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Monthly Newsletter – Volume 2, No. 6 – June 6, 2006

Highlights of the Month

1. Xerox's Phantom Accounts Used to Calculate Rehired Employees' Retirement Benefits Held Invalid Under ERISA
2. PBGC Finalizes Rule Requiring Mandatory Electronic Filing
3. IRS Official Addresses Timely Response on Employee Plan Ruling Requests
4. Supreme Court Issues Ruling on Subrogation
5. IRS Issues Proposed Regulations on Dependent Care Expenses

Xerox's Phantom Accounts Used to Calculate Rehired Employees' Retirement Benefits Held Invalid under ERISA

The Ninth Circuit Court of Appeals recently ruled that Xerox had violated ERISA in calculating rehired employees' retirement benefits (*Miller* v. *Xerox Corporation Retirement Income Guarantee Plan* (2006, CA 9) 2006 WL 1215764). The Court held that the methodology for calculating the rehired employees' benefits violated the actuarially equivalency requirements because the employee's benefits were reduced by more than the pension benefit attributable to the earlier distributions.

Facts

Waldamar Miller, William Sudduth, Jr. and J. Denton Allen worked for Xerox for several years. They left Xerox in 1983 and received pension payouts for their accrued pension benefits at that time. They returned to work at Xerox many years later. While employed at Xerox they participated in the Xerox Corporation Retirement Income Guarantee Plan ("IGP") which is a defined benefit plan and the Xerox Corporation Profit Sharing Plan ("PSP"). Their benefits under the IGP were based on a percent of their salary for each year of service at Xerox according to the benefit formula in the IGP. Each of them also had an account in the PSP.

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The IGP and the PSP were linked in a floor offset arrangement. Under this arrangement each retiree would receive the value of his PSP account supplemented by the value under the IGP formula to the extent it exceeded the PSP account. When each employee left in 1983, they received a lump-sum distribution from the PSP because it exceeded the lump-sum present value of each employee's accrued benefit under the IGP. Therefore, no payment was made from the IGP.

In 1989 Xerox amended and consolidated the plans. The IGP formula was amended and the PSP was replaced with two new accounts within the IGP: the Cash Balance Retirement Account ("CBRA") and the Transitional Retirement Account ("TRA"). For employees who had terminated service with Xerox prior to the plan amendment and had received a distribution of benefits, Xerox reduced their final benefit to account for the earlier retirement distribution by using "phantom accounts." Phantom accounts under the CBRA and the TRA were calculated based on the actual distribution amount paid to the employees at the time of separation from service plus the increase or the decrease that the distribution would have earned if it had remained in each plan.

Under the amended IGP, the relevant phantom account was added to the amount of each participant's benefit. The participant was given the benefit that yielded the highest monthly payment (with the phantom accounts included), and the phantom account was then subtracted out to yield the actual benefit amount.

The benefits payable to the employees were significantly reduced as a result of the phantom account offset. For example, Sudduth's monthly benefit was reduced from $1,680 to $83.

The employees sued in federal district court. The district court ruled in favor of Xerox and the employees appealed to the Ninth Circuit.

Ruling

The Ninth Circuit stated that while ERISA permits floor offset arrangements, the defined benefit and defined contribution portions must each satisfy the ERISA requirements applicable to the respective types of plans. The 1983 distributions were intended to satisfy Xerox's obligations under both the PSP and the IGP even though they were made solely from the PSP. For the lump-sum distributions to have satisfied the employees' vested IGP benefits, the lump sum must have been actuarially equivalent to those benefits in order to comply with ERISA's requirements.

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The court stated that it was appropriate to reduce the future retirement benefits to account for the prior distribution. However, the value of their PSP balances exceeded the accrued benefit which they were guaranteed under the IGP formula and the PSP distributions substituted for the lump-sum equivalent of the IGP formula. The portion of the PSP distributions that exceeded the lump-sum equivalent value of the IGP annuity represented a payment from a defined contribution plan not any portion of a benefit under the IGP formula. The court further stated that the excess distribution and any change in the value of the distribution should not affect the amount of the accrued benefit under the IGP formula. Therefore, Xerox could not use a projected-to-the-present value generated from a phantom account as a proxy for the actual distribution amount.

The court held that Xerox could subtract from the final defined benefit only the accrued benefit attributable to the prior distribution. Xerox's phantom account offset exaggerated the amount of the accrued benefit under the IGP attributable to the employees' PSP distributions, by deducting from the employees' final benefits the accrued benefit attributable to the earlier distribution's hypothetical value at final retirement, rather than the benefit attributable to the distribution itself. Therefore, Xerox was only entitled to subtract from the employees' final benefits the value of the IGP accrued benefit that was previously distributed. Xerox's approach was impermissible because ERISA requires actuarial equivalence between the actual distribution and the accrued benefit it replaces.

PBGC Finalizes Rule Requiring Mandatory Electronic Filing

PBGC issued a final rule that requires sponsors of insured defined benefit plans to submit their premium filings electronically. For large plans, the filing requirement is effective for 2006 plan year filings that are made on or after July 1, 2006. For smaller plans the rules apply for plan years beginning on or after January 1, 2007. A large plan is defined as a plan with 500 or more participants. The final rule adopts the proposed rule that was issued in March 2005 with some modifications.

In 2004, PBGC introduced an on-line filing facility called "My Plan Administration Account" ("My PAA") through which plan administrators could prepare and submit premium filings electronically. The use of My PAA was optional and plan administrators could still file paper forms. Premium payments can be made either through My PAA (by credit card, electronic check, or Automated Clearing House (ACH) transfer) or outside of My PAA (by paper check or wire transfer).

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IRS Official Addresses Timely Response on Employee Plan Ruling Requests

Joseph Grant, Director of IRS Employee Plans, Office of Rulings and Agreements, spoke to the Washington, DC Bar Association on May 2nd regarding new developments and to share his vision of the future with practitioners. Mr. Grant became director in August 2005.

Mr. Grant stated that it currently takes an average of 286 days from the time the IRS receives a determination letter request to the time the determination letter is issued. He said that the open inventory for determination letter requests is approximately 10,000. He believes that this time lapse will improve based on the new EPCRS revenue procedure. He also stated that there are approximately 1200 determination letter requests for cash balance plans and that many have been there for several years. Mr. Grant said that the final resolution for the cash balance plans will depend on the current pending legislation.

Mr. Grant said that it was also taking longer to process voluntary compliance cases. In the last 6 months, the average time to process a voluntary compliance case was 413 days. He has set a goal of reducing the response time to 120 days but said that the practitioners should expect the process to take longer if they do not cooperate with EP's requests for information.

Mr. Grant said that private letter ruling requests were taking more than 18 months to process.

Supreme Court Issues Ruling on Subrogation

On May 15th the Supreme Court issued a unanimous decision in *Sereboff v. Mid Atlantic Medical Services, Inc. (MAMSI)*. The Court held that an administrator of a group health plan may enforce plan provisions that require participants who recover damages from third parties who injured them to reimburse the plan for what it paid for their care.

Facts

Ms. Sereboff was injured in a car accident and MAMSI's group benefit plan paid for approximately $70,000 in medical expenses related to the accident. Ms. Sereboff filed a lawsuit against various third parties involved in the accident and eventually settled the lawsuit for $750,000.

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MAMSI's group benefit plan contained a reimbursement provision requiring a beneficiary who is injured as a result of the act or omission of a third party, and who receives benefits under the plan for those injuries to reimburse the plan for these benefits from "all recoveries from a third party (whether by lawsuit, settlement or otherwise)." When MAMSI learned that Ms. Sereboff filed the lawsuit, the plan administrator sent a letter to her attorney asserting a lien on any anticipated proceeds from the suit for medical expenses incurred.

Ms. Sereboff's attorney distributed the settlement proceeds to her. MAMSI secured a court order that required her to keep $70,000 from the settlement proceeds in an "investment account" until the merits of the reimbursement action were decided.

Ruling

The issue in the *Sereboff* case was whether the plan was entitled to recover from Ms. Sereboff the money paid to treat her injuries. Under ERISA a plan is entitled to seek equitable relief. Therefore, the issue before the Supreme Court was whether the reimbursement could be considered equitable relief. The Court concluded that the reimbursement was equitable relief under ERISA and then focused on whether the funds in Ms. Sereboff's control were specifically identifiable. The Court concluded that since the funds were specifically identifiable and in the possession and control of Ms. Sereboff the action to obtain these funds by the group benefit plan was considered equitable relief.

The Court was able to distinguish this case from its decision in *Great-West Life & Annuity Insurance Co. v. Knudson* (*"Great-West"*) in which the Court held that a similar subrogation/reimbursement provision could not be enforced under the facts of the case. In *Great-West* the funds that Great-West sought to recover were not in the beneficiaries' possession but were instead in a "Special Needs Trust" under California law. Therefore, the beneficiaries did not have possession of the funds and the attempt by Great-West to recover money from them was an attempt to impose personal liability which is a legal remedy that is not available under ERISA.

Plan Design Issues Based on Ruling

You should consult with the plan's legal counsel about incorporating language into the plan document's subrogation clause that permits the plan to bring an action to obtain a constructive trust or equitable lien. The plan should also contain language that requires the beneficiary to notify the plan administrator when he/she initiates a third party action to recover damages.

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IRS Issues Proposed Regulations on Dependent Care Expenses

On May 24, 2006 the IRS issued proposed regulations regarding dependent care expenses. These proposed regulations take into account the legislative changes that have occurred since the original regulations were issued 22 years ago. These regulations deal with the requirements that a taxpayer must meet to claim the dependent care tax credit. These rules are similar but not identical to the requirements for expenses to be reimbursable under a Dependent Care Assistance Program ("DCAP") which includes Dependent Care Flexible Spending Accounts. The proposed regulations are not effective until published in final form.

In order for the expenses to be deductible/reimbursable, the expense must be employment-related. These expenses must be for household services and expenses for the care of a qualifying individual, but only to the extent incurred to enable the taxpayer to be gainfully employed.

Who is a Qualifying Individual?

The first issue that needs to be addressed is who is a qualifying individual. The regulations define a qualifying individual as any of the following:

- The taxpayer's dependent who is under age 13; or
- The taxpayer's spouse or dependent who is physically or mentally incapable of caring for himself/herself and who has the same principal place of abode as the taxpayer for more than 6 months during the taxable year. An individual is physically or mentally incapable of self-care if, as a result of a physical or mental defect, the individual is incapable of caring for their own hygiene or nutritional needs or requires full-time attention of another person for the individual's own safety or the safety of others.

Whether an individual is a qualifying individual is determined on a daily basis. For example, if a spouse is injured in a car accident and unable to care for himself/herself on August 20th, then he/she is a qualifying individual from August 20th through December 31st of the taxable year.

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What is Gainful Employment?

The next issue that must be addressed is the gainfully employed requirement. The proposed regulations state that employment can consist of services within or outside the taxpayer's home and includes self-employment. In addition, actively seeking gainful employment also counts. However, working for nominal compensation or working as a volunteer does not count. Additionally, the expense must be incurred to enable the individual to be so employed. This determination is made on a facts and circumstances basis and the test is applied on a daily basis.

The proposed regulations provide that dependent care expenses for a period during which the taxpayer is absent from work (whether paid or unpaid) are not employment related. For administrative convenience, however, the regulations disregard short, temporary absences from work, e.g., vacation or minor illness, for taxpayers who must pay for dependent care on a weekly, monthly, or longer basis. In addition, if a taxpayer works part time but is required to pay for dependent care on a periodic basis, e.g., weekly, monthly, that includes both days worked and days not worked, the proposed regulations do not require the taxpayer to allocate expenses between work and non work days.

What types of expenses are allowed?

Expenses have to be for the care of a qualifying individual or for household services provided in connection with the care of a qualifying individual. The proposed regulations clarify that expenses that relate to but are not directly for the care of a qualifying individual may be employment related expenses. These types of indirect expenses would include application fees, agency fees, and deposits. However, if the care isn't ultimately provided, then these types of indirect expenses are not allowed.

The proposed regulations provide that expenses of programs pre-kindergarten may be employment related and will qualify for reimbursement even though education may be a significant part of these programs. However, kindergarten expenses are primarily educational and do not qualify for reimbursement. Additionally, after-school care expense may qualify as employment related expenses. The cost of a day camp can also qualify even though the camp specializes in a particular activity, e.g., soccer or computers. The cost of transportation to or from day care or a camp that is furnished by the provider can also qualify as employment related expenses.

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