BCG Retirement News Roundup

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Boomershine Consulting Group (BCG) has launched this monthly news roundup of highlighted significant articles from the retirement industry – for clients and friends. Retirement plan news has become increasingly pertinent for many audiences these days, including:

- Retirement Plan Sponsors – addressing both private and public sector issues
- Employers – dealing with complicated decision making for their plans
- Employees – educating the Boomer generation that is nearing retirement
- Industry Practitioners - helping to understand and resolve today's significant challenges

We review numerous industry news services daily and will include a collection of timely and significant articles each month concerning compliance, actuarial plan costs (including assumption debates), plan design change issues and benefit trends, as well as other related topics.

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THE REAL HISTORY OF PUBLIC PENSIONS IN BANKRUPTCY

There appears to be a frenzy of comments lately that public retirees receive excessive pensions in the current economy, and that they need to be reduced. Reuters.com says that many in the media have taken a brief look at Detroit, and decided that costly pensions were the cause of the city's bankruptcy. Nothing could be farther from the truth. Detroit pays a relatively modest median pension of $19,000 a year to general government retirees and $30,000 to police and fire retirees. Detroit's general employees pension system was funded at 82% in 2011 (99% for police and fire). That level is higher than the national median of 74%. Public benefits make easy targets for critics. Here is a little tour of pensions in bankruptcy through the years.

- Prichard, Alabama, which experienced a population decline of approximately 50% over the past 50 years, filed for bankruptcy in 1999 after it was unable to pay approximately $3.9 million in delinquent bills. In addition to the unpaid bills, Prichard also admitted not making payments to its employees' pension funds, and, even though the city had withheld taxes from employees' paychecks, it failed to submit such withholdings to the state and federal governments. Although the city successfully revised its budget, it was still unable to meet its pension obligations. So, in 2009, Prichard filed for bankruptcy again, to stay a pending suit brought by its pensioners after it failed to make pension payments for six months. Prichard had failed to make a $16.5 million payment to its pension fund under its previous plan of adjustment. Prichard has not yet met the court's eligibility requirements for the second bankruptcy, and pensions have not been paid, leaving retirees to struggle.

- Central Falls, Rhode Island's bankruptcy began in August 2011, when the city of 18,000 declared bankruptcy. At the time, it had a debt of $21 million, an unfunded pension liability of $80 million and an annual budget deficit of $5 million. Under the Chapter 9 bankruptcy filing, the state-appointed overseer, slashed the pensions of police and fire retirees by as much as 55%. Retiree representatives say cuts to pensions were rammed through with no time to study the matter or offer to negotiate. There was a single meeting during which the cuts were spelled out. It turned out to be a take-it-or-leave-it proposition.

- In a very unusual case, Vallejo, California, exited bankruptcy after actually paying more for pensions. Vallejo recently received court approval to exit from bankruptcy with a plan that includes a sharp increase in pension payments to California Public Employees' Retirees System, the opposite of what many expected when the city declared bankruptcy in May 2008. Vallejo demonstrated that bankruptcy proceedings are not cookie cutter, and that their outcomes rely on many factors.

- Jefferson County, Alabama, the largest municipal bankruptcy until Detroit, actually did nothing to the city's pensions, and never even listed them as creditors.

Jefferson County pensions were funded at the approximate level of the Detroit Police and Fire Retirement System.

• Stockton, California, was recently ruled eligible to proceed into bankruptcy, but the pension issue is complex. The city manager and city council do not want to cut pensions after eliminating retiree health care benefits. City officials believe that it is vital to retain full pensions to attract top-notch public employees. Meanwhile, bond insurers appear to have convinced the bankruptcy judge that Stockton pensions should suffer haircuts if bondholders have to also. Yet the real story has yet to unfold: it must still be determined whether the city's creditors or its public employee retirement funds get paid off first. Since this is the first Chapter 9 bankruptcy case challenging state pension obligations, the issue is whether the 10th Amendment to the United States Constitution preserving states' rights trumps federal bankruptcy law. Thus, the case will likely end up before the U.S. Supreme Court.

• San Bernardino, California, filed for bankruptcy eligibility in 2012, but the city has numerous muddled issues related to pension obligations. The city stopped making pension payments to CalPERS last year, but it resumed these payments in July of this year. The city's approach to its large pension liabilities is unknown.

Detroit presents the only municipal bankruptcy case, other than Central Falls, where the bankruptcy manager has directly gone after the pension liabilities from the beginning of the proceedings. However, unlike Central Falls, Detroit's pensions are well-funded by national standards. It may also likely present state and federal legal issues if Detroit's pensions, enshrined in the state's constitution, are given haircuts. The treatment of public pensions is not as straightforward as many expect it to be. The show in Detroit is just beginning.

San Bernardino Wins Eligibility for Bankruptcy

LOS ANGELES — A federal bankruptcy court judge granted the city of San Bernardino eligibility for bankruptcy protection on Wednesday, raising the possibility that the city will propose a plan to dig itself out of debt by cutting money promised to the public pension system.

The ruling by Judge Meredith Jury came despite opposition from the powerful California Public Employees' Retirement System, more commonly known as Calpers.

San Bernardino, a working-class city of 240,000 about 60 miles east of Los Angeles, declared Chapter 9 bankruptcy last summer, saying it had effectively run out of money to pay for day-to-day operations, in large part because of pension obligations.

Lawyers for Calpers had argued that the city should not treat pension funds like other creditors. For the past year, Calpers has also argued that the city has not provided enough documentation for the court to rule in the bankruptcy case and that the city had ignored warnings about a financial crisis for years and filed for bankruptcy as a matter of convenience.

But in her ruling on Wednesday, Judge Jury said that it had been clear for months that San Bernardino was insolvent and that only its most recent financial predicaments were relevant.

“Because they didn’t do something then, doesn’t mean they can’t now,” Judge Jury said in the Riverside, Calif., courtroom. “The city desires and needs to formulate a plan; it is their only hope.”

All of the 10,000 creditors are better served by allowing the bankruptcy to go forward, Judge Jury added.

“I can’t see anything other than dissolving the city if they can’t reorganize under Chapter 9,” the judge said. “They can’t make cash where it isn’t. If they got all the money they want — who isn’t going to get paid? All the employees? I don’t know, how does that help Calpers if the employees aren’t paid?”

“The citizens of this city deserve a chance,” she said.

A similar court battle is brewing in Detroit, which in July became the largest city in the country’s history to file for bankruptcy.

City officials there have said that they will need to cut current and future pension benefits in bankruptcy. But public unions say that pension benefits are protected by Michigan’s Constitution. A federal bankruptcy judge is to hear initial oral arguments in the Detroit case on Sept. 18.

While the rulings in the San Bernardino case do not necessarily set a precedent for Detroit, the cases center on the same federal laws. Municipal finance experts say the issue of how public pension funds are handled after cities declare bankruptcy could find its way to the Supreme Court.

Last year, San Bernardino stopped making biweekly payments to Calpers, making it the first California city to do so. At roughly $260 billion, Calpers is the biggest pension fund in the country and is San Bernardino’s largest creditor.

Stockton, a Northern California city that declared bankruptcy in 2012, has continued to pay all money owed to the pension system, but the judge in that case has said the pension fund is likely to become a key issue for the city in its restructuring plan.

Many employees in San Bernardino left just before the city declared bankruptcy last year and received payments from the city, which Calpers argued gave preferential treatment to some employees and was a sign that the city was not acting in good faith. Judge Jury said that while the decision might not have been financially wise, it did not impede the city's ability to declare bankruptcy.

"The employees of the city weren't stupid," she said. "Anybody that had any other options was going to leave."

In a statement, Calpers said that it would participate in the bankruptcy proceedings and at the same time "aggressively pursue all past due contributions" and would consider appealing.

"These payments are statutorily required and necessary to deliver on the pension benefits promised to San Bernardino employees as a form of deferred compensation," the statement said. "They have worked for and earned these benefits."

By JENNIFER MEDINA
Published: August 28, 2013

Rising returns give US public pension funds chance to reform

Many U.S. public pension funds are benefiting from double-digit annual returns in fiscal 2013 that are giving them breathing space to try to implement reforms and fix gaping deficits.

A raft of pension reforms since the financial crisis by many U.S. state and local governments have not repaired their pension debt, a factor in the bankruptcies of Detroit, Michigan, and the California cities of Stockton and San Bernardino.

A 20 percent gain on the U.S. stock market in the twelve months to June is, however, alleviating acute funding gaps in many areas.

"It is a marathon, not a sprint," said Keith Brainard, at the National Association of State Retirement Administrators. "I do not think any one-year returns are likely to affect the thinking about pension reforms but we have seen very strong returns since the low point of the equity market in 2009 and it is encouraging," he said.

Recent reforms by many U.S. cities and states have seen retirement benefits for new hires cut, and their contributions into pension plans raised. It will be several years before these reforms start to have an effect on gaps in pension funding.

As well as stock market gains, pension funds are being helped by relatively low exposure to the struggling bond market.

In the last decade bonds held by public pension funds fell from around one third to around one fourth of assets as yields declined.

According to Wilshire Associate U.S. public pension funds have about 25 percent of assets invested in bonds, compared to an average of 37 percent for corporate funds.

(Read more: Investors eyeball French pension reform plans)

In the longer run, higher yields could even provide a boon for pension funds because of higher returns.

Funding gap could swell under new rules

Funds will need higher returns as they adapt to new accounting rules set to begin taking effect next year.

Alicia Munnell, at the Center for Retirement Research at Boston College, co-authored a report last month showing U.S. state and local public pensions would have been a paltry 60 percent funded in 2012 if measured by the new rules. That compares with an estimated 72 percent for fiscal 2012 under old rules.

The new rules have been issued by the Governmental Accounting Standards Board (GASB). One key provision is to slash projected rates of return for pension funds' unfunded portions from roughly 7.5 percent to a much lower market level. The move will greatly increase the amounts at which unfunded liabilities are calculated and the money states and cities will have to pay into their funds.

Munnell's study showed that if current projected return rates for public funds are reduced nationwide to five percent, the unfunded figure for America's public pensions jumps from $1 trillion (£641.56 billion) currently to $2.8 trillion.

Still, Munnell is warning against alarmism.

"Public plan sponsors have made numerous changes to reduce their pension costs in the wake of the financial crisis and ensuing recession. The market has performed well in the last few years. Let's give the plans the time and space to work their way back to more comfortable funding limits," Munnell said. The funded ratios of state and local pension funds was at 103 percent in 2000, after a decade-long bull market.

Returns could make or break reforms

So far this year, plans such as the California Public Employees' Retirement System, Florida's state fund, Ohio state teachers and Connecticut have reported returns well above 11 percent. Most others are expected to follow suit.

A recent report by Wilshire Associates found that in the 12 months preceding June all public funds had a median return of 12.4 percent, although that declined in the last quarter to just 0.24 percent.

Similar results are reported by Callan Associates, the San Francisco-based investment consulting firm.

A report by the credit rating agency Standard & Poor's said there are signs of stabilization in public pension underfunding.

John A. Sugden, primary analyst on the report, said signs were encouraging but warned against over-optimism.

"Good returns are a positive development," Sugden said. But he said recent reforms, where many states and cities have curbed benefits and increased contributions for new hires, will take a long time to produce results.

Rachel Barkely, a municipal credit analyst at Morningstar, said the new GASB accounting system and the stock market "are the two key factors that will drive the pension conversation for governments over the next few years."

Barkley said stock market returns could change if the Federal Reserve eases off its expansionary policy known as quantitative easing.

Published: Thursday, 22 Aug 2013 | 11:01 AM ET

New York's Pension Rates Decline for First Time in Five Years

The rate New York state and its local governments pay to the $160.4 billion pension fund will drop for the first time in five years, Comptroller Thomas DiNapoli said.

DiNapoli, the sole trustee of the plan, sets the rates employers pay every year to ensure obligations to retirees can be met. Rates paid by government employers outside New York City for the fiscal year that starts April 1 will fall to 20.1 percent of wages from 20.9

percent for most employees, and to 27.6 percent from 28.9 for police and firefighters, according to a statement e-mailed by DiNapoli today.

“The New York State Common Retirement Fund’s strong gains over the last four years have mitigated some of the impact of the financial market collapse of 2008-2009,” DiNapoli said. “Strong investment performance, along with revision in actuarial smoothing, has lowered the employer contribution rate.”

Under a new accounting method, the state assumes the entire fund will get the same annual rate of return, he said. Previously, the pension had separated assets into equities and non-equities when computing the assumed return.

New York’s counties, cities and towns, particularly those upstate, have been struggling to meet rising pension costs since the recession that ended in 2009 sapped them of property taxes. They were further restricted after Democratic Governor Andrew Cuomo pushed through a 2 percent property tax cap in 2011. The lower rates will relieve them of some costs, which have caused firings and credit-rating downgrades.

The fund provides retirement benefits to more than 1 million employees and retirees from state and local governments outside New York City, which has separate retirement plans.

By Freeman Klopott - Aug 27, 2013 11:45 AM ET

UPDATE 1-Judge speeds hearing on Detroit bankruptcy eligibility

Aug 27 (Reuters) - The federal judge overseeing Detroit's bankruptcy filing is accelerating the already hurried process of determining whether the city is eligible for protection from its creditors.

Judge Steven Rhodes ordered late Monday that initial oral arguments in the case begin on Sept. 18, well ahead of the Oct. 23 date he originally scheduled for the start of the trial on the issue of eligibility.

Detroit filed the largest municipal bankruptcy in U.S. history on July 18. Kevyn Orr, Detroit's state-appointed emergency manager, has said he wants the city to be out of bankruptcy court by the time his term as emergency manager is scheduled to end in the fall of 2014.

Monday's order was the latest sign that Rhodes wants to set an aggressive timetable to move the city through bankruptcy court.

"A prompt oral argument on these legal issues will promote just, speedy and efficient determination of the city's eligibility to be a debtor" under the bankruptcy code, Rhodes wrote on Monday.

Rhodes also said he would delay hearing objections to the bankruptcy that center on potential cuts to retiree pensions, which unions and retiree groups argue are protected by the Michigan state constitution.

The judge wrote in his order that he "appreciates the extraordinary importance of the pension rights," but he will not consider arguments about potential cuts to pensions until after he decides whether the city is eligible for bankruptcy.

The eligibility argument will center on whether Detroit is insolvent, whether the city negotiated in good faith with its creditors, or whether there were too many creditors to make negotiations feasible.

The bankruptcy code requires only that Detroit's emergency manager, Kevyn Orr, prove that the city is insolvent, Rhodes wrote, adding that the city does not need to "prove that any particular plan that it might later propose is confirmable."

Bill Nowling, Orr's spokesman, said Tuesday that delaying a decision on the pension funds until the city has filed a restructuring plan with the court was appropriate.

"We think the judge is absolutely right to say that that's a plan of adjustment issue and should be litigated during that phase of the proceedings."

Laura Bartell, a law professor and bankruptcy expert at Wayne State University in Detroit, said the judge's decision to postpone discussion of the pension issues was "logical."

In a June 14 report to the city's creditors, Orr said unsecured creditors, including pension funds, will receive a pro rata share of $2 billion of notes the city would issue and pay off as its financial circumstances improve.

City workers and retirees would also face changes to their pensions and health care coverage "consistent with available funding," Orr said at the time, which was before the city filed for bankruptcy.

Creditors filed 109 objections to the city's bankruptcy before the deadline last week. In their objections, unions and the city's two public pension funds made similar arguments, claiming a bankruptcy filing will lead to an unconstitutional reduction in retirement benefits.

The Sept. 18 hearing will be used to hear arguments on legal issues in the case raised by city labor unions and others, including the constitutionality of Chapter 9 municipal bankruptcy and of the Michigan law that allowed the city to file for bankruptcy.

The American Federation of State, County and Municipal Employees Council 25, in its filing with the U.S. Bankruptcy Court in Detroit, argued that Chapter 9 encroaches on states' rights.

AFSCME, as well as the United Auto Workers and the city's two retirement systems, also claimed that the state law Gov. Rick Snyder used to appoint Orr violated the state constitution.

AFSCME's Ed McNeil, the chief negotiator for a coalition of 33 unions that represent most of the service workers for the city, said in a statement that the union is concerned about the hasty schedule.

McNeil added that "the order does not prohibit us from making constitutional arguments or arguments about the pensions at the September 18 hearing."

Arguments objecting to the underlying facts in the case, such as whether the city negotiated with creditors in good faith, will be heard on Oct. 23, as originally planned.

AFSCME and the organizations representing retired Detroit police officers and firefighters also argued that Detroit has not proven it is insolvent and has not negotiated in good faith with its creditors.

Tue Aug 27, 2013 3:58pm EDT
By Joseph Lichterman

Private Sector

Some Pensions Embrace Riskier Assets

Thinly traded and hard-to-value investments such as real estate and private equity stakes are taking up a larger piece of the corporate pension pie. The shift lets companies chase higher returns for their plans, but merits a closer look because such assets can be risky, says Fitch Ratings.

Among 224 large corporate pensions studied by Fitch, plans were on average 8.5% invested in illiquid “Level 3” assets, a significant boost from 7.8% at the end of the year-earlier period. Some 66 of those plans held illiquid assets worth more than 10% of their plans, which Fitch says is concerning.

“Plans with more than 10% of assets in Level 3 assets may call for further investigation, because these include relatively illiquid holdings,” Fitch said in a research note. Pension plans at companies with lower credit ratings and higher near-term benefits obligations are the most at-risk, Fitch said.

Concentrations of illiquid assets could complicate business decisions. For example, if a company needed to sell or close a business line, triggering large one-time cash payments to pension plan beneficiaries that work in that unit, illiquid assets could make it hard to come up with the cash.

But retirees shouldn’t necessarily worry that a buildup of hard-to-value assets mean their plans won’t be able to meet obligations. Companies with pension funding difficulties could find themselves further underfunded if those assets become impaired, according to Don Fuerst, senior pension fellow at the American Academy of Actuaries. Mr. Fuerst couldn’t recall a case where this happened, however.

The Financial Accounting Standards Board requires companies to break down assets into three levels, according to how easy they are to price and sell. Such rules went into effect after the financial crisis froze markets for many inscrutable investments, such as mortgage-backed securities.

Fitch said the top five corporate pensions, in terms of the proportion of Level 3 assets to the total, are: Exelis Inc., at 45%; Hanesbrands Inc., 44%; Verizon Communications, 43%; Lorillard Inc., 38%; and Kroger Co., 37%.

“From a management standpoint, it doesn’t scare us,” Hanesbrands treasurer Donald Cook told CFO Journal. Most of its Level 3 assets are in “hedge fund of funds,” or investments products that allow companies to invest in a basket of hedge funds simultaneously, he said, and just 5% or so of the pension’s assets are in real estate.

Mr. Cook said half of the Hanesbrands’ plans’ roughly $644 million in assets can be liquidated immediately, with the cash received a few days later when the trade settles, Mr. Cook said. He added that another 25% of the assets can be turned into cash in one quarter or sooner.

Pension managers typically do a good job of keeping the funds liquid enough to meet their liabilities as they come due, industry watchers say.

Although hedge funds are considered Level 3, valuing them correctly isn’t terribly difficult as they typically bet on and against stocks, said Scott Henderson, vice president of pension and investment strategy for grocer Kroger.

Mr. Henderson said investment-grade rated Kroger isn’t concerned about its plan, which had about $2.7 billion in assets at the end of its fiscal year in February. But he said Fitch is correct that companies with sizable Level 3 assets and a combination of low credit ratings and weak cash flow, or whose pensions are underfunded, have reason to worry. If Kroger found itself in such a situation, he said, “We would move away [from such investments].”

Spokesmen for Exelis, Verizon and Lorillard declined to comment. Companies are required to update their pension funding levels and broadly categorize their asset classes annually.

Hanesbrands’ Mr. Cook said the undergarment and casual-apparel maker, which was spun off with a large debt burden from what was then Sara Lee Corp. in 2006, decided to try “to get a nice risk-weighted return” for its pensions. By choosing hedge funds that can both buy long-term positions and sell short stocks, the company’s returns have outperformed long-only funds, he said.

Wednesday, September 4, 2013 As of 12:46 PM EDT

Appellate ruling changes game for private equity
Portfolio companies' pension obligations now funds' liability

Private equity funds face increased risk of being on the hook for their portfolio companies' pension liabilities following a federal appeals court ruling that is also raising broader questions about tax exposure for private equity partners and their investors.

The 1st U.S. Circuit Court of Appeals in Boston ruled July 24 that a private equity fund could have joint and several liability for its portfolio companies' pension obligations if the fund holds a sufficient stake in the companies. While the appeals court did not define the size of a stake, legal experts say 80% is considered typical.

The ruling in Sun Capital Partners III LP vs. New England Teamsters & Trucking Industry Pension Fund is considered precedent-setting because it is the first such decision at the appeals court level. It overturns a 2012 district court ruling stating private equity firms did not operate as “trades or businesses,” but rather were passive investors and therefore did not have liability for portfolio companies' pension liabilities.

The U.S. District Court for the District of Massachusetts now will have to address the issue of ownership control in this specific case, and Sun Capital has requested a circuit court rehearing on the “trade or business” issue.

“This is an important precedent for defined benefit plans and scary for private equity funds and their investors,” said David Fann, CEO of TorreyCove Capital Partners LLC, San Diego, a private equity investment consultant.

In addition to the legal uncertainty that could complicate future buyouts of companies with pension plans covered by the Employee Retirement Income Security Act, “one major consequence,” said Mr. Fann, “is that private equity investment returns could be lowered materially if pension liabilities of underperforming companies are borne by private equity funds.”

That prospect has also occurred to private equity investors, who are waiting for further legal clarification “This area of the law is new and still developing. We are working with counsel to determine the impact to our private equity program,” said Jeanne Chenault, spokeswoman for the $59.1 billion Virginia Retirement System, Richmond, which has a 9% private equity allocation. “It is on our radar.”

The Sun Capital Partners case rose to the circuit court level in a challenge by pension fund officials seeking $4.5 million in withdrawal liability for Rhode Island metal fabricator Scott Brass Inc. The company, which declared bankruptcy in 2008, was a portfolio company of two Sun Capital funds, which in 2006 invested $3 million in cash and borrowed another $4.8 million that resulted in one fund owning 70% of Scott Brass and the other owning 30%. According to court documents, Sun funds lost their entire investment in Scott Brass as a result of the involuntary bankruptcy.

PBGC support

The Pension Benefit Guaranty Corp. supported the Teamsters pension fund challenge. PBGC officials worried that the lower court ruling would create a major loophole for private equity owners to walk away from benefit obligations.

The PBGC, when it is an unsecured creditor, has more forcefully argued in bankruptcy courts since 2007 that private equity funds are “trades or businesses” that should be held liable for pension withdrawal liabilities. Legal experts note that the counterargument by private equity firms that they are not trades or businesses has been the first-line of defense against pension liability, until now.

“There is no doubt that the ruling could potentially have important implications for the private equity and growth capital industry within the ERISA context, even though it only applies in the 1st Circuit,” said Steve Judge, president and CEO of the Private Equity Growth Capital Council, the industry's Washington advocacy group. The PEGCC filed an amicus brief in the circuit court case in support of Sun Capital, arguing that the ruling raised a question of “exceptional importance ... with the potential to effect a major shift in liabilities.”

“One plainly has to take this development seriously,” said Jonathan Zorn, a partner in the tax and benefits department of law firm Ropes & Gray LLP, Boston. “The (1st Circuit) case got everyone's attention, and highlights the importance of considering ERISA liability when structuring private equity investments. You have to ask yourself, "How easy will it be to draw a clear, distinguishing line?'”

Ronald Sussman, a partner in the corporate restructuring group of law firm Cooley LLP in New York and chairman of the Turnaround Management Association, which represents corporate turnaround and restructuring professionals sees “a whole lot of inventory” of distressed companies with defined benefit plan liabilities that could fuel those legal challenges following the circuit court's ruling. “As a bankruptcy litigator, the question for me is, "Why should private equity be different?'”

Mr. Judge dismisses speculation that the issue of who controls the portfolio company will spill over to tax issues, but Steven Rosenthal, a tax lawyer and visiting fellow at the Tax Policy Center in Washington, calls that “wishful thinking.”

“The fundamental issue here is that the private equity firms promise their investors that they will actively manage these companies. I think there is tax exposure here that the private equity lawyers have downplayed,” said Mr. Rosenthal.

Lower tax rates

Currently, the profit share paid to a private equity fund's managers is typically taxed at lower long-term capital gains rates. If those managers are viewed as being engaged in a trade or business, they could be taxed at ordinary income rates, a change that would raise $13 billion in new federal tax revenue over 10 years, according to President Barack Obama's fiscal 2012 budget estimates.

That tax exposure could extend even to tax-exempt institutional or foreign investors in private equity funds if the funds are found to be engaged in a trade or business. Such a finding could subject investors to unrelated business income tax or withholding taxes. For now, because the court's ruling extends only to the 1st Circuit, that risk is highest in the 1st Circuit's New England jurisdiction. Within that jurisdiction are large institutional investors like the $53.2 billion Massachusetts Pension Reserves Investment Management Board, Boston, which has a 10% private equity target allocation.

But all investors should be thinking about this, experts say. “Look at the precedent and ask your adviser how much risk do you want to take. There is still a lot of deliberation to come, but everybody should be evaluating,” said Mr. Rosenthal, who thinks the debate could easily spill over into whether private equity managers should be taxed at higher, ordinary income rates.

“The "trade or business' vs. mere investor distinction has a long history in the tax world, and there is enough of a tie between the federal income tax rules and the pension rules,” said Mr. Zorn of Ropes & Gray. “I would expect that we will see more arguments in other courts.”

“If a single private equity fund owns more than 80% of a portfolio company, they should at least discuss these issues with their lawyers,” said Michael Falk, an ERISA expert and partner with Winston & Strawn LLP in Chicago who has several private equity clients. “The controlled group rules are used in many areas of compensation and benefits law. Ultimately, this applies to the most actively managed” portfolio companies.

More court challenges

Legal experts expect plenty more courtroom challenges and years of legal uncertainty over pension liability for portfolio companies and possibly tax liability as well that may have to be settled eventually by the U.S. Supreme Court.

For now, the 1st Circuit decision is expected to strengthen the PBGC's hand in bankruptcy negotiations and offer a new tactic for pension fund officials, particularly at multiemployer plans hit hard hit by a recession that brought reduced contributions and steep investment losses.

“We saw very little activity on this until the last few years. The multiemployer plans are being much more aggressive to find sources to pay liability,” said Michael Collins, co-chair of the employee benefits group at law firm Gibson Dunn & Crutcher LLP's Washington office. Mr. Collins expects “much more aggressive digging into corporate structures. They will clearly go after any fund that is 80% or more” controlled.

BY HAZEL BRADFORD
AUGUST 19, 2013

Foreign Retirement Plans Seen Scrutinized in U.S. Effort: Taxes

A U.S. tax crackdown is coming for foreign retirement plans.

The U.S. has been pushing banks and individuals to report overseas assets, making it tougher to hide money abroad with new rules and penalties rolling out under the 2010 Foreign Account Tax Compliance Act, known as Fatca. The next wave of scrutiny will cover retirement accounts, Bloomberg BNA reported.

“The retirement community has been a little slower to catch up,” said Russell E. Hall, a senior consultant at Towers Watson.

Foreign retirement plans generally must agree to report their U.S. account holders to avoid a 30 percent withholding tax on U.S.-sourced interest, dividends and proceeds from the sale of securities beginning July 1. Global companies with programs overseas will need to catalog their funded retirement plans to figure out which ones may be exempt, Hall said.

The congressional Joint Committee on Taxation estimated in 2010 that the law would generate $8.7 billion in tax revenue over 10 years. It’s also spurring a spate of agreements between countries to bolster exchanges of information on bank accounts.

The law requires foreign banks to turn over information to the IRS about their U.S.-owned accounts or potentially face withholding taxes. Under the aegis of Fatca, the U.S. has signed a series of agreements for government-to-government information exchange -- a phenomenon that is gaining momentum in the world of tax administration. Negotiations are in the works with as many as 80 other nations.

Many retirement plans may be exempt under these intergovernmental agreements and separate exemptions that the Treasury Department and the Internal Revenue Service, said Andrew D. Bloom, an associate at Dechert in New York.

‘Helpful Exceptions’

“There are a number of helpful exceptions contained in the regulations,” Bloom said. If there is an agreement between the U.S. and the location where the retirement plan is treated as a resident, there may be additional exceptions, he said.

Some items still may not be exempt. Whether the exemptions outlined in the final rules will apply to offshore deferred compensation plans or to offshore equity-based compensation will depend on specifics of the arrangements, Bloom said.

Foreign retirement and compensation plans that fail to qualify for exemption generally must register with the IRS and either comply with the rules of an intergovernmental agreement with the Treasury Department or enter into a “foreign financial institution” agreement and report U.S. account holders, he said.

The IRS opened an online registration site Aug. 19. Foreign financial institutions must register by April 25, 2014, for inclusion on a list to be published for the first time in June 2014 and updated monthly, the IRS said.

Modified Rules

The intergovernmental agreements essentially modify the general requirements of the regulations, Bloom said. They provide a list of entities, including certain retirement plans, to be exempted or deemed compliant, he said.

Under the rules, financial institutions formed under the laws of the U.S. territories generally are treated as “foreign,” Bloom said. Some, such as U.S. Virgin Island pension funds, may be eligible for treatment as nonfinancial foreign entities, so compliance with Fatca will be relatively easy, he said.

Determining whether Fatca exemptions will apply to specific offshore deferred compensation and equity-based compensation will require more work, said Andrew L. Oringer, a partner in the New York office of Dechert.

“It won’t be one-size-fits-all. It won’t be an easy answer,” Oringer said.

By Florence Olsen - Aug 28, 2013 6:00 AM ET

IRS grants church-plan status to St. Peter's Healthcare System

The IRS has granted church-plan status to the defined benefit pension plan of Saint Peter's Healthcare System, New Brunswick, N.J., exempting it from Employee Retirement Income Security Act rules on reporting, minimum contributions and paying premiums to the Pension Benefit Guaranty Corp.

The Internal Revenue Service revealed its decision in an Aug. 22 letter to plan participants, many of whom had contested granting the church-plan status, which the hospital first sought in 2006. IRS officials did not disclose the details of the decision.

The hospital system, formerly known as St. Peter's University Hospital, is also involved in a legal challenge over having church-plan status. While St. Peter's officials were not available to comment on the ruling, spokesman Philip Hartman said when the lawsuit was filed that the hospital considered it to be without merit.

The IRS ruling raises the prospect of more legal challenges to church-plan status rulings, said Karen Ferguson, director of the Pension Rights Center, who called the decision “deeply disappointing. It will now be for the courts and Congress to determine whether the IRS should be allowed to continue to allow retirement plans that have been ERISA plans for decades to convert to church-plan status solely for the purpose of saving millions of dollars at the expense of the retirement security of their current and former employees.”

Thomas E. Clark Jr., chief compliance officer and director of fiduciary oversight at FRA PlanTools, a fiduciary consulting firm, agreed.

“The real fight is going to be in the courts for those that believe the IRS has been getting this wrong for decades,” said Mr. Clark, a former ERISA litigator. “I wouldn't be surprised at all to see this issue eventually decided by the Supreme Court.”

In May, the IRS revoked the church-plan status of the now-closed Hospital Center at Orange, N.J., enabling the PBGC to cover the pension benefits for nearly 800 former employees. That reversal involved an unusual coalition of advocates from the Pension Rights Center, the PBGC, plan participants and their legal counsel.

BY HAZEL BRADFORD
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(updated with correction)

Funding Improvements Shouldn't Nix Pension Contributions

New study suggests pensions plans' funded status is improving this year, but still warns companies against reducing contribution levels.

This week, Fitch Ratings released a new study which supports the idea that pension plans' funded status is improving this year, as interest rates rise and bond prices fall. Fitch evaluated the year-end 2012 funding of pension plans at 224 U.S.-based companies outside the financial services industry.

The bad news in the Fitch report is that even though plan assets grew 5 percent in 2012 and contributions to the plans increased, the median funded status of U.S.-based pension plans fell to 73.8 percent, from 74.4 percent in 2011. The analysis revealed that two-thirds of the plans (148) are less than 80 percent funded, a trigger point requiring further scrutiny to determine whether the plan is "at risk." One-quarter of the plans (57) are between 80 percent and 90 percent funded, and fewer than 10 percent of the plans (19) are more than 90 percent funded. Fitch identified the oil and gas, retail, and telecom sectors as standing out for their low funding status; companies in each of these industries had a median funded status of 70 percent or less.

The good news is that Fitch identified falling discount rates, which increase plan liabilities, as a key driver of the plans' declining funded status. The median discount rate fell from 4.8 percent in 2011 to 4.1 percent in 2012. This is good news because it suggests that as interest rates have risen in 2013, plans' funded status should have improved as well.

"Interest rate volatility causes large changes in benefit obligations—a 1 percent rise in the discount rate can lead to a 10 to 20 percent decline in the present value of a company's liabilities," the report states. Nevertheless, it report adds: "While Fitch believes near-term prospects signal potential funding improvements, companies contributing the minimum under recent funding relief [MAP-21] may face a day of reckoning in the coming years due to the potential for a steep accelerating of funding requirements.

By Treasury & Risk Staff
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