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Ten Common Mistakes When Designing Benefit Packages for Top Brass

This year, the news has been full of negative reports on benefit packages for top executives. Despite these new concerns and a more acute awareness of how these packages are developed, industry experts find that many companies continue to make a number of common errors when putting together benefits packages and, in particular, nonqualified benefits packages. The outcome, experts say, could harm the executive, the company, or both.

"Many executives think the primary reason for income deferral is to shift earnings from a currently high tax bracket into what will hopefully be a lower future tax bracket postretirement," says Jim Clary, president of Mullin Consulting, a benefits consulting firm based in Los Angeles. "In fact, compensation deferral plans continue their popularity, because they remain the only solution for tax-effective savings in a world where government restrictions create reverse discrimination against executive savings. And while these compensation deferral plans continue their popularity, a host of errors are often made in designing these programs.

Mullin Consulting has developed a list of common errors made by company executives in handling this benefit:

1. Overemphasis on industry peer group. Companies too often look to peer groups within their industry in designing competitive packages for top executives. This was fine a decade ago. In today's marketplace, however, top executives are making more lateral moves from companies outside of their industry. It's no longer good enough just to compete with companies inside of your own industry for executive talent; executive benefit plans must be competitive with those offered all over the globe.

2. Over-reliance on stock options. Companies are still relying too heavily on stock options, which created significant executive wealth in the 90s but have lost their luster in 2002. Companies, therefore, need to better balance their packages, educate themselves about other alternatives, and create improved strategies to reduce risk.

3. Ceding plan control to a single executive. Once a plan design is in place, companies often allow executives to take control of plan provisions, with management sometimes becoming slaves to whatever a top executive wants to do with assets inside the plan. This lack of central control can harm the overall company plan.

4. Treating the plan as if it were a 401(k). Companies often use mutual funds to fund their nonqualified plans but then defer to a vendor to run it much like a 401(k) plan. This allows plan participants to shift their individual holdings around, often triggering a taxation risk that could catch both company and participants unaware. In these instances, it is the participant who must pay any tax fine, not the company.

5. Lack of communication. Companies often experience value perception problems when they allot too little time and effort to communicating their benefit package fully to executives. If executives are unsure of

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the plan's real value, then the plan will be unsuccessful because of the lack of buy-in from all eligible executives.

6. Lack of awareness of "Source Tax" laws. Often, companies are not aware of Source Tax laws that exist in a number of states across the country. Source Tax laws create a double taxation for the retiree who moves to another state. To reduce this risk, companies should confer with a tax expert to learn about plan provisions available to offset this potential tax.

7. Not being able to "trust" the rabbi trust. Many companies will design a nonqualified plan using the security provisions of a rabbi trust. However, often notably missing is the provision that the trust be "callable." The rabbi trust is a grantor trust used to secure the company's promise against the company's bankruptcy. With a callable provision, the participant can have a right to "call" for his or her benefit at any time (subject to some forfeiture to prevent all plan participants from being in constructive receipt). This is a critical provision that should be included in a rabbi trust.

8. Failing to register the plan with the SEC. Many publicly-held companies fail to register their plans with the SEC. By not doing this, the company is at risk of a lawsuit from the participant if their deferred compensation plan loses its value.

9. Undercommunicating the risk. Many companies have not done a good job in explaining the risks of nonqualified benefit plans to their employees. The outcome of this is often an employee not handling the withholding tax correctly or not fully understanding the plan's provisions in the event of separation.

10. Creating a "Social Security syndrome" plan. Often, when management sets down provisions for funding a plan, the plan gets designed to pay out handsomely for current top executives but pushes down the plan's financial burdens to future employees and shareholders for future generations to pay.

"Developing an executive compensation package that is highly perceived and financially sound requires a dramatic shift in thinking," Clary says. "The good news for employers is that there are a variety of solutions for deploying benefits without falling into any of the common traps that can reduce value to the participant or unnecessarily increase their cost to the company."

Mullin Consulting has more than 30 years of experience on a wide range of executive topics, including corporate benefit practices, creative financing solutions, and employment contract negotiation services. For more information, visit www.mullinconsulting.com.

One Uninsured Family Member Affects Entire Household

If even one family member does not have health insurance, it can adversely affect the entire household, says a study released by the Institute of Medicine. The study, based on 2001 Census Bureau information, found that 58 million people living in the United States either do not have health insurance or live in a family in which someone is uninsured.

"Even in the healthiest of families, if one member has an accident, the resulting medical bills can affect the economic stability of the whole family," the report says. "Families with uninsured members also tend to have fewer assets and are less likely to be able to borrow money to pay medical bills."

Private, employment-based health plans increase the likelihood that all family members will be covered, but these plans also have limitations, the study says. Changes in the plan-holder's eligibility or status often disrupt coverage for the entire family. Families with members in late middle age and approaching retirement are most susceptible to the negative consequences of losing coverage, since they tend to have greater health care needs and higher medical costs than younger families. COBRA offers protection during transitional periods to some of those with workplace coverage, but many families cannot afford to pay for it. Also, the cost of health care is rising fast, resulting in higher premiums, co-payments, and deductibles. This may lead more employees to decide they cannot afford coverage for themselves or their families, and more employers to reduce their coverage offerings.

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Consider the Options for Short-Term Reward Programs

Short-term reward programs can quickly improve employees' performance—and even bring about the level of performance desired, says R. Brayton Bowen, author of *Recognizing and Rewarding Employees* (McGraw-Hill).

However, Bowen says that for a reward program to succeed, employers must avoid the following:

✓ **Institutionalizing the program.** Don't let a short-term reward program run for too long. It should cover a performance period of a year or less. "If a short-term program goes on for too long, it ends up as an entitlement," says Bowen. "What's more, eventually, it may be perceived as 'not generous enough' or 'unsatisfying.'"

✓ **Devaluing its purpose.** "Make sure that the *extrinsic* reward (gift, bonus, etc.) is connected to an *intrinsic* value (good attendance, higher productivity, etc.)," says Bowen. "This recognizes the work of the employee or team as valuable in and of itself."

Bowen describes some short-term reward programs to consider:

1. Bonus plans with near-term payouts. Bonuses may be paid annually, semiannually, or quarterly. Many companies have discontinued the standard holiday bonus because they weren't getting better job performance from their investment, says Bowen. Standard bonuses can also cause morale problems among employees who would rather receive bonuses based on achievement.

2. Short-term incentive plans. These plans generally cover a shorter performance period than bonus plans. Also, they're usually tied to piecemeal work. For example, a manager may offer an incentive over and above the normal commission to an employee who sells the remaining stock of discontinued items within 30 days.

3. Measurement-based plans. Specific measurable performance goals, such as increased productivity or reduced cycle time, are the hallmarks of these types of rewards.

4. Cash and cash-equivalent prizes. These rewards could be as basic as giving a $25 cash award to an employee who was the subject of a particularly complimentary letter from a customer," says Bowen. "On the high end, the reward might be a six-day cruise for the best innovative idea submitted during a six-month period."

5. Group incentive plans. Bowen recommends that companies place their greatest emphasis on team rewards. "However, these awards are difficult to design because they involve quantitative *and* qualitative results. For example, a team that's charged with designing a product in six months but accomplishes the task in four months has clearly met its goal. However, it may have done so by demonstrating extraordinary problem-solving and collaborative skills. Therefore, exceeding the program's goals may merit a larger bonus or more expensive gift than originally planned. Because of their familiarity with a team and its work, managers should be allowed extensive latitude in designing group incentive plans.

6. Merger and other event-specific incentive plans. After a merger, specific events must often occur, such as the integration of the two companies' technology systems or sales departments. Consider offering rewards when the integration has been completed within a required time period.

7. Stock and stock options. Companies tend to offer these rewards according to job titles and earnings. For example, they may offer lower-level employees five stock options while offering higher-level employees much bigger stock options along with bonuses. "I believe that these awards should be available to employees at *all* levels of an organization," says Bowen. "They increase people's accountability to, ownership in, and identity with the company."

8. Retention-incentive programs. Talented employees are hard to find, let alone keep. These programs may offer managers bonuses for maintaining certain staffing levels in their departments during a specified short-term time period.

Whatever your goals are for a short-term reward program, Bowen says you should make sure that managers…

✓ Keep employees continually aware of the results, including how they're performing and who has earned the reward and why.

✓ Present rewards promptly when goals are met. ●

Employers Work to Avoid "Too Many" Dependents

According to new research from the Employee Benefit Research Institute (EBRI), employers walk a balancing act when it comes to offering a solid benefits plan and taking on more dependents than they need to. EBRI notes that because a husband and wife often work for different organizations, employers are sensitive to the risk that offering "too generous" family coverage may draw a disproportionate share of dependents. Therefore, some employers offer incentives for employees and their dependents not to enroll in their plans.

The new report, "Employer Attitudes and Practices Affecting Health Benefits and the Uninsured," can be purchased for $25 from EBRI by calling 202-659-0670. ●

What's Up with Salaries for 2003? Not Much

Steven E. Gross, US compensation practice leader for Mercer Human Resource Consulting (http://www.mercerhr.com) and frequent speaker on compensation and human resource issues, recently revealed the findings of the firm's annual compensation survey. Mercer HR, has conducted the survey, which focuses on pay increase budgets as well as incentive pay and emerging pay practices, for more than 20 years. More than 1,600 organizations representing more than 15.5 million workers participated in the most recent survey. We spoke to Gross, an author and faculty member of WorldatWork, the Society for Human Resource Management, and the American Management Association, about the survey results, the trends it uncovered, and the implications that others can derive from it.

Q. *What were some of the key findings of Mercer HR's "2002/2003 US Compensation Planning Survey"?*

A. We were not surprised by a mood of cautiousness among U.S. employers. We found that overall pay increase budgets were down—3.8 percent in 2002 and 3.9 percent in 2003—compared to 4.4 percent in 2001 and 4.2 percent in 2000. When we include organizations planning salary freezes (0 percent pay increase budgets), the numbers drop to 3.4 percent in 2002 and 3.8 percent in 2003. And although employers expressed optimism about an economic recovery during the second quarter, we're now in the fourth quarter and profits remain soft, inflation remains low, GNP is flat, unemployment and health care costs are rising, and defined benefit pension plans may not be funded for the first time in years. These factors are converging on compensation planning activities, making employers reluctant to commit to higher numbers and uncertain about what to budget for next year's increases.

Q. *What do you think will actually happen to salary increases in 2003?*

A. My prediction is that salary increases will be down an average of one-half percent in 2003. We'll see salary increases come down to the 3 to 3.5 percent range.

Our clients are asking some very interesting questions, such as *can we take money from the salary increase budget to help fund some of the health care costs?* This issue and others like it are forcing organizations to consider how holistically or how much in a silo they look at compensation and benefits.

Q. *What about salary freezes? Is that a strategy that's widely used or that you would recommend?*

A. Many employers used salary freezes in 2002: One in six, or about 17 percent, froze salaries for some or all employees. In the coming year, though, only 6 percent predict they'll resort to freezes, but this could change depending upon year-end results. Salary freezes are better than job cuts, but they have the potential to disenfranchise top performers who have the greatest market opportunities.

Q. *How are salary increases traditionally calculated?*

A. Salary increases historically average 1 to 1.5 percent above inflation. If inflation stays at 1.5 percent or so, to give out 3.8 percent salary increases would be historically high. With mortgage rates low, and 0 percent car loans available, a 4 percent salary increase is a damn good increase. But I can see no economic justification for anything higher.

Q. *How important is the changing labor market when it comes to salary planning?*

A. The shift from an undersupply to an oversupply of talent during the economic downturn has affected most companies' pay plans. Traditionally, during a labor shortage, employers focus externally on what they have to pay to remain competitive with the market. When the economy softens, companies look at what they can afford to pay, not just what they have to pay. That's why we're seeing pay variations by industry.

Q. *How so?*

A. Industries that are doing well are paying differently than those that are struggling. Mercer's survey confirms that the 2002 pay freezes hit some industries harder than others. Freezes were most common in the computer software/services and telecommunications industries, while fairly rare in more recession-proof industries such as utilities, health care, and insurance.

Employers in the consulting/legal/accounting industry plan average pay increases of 4.5 percent for 2003, while employers in education will raise worker pay an average of 3.4 percent next year. It's really hard to justify giving lots of money when you're not making that much.

Q. *What's the emerging role of the HR professional in all of this?*

A. There's increased pressure on HR folks to create a return on the pay "investment." One CFO said everybody that comes through his door asking for money has to tell him what he's going to get for that money. HR comes in and first they say they have to give a 4 percent salary increase because the market is

paying 4 percent, health care costs have gone up 15 percent, and the pension plan needs funding. He said no one else gets a blank check, why should HR? One company wanted to put more money into an incentive program, thinking it would improve employee performance and, therefore, company results. The plan was to build talent, rather than buy talent, and then share some of that return with the workers.

Q. *What do you mean when you talk about building talent rather than buying talent?*

A. Every company has to decide whether it is more important for its workers to have company or industry knowledge and build that talent from within, or whether it's better to just bring people in who already have the industry knowledge it needs.

The plain fact is that you sometimes have to bring talent in from the outside. But the advantage of growing from within is you have loyal people and they develop internal networks and communication channels.

Each approach has its own advantages, but you have to make sure your HR systems support whatever mode you're in. For example does a defined benefit (DB) pension plan, which tends to reward long service, make sense when you're hiring free agents and people are spending, on average, just three to seven years with you? No. However, if your strategy requires "cradle to grave" employment, the DB plan provides an incentive for people to stay.

Internal growth can be very insulated. On the other hand, more companies are saying the free-agency method isn't as effective. In our survey data, we see a shift toward growing talent organically. One of our clients grew talent from within over a number of years, and then hired a lot of people. But they inadvertently created a "tournament" inside that said you're more likely to be promoted if you came from the outside versus the inside. Older employees left, and then they had to hire more outsiders, causing confusion about internal career paths.

Q. *How could the company have avoided this problem?*

A. They should have adopted what we call an "inside out" approach to reward management. Although you can't divorce yourself from your environment, it's our belief that there needs to be a healthy balance between inside and outside factors. What can you afford, and what are your beliefs and philosophies, versus what everyone else is doing? The traditional model was to survey the world and match or develop positions against that survey data. What is everyone providing for salary increases? for benefits? We believe that's good to a point, but everyone's business strategy is unique, so why wouldn't your pay strategy and your benefits strategy be somewhat unique? If you think about it, it makes no sense to say we have a very customized business strategy but we're going to pay the average rate.

Q. *What advice would you give to people as they plan their compensation programs for 2003 and beyond?*

A. I would suggest several steps:

✓ Realize that the surveys conducted in the spring reflected optimism about the economy, so salary plans developed earlier in the year may need to be revised based on year-end business results.

✓ Look at pay and benefits together, not as isolated functions.

✓ Balance pay, benefits, and careers as you look at your reward systems. Recognize that employees at different career stages value different things.

✓ Differentiate pay for high performers and those with the critical skills vital to your long-term success.

✓ Factor in the career opportunities and training you provide. If you ask a group of people if they've ever turned down a job that paid more money than they were currently earning, lots of them would confirm that pay isn't the only attraction and retention factor.

✓ Assess the return you're getting on your investment in various reward program elements and in your overall reward program. Make sure you are investing in the right areas to get the right results.

✓ Consider where you are in the buy talent/build talent continuum, and make sure your HR programs support the related goals.

Q. *And what if I have very little money to spend?*

A. Some of our survey respondents enacted creative cost-cutting measures instead of, or in addition to, layoffs. These measures included extending the time between pay increases from 12 to 18 months or longer, reducing work schedules, and offering voluntary leaves of absence. You need to make sure, however, that your belt-tightening measures don't destroy future business value.

You have to look for the combination of benefits, salaries, bonuses, and other incentives that has the greatest impact. When you look at your competition today, what you'll find is the way a company is successful is not who has the biggest factory anymore; it's who can get the most amount of intellectual capital. It used to be that "size mattered" (i.e., economies of scale) or how you managed your finances mattered. Now it's how you translate the creativity of your people into commercial success. I take it to the next level and say you have critical skills and high performers, so place your bets where you'll get the greatest return. ●

Value Purchasing: The Wave of the Future

As health care costs continue to rise, it will become more and more essential for employers to cut corners and get the best bang for their buck. One way to do this is to simply offer the smallest benefits package available. But over the years, studies have shown that a solid benefits package can make or break a company's ability to hire and retain quality employees.

What is the best way to strike a balance between a benefits package's attractiveness and cost effectiveness? Gary Kushner, president of Kushner & Co., says he knows the trick. Kushner, a benefits consulting professional, spoke at the annual meeting of the Society for Human Resource Management in Philadelphia.

"The trends don't change from year to year," he says. "We already know we are going to see significant double-digit increases next year. We have our work cut out for us in the health care arena."

Kushner says more employers will likely adopt a philosophy of *value purchasing* in order to offset the inevitable increases in basic health care. Value purchasing would allow employers to pick and choose benefits according to the characteristics of their employee population. This, Kushner says, is a way for employers to offer benefits that are high quality but low cost.

"At least every three to five years, I need to go back and take a look at my employee population and adjust my offerings," Kushner says.

For example, if you tend to have a younger employee population, they may be more interested in flex time and vacation accrual than in retirement benefits and 401(k) savings plans. However, you need to be careful about limiting yourself, because not all 20-somethings are ignoring their plans for the future and not all 50-somethings are simply looking for benefits for their retirement years.

Mistakes of Our Past

There are many areas of benefits management that have outstayed their welcome, Kushner says. Some aspects of employer offerings remain because they are cheap, while others stick around simply because employers have failed to reevaluate the needs of their employee populations.

What benefits do your employees need most?

There are three areas that Kushner says need to be reexamined:

✓ **Accidental death and dismemberment.** About 90 percent of the HR professionals in the audience admitted to offering this benefit to employees. "Why do employers continue to offer this benefit? The first answer I get from people is that it's cheap," says Kushner. "People don't collect on it, so why do we offer it?"

Kushner says benefits should be offered with the intention of attracting and keeping good employees. Offering $50 for a severed toe and $100 for a severed thumb are not the benefits employees will get excited about.

✓ **Vacation accrual.** The way most vacation packages work is that employees who have worked longer get more vacation time. Kushner says there may be a better alternative, short of offering new employees more vacation time. Employees who are near retirement may prefer to sell some of their vacation time in order to put away more money to be used once they retire. Younger employees may want to give up a certain amount of money to buy some more time off. Allowing this kind of flexibility would make all groups of employees feel more empowered and able to tailor the plans to their own needs.

✓ **Better money/benefits for wedding vows.** Insurance plans and other benefits change for married employees and, sometimes, allow them to save money in the long run. It may be wise to find a way for single employees to find the same type of savings.

Defined Contribution Plans

Another way of dealing with value purchasing is to devise a plan that allows employees to choose which benefits fit them best.

"It's almost a second generation of flex," Kusher says. As I age my benefits needs change with me. We need to build designs that will be attractive at different points in my lifetime."

With a defined contribution health plan, employees would have a certain amount of money contributed by the employer to spend on health benefits. For example, the employer could contribute $1,000 initially. The next $1,000 would be considered a deductible. and then the next $4,000 would be paid 80 percent by the employer. With new rules published recently by the Internal Revenue Service, employees would be able to roll over any remaining balance from year to year.

The key for employers is to truly understand their employee base and what those employees need most in a benefits package. A benefits package that worked well 10 years ago may fail to meet your workers' current benefits needs. Communicate with employees and start now to put together a package that will meet your employees' future needs.

Making Wellness Work for Your Company

For years, wellness programs have been promising a healthier workforce, more productive employees, and reduced health care costs. But are these promises for real?

According to a nine-year study by The MEDSTAT Group of Johnson & Johnson's (J&J's) Health and Wellness Program, employees who participated in the wellness program experienced significant improvements in eight of 13 health risk categories including tobacco use, sedentary lifestyle, high blood pressure, and high cholesterol.

The study showed that inpatient days, mental health visits, and outpatient doctors' visits were reduced. The program resulted in a per-employee saving of $225 per year, and J&J reaped an annual saving of $8.5 million.

Ron Z. Goetzel, Ph.D., vice president of consulting and applied research for MEDSTAT and director of the Cornell University Institute for Health and Productivity (a Cornell-MEDSTAT joint venture), discusses how employers can get the most out of wellness programs.

"Wellness programs are no longer focused on getting healthy people to exercise and eat well," he says. "Programs now deal with people who are already at high risk—people who smoke or who are obese—to reduce their risk profiles so they move closer to wellness. Programs are also focused on helping people manage disease better through behavioral interventions and, in many cases, clinical interventions."

Goetzel says wellness programs place a greater emphasis on productivity enhancement and helping employees make the connection between health and well-being and personal productivity. "If you are suffering from migraines or depression or the flu, it's going to affect your performance at work and in your personal life," he says.

A Look at J&J's Program

According to Goetzel, J&J provides three broad categories of interventions in their Health and Wellness Program:

✓ **Pre-event management.** This includes an employee health-risk assessment, which is backed by incentives to encourage a high participation rate. People found to be at high risk are invited to participate in intervention programs focused on their specific areas of risk. The organization also provides preventive screening services, health education, ergonomic assessments, job conditioning, medical surveillance, and workplace drug and alcohol awareness programs.

✓ **Support programs.** J&J provides emergency care, occupational medicine, medical case management for people who have certain diseases and disorders, counseling services through the employee assistance program, and substance abuse programs.

✓ **Return-to-work efforts.** J&J sees their workers' comp and disability programs as part and parcel of wellness. For people unable to work because of illness or injury, J&J offers such programs as functional assessments, substance abuse post-rehabilitation programs, and modified duty activities.

Get Your Company on the Wellness Track

"There are two broad ways for smaller organizations to implement wellness or health programs," Goetzel says. "One is to purchase these programs and services from nationwide vendors, such as J&J. A lot of these programs are now being delivered through the Internet, or through telephone and mailings, so organization size is not as much of an issue."

The other method is to work through a health plan. Look at the major health plans around the country and ask them directly what kinds of health and productivity programs they offer to subscribers.

"No matter how you start a program, though, you must remember that results take time," Goetzel warns. "Research shows it can take anywhere from two to four years to see cost savings. And you can't take an average savings number or return on investment (ROI) and assume you'll reach those numbers. I have had people come up to me and say 'I'm spending money on this health promotion program. When do I get *my* three-to-one ROI?'"

He says employers must be cautious about how programs are structured and administered. "There are many programs out there calling themselves wellness programs or health promotion or health productivity programs, but they are not all the same," he says. "I always encourage people to look at the data to see if these programs work and ask for an objective third-party review. You want to have credible, outside evaluation or research organizations examining these vendors' programs to make sure they actually do what they promise to do."

Goetzel recommends talking to employers that have successful programs to find out who they used as a vendor. For example, there is a list of companies who have won awards for their wellness programs located on the Stanford University Health Project Web site: http://healthproject.stanford.edu/.

You can reach Ron Goetzel at ron.goetzel@medstat.com.

Severance Benefits

Employer's Severance Plan Was "Vague"

When an employer says it will give its worker severance pay should they find themselves out of work for reasons outside of their control, workers expect this promise to be fulfilled. Courts have said that severance policies should be in writing, but will also find the employer liable for severance payments if an oral promise is clear enough to make a contract with employees. However, whether oral or written, clarity is the key to having a severance pay plan that will stand up to challenges.

Facts: A company set forth a severance pay plan in 1992 that said it would pay a specific amount of money to separated employees "if the Company determines that there should be a reduction in the workforce for business reasons." However, the following year, the company changed that policy to say, "The company will develop and implement an appropriate separation program if business and economic conditions necessitate a reduction in force."

The company then sold off one of its divisions. The company told the workers in that division that it would provide severance pay to any worker who was not offered a permanent, comparable position with the new employer. The new employer offered to hire all 55 of the current employees at the same wages plus 3 percent, with a similar, though not identical, benefits package. All but one employee accepted the offer. That employee received separation pay from the company.

However, the 54 remaining employees believed they were entitled to separation pay as well. They said that their new jobs were not truly comparable to their old jobs and that the company's separation pay policy assured them compensation.

Issue: Did the company's separation pay policy promise all employees compensation?

Decision: No. The court said the company's statement that it would "develop and implement an appropriate separation program," did not create a "legally enforceable promise." "Its vagueness alone would make it impossible for a court to provide any relief" to workers. "What is an 'appropriate' separation program?" the court asked. "The possibilities are endless. And by when was the company required to develop a program and put it into effect?" These vague statements showed that the company had not promised separation pay to any employee, the court said. Therefore, it dismissed the case [*Brines v. XTRA Corp*, 304 F.3d 699 (7th Cir. 2002)].

Impact: The court noted that there is some judicial skepticism surrounding "informal" benefits plans that allow employers to offer certain benefits haphazardly. However, the court said it was clear that this employer intended to offer separation pay only when business conditions warranted. "The normal understanding of severance pay (when not provided for in a written plan), as of bonuses, is that it is at the discretion of the employer; there is nothing here to upset that understanding," the court said. However, clearly, the employees were confused by a written severance plan that promised definite separation benefits one year and made no promises just one year later.

When making changes to your benefits plans, make certain that employees understand what those changes will mean going forward.

Health Benefits

Employee Expected Personal Advice on His Benefits Plan

Employees are often confused by how changes in their work schedule or personal status will affect their health benefits. However, unless an employee asks specific questions, it may be difficult for employers to give employees the personal advice they need.

Facts: A part-time worker moved to full-time work. The employer's long-term disability (LTD) plan automatically covered all employees who maintained a 36-hour workweek. After a few years, the employee began to suffer from heart ailments and was unable to put in a full week. His supervisor suggested that he make the move to part-time once more. The employee took the suggestion, but was then told by his doctor that he was permanently disabled by his condition and should not work. Unfortunately, because the employee was working only part-time hours at this point, he did not qualify for LTD payments. He sued the employer, claiming the employer had not done enough to explain how his change of work status would affect his benefits. He said that if he had understood how hours affected LTD eligibility, he would have made different decisions about his work schedule.

Issue: Should the employee be allowed to collect LTD benefits?

Decision: No. The court did note that the employer had not explained how LTD benefits were affected by work hours either when the employee went to full-time work or when he returned to part-time work. However, the employer held an annual "benefits fair" during open enrollment that explained all the benefits available to employees. The employee could have had his questions answered at this fair or could have asked HR specific benefits-related questions at any time, the court said. There was no way the employer could have known that the employee would require LTD benefits in the future and, therefore, had no requirement to provide individualized, unsolicited advice. The court did not believe that the employer had acted in bad faith by purposely trying to conceal its LTD plan from the employee, and it dis-

missed the case [*Watson v. Deaconess Waltham Hospital*, 298 F.3d 102 (1st Cir. 2002)].

Impact: The court did note that this employee "slipped through the cracks" of the employer's benefit system. All new employees received a checklist of benefits for which they were eligible. The worker received a list when he began as a part-time employee that stated he was ineligible for LTD benefits. However, he did not receive a new list when he moved to full-time nor when he returned to part-time work. This "unfortunate" occurrence, the court said, led to the worker being unaware that his change in status would affect his LTD benefits.

Don't let your employees become unfortunate occurrences. When there is a change in their benefits status, make certain that employees receive new summary plan descriptions explaining their benefits eligibility.

COBRA

Coverage Cancelled During Election Period

While some employers continue benefits coverage for employees in the COBRA election period, others cancel coverage until an employee actually elects and pays for COBRA coverage. One employee said such cancellation violates the law.

Facts: A worker was terminated on October 31 and received a COBRA notification that explained his rights for benefits continuation and that stated his medical coverage was cancelled on October 31. He sued the employer, claiming that the discontinuation of his coverage during the COBRA election period violated the law.

Issue: Should the employer have continued coverage during the election period?

Decision: No. The court said an employer is not required to provide medical coverage for an employee until he or she has elected COBRA coverage and has made the premium payment [*Reuther v. Smith*, 2002 Wl 2022582 (E.D. La. 2002)].

Impact: While employers need not continue coverage during the election period, they are expected to reinstate coverage retroactively once COBRA election has been completed. That is why many employers opt to continue coverage and later retroactively cancel benefits if the employee refuses COBRA benefits. Although the court in this case did not provide the actual language contained in the COBRA notification, the employee's response suggests that he did not understand that his benefits would be reinstated to October 31 when he elected COBRA coverage. Make certain that your COBRA announcements are easy for the average employee to understand so that employees will be less likely to infer your company is trying to cheat them out of necessary coverage.

Retirement Benefits

Employer's Representative Misstated Retirement Plan

One way employers attempt to encourage early retirement is to offer special retirement benefit packages. But you must make certain the person explaining those packages has his or her facts straight if your company wants to avoid going to court.

Facts: A company wanted to offer employees a special benefits package to encourage employees to take early retirement. The woman sent to explain the package told all employees that the retirement benefits were fixed and that they would not change—for the employees or their spouses—as long as the employees lived. Several employees pointed to a clause in the benefits package that stated that the employer maintained the right to modify or terminate the plan at any time. The company representative said that this simply meant that the employer could change providers. It would not affect the employees' benefits eligibility. Of course, several years after the workers accepted early retirement, the company changed its benefits plans, requiring higher deductibles and larger out-of-pocket payments. The retirees sued the company.

Issue: Did the incorrect information provided by the company representative count as a promise from the company?

Decision: Yes. The court said this misinformed individual presented "materially misleading and inaccurate information about the plan benefits" to employees in both informational meetings and exit interviews. The court believed the retirees relied heavily on this misinformation when they made their decision to retire. Therefore, the employer breached its fiduciary duty. The court ordered the matter to be reviewed by a lower court to determine the proper penalties for each affected retiree [*James v. Pirelli Armstrong Tire Corp.*, 305 F.3d 439 (6th Cir. 2002)].

Impact: The corporate lawyer, after reviewing what the representative had said at the various early-retirement benefits meetings, admitted that the information presented was incorrect. The lawyer said it would have been "prudent" for the representative to have read the plan more carefully and to have had a copy of it in her office, because she was "responsible for providing accurate information to employees about the terms and conditions" of that plan.

Before sending anyone out to discuss benefits with employees, make certain he or she truly understands what your company is offering and what promises it is making for the future. Consider having representatives give a demonstration presentation for management to make certain they are painting a clear picture of your benefits plans. Also, remind representatives to refer any questions they are unsure how to answer to HR or other company benefits/legal experts.

Standard Mileage Rate Reduced for 2003

The IRS has announced that the standard mileage rate for the use of a car for business purposes will be 36 cents per mile in 2003 [Rev. Proc. 2002-61, IRB 2002-39 (9/30/02)]. Yes, that's actually a decrease from the current rate of 36.5 cents per mile.

This standard mileage rate can be used for these three valuations:

- By employers, to provide tax-free reimbursements to employees for business use of their personal vehicles.
- By employers, to calculate additional income to employees generated by personal use of a company-provided vehicle.
- By taxpayers (employees and self-employeds), for calculating their income tax deduction for expenses incurred driving their personal vehicle on business.

Note: Use of the standard mileage rate alone is not enough to guarantee that your reimbursements to employees will qualify as tax-free. Reimbursements for business mileage must be substantiated under an accountable plan. Employees must be able to provide you with a contemporaneous record of their mileage showing the date, place, mileage, and business purpose of the trip. The plan should also require employees to return any excess reimbursements—that is, payments for personal mileage or miscalcuated amounts.

Additional Options

Employers are also free to reimburse employees for business use of their own vehicles at more than, or less than, the standard mileage rate. If your employer selects either of those options, be sure employees know what that will mean to them:

✓ Reimbursements at less than the standard mileage rate: Employees can claim the difference as a deduction on their income tax returns.

✓ Reimbursements at more than the standard mileage rate: You must report and withhold on the excess amounts as income to employees.

Other Standards

The IRS also announced the updates for the other three standard mileage rates, which will also be effective January 1, 2003:

✓ To calculate or reimburse employees for deductible moving expenses, the standard rate will drop to 12 cents per mile.

✓ To calculate the deductible costs of operating a vehicle when volunteering services to a charitable organization, the standard mileage rate will remain at 14 cents per mile.

✓ To calculate the deduction for the expenses incurred using a personal vehicle for medical purposes, the rate will drop to 12 cents per mile.

Rate Roll-up

The standard mileage rate for charitable driving deductions is established by law. The standard rates for business-, medical-, and moving-related travel are determined by an independent consultant and are based on the annual fixed and variable costs of operating an automobile. These costs include maintenance, oil, tires, insurance and registration fees, depreciation, and gasoline. In recent years, rising gas prices have spurred an increase in the standard mileage rate. This year, says the IRS, lower gas prices were behind the atypical decrease in the rate.

Exception for Luxury Vehicles

The cents-per-mile method is not available to value employees' personal use of company-provided "luxury" vehicles. For a vehicle first placed in service in 2002, the IRS defines luxury vehicles as those with a fair market value of $15,300 or more.

Other Valuation Methods

As noted before, use of the standard mileage rate is optional. (And, in the case of luxury vehicles, it's prohibited.) The IRS has approved three other methods to value employees' personal use of company-provided vehicles. These other methods are...

- the general, or fair-market, value
- the commuting value
- the annual lease value

Archer MSAs to Continue Into 2003

The IRS has announced that 2002 will not be a cutoff year for establishing Archer MSA accounts. However, the agency believes that the Archer MSA program may end before the set cutoff date in 2003.

The program, which enables self-employed individuals and employees of small employers to make deductible contributions to medical expense reimbursement accounts, had an end date of either December 31, 2003, or when 750,000 accounts were opened. The IRS has determined that 21,079 individuals filed for an Archer MSA tax deduction in 2001 and projects that 59,151 will be filed for the 2002 tax year. These numbers, the agency says, are below those required to make 2002 a cutoff year.

The announcement, 2002-90, can be found at http://www.irs.gov/pub/irs-drop/a-02-90.pdf.

California's Paid Family Leave Law May Be Model for Others

Paid family leave has made headlines from coast to coast. The media has been full of reports about the new California paid leave law—reports that have discussed employee benefits and employer concerns over costs and lost productivity. While the law is of major concern to California employers, others should be aware of how the law will work. Understanding this law may help you find a way to affect your own state's policy should lawmakers attempt to pass a similar law.

Employers Won Some Leeway

As originally designed, the California paid family leave law would have allowed employees to take up to 12 weeks of paid leave to care for a new child or a sick family member. However, employers and employer groups argued that this period of paid leave was too long—that employees would take all the leave they could if it was paid, and that it would be more cost-effective to limit paid time off. Employers suggested that six weeks of paid leave was enough. The Legislature agreed—but managed to gain employees some time through the use of vacation pay. Here's how it works:

✓ **Paid leave under FTDI.** Employees are allowed to take up to six weeks of paid leave for the birth or adoption of a child or to care for a sick relative. Employees will receive 55 percent of their base wage during these six weeks, paid from a special extension fund of the existing State Disability Insurance. The new fund will be called Family Temporary Disability Insurance (FTDI).

✓ **There's a waiting period.** Employees must be out of work for one week before they may start collecting from the FTDI.

✓ **Employers may require use of vacation time.** Employers may require employees to use up to two weeks of their paid vacation before they can start collecting from the FTDI. However, one week of that vacation will count as the waiting period. Therefore, the employee will be able to collect FTDI payments after one week of vacation time. "This seems to me like an administrative nightmare," says Mary Topliff, a San Francisco-based employment law attorney and HR consultant. "Somebody is going to have to be closely monitoring employee use of vacation time if the employer wants to take advantage of this provision. Presumably, a lot of employers will want employees to use their vacation time first. It seems to me an employer will have to make someone responsible for monitoring how much vacation time an employee uses and then providing the employee with enough information to file the state benefits claim. Granted, it's the employee's responsibility to file the claim. However, because the employer must make sure the employees know their rights and know how to seek benefits, the employer has to provide that specific information to the employee before the claim is filed."

✓ **Employees foot the bill.** FTDI will be funded entirely from payroll deductions. Estimates state that the average employee will pay an additional $27 per year starting January 1, 2004. Employees may begin to take paid leave on July 1 of that year.

✓ **FTDI and FMLA.** The new paid family leave will run concurrently with leave under the Family and Medical Leave Act (FMLA), which allows certain employees to take up to 12 weeks of unpaid leave for personal sickness, to care for a sick a relative, or for the birth or adoption of a child. Therefore, a California employee could receive six weeks of paid leave under FTDI and then an additional six weeks of unpaid leave. If an employer requires the use of vacation, all of the paid time could count against FMLA time. So, if an employee took two weeks of vacation time and six weeks of FTDI time, he or she would have only four weeks of unpaid FMLA leave remaining.

✓ **Certification required.** Employees will be required to present certification in order to obtain FTDI payments. The forms for both applying for benefits and presenting certification will be developed for 2004.

✓ **Two family members at a time?** Topliff points out a confusing element of the family leave law. The law states, "An individual is not eligible for these benefits on any day that another family member is able and available to provide the care for the family member."

"It will be difficult, if not impossible, for HR to oversee that situation," Topliff says. "In fact, it is not clear yet how that vague provision will be implemented. It's kind of up to the individual employer to reserve the right to question whether another family member *could* care for/bond with the family member. Mostly, though, it will not be up to the employer to determine whether the employee is eligible. It's more of a question of what steps the state of California will take to enforce this through the regulations." ●

New Sign-in for HRFlash

Our free weekly e-mail update of HR and benefits news has a new home and a new sign-up process. If you're not already receiving the latest news and information free each week, sign up by sending a blank e-mail to join-hrflash@bbplists.com. If you have difficulties signing up, contact marylou.devine@aspenpubl.com. ●

Final Word

Two-Thirds of Workers Spend Part of Lump-Sum Distributions

According to a recent survey by the Employee Benefit Research Institute (EBRI), workers are increasingly likely to preserve their lump-sum distributions from retirement plans when they change jobs, and are less likely to spend the money on the consumption of goods and services (such as boats or vacations). However, EBRI further found that approximately two-thirds of those who received a lump-sum distribution through 1998 cashed out at least some of their retirement savings instead of rolling it over into another tax-qualified savings vehicle. Of course, those employees suffered tax penalties on the amount they failed to roll over.

"While the data show a positive trend in rolling over lump-sum distributions, more education and possibly incentives are needed to make defined contribution plan participants understand the importance of retaining their assets for retirement," says EBRI president and CEO Dallas Salisbury.

Copies of EBRI Notes No. 7, which features "Lump-Sum Distributions: An Update," may be obtained for $25 prepaid by calling EBRI at 202-659-0670.

Salary Increases Fall, Expected to Rebound in 2003

According to a report from The Conference Board, salary budgets took a hit in 2002. For the first time in nine years, average salary increases in many key industries, including manufacturing, trade, and utilities, dropped below 4 percent in 2002. However, the projected 2003 increases show that budgets, for the most part, will rebound to 4 percent. The Board did note, however, that an increasing number of companies are actually setting budgets at less than the traditional 4 percent. Although the majority of employees will still receive the average 4 percent increase, a higher proportion of all employee groups will get lower increases both this year and next than in the preceding years.

Reimbursement Plan Must Be Final for Claim to Be Tax Free

The IRS has issued Revenue Ruling 2002-58, concerning reimbursements under a self-insured reimbursement plan for medical expenses. The IRS says that plans must be fully established before employees may receive reimbursements tax-free. It is inappropriate, the IRS says, to establish a plan and then state that it is "retroactive" to an earlier date. Therefore, if an employer reimburses an employee for medical expenses "in accordance with the terms" of a plan before that plan is fully established, that money will be considered taxable income for the employee. For information regarding this revenue ruling, contact Shoshanna Chaiton at 202-622-6080.

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