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Benefits and Compensation Pitfalls for Closely Held Businesses: Health Insurance, 401(k) Plans and More

Identifying and Overcoming Compliance and Administrative Issues

TUESDAY, JANUARY 22, 2019

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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Jason P. Faust, Attorney, **Michael Best & Friedrich**, Chicago

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Carrie Byrnes Bio

Carrie E. Byrnes cebyrnes@michaelbest.com

is a partner at Michael Best & Friedrich LLP. Carrie crafts practical solutions to complex problems without overlooking technical details –guiding employers through the development and implementation of talent, compensation, and benefits strategies designed to enhance top line growth while managing bottom line expenditures and compliance.

With her experience starting the ERISA practice in the Chicago office of an Am Law 100 law firm and spending time as both in-house counsel and a human resources leader, Carrie has been engaged in all aspects of human resources and talent management. These experiences provide Carrie a unique and holistic understanding of the demands of the modern workforce.

Her practice focuses on employee benefits and executive compensation law, representing primarily employers – large and small, public and private, for-profit, and tax-exempt – in developing, maintaining, and sometimes terminating their benefits, compensation programs, and policies. In her practice, Carrie handles a wide variety of compensation and benefits matters spanning retirement plans, executive compensation arrangements and health and welfare plans.

Carrie is active in the benefits community including as a member of the Women in Pension Network, Women Investment Professionals and as an Adjunct Faculty Member and Advisory Board member at The John Marshall Law School Center for Tax Law & Employee Benefits.

Jason Faust Bio

Jason P. Faust jpfaust@michaelbest.com

is an associate at Michael Best & Friedrich LLP. Clients rely on Jason for strategic counsel regarding a broad range of employee benefits and executive compensation matters, including:

- Qualified defined benefit and defined contribution retirement plans, including pension and 401(k) plans
- Health and welfare plans, including Patient Protection and Affordable Care Act compliance
- Nonqualified deferred compensation plans
- Multiemployer pension and health and welfare plans
- Compliance with the Employee Retirement Income Security Act (ERISA) and Internal Revenue Code

Clients benefit from Jason's unique background and perspective gained from former experience in the employee benefits practice of a large international law firm, as in-house counsel for one of the nation's largest multiemployer Taft-Hartley defined benefit pension plans, as a compliance associate for a benefits, compensation, and human resources consulting firm, and as an extern with the U.S. Department of Treasury's Office of Benefits Tax Counsel.

Jason also holds an LL.M. in Employee Benefits from The John Marshall Law School.

Benefit and Compensation Tips and Pitfalls

AGENDA

- Health Benefit Plans
- 401(k) Plans
- Administrative “Gotchas”
- Perks
- Executive and Deferred Compensation

HEALTH BENEFIT PLANS

Health Benefit Pitfalls

- **Offering coverage to ineligible employees/individuals**.
  - It isn't uncommon to hear that someone –related to the family (either a family member or employee of the family in an unrelated capacity (e.g., the nanny)) is on the employer plan despite the fact that he/she does not perform much or any services for the company.
    - Example: Uncle Joe was a founder and worked 50 hours a week setting up the company, but hasn't performed any real services for the company in a decade. His office is still there and he still collects a paycheck (an issue for a different alert). Bottom line, he likely is not eligible for coverage under the company benefit plan.
  - It is of paramount importance to carefully consider who is offered coverage – and when.

Health Benefit Pitfalls

(cont'd)

- The starting place - **read the contract/policy/certificate of coverage.**
  - Often times, coverage will be limited to "Employees" – most often full-time employees. If someone is not truly an employee (e.g., is a contractor or an employee of a non-covered business) or is not working/performing services for the requisite amount of time (e.g. is not a full-time employee), then they cannot be offered coverage.
- Continuing to keep someone on coverage (or simply not removing their name from the file transmitted to the insurance carrier to keep them on coverage) may seem "nice" and may go undetected for a period of time – however, that is not legally permissible.

Health Benefit Pitfalls

(cont'd)

- In the event of an insurance audit (either random or following a catastrophic event triggering high coverage utilization), the carrier will identify when an ineligible employee/individual has been covered and may rescind coverage (even retroactively). This may leave the employer to essentially "self-insure" (from $1) the coverage provided to that ineligible individual from the date of ineligibility.

- **Providing "family office" benefits v. rank and file benefits.**
  - Under the current legal landscape, employers are generally not allowed to "distinguish" benefits – e.g., provide "better" benefits to family office or management employees than provided to the rank and file workforce. Note that the law in this area is complicated – and somewhat in flux – so guidance should be sought on this matter if different benefits are desired for different classes of employees.

Health Benefit Pitfalls

(cont'd)

- **Appropriately Continuing Coverage.**
  - The federal health insurance continuation law ("COBRA") generally applies when an organization has 20 or more employees. State laws (referred to as "mini-COBRA laws") often kick in at an even lower employee threshold.
  - As noted above, once someone fails to qualify as an eligible employee, their active coverage should be terminated (pursuant to the terms of the governing insurance contract). Where necessary, continuing coverage under COBRA or mini-COBRA laws should be offered to qualified beneficiaries (i.e., those eligible for coverage continuation). There are risks for continuing coverage post-employment without appropriate grounds under contract/COBRA.
  - Careful consideration should also be given to providing COBRA elections at the right time to avoid penalties.

Health Benefit Pitfalls

(cont'd)

- **Accessing or Accepting Health Insurance Information Regarding Employee Coverage.**
  - Employers should remember that the Health Insurance Portability and Accountability Act ("HIPAA") comes into play with group health plan coverage and should be at the forefront of the minds of those who do or may interface with group health plan information. A few tips:
    - Employee enrollment information maintained by/for the plan sponsor is generally not covered by HIPAA, BUT other information (and privacy and security of same) may be covered and highly regulated;
    - Training individuals who will/may access protected health information ("PHI") is imperative;

Health Benefit Pitfalls

(cont'd)

- Security assessment and safeguards also mandated; and
- Additional state privacy laws exist, which may be more stringent than the HIPAA, and may apply in addition to HIPAA.

401(k) PLANS

Common Benefit Pitfalls

- 401(k) Plan
  - **Assuming it's on auto-pilot**
    - Not paying enough attention to plan – no "set it and forget it"
  - Offering company stock without appropriate governance
    - Independent fiduciary?
  - Handling administration and investment appropriately is **paramount**
    - Who makes fiduciary decisions?
      - 3(21) v. 3(38) investment manager
    - Fiduciary roles formalized – committee?

Common Benefit Pitfalls

- 401(k) Plan
  - Formalizing plan governance (e.g., by establishing a committee and adopting a charter governing a retirement plan committee) is key to avoiding some of these common mistakes.

Common Benefit Pitfalls

- 401(k) Plan
  - **Not closely monitoring payroll set up.**
    - It is crucial to match the payroll system to the precise definition of "compensation" as set forth in the 401(k) plan document. For example, if bonuses are considered "compensation" under the plan, but the transmission file doesn't capture those amounts when sending over information from the company to the 401(k) provider, the plan will have an "operational failure" (which, technically speaking, can disqualify the plan and cause adverse tax consequences).

Common Benefit Pitfalls

- 401(k) Plan
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Common Benefit Pitfalls

- 401(k) Plan
  - **Offering company stock without appropriate governance**.
    - Offering company stock may seem like a great idea for many reasons (such as increasing the market for the same or incentivizing employees to work to increase share value), however, it comes with special rules and increased risks. Carefully navigating how to set up a company stock fund and the added considerations that come along with doing so (for example, whether engagement of an independent fiduciary make sense) is critical to ensuring that you do not run afoul of any rules or regulations.

Common Benefit Pitfalls

- 401(k) Plan
  - **Confusing how "covered" the fiduciaries are.**
    - For those families or executives running closely-held businesses, they may not be (nor have any interest in becoming) an ERISA guru. But even those who don't speak ERISA will need to understand the fiduciary rules if they decide to set up a 401(k) plan.
    - The difference between fiduciary liability insurance and a fidelity bond is a common area of confusion.
  - A fidelity bond is specifically required by ERISA for any "plan official." For this purpose, a "plan official" is a fiduciary of an employee benefit plan and/or a person who handles funds or other property of such a plan.
    - A fidelity bond guards the applicable plan against losses due to fraud or dishonesty – for example, theft – by any covered plan official.

Common Benefit Pitfalls

- 401(k) Plan
  - **Confusing how “covered” the fiduciaries are.**
    - Fiduciary liability insurance, unlike a fidelity bond, is not mandated by ERISA.
      - Fiduciary insurance is designed to insure the plan against losses caused by breaches of fiduciary responsibilities and, simultaneously, protect the covered fiduciary or fiduciaries from any personal liability resulting from such breaches.
    - Checking to make sure a fidelity bond (in the appropriate amount and form) is in place is completely necessary; checking to ensure that an approximate amount of fiduciary liability coverage is in place is a best practice. An indemnification agreement/provision benefitting employees serving as plan fiduciaries may also be worth considering. Note, however, that ERISA carefully regulates these arrangements (voiding some as against public policy), so this area should be carefully navigated.

ADMINISTRATIVE “GOTCHAS”

Administrative “Gotchas”

- Adopting a 125/Cafeteria Plan Document
  - In order to facilitate pre-tax premium contributions, Internal Revenue Code Section 125 requires that a written plan document (often referred to as a 125 plan, cafeteria plan and/or flex (or flexible benefits) plan) be adopted. A failure to adopt a proper written plan can result in adverse tax consequences to both the employer and employees – clearly an undesirable outcome.
    - Legal counsel should review any plan that is/will be adopted to ensure compliance with the myriad of applicable legal guidance.
  - In addition to being written, the plan should be properly adopted. Evidence of the plan’s adoption should be made by corporate or board resolution (or otherwise as approved by delegation).

Administrative "Gotchas"

- Managing Claims and Appeals
  - What's a claim as opposed to a casual inquiry? Stated in an oversimplified manner, a request for a plan benefit, or benefits, made by a claimant (generally an employee, participant or authorized representative) in accordance with a plan's reasonable procedure for filing benefit claims must be treated as a claim for benefits.
    - Compare a claim for benefits that with a casual inquiry regarding benefits, which is more of a general question that is not specific enough to rise to the level of a claim (and need not be treated/processed as such). ***A word of warning*** – there are not many bright line rules here and a plan sponsor should be cognizant of whenever there is a basis for concluding that the person making an informal inquiry is actually trying to file or further a claim for benefits. For example, is asking about whether a particular treatment or condition a claim?

Administrative “Gotchas”

- Managing Claims and Appeals (cont’d)
  - A protocol for responding to claims and appeals should be adopted (and followed!).
    - The rules governing the claims and appeals process requires certain reviewers at certain times reviewing and communicating specific information. Note that a failure to adhere to these rules may result in the loss of the deferential standard of review in litigation (i.e., the court may review the claim on its own rather than deferring to the initial reviewer – which can increase the cost of litigation and decrease the employer’s chances of successfully defending the lawsuit).

Administrative “Gotchas”

- Timely Responding to Requests for ERISA Documents
  - Penalties may apply with respect to a failure to timely respond to requests for certain ERISA information (e.g., plan documents, SPDs). Again, a protocol for forwarding and responding to such requests should be adopted and compliance with the same should be audited.
- Annual Filings/”Top Hat” Plan Filing
  - Generally speaking, there is a requirement to complete and file an annual return/report (on the Form 5500) for each benefit plan.
    - Smaller plans ***may*** have a pass for filing a return for certain unfunded plans, but increases in coverage can cause a “springing obligation” to file in the next year.

Administrative “Gotchas”

- Annual Filings/”Top Hat” Plan Filing (cont’d)
    - Also, it’s important to understand the filing requirement distinctions between retirement plans (e.g., 401(k)s, pensions and ESOPs) as compared to health & welfare plans. Retirement plans almost ALWAYS require an annual filing; an audit may be required as well.
  - An unfunded plan maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees (commonly known as a “ top hat ” plan) will generally be excluded from needing to comply with various provisions of ERISA (including the fiduciary responsibility rules) if a one-time notice is timely filed with the government.

Administrative "Gotchas"

- Avoiding Conflicts of Interest
  - Hiring (and monitoring) service providers/vendors for benefit plans is one of many fiduciary functions. In short, this means that the best interest of the participants and beneficiaries needs to be center stage in this decision making.
    - Consider the following example. Mary is the founder of Company X. Company X decides to adopt a 401(k) plan, effective 1/1/19. When setting up the plan, Founder Mary cannot simply hire her cousin or best friend to perform services for the benefit plan UNLESS a prudent fiduciary would hire that individual/company as well (and there's not otherwise a prohibited transaction).
    - When in doubt concerning if/when/how a transaction with a benefit plan can be entered into, plan counsel should be engaged.

PERKS

Common Benefit Pitfalls

- Perks
  - **Is it Includible in Taxable Income?**
  - The starting place in answering this question is Internal Revenue Code Section 61. That Code Section states, in relevant part, that "Gross income means all income from whatever source derived, including (but not limited to) . . . [c]ompensation for services, including fees, commissions, **fringe benefits**, and similar items."
  - Unless another Code provision carves out a "perk" from the definition of gross income, it is included. That fact notwithstanding, many executive perks are not taxed without any meaningful consideration of why the executive should benefit from such a gross income exclusion.

Common Benefit Pitfalls

- Perks
  - A few examples:
    - A company provided cell phone. Provision of such a phone will be excluded from gross income and exempt from employment tax withholding if provided primarily for noncompensatory business purposes. Here, even de minimis personal use is ignored.
    - On-site meals. While, generally speaking, an employer can exclude from income the value of de minimis meals provided to an employee, an employer is precluded from excluding from the wages of a highly compensated employee the value of meals provided at an employer-operated eating facility ***IF*** that meal isn't available on the same terms to all employees or a group of employees defined under a reasonable classification that doesn't favor highly compensated employees.
    - Personal travel on a company's private jet. This personal use is also considered a fringe benefit provided to the employee or owner in which income almost always needs to be imputed to the individual, or reimbursed, for use of the plane.

Common Benefit Pitfalls

- Perks
  - **REMEMBER**: When the value of the perk/fringe benefit is NOT included in income, there should be a sufficient legal basis found in a particular provision of the Internal Revenue Code (or supplementary IRS guidance) indicating that there's an exclusion for that specific purpose.
  - **Is it Deferred Compensation?**
    - After determining whether a perk should be included in gross income, determining whether it is/may be "deferred compensation" under Internal Revenue Code Section 409A is necessary.

Common Benefit Pitfalls

- Perks
  - The rules on reimbursement are numerous and include (but are not limited to) the requirement that all reimbursements must occur by the end of the taxable year following the year in which the expense was incurred; and the requirement that the amount of reimbursements in one year not affect another year.
  - That last requirement is often the biggest stumbling block for employers.
    - Consider, for example, a multi-year (say, for our purpose, two years) employment agreement that limits reimbursable expenses for club membership over the life of the agreement (rather than on an annual basis) to $50,000. This multi-year reimbursement provision violates Code Section 409A. If the employee incurs and submits reimbursement for $30,000 in expenses in the first year of the contract, the amount eligible for reimbursement in the second year is necessarily affected (i.e., reduced to $20,000 from $50,000).
    - Similar 409A reimbursement problems would arise for a specified reimbursement amount that applies to a non-calendar contract year (for example, “during the first year following hire”) in an employment agreement.

Common Benefit Pitfalls

Typical Examples of Arrangements Covered by 409A:

- Split dollar life insurance plans;
- Excess deferred compensation and "wrap" plans (plans that provide for deferrals in excess of statutory limits such as the limitation on employee deferrals under a 401(k) plan);
- Incentive deferral plans;
- 457(f) deferred compensation plans (for tax-exempt entities);
- Phantom stock plans and stock appreciation right plans;
- Restricted stock plans;
- Deferred compensation arrangements for board of director members or for consultants;
- Taxable welfare benefits;
- Certain perks (use of car; country club payments; internet connection; cell phone use);
- Some severance plans;
- Employment agreements that contain any provisions deferring compensation;
- Bonus plans that include deferral features or that are paid more than 2½ months after the year for which the bonus is granted; and
- Stock options granted at less than fair market value.

EXECUTIVE AND DEFERRED COMPENSATION

Deferred Compensation "Watch Outs"

- **"Pay me next year" or "Pay me later"**
- **Informal, unwritten deferred compensation arrangements**
- **Funding deferred compensation arrangements**

Deferred Compensation "Watch Outs"

- **"Pay me next year" or "Pay me later"**

  - The organization is struggling and the CEO says: "I know I'm due wages this year (2018), but we're a little tight on cash, so just pay me next year." Seems reasonable, right? Well, it may be reasonable, BUT if the compensation is earned in year one (2018) and paid in year two or later (2019 or beyond), we've created deferred compensation.

  - Unless the compensation is structured to meet an exemption from 409A, it must comply with those draconian rules (including having the arrangement set forth in writing specifying time and form of payment, among other things). Counsel versed in 409A should be consulted in this scenario so as to avoid unintended tax consequences.

Deferred Compensation "Watch Outs"

- **We'll Formalize it Later.**
  - A group of siblings strike a "handshake deal" whereby they agree that each will receive certain compensation if/when they retire.
  - Again, having informal, unwritten deferred compensation arrangements may violate Code Section 409A. Counsel needs to be involved to properly structure and document the arrangement to avoid immediate taxation and penalties on that future payable compensation.

Deferred Compensation "Watch Outs"

- **We'll Fund it Now.**
  - The sibling deal noted above is properly documented (phew!) and now there's concern about liquidity to fund the benefits if/when they become due. So, the siblings set up a trust and fund the deferred compensation arrangements. Seems smart, right?
  - Well, unless the trust is set up as a "rabbi trust" (also called a grantor trust), the trust corpus will become taxable to the beneficiary immediately. A so-called "rabbi trust" is generally established as an irrevocable trust created for the benefit of the plan participants but with respect to which the assets remain subject to the claims of the employer's general creditors in the event of the employer's bankruptcy. Otherwise, the assets may only be used to pay benefits under the plan.
  - Once a rabbi trust is funded, consider the litany of investment vehicles, including company owned life insurance (i.e., COLI).
    - COLI is sometimes purchased by a company to help ensure that the company will have the cash to fulfill its promise to provide benefits. The employer is the owner and beneficiary of the policies and pays the premiums. The employer will pay benefits to the employee with funds obtained from borrowing against the cash value of the policies and from the proceeds received on the death of the employee.
    - Split Dollar life arrangements are no longer popular but might be worth considering.

Deferred Compensation “Watch Outs”

- Assuming 409A doesn't apply…
  - That’s a public company concern…. Or is it?
  - The IRS hasn’t yet released promised guidance regarding partnerships or LLCs, most of the 409A rules (like the option rules) apply by analogy
  - While certain more draconian provisions (e.g., the 6-month delay in payments made on account of a separation from service) are limited to public companies, the law generally applies to private and public companies alike. When a company is or may be setting up deferred compensation (even in adopting a new executive employment agreement), 409A counsel should be engaged to ensure the arrangements do not unexpectedly result in unintended unfavorable tax treatment

Deferred Compensation "Watch Outs"

- Assuming 409A doesn't apply…
  - Severance agreements
    - Agreeing to keep employee on benefits…
    - Including release without time frame (important to consider 409A)
    - Delaying payments into second tax year without consideration of tax implications
    - Changing time and form of payment of previously negotiated payments

Deferred Compensation "Watch Outs"

- Paying when there ISN'T a "separation from service" or not paying when there IS
  - Code Section 409A generally only allows for payment in certain limited circumstances, including a separation from service
  - Whether a separation from service has occurred under Section 409A's definition may or may not be different from the company's practice on termination of employment
  - Under Section 409A, a separation from service occurs when the employer and employee anticipate one of the following at the time of the termination of employment:
    - The employee will not perform any further services after a certain date; or
    - The level of services that the employee will perform after a certain date (whether as an employee or an independent contractor) is no more than 20% of the average level of services the employee performed in the previous 36 months.
- Note, generally a separation from service requires an 80% reduction in the average level of services, but agreements may provide a threshold of as low as 50%

Deferred Compensation "Watch Outs"

- EXAMPLE - Paying when there ISN'T a "separation from service" or not paying when there IS
  - The organization has decided that Mom, now CEO, will "retire", change her title to Executive Vice President and only come in 4 days a week instead of 5 (or 6 or 7) – under these facts, there is NO separation from service (or severance from employment which is the relevant term of art for 401(k) plan purposes), so payment from nonqualified deferred compensation arrangements (and 401(k) plans) cannot begin on those grounds.
  - Alternatively, Mom CEO hasn't come into the office but once a month for 3 years and doesn't work remotely, but remains "available" for advisory/consulting services (which have never been nor are ever expected to be used) and still draws a salary. Here, if she performs no services and the expectation is that she will not perform any such services, she has incurred a separation from service. Thus, payments due upon a separation from service should be made (or commence, as applicable) despite her continued treatment as an "employee."

Note, whether the organization can continue to deduct her compensation as a reasonable business expense (and/or keep her enrolled in active employee benefits as an "employee") is an entirely separate topic.

Phantom Stock Thoughts

Description	Tax Treatment
Phantom Shares: Rights that permit the employee to receive a payment equal to the full value of a share/unit as of a Payment Event (i.e., the excess of the underlying value of a share/unit over zero). **OR** **409A Stock Appreciation Rights: Rights that permit the employee to receive a payment equal to the appreciation value of a share/unit as of a Payment Event.** **Payment Event: Payment must begin or occur upon one of the following: death, disability, change in control, unforeseeable emergency, separation from service, or a pre-established fixed date. Payment may be set to occur upon the earlier or later of some or all of the payment events described in the previous sentence.** **Payment Form: May be in lump sum, annuity, installments, or combinations of the same. Payment in cash.** **Vesting: Generally subject to vesting (e.g., may not be exercised until employee has been employed for X years). Events that commonly result in vesting acceleration include change in control, death, and disability.** **Valuation? Not required, but must be clear as to how value will be determined.** **ERISA Treatment: Often subject to ERISA because payment is usually deferred to termination of employment or beyond. Participation must be limited to a "top hat" group of employees.**	Code section 409A applies and will limit the flexibility of future changes to this arrangement, but will not have negative tax consequences if Code section 409A is complied with. The payment events are subject to detailed Code section 409A definitions and rules. Deviation from Code section 409A requirements in writing or in operation will result in very negative tax consequences for the employee. __________________________ Employee: At grant: No tax consequences. At vest: No income tax consequences. Value of Phantom Shares (but not SARs) at vesting date may be subject to FICA taxes. At payment: Payment amount taxed as ordinary income and is wages subject to social security and Medicare tax (FICA tax) and income tax withholding (if employee), unless FICA tax already paid at vesting. __________________________ Company: At grant: No tax consequences (no deduction). At vest: No income tax consequences (no deduction, except to the extent FICA tax is paid). Value of Phantom Shares (but not SARs) at vesting date may be subject to FICA taxes and withholding. At payment: Tax deduction is allowed for the amount of the employee's taxable income. Company must pay its portion of FICA tax and withhold FICA (unless already paid) and income taxes on wages.

Phantom Stock Thoughts

Advantages	Disadvantages
Employee: • Possibility of large gains (although some plans limit gains). • Requires no personal investment. Avoids costs and risks of continuing to hold shares after payment associated with actual ownership. • Deferral of income taxes until payment. ______________________ **Company:** • Promotes owners' interests by aligning employee's interests (employee's gains parallel shareholder gains). • No need to assist employees with financing since no investment is required. • Impact on cash flow can be more predictable depending on payment events used under the plan. • Golden Handcuff Features include vesting and the connection to value of underlying shares/units. Vesting schedule can be very long, and graded, to increase Golden Handcuff impact. Could also consider performance-based vesting to increase Golden Handcuff impact.	**Employee:** • Share/unit price changes may not parallel internal performance standards and/or actual management performance; no gain unless market value increases. • Gains may be capped by company-imposed maximums. • Cannot time exercise to maximize gains, other than by terminating employment. • No opportunity for capital gains. • Minimal value as a retirement focused arrangement. • Payment subject to risk of company bankruptcy or insolvency. ______________________ **Company:** • Does not necessarily parallel internal performance standards and/or actual management performance. • Deferral of deduction until payment date. • Depending on structure of payment events, employee could be inadvertently incentivized to terminate employment to access the money (can be addressed with "later of" provisions). • Administrative complexity high, but can be mitigated with simple payment event structure.

Closing thoughts….

- While benefits and compensation are a necessary part of attracting, engaging, rewarding and retaining talent (both rank-and-file and management), properly implementing and managing these programs takes work.
- And being proactive in “cleaning up” any issues will almost certainly limit liability for future problems (and liability) on audit or in litigation.

Questions?

?