

Staying Ahead

with Saul Ewing

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Employee Benefits

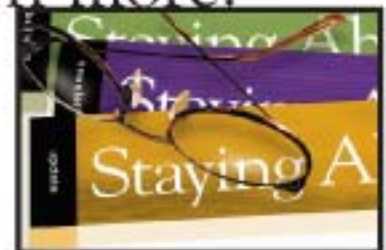
What happened?

Over the last thirty years, the regulation of employee benefits in the U.S. has become increasingly complicated. Significant penalties apply when the applicable laws are not followed.

What does it mean?

Businesses that operate in the U.S. need to have an understanding of the system of employee benefits in the U.S., which can help them avoid penalties and operate more efficiently.

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The system of employee benefits regulation in the U.S. can be confusing, and the failure to follow its detailed legal requirements can result in fines and litigation. While there is no substitute for advice from legal counsel in each employer's situation, some general guidelines can be helpful in navigating a regulatory scheme that differs from that of many other countries and is subject to frequent revision.

Retirement Benefits

There is no government pension plan system in the U.S., with the exception of the Social Security system. Under that program, first established in the 1930s, most employers and employees are required to contribute a percentage of compensation to the federal government, which, upon the employee's retirement, pays a pension for the employee's life and that of the employee's spouse. The amount of the pension is based on the employee's compensation level in each year contributions are made. At the present time, the tax rate for employers and employees is 6.2% each, up to annual compensation of \$94,200 per year. The tax rate has been steady for several years, but the level of compensation on which tax is assessed rises each year. In addition, employers and employees must pay an additional 1.45% tax to support the Medicare old age health system, and this tax rate is imposed on all income. For self-employed persons, such as partners in a law firm or other business entity, the full amount of the tax is paid by the partner.

Nearly every type of worker in the U.S. is subject to the Social Security system. There are exceptions for certain government workers, clergy, and farm workers, but it may safely be assumed that workers in nearly all U.S. businesses will be subject to the tax. It is, in fact, a tax, although the law imposing it is called the Federal Insurance Contributions Act. Contributions suggest a voluntary act, and this tax is mandatory. There are very severe penalties imposed on employers who fail to withhold and pay over the tax.

Other than required contributions to Social Security, employers are generally able to offer whatever retirement plan they wish. (In some countries, reference is made to retirement or pension "schemes," but that terminology is not used in the U.S., where the word scheme has a negative connotation.) There is often competitive pressure to provide one or another form of retirement plan and, where employees are members of

a union, the form of retirement will often be determined through the collective bargaining process. Some industries have a tradition of a particular type of retirement plan, but in recent years the pull of tradition has lessened as employers seek means of holding down costs.

Regulatory Framework

The regulation of most forms of employee benefits in the U.S. is based on a law enacted in 1974, the Employee Retirement Income Security Act of 1974, which is referred to as ERISA. This law has been amended in almost every year since its enactment, and further amendments are considered by the U.S. Congress on a regular basis. Prior to ERISA, there was virtually no regulation of employee benefits, and retirement plans in particular were very uneven in their funding, sometimes with unfortunate results when businesses failed. The purpose of ERISA was to produce more disclosure and certainty in retirement and other benefits, and especially to ensure that employer promises of benefits reached fruition.

ERISA is contained in the Internal Revenue Code, the law that imposes all U.S. taxes, as well as in free-standing provisions of the law. Parts of the law, particularly those concerned with setting guidelines for participation in, vesting of and funding of retirement plans, are administered by the U.S. Internal Revenue Service, which also administers the U.S. tax system. Rules as to fiduciary responsibility and related subjects are administered by the U.S. Department of Labor. There is some overlap of their responsibilities, so that for some issues, it is necessary to deal with both agencies. A third agency, the Pension Benefit Guaranty Corporation, administers an insurance program for defined benefit pension plans, described below.

Types of Retirement Plans

A defined benefit pension plan promises employees a benefit at retirement, often determined as a percentage of compensation multiplied by years of service. The employer makes contributions each year that are calculated to produce the benefits promised when employees retire. The amount of each year's contribution takes into account income earned on prior contributions and is, consequently, sensitive to changes in investment markets.

In effect, the employer assumes the market risk in a defined benefit pension plan. Because benefits promised can increase as annual compensation rises and service increases, the unfunded liability in such plans can become a large number. In recent years, steel manufacturers and automakers in particular have seen these liabilities threaten their solvency. Defined benefit pension plans work well in many situations, but care must be taken to control costs. Despite the problems of large industries with defined benefit pension plans, they can produce substantial retirement benefits. They are an ideal choice for small employers with high income employees who are age 45 or older.

The promise made by employers in defined benefit pension plans is insured by a government agency, the Pension Benefit Guaranty Corporation. Each employer who sponsors a defined benefit pension plan must pay an annual premium to the PBGC, designed to cover expected liabilities from plans or employers that cannot meet their obligations. The premiums have risen substantially in recent years but, unfortunately, so many employers have become unable to meet their obligations, especially in large industries with thousands of employees, that the PBGC is running a deficit of many billions of dollars. This problem has led to the development of a new form of retirement plan, the cash balance plan. While it has some similarities to defined benefit pension plans, it does not develop the large unfunded liabilities of defined benefit plans, and it tends to favor newer, younger employees over older employees. For that reason, some people claimed that this type of plan violated age discrimination laws, but apparently cash balance plans have satisfied that form of scrutiny and are being approved by the Internal Revenue Service.

The other major category of retirement plans is defined contribution plans. In a defined contribution plan, the employer makes a contribution to the plan, which is often allocated among the employees participating in the plan in proportion to their compensation. The contributions are invested, and income earned is added to the participant's account in the plan. When the participant retires, he or she gets whatever is in the account. The employee/participant bears the risk and enjoys the benefit of changes in the investment markets.

Within the category of defined contribution plans are several varieties. In a money purchase pension plan, the employer is obligated to contribute a fixed percentage of each employee's compensation each year. In a profit-sharing plan, the employer may decide from year to year whether to make a contribution.

A Section 401(k) plan is a subset of a profit-sharing plan. Section 401(k) of the Internal Revenue Code permits employees to elect each year to reduce their compensation and to have the reduced amount contributed to the retirement plan. The reduced amount is not subject to income tax currently. The employer may make matching contributions to encourage participation, as well as profit sharing contributions that are not tied to employee contributions.

Employee stock ownership plans are a specialized form of retirement plan that are tied to the ownership by employees of stock in their own employer. They permit employees to participate in the growth (or decline) of the employer. They also offer valuable income tax benefits to business owners who want to cash out some or all of their ownership in the business.

Required Provisions in Retirement Plans

ERISA and the Internal Revenue Code impose some requirements on retirement plans:

- participation – generally, plans must cover a large and non-discriminatory group of employees
- vesting – participants in retirement plans must obtain non-forfeitable right to the amount deferred from employer contributions over a specified minimum period of years
- contribution levels – the amount that may be contributed to retirement plans is limited by the law. For Section 401(k) contributions, the limit is now \$15,000 per year, while for defined contribution plans with employer contributions, as much as \$44,000 per participant may be contributed with some limitations. For those 50 and older, an additional \$5,000 may be contributed. For defined benefit plans, the limits are expressed in terms of benefit payments permitted at retirement.

- administrative provisions – plans must indicate when retirement benefits may be paid out, when and how plans may be amended, and what appeal rights participants have if they believe they have not received the benefits to which they are entitled

The form of retirement plan documents is highly regulated. Employers generally submit plan documents to the Internal Revenue Service for a determination that they satisfy the requirements of law and are “qualified” plans.

Taxation of Retirement Plan Distributions

Retirement plans offer several valuable tax benefits. The contributions made by the employer each year are not treated as taxable income to the employees, and that is also true of the compensation reductions by employees that are contributed to Section 401(k) plans. The earnings on the amounts contributed are also not currently taxed. Federal income taxes are imposed when amounts are distributed: at retirement, termination of employment, disability, or death. In many cases, the distribution of benefits can be postponed until the employee reaches age 70 1/2, and even then distribution and taxation can be spread out over a long number of years.

Fiduciary Responsibility

ERISA imposes numerous fiduciary responsibilities on employers and plan trustees. The law requires extensive disclosure to employees of the terms of retirement plans. There are very detailed rules that prohibit self-dealing transactions. Violation of these rules can lead to substantial penalties, as well as litigation in federal courts.

Other Types of Compensatory Benefits

In addition to retirement plans, employers may offer the opportunity to acquire ownership in the employer through stock options or stock purchase or grant plans. Incentive stock options may be offered to employees, with the favorable tax benefits that the employee is not taxed when the option is granted, nor when it is exercised. Further, if the stock purchased is held long enough, the gain on its sale is treated as capital gain and taxed at reduced rates. If incentive stock options are not feasible or appropriate,

nonqualified stock options offer some of the tax benefits. Employee stock purchase plans and restricted stock also provide some tax benefits to employees.

Nonqualified Deferred Compensation

Many employers want to provide additional benefits to higher echelon employees, rather than offering them to a broad cross-section of income levels. Plans of this type come in many forms, including management incentive plans, stock appreciation right plans, phantom stock plans, and supplemental executive retirement plans. The tradeoff in having such finely tuned benefit programs is a loss of some of the benefits that are enjoyed through qualified retirement plans. Many employers believe that the tradeoff is a worthwhile bargain for the increased motivation that derives from nonqualified plans. While such plans were generally unregulated for many years, a recent change in federal law, enacted in 2004, provides for the first time a regulatory framework. While the new law limits some forms of nonqualified deferred compensation, plans of this type still work and are expected by many executives.

Individual Retirement Accounts

This type of retirement vehicle was created by ERISA as a means of allowing individuals to establish their own retirement plans. The amount that may be contributed is lower and, if an individual is also a participant in an employer’s retirement plan, the employee’s right to contribute may phase out at certain income levels. A very basic form of employer-sponsored retirement plan, the simplified employee plan or SEP, makes use of the IRA structure.

Welfare Benefits

In addition to retirement and stock-related plans, employers frequently offer additional employee benefits. The most important of these is health benefits. Health benefits that are provided through insurance may be tailored to the employer’s needs, and different levels of benefits may be offered to various employee groups. There is no requirement of non-discrimination with respect to insured health benefits. Because of the rapid increase in the cost of health benefits, employers have added provisions to plans, such as co-pays and deductibles, that hold down usage and costs.

Many large employers and some small ones have begun using self-insurance, in whole or in part, as a further cost control method.

Another method of controlling health costs is through the use of cafeteria plans. Under a cafeteria plan, employees reduce their compensation, avoiding federal income tax on the reduced amount, and use the reduced amount to pay medical expenses not covered by health insurance. This creates tax advantages both for the employer and employee.

Beyond health insurance benefits, employees frequently offer life insurance and disability insurance, and sometimes long term (or nursing home) insurance. Again, because these benefits are insured, employers have considerable discretion as to the extent of coverage of such plans.

Numerous other federal laws govern employee benefits and the employment process in the U.S. The Family and Medical Leave Act, the Age Discrimination in Employment Act, and the Americans With Disabilities Act are a few examples of laws that must be consulted in the employment and employee benefits process.

Employee Benefits in the U.S.

While the forms of employee benefits in the U.S. are many and varied, all are governed by the provisions of ERISA and other federal laws. With careful planning, it should be possible to provide such benefits in an efficient and cost-effective manner.

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