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THE SUPREME COURT RULES ON EMPLOYER STOCK FUNDS--FIDUCIARY RESPONSIBILITY AFTER THE PRESUMPTION OF PRUDENCE **13**

Andrew Irving

On June 25, 2014 the Supreme Court of the United States made its first ever ruling applying the fiduciary standards of ERISA to employer stock funds in 401(k) and other defined contribution plans. We welcome Andrew Irving, Area Senior Vice President and Area Counsel of the Institutional Investment & Fiduciary Services group of Arthur J. Gallagher & Co., who writes in his article, "The Supreme Court Rules on Employer Stock Funds-Fiduciary Responsibility after the Presumption of Prudence" that the unanimous opinion in Fifth Third Bank v. Dudenhoeffer ruled that fiduciaries responsible for employer stock funds "are subject to the same duty of prudence that applies to ERISA fiduciaries in general, except that they need not diversify the fund's assets." Mr. Irving points out the nuances of the case, while providing practical tips to employers on how to proceed in light of the holding.

WORKFORCE RETIREMENT-READINESS: FIVE QUESTIONS YOUR COMPANY MUST BE ABLE TO ANSWER **26**

Adam Berk, Jennifer Haid, Lynn Pettus, and Ben Yahr

Baby-boomers--today reaching the age of 65 age in droves--are notoriously underprepared for retirement. Anxious, distracted, working because they have to (and not because they want to) employees tend to be significantly less engaged and potentially harm workforce morale, quality, productivity and even company reputation. This article discusses the five key questions plan sponsors need answer, including: What can companies do to inculcate a culture of retirement readiness? Begin with automatic enrollment and escalation as default settings for retirement programs. But add ongoing employee financial education and counseling along with help centers for personalized planning. This can help not only baby-boomers, but also Gen X and Gen Y workers whose careers will feature shorter stays with each company alongside a shift from defined benefits to defined contributions. Overall, companies will see the best retirement readiness outcomes if they engage the workforce with quality communications that help employees develop appropriate behaviors--plan, save, invest, control spending (budget)--for retirement-readiness.

INCENTIVE DESIGN VARIES BY INDUSTRY: SPOTLIGHT ON ELECTRIC UTILITIES **39**

James F. Reda, David M. Schmidt and Kimberly A. Glass

The article an analysis of how incentives are being structured to connect pay and performance at electric utility companies. This article directly applies to a narrow industry, yet it provides excellent insight in how critical it is in designing compensation programs to understand the underlying business and environment in which it operates.

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CRACKING THE CODE: TAXING DEVELOPMENTS IN BENEFIT COMPLIANCE

Reevaluating Paid Time Off and New Challenges

Mary K. Samsa, McDermott Will & Emery*

Cost containment evaluation and strategies relating to overall management of human capital costs remain a continual struggle for many organizations. Labor costs, far and away, continue to be the largest cost for many organizations. Consequently, this has resulted in an organizational focus on ways to create efficiencies within their existing benefits programs. Interestingly, it appears that paid time off (PTO) is one area where organizations have an opportunity to create efficiencies, as

well as mitigate long-term financial risk and compliance risk.

Historically, many organizations provided their employees with separate holidays, vacation days, personal days, and sick time. Over time, however, many of these organizations have redesigned these programs to incorporate a "total" combined time off (CTO) approach where all of these different categories of personal time are included in one overall pool of days. A CTO approach simplifies administration of these arrangements and,

in general, when compared to the traditional separate days approach, results in organizations overall providing fewer days of total time off.¹ Changing to a CTO methodology did provide many of these organizations with initial cost savings, but other potential opportunities may exist as well as new challenges that have arisen.

CASH OUT OR SELL BACK OF PAID TIME OFF (PTO)

It is still a predominant practice at many organizations to allow employees to cash out (or

*MARY K. SAMSA is a partner in the law firm of McDERMOTT WILL & EMERY LLP and is based in the Firm's Chicago office. Mary has more than 15 years of experience and has represented a wide range of organizations including, but not limited to, Fortune 100 public companies, privately held companies, multinational organizations and not-for-profit hospital systems as well as educational institutions. Her primary practice focuses on executive compensation (for both taxable and tax-exempt entities) where she regularly advises on nonqualified deferred compensation arrangements, executive employment arrangements (including the rebuttable presumption of reasonableness for tax-exempt entities), equity compensation arrangements, reporting and disclosure of compensatory arrangements, severance arrangements and change in control issues, to name just a few. Mary has also developed significant experience in international employee benefit issues, whereby her relationships with attorneys in over 100 countries enables her to provide rapid turnaround on time-sensitive international mobile employee tax and employment issues. She also maintains a core practice with respect to qualified retirement plans for both taxable and tax-exempt entities (including defined benefit, 401(k), 403(b) and 457(b)). The Legal 500 United States writes that Mary provides "practical and thorough advice on retirement and executive compensation" matters.

sell back) PTO. In many instances, the decision to offer employees an opportunity to cash out PTO is often tied to historical practices, as well as the culture of the organization. However, as organizations attempt to become more efficient and eliminate waste, this is one provision that could provide some potential cost-saving opportunities.

The decision may not be as simple as eliminating cash out altogether. Some organizations have explored implementing a policy where only non-exempt employees may sell back PTO, while exempt employees are not provided that option. The rationale behind this distinction is that a non-exempt employee's position often needs to be filled by a replacement worker, while exempt employees are typically not replaced when they use PTO. As a result, the organization incurs an additional cost when the non-exempt employee does not come to work, so they are generally indifferent if the employee sells back the PTO in favor of coming to work.

On the flip side, when an exempt employee takes a day off, there generally is no replacement cost to the organization. There is clearly an argument to be made regarding lost productivity, but many exempt employees are required to accomplish their goals and ob-

jectives regardless of when or how much PTO is taken. As a result, allowing an exempt employee to cash out PTO effectively results in "double-paying" them for accomplishing the same amount of work they would have otherwise accomplished. While many organizations have obviously not gone quite as far as eliminating sell back for all exempt employees, it has become more common to implement this practice, as a first step toward addressing the cost of PTO, on a more limited basis with executives/senior management.

However, regardless of the group or groups to whom an employer may offer cash out or sell back programs, it is critical that any cash-out or sell-back arrangement be structured appropriately to avoid adverse tax consequences to employees. Specifically, PTO is taxable when actually or constructively received. What this means is that the tax law requires that PTO be taxed when the employee acquires the right to withdraw the PTO amounts, whether or not he/she actually does withdraw the PTO amounts. Consequently, the timing of this "right" is the key to invoking or avoiding constructive receipt.

For example, when a PTO plan allows an employee to choose between cashing out

their PTO days or applying the value of those days to purchase a non-taxable benefit such as health insurance, even those employees who choose to purchase the non-taxable benefit will be treated as if they had "constructively received" the cash-out and will be taxed on the value of the cash-out that they could have received.

However, several tax rulings have concluded that a PTO cash-out program did not result in taxable income to employees who were not electing the cash-out option. In these specific situations, the program additionally allowed an employee to choose cash instead of PTO *that would accrue in a subsequent year—as opposed to choosing cash instead of already-accrued PTO.*² Therefore, the key distinction is that the constructive receipt doctrine can be avoided if the program is drafted such that an employee's legal right to make an election to receive cash in lieu of PTO is made in the year prior to when the PTO is earned (as structured in accordance with the tax rules).

Another PTO design characteristic that is still relatively common is whether the application of a percentage penalty, or haircut, to those employees electing to cash out PTO, is sufficient to avoid constructive receipt. Under the constructive

receipt tax regulations, income is not constructively received if a taxpayer's control of its receipt is subject to "substantial limitations or restrictions."

Unfortunately, the term "substantial limitations or restrictions" is not expressly defined for these purposes. Instead, the constructive receipt regulations provide only limited guidance through four examples that are *not* considered substantial limitations or restrictions:

1. The requirement that the deposit or account must be withdrawn in multiples of even amounts;
2. The fact that the taxpayer would receive earnings that are "not substantially less" than the earnings to which the taxpayer would otherwise be entitled if he left the account on deposit until a later date;
3. The requirement that earnings may be withdrawn only upon a withdrawal of all or part of the deposit or account; and,
4. The requirement that a notice of intention to withdraw must be given in advance of the withdrawal.

The second example is the one which is helpful in analyzing haircuts. This example suggests that some kind of economic penalty suffered upon

withdrawal, which makes the participant's balance "substantially less" than the amount that it would have otherwise been, absent the withdrawal, satisfies the meaning of substantial limitation or restriction.

The haircut percentage penalty concept was formalized in the drafting of an example for the constructive receipt regulations. Some practitioners have interpreted the example in the regulations to suggest that a twenty-five percent (25%) haircut constitutes a substantial limitation or restriction, because the example provides for the forfeiture of one-quarter-year's interest in connection with the premature withdrawal of funds. The Treasury decision which added this example stated that "such an interest forfeiture penalty would be a substantial limitation or restriction."³

In several private letter rulings, however, the IRS has explicitly approved much lower haircut provisions in tax-qualified retirement plans and Code Section 403(b) annuities, when these arrangements were subject to the constructive receipt doctrine (meaning all of this guidance pre-dates the 1986 Tax Reform Act). In one ruling, the IRS approved a ten percent (10%) penalty on the amount withdrawn from a profit sharing plan as a "sufficient restriction" to avoid the construc-

tive receipt of income. Moreover, in the majority of these rulings, the IRS approved the imposition of a six percent (6%) penalty on withdrawal amounts. In each of these rulings, the IRS specifically held that the ability of the participants to receive early withdrawals subject to the haircut percentage would not cause the participants to be in constructive receipt of any available amount that was not withdrawn.

However, as time has marched on, Code Section 409A has been enacted which provides insight creating another wrinkle. With the enactment of Code Section 409A, it is no longer possible to use "haircut provisions" with respect to deferral of compensation and such regulations otherwise substantially limit participant control under which promised compensation may be treated as tax-deferred. Notwithstanding this, certain arrangements are statutorily exempt from Code Section 409A. Specifically, Code Section 409A exempts "any bona fide vacation leave, sick leave, compensatory time, disability pay or death benefit plan" from its provisions. To date, the IRS has not provided a definition of a bona fide vacation or sick leave program for purposes of Code Section 409A. While the IRS has not published guidance under Code Section 409A re-

garding what constitutes a bona fide leave program, it has been more forthcoming under Code Section 457. In particular, the examples in the Code Section 457 regulations indicate that PTO programs allowing accumulated leave to be cashed out provide bona fide leave. Thus, under current law, there is a reasonable argument that PTO cashout programs are exempt from Code Section 409A by virtue of the statutory exclusion from Code Section 409A for certain bona fide leave programs.

Keep in mind that to date, the IRS has never formally challenged (in published general guidance) a haircut provision used in a PTO cashout arrangement. However, the above Code Section 409A tax guidance clearly gives us an indication of the IRS' thought on haircut provisions in general in today's current environment and this position should not be taken lightly. Additionally, employers must also be aware of state laws that could impact the ability of an employer to impose a haircut on an employee, regardless of whether the employee agrees to the haircut. As a result, continued use of haircut provisions or implementation of a haircut provision in a PTO cashout program should be fully vetted with legal counsel to ensure a full understanding of any legal risks and exposure

in providing such a PTO program design.

Further, note that PTO programs have not been a heavily audited area by the IRS in recent years. Historically, the IRS does not come in and do a "PTO audit." However, audits of PTO programs have been swept into larger corporate tax audits of organization making PTO program potentially subject to further scrutiny.

At the end of the day, there is some flexibility in the design of PTO arrangements, but from a legal and tax perspective, the recommendation would be that all cash out elections regarding PTO should be made by the employees prior to the respective PTO days being earned or accrued, as that is clearly the design structure most firmly supported by the tax regulations.

PTO CARRYOVER AND MAXIMUM BANKS

There are also valid arguments to be made for allowing employees to carryover some portion of unused days. If an organization uses this type of PTO structure, when evaluating the appropriate approach to carryover, there are some key questions to consider.

What Is The Purpose of Allowing Carryover?

Identifying the purpose of al-

lowing the carryover of PTO will help evaluate the answers to the other key questions. As an example, historically, in many cases carryover was used as protection against a disability event or to supplement pay in the event of a long-term illness. If an organization provides company-paid short-term disability coverage, there may no longer be the same need for carryover as there was in the past.

What appears to be happening to organizations with carryover policies is that employees tend to use PTO carryover as a supplemental retirement plan. In some instances, these employees sometimes bank upwards of six months of pay in a carryover account to be paid out when they retire or terminate employment. When used in this manner, the carryovers can be a very costly benefit and an unintended consequence of allowing carryover.

Should All Employees Be Allowed to Carryover Paid Time Off?

As with sell back of PTO, some organizations employ different carryover provisions for different classes of employees. An emerging best practice is to have a use-it-or-lose policy for executives. This type of policy typically goes hand-in-hand with a 100% salary continuation program. Under this approach,

executives are already fully protected in the case of a disability event, so PTO carryover would almost always result in a payout event at termination or retirement, which can be very costly.

The challenge here is that many organizations are not in favor of executives "cashing in" their PTO because time off, based on their positions, has a very beneficial purpose and PTO time offers the ability for them to "recharge" with needed downtime. These same organizations are also not in favor of rolling PTO over to a new year because the market has seen a significant increase in executives (particularly in the last several years since the recession) delaying this valuable benefit because they are worried that time off equals losing their competitive edge within the organization. Inevitably, if this is occurring, it defeats the point of offering PTO to this group at all.

In general, there are no laws requiring benefit programs to provide identical coverage to all employees. Employers have some discretion when structuring their benefits programs and are able to make distinctions among employee populations (broad-based versus executives) regarding access and the types of benefits offered. The key is to make sure that benefits program decisions (PTO

included) are not discriminatory, which means that employers should keep in mind the adverse impact on certain groups and any unintentional discrimination that may result from those decisions. For example, it is important to always take a high-level overview of the entire employee population to ensure that a "use it or lose it" solely for executives design decision does not have unintended discriminatory consequences such as disproportionately impacting employees protected by Title VII of the Civil Rights Act, Americans with Disabilities Act, Age Discrimination in Employment Act or pregnancy discrimination laws.

How Much Carryover Should Be Allowed?

When an organization decides that some level of carryover is appropriate to support the objectives of the program, the next step is to determine how much. This decision, as with all PTO decisions, should be made by evaluating all time off, sick leave, and disability programs as a whole. For example, an organization that offers a short-term disability program with a 30-day elimination period may decide to offer higher carryover than an organization with a 7-day elimination period to help bridge the gap between the two benefits. Further, this type of evaluation

may lead an organization to discover other potential efficiencies (i.e., reducing carryover and offering a shorter elimination period).

Additionally, keep in mind that a PTO carryover policy does not set a "sunset date" or expiration date for earned PTO time. The opposite is the "use it or lose it" policy where current employees must use their PTO time by a certain date or it expires. Unfortunately, setting expiration dates are becoming harder to structure under newly emerging state laws (discussed later in this article). Currently, there are no states (California being the exception) that mandate vacation carryover, there are only states that prohibit "use it or lose it" policies.

In most states (again California being the exception), carrying over PTO to the following year is at the employer's discretion. One common solution is to allow days to carry over, but to place a limit on the number of days that can be carried over. This keeps the associated unused days and cost of those days under the employer's control and also encourages employees to take the time off they need. A common approach is to limit the carryover to three (3) days (or twenty-four (24) hours) and require that it be used in the first three months after it is carried over.

As a general matter for risk mitigation, it is always recommended that an employer clearly communicate their PTO policy on carryover, particularly if the policy limits the carryover. Further, subsequent and regular re-communication of the PTO policy to employees to remind them of how the policy works as well as to provide them appropriate notice to determine a strategy for PTO carryovers that may otherwise expire, creates a collaborative work environment between employee and employee to foster greater understanding and facilitate the use of PTO. Since carryover caps have become the current trend, ensure that the organization understands whether the amount of cap is consistent across all states in which they operate or whether such caps must be adjusted per state for compliance purposes.

What Happens When An Employee Reaches The Maximum Bank?

Another key decision that an organization has to consider when deciding to use a cap on a PTO bank is what to do when an employee reaches his or her maximum PTO bank. While this may not seem like a major issue, the cost impact could be significant. From a liability and cost management standpoint, the best practice approach is to stop accruals for employees

who have reached the maximum PTO bank. At the other end of the spectrum, some employers allow for an “automatic” cash out of amounts in excess of the maximum bank which can result in a large ongoing annual cost for longer-term employees.

From a legal standpoint, keep in mind that setting a maximum cap on PTO is typically viewed more favorably than a “use it or lose it” policy. For example, let’s assume an employer caps the amount of PTO that an employee can accrue at 160 hours (a 4 week equivalent). As we know, most PTO policies accrue PTO every week (or based on the amount of worked hours). When the employee reaches the 160 hour cap for the year, the employee will cease accruing any more PTO under the policy. In order to continue accruing, the employee will need to use some of the accrued PTO. This is typically more adaptable legally because under an accrual “cap” the employee is technically not losing any accrued time (as he/she might be forced to forfeit such time under a “use it or lose it” approach). The employee does not lose any accrued time but neither is he/she accruing any additional time. This can be a key distinction because where “use it or lose it” policies can be illegal in some States, an accrual cap is normally quite legal (particular in States were no

PTO requirements exist) and an effective way of managing the amount which is accrued for the workforce over time.

Additionally, an emerging practice which is being explored by some organizations is a move to an “unlimited” time off approach for senior leadership. Under this approach, there are no more accruals and, as a result, no more cost or liability associated with PTO for this group. These types of programs recognize that senior leaders have a unique job to do, and very rarely have the opportunity to fully unwind, even when they are taking time away from work. This type of program gives executives the flexibility to use time off as needed, and typically encourages at least four to six weeks of time off to relax and rejuvenate, while limiting the financial exposure of the organization.

As with any new offering, the “unlimited” aspect may be susceptible to abuse. Consequently, a written policy is critical to success and mitigating the risks to the organization. Employers will want to clearly communicate the continuing expectation of the employee to satisfy his/her job responsibilities but also define the disciplinary actions (including termination) that will be taken for not meeting the requirements and conditions of his/her job. Spe-

cifically, if abuse of such a policy would be grounds for a "cause" termination, that particular aspect may need to be synchronized with executive employment agreements which may not otherwise contemplate this new benefit.

As with any benefit which is solely offered to a single group, employers should also anticipate that they may face issues such as perceived favoritism which can lead to discrimination claims. Any unlimited PTO policy should be consistently applied across the group eligible for the benefit without the need to make discretionary judgment calls on whether a particular employee can use it or not. The more discretion which is built into the system, the higher the probability of an employee claiming arbitrariness in application of the policy. Accordingly, employers will want to seek legal review with respect to the parameters of any "unlimited" policy offered to a select group.

NEW CHALLENGES POSED BY LOCAL SICK LEAVE ORDINANCES

A particular challenge which is growing with respect to implementing CTO approaches is the trend of cities within the US in enacting separate sick leave ordinances. Historically, sick leave policies were left up to the employing organizations

to design as well as whether to offer at all. But, with the new challenges employees continue to face with working and being a primary care giver either as a single parent or for aging parents, there has been a developing trend across the country in cities mandating a certain amount of paid leave to be available to employees for such situations.

Normally, these ordinances require that employees accrue a specified amount of sick leave based upon the amount of time that they work (e.g., one hour for every thirty (30) hours worked up to a designated cap for the year). Generally, the sick leave ordinances have been broadly defining the circumstances in which the sick leave can be used, such as taking care of themselves when they are ill or caring for someone else who is ill such as parents, children, spouses, domestic partners, siblings, grandparents, grandchildren or any other designated person under the law.

When an employer moves to a CTO approach, a separate city sick leave ordinance can create a challenge depending on how it is worded. When a city sick leave ordinance applies, any CTO policy will need to be amended to expressly articulate compliance with the specific sick leave ordinance, such as allowing the employee

to use the accrued time for the same purposes as the city ordinance and the accrual rate and cap will be required to be at least as generous as the sick leave ordinance to which they are subject. This can be further complicated when an employer is located in more than one city who mandates its own sick leave requirements. Then the employer needs to undertake an analysis of the pros and cons of offering a uniform CTO policy that accounts for an ordinance in only one city or carving out that city from the main CTO policy. Either way, increased administrative cost is likely to incur in these situation and legal compliance becomes challenging particularly where a uniform policy is no longer possible.

Cities which have implemented their own sick leave requirements include, but are not limited to, Jersey City (NJ), New York City, Portland (OR), San Francisco (CA), Seattle (WA) and Washington D.C.

CONCLUSION

While this article was focused on the detailed aspects of the paid time off program, and how to limit financial and compliance risk, it is important to not lose sight of the bigger picture. Paid time off is only one aspect of an employee's benefits package and changes to this program can influence other pro-

grams such as extended sick leave, short-term disability/salary continuation, and long-term disability. In addition, depending on the structure of the current program, changes may have an impact on total com-

pensation, which might separately need to be evaluated and addressed.

NOTES:

¹Separate studies by Worldat-

Work and the Society of Human Resource Management reflect a range anywhere from 5 to 7 days.

²Private Letter Rulings 200130015 (Apr. 26, 2001), 200351003 (Sept. 16, 2003), and 200450010 (Aug. 18, 2004).

³T.D. 7663, 1980-1 C.B. 101.