



*Let us help you manage your benefits cost and risk.*

## Monthly Newsletter – Volume 2, No. 7 – July 5, 2006

### *Highlights of the Month*

1. PBGC Finalizes Rule on Computing Liability When Employer Ceases Operations at a Facility
2. IRS Provides Guidance on Tax Consequences of Major Disaster Leave-Sharing Plans
3. GAO Issues Report on the Growth of Employer Spending on Benefits
4. Recent Court Decision in Hedge Fund Case
5. Court Decision Highlights the Need for Clarity in the Summary Plan Description

### **PBGC Finalizes Rule on Computing Liability When Employer Ceases Operations at a Facility**

PBGC finalized the rule on computing liability when employers with underfunded pension plans close down a facility or lay off a significant percentage, i.e., 20%, of their workforce. ERISA section 4062(e) requires special computations in situations where an employer ceases operations at a facility that results in a reduction of more than 20% of the number of employees who are participants in the employer's defined benefit pension plan. When this type of event occurs the employer is treated as if it were a substantial employer under a plan where more than one employer makes contributions.

The first step is the calculation of the total liability amount which is determined by treating the plan as though it was terminated immediately after cessation of the operation of the facility. This liability amount is multiplied by a fraction. The numerator is the number of employees who are participants under the plan who are separated from employment as a result of the cessation of operations. The denominator is the total number of employees who were active participants in the plan prior to the cessation of operations of the facility. Retirees and other former employees who separated from service prior to the cessation of operations are not included in the denominator.

For example, XYZ Company sponsors a pension plan with 50,000 participants. Of the 50,000 participants only 20,000 are current employees and 30,000 are retirees or deferred



*Let us help you manage your benefits cost and risk.*

Monthly Newsletter – Volume 2, No. 7 – July 5, 2006

vested participants. PBGC's determination basis indicates that the plan is underfunded by \$80 million. XYZ Company ceases operations at one of its facilities which employs 5,000 employees who are all participants in the plan. Under the final regulations, the numerator of the fraction is 5,000 and the denominator is 20,000. Thus the amount of liability is 5,000/20,000 times \$80 million or \$20 million.

The final rule is effective for Section 4062(e) events occurring on or after July 17, 2006.

### **IRS Provides Guidance on Tax Consequences of Major Disaster Leave-Sharing Plans**

IRS issued Notice 2006-59 (June 20, 2006) which provides guidance on the federal tax consequences of arrangements under which employees may deposit leave in an employer-sponsored leave bank for use by other employees who are adversely affected by a "major disaster" as declared by the President of the United States. As long as the requirements in the guidance are met, the IRS will not consider the leave donations as taxable income for the donors. The leave donations must be made to "major disaster leave-sharing plans." In addition, the employee must be "adversely affected" by a major disaster. This means that the employee must be absent from work because the disaster caused severe hardship to the employee or a family member.

The following requirements must be met for the arrangement to qualify as a "major disaster leave-sharing plan":

- ❖ The plan must be in writing;
- ❖ Payments under the plan to the leave recipient are taxable wages for FICA, FUTA and income tax withholding;
- ❖ Donated leave must be used for disaster-related purposes and may not be converted into cash but can offset a negative leave balance or be substituted for unpaid leave;
- ❖ The plan must adopt reasonable time limits on the deposit of leave and use of donated leave following a disaster and the employer must make a reasonable decision on the amount of leave provided to a leave recipient;
- ❖ An employee cannot donate leave in excess of his/her leave accrual during the year;
- ❖ Employees who donate leave cannot designate specific leave recipients;
- ❖ Leave deposited on account of a disaster is only available to employees affected by that disaster; and
- ❖ Any leave donated that is not used within the applicable time limit must be returned pro rata to leave donors for that disaster.



*Let us help you manage your benefits cost and risk.*

Monthly Newsletter – Volume 2, No. 7 – July 5, 2006

This guidance provided by the IRS contains more detail and has a broader application than the prior IRS guidance under Revenue Ruling 90-29, 1990-1 C.B. 11.

## **GAO Issues Report on the Growth of Employer Spending on Benefits**

The Government Accountability Office (GAO) issued a report, “Employee Compensation: Employer Spending on Benefits Has Grown Faster Than Wages, Due Largely to Rising Costs for Health Insurance and Retirement Benefits.” This report identified: (1) recent trends in employers’ total compensation costs; (2) the composition of the trends; (3) whether employees’ costs, participation, or access to benefits have changed; and (4) the possible implications of those changes for private systems.

GAO examined federal data on private employers’ costs for current workers in private industries, and sought perspectives from a panel of 17 experts from a variety of backgrounds.

The report stated that private employers’ average inflation-adjusted real cost of total compensation (comprising wages and benefits) for current workers grew by 12% between 1991 and 2005. However, increases in benefit costs outpaced wages in recent years. Wages and benefits increased by about the same percentage for most of the period until 2002. Beginning in 2002 wages began to stagnate and real benefit costs continued to grow.

The primary drivers of the increase in the cost of a total benefits package were health insurance and retirement income costs. When added to paid leave, these benefits comprised almost 60% of benefit packages. Historically paid leave had been the most costly benefit to employers. However, by the end of 2005 the cost of health insurance equaled that of paid leave. This is partly the result of health insurance costs growing by a rate of 28% (adjusted for inflation) since 1991 while the costs for paid leave grew by only 5% (adjusted for inflation).

During the period covered by the report, employees’ access to most benefits remained stable, but participation rates declined for health benefits, greater cost shifting to the employees, and employees have assumed greater investment risk. The study indicated that employers have continued to pay approximately the same percentage for health insurance; however, the amount paid by the employees has increased as a result of higher overall premiums. Additionally some employees have seen increases in their deductibles and out of pockets.



*Let us help you manage your benefits cost and risk.*

Monthly Newsletter – Volume 2, No. 7 – July 5, 2006

Approximately 50% of all workers participated in employer provided retirement plans but there was a greater prevalence of defined contribution plans. This means that the employees are assuming greater investment risk and responsibility for their retirement income.

Finally, the report noted that employers may try to remain globally competitive by limiting increases in compensation to offset the higher benefit costs. In order to control total compensation expenses employers may locate some or all of their production activity overseas and or use more contingent workers to offset increased benefit costs. The panelists also stated that employers are concerned about taking on long-term liabilities, such as retiree medical and defined benefit pension plans.

### **Recent Court Decision in Hedge Fund Case**

Does your retirement plan invest in hedge funds or are you thinking about allocating a portion of your retirement plan's assets for investments in hedge funds? If so, you should be aware of a recent court decision that overturned the SEC's new rule which required the majority of unregistered hedge fund managers to register as an investment adviser with the SEC.

In December 2004 the SEC adopted a new rule under the Investment Advisers Act of 1940 (the "Advisers Act") that required most hedge fund managers to register with the SEC. The Advisers Act gives the SEC the authority to regulate an investment adviser with more than 15 clients. Under the Advisers Act, a registered investment adviser has to file an annual form (ADV) with the SEC that describes their office locations, what types of money they manage, and whether they are felons. In addition, the Advisers Act requires a registered representative to develop a code of conduct and identify a chief compliance officer.

Prior to the issuance of the new rule most hedge fund managers had used the de minimis exception under the Advisers Act. Until the new rule was issued in December 2004 both the industry and the SEC had considered the hedge fund as a single client. The new rule required that the hedge fund adviser look through the hedge fund to determine the number of clients, i.e., beneficial owners of interests in the hedge fund became clients for purposes of registration under the Advisers Act. The first registration was due in February 2006 under the new rule.

Almost as soon as the new rule was issued Philip Goldstein who is the principal of a hedge fund investment advisory firm filed suit against the SEC alleging that the SEC had overstepped its regulatory authority by effectively redefining the term "client," a term



*Let us help you manage your benefits cost and risk.*

Monthly Newsletter – Volume 2, No. 7 – July 5, 2006

that is not specifically defined in the Advisers Act. On June 23<sup>rd</sup> the U.S. Court of Appeals for the District of Columbia unanimously vacated the new rule and remanded it to the SEC for further review. The SEC has not stated whether it will appeal the Court's ruling.

## **Court Decision Highlights the Need for Clarity in the Summary Plan Description**

A recent decision by the Second Circuit highlights the need for a plan's Summary Plan Description (SPD) to be clear. In *Wilkins v. Mason Tenders' District Council Pension Fund* (2006, CA2) 445 F.3d 572, 2006 WL 1046210, the Second Circuit held that a union-administered pension plan was not required to continually conduct employer audits to determine whether employers were accurately reporting employee earnings to the plan. However, the failure to disclose the pension plan's policy that required participants to prove their entitlement to additional benefits when the employer underreported earnings in its SPD violated ERISA and that the participant could potentially be awarded damages based on the SPD violation.

The plaintiff in this case worked in construction trades from the 1950s until the 1980s and belonged to a Mason Tenders (the "Union") Local during that time. The Mason Tenders District Council Pension Fund (the "Plan") provided retirement benefits for members of the Mason Tenders locals. As is commonly the practice, construction trade workers work for many different employers during their working lives. Some of these employers have collective bargaining agreements (CBAs) with the various trade unions and others do not.

In this case Abraham Wilkins worked for several employers who had CBAs with the Union. The CBAs required the employers to contribute to the Plan based on their employees' covered employment. Under the terms of the Plan, employees' retirement benefits were based on the number of pension credits. Basically, participants were awarded one pension credit for every 150 hours or \$750 worth of covered employment.

The Plan conducted random audits of contributing employers' payroll records to determine that the employer was reporting employee wages accurately. In Wilkins case there was a significant difference between the earnings that the employers reported to the Plan and to the Social Security Administration (SSA). Since the contributing employers were only required to report earnings for covered employment to the Plan, the discrepancy could have represented work that Wilkins performed for other unions.



*Let us help you manage your benefits cost and risk.*

Monthly Newsletter – Volume 2, No. 7 – July 5, 2006

In 1999, the Plan paid Wilkins a lump-sum benefit which was based on pension credits earned in 1962, 1963, and 1965. Based on the Plan's records Wilkins' earnings for the other years were insufficient to qualify for pension credits. Wilkins filed an appeal in 2001 which claimed additional benefits based on the discrepancy between the Plan's records and the SSA records. The Plan required claimants to prove their entitlement to additional benefits that had been underreported by their employers. Wilkins had not kept copies of his earnings records from his various employers. Therefore, the Plan denied his claim for additional benefits.

Wilkins brought suit in district court for a wrongful denial of benefits and sought equitable relief. The complaint alleged that the Plan had violated its fiduciary duties by failing to audit the employers' reporting of covered employment, failing to maintain the records of audits it did conduct, and failing to publish the policy in the SPD. The district court granted summary judgment in the Plan's favor.

In its decision, the Second Circuit agreed with the district court with respect to the audit requirement. The Second Circuit held that the trustees could conduct random audits of contributing employers and still meet their fiduciary obligations to ensure that the Plan receives all monies to which it is entitled.

However, the Second Circuit disagreed with the district court ruling regarding deficiencies in the Plan's SPD. The Second Circuit stated that the policy of requiring the participants to prove they had covered employment when the contributing employers underreported hours and wages should have been disclosed in the Plan's SPD. The Second Circuit based its holding on the fact that the Plan's SPD did not even mention the policy let alone make clear to participants that without the proof of covered employment their benefits could be reduced or be nonexistent. Therefore, the court held that the SPD fell short of the high standards of clarity and completeness that ERISA requires.

The case was remanded to the district court for a determination as to whether the omission in the Plan's SPD adversely impacted Wilkins and, if so, the district court was directed to determine the amount of additional benefits due Wilkins.