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**CONSIDERATIONS FOR EMPLOYEE BENEFIT PROGRAMS  
THAT BENEFIT EMPLOYERS AND EMPLOYEES**

Employers must compete in the marketplace for talented employees at every level—both in recruitment and retention. It is thus in employers' best interests to provide employee benefit plans that are attractive to employees and at the same time operate in ways that, where possible, favor the employer as well. As discussed below, recent changes in tax law and court decisions in the ERISA area encourage employers to revisit their retirement plans and consider pocketbook and non-pocketbook improvements for the employer and employee alike.

For up-to-date information for employers on employee benefits, compensation, litigation involving the Employee Retirement Income Security Act (ERISA), and developments related to ERISA law, subscribe to our [Employee Benefits Insight](#) blog.

This *Take 5* features five considerations suggesting the advantages of employee benefit plans as programs that are beneficial to both employers and employees:

- 1. Tax Aspects of Qualified Retirement Plans Can Save Money For Both Employers and Employees**
- 2. The Benefits of a Contractual Claims Limitation Period**
- 3. The Benefits of a Contractual Venue Selection Clause**
- 4. The Standard of Judicial Review in the Context of Top Hat Plan Benefit Disputes**
- 5. Fiduciary Exception to the Attorney-Client Privilege in Plan Administration**

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**1. Tax Aspects of Qualified Retirement Plans Can Save Money For Both Employers and Employees**

Some employers and employees have come to take their retirement plans for granted. Employers may become comfortable with the basic design of their plans. Employees

may assume their 401(k) will be available as a convenient way of deferring some modest portion of compensation in a systematic way to grow a small nest egg for future use.

A fresh look at qualified retirement plans is now in order. That is because, when taxes rise, simple math tells us that tax-exempt programs increase in value. The focus here is that tax law changes that came into effect in 2013 created new, or higher, levies—both payroll taxes and income taxes—and those changes call for employers to revisit the potential money savings from their qualified plans for *both* employers (primarily through payroll tax savings) and employees (through income tax and payroll tax savings). The following comments share a few numbers and related observations.

Employers make contributions to the plan and receive an immediate income tax deduction. Employees are not subject to income tax corresponding to the employer's plan contributions; instead, employees are subject to income tax when they receive distributions.

As for payroll taxes, described below, employers and employees are not taxed at any time on employer contributions. However, when an employee makes elective contributions to a 401(k) or 403(b) program, those contributions are subject to payroll taxes on both the employer and employee at the time of contribution.

### *Payroll Tax Increases*

Payroll taxes have become a significant cost for both employers and employees—particularly since 2013. By way of background, an employer pays 7.65 percent on each employee's wages up to the Taxable Wage Base ("TWB"), and 1.45 percent on wages above the TWB. The TWB is an indexed number and has been rising every year (e.g., in 2013, \$113,700; in 2014, \$117,000; in 2015, \$118,500). Employees pay the same payroll tax. So, the total for the employer and the employee combined is 15.3 percent of wages up to the TWB, and 2.9 percent of wages above the TWB. (There is also a new 0.9 percent payroll tax on higher levels of employee wages but not on employers.)

Employers should revisit their retirement plan design and consider strategies that would shift some ordinary W-2 wages (or future wage increases) into the "employer-contribution category" and secure a reduction of payroll taxes for such contributions. The larger the workforce, the greater the savings to be had. For example, if an employer with a workforce of 1,000 employees earning less than \$118,500 had \$1,000 of compensation per employee paid into a profit-sharing plan, that \$1,000,000 would save the employer \$76,500 per year in payroll taxes compared to payment of that \$1,000,000 as W-2 wages (\$1,000,000 x 7.65%). The aggregate payroll tax savings for the employees would be the same, i.e., \$76.50 per employee.

The suggestion to reduce payroll tax expenses by increasing employer contributions to the plan does not require any reduction in employees' current salaries or wages. Some portion of the employer contribution might come from current or future pay increases. Some from year-end bonuses. Thus, an employer's compensation policy may be

structured so that an increased employer contribution is a win-win arrangement. That is, both employer and employee will enjoy relief from payroll taxes, and the employees also will enjoy relief from the new or higher income taxes. This is particularly true for higher income management employees and professional personnel.

### *Income Tax Increases*

With respect to savings down the road, almost all employees are interested in growing their nest eggs for future years and avoiding current income taxation. Consider the new or higher income taxes hitting employees (particularly higher income taxpayers) that began in 2013: a new 39.6 percent tax bracket (up from 35 percent); phase-outs of personal exemptions and itemized deductions at higher income levels; and a one-third increase in the tax on capital gains and qualifying dividends from 15 percent to 20 percent for higher income taxpayers.

In addition, all employees will be subject to income tax on their savings (nest eggs) outside a tax-exempt plan, plus higher-income taxpayers will be hit by a new tax equal to 3.8 percent on unearned income (dividends, interest, royalties, etc.). Compare the higher-income employee who incurs federal and state taxes on his or her savings *outside* any tax-sheltered plan with the employee who *avoids* current income, payroll, increased capital gains taxes, dividend taxes, and the new unearned income tax (3.8 percent) with his or her nest egg savings held *inside* a tax-sheltered plan.

Year after year, ordinary compensation and other income received outside the plan will be hit by high income and payroll taxes and by the 3.8 percent unearned income tax on investment income. By contrast, the savings that grow in the tax-sheltered plan (i) will avoid all income and payroll taxes at the front end going into the plan, (ii) will avoid taxes on investment income while in the plan, and (iii) will avoid the 3.8 percent tax on so-called unearned income. At the backend, upon distribution, after years of growth, plan payouts will be subject to income tax, but there will never be any payroll taxes. If well designed, the qualified plan can be an attractive employment feature for all employees, from entry level to senior management.

With good communication, employees can appreciate that these measures resulting in savings, particularly for higher paid employees, can only be achieved by the employer's adjustment in its retirement plan's design. The employer may receive praise for a shift in compensation policy that favors the employer and employees. That is, depending on the design of the employer's qualified plans, slight adjustments could produce attractive savings for both employer and employees. At a more ambitious level, where greater tax savings are targeted, employers may consider more sophisticated plan designs using cross-tested contribution arrangements or even a cash balance plan option. The more sophisticated plan designs typically generate more tax savings.

Finally, in terms of an employer's obligation to adhere to any new compensation policy, the tax laws allow contributions to a profit sharing plan to vary from year to year—from \$0 to the maximum permitted by law. The employer is not "locked in." Thus, in a year

of tight cash, an employer is permitted to reduce the profit sharing contribution—or eliminate it entirely. That rule does not apply to pension plans.

The point here is that the new or higher federal taxes encourage employers to rethink their plan designs to capture greater savings for all. This point is even more compelling where high tax jurisdictions, such as New York State, New York City, and California, significantly worsen the after-tax numbers.

## **2. The Benefits of a Contractual Claims Limitation Period**

All ERISA plans, both welfare and pension plans (including executive compensation agreements, top hat plans, and supplemental employee retirement plans (“SERPs”)), are subject to various types of claims that can end up in court. For claims of fiduciary breach, ERISA contains a statutory limitations period to cut off the time in which a plaintiff may assert a fiduciary claim. (That period is three years or six years, depending on the circumstances.)

But for the vast majority of ERISA lawsuits, non-fiduciary complaints such as ordinary benefit claims, interference with ERISA rights, document request claims, COBRA notice claims, etc., there is no ERISA provision serving the function of a statute of limitations. In such cases, the federal courts apply the “most analogous” state law statute of limitations. In Illinois, for example, ERISA benefit claims are treated as subject to that state’s statute of limitations for written contracts—10 years. That’s a long period for a plan to be exposed to a lawsuit.

In past years, a few ERISA plans provided for a contractual statute of limitations in their plan documents. However, most plans have not done so—some no doubt waiting for guidance from the U.S. Supreme Court, which had never reviewed the issue in the 40 years of ERISA’s existence. In 2013, however, that changed with the Court’s decision in *Heimeshoff v. Hartford Life & Accident Insurance Co.*, No. 12-729, \_\_ U.S. \_\_ (Dec. 16, 2013). *Heimeshoff* gave the Court’s blessing to a contractual limitations period, provided that it is reasonable in length and not subject to a controlling statute to the contrary.

In virtually all cases now, a court would consider a three-year period, and perhaps even a two-year period, commencing with a benefit claim denial or other definitive action of a plan administrator, to be reasonable.

Compare the advantage to a large benefit plan of having a single unambiguous contractual limitations period to a situation where the plan prescribes no such limit. Unnecessary court wrangling can be eliminated on a variety of issues. When the plan and the plaintiff are in different states, which state’s limitations period should apply? What is the “most analogous” state law? What about class actions commenced in several jurisdictions?

With *Heimeshoff* now on the books, it is hard to argue that an ERISA plan should *not* have a contractual limitations period. This subject should be on the agenda of many fiduciary committees in the coming months. And, if a plan adopts a contractual

limitations period, the plan administrator should also communicate the change to participants in appropriate ways, such as in the plan's summary plan description ("SPD"), and in the case of benefit claim denials, in the denial letter. The plan and participants will gain from greater predictability.

### **3. The Benefits of a Contractual Venue Selection Clause**

ERISA contains a special statutory provision governing venue—where a lawsuit under Title I (which covers most ERISA litigation) can be brought. That section of the law provides that an action *may* be commenced in the district (i) where the plan is administered, (ii) where the breach took place, or (iii) where the defendant resides or may be found. This statutory provision has triggered a number of disputes at the district court level concerning *plan* provisions designed to restrict where a plan can be sued. In most of those cases, the court has enforced the plan's venue selection clause narrowing the statutory provision.

Although there have been two U.S. Supreme Court decisions in non-ERISA cases favoring parties' rights to fashion contractual venue provisions, until recently, no appellate court had addressed an ERISA plan's venue selection issue in a meaningful way. That changed recently with a decision from the U.S. Court of Appeals for the Sixth Circuit in *Smith v. AEGON Cos. Pension Plan*, No. 13-5492 (6th Cir. Oct. 14, 2014), enforcing the defendant plan's venue selection clause.

Although there are arguments *against* venue selection clauses in ERISA plans, under the more common view favoring such clauses, the plan, for example, could provide that a plaintiff may sue the plan *only* in the district where the plan is administered. For employers, plan sponsors, and administrators, the inclusion of such a clause would seem to be an attractive feature in several respects. Obviously, there is administrative convenience to plan managers in dealing with lawsuits "at home" rather than where a retiree resides. On a substantive level, however, there are other advantages. For example, a consistent set of rulings from a single body of circuit case law affords greater predictability on issues where there is a clear circuit split or even just a subtle nuance in local case law, local judges, etc. In addition, a consistent legal environment enables the plan that covers participants in more than one district to operate in a more consistent manner. Along the same lines, the plan's informational materials, such as the SPD, might be well served by a consistent body of case law. The same can also be said of ancillary documents that can trigger lawsuits, for example, beneficiary designation forms. A number of multiemployer (Taft-Hartley) plans with wide geographical coverage have commenced using venue clauses.

From a plan administration perspective, there seems to be little downside to amending the employer's plans to include a venue selection clause. Much the same as with contractual limitation clauses, plan committees should consider addressing the subject of a venue selection clause and, if one is adopted, communicate to participants its effect in appropriate ways, such as in the plan's SPD and in the case of benefit claim denials, in the denial letter. Here again, the plan and participants will gain from greater predictability.

#### **4. The Standard of Judicial Review in the Context of Top Hat Plan Benefit Disputes**

Executive compensation plans are ubiquitous. All deferred compensation programs subject to ERISA, including executive compensation, SERPs, and similar arrangements, are commonly referred to as “top hat plans.” Programs conferring deferred compensation for a “select group of management or highly compensated employees” are subject to enforcement under ERISA when benefit disputes arise. A distinguishing feature of top hat plan benefit disputes is that fiduciary duties are not at issue, and courts take a more contract-oriented approach.

One of the most important issues in lawsuits over top hat plan benefits is the standard of judicial review. The question concerning the standard of judicial review is this: Will the judge (i) review the dispute with a fresh eye (a “de novo” standard), or (ii) defer to the plan administrator’s decision, unless it is shown to be clearly unreasonable (an “abuse of discretion” or “arbitrary and capricious” standard)? The standard of judicial review frequently dictates the outcome of a disputed benefit claim denial, and it can be the most hotly contested issue in a given case.

With that background, the case law has evolved in a way that some jurisdictions treat plan administrator decisions with more deference than other jurisdictions. Notable in this regard are the U.S. Court of Appeals for the Seventh Circuit, covering Illinois, Wisconsin, and Indiana, and the Ninth Circuit, covering California and other Western States, whose case law calls for deferential judicial review favorable to employers and plans. By contrast, precedents in the Third Circuit, covering Pennsylvania and New Jersey, and the Eighth Circuit, covering Minnesota, Missouri, and Arkansas, suggest that judges should not defer to the plan administrator’s decision, but should review the claim denial with a fresh eye.

The Second Circuit, covering New York, Connecticut, and Vermont, has noted the existence of the split but has not taken a position on this issue.

Thus, as with the venue selection clause (see above), it can make a big difference where a top hat benefit claim is litigated because controlling case law may differ from one locale to another.

A clear understanding of a potential claim’s likely reception in court will enable the parties involved in a claim to assess the plan administrator’s exercise of discretionary authority, for example, in denying a claim. Hopefully, case law precedent will help the parties avoid litigation that should not have been filed in the first place.

#### **5. Fiduciary Exception to the Attorney-Client Privilege in Plan Administration**

The confidentiality of plan-related communications is not always a prime consideration in the course of routine benefit plan activities. Nonetheless, those involved in plan activities—whether decision-making about investments, selection of service providers, benefit claim decision-making, or preparations for counseling participants and beneficiaries—should be continuously conscious of issues pertaining to the attorney-

client privilege. Those issues include: when it applies and when it doesn't; to whom it applies; and other questions not always easy to discern.

Most have heard of the attorney-client privilege, an aspect of law that has been with us for centuries. The privilege applies where a lawyer and client communicate with a reasonable expectation of confidentiality. The privilege applies in the context of employee benefits law as it does in other areas of law. Importantly, however, employee benefits activities are different from routine commercial activities in that they are often overshadowed by fiduciary duties. The presence of fiduciary duties can intrude on the privacy of communications between a plan administrator and legal counsel. The issue becomes prominent when a dispute goes to court and a claimant wants documents or testimony from a plan representative.

In recent years, the courts increasingly have recognized that, while the attorney-client privilege applies as a general rule, situations can arise in which an exception applies to communications involving fiduciary activities. The courts recognize a fiduciary exception to the attorney-client privilege. The notion driving the distinction between the general rule and the exception is that, as in certain other areas (e.g., trustees acting for trust beneficiaries, or corporate board members acting on behalf of shareholders), plan fiduciaries act for the exclusive benefit of participants and beneficiaries—almost as their agents.

Sometimes the distinction is elusive. A member of the company's management team may leave a meeting with business managers in "Room A" and go across the hall to a meeting of plan fiduciaries in "Room B." Legal counsel may or may not even be present in Room B for that plan-related meeting. Sometimes, unfortunately, fiduciary and non-fiduciary subjects may be covered in the same meeting in the same room with a mixed agenda where it is difficult to classify subject matter.

Compounding the question, the law clearly treats company-related activities as "settlor" activities that are *non-fiduciary* in nature. Thus, for example, the attorney-client privilege should apply to company decisions to establish, amend, or terminate a plan.

In addition, the courts generally recognize that some activities of fiduciaries are personal in nature and, thus, preserve the attorney-client privilege to protect the confidentiality of plan administrators' communications with their legal counsel. In other situations, however, the fiduciary is acting as an agent of the plan and its participants; in such cases, the court may conclude that the administrator has no right to confidentiality in those other circumstances.

One recently emerging distinction in the case law can be seen when a participant asserts a claim against a plan when litigation has commenced or is threatened. There, the court may conclude that the participant's interests have *diverged* from those of the plan and the privilege may be asserted to protect the confidentiality of communications between a plan representative and counsel. By contrast, at an earlier stage of that same benefit claim, the court may conclude that, before a decision to deny the claim is made, the privilege should not protect the confidentiality of communications between

the administrator and counsel because the claimant's interests had not yet diverged from the interests of the plan, which owes the claimant a full and fair claim review.

Let's look at a few examples:

- **Internal communications between plan counsel and administrators on amending the plan:** The law treats plan amendment decisions as "settlor" decisions, not fiduciary decisions, and thus the privilege should protect those communications.
- **Communications between counsel and the plan administrator after a claim is denied and the claimant threatens a lawsuit:** Here, the claimant's interests have diverged from the plan, and the privilege should protect the attorney-client communications.
- **Communications between the plan administrator and an outside, non-attorney consultant:** In this case, there is no attorney present to establish the protection of the attorney-client privilege.
- **Communications between the company's labor counsel and a plan administrator before going into negotiations with the union:** Here, fiduciary duties are not applicable; these are "settlor" activities that are protected by the attorney-client privilege.
- **Communications between legal counsel and a plan fiduciary being sued personally for breach of fiduciary duty:** Here, the fiduciary's personal interests have diverged from duties to the plan, and the fiduciary's communications with his or her counsel should be protected by the attorney-client privilege.

In summary, case law in this area encourages legal counsel and plan personnel to have an ongoing awareness of (i) all parties who are privy to communications where confidentiality is expected; (ii) the fiduciary status of the parties or the activity involved in the communication; (iii) the content and nature of the communication; and (iv) the timing of the communication, e.g., whether a party's interests have come to be in conflict with or diverged from the plan.

Plan representatives and their legal counsel as well as counsel for participants will benefit from a clear understanding of when fiduciaries' communications are protected by the attorney-client privilege and when they are not.

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