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Monitoring Service Providers *Now* May Save Trouble Later

A recent case from the Second Circuit demonstrates the importance of monitoring service providers.

Katherine Sullivan was a former Verizon employee who earned approximately $18,600 per year during her employment. Sullivan's former employment entitled her to a group life insurance benefit based on her annual salary. However, Verizon's third-party benefits administrator, Aon Hewitt ("Aon"), improperly coded Sullivan's annual income of

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Revisiting Qualified Birth or Adoption Distributions

The Setting Every Community Up for Retirement Enhancement ("SECURE") Act, adopted in December 2019, includes a broad array of provisions impacting the operation of qualified retirement plans. However, the impact of many of those provisions has been overshadowed by COVID-19, the Coronavirus Aid, Relief, and Economic Security ("CARES") Act, and the lack of guidance enabling plan sponsors to implement the provisions of the SECURE Act.

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Expansion of Qualifying Expenses for 529 College Savings Plans

The Setting Every Community Up For Retirement Enhancement Act (the "SECURE Act"), signed into law on December 20, 2019, expanded benefits to 529 Plans—tax-advantaged savings plans designed to help pay for education expenses. These new 529 Plan benefits are retroactive for distributions made after December 31, 2018.

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$18,600 as her weekly salary. This coding error caused Aon to repeatedly (but incorrectly) represent to Sullivan that she was eligible for a life insurance policy that provided up to $679,700 in life insurance coverage. Sullivan received a number of mailings from Aon representing this benefit. Sullivan also called the Verizon Benefits Center, where Aon representatives again confirmed the coverage amounts.

However, when Sullivan died, her daughter, Kristine Sullivan-Mestecky, received only $11,400 as the beneficiary of her mother's policy. Sullivan-Mestecky disputed the payment amount, but Verizon informed her that there had been an error in calculating the value of her mother's life insurance policy. Sullivan-Mestecky filed suit, alleging Verizon breached its fiduciary duties. The district court dismissed her claims, and Sullivan-Mestecky appealed.

The Second Circuit held that Verizon failed to act with the "care, skill, prudence, and diligence" required from ERISA fiduciaries. As plan sponsor, Verizon was bound by its fiduciary duty to properly administer the plan and was ultimately responsible for assessing Sullivan's eligibility and enrollment. Aon was grossly negligent when it made repeated oral and written misrepresentations to Sullivan as to her benefits under the plan, but Verizon arranged for Aon to communicate with participants like Sullivan on its behalf. Therefore, Verizon could not "hide behind [Aon's] actions to evade liability for the fiduciary breach that occurred." Even though Aon was acting as a ministerial agent, the court imputed Aon's gross negligence to Verizon. The court also held that Verizon's fiduciary breach justified equitable and monetary relief.

This ruling provides a reminder that plan sponsors should monitor and review the work performed by their service providers as part of their fiduciary duties to plan participants, as the plan sponsor is ultimately responsible for the proper administration of its plan.

Sullivan-Mestecky v. Verizon Communications, Inc., No. 18-1591 (2d Cir. 2020)

Revisiting Leave Sharing and Leave Donation Programs in the Time of COVID

At some point this year, many employers found themselves deciding whether to furlough large swaths of employees. That decision often involved discussing ways the company could continue to provide support to employees while they were furloughed. Two methods of support we found ourselves frequently discussing with clients were leave-sharing and leave-donation programs. Leave-sharing programs allow employees to donate accrued paid time off to a pool that can be used by employees who have no available leave. Leave-donation programs allow employees to forgo accrued paid time off in exchange for cash payments that their employers make to charitable organizations.

From a tax perspective, the general rule is that leave donated to either type of program is taxable to the donor (i.e., included in the employee's Form W 2 wages). However, the Internal Revenue Service ("IRS") recognizes three important exceptions to this default tax treatment. These exceptions apply to leave-sharing programs for "medical emergencies" and "major disasters" and to leave-donation programs when the IRS recognizes a temporary moratorium on the taxation of donations. Each type of program has different requirements that, if followed, take the tax burden off the leave donors.

Leave Sharing: What Is a "Medical Emergency"?

In a Private Letter Ruling from 1990, the employer's leave-sharing program defined a "medical emergency" as a medical condition of the employee or the employee's family member that will require the employee's prolonged absence from work. As a result of that prolonged absence and the employee's exhaustion of all available paid leave (other than through the leave-sharing program), the employee will experience a substantial loss of income. This definition has since consistently been adopted by employers offering medical emergency leave-sharing programs.

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Recent State Changes to Paid Family Leave Laws

This article provides a high-level summary of the key changes to paid leave laws recently enacted in Colorado and California.

Colorado

On November 3, 2020, Colorado voters passed Proposition 118, which creates a paid leave insurance program similar to those that already exist in several other states. Beginning January 1, 2024, an employee may receive partial wage-replacement benefits for up to 12 weeks of paid leave from their employer for several reasons, including their own serious health condition, though the leave can be extended to 16 weeks if the serious health condition is related to complications of pregnancy or childbirth. The measure also implements legal protections for employees who take leave under the program.

An employee is eligible for leave if they earned at least $2,500 in wages on which premiums are paid during their "base period" (i.e., the first four of the last five completed calendar quarters immediately preceding the first day of the individual's benefit year). Self-employed workers and government employees may also opt in for protection under the program. Eligible reasons for leave include childbirth, medical treatment for a serious health condition, providing care for a family member with a serious health condition, qualified military leave and "safe leave" needed to address issues involving domestic violence, stalking or sexual assault and abuse.

To qualify for leave, individuals must submit some form of documentation evidencing the need for leave. Further guidance on this is expected as the measure creates a new division within the Colorado Department of Labor and Employment (the Division of Family and Medical Leave Insurance) to administer the program and establish the supporting documentation needed to obtain benefits.Benefit amounts are tied to the state average weekly wage. Employees taking leave under the program may receive 90% of their average weekly wages for the portion of wages that is less than or equal to 50% of the state average weekly wage, and 50% of the portion of their wages that exceeds 50% of the state average weekly wage. The maximum weekly benefit for 2024 will be capped at $1,100.

The insurance program will be funded in 2023 and 2024 by a payroll tax equivalent to 0.9% of a worker's wages, equally split between the employer and the employee, though employers can choose to pay a larger percentage of the cost. Businesses with nine or fewer employees are exempt from paying the premiums, but employees can still choose to pay their half of the premium to receive coverage. For 2023, the maximum annual premium is estimated to be $1,455, because premiums can be assessed on wages only up to $161,700 per person. Premiums will be adjusted for 2025 so that the total collected premium equals 135% of the previous year's claims and 100% of the costs of administering the program, but are statutorily capped at 1.2% of employees' wages.

California

California Governor Gavin Newsom recently signed into law an amendment that significantly broadens the California Family Rights Act (the "CFRA"). Although California already had a paid leave insurance program similar to Colorado's (described above), this law expands the bases on which employees can receive paid leave. Starting January 1, 2021, the CFRA will apply to employers with as few as five employees and provide employees with job-protected leave to care for grandparents, grandchildren and siblings with serious health conditions. Other changes to the CFRA by this amendment include:

- Extending coverage from employers with 50 or more employees within a 75-mile radius to those with five or more employ-

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IRS Issues Proposed Regulations Under 162(m)

Internal Revenue Code (the "Code") Section 162(m) disallows a tax deduction by a publicly held corporation for compensation paid to covered employees that exceeds $1 million per tax year. The Tax Cuts and Jobs Act of 2017 (the "TCJA") amended Code Section 162(m) to remove an exception for performance-based compensation from the non-deductibility limit and to expand the entities subject to Code Section 162(m). In 2018, the IRS provided initial guidance through Notice 2018-68 regarding the TCJA's changes to covered employees and the application of the grandfather rule. On December 16, 2019, the IRS published proposed regulations incorporating much of Notice 2018-68 and clarifying key terms, including what constitutes a publicly held corporation, who is considered a covered employee, what compensation is subject to Code Section 162(m), and the operation of the grandfather rule.

Publicly Held Corporation

A publicly held corporation subject to Code Section 162(m) is any corporation that, as of the last day of its tax year, is an issuer of a class of securities (debt or equity) that either is required to be registered under Section 12 of the Securities Exchange Act of 1934 (the "Exchange Act") or is required to file reports under Section 15(d)

The Tax Cuts and Jobs Act of 2017 (the "TCJA") amended Code Section 162(m) to remove an exception for performance-based compensation from the non-deductibility limit and to expand the entities subject to Code Section 162(m).

of the Exchange Act. The proposed regulations clarify that various types of entities that were exempt from Code Section 162(m) prior to the TCJA may now be considered publicly held corporations. These include privately held C corporations, S corporations, foreign private issuers, publicly traded partnerships, disregarded entities, and affiliated groups.

Covered Employee

A covered employee subject to Code Section 162(m) includes a publicly held corporation's principal executive officer, principal financial officer, and the next three highest-paid employees holding office on the last day of the corporation's tax year. The proposed regulations provide guidance for determining a publicly held corporation's covered employees, including the following:

- Only executive officers (as defined by the Exchange Act) qualify as covered employees.
- If a publicly held corporation's tax year differs from its fiscal year, the three highest-paid employees are determined by applying the executive compensation disclosure rules under the Exchange Act as if the tax year is the fiscal year.
- A covered employee in any tax year beginning after December 31, 2016 who separates from service remains a covered employee for any post-separation compensation received from that corporation in all subsequent tax years.
- A covered employee of a predecessor of a publicly held corporation in any tax year beginning after December 31, 2016 remains a covered employee in all subsequent tax years.

Compensation

The proposed regulations expand the types of compensation subject to Code Section 162(m). Compensation now also includes payments made to a beneficiary following the covered employee's death and compensation paid to a covered employee for services performed in a capacity other than as an executive officer (e.g., as a board member or independent contractor).

The proposed regulations also depart from the IRS's prior private letter rulings regarding compensation paid by a partnership to covered employees of a corporate owner. Where a publicly held corporation owns an interest in a partnership, any compensation the partnership pays to the publicly held corporation's covered employees is subject to Code Section 162(m), but only to the extent the corporation is allocated a share of the deductible compensation based on its ownership in the partnership.

Grandfather Rule

The grandfather rule provides that certain compensation paid pursuant to a written, binding contract in effect on November 2, 2017 is grandfathered from amended Code Section 162(m), provided that the contract is not materially modified on or after that date. Grandfathered compensation remains subject to Code Section 162(m) as in effect prior to the TCJA, including the exclusion for perfor-

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mance-based compensation. The proposed regulations describe the impact of certain situations on the grandfather rule, including the following:

- Severance. If a written, binding contract in effect on November 2, 2017 provides for severance, only the compensation that the employer would be obligated to pay under the contract if employment was terminated on November 2, 2017 may be grandfathered.
- Clawback. If a written, binding contract in effect on November 2, 2017 requires or permits an employer to claw back compensation upon a future event that is objectively outside of the employer's control, the clawback provision will not cause a loss of grandfathering.
- Cost of Living Adjustment. If a written, binding contract in effect on November 2, 2017 is modified to increase compensation by more than a reasonable cost of living adjustment, then all compensation paid under the contract after the modification will lose grandfathered status.
- Earnings. If a written, binding contract in effect on November 2, 2017 is amended to defer the payment of compensation, any increase in the payment amount will not cause a loss of grandfathering as long as the additional amount reflects only a reasonable rate of interest or the rate of return on a predetermined actual investment.
- Accelerated Vesting. If a written, binding contract in effect on November 2, 2017 is subject to a vesting provision, the employer's acceleration of such vesting will not cause a loss of grandfathering.

HHS Settles Two HIPAA Breach Lawsuits for a Combined $9.15M

Premera Blue Cross ("Premera") has agreed to pay a $6,850,000 fine to the U.S. Department of Health and Human Services' Office for Civil Rights ("OCR") for HIPAA violations. Community Health Systems Professional Services Corporation n/k/a CHSPSC, LLC ("CHSPSC") has agreed to pay OCR $2,300,000. Both companies also agreed to implement a corrective action plan. The fines stem from data security incidents in 2014 that exposed the protected health information ("PHI") of over 16 million people (combined).

Premera's fine is the second-largest payment to resolve a HIPAA violation in OCR history. The largest OCR fine ($16,000,000) was paid by Anthem in 2015 for a security breach that exposed the PHI of 79 million consumers.

The cases share many similarities. First, Premera and CHSPSC were both successfully targeted by hackers. In Premera's case, hackers used a phishing email to install malware that gave them access to Premera's IT system. In CHSPSC's case, hackers used compromised administrative credentials to remotely access CHSPSC's information system through its virtual private network.

Second, both companies were also warned in advance of system vulnerabilities and alerted to the threats to their systems—Premera by its own auditors and CHSPSC by the FBI. However, neither company took adequate corrective action to fix the identified vulnerabilities. The compromised PHI included names, addresses, birthdates, Social Security numbers, and, in some cases, telephone numbers or the names of employers.

Third, OCR found that both companies exhibited long-standing, systemic noncompliance with the HIPAA Security Rule, including failure to conduct a risk analysis and failures to implement information system activity review, security incident procedures, access controls, risk management, and audit controls.

Finally, both companies were separately sued in class-action lawsuits stemming from their security breaches. Premera settled its lawsuit for $74,000,000; CHSPSC settled its lawsuit for $3,100,000.

These settlements highlight the importance of employers reviewing and updating their HIPAA privacy and security procedures and protocols.

ees (and not requiring that those employees work within any given distance or area).

- Expanding the qualifying uses of leave to include leave to care for a grandparent, grandchild or sibling with a serious health condition. The definition of "child" now includes adult children and the children of domestic partners.
- If both parents work for the same employer, requiring the employer to give each parent 12 workweeks of unpaid leave to bond with their child, rather than limiting them to a combined total of 12 workweeks of leave to bond with their child.
- Requiring employers to provide up to 12 workweeks of leave due to a qualifying exigency arising because a spouse, domestic partner, child or parent is on active duty in the Armed Forces of the United States. This change brings the CFRA in step with the FMLA, although the FMLA does not cover domestic partners.

Recommendations

Employers in California and Colorado will need to review and update their current leave procedures. This may include drafting leave policies, revising employee handbooks, updating employee disclosures, and implementing procedures to track and administer employee leave. If you have any questions about the family leave laws described above and their application to your business, please contact a member of the Kutak Rock Employee Benefits Practice Group.

On November 3, 2020, ***Colorado*** *voters passed Proposition 118, which creates a paid leave insurance program similar to those that already exist in several other states.*

California *Governor Gavin Newsom recently signed into law an amendment that significantly broadens the California Family Rights Act (the "CFRA").*

One such provision permits early withdrawals from qualified retirement plans for qualified childbirth and adoption expenses. To date, few plan sponsors have implemented these withdrawals, largely as a result of the lack of clarity about how to do so. In September, the IRS published Notice 2020-68, which answers many questions about administering these withdrawals. In light of this new guidance, plan sponsors may wish to revisit whether to permit qualified birth or adoption distributions in their plans.

Features Of Qualified Birth Or Adoption Distributions

Under the terms of the SECURE Act, a qualified birth or adoption distribution:

- Must be limited to $5,000 or less;
- Must be made within the one-year period beginning on the date of the child's birth or the finalization of the child's adoption;
- For adoptions, must be made only when the adoptee is an individual who is not a child of the participant's spouse and who has not attained age 18 or is physically or mentally incapable of self-support; and
- May be repaid to the plan.

The primary benefit of offering such distributions to participants is that those distributions are exempt from the ordinary 10% early withdrawal penalty. Qualified defined contribution (but not defined benefit) plans may, but are not required to, permit participants to take qualified birth or adoption distributions.

Administrative Guidance

In large part, concerns about implementing qualified birth or adoption distributions arose from questions about what steps plan sponsors would need to take to verify that a participant was eligible for such a distribution. The IRS's guidance in Notice 2020-68 gives plan sponsors clarity on the substantiation requirements for qualified birth or adoption distributions, as well as other administrative questions. Specifically, the guidance indicates that:

- Plan sponsors may rely on a participant's reasonable representation that the participant is eligible for a qualified birth or adoption withdrawal. (Although not explicitly stated in the guidance, it is clear that the plan sponsor does not need to obtain substantiation regarding the specific qualified birth or adoption expenses.)
- If a plan offers qualified birth or adoption distributions, it is required to permit repayment of any such distribution as long as the participant is eligible to make a rollover contribution.
- Even if a plan does not permit qualified birth or adoption distributions, a participant can characterize a distribution as a qualified birth or adoption distribution if they are otherwise eligible to receive one.

In light of the additional clarity provided by Notice 2020-68, plan sponsors may want to reconsider whether to permit such distributions. In considering whether to do so, a plan sponsor should evaluate:

- The extent to which participants are likely to utilize the distributions, and whether permitting such distributions is consistent with the plan sponsor's overall benefits package and objectives;
- Its recordkeeper's capability to administer such distributions and repayments; and
- Whether the plan permits other distributions that would enable a participant to take advantage of qualified birth or adoption tax treatment without the need to amend the plan.

Although it remains unclear whether plans will widely adopt qualified birth or adoption distributions, the additional guidance issued by the IRS resolves some of the most pressing administrative questions related to permitting those distributions. If you have questions about qualified birth or adoption distributions, please reach out to a member of the Kutak Rock Employee Benefits and Executive Compensation practice group.

Leave Sharing: What Is a "Major Disaster"?

IRS guidance defines the term as a major disaster that is declared by the President pursuant to Section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act (the "Stafford Act"). Under the Stafford Act, a "major disaster" is defined as "any natural catastrophe (including any hurricane, tornado, storm, high water, wind-driven water, tidal wave, tsunami, earthquake, volcanic eruption, landslide, mudslide, snowstorm, or drought), or, regardless of cause, any fire, flood, or explosion, in any part of the United States, which . . . causes damage of sufficient severity and magnitude to warrant . . . assistance under this Act . . . ."

Notably missing from this definition is a pandemic. Regardless, the President declared a major disaster under the Stafford Act in every state, the District of Columbia and Puerto Rico as a result of COVID-19. Whether COVID-19 truly qualifies as a major disaster under the Stafford Act may yet be litigated. For the time being, however, many employers are utilizing major disaster leave-sharing programs to provide paid leave to employees who have been negatively impacted by the virus.

An employer's leave-sharing program should, first and foremost, be in writing. An employer wishing to sponsor a medical emergency or major disaster leave-sharing program should include specific information in its written policies.

Leave Sharing: Medical Emergency and Major Disaster Program Requirements

An employer's leave-sharing program should, first and foremost, be in writing. An employer wishing to sponsor a medical emergency or major disaster leave-sharing program should include specific information in its written policies. This information differs depending on the type of leave-sharing program. With respect to medical emergency leave-sharing programs, the IRS has approved plans that contain the following provisions:

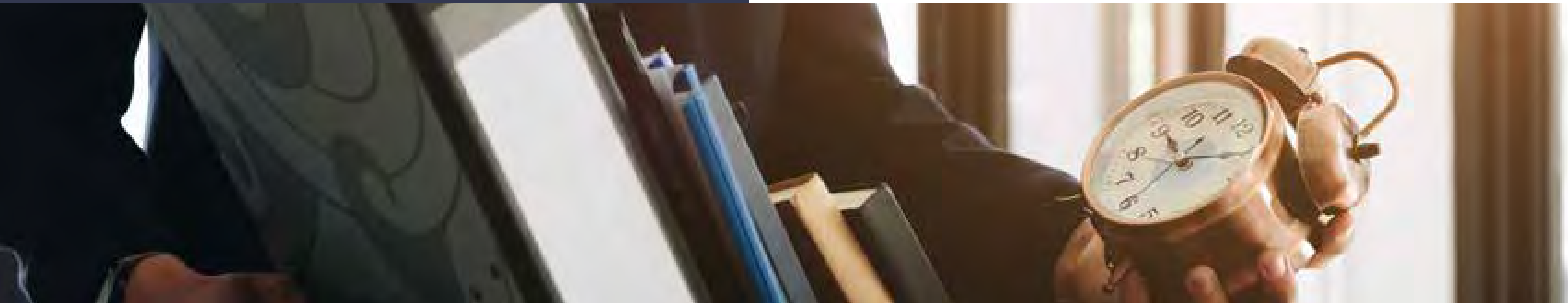
- The process for submitting written requests describing the medical emergency;
- A requirement that the applicant has exhausted all their own available leave;
- How donated leave will be paid (e.g., at the recipient's regular rate of pay);
- Restrictions on the amount of leave an employee may donate; and;
- Rules concerning how donated leave will be granted to leave recipients.

We also suggest stating whether the leave donor may designate the leave recipient (informal comments from IRS officials indicate that such designations are permissible).

With respect to major disaster leave-sharing programs, the IRS has established more specific requirements that must be adhered to. These requirements are:

- The policy allows employees to donate accrued leave to the leave bank for use by other employees who have been adversely affected by a major disaster. (An employee is considered adversely affected by a major disaster if the disaster has caused severe hardship to the employee or an employee's family member and requires the employee to be absent from work.)
- The policy specifies a reasonable limit on the period in which an employee may donate, and a recipient must use, leave following a major disaster. The reasonable limit should be based on the disaster's severity.
  - Leave donated in response to a major disaster may be used only by employees affected by that disaster and for purposes related to the disaster.
  - The amount of leave an employee may donate in a given year does not exceed the maximum amount of leave the employee normally accrues during the year.
  - The employer must make a reasonable determination, based on need, as to how much leave each approved leave recipient may receive.
- The policy must prohibit converting leave received under the program into cash. (A policy may allow leave recipients to substitute leave without pay taken on account of the major disaster with donated paid leave, however.)
- Except for an amount of leave so small as to make accounting for it unreasonable, any unused leave remaining at the end of the period specified by the policy must be returned to the leave donors within a reasonable time. (The amount of leave returned to each donor must be in the same proportion as the amount of leave donated by each donor bears to the total amount of leave donated on account of the major disaster.)

Revisiting Leave Sharing from page 8



- The policy does not allow employees to donate leave to a specific recipient.

Leave Sharing: Taxation of Donated Leave

Any type of leave-sharing program other than a medical emergency or major disaster leave-sharing program will be subject to the assignment of income doctrine established by the Supreme Court in *Lucas v. Earl*, 281 U.S. 111 (1930). This doctrine provides that income from services is taxed to the party who performed the services. In other words, paid leave that an employee earns will be taxable to the employee, even if the employee donates leave to someone else. Thus, the following would hold true:

- With respect to the leave donor:
  - The cash value of surrendered leave is includable in the employee's gross income.
  - The value of donated leave is treated as "wages" for employment tax purposes.
  - These wages would be subject to tax withholding requirements and employment taxes.
- With respect to the leave recipient:
  - The value of the leave is unlikely to be included in the employee's gross income.
    - In general terms, a donation will not be considered gross income to the employee unless there are facts establishing that the donation is disguised income (e.g., the employee provided something of benefit to the leave donor, in exchange for which the employee is receiving paid time off).
  - Donated paid leave is not treated as "wages" subject to employment tax.
  - The employee is not subject to any withholding or employment tax obligations.

For bona fide medical emergency or major disaster leave-sharing programs, the following tax treatment would apply:

- With respect to the leave donor:
  - The employee does not have income under Code Section 61.
  - Donated paid leave is not treated as "wages" subject to employment tax.
  - The employee is not subject to any withholding or employment tax obligations.
- With respect to the leave recipient:
  - The leave payments are includable in the employee's gross income.
  - The leave payments should also be treated as "wages" for employment tax purposes.
  - These wages would be subject to tax withholding requirements and employment taxes.

Leave Donation: Program Requirements and Taxation

In Notice 2020 46, the IRS announced that cash payments an employer makes to governmental charitable organizations in exchange for paid leave that employees elect to forgo will not be treated as wages of employees if the payments are made for the relief of victims of the COVID-19 pandemic no later than December 31, 2020. In addition, employees forgoing leave may not deduct the value of the donated leave on their income tax returns, as this would create a double tax benefit. Employers may deduct the payments pursuant to the rules of Code Section 162 or 170.

Summary

Thanks to leave-sharing programs, companies are able to provide eligible employees with additional paid time off in times of need. Employees who donate leave for medical emergencies, major disasters, or charitable relief efforts will reduce their taxable income and will not be taxed on the donations if the programs are properly structured.

Student Loan Repayments

Student loan debt is second only to mortgage debt in America. Forty-five million borrowers financed their educations with loans; approximately 11% of those borrowers are in default. The SECURE Act provides some relief from those loans by allowing 529 Plan holders to use plan savings to pay down the student debt of plan beneficiaries, including interest. A 529 Plan may also be used to pay down the student loan debt of a plan beneficiary's sibling. The definition of "sibling" includes a stepbrother or stepsister.

The lifetime limit on the amount used to repay loans with plan funds is $10,000 per plan beneficiary and/or sibling. The limit is applied to each beneficiary/sibling and not applied per plan. For example, a family with four children may take out a maximum of $40,000 from a 529 Plan to repay loans, with each child subject to the $10,000 limit.

The popularity of 529 Plans is partially based on their flexibility: a plan holder may change the beneficiary without adverse federal income tax consequences. Under the SECURE Act, a plan holder may, for example, designate their spouse as a beneficiary in order to apply unused funds toward their spouse's student loan debt.

Finally, while a 529 Plan holder may now repay student loan interest tax-free with 529 Plan funds, the holder cannot "double-dip"—the student loan interest deduction under Section 221(e)(1) of the Internal Revenue Code is not available for interest paid down using 529 Plan funds.

Apprenticeship Programs

529 Plans were originally designed to pay the qualified education expenses incurred by a named beneficiary in obtaining post-secondary education. The Tax Cuts and Jobs Act of 2017 expanded the eligible educational institutions to include public, private or religious elementary or secondary schools. The SECURE Act has further expanded this eligibility to include registered apprenticeship programs. Fees, textbooks, supplies, and equipment required for the apprenticeship are eligible qualified higher education expenses for a 529 Plan beneficiary. A registered apprenticeship program is one that is certified and registered with the Department of Labor.

Providing Qualified Disaster Relief to Employees Under Code Section 139

In the aftermath of the Sept. 11 terrorist attacks, Congress moved quickly to provide relief to the victims of the attacks. Part of this relief was the addition of Section 139 to the Internal Revenue Code (the "Code").

Code Section 139 allows employers to make payments to their employees that are exempt from income and employment tax in the event of a "qualified disaster." These qualified disaster relief payments can also be deducted by employers as ordinary and necessary business expenses. Employees are not required to include the payments in their gross income. While the Code does not place a cap on how much an employer can pay its employees on a tax-free basis, there are some limitations on Code Section 139 plans. Namely, the payments must be to reimburse or pay reasonable and necessary expenses associated with the qualified disaster.

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Interim Guidance From IRS Regarding Excise Tax on Excess Compensation Under Code Section 4960

Last year, the IRS issued interim guidance, Notice 2019-09, to help taxpayers apply Section 4960 of the Internal Revenue Code, which imposes a 21% excise tax on excess compensation paid by an applicable tax-exempt organization ("ATEO") to covered employees. This year, the IRS proposed new regulations largely incorporating Notice 2019-09, but also addressing some industry concerns with the interim guidance. Key clarifications are as follows:

Government Entities May Be ATEOs

A 501(c)(1) entity and a 501(c)(3) entity are ATEOs, as are government entities that exclude income from gross income under Section 115(1). However, a state, political subdivision of a state, or an integral part of a state or political subdivision ("governmental unit") cannot exclude income from gross income under Section 115(1) and is therefore not an ATEO.

Volunteers Are Not Covered Employees

Section 4960 defines a "covered employee" as any employee or former employee who was one of the organization's five highest-compensated employees. Once an employee is a covered employee of an organization, the employee will continue to be a covered employee of that organization for all future taxable years. Industry comments reflected concern that the interim guidance's ambiguous language could lead highly paid executive volunteers—i.e., individuals who perform temporary services for the ATEO and receive excess compensation from a related non-ATEO—to be considered "covered employees." To avoid volunteers qualifying as covered employees, the proposed regulation describes several exceptions.

A person will not be a "covered employee" (one of the organization's five highest-compensated employees) in any of the following scenarios:

- Limited hours. The employee works limited hours for the ATEO, meaning that the employee works for both an ATEO and a related organization but is not paid by the ATEO and spends less than 10% of their time (or fewer than 100 hours a year) providing services to the ATEO and all related organizations.
- Limited services. The employee performs limited services for the ATEO, meaning that the ATEO pays less than 10% of the employee's total compensation for services performed for the ATEO and all related organizations, and at least one related tax-exempt organization paid at least 10% of their compensation.
- Nonexempt Funds. The employee works up to 50% of their time for an ATEO but is primarily employed by a related non-exempt organization and is not paid individual compensation by the ATEO for their services. For example, if a corporation's employee provides services to a related foundation, the employee will not be a covered employee of the foundation if the corporation is the sole source of the employee's compensation.

An entity is "related" to an ATEO under Code Section 4960(c)(4)(B) if it (i) controls or is controlled by the ATEO, (ii) is controlled by one or more persons who control the ATEO, (iii) is a supported organization of the ATEO, (iv) is a supporting organization to the ATEO, or (v) establishes, maintains, or makes contributions to a voluntary employees' beneficiary association.

> *A person will not be a "covered employee" (one of the organization's five highest-compensated employees) in any of the following scenarios:*
> *Limited hours*
> *Limited services*
> *Nonexempt funds*

Departure From Interim Guidance

The Proposed Regulations also changed how taxes are calculated with respect to excess parachute payments. Notice 2019-09 provided that an ATEO or related organization may be liable for the tax on an excess parachute payment based on the aggregate parachute payments made by the ATEO and its related organizations. However, the proposed regulation provides that only an excess parachute payment paid by an ATEO is subject to the excise tax on excess parachute payments. A covered employee's base amount calculation and parachute payment calculation will still include all compensation from ATEOs and related organizations, but the ATEO will be responsible only for the 21% tax based on the ATEO's excess parachute payments.

What is a "Qualified Disaster"?

The Code defines a "qualified disaster" as:

- A disaster resulting from a terroristic or military action;
- A federally declared disaster;
- A disaster resulting from an accident involving a common carrier;
- A disaster determined by the Treasury Secretary to be catastrophic; or
- A disaster determined by the applicable federal, state, or local authority (as determined by the Treasury Secretary) to require assistance from the federal, state, or local government or agency.

Most of these qualified disasters are disasters as declared by the federal government. Disasters declared by the federal government in 2020 include, but are not limited to: Hurricane Delta, wildfires and straight-line winds in Oregon, Hurricane Sally, and COVID-19.

What expenses qualify?

In order for a payment to be excluded from gross income, the qualified disaster relief payment must be made to reimburse or pay for the reasonable and necessary expenses that have been incurred as a result of a disaster. Further, these expenses cannot already be covered by insurance or compensable or reimbursable. Such reasonable and necessary expenses can be related to personal, family, living, or funeral expenses incurred as a result of the qualified disaster, or used for the repair or rehabilitation of a home and the repair, rehabilitation, or replacement of its contents to the extent such repair, rehabilitation, or replacement is due to the disaster. A recipient does not need to be financially needy in order to receive a payment.

Payments cannot be provided to reimburse for luxury items or services. Payments also cannot be used to make up for lost compensation, and cannot be treated as sick leave or other employer-paid time off.

COVID-19 and Section 139

President Trump's declaration of a national emergency in March on account of the COVID-19 pandemic means that COVID-19 is a qualified disaster for which employers can make qualified disaster payments. There is little guidance for employers who are considering what expenses should qualify for disaster payments, and, because of the unique nature of the COVID-19 pandemic, payments may not look like other qualified disaster payments. COVID-19 payments may include payments such as the following:

- Costs associated with homeschooling or childcare for dependents;
- Grocery delivery costs;
- Costs of personal protective equipment (PPE) including gloves, masks, or other garments designed to protect the wearer from infection;
- Costs of cleaning supplies associated with the pandemic; or
- Work-from-home-related expenses.

Administering a Plan

Code Section 139 plans are not covered by ERISA and there is very little formal guidance from the IRS about the administration of a Code Section 139 plan. Revenue Ruling 2003-12 does provide some idea of what an employer should consider when implementing a Code Section 139 plan. For example, there is no requirement that a Code Section 139 plan have a written document. However, in the Revenue Ruling, the IRS found that an employer that provided relief to its employees in accordance with a documented plan was providing qualified disaster relief payments that were excludable from the employees' gross income.
Employers should also consider:

- Limitations and parameters of the plan (i.e., which employees and what expenses will be eligible);
- How the payments will be made (direct deposit through payroll or otherwise);
- Any limits per employee imposed;
- The request process and required (if any) documentation;
- When claims can be made and when they will be paid;
- How an employee might show that the expenses are not already being reimbursed; and
- The recording process for requests and payments.

There are a number of other additional considerations and decisions an employer may need to make. If you are considering implementing a Code Section 139 plan, Kutak Rock's Employee Benefits Group is here to assist you in the process.

Redesign and Restructuring Ideas for Executive and Equity Compensation to Address COVID-19 Concerns

Employers all over the United States are looking for ways to redesign or restructure their executive and equity compensation arrangements to address concerns that have arisen out of the presence of COVID-19. Some employers are concerned about their businesses continuing as going concerns, while others wish to provide increased benefits to encourage employee retention, to assist their employees during a challenging time, or to reward employees for working through COVID-19 issues. Fortunately, there are several strategies companies can employ to deal with issues created by COVID-19.

Performance-Based Award Criteria

Granting awards that are triggered and valued based on performance criteria provides the employer with considerable flexibility to design the awards in reaction to current events. If structured correctly, performance-based awards will pay out only if the company does well enough to afford the payments. For companies looking to provide greater rewards to employees, performance criteria can be restructured for 2021 to include individual performance metrics that are not as affected by the volatility arising from COVID-19. Employers also have until 90 days after commencement of the performance period to establish the performance criteria (e.g., by March 31, 2021 for awards based on performance over the 2021 calendar year).

Performance-Based Award Election Flexibility

While an election to defer nonqualified deferred compensation must normally be entered into prior to the calendar year in which it is earned, performance-based deferred compensation awards may be deferred by a participant under a nonqualified plan as late as six months before the end of the performance period (e.g., by June 30, 2021 for an award based on performance over the 2021 calendar year).

Unforeseeable Emergency Distributions

Participants in a nonqualified deferred compensation plan may elect to receive an unscheduled distribution due to an "unforeseeable emergency" (as defined in Internal Revenue Code ("Code") Section 409(A)). In such cases, deferral elections may also be cancelled. Even if an employer's plan does not currently allow for unforeseeable emergency distributions or election cancellations, the plan can be amended to allow for them.

Employer's Inability To Pay

Generally, an employer must make a distribution from a nonqualified deferred compensation plan by the date elected by the participant (or, if no election, by the date specified by the plan). However, Code Section 409(A) allows distributions to be delayed in some cases due to the employer's inability to make the payments.

Repricing Underwater Stock Options

Stock options must have a strike price (or exercise price) no lower than the fair market value ("FMV") at the time they are granted. Normally, an employer would never reprice an option after grant for a lower strike price because the new price would be greater than the then-current FMV, in violation of what is allowed. However, with so many stock options underwater (i.e., with a strike price higher than the current FMV of the options), employers have the opportunity to reissue options with the lower FMV as the new strike price.

If you are exploring redesign or restructuring ideas for your executive or equity compensation plans in light of COVID-19, please reach out to a member of the Kutak Rock Employee Benefits and Executive Compensation practice group to help you design arrangements that work best for you.

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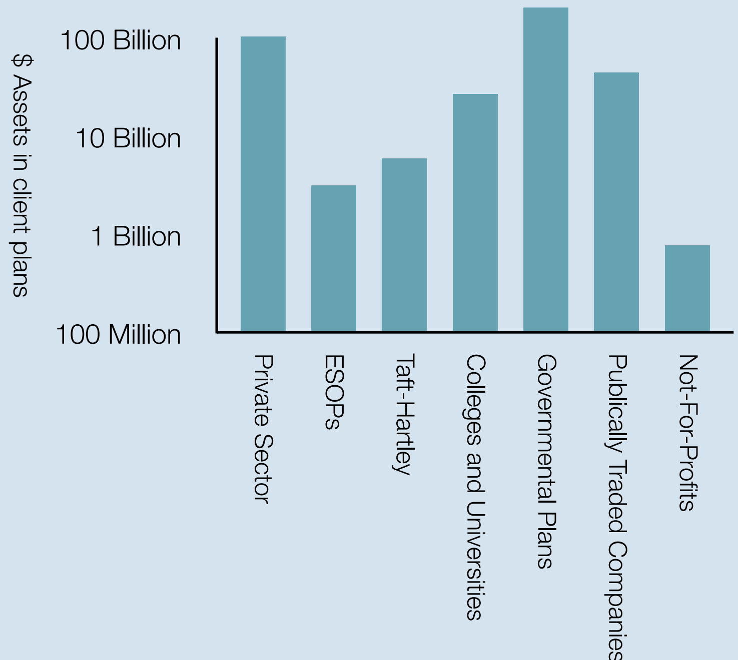
ERISA Litigation

Non-qualified & Executive Compensation Plans

Health & Welfare Plans

Who We Represent



New Hires

Jim Crossen joined the firm in September as an associate in our Minneapolis office after practicing employee benefits law at the Chicago office of an international law firm. Jim is a graduate of Harvard College and Columbia Law School. His practice encompasses all aspects of Taft-Hartley and single-employer plan design, administration, and compliance matters. Jim also has significant experience advising employers on employee benefit plan and executive compensation matters in the context of corporate transactions. He is admitted to practice in Illinois, with Minnesota bar admission pending.

Emily Dowdle joined the firm in August as a first-year associate in our Omaha office. Emily is a recent graduate of Washington University in St. Louis School of Law. She also holds an M.A. in English literature from the University of Nebraska-Lincoln and a B.A. from Creighton University. Her work involves all manner of employee benefits-related topics, including college and university retirement plans, multiple-employer welfare arrangements, and college savings programs. She is admitted to practice law in Nebraska.

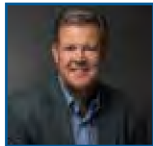
Dan Wasson is an associate in the Omaha office and joined the firm in April. He assists employee benefit plans with issues related to plan design, compliance, administration, and termination. Prior to joining the firm, Dan practiced general litigation for several years. Before beginning his law career, he was an independent contractor. Dan has a B.A. in creative writing from Ohio University and a J.D. from Creighton University School of Law. He is admitted to practice in Nebraska.

John Westerhaus joined the firm in April as an associate in the firm's Omaha office, previously working for five years at a boutique Taft-Hartley firm in Kansas City. He advises plan sponsors regarding the design, administration, and operation of employee benefit plans, and supports their compliance, litigation, and transactional needs. He holds a B.B.A. and J.D. from Washburn University in Topeka, and an LL.M. from University College London. He is admitted to practice in Nebraska, Kansas, and Missouri.

Bob Hannah is a law clerk in our Omaha office and a 3L at Creighton University School of Law. His work supports partners and associates across the range of employee benefits topics and he will join the firm as a first-year associate after graduation in the spring of 2021. Bob holds a B.S. from the United States Military Academy and comes to Kutak Rock following a career in the United States Army in which he led troops and worked to develop future weapons systems.

Emma Franklin is a law clerk in our Omaha office and a 2L at the University of Nebraska College of Law, where she is a candidate member of the *Nebraska Law Review*. Emma grew up in Wallace, Nebraska and intends to practice law in Omaha upon graduation. She received a bachelor's degree from the University of Nebraska Omaha, majoring in English and political science. This summer Emma gained hands-on experience as a new member of the Employee Benefits group, and she will rejoin the firm as a clerk next summer.

Kutak Rock Employee Benefits Key Contacts



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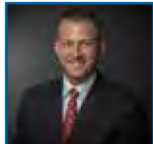

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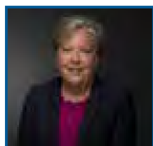

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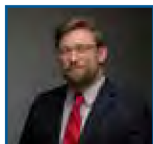

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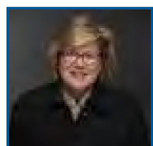

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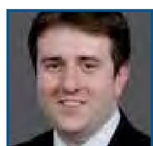

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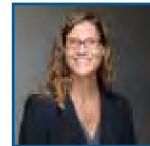

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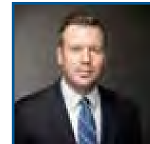

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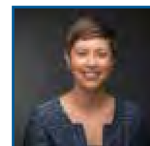

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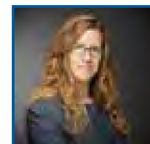

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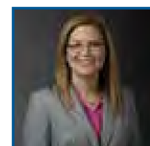

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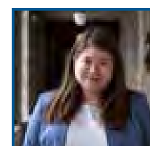

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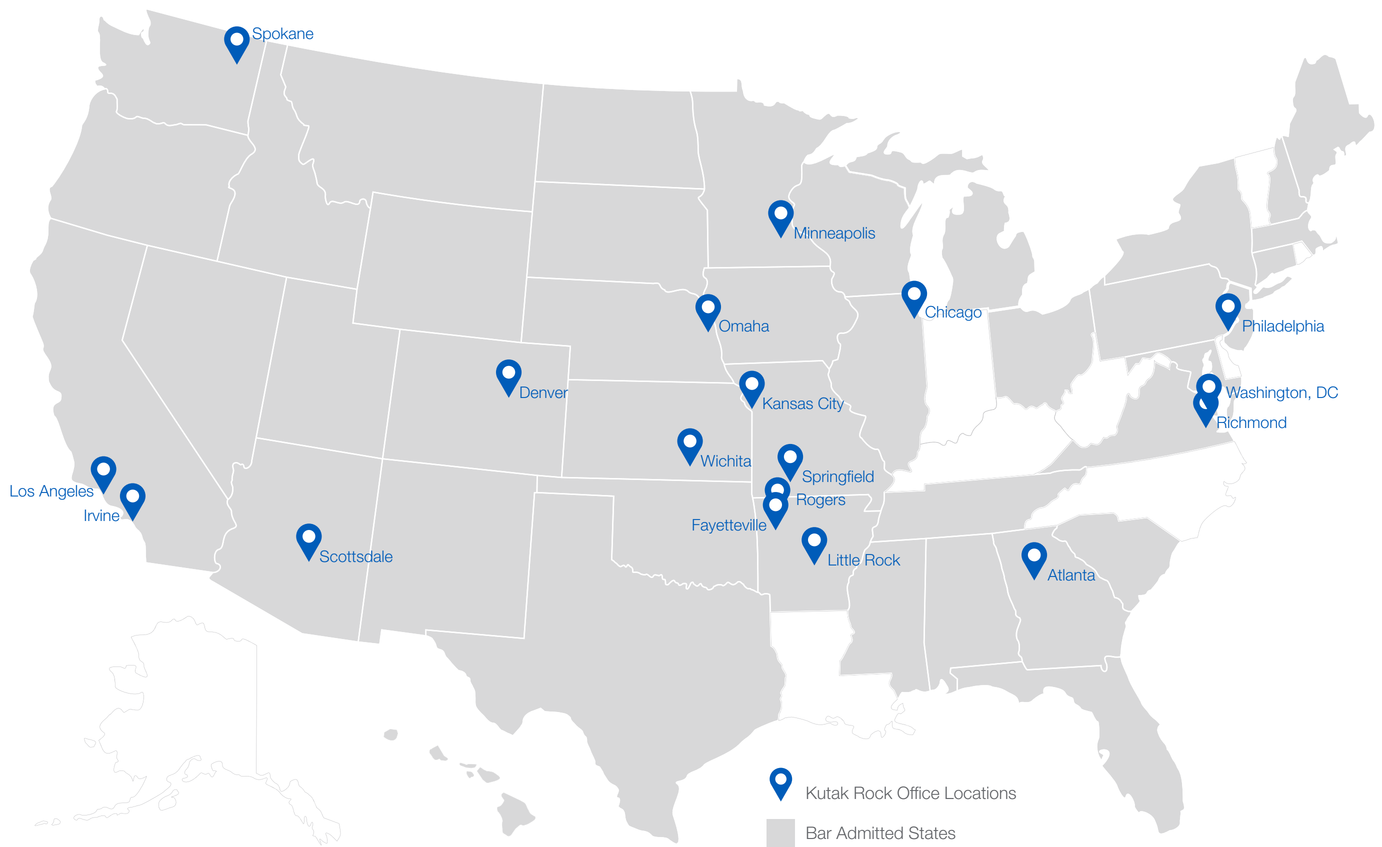

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