Blitman & King LLP

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CUEd In:

The Law and Business of Employee Benefits for Credit Union Executives

In this Issue

Assets held by credit unions in the United States represent one of the largest remaining pools of capital in the nation. Worldwide there are 54,000 credit unions with 186 million credit union members controlling total assets of approximately 1.1 trillion in assets.[1] In the U.S.—the nation with the greatest number of credit union members—there are 7,708 credit unions with 91.1 million credit union members controlling total assets of $896.8 billion.[2] To protect this asset pool while seizing strategic opportunities to increase surplus (without increasing service fees on existing members), executives need foresight to create and navigate markets that may be ripe for credit union participation and minimize liability, including exposure from employment practices.

In CUEd In, we will address ways to attract, motivate and retain such executive talent as well as business opportunities we see for credit unions to provide employee benefits related financial services and products to companies, executives, employee benefit plans, and individuals. In setting executive compensation, credit unions need to be aware of the current compensation environment where the global economy, and in particular the rise of Asia, has sparked an ongoing fight for talent in financial sectors. The nature of credit unions as community based organizations with local decision makers does not undo the fact that competition for talent is on a global basis.

The success of credit unions will depend on the talent of executives to develop and expand innovative financial service offerings that assist community leaders compete in the global market. One such opportunity is employee benefits services and products including investment services, trustee services, custodial services as well as carefully designed financial products. Providing employee benefits services is an $18 billion industry. The financial services industry is much larger but has traditionally been dominated by investment banks and now, since the 2008 global recession, bank holding companies. However, for a variety of reasons, the financial services industry is ripe for strategic credit unions to make headway.

We at Blitman & King are seeing complex, cutting-edge legal issues arising from the global fight for executive talent and the search for new or expanded financial services. These issues have only been compounded by the 2008 global recession and changes within the financial services industry. In an effort to stay on top of these employee benefits and employment issues faced by credit union executives, as well as credit unions as institutions, and to keep our clients and friends informed of new developments, we are launching a newsletter for credit union executives—"CUEd In"—devoted to the law and business of employee benefits and employment law.

To minimize our environmental footprint, future issues of CUEd In will be distributed electronically. As such, we kindly ask you to complete the enclosed postage-paid postcard with your email address and contact information and return to us.

Welcome to our inaugural issue.

[1] Source: World Council of Credit Unions, Inc., March 2010
[2] Source: CUNA and Associates, March 2010

THE 457 TRAP:

TAXING CREDIT UNION EXECUTIVES UPON VESTING, REALLY?

A nonqualified deferred compensation plan ("plan" or "plans") is generally an agreement between an executive employee and a credit union under which the credit union will pay the executive, at some future date, for services performed currently. Credit unions typically make these future payments in cash often for the purpose of providing executives with supplemental retirement benefits (SERPs) or payments upon a change in control such as a merger.

Except in the case of a plan subject to Internal Revenue Code ("Code") Section 457 where contributions are taxed when they become vested, amounts contributed by a credit union are generally not included in the executive's income until the time the amounts are paid or made available to the executive.[3] Deferring taxation until receipt of the benefit (as opposed to the time of contribution) is a tax savings for executives. Unfortunately, executives of credit unions need to pay careful attention to the exception and not the general rule. We recently came across such circumstance in connection with the merger of one credit union into another and its impact on an executive's compensation package. In this instance, we served as special counsel to the acquiring federal credit union in connection with the employee benefits aspects of the merger.

Code Section 457 generally applies to plans sponsored by tax-exempt entities and state and local governments. Many state and federal credit unions believed they were subject to Code Section 457 as tax-exempt entities. Indeed, credit unions have historically maintained Code Section 457(b) plans—plans similar to a Code Section 401(k) plan-for rank-and-file employees whereby the employees reduce salary on a tax-deferred basis and are taxed at the time benefits are made available. In addition, credit unions also maintain Code Section 457(f) plans for their executives that permit a larger amount of compensation to be deferred and taxed upon vesting. However, in 2004, the IRS surprised many federal credit unions when it held that federal credit unions are not eligible employers and cannot maintain Code Section 457 plans because they are "federal instrumentalities." The IRS reasoned that federal credit unions are therefore neither tax-exempt entities nor state and local governments.

Unfortunately, executives of credit unions need to pay careful attention to the exception and not the general rule.

This 2004 development was favorable for federal credit union executives because it would have removed the tax on vesting rule and replaced it with taxation upon receipt of benefits. Nevertheless, commentators immediately questioned the validity of the ruling and the IRS, closely on the heels of the ruling, announced it was reconsidering its position. The following year, the IRS issued a notice advising that plans sponsored by federal credit unions will be covered by Code Section 457 if the plan is in effect on August 15, 2005 and the credit union has *consistently* claimed the status of a non-governmental tax-exempt organization for all employee benefit plan purposes.

[3] In addition, a violation of the rules applicable to nonqualified deferred compensation plans under Internal Revenue Code Section 409A accelerates the time when an executive must include such benefits in income and subjects the executive to a hefty 20 % tax penalty and interest.

Recently, while conducting benefits due diligence in connection with the merger of two credit unions, we discovered that the target credit union maintained a plan for its CEO that contained a single trigger change in control provision. Upon acquisition of the target credit union, the CEO would receive cash payments over the reminder of his/her life. This agreement was silent as to whether Code Section 457 applied to the plan but the arrangement had been implemented and maintained by the credit union since prior to August 2005. In addition, the credit union maintained a plan that permitted its rank-and-file employees to make pre-tax salary deferrals. The plan for rank-and-file employees, also had been implemented and maintained since prior to August 2005, explicitly referenced being governed by Code Section 457(b).

The problem. The CEO was set to receive a large amount of compensation over the remainder of the CEO's life but would be taxed all upfront (even on the future payments) in the year of the merger because the change-in-control event gave the CEO vesting rights to that entire payment.[4] The target credit union asserted that the CEO should not be taxed on each payment until received because Code Section 457 was not applicable based on the IRS' 2004 ruling. However, as noted above, subsequent IRS guidance required that federal credit unions *consistently* claim non-governmental tax-exempt status for *all* employee benefit purposes meaning that a credit union cannot cherry pick when or when not to apply Code Section 457 without risking adverse tax consequences.

The stakes. Undoing the application of Code Section 457(b) to the employees' salary deferral plan not only contradicted the express terms of the plan but would mean that all employees participating in the 457(b) plan would be immediately subjected to income taxation because benefits were currently available to them. However, applying Code Section 457(f) to the CEO's plan meant that the CEO would face an immediate and large tax liability.

After our review of all employee benefit plans maintained by the target credit union and in effect in August 2005, it was clear that the credit union consistently claimed (and intended to claim) the status of a non-governmental tax-exempt organization for all employee benefit plan purposes. As such, the lifetime payments that the CEO would receive all became immediately taxable to the CEO in the year of the merger.

Based on the structure of the plan for the CEO, it appears that neither the CEO nor the target credit union addressed, or anticipated, the potential application of Code Section 457. Another pitfall subsequently occurred when overlooking, or simply taking for granted, what impact adopting the Code Section 457(b) plan for rank-and-file employees would have on the CEO's existing plan. To make the CEO whole for this unforeseen occurrence, we structured, at the request of the acquiring credit union, additional benefit payments

"Remember, son, these are your tax-free years. Make the most of them."

[4] For reasons outside the scope of this article, the CEO's plan could not be amended to change the payment form.

to satisfy the tax-liability. Nevertheless, this employee benefits issue resulted in the removal of additional assets from the coffers of the target credit union and thereby lessened, to some degree, the value of the merger transaction. This situation is an example of an unfortunate but preventable quagmire.

The interaction of different plans for executives and rank-and-file employees, in conjunction with the tax on vesting rule for executives, can present adverse tax consequences under Code Section 457. Furthermore, the IRS has noted that future regulations defining a "governmental plan" will be forthcoming and may provide that plans sponsored by federal credit unions are not subject to Code Section 457. Any such future guidance should include a reasonable transition period during which any federal credit union will be permitted to revise its deferred compensation arrangements to avoid possible adverse tax consequences for its executives as well as its rank-and-file employees. Recently, in referring to the status of the regulations, the IRS indicated that the public "can expect to see [them] soon." As such, credit union executives should continue to monitor developments in this area and the potential impact they may have on compensation deals currently in place.

Examining Fiduciary Compliance

Credit unions may function both as a service provider to certain employee benefits plans as well as a plan sponsor for benefit plans of their employees. Therefore, credit unions may need to comply with ERISA's fiduciary responsibilities and prohibited transaction rules on different fronts. Such employee benefit services may include acting as a trustee or custodian for certain pension plans and profit sharing plans, including individual retirement arrangements (IRAs), for its members or groups of members. With respect to benefits provided by the credit union to its employees, credit unions often sponsor participant-directed individual account plans (such as a 401(k) plan). With respect to these employee benefits activities, credit union executives should be aware of two pending regulatory proposals of the U.S. Department of Labor ("Department"). In addition, it has become clear that fiduciary compliance will be a major emphasis for the Department in the near future in terms of enforcement and rulemaking.

First, the Department has proposed an amendment to the regulations defining fiduciary status under ERISA. Under ERISA, fiduciaries are obligated to act prudently and solely in the interests of plan participants and beneficiaries. In addition, ERISA, and, with respect to IRAs, the Internal Revenue Code, prohibit fiduciaries from engaging self-dealing and transactions that present conflicts of interest. The proposal would substantially expand the classes of service providers subject to ERISA's fiduciary duty and prohibited transaction rules by more broadly defining the activities and circumstances by which individuals render "investment advice."

A delineated list of covered activities constituting investment advice includes: advice, appraisals and fairness opinions concerning the value of assets; recommendations regarding investment in, purchasing, holding, or selling plan assets; and advice or recommendations regarding management of plan assets. The Department believes these changes are necessary due to the development of participant-directed individual account plans and to address problems uncovered during audits of employee benefit plans. The regulations are proposed to be effective 180 days after they are published in final form in the Federal Register.

Second, the Department has issued new fee disclosure requirements that, in part, mandate certain service providers to defined contribution plans (including 401(k) plans) disclose all fee information, including hidden fees, related to those services. These new rules are particularly relevant to credit unions as sponsors of 401(k) plans since the final rule expressly excludes IRAs from coverage.

In this regard, credit unions often contract with a broker-dealer that provides services to the credit union's defined contribution plan. Credit unions, operating through an executive committee, generally determine what investment options to make available to participants of the plan for investment of assets in their individual accounts. The broker-dealer executes trades, generally in mutual funds and insurance products, at the direction of plan participants. This contractual relationship is permitted so long as, in part, the broker-dealer receives "reasonable compensation." Thus, fundamental to a credit union's ability to properly discharge its duties under ERISA when engaging a service provider to its 401(k) plan is the availability of information to enable the credit union to make an informed decision about the services being provided and the associated costs. These new rules are aimed at making sure the credit union received information to make a determination on whether the compensation the broker-dealer receives is "reasonable." However, the stakes are higher because paying unreasonable compensation results in a prohibited transaction by both the credit union and broker-dealer.

However, these rules are not limited just to the broker-dealer relationship with a credit union plan. Instead, covered services providers to defined contributions plans include:

• those that perform services as a fiduciary or registered investment adviser,

These new disclosure rules are not limited just to the broker-dealer relationship but instead cover a range of service providers to a 401(k) plan. As such, under these new rules, credit unions will need to obtain certain written disclosures from their 401(k) service providers. These final rules become effective January 1, 2012.

Under the new rules, the broker-dealer is required to disclose a description of:

• services to be provided to the plan;

• the status of the service provider with respect to the plan;

• compensation the service provider reasonably expects to receive and the manner of receipt in which disclosed compensation is received; and

• certain investment compensation information with respect to each investment alternative available under the plan.

• those that provide certain recordkeeping or brokerage services to participant-directed defined contribution plans, and

• those that provide other services for indirect compensation (any compensation not received directly from the plan).

As such, under these new rules, credit unions will need to obtain certain disclosures from their 401(k) service providers. These interim final rules become effective January 1, 2012.

Employment Corner

As a reminder, the Wage Theft Prevention Act ("Act"), which provides enhanced remedies and greater enforcement powers to prevent violations of New York wage laws, goes into effect April 12, 2011. Under New York's current wage statutes, a credit union may be held civilly liable for the amount of wages withheld, plus damages equal to 25% of the owed wages. Another labor law provision requires that credit unions provide its employees with notice of their rate and date of pay and to retain employment records for three years. The current retaliation law provides a burdensome process for employees claiming employer retaliation for reporting violations of wage laws, which requires the employees to cite the section of the law the employer violated. The following is a summary of the key provisions of the Act:

• **Increased Damages and Criminal Punishment.** The Act's most notable provision is its amendment of the liquidated damages available in civil suits, increasing potential damages from 25% to 100% for violations, plus interest. Further, willful or egregious violations allow the Commissioner of Labor to require the employer pay a civil fine "not exceeding double the amount of unpaid wages." Moreover, attorney's fees are provided for under the Act. Criminal punishments have also been added for employers offending the minimum wage and overtime provisions.

• **Notice Requirements.** The Act's most controversial aspect is the affirmative requirement imposed on employers to provide notice of certain wage information at the time of hire. In addition to existing requirements under law, the employer will be required to provide notice of how wages are to be determined, allowances claims as part of the minimum wage as well as other information. Employers must provide this written notice in English as well as the employee's identified primary language.

The Act also has requirements regarding the receipt of the employee's written acknowledgement of receipt, the timing of providing initial and subsequent notice and the employer's retention of certain records for six years. The power of the Commissioner of Labor to enforce the notice requirements is also expanded to enforce the Act, and added a fine of $50.00 per week until the violation is remedied (up to $2500).

• **Additional Pay Statement Information.** The Act also adds another affirmative requirement impacting the information to be included in the employee's pay statement. Employers will be required to provide the dates of work covered, name of employee and employer, address and phone number of employer, rate or pay and basis thereof, allowances claimed as part of minimum wage, rate of overtime pay and the number of overtime hours worked. Employers will also be required to maintain weekly payroll records to six years.

With certain exceptions, failure to provide this statement will subject the employer to a fine of $100 per week for each statement not provided with wages. In addition, the statute creates a private right of action, rather than limiting remedies to the Commissioner and/or Department of Labor.

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Our Employee Benefits Practice is comprised of 10 attorneys, as well as several other professionals, who work full time on all types of ERISA, employee benefits, and executive compensation matters, including benefits litigation. As a leader in the employee benefits industry, we use our comprehensive knowledge and technical skills to assist our clients with complex and significant benefit matters.

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