
Morgan Lewis
THE BENEFITS OF
EMPLOYEE BENEFITS
Attracting and Retaining Top Talent Through Benefit Plans
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Structuring Incentive Plans in a Volatile Stock Market
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Structuring Incentive Plans in a Volatile Stock Market

1. Evaluating Incentive Compensation Metrics
2. Managing Equity Plan Share Reserve
3. Incentives for New Hires: Inducement Grants
4. Incentives for Existing Talent: Retention Grants
5. Addressing Underwater Stock Options

1. Evaluating Incentive Compensation Metrics

- Update performance metrics to align with the company's strategic approach to address market volatility
  - For example, companies could include metrics that disincentivize inappropriate risk-taking, focus on non-financial measures, and emphasize near-term goals
  - Relative TSR may be more appropriate than absolute TSR
- Consider using a shorter performance period
- Evaluate whether to adjust performance goals in outstanding grants (if grant agreements allow for discretion to adjust)
- Review employment and severance agreements if making changes to incentives (including whether a change will trigger "Good Reason")

2. Managing Equity Plan Share Reserve

- Significant drop in stock price can lead to dwindling share reserve
  - Volatile stock market can lead to discrepancies in number of shares covered by awards that are meant to deliver similar value
- Strategies to manage equity plan share reserve
  - Grant RSUs/PSUs instead of stock options
  - Set the number of shares subject to equity grants based on a trailing average stock price that includes a prior trading period when prices were higher
  - Increase cash compensation or use awards payable in cash
  - Reduce upside on performance awards so fewer shares have to be reserved for maximum performance
  - Grant equity awards outside the shareholder-approved equity compensation plan as "inducement grants" for newly hired employees

3. Incentives for New Hires: Inducement Grants

- NYSE/NASDAQ rules permit equity awards to be made to newly hired employees as an inducement to employment without shareholder approval if certain requirements are met
- An inducement grant must be:
  - A "material inducement" to the individual being hired (or rehired)
  - Granted to a prospective employee (nonemployee directors and consultants are not eligible)
  - Approved by the independent compensation committee or a majority of independent directors
  - Disclosed in a press release that includes the recipient of the award and the number of shares involved
    - Note: filing a Form 8-K does not satisfy the press release requirement

3. Incentives for New Hires: Inducement Grants

- Inducement grants can be structured as:
  - Awards of inducement grants outside of any equity plan
  - A separate equity plan for inducement grants only
- They are not "free" shares and will be taken into account by ISS and Glass Lewis as outstanding equity grants when an equity plan is next submitted to shareholders for approval
- Shares for inducement grant must be listed on the exchange and registered on Form S-8
- For more information: Inducement Grants Enable Companies to Avoid Depletion of Equity Plan Share Reserves – Publications | Morgan Lewis

4. Incentives for Existing Talent: Retention Grants

- Retention grants have become popular as one-time enhanced or supplemental grants to support retention
- Performance-based retention awards are viewed more favorably than time-based retention awards
- A clear, thorough explanation of the rationale of retention awards needs to be in the CD&A of the next proxy
  - Explanation needs to go beyond mere retention

5. Strategies for Underwater Options: Summary

- Rare for public companies to reprice/exchange underwater options because it usually requires shareholder approval
  - ISS and Glass Lewis have significant restrictions on repricings/exchanges in order to receive recommendation in favor of proposal

- Private companies can reprice without shareholder approval if equity plan and corporate documents do not require shareholder approval
  - Must comply with SEC tender offer rules in certain circumstances

5. Strategies for Underwater Options

- Alternatives for underwater options:
  - Option Repricing: The option is unilaterally amended to provide for a lower exercise price
  - Option Exchange: The option is cancelled in exchange for another form of award (e.g., RSUs)
  - Option Buyout: The option is cancelled in exchange for cash
- Reasons to do a repricing/exchange/buyout
  - Attract and retain talent
  - Reduce dilution
- Reasons not to do a repricing/exchange/buyout
  - If immaterial number of options
  - If stock drop is expected to be short-lived
  - Negative optics
  - Time-consuming, costly, and involves multiple advisors (accounting, tax, legal, outside counsel)


Tax Benefits and
Fringe Benefits
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Tax Benefits of Hiring New Executives Who Have Clawback Obligations

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Background for Tax Treatment of Compensation Repayments: Pre-2018 Favorable Alternatives

- Pre-2018 tax law: an employee subject to a clawback repayable in a calendar year AFTER the original compensation was paid could:
  - Deduct the repayment as a miscellaneous itemized deduction under §165(c)(1) or §162, subject to possible alternative minimum tax (AMT) and 2% floor; OR
  - Try to deduct the repayment as a "claim of right" deduction under Code §1341, which is not subject to the AMT or 2% floor;
  - Try to persuade his/her employer that the compensation repaid in one year should be offset against other compensation payable in that year for all tax reporting and withholding purposes, under case law; or
  - Negotiate with new employer to reimburse clawbacks as a "working condition fringe" (as discussed below).

Post-2017 Rules Block Employee Deductions For Clawbacks

- Post-TCJA Law:
- An employee may not claim a Form 1040 deduction for a clawback under Code §165(c)(1) or 162, due to the elimination of itemized deductions for employee business expenses from 2018 to 2025 (per §67(g)).
- An employee may still try to deduct a clawback under Code §1341.
  - Section 1341 is still available for amounts "otherwise deductible."
  - Problem: IRS hates Section 1341.
- The employer may still try to take the position that a clawback can be collected by offset against other compensation for tax withholding and reporting purposes.
  - Problem: While some case law supports this position, IRS may not agree.
- The employer (old or new) may reimburse its employee for a clawback on a nontaxable basis.
  - Excludable working condition fringe if the employee could deduct under Section 162. An employee's deduction under Section 162 is not repealed just suspended until 2026, per elimination of itemized deductions!
  - Thus, a new employer might reimburse for a noncompete clawback, since the expense was incurred as a result of the employee accepting employment with the new employer.

Code §132(a)(3) Working Condition Fringes & Repayment of Newly Hired Executive Clawback Obligations

More specifically, Code §132(a)(3) excludes from taxable wages "working condition fringe benefits" provided by the employer that meet the following requirements (perTreas. Reg. §1.132-5(a)):

- payment must be for a specific or pre-arranged activity or undertaking, the expense of which would have been deductible to the employee under Code §§162 or 167 if the employee had paid the expense directly;
- expense would have been deductible to the employee in the trade or business of being an employee of the employer, i.e., the expense relates to the business of the employer making the payment (here, an expense triggered by accepting new employment);
- recipient is an employee (or a new hire) of the employer paying the benefit; and
- benefit is not offered under a "flexible spending account" permitting the recipient to choose between cash and the benefit and providing "over a time period a certain level of unspecified non-cash benefits with a pre-determined cash value."

Code §132(a)(3) Working Condition Fringes & Repayment of Newly Hired Executive Clawback Obligations, cont'd.

The working condition fringe benefit exclusion likely applies because:

- the new employer is paying a contractually agreed-upon reimbursement for the clawback payment in the context of the new employer's business (and is thus deductible under Code §162, per Rev. Rul. 79-311, 1979-2 C.B. 25);
- except for the TCJA moratorium on unreimbursed business expense deductions, the current employee would have been able to deduct the clawback payment under Code §162;
- the affected executive is a current employee of the new employer paying the benefit; and
- the affected executive has no right to choose between receiving cash or payment by the new employer of the clawback obligation.

The benefit can itself be subjected to a clawback provision, so that if the employee terminates employment within a certain period after hire the employee would be required to repay the new employer for the amount of the clawback paid to the prior employer.

Negotiations with Prior Employer over Clawback Amount to be Repaid

- Notably, the payment to the prior employer might be the prior payment **net of any FICA taxes (likely only Medicare and Additional Medicare Taxes)** withheld by the prior employer because the prior employer would be allowed to adjust the FA's Medicare-taxable income that was subject to the clawback, and either claim a refund (or receive a credit) for both the employer and employee shares of the Medicare taxes previously paid on the clawback, so long as the refund or credit is claimed within the statute of limitations applicable to such claims.
- The prior employer has an incentive to accept a payment net of Medicare taxes because the prior employer could realize a savings of an additional 1.45% of the clawed-back amount (the **employer** share of Medicare taxes), although the prior employer would be required to file a Form W-2c, adjusting the FA's Medicare - taxable wages for the prior years. If such a form is filed, the employee would be entitled to claim a refund for the Additional Medicare Tax (0.9% of the clawed-back amount).

Also Consider Possible Limitations on Effectiveness of Clawbacks Based on Noncompetition Provisions

- Any payback to a prior employer may also be limited (or prohibited) by the FTC's proposed rules (published January 5, 2023) that would ban employers from entering into or maintaining noncompete clauses with their workers.
- The proposed rules would require employers to rescind existing noncompete clauses by affirmative notification in connection with the final rule's compliance date (and the proposed rule includes a safe harbor notice for this purpose). As a result, companies would need to review all executive agreements to identify any violative restrictive covenants and provide notices to the covered executives, explaining that they may be blocked completely from enforcing clawbacks designed to block employees from accepting work with competitors.
- It has not yet been resolved whether these rules (as proposed to be applied even to existing contracts) violate the constitutional prohibition against ex post facto laws. But, unless the rules are changed, they may render many clawbacks unenforceable.

Proposed Rule and Morgan Lewis LawFlashes and Publications

- FTC's Proposed Ban on Noncompete Clauses May Have Far-Reaching Implications for Executive Compensation
- Federal Trade Commission Proposes Banning Noncompete Clauses for Workers
- FAQs on Federal Trade Commission's Proposed Rule Banning Worker Noncompete Clauses
- FTC notice of proposed rulemaking
- FTC press release announcing the proposal

Recently Amended Fringe Benefits for Employees and Independent Contractors (including Directors)

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Code §127 Expansion for Forgiveness of Student Loan Debt

1. CARES and CAA expanded the Code §127 "educational assistance" income and wage exclusion to cover certain pre-existing student loan debt (principal and interest), whether paid by reimbursement to the worker or directly to the lender or lenders, for assistance provided between March 27, 2020 and December 31, 2025.
2. Prior to enactment, companies could only make nontaxable "educational assistance" payments to defray educational expenses that employees and independent contractors incurred while working for (or on leave from) the reimbursing company (although a special exception applied to educational assistance to terminated workers, per Rev. Rul. 96-41, 1996-2 C.B. 8).
3. Qualifying student loans are limited to higher education expenses that the student incurred within a reasonable period of taking the classes, and provided that the student carried at least a half-time course load.
4. The repayments do not extend to loans from any qualified employer plan (such as a 401(k) loan).
5. Care should be taken to:
   - implement new or update existing educational assistance program materials in writing; and
   - not offer loan forgiveness through a wage reduction arrangement, or through a "choice" between a Code §127 benefit and other taxable benefits.

Code §127 Expansion for Forgiveness of Student Loan Debt, cont'd.

CARES and CAA do not otherwise change the Code §127 exclusion:

1. $5,250 maximum annual exclusion per "employee" (a term defined to include independent contractors, per Code §127(c)(2)).
2. The educational assistance program must be memorialized in a separate written plan (although the IRS has never issued any "model plans" or explained how detailed any plan must be).
3. Reasonable notice must be given to employees of the program's existence and as to program terms.
4. "Education" broadly includes "instruction or training that improves or develops the capabilities of an individual" and is "not limited to courses that are job-related or part of a degree program."
5. Assistance can be provided to:
    a. Current employees (whether actively employed or on leave); and
    b. Former employees (due to retirement, disability, being laid off, or voluntary termination to pursue certain post-termination education, such as vocational instruction and training).
6. Spouses and dependents remain ineligible.
7. Programs that discriminate in favor of highly compensated employees do not qualify for exclusion.

Code §129 Dependent Care Assistance Programs

1. ARPA increased the Code §129 annual exclusion for "dependent care" assistance provided during 2021 from the standard $5,000 limit to $10,500 for single and married-filing-jointly taxpayers. Plan amendments were required.
2. Post-2021, Code §129 returned to its pre-pandemic form (including the lower ($5K) limit on excludable benefits):
   a. The term "employee" is defined by Code §129(e)(3) to include self-employed persons; however the provision of benefits through salary-reduction "cafeteria plans" is limited to employees, per Code §125.
   b. Assistance program must be memorialized in a separate written plan.
   c. Care can be provided to dependents under age 13, dependents and spouses who are physically or mentally unable to care for themselves, others who would qualify as dependents but for income issues or being a dependent on another taxpayer.
   d. Care provider cannot be the worker's spouse, a parent of a qualifying individual, or a dependent or child of the employee (or contractor) who is under 19 years old as of the last day of the plan year.
   e. Programs that discriminate in favor of highly compensated employees do not qualify for exclusion.
   f. Reasonable notice must be given to workers of the program's existence and the program terms.
   g. Individual taxpayers must report on Form 2441 (filed with their 1040 tax returns) the care provider's name, address and EIN, and the value of the company-provided dependent care assistance.
   h. Employers must report the value of nontaxable benefits on employee Forms W-2 in box 10, inclusive of in-kind benefits, cash reimbursements, and any employee pre-tax dependent care FSA contributions. (No reporting rules for contractors are specified in the Form 1099-NEC instructions.)
   i. Special "direct cost" valuation method available under Notice 89-111.

Wellness Programs

- Considerable confusion arises about the tax treatment of "wellness programs" that do not specifically either provide insurance or treat medical conditions but which may separately be excludable as "health benefits" (e.g., for health screenings), or under Code §127 (for education for employees and contractors) or §132 (for athletic facilities **on the employer's premises**) or 139 (for pandemic-related expenses).
- Some programs do not even provide specific counseling, but instead are "referral" or "concierge" programs that put employees in touch with doctors and clinics.
- There is also confusion about information reporting of wellness benefits, due to confusion over whether the third-party benefit-providers are (a) independent providers – covered by Rev. Ruls. 70-331 and 70-337, (allowing Form 1099-MISC reporting, but only where payments are valued at $600 or more); (b) providing "*de minimis*" benefits (as explained in PLR 201117014); (c) a "statutory employer" independently required to report taxable benefits as "wages," or (d) an "agent" that is jointly liable with the employer for W-2 reporting.
- If employers provide the benefits directly, then ILM 201622031 (4/15/2016) warns that NO EXCLUSION applies to participant prizes, including cash rewards, in kind benefits (e.g., Fitbits or "points"), or any other "benefits that do not qualify as Code §213(d) medical expenses, such as gym membership fees."

Other Benefits and Planning Opportunities for Independent Contractors (Including Corporate Directors)

- Since the special FICA tax timing rules of Code §3121(v)(2) apply only to common law employees, it is important to understand that these special timing rules do NOT apply to corporate directors or other non-employees (excepting certain retired partners).
- For the self-employed, whose compensation is not subject to the special timing rules of Code §3121(v)(2), there's no way to pay SECA early other than to pull in the income early (and such accelerated payments must be monitored for compliance with Code §409A).
- However, directors' fees earned between 1988 and1990 that were deferred were technically subject to SECA taxes during those years although the FICA/SECA wage base in those years was capped at $45K, $48K and $51.3K. (See Code § 1402(a)(14), added by P.L. 100-647, § 3043(c)(1), and repealed by P.L. 101-508, § 5123(a)(3).)
- Otherwise SECA taxes (and possibly state income taxes) likely will apply to deferred compensation, as discussed below.

Planning Opportunities for Independent Contractors (Including Directors): SECA on Post-Termination Payments

- It may be possible for at least some self-employed workers to avoid SECA taxes on compensation paid to them after stopping services (e.g., for partnership partners who have withdrawn all capital contributions, and otherwise meet the rules of Code § 1402(a)(10), or have died, per Code § 1402(f)). (See PLR 200403056.)
- Apart from these special SECA exceptions for partners, there is no clear exception from SECA for other deferred compensation payouts simply because a director (or other independent contractor) has retired. (See all the authorities discussed in PLRs 8529056 and 9235040.) However, even though there's no specific exemption in the SECA statute such as that in Code § 3121(a)(14) for payments in calendar years after death, there seem to be no SECA taxes after death (perhaps even including payments in the calendar year of death.)

Planning Opportunities for Independent Contractors (Including Directors): State Income Taxes on Post-Retirement Payments

- Additional ambiguities apply in the case of state income taxation of post-termination payments to independent contractors:
- Most states have rules extending their income taxes to compensation paid to former residents who move out of the state.
- A special exemption from state income taxes applies under the so-called "Federal Blocker," in 4 U.S.C. § 114 (protecting taxpayers from state taxation of certain nonqualified deferred compensation ("NQDC").
- This Federal Blocker is generally viewed as protecting only **employees'** NQDC.
- However, it is it is unclear whether directors/contractors might argue for exemption from state income taxes in the state where the services were performed, if they elect an annuity-type payout of NQDC, for two reasons:
  - The Federal Blocker applies generally to "retirement income of **an individual**."
  - In the case of any 10-year or annuity-type payouts, this Federal Blocker applies to "any plan, program or arrangement described in § 3121(v)(2)(C)." Although Code §3121(v) generally controls only FICA taxation of employees, the referenced language in **§ 3121(v)(2)(C) is much broader**. It states: "Nonqualified deferred compensation plan. For purposes of this paragraph, the term "nonqualified deferred compensation plan" means any plan or other arrangement for deferral of compensation other than a plan described in subsection (a)(5)."

Employer Considerations in Negotiating Benefits for Newly Unionized Bargaining Units

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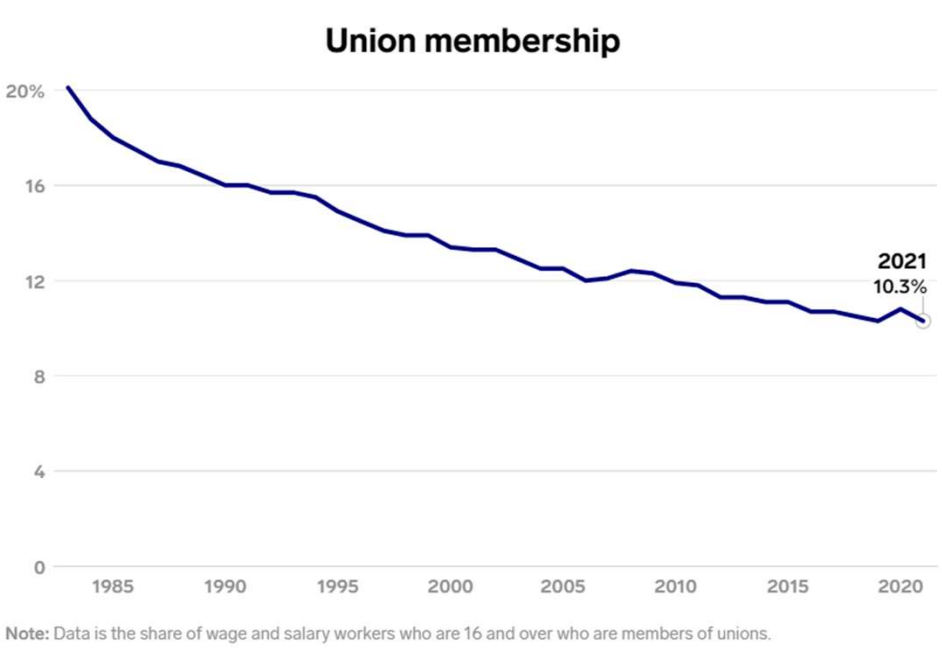
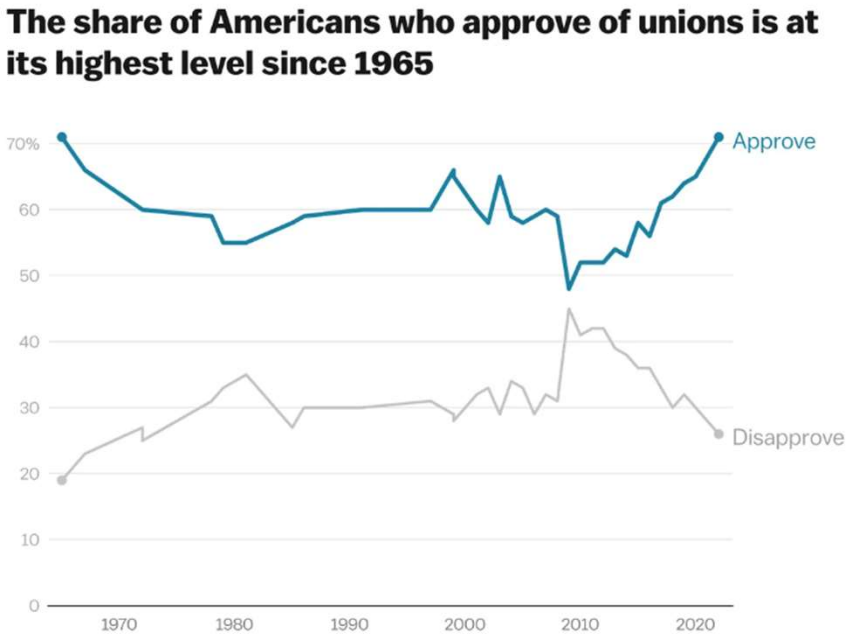
Unionization in America – A Tale of Two Charts

Despite years of declining membership, public perception of unions has become more favorable.

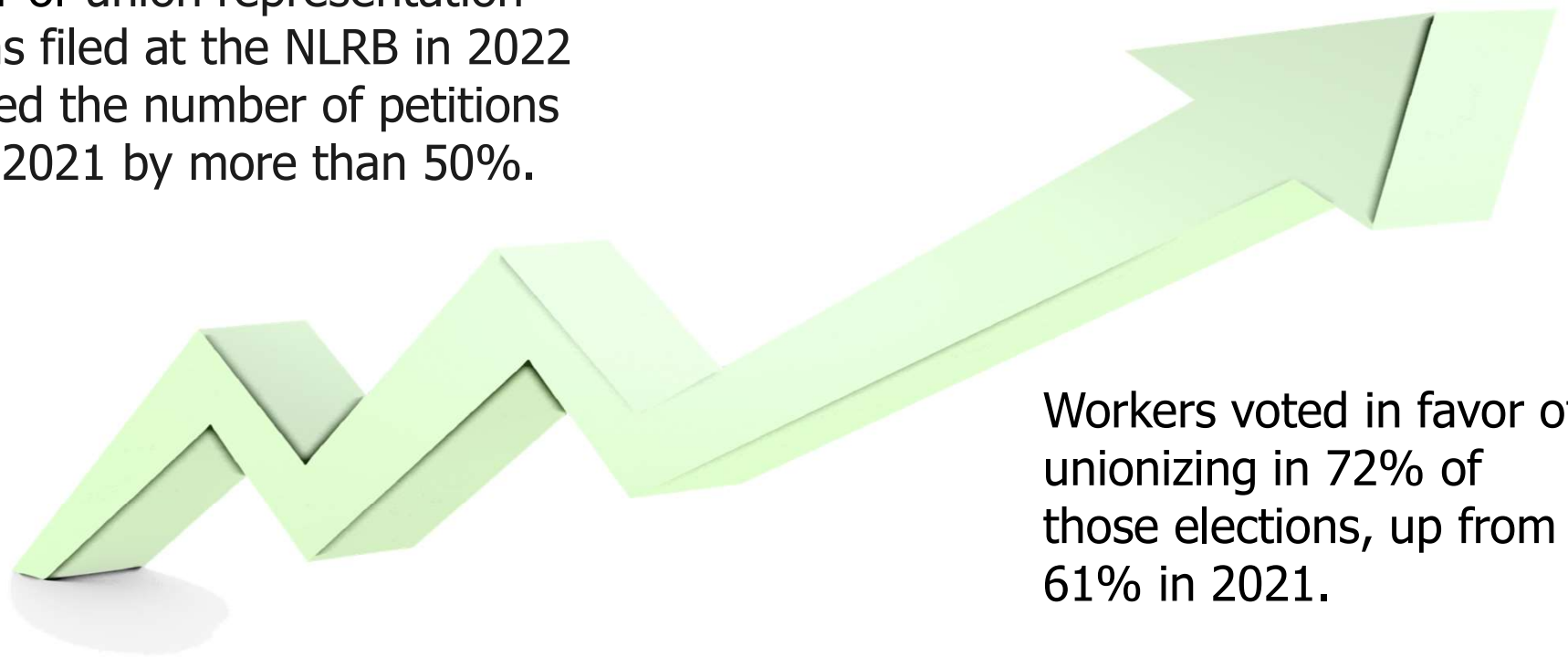


Note: Data is the share of wage and salary workers who are 16 and over who are members of unions.



Unionization Efforts Are On the Rise

Number of union representation petitions filed at the NLRB in 2022 exceeded the number of petitions filed in 2021 by more than 50%.



Workers voted in favor of unionizing in 72% of those elections, up from 61% in 2021.

What Does This Mean for Employers?

- Unionization efforts have increasingly affected employers of various sizes and in various industries, including industries other than government and manufacturing.
- Where unionization efforts are successful, employers and unions enter into collective bargaining agreements (CBAs) memorializing the mutual agreement to terms of employment for the newly unionized bargaining units.
- Covered workers (some of whom may not have had access to benefits in the past) will invariably push for more fulsome benefits, which typically includes some form of **retirement** benefit and **health and welfare** benefits coverage.

Joining a Multiemployer Plan

- Employers may be pressured to join **a multiemployer plan** to provide these retirement and health and welfare benefits.
- A multiemployer plan is a plan maintained by two or more employers, usually within the same or related industries, and a labor union. These plans are often referred to as "Taft-Hartley plans" because they are permitted under the Taft-Hartley/Labor-Management Relations Act.
- Multiemployer plans provide benefits to employees in the bargaining unit covered by a CBA, which generally allows employees to receive benefits for hours worked with several different employers during their careers (if they change employers but remain in the same union or an affiliated union).

Risks of Joining a Multiemployer Plan

- Joining a multiemployer plan may be pitched as a win for the employer – responsibility for plan administration and governance are borne by the plan and the employer's role is generally limited to making contributions to the plan.
- But there are risks that employers should factor in when considering whether to join a multiemployer retirement or health & welfare plan.
  - An employer's risks go well beyond how much the employer is required to contribute to the plan for covered work.

Types of Retirement Plans

- Broadly, there are two types of retirement plans: defined benefit (DB) plans and defined contribution (DC) plans.
  - DB plans promise a specified monthly benefit at retirement. The amount of the benefit is typically a function of salary (or the DB plan's accrual rate) and service.
  - DC plans do not promise a specific amount of benefits at retirement. The amount of the benefit is based on contributions to an individual's "account" under the plan and investment gains and losses. The value of the account will fluctuate due to the changes in the value of the investments.

Multiemployer Defined Benefit Plan Considerations

- Multiemployer DB plans are the riskier of the two types of plans for employers primarily due to the **risks associated with withdrawal liability**.
  - Withdrawal liability is a sum of money that employers are statutorily required to pay when they stop having an obligation to contribute to an underfunded multiemployer DB plan. Multiemployer DB plans with unfunded liabilities can require withdrawn employers to pay a pro rata share of the plan's unfunded liability upon the employer's withdrawal.
  - For withdrawal liability purposes, unfunded liability is generally the extent to which the present value of vested benefit liabilities exceeds the market value of the plan's assets.
- The rules governing withdrawal liability are complex.
- Withdrawal liability can be **large, even where the number of employees in the bargaining unit is relatively small** – withdrawal liability for even a small (e.g., <10 employee) bargaining unit can be in the multiple millions of dollars in severely underfunded plans.

Defined Contribution Plan Considerations

- For an employer, there is less downside to participating in a multiemployer DC plan, but there are still considerations to weigh:
  - If the employer has its own DC/401(k) plan that the employees could otherwise participate in, putting those employees in a multiemployer DC plan would erode the employer's relative bargaining power with the employer's own DC plan's vendors, such as the recordkeeper and the investment manager/platform provider.
  - Loss of economies of scale in the employer's own DC plan due to fewer assets under management could impact access to certain types of investments and/or access to certain mutual fund share classes with lower fees.

Multiemployer Health and Welfare Plans

- Health and welfare benefits in a multiemployer plan can be broad and cover several different types of benefits including medical, Rx, dental, vision, STD/LTD, etc.
- Benefits can be provided on a fully insured basis (where contributions are used to pay fixed insurance premiums and the insurer covers claim expenses) or self-insured basis (where contributions are used to pay for claims directly and for stop-loss premiums and administrative services fees).
- The largest costs are generally the medical and pharmacy benefits.

Multiemployer Health and Welfare Plan Considerations

- Moving large group of bargained employees to a multiemployer H&W plan can erode the employer's pricing/negotiation power with the employer's own group health plan vendors (e.g., insurance carriers, provider networks)
- Employers with multiple CBAs could end up participating in multiple multiemployer plans, which could result in some administrative complexity/burden in accurately tracking and transmitting contributions, and keeping abreast of each plan's financial performance, premium increases, etc.
- The employers have essentially no input in a multiemployer plan's design and administration, and such plans typically have the right to unilaterally impose premium increases over time (e.g., each year or when a CBA expires).

Multiemployer Health and Welfare Plan Considerations

- Multiemployer H&W plans may accumulate significant (often excessive) cash reserves due to contribution rates/premiums that are too high. Once this happens, there is no easy way for employers to effectively recover or use such reserves, and excessive reserves are often ultimately used to increase benefits, creating a vicious cycle of ever-improving plan design and increased premium costs
- Retiree coverage may be provided through an additional employer contribution that is not required (or retiree coverage may be provided through a hidden subsidy in the active employee premium rate)
- Multiemployer plans may have continuing eligibility rules that effectively help a union during collective bargaining, by providing extended health coverage in the event of a strike or work stoppage
- Smaller multiemployer plans are typically not able to achieve economies of scale, resulting in an inefficient delivery of benefits vs. a larger group health plan.

Retirement Plan Features and Enhancements

- Student loan repayment feature
- In-service distributions and phased retirement
- ESG considerations for plan investments
- SECURE 2.0 Features and Enhancements

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Student Loan Repayment Features

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Student Loan Repayment Features

- General issues and considerations:
  - Some newer and younger workers have significant student loan obligations
  - Repaying student loans can interfere with important early career retirement savings
  - Technical tax-qualification rules complicate the ability to make matching contributions to employees on the basis of their student loan repayments
- Current IRS ruling position:
  - Employers can make "non-elective" employer contributions, but not true matching contributions
  - Helpful start but complicated to administer, subject to separate nondiscrimination testing requirements, and not a true matching contribution

Student Loan Repayment Programs

- Under SECURE 2.0, employers may now match employee student loan repayments with contributions to a retirement plan
  - New feature is available to 401(k), 403(b), governmental 457(b), and SIMPLE IRA plans
  - Permits employers to treat "qualified student loan payments" for "qualified higher education expenses" as elective deferrals and corresponding plan contributions as true matching contributions
  - Subject to certain rules and requirements (e.g., payments subject to elective deferral limit, all employees eligible to receive match are eligible for program, same matching rate as for other elective deferrals, etc.)
  - Employers can rely on employees' certification of qualified student loan payments
  - Employees receiving student loan repayment matching contributions can be tested separately
- Optional change effective for plan years beginning after December 31, 2023
- Potentially valuable plan feature, but employers may want to consider potential impact on design and operation of the plan

In-Service Distributions and Phased Retirement

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In-service Distributions

- General issues and considerations:
  - Older employees may need or want to delay retirement for a variety of reasons (e.g., inflation, inadequate retirement savings, longevity, desire to stay in workforce)
  - Employers may want to retain older works for a variety of reasons (e.g., tight labor market, specific knowledge and skills)
  - Retirement plan distribution rules can sometimes restrict in-service distributions
- Key retirement plan distribution rules:
  - As a result of the Setting Every Community Up for Enhanced Retirement Act of 2019 (SECURE Act 1.0), traditional pension plans can now offer in-service distributions as early as age 59½
  - Defined contribution plans can offer in-service distributions of employer contributions at any age, but subject to certain limits (e.g., 2-year accumulation/5-year participation rules)
  - Distributions before age 59½ may be subject to 10% early withdrawal penalty if there is no available exception

In-service Distributions and Phased Retirement

- Potential design alternatives:
  - Offer in-service distribution option in a pension plan starting at age 59½ or later age (e.g., other early retirement age or normal retirement age)
  - Offer in-service distribution in a defined contribution plan starting at age 59½ or later age, but:
    - Limit available sources of distribution (e.g., only employee, matching or non-elective contributions)
    - Limit amounts, frequency and forms of distribution
- In-service distribution programs can be offered in connection with a phased retirement program
  - Employees reduce their level of work and simultaneously start receiving retirement benefits
  - Combination of phased retirement and in-service distribution may be attractive to employees
  - Many design and employment law considerations for phased retirement programs

ESG Considerations in Retirement Plans

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New Rules Clarify Consideration of ESG Factors

- Recent studies highlight employee interest in environmental, social, and governance (ESG) investment options in retirement plans
- Department of Labor's "Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights" (the ESG Rule), released in November 2022, recognizes that fiduciaries may consider certain ESG factors when making investment decisions on behalf of a plan:
  - If financially relevant: may always consider
  - Even if not financially relevant: may consider as part of the "tie breaker"
- Welcome clarification for fiduciaries considering whether (and, if so, how) to consider ESG factors as part of investment oversight

ESG Rules & Consideration of Participant Preference

- The ESG Rule explicitly recognizes that fiduciaries may consider participant preferences in ESG investments without violating the duty of loyalty
  - Preamble for new ESG rules suggests that accommodating participant preference (such as for an ESG option) may lead to higher rates of participation and deferral
  - But fiduciaries must still satisfy duty of prudence in selecting and monitoring any ESG investment
- Welcome clarification for fiduciaries who may be considering whether (and, if so, how) to respond to participant demand for ESG investments

New Qualified Distributions

- Birth or adoption
- Domestic abuse
- Terminal illness
- Qualified federal disasters

New Qualified Distributions

- In general, retirement plan distribution rules sometimes impose limits on when employees can take distributions from tax-qualified retirement plans, including:
  - 10% early distribution penalty on distributions from retirement plans
  - Age 59½ limit on in-service distributions for elective deferrals from 401(k) plans
- SECURE 1.0 and SECURE 2.0 introduce a number of new qualified distribution events and exceptions
- Qualified birth and adoption distributions (QBAD) established under SECURE 1.0:
  - A plan *may* allow for penalty-free distributions of up to $5,000 for expenses related to the birth or adoption of a child; exempt from 10% early tax and in-service distribution limits
  - Participants must have ability to repay QBAD to the plan
  - QBADs must satisfy certain requirements (e.g., adopted child cannot be the child of the participant's spouse, distribution must be made during the one-year period following the birth or legal adoption of the child, etc.)

Other New Qualified Distributions (SECURE 2.0)

SECURE 2.0 introduced more optional distribution events that are not subject to the 10% tax early distribution penalty tax or (in some cases) in-service distribution limits:

1. Domestic abuse: Plans *may* allow participants who self-certify that they have experienced domestic abuse within the last year to withdraw the lesser of $10,000 as indexed for inflation or 50% of the participant's account (available in 2024)
2. Terminal illness: Plans *may* allow participants who are "terminally ill" (certified by a physician) to take a distribution (available in 2023)
3. Qualified federal disasters: Plans *may* permit up to $22,000 in distributions for qualified disasters occurring on or after Jan. 26, 2021
   - Additionally, a plan may increase the maximum loan limit up to the lesser of $100,000 or 100% of the participant's account balance and extend the loan repayment period by one year
4. Emergency Withdrawals: Plans *may* allow participants who self-certify that they have emergency personal or family expenses to take one withdrawal per year of up to $1,000 in a year for such expenses (available in 2024)

Other Changes from SECURE 2.0

- Rothification of employer match and nonelective contributions
- Emergency savings accounts

"Rothification" of Employer Contributions

- 401(k), 403(b), and governmental 457(b) plans *may* offer employees the ability to designate some or all of their matching or nonelective employer contributions as "Roth" contributions (i.e., after-tax contributions with accumulated earnings that are not taxed if distributed through a "qualified distribution")
- Limited to fully vested employer matching or nonelective contributions
- Revenue-raising provision to offset the costs (lost tax revenue) of other SECURE 2.0 provisions
- Can be effective for contributions made after the December 29, 2022 date of enactment of SECURE 2.0
- However, open questions remain as to how employer contributions should be included in employees' income, subjected to withholding, and reported; also administrative and implementation issues to consider

Emergency Savings Accounts

- 401(k), 403(b), and governmental 457(b) plan sponsors may create "in-plan" emergency savings accounts (ESAs)
- ESAs would permit non-highly compensated employees to make Roth (after-tax) contributions to a special savings account within the plan:
  - ESA contributions balance is capped at $2,500 (adjusted for inflation), or a lesser amount established by the plan sponsor
  - Balances may be withdrawn at least once per month; no early distribution penalty
  - ESA contributions must be invested in a capital preservation investment option
  - Employee ESA contributions must be eligible for matching contributions at the same rate as elective deferrals (but matching contributions go to general plan; not to the ESA)
  - ESA contributions permitted to be made through auto enrollment program
  - Effective for plans years beginning after December 31, 2023
- Potentially valuable feature for some participants, but plan sponsors will need to consider the administrative burdens and complexities of offering it


What Employers Are Doing Post-*Dobbs*
Morgan Lewis

Overview of the *Dobbs* Decision – June 24, 2022

6-3 (5-4?) Opinion - Overturns *Roe* and *Casey*

- **Two Main Principles:**
  1. The Constitution does not expressly or implicitly protect the right to choose abortion and leaves it to the states to regulate
  2. Laws regulating abortion are entitled to a "strong presumption of validity" and will be upheld unless there is no "rational basis on which the legislature could have thought [the law] would serve legitimate state interests"

Open Issue:
Justice Kavanaugh's concurring opinion indicates that, in his view, a state may not bar a resident of that state from traveling to another state to obtain an abortion

Future Decisions Could Address This Question

Travel and Lodging Benefits

- Employers have added travel and lodging benefits to facilitate abortion access in the following ways:
  - **Add travel and lodging benefits under an existing group health plan (Most common)**
    - Most common approach so far
    - Limited to participants enrolled in the plan, and state law may prohibit this for fully-insured plans
  - **Add travel and lodging benefits under a HRA (Less common)**
    - Cannot reimburse expenses in excess of IRS limits
    - Must be integrated with other group health plan coverage or qualify as an "Excepted Benefit HRA"
  - **Provide travel and lodging benefits as a general taxable reimbursement (Least common)**
    - Would require substantiation of the travel expenses, but not the underlying medical expense
    - More costly to employer, but may protect employers and employees from liability under state law

Travel and Lodging Benefits

- Tax treatment of travel and lodging benefits
  - Transportation expenses
    - Must be primarily for and essential to medical care
    - Automobile travel may be reimbursed on a tax-free basis, based on IRS mileage rate
    - Bus, train, or plane expenses may be reimbursed on a tax-free basis
  - Lodging expenses
    - Also must be primarily for and essential to medical care
    - May not be lavish or extravagant
    - Must be no significant element of personal pleasure, recreation, or vacation in the travel
    - May be reimbursed tax-free up to $50 per person per night
  - Meal expenses – may not be reimbursed on a tax-free basis
  - Okay to provide benefits above these limits in a group health plan if the excess benefits are taxed as wages, but may not do this in a FSA or HRA

Travel and Lodging Benefits

- Other considerations for employers:
  - Should an annual or lifetime limit be imposed on travel and lodging benefits?
    - May result in Mental Health Parity concerns if the same limit is imposed on mental health and substance use disorder benefits
    - Safer to include a per occurrence limit
  - Should abortion coverage under the plan be treated as an in-network benefit if travel to an out-of-network provider is required to access the care?
  - A high deductible health plan cannot reimburse travel expenses until the deductible has been satisfied. Otherwise, the participants will not be allowed to make or receive contributions to Health Savings Accounts (HSAs).
  - Third party administrator may require a separate contract or rider to provide this benefit.

Restrictive State Laws

- **Twenty-seven** states have active laws restricting abortion access:
  - **20** prohibit abortion at any point.
  - **Five** prohibit abortion after the detection of a fetal heartbeat (roughly six weeks).
  - **Three** prohibit abortion after 15 weeks.
  - **Five** prohibit abortion after 20 weeks
  - Several states have multiple prohibitions that could come into effect (pre-*Roe* bans, week-based bans, and trigger bans on all abortions).
- The status of the laws remains in flux due to ongoing litigation

Criminal

The great majority of laws are criminal and apply to the actions of abortion providers, not patients or benefit plan sponsors.

Civil

Oklahoma and Texas also have civil laws that allow private citizens to file suits to enforce violations and recover civil penalties, including against entities that *aid and abet* the performance of an abortion.

Legal Risks Under Current Law – Criminal Liability

Nearly all of the restrictive state laws currently in force criminalize the **performance** of an abortion within state territory.

"Aid and Abet"

The **theoretical** risk to a company is that coverage of abortion benefits would be viewed as aiding and abetting the performance of an unlawful abortion or conspiring with another to perform an unlawful abortion.

Assessing Risk

As long as a company does **not** pay for abortion services within states where abortion is banned, the **practical** risk of prosecution and conviction is relatively low (except, perhaps, in Georgia).
There is always the risk of rogue prosecutors though.

Mitigating Risk

To ensure that the company is not paying for unlawful abortion services within a state where those services are banned, employee receipt of abortion services (including medication abortion) should occur **totally** outside of states with bans.

Legal Risks Under Current Law – Civil Liability

What Is Banned?

- Texas and Oklahoma have enacted civil laws that permit any individual to file suit and recover damages, including civil monetary penalties, against **(1)** persons who **perform** unlawful abortions and **(2)** persons who **knowingly aid and abet** the performance of unlawful abortions.

How Could an Employer or Plan Sponsor "Aid and Abet"?

- Both laws explicitly state that **reimbursing** an individual for receipt of unlawful abortion services, **including through insurance**, constitutes unlawful aiding and abetting, regardless of whether the individual knew or should have known that the payment was tied to an unlawful abortion.
- A similar law with an even broader scope has been proposed in Missouri, but it seems unlikely that the bill will pass.

Potential Employer Defenses

- **Potential employer defenses to state actions in this area include:**
  - ERISA Preemption
  - Right to Interstate Travel (see Justice Kavanaugh's concurrence)
  - Dormant Commerce Clause (states cannot pass legislation that excessively burdens interstate commerce)
  - Federalism Principles
- **These defenses are largely untested and will likely be the subject of extensive litigation.**

ERISA Preemption

- ERISA Section 514 generally preempts any state laws that relate to an ERISA Plan, except for banking, securities and insurance laws.
  - Fully-insured plans are subject to state insurance laws.
- ERISA's preemption statute does not preempt "generally applicable" state criminal law.
  - Generally applicable means the law does not specifically target the group health plan.
  - Criminal liability may be imposed on the plan fiduciary.
  - Application of ERISA to state civil statues remains an open question.

Ways to Mitigate Legal Risk

Time and Place Matter: Consider adding language to plans indicating that covered individuals must receive all services (e.g., pharmaceutical abortion) in state where abortion is legal.

Broad Coverage Language: Coverage for travel and lodging when *any* medical service is not available within certain radius, rather than just specify abortion services.

Be Ready to Pause: Structure benefit to permit temporary pauses or elimination if legal landscape changes.

Our Global Reach

Africa
Asia Pacific
Europe
Latin America
Middle East
North America

Our Locations

Abu Dhabi
Almaty
Beijing
Boston
Brussels
Century City
Chicago
Dallas
Dubai
Frankfurt
Hartford
Hong Kong
Houston
London
Los Angeles
Miami
New York
Nur-Sultan
Orange County
Paris
Philadelphia
Pittsburgh
Princeton
San Francisco
Seattle
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