benefit structure will be required for new employees hired on and after July 1, 2013, called a "hybrid plan." It would be the only plan that a public employer could offer to its employees.

a. New Employees

The only retirement plan that may be offered by a public employer to its employees who are first hired on and after July 1, 2013[1] is a hybrid plan as determined under the proposed new constitutional provisions.[2] The hybrid must be a combination of a DB and a DC plan.[3] Another "alternative plan" may be offered, but this has major hurdles.[4]

b. DB & DC

The hybrid plan must have both a DB and a DC "component." The bill does not provide what percentage of benefits must be provided through DB or DC. Theoretically, 99% could be from the DB, but this is unlikely. We expect that the State Director of Finance will determine the mix of DB and DC.[5]

c. 75% Replacement Ratio

The hybrid plan must "be designed with the goal" of providing an annual retirement "replacement income" of 75% of the employee's final compensation "based on a full career in public service."[6] Full career is defined as 30 years for safety and 35 years for general (also called miscellaneous) members.[7] This provides an accrual of about 2% per year of service for general members and about 2.5% per year accrual for safety.[8]

d. Target Retirement Age

The target age for the 75% replacement income is 57 for safety members with 30 years of service and 67 for general members with 35 years of service. This suggests that there will be an actuarial reduction from the 75% replacement for members who retire at younger ages.

e. Additional Dollar Cap On Benefits

There are additional caps in the proposal. Perhaps the most important is that the target benefit is not only capped at 75%, but it is also capped at the Social Security wage base.[9] The wage base for 2012 is $110,100. If the employee is not "eligible" for Social Security, the target is 120% of the wage base, or $132,120 for 2012.

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1 The bill and constitutional amendment also provide that if the IRS allows an election, current employees "shall" be given the option to participate in the hybrid plan. Prop. Art. VII, Sec. 12(a)(5). Prop. Code Sec. 7514.70(b)(3)(A). References to Art. VII, Sec. 12 are references to the proposed constitutional amendment. References to code sections are to proposed or current sections of the Government Code unless otherwise stated.

2 Prop. Art. VII, Sec. 12(a)(3). It takes a bit of digging to find the "mandatory" part of the proposal. The proposed bill only requires employers to "offer" a hybrid plan. Prop. Code Sec. 7514.70(b)(1).

3 Prop. Code Sec 7514.70(a)(2).

4 To offer an "alternative plan," the governing board of the agency and the system's "chief actuary" must certify that has less risk and lower costs than "any available hybrid plans" that satisfies the rules. Prop. Code Sec. 7514.70(b)(1). The bill also opens the way for taxpayer lawsuit against the actuary and board and the employer to challenge any such certification, the authorization to offer the alternative plan, or the actual offer of the alternative plan. Prop. Art. VII, Sec. 12(a)(4). Prop. Code Sec. 7514.70(b)(2).

5 Prop. Art. VII, Sec. 12(a)(2).

6 Prop. Code Sec. 7514.70(a)(2). Prop. Art. VII, Sec. 12(a)(1). Meeting this target can be complex; we discuss some examples below.

7 Prop. Code Sec 7514.70(a)(2). Prop. Art. VII, Sec. 12(a)(1). Also, "safety" is narrowly defined as essentially police and fire. Probation officers, for example, would not be "safety".

8 Note that it does not appear that an employer could offer a lower benefit than 75% replacement benefit because the hybrid described appears to be mandatory. Question -- will the proposal provide for benefits higher than the 75% target for employees who work to an older age or have more than the 30/35 years of service? If so, this may encourage older employees to stay longer.

9 Prop. Code Sec. 7514.70(a)(2). Prop. Art VII, sec 12(a)(1).

Under a strict reading of the bill, it appears that this cap is imposed system-by-system.[10] This will probably encourage higher income employees to move jobs from, e.g., a PERS employer to a 37 Act employer when they hit the dollar cap in their current system.

f. Will There Be COLAs?

Another cap in the proposal exists by implication only, so we are not sure that it exists. The 75% cap is "retirement replacement income of 75 percent of a public employee's final compensation."[11] Final compensation does not have an inflation adjustment. By implication, the hybrid would not have any COLA adjustment after retirement. If this is correct (and perhaps the Director of Finance who sets the criteria for hybrid plans, would have a different interpretation), elimination of COLAs will significantly reduce the cost of pensions. From our actuary friends, we understand that COLAs can cost as much as 30% of total pension cost.

g. Early Retirement

Employees may retire with 5 years of service at age 52 (safety) or age 57 (general). If the Social Security minimum age for retirement is increased, these ages will be increased by an equal number of years.[12] As noted above, the implication of the proposal is that retirement benefits that start before age 57 (safety) and 67 (general) will be reduced actuarially to be equivalent to the benefit payable at 57 or 67, as applicable.

h. Working With the DC Component

There are no statutory guidelines for the DC component of the hybrid, so there are no guidelines as to how their portion of the 75% is to be determined. Under the constitutional amendment, the State Director of Finance will establish the criteria and requirements.[13] DC plan investment returns are notoriously volatile; perhaps the Director of Finance will take that into account in setting the criteria.[14] Additionally, a key deficiency of a DC component is that it is very difficult for members to obtain a lifetime income from the DC account balance – the risk of outliving the DC account balance (some call this the "mortality risk") is shifted to the individual. The IRS has just last week formally recognized this problem and is trying to encourage a market for longevity insurance. It is unknown whether this market will develop or not, and if so what it will cost to buy this insurance.[15]

i. Final Compensation

For the defined benefit part of the hybrid, "final compensation" is the member's highest average payrate for a 36 consecutive month period[16]. (This definition applies only to employees hired on and after July 1,

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10 "System" is not defined in a meaningful way. It is not clear if this means any "plan" including a stand-alone plan or if it only includes multiple employer plans as PERS and 37 Act plans. It is more likely to include a stand-alone plan however. Otherwise some very large retirement plans would be exempt, such as those for San Francisco, Los Angeles, San Diego, etc.

11 Prop. Code Sec. 7514.70(a)(2).

12 Prop. Code Sec. 7514.81(c). Prop. Art. VII, Sec. 12(b)(2).

13 Prop. Art. VII, Sec. 12(a)(2).

14 There are a number of ways to set up a hybrid plan with a 75% replacement ratio target. It could be as easy as providing a lower than 2% (or 2.5%) accrual rate with a "make up" DC contribution. Or it could be as complex as providing that the DB accrual is 2% (or 2.5%) with an offset at retirement for the value of the DC plan account balance. In the pension world, this is called a "floor-offset" plan; usually the investments in the DC component of a floor-offset are professionally managed without employee investment choice.

15 An alternative would be to allow retirees to transfer their DC balances to the DB component of the plan to essentially buy additional lifetime pensions. If the pricing is right, this can be at low or no cost to the DB plan (or even at a slight gain to the DB plan), and yet at a substantially more favorable cost to the retiree than can be obtained from the insurance market. If this were to occur, the State could be a leader in solving a difficult retirement issue for DC plan members. Of course this does mean that the DB plan is assuming risk and will need to be priced accordingly, but would not need to "profit" as is the case for commercial products.

16 Prop. Code Sec. 7514.60(b); Prop. Art. VII, Sec. 12(d).

2013 because it is used only in the rules for hybrid pensions.) Payrate is "normal monthly rate of pay or base pay…paid in cash to similarly situated members of the same group or class."[17] This is essentially the PERS definition, and it would be applied to the 37 Act as well.[18] Payrate includes the customary deductions from salary to, e.g., a 457 plan, 401(k) plan, 401(a) plan, or flexible benefits program.[19] Payrate does not include accrued leave, severance pay, in-kind pay, supplemental payments for items such as uniform allowances, bonuses, and certain types of overtime.[20]

This bill would eliminate pay items that are now included by 37 Act systems pursuant to the *Ventura* decision, often set by court approved settlement.

j. Survivor Benefits

The proposal says that survivor benefits would not be "restricted."[21] Exactly what this means is unclear. Possibly it means that if survivor benefits currently are provided without an actuarial charge to the member's benefit this will continue. For example, if the current benefit to the member is $1,000/month and with this comes a $600/month survivor benefit – without reduction to the $1,000/month – then the 75% target could also provide a survivor benefit of 45% without actuarial reduction to the 75% benefit.

k. Administration of Hybrids

It appears that retirement systems will have to administer at least 2 separate programs: the current DB program, often with multiple tiers of benefits, and another separate DB program for the new lower tier.

These systems may also have to administer a DC component. The proposed constitutional amendment would require each "system" to "provide" one or more hybrid plans.[22] The proposed bill would require each public employer to "offer" to employees hired on and after July 1, 2013 a hybrid plan.[23] Furthermore, the definition of "system" does not give much direction.[24] In this situation it is unclear who will administer the DC part. It could be done by existing retirement systems as PERS or 37 Act systems. They, in turn, could outsource administration to vendors, which might be most cost-efficient because DC administration is highly technical and software intensive. Alternatively, they could buy or lease existing software and have it customized for their members, with the system doing the administration. Another method would be for the employer to use its existing 457 or 401(a) plan vendor.[25] Presumably the Director of Finance will give guidance.

2. Purchase of Service Credit

The bill has a general section that prohibits the purchase of "nonqualified, additional retirement service credit."[26] The term "nonqualified" is not defined. "Additional retirement service credit" means any credit for time that does not otherwise qualify as "public service, military service, leave of absence, or other time recognized for service by a public retirement system."[27] It is not clear what the purpose of this section is because if the system does not recognize the time, then of course it could not be purchased. This section

17 Prop. Code Sec. 7514.60(a)(1).
18 Code Sec. 31461.
19 Prop. Code Sec. 7514.60(e)(2).
20 Prop. Code Sec. 7514.60(e)(3).
21 Prop. Art. VII, section 12(e).
22 Prop. Art. VII, Sec. 12(a)(3).
23 Prop. Code Sec. 7514.70(b)(1).
24 Prop. Code Sec. 7514.60(h) ("'Public retirement system' means any pension or retirement system of a public employer.")
25 For example, the University of California Retirement "System" consists of both DB and DC plans, and the administration of the DC plans is outsourced to vendors. Similarly, the State's employees now are eligible to participate in 401(k) and 457(b) plans administered by the Department of Personnel Administration using outsourced vendors.
26 Prop. Code Sec. 7503.74(a). Prop. Art. VII, Sec. 12(c)(4).
27 Prop. Code Sec. 7503.74(c).

applies to all service credit purchases except pursuant to "official application" received by the system before the operative date of the section.

The bill also includes a number of provisions that eliminate the ability to purchase airtime. The provisions generally apply to all relevant employees – currently employed and new – with an exception for "official application" received by the system before the operative date of the section.[28]

3. Funding

a. Normal Cost

Both the bill and the constitutional amendment would require employer and employee contributions each year to cover normal cost of the defined benefit plan.[29] It appears that this applies to the existing DB plan as well as the new DB component of the hybrid plan. Very generally, normal cost is the cost of benefits earned in the current year.

This requirement is most likely proposed to avoid "contribution holidays." However, as we have seen, there will be times when systems will be significantly overfunded. Under the proposal, it will be difficult to increase benefits even if systems are vastly overfunded because of the benefit caps for hybrid plans.[30] It will also be difficult to avoid these contributions because the funding requirement will be in the constitution. The consequence is that in some circumstances employees and employers could be making contributions when it is perceived that they are not receiving any benefit from them. Even so, eventually contributions will have to be restarted and it is never easy to do that.

b. Member Contributions

Employees, including current employees[31], will have to contribute "at least" one-half of the normal cost of a defined benefit plan. If normal cost goes up, member contributions go up, and member contributions go down if normal cost goes down. Change may occur every year because this is based on the "annual actuarially determined" normal cost.[32] The employer cannot pay a part of these member contributions.[33] If, on enactment, the employee is not paying the full 50%, there can be a three year phase in, determined by bargaining for represented employees and by the employer for others.[34]

The requirement that employees pay the full amount of their statutorily required contributions is a current trend in bargaining and is allowed under both the 37 Act and PERS law.

The proposal states that all member contributions will be "considered employer contributions for the purposes of federal tax law."[35] This is an attempt to sweep in the federal tax rule to make member contributions pre-tax "pick-ups"; however it does not meet the requirements set by the IRS so should not be relied on. Moreover, there will be times that it is better for members that their contributions are post-tax so perhaps more flexibility should be allowed.

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28 E.g., Prop. Code Sec. 20909 (PERS) and 31486.35 and 31658 (37 Act).

29 Prop. Code Sec. 7503.73. Note that this is only a requirement to contribute normal cost. There is no requirement to contribute to fund the UAAL (unfunded accrued actuarial liability). To do this would require establishing minimum funding rules as exist under ERISA.

30 Benefits for current employees who are not under the hybrid plan regime presumably could be increased, though for future service only.

31 This applies to current employees only to the extent permissible under both the California and U.S. Constitutions. Prop. Sec. 7503.73 (a). Prop. Art. VII, Sec. 12(c)(3). See below for comments on vested rights.

32 Id.

33 Id.

34 Prop. Code Sec. 7503.73(b).

35 Prop. Code Sec. 7503.73(d).

4. Return to Work

An employee who "retires from a public employer" cannot "serve, be employed by, or be hired through a contract either directly or through a third party by, a public employer without reinstatement from retirement."[36] The exceptions are the existing ones for an "emergency" or because the retiree has skills needed "to perform work of limited duration."[37] The existing 960 hour rule also is in the bill and the constitution proposal.[38]

There are operational questions about this rule. Here are some – if "work of limited duration" will be interpreted strictly:

(i) What if the most cost efficient way for a small city to obtain services is to hire, e.g., the police chief and pay a part-time salary because he/she also receives a pension? Does this bill prevent the city from doing this for more than a limited period?

(ii) The bill is unclear on the ability of retirees to serve on public boards with no or minimal compensation. For example, what happens to the retiree representatives on public retirement boards; must they give up their pension to serve? Do they, by virtue of election or appointment, have the "special skills" required? Would the "limited duration" rule limit their terms on a retirement board?[39]

(iii) On its face, the rule applies to work for any public agency, not just one to which the retiree provided services and not just one that participates in the system from which the retiree receives benefits. Is this the intended scope of the prohibition?

This change would apply to current employees who retire after the operative date of the new rule, as well as to new employees, but only to the extent "permissible" under the California and U.S. Constitutions.[40]

5. Limit on Benefit Enhancements

Any "enhancement" will apply only for future service and not to service before the operative date of the enhancement.[41] Enhancement includes a change in classification or change in employment that results in a better benefit.[42] This applies to new employees, and to current employees to the extent "permissible" under the California and U.S. Constitutions.[43]

6. PERS Board Composition

The proposal would change the PERS board by (i) eliminating the membership of the State Personnel Board and the person representing the public, and (ii) adding the following four members appointed by the Governor: one with health insurance expertise; one elected official from a local contracting agency; two representing the public who have financial expertise.[44]

7. Transition For Existing MOU's

If any provision in the proposed constitutional amendments (all of which are mirrored by the statutory proposals) would "impair" an MOU in effect on November, 2012, the terms of that contract govern until

36 Prop. Code Sec. 7503.76(a).
37 "Limited duration" is in PERS law at existing Code section 21224; it does not seem to be in the 37 Act.
38 Prop. Art VII, Sec 12(c)(6).
39 What if board service requires more than 960 hours and remuneration is minimal or nonexistent?
40 Prop. Art. VII, Sec. 12(c). The proposed bill does not state this constitutional limitation. Proposed section 7503.76.
41 Prop. Code Sec. 7303.71(a). Prop. Art. VII, Sec. 12(c)(1).
42 Prop. Code Sec. 7503.71(b).
43 Prop. Art. VII, Sec. 12(c).
44 Prop. Sec. 20090 and Prop. Art XVI, Sec. 17(f).

its expiration.[45]

8. Other Provisions

The new rules would not "restrict" any disability, death, or survivor benefits "provided by a public employer."[46]

There are new forfeiture-of-pension rules for employees who commit felonies involving conduct arising out of or in the performance of official duties.[47]

The amount paid by the State (not local agencies) for retiree health benefits under PEMHCA are reduced and the amount of service required to qualify for these benefits is lengthened.[48]

VESTED RIGHTS

It appears that care was taken to try to avoid vested rights issues.

The required hybrid plans only apply to employees first hired on and after July 1, 2013.[49]

A number of proposed changes would only affect current employees if the changes are permissible under the California and U.S. Constitutions: changes in benefit formulas can be for future service only; contributions to DB plans must equal normal cost annually; employees must pay 50% of normal cost; "nonqualified service credit" cannot be granted to members except as specified; convicted felons forfeit benefits; changes in the return to work rules[50]. There are questions about the process for determining that these changes are or are not permissible. One way may be by a separate court challenge to each; another might be through declaratory judgment actions.

It appears that the only material change for current employees that is not subject to the "permissible under the constitutions" rule is the elimination of the ability to purchase airtime. Airtime is part of the existing statutory rules which the courts generally say establishes the terms of the contract. We expect that this elimination would be challenged.

WORKINGS OF A HYBRID PLAN – A FEW CONSIDERATIONS

Here's a simple example:

1. DB Component of Hybrid Plan

We start with a DB-only plan and then look at a hybrid plan.

The first cap is a 75% replacement ratio. For a DB plan-only, this would be an accrual rate of a bit more than 2% per year of service times high average 36 months compensation ("HAC")[51] for a full benefit after 35 years of service, at age 67.

The second cap is a dollar cap for the annual DB benefit of the Social Security wage base, currently $110,100.

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45 Prop. Art. VII, Sec. 12(f).

46 Prop. Art. VII, Sec. 12(e). How this would work is unclear. Could it mean that, e.g., disability benefits that are based on the current DB plan formulas would continue under these formulas instead of the new hybrid DB plan formula?

47 Prop. Code Sec. 1244 and 1245.

48 Prop. Code Sec. 22871.1 and 22874.2.

49 Prop. Art. VII, Sec. 12(a)(3). Prop. Code Sec. 7514.70(b)(1).

50 Prop. Art. VII Sec. 12(c).

51 This is the way that private sector plan formulas are written

Assume a member with a HAC of $147,000. After 35 years of service, a DB plan-only benefit would hit the $110,100 cap.[52] Assume instead an HAC of $160,000. A 2% per year accrual for 35 years would provide a benefit of $112,000; $1,900 per month of that full benefit could not be paid because it would exceed the $110,100 cap. (This example, of course, uses a static Social Security wage base for illustration.)[53]

This simple example uses only a DB plan. Next, a DC plan must be factored in to get a hybrid.

2. Adding A DC Component

Together the DB and DC components of the hybrid must provide a target benefit of 75% of HAC at 67 (general members) or 57 (safety). To do this, the DB portion must be reduced as the DC is added. We found no guidance in the proposal on what percent of the 75% target is to be provided by DB and DC. For simplicity, we assume that the hybrid will be 50/50 DB/DC. That may not be the ultimate result.

In a 50/50 environment, the DB side is easy to establish. The DB plan accrual rate becomes a bit more than 1% per year for 35 years for general members for a total DB accrued benefit of 37.5% of HAC. The other 37.5% must come from the DC component.

This is where things can get a bit tricky.

To a large extent, the complexities occur because of the "target." If the target is a very soft target, then the account balance needed, the contribution pattern, the earnings rate, and other factors can be easily determined and stated. If the target is a real target (or a real target plus or minus a modest variance) then it can be complicated to reach with a DC plan.

Target Account Balance – Actuaries must calculate the target account balance needed at retirement to provide an annual benefit of 37.5% of HAC. This target will be influenced, however, by the cost of obtaining an annuity to pay a lifetime benefit, which generally cannot be predicted in advance because market rates change. Predictability increases if the annuity can be obtained by transferring the DC account balance to the DB plan to "purchase" an annuity. However, such a transfer can shifts risk back to the DB plan.

Reaching the Target Account Balance - Contribution Pattern – Contributions usually are a percentage of current compensation. That presents an immediate challenge, because DC plan contributions are not based on the highest 36 months average compensation at retirement but are based on actual compensation earned in each year of employment. (Pension folks call this a "career average" plan as opposed to "final average" plans that use HAC.)

Actuaries prefer to level out contributions over working lifetimes. Leveling may require a higher-than-wanted contribution in the early years of a career. Alternatively, the contribution percentage can be varied over a working lifetime. It should be possible to model a standard career and compensation progression

52 This limit is for an employee who is "eligible" for Social Security. The limit is $132,120 for a member show is not so eligible. We do not know what "eligible" means. There are a number of questions that must be addressed by the Director of Finance about who is "eligible". For example: is it only a member who is currently covered by Social Security as a public sector employee? Is it a member who earned Social Security in prior private sector employment and is not covered in public employment? What if a member is not eligible for Social Security for 30 years and then his/her agency elects to join Social Security? Does "eligible" mean eligible to receive full Social Security benefits without the adjustment under Social Security made for public employees (the WEP adjustment)?

53 Suppose the accrual rate is not 2% but is 2.5%. After 35 years, the benefit would be 87.5% and that could not be paid under the proposal. But actuaries can design formulas that "front load" the accrual rate or "backload" the accrual rate to get 75%. For example, with frontloading the first 18 years of service could accrue at 2.5% and the last 17 years could accrue at 1.76%. With backloading the pattern would be reversed. Both of these types of patterns – with multiple variations – are used in the private sector, though backloading is more common to reward longer service employees.

to determine how the percent of compensation contribution should change. It is unlikely that a standard progression will fit all, particularly those who lag or excel in their career. Again, the question is the meaning of "target." If the target is very soft, the Director of Finance can just use a standard career progression for the plan design.[54]

Reaching the Target Account Balance - Account Earnings – Any model used to determine the contributions needed to reach a target account balance must include earnings assumptions. Assumptions and actual earnings never match.

What happens under the hybrid plan for the employees who retire in another 2008 year? Will they be protected or not? What happens for the employees who retire in another boom period – will they be allowed to keep their gains? What happens if the earning rate assumed is 5% but employees make bad investment choices (or just very conservative investment choices) and earn much less?

Again, these questions really are questions about the meaning of "target" and again presumably the Director of Finance will decide.

Additionally, systems and employers (and the Director of Finance) may wish to consider whether all of the assets in the DC component should be professionally managed instead of giving members an array of mutual funds to choose from (or even allowing complete individual choice of traded securities). Generally, professionally management yields a much better result than individual selection.

Cost of the DC Component – The Labor Department has just issued final regulations on a hotly contested issue for ERISA-covered DC plans: the real cost of administration and investment. These regulations newly require full disclosure of all costs. Some vendors are taking advantage of these new rules by providing very low cost DC plan administration bundled with index fund investing. Examples are Vanguard and Charles Schwab. We expect that there will be significant changes in the DC plan market soon and this could influence the DC component of the hybrid plan.

Fiduciary Considerations – Both the Labor Department and the courts, under ERISA, have ruled that as a fiduciary matter, whoever chooses the way that the DC plan component is designed and administered must carefully watch the market to ensure that the best program is being provided. This is not just a one time, initial choice issue, but must be done on a regular ongoing basis. We expect this same fiduciary requirement will apply under California law to the DC component of a hybrid plan.

54 If the goal is a real target, then employees who receive substantial promotions at the end of their careers will need substantially higher DC plan contributions in a short period. The tax law may prevent this under section 415(c) of the Internal Revenue Code.

Hanson Bridgett's Employee Benefits Practice

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