# Employee Benefits & Executive Compensation Fall Broadcast

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# Today's Presenters


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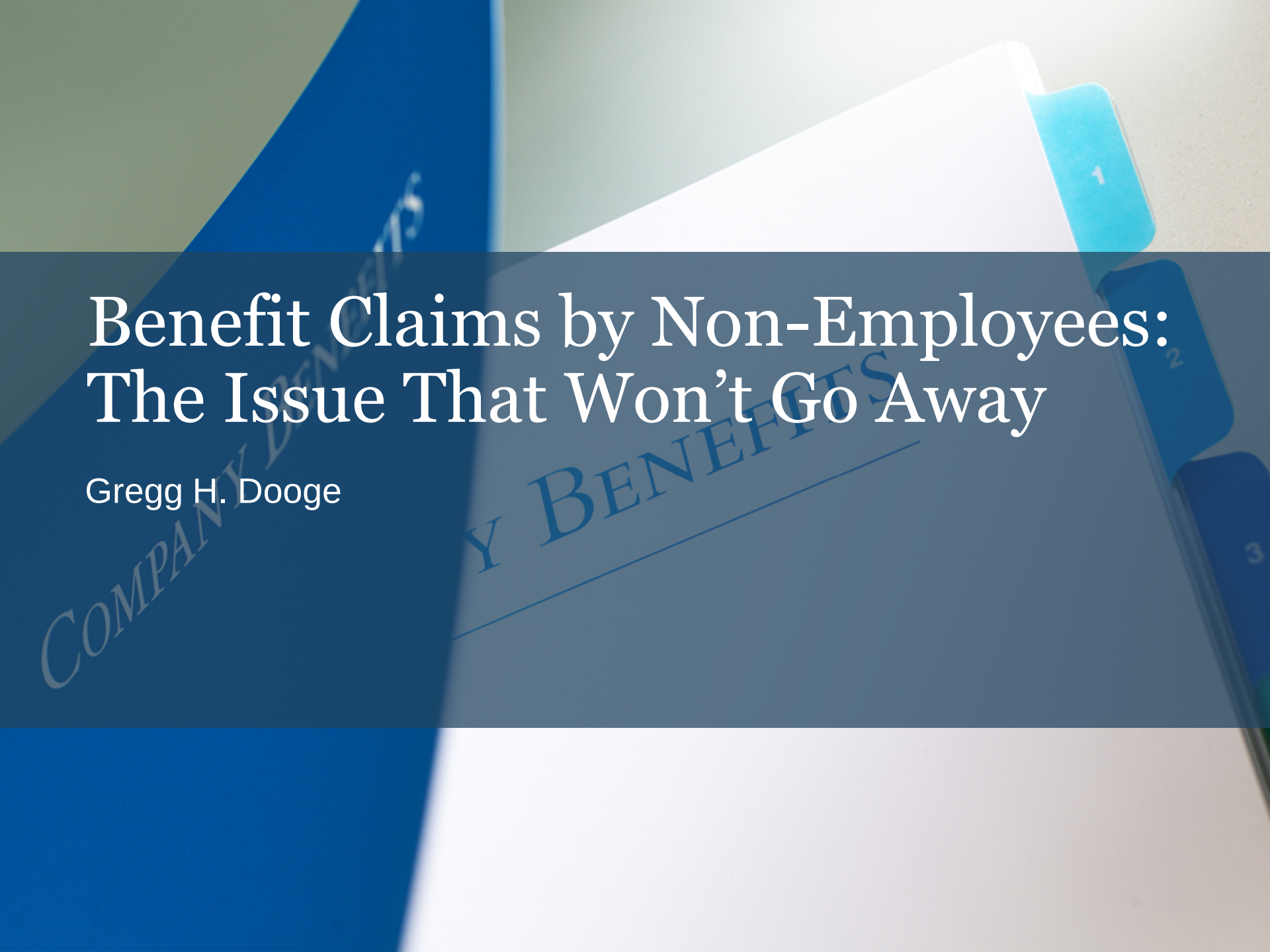
# What We Intend To Cover

- **Benefit Claims by Non-Employees: The Issue That Won't Go Away**
  - Gregg H. Dooge
- **Severance Agreement Tax Traps (and Solutions)**
  - Casey K. Fleming
- **How to Use Carefully Crafted Health Plan Provisions to Reduce HR Headaches**
  - Marian E. Dodson



# Benefit Claims by Non-Employees: The Issue That Won't Go Away

Gregg H. Dooge

# Benefit Claims by Non-Employees

- This is an “old” issue that continues to be relevant
- Very little of today’s discussion will be “new”
- Yet, the discussion has continuing relevance, as the issue resurfaces time and time again

# What Is the Issue?

- Company receives services from two categories of workers
- Category #1: Workers classified by the company as employees
  - Paid through company payroll
  - Receive a Form W-2
  - Company withholds and remits taxes
  - Eligible for employer-sponsored benefit plans
- Category #2: Workers classified by the company as non-employee contractors

# What Is the Issue?

- Category #2 Workers classified by the company as non-employee contractors (continued)
  - Paid by company through accounts payable (no tax withholding) or paid by third party agency (as employee of agency)
  - Considered ineligible for employer-sponsored benefit plans and coverages

# What Is the Issue?

- #1: Workers in category #2 allege that they are employees under category #1
  - Employment (rather than contractor) status may entitle the workers to 401(k) benefits, medical coverage or similar
- #2: The IRS might argue that the workers are employees (making the employer liable for tax collection)
- #3: Company responsibility for workers compensation and similar benefits

# A Current Case (now in the courts)

- Insurance company agents
  - Agents sell insurance company products
- Insurance company has classified agents as non-employees
  - Classification not unusual in the insurance business
  - Argument is that agents are not under the “direction and control” of insurance company, e.g., set own hours, determine how best to do their job, etc.
- Agents claim that they are common-law employees of insurance company

# A Current Case (now in the courts)

- Agents claim that they are common-law employees of insurance company (continued)
  - At issue is the funding of certain “retirement” benefits
  - Company pays benefits as they become due
    - However, in the unlikely event that Company were to become insolvent, benefits might be lost
  - Under ERISA, if agents are employees, the insurance company would have to set aside in a trust assets to cover future benefits
- District court determined that agents are employees

# A Current Case (now in the courts)

- District court decision determines that agents are employees (continued)
  - Court determines that insurance company exercises day-to-day control over how agents do their jobs
- Case is now on appeal
- Insurance company might be correct in this case
  - However, who is correct doesn't matter for our purposes
  - What matters is that this is an on-going fight (that started in 2013) with somewhat dramatic consequences based on whether a "worker" is an employee or a non-employee

# Déjà Vu All Over Again?

- If this sounds familiar, it should
- Vizcaino v. Microsoft (1997)
  - "Freelancers", who might provide services over multiple years, were classified as independent contractors
- The IRS determined that the "freelancers" were employees, i.e., Microsoft should have been withholding taxes and making FICA tax payments
- The "freelancers" then sought benefits available to employees (including certain stock rights)

# Why Has This Taken 20 Years?

- First, there is a lot at stake
  - In the current insurance company case, the issue is the security of the benefit, rather than the availability of the benefit
  - In other cases, the issue is the worker's eligibility for the benefit or responsibility for taxes
  - In either case, significant amounts are at stake
- Second, companies often misunderstand the issue
  - Company is not the ultimate decision-maker
    - A worker does not become a contractor (non-employee) simply because the company classifies the worker as a non-employee

# Why Has This Taken 20 Years?

- Companies misunderstand the issue (continued)
  - Whether someone is legally considered to be an employee is based on the facts and circumstances of each case
  - IRS 20 factor test
  - Exercise of authority and control over how worker does his or her job is hallmark of an employment (rather than contractor) relationship
    - In the case currently on appeal, lower court determined that insurance company was “trying to have it both ways” -- classifying workers as contractors, but controlling the manner in which the job was performed

# A Clear Message

- In the pending case, the insurance company might ultimately prevail, but …
- The case highlights an inherent tension
  - Company wants control
  - Yet, the level of control may suggest employee status

# Lessons and Action Steps

- First, be certain that benefit plans extend eligibility only to workers that the company classifies as employees
  - Language should indicate that if a person who is classified as a non-employee is reclassified as an employee, the reclassification affects benefit plan eligibility on a prospective basis only
  - Almost all pension/401(k) plans have this language
  - Many (but not all) welfare benefit plans do
  - So, check all benefit plan documents

# Lessons and Action Steps

- Second, scrutinize long-term non-employee relationships
  - Many of the cases involved classes of workers who, although classified as non-employees, worked for multiple years at the company's premises, worked alongside "regular" employees, worked prescribed hours, etc.
  - The longer term the relationship, the more likely it is to be an employer-employee relationship
  - Are the workers doing work that is, or historically was, being done by employees?

# Lessons and Action Steps

- Are the workers doing work that is, or historically was, being done by employees? (continued)
  - There might be certain categories of workers that have historically been viewed as contractor positions

- Third, think about other potential consequences if workers who are classified as non-employees really are employees
  - ACA employer mandate (to the extent in effect or enforced)
  - Retirement plan non-discrimination testing
    - Are all employees or “leased employees” being counted in non-discrimination testing?


# Severance Agreements: Tax Traps for the Unwary

Casey K. Fleming

# Setting the Stage

- Standard/Form Severance Agreements
- Executive Severance Agreements
- Existing Agreement?

# Tax Trap 1: Choice Between Lump Sum and Installments

*"We want to give our employees maximum flexibility."*

*"We want to accommodate this executive."*

# Tax Trap 1: Choice Between Lump Sum and Installments

- **Issue 1: Constructive Receipt**
  - Entire payment taxable as W-2 wages in Year 1, regardless of form of payment
- **Issue 2: Potential Code Section 409A Violation**
  - Form of payment is different than form in existing agreement
  - 409A exemption may apply
  - If no exemption, then additional 20% income tax

# Code Section 409A

## VERY Complicated Rules

- **Generally** okay if:
  - Paid out prior to the later of March 15 or 2 ½ months after the end of the employer's fiscal year following the year of separation from service.
  - Severance is (i) due following an involuntary separation (or voluntary separation under a window program lasting no longer than 12 months), (ii) no more than the lesser of 2x employee's base salary or 2x the Code Section 401(a)(17) limit on compensation under a qualified retirement plan (currently, $270k), and (iii) paid out by the end of the second year following the year of separation from service.

# Tax Trap 2: COBRA

*"We do not want the executives to have to pay the full COBRA premium. Let's continue to pay the employer portion through their severance period."*

## Issue 1 = Discriminatory Health Coverage

- Today, only an issue if health plan is self-insured and benefit is only (or disproportionately) provided to highly compensated individuals
- May become an issue for fully-insured plans if ACA non-discrimination rules become effective
- Consequence = Value of the benefit is taxable as W-2 income
- Practical Issue = How to handle withholding?

# Tax Trap 2: COBRA

*"Instead of messing with supplemented COBRA, let's just give them cash."*

**Issue 2 = Taxable Non-Discriminatory Coverage**

- When benefit is not tied to coverage requirement
  - Lump sum with no repayment obligation
  - Installments with no enrollment obligation
- Issue even if health plan is fully-insured
- Consequence = Value of benefit is taxable as W-2 income

# Tax Trap 2: COBRA

*"Instead of providing supplemented COBRA for the executive's 24-month severance period, let's cash out the value of that benefit at termination."*

## Issue 3: Potential Code Section 409A Violation

- If benefit extends beyond 18-month COBRA period, then subject to Code Section 409A and the employer may not accelerate the benefit.
- Consequence = Value of benefit is taxable as W-2 income and subject to additional 20% income tax.

# Tax Trap 2: COBRA

**Potential Solution:**

Keep the structure, gross-up the executive.

<u>Amount Subject to Gross-Up (Value of Benefit)</u>

1 – Applicable Tax Rate(s)

# Tax Trap 3: Release of Claims

- Only a problem if severance pay is not exempt from Code Section 409A AND subject to a release of claims AND timing of the release will impact the calendar year in which installments begin.
- Example:
  - 12 months of severance equal to $1M
  - Executive must sign a release to receive the payment; release is subject to a 21-day “consideration” period and, once executed, a 7-day “revocation” period.
  - First payment is made with first payroll after the revocation period expires
  - Executive terminates on December 15
- **FIX**: Agreement explicitly provides that the first installment payment will always be made in the second calendar year if the 28-day release period spans two calendar years.

# How to Use Carefully Crafted Health Plan Provisions to Reduce HR Headaches

Marian E. Dodson

# How to Avoid Baby Blues

- When distributing annual plan notices, put large notice on first page about how/when to enroll a newborn
- Tell people about this when they ask about parental leave
- Give people separate verbal and written notice when they go out on parental leave
- Follow up with your new parents
- Consider lengthening your special enrollment period

# Avoiding Independent Contractor Catastrophes

- When in doubt, your worker is your employee
- Need strong plan language regarding employees who were misclassified as independent contractors
- No plan benefits until after the employer categorizes the employee as such on its payroll
- No plan benefits until after the employee actually enrolls in the plan

# CLE Information

- At this time, I'm going to read the CLE code for this program. If you are in need of CLE credit today, please enter this five-character code into the poll question on the screen after it is announced and press the submit button
- The code is **YWRV8**
- Again if you are seeking CLE credit for this session, please complete the polling question by entering the code that was just announced. The polling question will remain open briefly. For those seeking Kansas, New York & New Jersey CLE credit, in addition to the polling question, you will need to complete the attorney affirmation form and return it immediately following the program. A copy of the form can be found in the Resource List widget. As a reminder, certificates of attendance will be distributed to eligible participants approximately 8 weeks after the web conference via email
- A code is not necessary for HRCI credit. A record of your full attendance is all we need to apply for HRCI credit

# Don’t Make Your Own Payroll Problems

- Need to deal with mismatched payroll deductions and final coverage periods
- Put clauses in SPDs and payroll deduction consent forms:
  - There will be no refund for contributions that are paid in advance
  - If you pay in arrears, we’re taking your final contribution out of your final paycheck

# Tactics to Decrease COBRA Enrollment

- Distribute election notice ASAP
- Update election notice with Marketplace notice
- Tell people verbally about Marketplace

# Self-Funded Plans are Not Insurance

- The plan is self-funded
- The plan is not insurance
- You pay “employee-share contributions”
- You do not pay “premiums”

# Limit the Lawsuit Window

- SPDs and claims denial letters should say:
  - If you miss any of the plan's internal deadlines you waive your right to sue
  - You can't file a lawsuit until you exhaust the plan's remedies
  - You must file a lawsuit within one year of your exhaustion of the plan's appeal procedure

# Avoid De Novo Review

- SPD should grant the plan administrator full discretionary authority to:
  - administer and interpret the plan
  - determine eligibility for and amount of benefits
  - determine the status and rights of participants
  - make rulings and factual determinations;
  - make internal regulations and prescribe procedures;
  - gather, use, and disclose information;
  - exercise all duties under ERISA, Internal Revenue Code, other laws
  - employ or appoint delegates to help administer the plan
- Benefits will only be paid if the plan administrator, in its discretion, decides benefits are due

# Get Serious about Subrogation

- In exchange for plan benefits, participants to agree:
  - to notify the plan of any potential claim
  - to reimburse the plan
  - to allow the plan to offset future claims based on amounts received from third party
  - to give the plan the right to pursue payment directly from the third party
  - that the plan has a priority lien on any settlement
  - that the plan has no obligation to trace funds
  - to waive being “made whole”

# Questions

- At the conclusion of this program, a questionnaire will appear. Please take a minute or two to give us your feedback about the presentation today. It is important to us to know your thoughts and helps us shape our programs going forward
- CLE questions? Contact Harrison Papadakis at hpapadakis@foley.com. Certificates of attendance will be distributed to eligible participants approximately 8 weeks after the web conference via email

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# Thank You For Attending!



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