



# WORKING THE FRINGE

Prevailing Wage Bona Fide Fringe Benefit Plan  
Strategies for Merit Shop Contractors

by Jeffrey Bennett





## **INTRODUCTION**

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Construction companies that contract with the government (federal government, many state governments, municipalities, school districts, etc.) are subject to a multitude of laws and regulations. Included among these regulations are special requirements that dictate mandatory wage and fringe benefit payments commonly referred to as "prevailing wage regulations."

The fringe benefit portion of prevailing wage regulations are particularly complicated and, therefore, often misunderstood and misapplied by contractors (including merit shop companies engaged in governmental work).

### **Fringe benefit confusion can lead to:**

1. Contractors missing opportunities to bid more competitively
2. Compliance problems that generate large unanticipated liabilities
3. Inferior benefit programs for your company compared to those provided by trade unions

This paper discusses options and strategies on how contractors can pragmatically comply with prevailing wage regulations while also potentially creating a competitive advantage that will help businesses bid more competitively, increase profits, and raise employee satisfaction and loyalty.

## **BRIEF HISTORY / BACKGROUND**

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### **Davis-Bacon Act (DBA)**

The Davis-Bacon Act was established in 1931 and amended several times, including in 1964, to include provisions for fringe benefits. The DBA was re-codified in 2002 and is located in 40 U.S.C. §§ 3141 et seq.

The stated purpose of the Davis-Bacon Act is "to protect communities and workers from the economic disruption caused by competition arising from non-local contractors coming into an area and obtaining federal construction contracts by underbidding local wage levels."<sup>1</sup>

Following enactment, when the DBA became effective, the United States Department of Labor determined what was "prevailing" in the location of a given federal contract and required those rates be paid to any mechanics or laborers working on job sites. Practically speaking, the prevailing rate historically has simply been what was collectively bargained (the union rate) in a particular area, leading to criticisms that the DBA protects union workers at the expense of taxpayers.

Regardless of general support or opposition to the DBA, the Act applies to federal government contracts in excess of \$2,000 for construction, alteration or repair of public buildings and public works in all 50 states and the District of Columbia.

<sup>1</sup> "Introduction to the Labor Standards Statutes Coverage." Prevailing Wage Resource Book. U.S. Department of Labor

It is important to note that 29 C.F.R. § 5.2k requires the application of the Davis-Bacon Act when work is "...carried on directly by authority of or with funds of a federal agency to serve the interest of the general public regardless of whether title thereof is in a federal agency." In other words, if there is federal money providing even part of the funding on a project, it may be subject to the Davis-Bacon Act and, therefore, prevailing wages and fringe benefits must be paid.

### **McNamara-O'Hara Service Contract Act (SCA)**

The McNamara-O'Hara Service Contract Act was established in January 1966 and amended in 1972 and 1976. The Act is codified as 41 U.S.C. §§ 6701 et seq.

The SCA is similar to the DBA except it was established to provide labor standards protection for contractors performing federal service contracts. Examples of contracts covered by the SCA include security guard services, janitorial services, grounds maintenance and data processing.

The SCA requires the payment of prevailing wage rates and fringe benefits for service employees working on contracts over \$2,500 in all 50 states and the District of Columbia.

### **State Prevailing Wage Laws and Regulations**

Currently 28 states and the District of Columbia have prevailing wage-type laws and regulations affecting companies that contract directly with the state or local governments for construction or service-type contracts.

In states that designate only a prevailing wage amount, and not a separate fringe benefit rate, contractors are commonly allowed to take credit for bona fide fringe benefits payments and reduce the amount paid towards wages.

Some states' laws closely mirror the DBA and SCA. However, many states have more restrictive laws, especially as they pertain to fringe benefits requirements. In our examination of state prevailing wage laws, we found important nuances in how states define bona fide benefits, grant or limit credit for benefit programs, and prohibit certain types of common bona fide benefits ... along with other very unusual rules.

Contractors are strongly encouraged to consult with their advisors if they have any doubt about the rules in the states in which they work.

## **BONA FIDE BENEFIT PLAN LEGAL REQUIREMENTS**

The DBA prevailing wage rate is made up of two components — a basic hourly rate and fringe benefits rate. The total of both the basic hourly rate and any fringe benefits rate listed in a wage determination of the contract comprise the DBA prevailing wage requirement for a given classification. The SCA and state prevailing wage rules are often structured the same, with some exceptions. For example, the DBA (and some states) allows a contractor to pay more in fringe benefits with a corresponding reduction in the basic hourly wage. If the wage determination in a contract included an hourly wage of \$20 and a fringe rate of \$10, the employer could choose to provide an hourly wage rate of \$17 and a fringe rate of \$13.

A contractor's prevailing wage obligation under DBA, SCA, or state laws may be met by any combination of cash wages and creditable "bona fide" fringe benefits provided for a covered worker.

**Common fringe benefits that can be considered bona fide include:**

- Health insurance
- Dental insurance
- Life insurance
- Disability insurance
- Pension / retirement plan
- Apprenticeship training
- Vacation
- Holidays
- Sick leave
- Supplemental unemployment

**Benefits that are not considered bona fide include:**

- Use of a company truck or other vehicle
- Tools
- Uniforms
- Cellular phone
- Travel expenses
- Holiday bonus
- Federal or state mandated paid time off
- Any statutory benefits such as:
  - Workers' compensation
  - Unemployment compensation
  - Social security contributions

*As noted earlier, some states may be more restrictive in the benefits that they allow.*

## **Types of Fringe Benefit Plans**

All fringe benefit plans fall into two categories: "funded" (29 C.F.R. §§ 5.26-5.27) or "unfunded" (29 C.F.R. § 5.28).

Funded plans are those where the contractor's fringe benefit contributions are made irrevocably (funds cannot revert back to the contractor for any reason) to a trustee or independent third party pursuant to a bona fide fringe benefit fund, plan, or program (in writing) on a regular basis (at least quarterly). These contributions can be credited towards meeting the prevailing fringe benefit requirement without prior United States Department of Labor approval. Examples of funded payments by contractors that can be credited include:

- Contractor makes weekly contributions to a health and welfare plan or trust for the provision of benefits (health insurance, vacation pay, apprentice training, supplemental unemployment, etc.)
- Contractor makes quarterly contributions to a retirement plan trust Contractor pays monthly health insurance premiums to an insurance company

Unfunded plans or programs where the contractor funds certain benefits from the company's general assets, rather than by payments to a trustee or third party, are referred to as an unfunded plan. Vacation and holiday benefits are the most common types of unfunded plans. This funding may be creditable towards meeting the DBA prevailing wage obligations if certain requirements are met, including:

- It can reasonably be anticipated to provide bona fide benefits as described in the DBA;
- It represents a commitment that can be legally enforced;
- It is carried out under a financially responsible plan or program; and
- The plan or program has been communicated in writing to the affected employees.

## Annualization

Annualization is one of the most commonly misunderstood concepts in the DBA, SCA, and state laws. However, knowledge about how annualization works, and how it affects contractors' financial obligations for benefit plans is critical for all businesses engaged in public work.

As stated in the U.S. Department of Labor Prevailing Wage Resource book, "Annualization is a computational method used to determine the hourly rate of benefit plan contributions that are creditable towards a contractor's prevailing wage fringe benefit obligation on DBA/DBRA-covered projects."

Because the fringe benefit portion of the prevailing wage is expressed as an hourly amount, the first step in calculating fringe benefit credit under annualization is to translate benefit cost from an annual to an hourly rate. This step is somewhat complicated for merit shop contractors because benefits are seldom purchased at an hourly rate. However, calculating benefit costs on an hourly basis mirrors how union contractors configure benefits, and since the DBA, SCA, and state laws are designed to level the playing field for union and merit shop contractors, hourly calculations permit easy analysis and are favored by regulators.

To compute the contractor's allowable hourly credit towards meeting the prevailing wage obligation for covered workers on a prevailing wage project, the total annual cost of the fringe benefits must be divided by the total number of hours individual employees work in a year, including work on both covered (public) and non-covered (private) work. The annualization computation must be done for each individual worker.

Annualization calculations for contractors that are subject to a collective bargaining agreement are simple because they are required to pay an hourly amount for benefits to the union benefit fund for all hours worked, regardless of if they are public or private work. Annualization is a non-issue for union contractors.

However, annualization can become a tangled web for merit shop contractors that work on both public work and private work because annualization requires the cost of benefits to be divided by all hours worked. Therefore, contractors must provide benefits that cost a sufficient amount to cover the prevailing wage rate across all hours even though hours on private projects worked are not covered by prevailing wage benefit rules.

Example of a laborer employed by a merit shop contractor:

|  |   |
|--|---|
| Total hours worked for the year:       | 1,500   |
| Total hours worked on public work:     | 500   |
| Prevailing fringe benefit rate:        | \$20 per hour   |
| Total annual cost of benefits:         | \$15,000 (Medical, dental, pension, etc.)               |
| Annualized hourly credit for benefits: | \$10 per hour (\$15,000 benefit cost/1,500 total hours) |

In this example, the contractor has a \$10 per hour underpayment of fringe benefits: \$20 per hour prevailing fringe benefit rate — \$10 per hour annualized credit. The total underpayment for the contractor is \$5,000 (\$10 per hour underpayment x 500 public work hours).

How can the contractor remedy the \$5,000 underpayment?

There are two options:

1. Pay the \$5,000 as additional cash wages; or
2. Provide additional benefits.

But how much would a contractor need to pay in additional benefits to make up the \$5,000 underpayment? Logic would tell you the contractor would need to provide another \$5,000 of benefits to make up for the underpayment. However, providing additional payments for benefits accelerates the underpayment problem rather than solves it because the annualized credit needs to be updated by the additional \$5,000 contribution.

|                                     |   |
|-------------------------------------|---|
| Total annual cost of benefits:      | \$20,000 (\$15,000 + additional \$5,000 contribution for annualization) |
| Updated hourly credit for benefits: | \$13.33/hour (\$20,000 benefit cost/1,500 total hours)                  |
| Revised underpayment:               | \$6.67/hour (\$20/hour fringe benefit rate - \$13.33 annualized credit) |
| Total revised underpayment:         | \$3,335 (\$6.67/hour underpayment x 500 public work hours)              |

As you can see in this example, even though the contractor computed the underpayment correctly as \$5,000 and provided additional benefits in that amount, the contractor still has a substantial underpayment because the \$5,000 contribution is divided by all of the hours worked, not just those covered by prevailing wage rate. Subsequent iteration of annualization calculations perpetuate the underpayment obligation rather than fix it.

So how much will the contractor need to fund in benefits to meet its obligation under the law? The answer is \$30,000 (1,500 hours x \$20 per hour). The effect of annualization levels the playing field between union contractors and merit shop contractors by requiring benefits to be provided across all hours worked at a cost sufficient to at least equal the hourly prevailing wage rate.

A contractor always has the option of making up the underpayment of benefits by providing the worker with additional wages equal to the underpayment. In our example, the obvious choice would be to pay the \$5,000 underpayment as additional cash wages, which is substantially less than the additional \$15,000 that would have been needed to get the annualized credit up to the \$20 per hour prevailing rate obligation.

## Exemptions from Annualization

Paying the prevailing fringe benefit rate as cash wages is always an alternative to providing actual fringe benefits, and those payments are never subject to annualization. This applies under the DBA, SCA, and each state examined.

The DBA, SCA, and most states exempt annualization for contributions made to a defined contribution retirement plan that provides for immediate participation and essentially immediate vesting (no more than 500 hours).

Under such plans, contributions are irrevocably made by the contractor to the employee's plan account. Pursuant to the exemption, the contractor may take credit for the full amount of the contribution even if the contractor makes no contributions to the plan during periods of private work as long as those contributions are made at least quarterly to the plan or an irrevocable escrow account.

This exemption can be very helpful and provides for some interesting planning techniques for contractors that work on projects covered by the DBA and SCA. Unfortunately, not every state allows this exemption. A careful examination of state law is highly recommended if there is any doubt about the existence of the exemption.

## **BONA FIDE BENEFIT PLAN ADVANTAGES**

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### Tax Advantages

A contractor can choose between providing the prevailing fringe benefit rate as additional cash wages or as bona fide benefits. The cost of paying the fringe rate as cash wages can be expensive since wages are subject to payroll taxes and payroll-based insurance premiums. In most circumstances this includes FICA, unemployment taxes, workers' compensation premiums and liability insurance premiums. These costs are typically referred to as "labor burden" and can range between 15%–40% of payroll depending on rates paid for workers' compensation and liability insurance.

However, contributions of the prevailing wage fringe benefit rate to bona fide benefit plans are not subject to labor burden cost because **they are not wages. They are treated as employer contributions to company benefit plans, not employee contributions or salary deferrals.**

This tax advantage can create a very large savings to contractors which can result in more competitive bidding.

For example:

### SCENARIO A:

**Paying prevailing fringe benefit rate as cash wages:**

Assumptions:

- The employee base wage is \$30/hour
- Fringe benefit rate is \$20/hour
- An employee works 40 hours/week
- Payroll labor burden is 30% (payroll taxes, workers' compensation, general liability premiums)

Base wage + Fringe = Total wage  
 $\$30 + \$20 = \$50/\text{hour}$

Total wage x Labor burden % = Labor burden  
 $\$50 \times 30\% = \$15/\text{hour}$

Base wage + Fringe + Labor burden = Bid Labor Cost  
 $\$30 + \$20 + \$15 =$

**\$65 PER HOUR**

### SCENARIO B:

**Paying prevailing fringe benefit rate to a bona fide benefit plan:**

Base wage = Total wage  
 $\$30/\text{hour}$

Total wage x Labor burden % = Labor burden  
 $\$30 \times 30\% = \$9/\text{hour}$

Base wage + Labor burden + Fringe (paid to benefit plan) = Bid Labor Cost  
 $\$30 + \$9 + \$20 =$

**\$59 PER HOUR**

**In this example a contractor would save \$6 per hour (over 9%) by contributing the fringe benefit portion of the prevailing wage to a bona fide benefit plan. A contractor with 100 employees each working 2,000 hours in a year would save \$1.2 million.**

Employees also achieve significant savings since contributions to bona fide benefit plans defer (for retirement plan benefits) or avoid (for insurance premiums) income-based taxes.

## Savings on Overtime Pay

The DBA, SCA, and some states do not require an increase in the fringe benefit rate for periods of overtime as they do with overtime wages. Many states require an overtime premium when prevailing wage fringes are paid as cash wages.

## Offset Cost of Other Benefits

Contractors that choose to pay prevailing wage fringe benefit contributions as cash wages and also provide certain bona fide benefits are essentially paying for benefits twice. This is common with employer-provided retirement programs such as 401(k) plans. However, with proper planning, employers that match employee contributions to a 401(k) plan, or make other types of contributions to retirement plans, can take credit for that cost against their prevailing wage fringe benefit obligations. This type of planning generates magnified savings when you take into consideration the labor burden savings outlined earlier.

## Compete with Labor Unions

Utilizing prevailing wage fringe benefit contributions to fund employee welfare and pension programs can result in benefit programs that make merit shop contractors more attractive for existing and prospective employees, as properly structured plans can far exceed those offered by labor unions. For example, union benefit plans are a pool, providing funding for benefits for existing workers as well as previously retired workers. Union retirement plans are defined benefit plans that promise a certain benefit at a certain age but are not tied to the amount that an employer contributes on behalf of an individual worker. Union retirement plans typically have long waiting periods before benefits start and long vesting periods that can be punitive to employees.

A merit shop contractor has tremendous flexibility in the design of its benefit programs. Proper benefit planning can help retain employees and attract potential new employees because benefits are linked to individual workers.

## Increase Employee Morale

Employee benefit programs can be designed to give employees maximum flexibility and provide income and benefits during periods of time when they need it most. For example, if funded with sufficient prevailing wage fringe contributions, health insurance premiums can be paid during periods of layoff. An additional option is to fund supplemental unemployment benefits, which are paid during a layoff and do not affect the amount employees can collect from state unemployment funds.

## **BONA FIDE BENEFIT PLAN STRATEGIES**

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There are a multitude of factors to consider when deciding what type of strategy to implement to satisfy the fringe benefit requirements of the prevailing wage laws. Some factors include:

- The amount of your work that is subject to prevailing wage law
  - The more prevailing wage covered work you perform, the less effect of annualization
  - The amount of money you can save in labor burden expenses and how that savings can translate to more successful bidding
  - How much money will be available to fund benefits

- Which regulations typically cover your work
  - DBA, SCA, state laws
  - Benefit plans should be designed for compliance with the relevant laws
- Demographics / Culture / Seasonality
  - How is the workforce organized?
  - Worker tenure — frequent turnover vs. long term team
  - Do employees work all year or is there a seasonal layoff?
  - Do some employees work substantial amounts of prevailing wage work while others work less or none?
- Existing benefit plan structure
  - Creative design may be able to complement what already is in place
  - Employee cost sharing

Designing the most effective benefit program should incorporate a strategy designed around analysis of each contractor individually, based on a review of each of the categories identified above. Solutions for clients can range from sophisticated comprehensive plans to strategic use of narrowing defined options.

## **GENERAL STRATEGIES**

### **COMPREHENSIVE FUNDED PLAN (Health and Welfare / Retirement Plan)**

For contractors that consistently perform higher than 75% public work

A comprehensive funded type plan strategy somewhat mimics a union-type plan except with much more flexibility and better advantages for the employees. It is most suitable for contractors that consistently do large amounts of work covered by prevailing wage laws, especially construction companies subject to fairly high prevailing rates.

Like a union plan, this is a mandatory plan. Employees are automatically enrolled and not given a choice to participate. They may be given the choice as to which benefits they will subscribe or enroll in, but the actual decision to fund a benefit plan with prevailing wage fringe contributions belongs to the contractor. The contractor also decides how much of the fringe benefit rate is to be contributed. Employers may elect to pay more or less than the prevailing rate, however, when contributions are less than the prevailing rate, the difference must be paid as cash wages.

A funded plan is permissible under all of the prevailing wage laws because an employer has the choice of paying the prevailing wage fringe benefits as additional cash wages or providing bona fide fringe benefits. Prevailing wage fringe contributions are employer-funded benefits, not employee contributions.

With this strategy an irrevocable trust fund managed by an independent trustee is utilized to collect and hold all the fringe benefit contributions that the employer is required to make under the prevailing wage law. Sub-accounts are established and held in the name of each individual employee similar to a 401(k) plan. The trust fund becomes the funding vehicle for the various bona fide benefits that an employee receives.

By segregating fringe benefit contributions in an irrevocable trust, the employer is able to take immediate credit (and tax deduction) for the benefits, even though the actual benefits may not be provided until later (e.g., when health insurance premiums are paid or when retirement plans are funded). The actual underlying benefits offered by the employer are important but secondary to the actual segregation of contributions in the trust when utilizing this type of plan.

This type of arrangement provides maximum flexibility for the employer and employees. For example, benefit reserves can be established to provide benefits during periods of layoff so that insurance coverage is not interrupted.

The employer decides on the bona fide benefits to be offered and funded with the trust fund. The benefit offerings can be made voluntary to the employees so that they can pick and choose from a menu that is best for them and their families.<sup>2</sup> A retirement plan benefit acts as a catch-all to collect funds that have not been used for other bona fide benefits.

This type of plan can also be tailored to target certain groups of employees who work the largest amounts of work covered by prevailing wage laws and eliminate those who don't, which greatly helps any issues related to annualization.

<sup>2</sup> This should not be confused with an IRS Sec. 125 Cafeteria Plan because the employees are not given the opportunity to opt-out of the Plan and receive wages in-lieu of benefits.

## **FUNDED PLAN (Retirement Plan Only)**

Similar to the comprehensive funded plan except the benefit plan is limited to retirement benefits.

The primary advantage to utilizing a retirement plan for the satisfaction of the fringe benefit requirements of prevailing wage laws is that it is usually exempt from annualization if it provides for immediate and full vesting. As mentioned earlier, it is recommended that you consult with your advisors to ensure the exemption is permitted by the states in which you work.

Other advantages to funding retirement plans with prevailing wage fringes is that the contributions offset other employer retirement plan contributions so that the company can more affordably fund retirement benefits for the owners and other key employees.

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## **SELF-ADMINISTERED / CREDIT TYPE PLAN**

A contractor is not required to utilize a funded plan for compliance with prevailing wage regulations. Although administratively complex, contractors may simply take credit for their existing bona fide benefit offerings if the benefit plan can be legally enforced, is carried out under a financially responsible plan or program and is communicated in writing to affected employees.

As we discussed earlier, it is necessary to calculate the hourly credit a contractor can deduct from the prevailing fringe benefit rate. This needs to be done for each individual employee.

In the example on page 6, the employer was funding health insurance, vacation pay, and a retirement plan. The annualized hourly cost was calculated by dividing the total annual cost of the benefits by the total number of hours worked to arrive at \$10 per hour credit.

If the prevailing wage benefit rate is \$10 per hour, the employer will have met its obligation to the employee. If, however, the prevailing wage rate is higher, for example \$20 per hour, the employer would need to provide an additional \$10 per hour in wages to meet the \$20 per hour obligation.

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## **HYBRID PLANS (Funded and Unfunded)**

Some contractors prefer to utilize self-administered unfunded benefits for a portion of their benefit program while utilizing funded programs for certain other benefits.

For example, a contractor may prefer to keep medical and paid time off benefits in an unfunded structure while utilizing a funded third-party administered trust to provide supplemental unemployment benefits to realize special tax advantages. (Refer to our whitepaper, *Harnessing the Power of Supplemental Unemployment Benefits Plan*).

## Tips:

- A contractor may only take credit for their cost of benefits. The contractor may not take credit for any contributions an employee makes towards the cost of their benefits.
- If taking credit for unfunded benefits such as vacation pay, the vacation program or policy must be in writing and given to all employees. The employee handbook would be the most common way of communicating this benefit.
- When calculating the number of hours an employee will work in a given year, it is permissible under the DBA to look to the preceding year to determine what is a representative normal work year. Where benefits are paid on a monthly basis, such as health insurance, it is permissible to look back to the prior month to determine the number of hours that is representative of a normal work month.
- If the hourly credit is less than the prevailing wage benefit rate, the contractor must either pay the difference in wages or provide additional benefits. Any contributions towards additional benefits must be annualized again. The annualization exemption may apply depending on jurisdiction, which would eliminate the annualization if the fringe benefit rate is contributed to a retirement plan that is immediately vested.
- Investigations and inquiries from regulators are common regardless of how a prevailing wage benefit program is structured. Careful accounting and the proper supporting documentation are critical to minimizing disruptions from regulatory bodies.

## **FACTORS TO CONSIDER WHEN CHOOSING A BONA FIDE BENEFIT PLAN PROVIDER**

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As you can see, prevailing wage regulations can be complicated, as they pertain to bona fide benefits, and the strategies to most effectively deal with them in a compliant fashion require special expertise.

Strategies such as simply taking credit for existing benefit plan payments can usually be self-administered by the contractor, perhaps with some help from a knowledgeable accountant or attorney.

The more advanced strategies involving trust funds require knowledgeable experts with the proper trust accounting and administrative tools to provide flexibility in the types of benefits to be offered, timely and accurate statements and reporting, as well as online access for you and your workers.

In our opinion, the best plan providers and consultants are those that do not have a conflict of interest in their business model. This means they are providing you with unbiased advice and are not requiring you to buy insurance or other financial products.

A well-designed plan should be able to incorporate any type of bona fide benefit sold by your existing insurance broker or advisor. A pre-packaged one-size-fits-all solution will most likely be inferior to a well thought out strategy designed around analysis of a contractor's situation and goals.

## HOW WE CAN HELP

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Direct Advisors, a division of HUB Retirement and Wealth Management, was established in 2001 and is located in the Albany, New York area. We provide bona fide benefit plan consulting and third-party administrative services to merit shop (non-union) construction companies that are subject to the Davis-Bacon Act and state prevailing wage regulations. Our clients are located throughout the United States and range in size from 10 to 3,000 employees.

Our construction company clients contribute tens of millions of dollars of prevailing wage fringe benefit contributions to The Direct Advisors Trust (health and welfare benefits) and retirement plans managed by our team.

Our solutions are free from any conflict of interest as we do not sell any financial or insurance products. We work with existing agents, brokers, and insurance companies.



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The content of this analysis regarding the applicability of the Davis-Bacon Act, Service Contract Act, and state laws to contractors engaged in public works projects reflects our best professional judgement of the implications of the law as of the date of circulating the document (September 2015). Readers are cautioned that federal and state rules and regulations regarding these acts constantly evolve. Please be advised that all individuals should consult with their legal and accounting professionals before relying upon the information contained herein.  
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