

November 2012

## A Guide to Employee Benefits Administration and Leaves of Absence

By Joni Andrioff, Michelle Barrett, Michael Congiu, Steven Friedman, Susan Hoffman, Diane Kimberlin, Adam Peters, Michelle Thomas and George Wood

### Summary: Intersection of Employee Benefits and Leaves of Absence

This InSight addresses employee benefits considerations during leaves of absence. Generally, the outline covers leave of absence issues for welfare benefit plans, retirement plans, bonus and incentive plans, and non-qualified deferred compensation plans. The various types of leave may be governed by federal or state law, including: the federal Family and Medical Leave Act (FMLA); federal and state laws governing pregnancy-related disabilities; state-law “mini-FMLAs;” the federal Uniformed Service Employment and Reemployment Rights Act (USERRA); the Americans with Disabilities Act (ADA) and its amendments (where leave is provided as a “reasonable accommodation”); and state laws governing disability discrimination and reasonable accommodation.

### Laws Providing Leaves of Absence

#### *Family and Medical Leave Act (FMLA)*

The FMLA,<sup>1</sup> as relevant here, requires covered employers to provide eligible employees up to 12 weeks of unpaid leave due to a serious health condition (26 weeks for a serious injury or illness due to military service) and continuation of medical benefits for the 12-week (or 26-week) leave period. A covered employer has at least 50 employees;<sup>2</sup> a covered employee has completed at least 12 months of employment and has worked at least 1,250 hours in the last 12 months at a location where 50 or more employees work within 75 miles of each other.

Except for medical benefits, the FMLA does not require the leave of absence period to count for purposes of benefits accrual.

<sup>1</sup> Family Medical Leave Act (FMLA), 29 U.S.C. §§ 2601 *et seq.*; 29 C.F.R. Part 825.

<sup>2</sup> Pregnancy Discrimination Act of 1978 (PDA), 42 U.S.C. §§ 2000(e) *et seq.*; 29 C.F.R. Part 1604. The PDA applies to employers with as few as 15 employees and generally requires employers to treat leave related to medical conditions associated with pregnancy or childbirth the same as other short-term disability leaves.

## ***Americans with Disabilities Act (ADA)***

The ADA<sup>3</sup> and its amendments require an employer to analyze whether a definite leave of absence is a reasonable accommodation for an ADA-protected disability and will assist a qualified individual to return to work to perform the essential functions of his or her job. The Act applies to employers with at least 15 employees. Additionally, the ADA contains an exception if the leave for reasonable accommodation causes undue hardship to the employer.

## ***Uniformed Service Employment and Reemployment Rights Act (USERRA)***

USERRA<sup>4</sup> divides benefit consideration into two categories: seniority and non-seniority based benefits. Seniority based benefits are those that accrue with, or are determined by, longevity in employment.<sup>5</sup> An employee on USERRA leave is entitled to receive, upon his or her proper reinstatement from leave, all seniority-based benefits that the employee would have received had he or she remained continuously employed during the period of service. With respect to non-seniority based benefits, the employee on USERRA leave is entitled to receive those benefits provided to persons of similar seniority, status and pay who are on a leave of absence or furlough.<sup>6</sup>

In general, USERRA's protections extend to certain "benefits," "benefit of employment," and "rights and benefits," where each such term is defined to mean:

[A]ny advantage, profit, privilege, gain, status, account, or interest (other than wages or salary for work performed) that accrues to the employee because of an employment contract, employment agreement, or employer policy, plan, or practice. The term includes rights and benefits under a pension plan, health plan, or employee stock ownership plan, insurance coverage and awards, bonuses, severance pay, supplemental unemployment benefits, vacations, and the opportunity to select work hours or the location of employment.

If an employee has been absent from a position of civilian employment by reason of service in the uniformed services, he or she will be eligible for reemployment, provided that: the employee gave advance notice of the need for leave, and the employee's total military service under USERRA is five years or less (subject, however, to a number of exceptions that require leave to be provided, but which do not count towards the five-year limit); the employee timely returns to work or applies for reemployment under the time periods set forth in USERRA (which are based on the length of the service at issue); and the employee has not been separated from service with a disqualifying discharge or under other than honorable conditions.

## ***State and Local Laws***

State FMLA and pregnancy leave laws may be more generous to employees than the corresponding federal laws, *e.g.*, requiring coverage of employers with fewer than 50 employees, providing an expanded definition of "family," and providing leaves of longer duration than 12 weeks.<sup>7</sup> Additionally, some jurisdictions have laws requiring paid sick leave, such as Connecticut,<sup>8</sup> Washington D.C.,<sup>9</sup> San Francisco,<sup>10</sup> and Seattle.<sup>11</sup> And state anti-discrimination laws may provide for a different "reasonable accommodation" or "undue hardship" standard, making additional required leave, beyond that provided expressly under the statute, possible.

3 Americans with Disabilities Act of 1990 (ADA), as amended by the ADA Amendments Act of 2008, 42 U.S.C. §§ 12101 *et seq.*

4 Uniformed Services Employment and Reemployment Rights Act (USERRA), 38 U.S.C. §§ 4301 – 4335; 20 C.F.R. Parts 1002 *et seq.*

5 A seniority-based benefit depends on whether: (a) the right or benefit is a reward for length of service rather than short-term compensation for work performed; (b) whether it is reasonably certain the employee would have received the right or benefit if continuously employed during the period of service; and (c) whether it's the employer's custom or practice (such as provisions of an employment contract or handbook policies, unless the employer's actual custom and practice is different) to provide or withhold the right or benefit as a reward for length of service.

6 38 U.S.C. § 4316.

7 See, *e.g.*, California Family Rights Act, Cal. Gov't Code § 12945.2.

8 Conn. Gen. Stat. §§ 31-57r - 31-57w.

9 D.C. Code §§ 32-131.01 *et seq.*

10 San Francisco, Cal., Admin. Code §§ 12W.1 *et seq.*

11 Seattle, Wash., Muni. Code §§ 14.16.010 *et seq.*

The federal Employee Retirement Income Security Act (ERISA) generally does not preempt state and local law with respect to self-insured medical plans. ERISA’s “savings clause” states that “[n]othing in [Title I of ERISA, including the preemption provision in section 514(a)] shall be construed to alter, amend, modify, invalidate, impair, or supersede any law of the United States.”<sup>12</sup> The FMLA’s provision for the protection of state and local laws provides that “[n]othing in *this* Act or any amendment made by *this* Act shall be construed to supersede any provision of any State or local law that provides greater family or medical *leave* rights than the rights established under *this* Act or any amendment made by *this* Act.”<sup>13</sup> The U.S. Department of Labor’s view is that ERISA does not preempt state FMLA laws on the ground that ERISA preemption of state leave laws would “impair” the federal FMLA. Additionally, the legislative history of the FMLA shows Congress’s intention not to preempt state FMLA laws that provide greater family and medical leave rights.

## Summary Table

The benefits provisions of leave of absence laws are summarized as follow:

Law	Benefit Provision
FMLA	Requires employer to continue medical benefits for the FMLA leave period as if the employee was still working.
ADA	Requires an employer to analyze whether a definite leave of absence is a reasonable accommodation for an ADA-protected disability, and will assist a qualified individual to return to work to perform the essential functions of her job.
USERRA	Requires employer to provide seniority-based and non-seniority-based benefits to person on military leave.
State and Local	Variable — May extend FMLA rights and other leave obligations or provisions.

## Leave Considerations for Welfare Benefit Plans

Employers should review their welfare benefit plans for consistency with applicable leave of absence laws and should coordinate their leave of absence provisions with plan administrators. In this context, welfare benefit plans include health, dental, and vision plans, flexible spending accounts, health reimbursement accounts, life insurance, short term disability, and long-term disability.

### Health Benefits

Under the FMLA, employers must maintain the same health benefits during an employee’s FMLA leave as if the employee was still working.<sup>14</sup> The FMLA applies to coverage provided through a group health plan. Thus, an employer is required to keep an employee covered in the group medical plan and continue to pay the employer-paid portion of the employee’s health premium (but may condition continued payment upon the employee’s payment of the employee portion of the premium). The employee may continue the employee-paid portion of the premium by deduction from any amounts paid to him or her during the leave, *e.g.*, short-term disability (either by payroll deduction or through an insurer); or by a payroll deduction from employer-paid supplemental military pay; by check, *e.g.*, on the same schedule as COBRA payments; or, if the employee elects and the employer allows it, by prepayments before the leave starts; or with a “catch-up” payment after the employee returns from leave under a cafeteria plan.<sup>15</sup>

<sup>12</sup> 29 U.S.C. § 1144(d).

<sup>13</sup> 29 U.S.C. § 2651(b) (emphasis added).

<sup>14</sup> 29 U.S.C. § 2614(c); 29 C.F.R. §§ 825.100(b), 825.209, 825.211, 825.215.

<sup>15</sup> Treas. Reg. § 1.125-3.

Coverage may be terminated during a leave if an employee's payment is more than 30 days late, provided the employee has received at least 15 days' written notice before the coverage is scheduled to end,<sup>16</sup> in any of the following scenarios: (1) the employee notifies the employer that the employee is not returning to work; (2) the employer terminates the plan; or (3) the employee does not return to work.<sup>17</sup> If coverage terminates during an employee's leave, the employee may experience a "qualifying event" under COBRA. In the case of a leave of absence, the qualifying event may typically be a reduction in hours and loss of coverage. Accordingly, COBRA does not begin until coverage lapses at the end of FMLA leave.

The ADA does not generally require continuation of health coverage or other benefits during a leave of absence.

USERRA requires that an employer provide health coverage, based on the regular employer-employee premium rates, to persons on military leave for periods of less than 31 days. After this period, an employer must offer the employee COBRA-like coverage provided for under USERRA for up to 24 months.

USERRA requires that a uniformed service member called to active duty may elect to continue coverage under the employer's group medical plan during military leave. The maximum period of coverage of a service member and his or her dependents under such an election is the lesser of the 24-month period beginning on the date on which the person's absence begins, or the day after the date on which the person fails to apply for or return to a position of employment. The service member is responsible for the cost of coverage at COBRA rates. In addition, special rules under USERRA allow the uniformed service member to elect coverage under a spouse's group medical plan without regard to restrictions on changes in coverage. Generally, most active duty uniformed service members are eligible for military medical coverage.

In providing benefits to employees on leave consistent with statutory requirements, employers must also consider ERISA implications. ERISA non-discrimination testing for health plans applies to eligibility and level of benefits provided to officers, 10% owners, and highly compensated employees (HCEs), compared with the eligibility and level of benefits provided to rank-and-file non-highly compensated employees during a leave or after termination of employment. If the HCEs receive coverage during leave and after termination to a greater degree than coverage provided to rank-and-file employees on leave or after termination, the plan may be discriminatory. For insured health plans, under the Patient Protection and Affordable Care Act, a plan found to violate nondiscrimination requirements may be fined \$100 per day per person "to whom the discrimination relates."<sup>18</sup> This provision will not be effective until additional regulatory guidance is provided. For self-insured health plans, a plan found to violate nondiscrimination requirements results in a loss of favorable tax benefits for officers, 10% owners, and highly compensated employees.

## ***Flexible Spending Accounts***

A flexible spending account allows pre-tax salary reduction deferrals to pay for certain costs, such as medical expenses or dependent care. Employers are required to continue health flexible spending account coverage during an FMLA leave.<sup>19</sup> Employees, however, may either cancel health FSA coverage during leave or continue it by prepaying FSA contributions before the leave starts, by sending a check during the leave, or by making "catch up" contributions upon return. If an employee elects to cancel health FSA coverage during the leave, an employer is not required to make any expense reimbursements for claims incurred while coverage lapsed.<sup>20</sup> Conversely, even if an employee elects to cancel FSA coverage during leave, an employer may decide to continue FSA coverage for the employee by paying both the employer's and employee's portion of the coverage during the leave. In this event, an employer may recover the employee's share of the contributions when the employee returns from leave or, if the employee fails to return from leave, the employer may recover the employee's share of contributions and its own share from the employee on a pre-tax or after-tax basis through other lawful means set forth in federal regulations.<sup>21</sup>

Dependent care flexible spending account plan coverage is not required to be continued during FMLA leave like the health care flexible spending account plan. Claims for reimbursement under the dependent care FSA are only allowed for temporary absences of two weeks or less.<sup>22</sup>

<sup>16</sup> Treas. Reg. § 54.4980B-10.

<sup>17</sup> Treas. Reg. § 54.4980B-10.

<sup>18</sup> See 26 U.S.C. § 105(h)(2), I.R.S. Notice 2010-63 (Oct. 12, 2010).

<sup>19</sup> Treas. Reg. § 1.125-3.

<sup>20</sup> Treas. Reg. § 1.125-3.

<sup>21</sup> See 29 C.F.R. § 825.213(a).

<sup>22</sup> Treas. Reg. § 1.21-1(c)(ii).

If a participant is out on FMLA for longer than two weeks, reimbursement claims for dependent care are not covered. However, when the participant returns to work, claims may be submitted for dependent care received after the return to work up to the total amount contributed to the dependent care FSA. The participant may elect to pre-pay FSA contributions before the leave begins, make contributions during leave with pre-tax contributions if the participant is receiving pay during leave or by sending in a check, or by making “catch-up” contributions upon return. If coverage lapses during leave, it may be reinstated upon return to work. COBRA does not apply to the dependent care FSA.

### ***Employee Assistance Plan***

An Employee Assistance Plan (EAP) is a confidential individual assistance and support service that helps employees cope with personal problems adversely affecting their lives, behavior, and/or performance, such as alcoholism, family disintegration, financial or legal difficulties, marital problems, and substance abuse. An Employee Assistance Plan may be a group health plan covered by the FMLA if it provides medical care, rather than only referral services. If the EAP does qualify as a group health plan, then coverage must continue during the FMLA leave period similar to other health benefits.

### ***Healthcare Spending Accounts***

A Healthcare Spending Account (HSA) is a healthcare reimbursement program that allows employees who elect health coverage under a High Deductible Health Plan to contribute additional pay by payroll deduction on a pre-tax basis to an individual account. For purposes of the FMLA, an HSA is not treated as coverage under a group medical plan that must be continued during the FMLA period. An employee on leave of absence may, however, continue to contribute to the HSA, provided that High Deductible Health Plan coverage continues during the leave (e.g., the employee continues to make required payments, etc.). If permitted under the terms of the HSA, employees may contribute by prepaying HSA contributions before the leave starts, by sending a check during the leave, or by making “catch up” contributions upon return.

### ***Health Reimbursement Accounts***

A Healthcare Reimbursement Account (HRA) is a program funded by employer contributions. In general, the terms of the HRA during a leave of absence may be determined by contract. For purposes of the FMLA, an HRA is not treated as coverage under a group medical plan that must be continued during the FMLA period.

### ***Life Insurance***

In addition to determining which leave laws may affect life insurance, it is important to determine whether the employer’s life insurance plan or policy provides coverage for employees on leave. Some plans require that an employee be “actively at work” to be eligible for benefits. Generally, an employee on leave is not treated as being actively at work. For an insured plan, the insurance company may refuse to pay if the employee is not “actively at work.” For a self-insured plan, the reinsurer may refuse to pay. If an insurer or reinsurer refuses to pay, an employer may still be required to make good on the liability out of its own pocket.

### ***Vacation Accrual Considerations***

Employers should have a policy covering when leave time counts for vacation benefit accrual purposes. For example, the policy should say whether vacation accruals stop or continue during leave. If the vacation policy provides for vacation accrual during “paid” leave, the policy should be clear as to whether short-term disability payments or other payments provided while on leave count for this purpose.

USERRA does not require an employer to continue to accrue vacation for an employee on military leave, but, once the employee returns from leave, he or she will begin to accrue vacation again based on the accrual rate the employee would have attained had he or she remained continuously employed.

In addition, some state laws require continuation of vacation accruals.

## Short-Term Disability and Leave Beyond FMLA

After 12 weeks (or 26 weeks for military entitlement) of FMLA leave, the FMLA rules cease to apply. The employee, however, may not be ready to come back to work. At the end of FMLA leave, absent the need for a reasonable accommodation under the ADA, federal statutory rights lapse as to reemployment and continued health coverage under the FMLA. An employee who does not come back to work after FMLA leave may cease to satisfy the health plan's eligibility requirements, causing health coverage to terminate (e.g., a requirement that the employee must be "actively employed" to be eligible for coverage).

In a recent unpublished decision,<sup>23</sup> the U.S. Court of Appeals for the Sixth Circuit affirmed a lower court ruling that an employee lost health insurance coverage at the end of FMLA leave, even though she was still on short-term disability for an additional 12 weeks, despite the fact that her employer continued to deduct health care premiums from her short-term disability benefits, because she was no longer "a regularly assigned, full-time employee . . . regularly scheduled to work at least 40 hours per week" as required by the health plan. The court also determined that the employee was not eligible for COBRA continuation upon her termination of employment at the end of the short-term disability period because by then it was too late. According to the court, she should have been offered COBRA at the end of FMLA leave when she became ineligible for coverage, rather than upon her termination of employment at the end of her short-term disability period. Presumably, at that time, the lapse of coverage would be treated as on account of her reduction of hours while on FMLA leave.

A state "mini FMLA" law may provide rights beyond what is required under the federal FMLA law. If so, the employer should review its leave policy for leaves that continue beyond 12 weeks.

An employee's inability to return to work may be the result of a "disability" for which a longer leave may be a "reasonable accommodation." While the federal Equal Employment Opportunity Commission (EEOC) does not take the position that a "no fault" policy of applying a time limit on continuous leave (e.g., a policy under which any employee on leave exceeding a set period of time shall be terminated) is a per se violation of the ADA,<sup>24</sup> the application of such policies may be problematic. In November 2009, the EEOC and a large retailer entered into a three-year consent decree whereby the retailer agreed to pay \$6.2 million to a class of employees.<sup>25</sup> Among other things, the retailer agreed to revise its one-year "no fault" policy to include a procedure whereby the retailer would notify an employee 45 days before the end of the one-year period and describe the employee's right to request a reasonable accommodation under the ADA, including modified duty, part-time work, reassignment to a different position, additional leave, and/or assistive devices. If the employee failed to respond, a second letter would be sent informing the employee of the ability to request a reasonable accommodation and stating that the employee would otherwise be terminated.<sup>26</sup>

## Long-Term Disability

Where an employer offers both a long-term disability plan and a defined benefit pension plan, it is important for the employer to coordinate the defined benefit plan design with long-term disability benefits. The following issues should be addressed:

- Is it intended for a disabled employee to receive both long-term disability benefits at the same time as receiving a disability benefit from the defined benefit plan? Or does the long-term disability benefit offset the pension disability benefit?
- How is a "disability" determined under the pension plan and does the claims procedure reflect the selected standard?

<sup>23</sup> *CLARCOUR, INC. v. Madison Nat'l Life Ins. Co., Inc.*, No. 11-6177 (6th Cir. July 31, 2012) (unpublished).

<sup>24</sup> "I want to address up front an issue that I know there have been questions on and some confusion about. And that is the question of whether employers can have uniformly applied leave policies and whether such policies on their face violate the ADA. *The Commission has never taken such a position.*" *EEOC Meeting, EEOC to Examine Use of Leave As Reasonable Accommodation* (June 8, 2011) (oral testimony of EEOC Assistant Legal Counsel Christopher Kuczyinski; written testimony at pp. 1-2) (emphasis added), available at <http://www.eeoc.gov/eeoc/meetings/6-8-11/index.cfm>. See also EEOC, Enforcement Guidance: Reasonable Accommodation and Undue Hardship Under the Americans with Disabilities Act, Q&A 17 (Oct. 2002).

<sup>25</sup> See Press Release, EEOC (Feb. 5, 2010), available at <http://www.eeoc.gov/eeoc/newsroom/release/2-5-10a.cfm>.

<sup>26</sup> Additionally, the EEOC filed suit against a large restaurant chain in the District of Maryland, Case No. 1:06-cv-02527-WDQ, in 2006, claiming that the chain had "a policy and practice of limiting employee medical leaves – regardless of whether those employees are disabled within the meaning of the ADA and require additional medical leave, in any combination of paid or unpaid, as a form of reasonable accommodation." The restaurant chain's policy generally capped continuous absences at six months. The case was settled for \$ 1.3 million in June 2011. Further, the EEOC filed suit against a large grocery store chain in the Northern District of Illinois, Case No. 1:09-cv-05637, claiming that the grocer employed an inflexible policy to terminate employees at the end of a one-year leave period without complying with its obligations to engage in an ADA interactive process, and obtaining a settlement of \$ 3.2 million. Lastly, the EEOC is engaged in litigation against United Parcel Service, also in the Northern District of Illinois, Case No. 1:09-cv-05291, claiming that the company has discriminated against a class of individuals with disabilities "by maintaining an inflexible 12-month leave policy which did not provide for reasonable accommodation and which instead provided for termination of employment." Though the district court granted the company's motion to dismiss, the EEOC is attempting to have the district court's order certified for appeal. At present, the parties' respective briefing to date on the topic of the appealability of the order is pending before the court.

- Is the disability benefit payable under the pension plan an “ancillary” benefit that may be eliminated?
- What if the pension disability benefit commences at early retirement age or normal retirement age, and the employee recovers from the disability prior to that time?
- How is “compensation” determined under the pension plan?

Additional issues arise in trying to determine when an employee on long-term disability ceases to be an employee. If the employee progresses to long-term disability, on what date does employment terminate? This is important for determining when pension benefits may commence. If an employee continues on disability benefits longer than the employer intended, a termination of such benefits could result in a benefit discrimination claim under ERISA section 510.

## Leave Considerations for Retirement Plans

Leave of absence considerations for tax-qualified retirement plans must be coordinated with the employer’s leave of absence policy. A retirement plan for this purpose includes tax-qualified defined contribution plans (e.g., profit-sharing plans, 401(k) plans, ESOPs) and defined benefit pension plans (e.g., cash balance plans, final average pay plans, career average pay plans).

### **Defined Contribution Plans**

Leave of absence issues for defined contribution plans include whether the leave counts for purposes of crediting eligibility or vesting service, whether pay during a leave (e.g., short-term disability pay) is included in the defined contribution plan’s definition of “compensation” for purposes of determining the amount of the employee’s benefit, how participant loans from the plan are to be repaid during the leave, and whether hardship distributions are available to persons on leave. The defined contribution plan should also cover whether participants may continue 401(k) contributions from pay received during leave, and how a returning participant is treated under the plan.

### **Defined Benefit Plans**

Leave of absence issues for a defined benefit pension plan include whether the leave of absence period is counted under the plan for purposes of benefit service,<sup>27</sup> vesting, or eligibility for an early retirement subsidy (e.g., where the employee is eligible at age 55 with 10 years of service), whether a “break in service” occurs, whether disability pay counts as “compensation” in a cash balance plan where employees are entitled to an annual contribution as a percentage of “compensation” or for purposes of determining an employee’s “final average pay” in a more traditional plan design. Other important questions are whether an employee is treated as “disabled” or “separated from service” as is required for a distribution under the pension plan, and how the plan operates upon the employee’s reemployment or return from leave.

### **Operational Errors in Retirement Plans**

The failure to properly handle leaves of absence under a retirement plan can result in “operational errors.” As a consequence, the plan can be disqualified from tax-favored status if not administered according to its terms with respect to a participant on leave. More realistically, operational errors discovered on audit or determination letter processes will likely be subject to an Audit Closing Agreement Program and to significant tax penalties.

IRS correction programs are available via the IRS’s Employee Plans Compliance Resolution System (EPCRS), including the Self-Correction Program (SCP) if the errors are insignificant or timely corrected and the Voluntary Correction Program (VCP) for a set fee if the errors are significant and not timely corrected under SCP.

---

<sup>27</sup> *Calhoun v. Ford Motor Co.*, Case No. 10-cv-15176 (E.D. Mich. 2012), provides a cautionary tale in favor of coordinating LTD with a disability pension. The employee, hired in 1965, commenced LTD benefits in 1993 but subsequently failed to provide required medical documentation of his disability. Accordingly, the employer recorded the employee as having voluntarily quit in 1994. His LTD benefits, however, continued erroneously until 2007, when the insurance company cut him off. The employee next applied for a disability pension benefit from the pension plan, claiming 42 years of benefit accrual service, and arguing that he could not have quit in 1994 because he continued to receive LTD benefits as if on disability leave until 2007. Further, the insurance company must have been satisfied with the medical records he submitted because it continued to pay his LTD benefit until 2007, giving him no reason to quit. The pension plan denied his claim for a disability pension, but commenced pension payments to him in deferred vested status based on his 29 years of service from 1965 to 1994. Although the court did not rule in the employee’s favor, the plan sponsor incurred considerable, avoidable expense.

## Service Crediting During Leave

Under applicable rules, there are two methods for calculating service under defined contribution plans and defined benefit plans. The two service crediting methods are referred to as “elapsed time” or “hours of service” and will be set out in the plan document.<sup>28</sup> One or more methods may be used under the plan (e.g., elapsed<sup>29</sup> time for vesting, hours of service for eligibility). Under the elapsed time method, the whole year counts as service under the plan if the employee was at work at the beginning and end of the plan year, regardless of any intervening leaves of absence. Under the hour of service method, the employee is credited with service for any hour for which the employee was paid or entitled to be paid. For this reason, if the plan requires 1,000 hours of service for a year of vesting service, a leave of absence for which the employee is not paid or entitled to be paid does not count for service crediting under the plan.

A “break in service” occurs for any year in which the employee is credited with 500 hours of service or less. The “break in service” rules are relevant only for determining whether vesting service earned before the break is counted for purposes of determining vesting service on the benefit earned after the break. In a defined contribution plan (and some insured plans), pre-break service is not counted toward post-break benefits after five consecutive one-year breaks in service. This seldom comes up because most vesting periods in a defined contribution plan are less than five years. In a defined benefit plan, if the leave is longer than the employee’s pre-break service, the pre-break service is lost for purposes of counting post-break vesting service. There is an exception that provides that maternity leave does not result in a one-year break in service, even if the leave exceeds 500 hours.

## Plan Definition of Compensation

Many retirement plans calculate the employee’s benefit as a percentage of pay (e.g., 401(k), cash balance, etc.). On a leave of absence, the employee may receive pay, depending on the type of leave, such as supplemental military pay received from the employer or disability payments. The issue is whether the plan’s definition of compensation includes or excludes these types of pay from its definition of compensation. If the definition excludes welfare benefit payments, but in operation the employee’s disability payments are erroneously counted, the employee will receive a larger benefit than allowed. If this error continues over several years for several employees, the required correction may be difficult and expensive. This is a hot-button item for the Internal Revenue Service.

Most 401(k) plans allow participants to stop making contributions by payroll deduction at any time, including during a leave.

## Benefit Accrual During Leave

Another issue is whether employees in a defined benefit plan will accrue a year of service for the year in which the leave occurs. While both the FMLA and ADA require the continuation of health benefits during leave, neither statute requires the continuation of retirement plan accruals during leave. Conversely, USERRA requires that a returning employee’s military leave must be counted for vesting and seniority purposes.<sup>30</sup> For defined contribution plans, an employee returning from military leave under USERRA must be given three times the period of the employee’s leave of absence, not to exceed five years, to make up any contributions missed during the period of leave.<sup>31</sup> For defined benefit plans, an employer has 90 days following the employee’s reinstatement under USERRA to make up any contributions missed due to military service.

## Plan Loans

Under applicable rules, a plan loan repayment period under a defined contribution plan is limited to no longer than five years (except for loans issued in connection with the purchase of the participant’s principal residence).<sup>32</sup> In general, a plan may provide for a suspension of loan repayments during a leave. For leaves other than military leaves, loan repayments may be suspended for up to a year, but it is impermissible for the payment period to be extended upon return. The returning participant must make bigger loan payments so that the loan is repaid during its original term. For delinquent payments not past a plan-provided “cure” period, a balloon payment at the end is permissible for non-military leaves.<sup>33</sup>

<sup>28</sup> Treas. Reg. § 1.410(a)-7.

<sup>29</sup> Treas. Reg. § 1.410(a)-7.

<sup>30</sup> 38 U.S.C. § 4318(b)(2); 26 U.S.C. § 414(u)(2).

<sup>31</sup> 38 U.S.C. § 4318(b)(2); 26 U.S.C. § 414(u)(2).

<sup>32</sup> 26 U.S.C. § 72(p)(2)(C).

<sup>33</sup> Treas. Reg. § 1.72(p)-1.

Under USERRA, for military leaves, loan repayments may be suspended during the entire military leave, and the payment period can be extended for a period equal to the duration of the military leave (e.g., loan repayment suspended during two-year military leave; upon return, loan repayment period extended for two years). No balloon payment is permitted.<sup>34</sup>

Unless the loan repayments are suspended during a leave, there will be tax consequences for the employee's failure to make scheduled loan payments. Typically, a loan default occurs under the plan when the participant ceases to make repayments, e.g., during a leave. Upon default, the outstanding loan balance is treated as a taxable distribution with a 10% penalty if the default occurs prior to age 59½. Such distributions are reportable on Form 1099.<sup>35</sup>

For a "disqualified person," the defaulted loan amount constitutes a prohibited transaction subject to a 15% excise tax. A Form 5330 filing must be filed until the loan is repaid.<sup>36</sup> Worse yet, even after the disqualified person's default, the person *must still continue loan repayments*. A "deemed distribution" on default is not treated as a correction for the prohibited transaction; however, the plan may provide "cure" periods for missed payments<sup>37</sup> where no default occurs.<sup>38</sup>

## Separation from Service

Under applicable rules, distributions from a 401(k) plan are permissible only upon death, disability, and separation from service. For this purpose, the "disability" definition under Internal Revenue Code (IRC) section 72(t) is used, providing that a person is permanently and totally disabled for section 72(t) purposes if the employee cannot engage in any substantial gainful activity because of a physical or mental condition, *and* a physician determines that the condition has lasted or can be expected to last continuously for at least a year or can lead to death.<sup>39</sup> Thus, a participant on disability leave is entitled to commence 401(k) plan distributions only if the disability satisfies this definition. For example, a disability defined as the employee's inability to perform his or her current job would not be sufficient to receive a distribution from his or her 401(k) benefit.<sup>40</sup>

## Bonuses, Incentive, and Equity-Based Plans

Similar leave of absence issues may arise under plans that are not subject to ERISA, such as bonus, incentive, or equity-based plans. In this context, a bonus, incentive, or equity-based plan includes an annual bonus or a bonus paid over a period of time based on the company's and employee's performance, a bonus based on meeting production goals, as well as stock options, restricted stock unit or performance unit plans, etc. In general, the effect of a leave of absence on these types of plans may be determined contractually, taking into account applicable law.

## Bonus Eligibility

The FMLA provides that "if a bonus or other payment is based on the achievement of a specified goal such as hours worked, products sold or perfect attendance, and the employee has not met the goal due to FMLA leave, then the payment may be denied, *unless otherwise paid to employees on an equivalent leave status for a reason that does not qualify as FMLA leave.*"<sup>41</sup> For example, if an employee who used paid vacation leave for a non-FMLA purpose would receive the payment, then the employee who used paid vacation leave for an FMLA-protected purpose also must receive the payment. Suppose the bonus is based on the company's financial performance during the years or years in which the employee was on leave. The FMLA rules may be read to require that the employee out on leave receive a pro-rata share of the amount he or she otherwise would have received if not for the leave.

An employee's entitlement to a bonus under USERRA will depend on whether the bonus is considered a seniority-based or non-seniority-based benefit.

<sup>34</sup> *Id.*; 26 U.S.C. § 414(a)(4).

<sup>35</sup> Treas. Reg. § 1.72(p)-1.

<sup>36</sup> 26 U.S.C. § 4975.

<sup>37</sup> Treas. Reg. § 1.72(p)-1.

<sup>38</sup> Treas. Reg. § 1.72(p)-1.

<sup>39</sup> 26 U.S.C. § 72(m)(7).

<sup>40</sup> 26 U.S.C. § 72(m)(7).

<sup>41</sup> 29 C.F.R. § 825.215(c)(2).

## Vesting Considerations

Generally, bonus, incentive, and equity-based plans may determine vesting requirements contractually, rather than under the tax code or other law.

## Non-Qualified Deferred Compensations and Other Arrangements Subject to IRC Section 409A

IRC section 409A contains special rules for non-qualified deferred compensation plans. For example, a participant is entitled to commence benefit payments upon disability, but only if the plan uses section 409A's definition of "disability" for purposes of determining eligibility for payout.<sup>42</sup> That definition differs from the definition under ADA.

Additionally, for purposes of commencing benefits under a deferred compensation plan, the definition of "separation from service" may differ from the definition used for other purposes. For example, under IRC section 409A, separation from service is presumed to occur if an employee's level of service is reduced to 20% or less of the average level of service provided by the employee during the immediately preceding 36-month period. Conversely, there is a presumption that no separation from service has occurred if the level of service is reduced to no less than 50%.<sup>43</sup> Thus, even if the employee is moved to independent contractor status, he or she is not treated as incurring a "separation from service" for section 409A purposes if the employee continues to perform services more than 50% of the hours that he or she had previously worked. Persons working between 20% and 50% are treated as separated from service only on a facts and circumstances basis.<sup>44</sup>

Further, Section 409A has a specific standard for determining when a leave of absence constitutes a "separation from service" for section 409A purposes. Under applicable regulations<sup>45</sup>, an employee does not incur a separation from service on account of military leave, sick leave, or other bona fide leave of absence if the period of such leave does not exceed six months, or if longer, so long as the individual retains a right to reemployment with the employer under an applicable statute or by contract. A leave is "bona fide" for this purpose if there is a reasonable expectation that the employee will return to perform services for the employer. If the period of leave is greater than six months or there is no statutory or contractual right to reemployment, the separation from service occurs on the day after the six-month period elapses. There is an exception for medically determinable physical or mental impairments that can be expected to result in death or to last for at least six months where the employee is unable to perform the duties of his or her position of employment or any substantially similar position. In that case, 29 months is substituted for the six month limit.

## Special Issues During a Leave of Absence

### Downsizing

Can an employer permanently replace an employee or eliminate the job during a leave of absence? The rules are that the job must be kept available during an FMLA leave unless the employee unequivocally resigns from his or her position (*i.e.*, indicates that he or she will not be returning to the position), the employee's position was eliminated or the employee would have been laid off due to downsizing, or the employee was highly compensated and the employer meets the requirements to deny reinstatement.

Reasonable accommodation during an extended ADA leave may require the employee to keep a job available even during downsizing.

USERRA applies an "escalator" rule to reinstatement determinations. An employee is only entitled to be reinstated to the position he or she would have attained had he or she remained continuously employed during the period of service. If this position would be a downsized position, the employee may be downsized.

If an employee on leave is one of only a few whose job is being downsized, there is an enhanced risk of position: the employee bringing a claim for interference with benefits under ERISA section 510.

<sup>42</sup> 26 U.S.C. § 409A(a)(2)(A)(ii); Treas. Reg. § 1.409A-3(a)(2).

<sup>43</sup> Treas. Reg. § 1.409A-1(h)(1)(ii).

<sup>44</sup> Treas. Reg. § 1.409A-1(h)(1)(ii).

<sup>45</sup> Treas. Reg. § 1.409A-1(h)(1).

## Key Takeaways for Employers

- Review leave policies with affected employee benefits plans to ensure consistency and proper integration.
- Make sure leave administrators are informed of plan provisions and that third party plan administrators are informed about leave procedures.
- Disclose to participants the effect of benefits regarding each leave.
- Review participant distribution and election forms for consistency with leave policies.

## Checklist Benefit for Employees on Considerations Leaves of Absence

Examine plan documents for the following:

### Health, Dental, and Vision Plans

- 12 (or 26) weeks leave required under FMLA for eligible employees; check state law for any extension of the 12- (or 26-) week period.
- Same health benefits must be maintained during the employee's FMLA leave as if the employee was working.
- Determine how employees will continue to pay premiums:
  - Deduction from any short-term disability payments (or other employer-provided benefits payments) at the same time as payroll deduction
  - By check on the same schedule as COBRA payments (after-tax)
  - If the employee elects, by prepayments before the leave starts
  - With a "catch-up" payment after employee returns from leave under a cafeteria plan
- Determine procedure for terminating coverage on leave or if the employee does not return to work, and when qualifying events occur under COBRA

### Flexible Spending Accounts (FSA)

- Ensure participants are given the option to continue participation in the health FSA during leave.
- Determine how participants may continue contributions:
  - Prepayment before the leave starts,
  - By sending a check during the leave,
  - Allowing the employee to "catch up" contributions upon return.
- Ensure dependent care FSA claims are only allowed for up to two weeks of leave.

### Health Reimbursement Accounts (HRA, HSA)

- Determine how participants may continue to contribute to the HSA during leave.

### Employee Assistance Programs (EAP)

- Determine if the EAP is considered a group health plan. If so, coverage should be continued during leave.

## Nondiscrimination Testing Issues

- Test eligibility and level of benefits provided during leave or after termination of employment comply with nondiscrimination testing application to both self-insured and insured health plans.

## Life Insurance

- Determine whether the plan or policy requires employees to be “actively at work” for coverage to apply.
- Check vacation accrual policy for treatment of employees on leave of absence.
- Determine when coverage terminates if the participant does not return from leave.

## Vacation Policy

- Is it specific on whether vacation accruals stop during leave?
- If the vacation policy provides for vacation accrual during “paid” leave, do short-term disability payments count for this purpose?
- Does the policy provide that accruals must continue for military leave?
- Is state law preempted by ERISA?
- Check state law. Some states may have a paid leave requirement, or substitution of paid leave.

## Sick Pay, Paid Leave, Paid Time Off Policy

- Is it specific on whether accruals stop during leave?
- If the policy provides for accrual during “paid” leave, do short-term disability payments count for this purpose?
- Does the policy provide that accruals must continue for military leave?
- Is state law preempted by ERISA?
- Check state law. Some states may have a paid leave requirement, or substitution of paid leave.

## Short-Term Disability – Beyond FMLA

- Review the employer’s leave policy for leaves that continue beyond 12 weeks or state extension period.
- Is there special provision for military leaves?
- Does the employer have a “no-fault” leave policy setting a specific duration for the leave and providing that the employee’s employment will terminate if the employee has not returned to work by the end of the specified period.
- Determine process for determining whether the employee’s inability to return to work is a “disability” for which a longer leave may be a “reasonable accommodation.”
- Does the employer use an “interactive process” to determine whether an employee with a disability requires a leave extension as a “reasonable accommodation”?

## Long-Term Disability

- Does the employer offer both a long-term disability plan and a defined benefit pension plan?
- Involve a benefits specialist to determine whether the defined benefit plan design is coordinated with long-term disability benefits. Consider:
  - Is LTD offset by pension?
  - When do benefits commence?
  - Is the same definition of disability used for both the LTD and pension?
  - Does the pension plan's definition of "compensation" include long- or short-term disability benefits?
  - When do LTD benefits cease?
  - Do employees continue to accrue pension benefits during long-term disability?
  - Is there a benefit discrimination risk under ERISA §510?

## Leave Considerations for Retirement Plans

Tax-qualified defined contribution plans (e.g., profit-sharing plans, 401(k) plans, ESOPs) and defined benefit pension plans (e.g., cash balance plans, final average pay plans, career average pay plans).

- Does the leave of absence period or any disability payments during leave count for:
  - Eligibility under the plan for a benefit (e.g., a 401(k) plan may provide a matching contribution only for employees credited with 1,000 hours of service)?
  - Credit for vesting service?
  - Definition of "Compensation" in a profit sharing plan (e.g., where employees are entitled to an annual contribution of 3% of "compensation")?
- Are there administrative procedures on how participant loans are treated during a leave of absence?
- Are hardship distributions available to persons on leave? Does leave count for purposes of the hardship withdrawal waiting period?
- When is an employee treated as "disabled" or "terminated" as is required for a distribution under the 401(k) plan?
- Can the employee make 401(k) contributions while on leave from disability payments or other payments?

## Defined Benefit Pension Plans (Cash balance, final average pay, career average formula)

- Does the leave of absence period count for:
  - Years of benefit service, vesting, or eligibility for early retirement subsidy (e.g., where the employee is eligible at age 55 with 10 years of service)?
  - Is a "break in service" relevant for plan purposes?
- What is the definition of "Compensation" in a cash balance plan (e.g., where employees are entitled to an annual contribution of 3% of "compensation" or as "compensation" for purposes of determining "final average pay"?)
- When is an employee treated as "terminated" as is required for a distribution under the pension plan?
- What happens on reemployment?

## ***Special Rule for Military Leave***

A returning employee must be “made whole” by:

- Permission to contribute to the pension or thrift plan any amount that would have been contributed had the employee not been absent (for a period of up to 5 years), with accompanying employer matches; and
- Reinstatement of privileges and status earned by length of service (for example, after 3 years with a company an employee may be entitled to accrue more vacation per year)

## **Plan Loans**

- Does the plan provide for a suspension of loan repayments during a leave?
- Leaves (other than military leaves).
  - Loan repayments may be suspended for up to a year, but the payment period cannot be extended upon return. The returning participant must make bigger payments so that the loan is repaid during its original term.
  - For delinquent payments not past a “cure” period, a balloon payment at the end is permissible.
- Military leaves under USERRA.
  - Loan repayments may be suspended during the entire leave, and the payment period can be extended for a period equal to the duration of the leave (e.g., loan repayment suspended during two-year military leave; upon return, loan repayment period extended for two years).

## **Leaves of Absence Considerations Apply to Bonuses, Incentive, and Equity-Based Plans**

- Is the bonus or other payment based on the achievement of a specified goal such as hours worked, products sold or perfect attendance?
- Did the employee fail to meet the goal due to FMLA leave?
- Is the bonus paid to employees on an equivalent leave status for a reason that does not qualify as FMLA leave?
- Is the leave based on the company’s financial performance over a period longer than the leave?
- Does the bonus require the employee to be at work on a particular day to be eligible for payment?

## **Non-Qualified Deferred Compensations and Other Arrangements Subject to IRC Section 409A**

- A non-qualified deferred compensation plan must contain the definition of “disability” contained in IRS section 409A. Is that definition of disability the same being used for other programs?
- Non-qualified deferred compensation plan and other arrangements subject to IRC section 409A must contain the definition of “Separation from Service” contained in IRS section 409A. Has the participant on leave had a Separation from Service under the plan?
- Does the period of leave count for purposes of eligibility, vesting, or benefit accrual?
- Does the plan’s definition of “compensation” include disability and other benefits paid during leave?

## Downsizing During a Leave of Absence

- Can the employer permanently replace the employee or eliminate the job during a leave of absence? The rules are as follows:
  - Job must be kept available during FMLA unless:
    - Employee unequivocally resigns employee's position (*i.e.*, indicates will not be returning to the position)
    - Employee's position was eliminated or employee would have been laid off due to downsizing
    - The employee was highly compensated and the employer meets the requirements to deny reinstatement
  - Reasonable accommodation during extended ADA leave may require job to be kept available.
  - Enhanced risk of retaliation claim for single job elimination or consolidation.
  - Consider treatment of employees on LOA in the sale of a business.
- Is an employee on leave eligible for severance benefits?
  - What does the severance plan say?
  - Does ADA or USERRA require provision of benefits?
  - Can the employer require ability to return to work within a specified period as a condition of benefits?
- Are employees on leave included in Older Worker Benefit Protection Act (OWBPA) disclosure tables?

[Joni Andrioff](#) is a Shareholder and [Michael Congiu](#) is an Associate in Littler Mendelson's Chicago office. [Michelle Barrett](#) is a Shareholder in the San Francisco office. [Steven Friedman](#) is a Shareholder in the New York office. [Susan Hoffman](#) is a Shareholder in the Philadelphia office. [Diane Kimberlin](#) is a Shareholder in the Los Angeles / Century City office. [Adam Peters](#) is an Associate in the Dallas office. [Michelle Thomas](#) is Special Counsel in the Washington D.C. / Northern Virginia offices, and [George Wood](#) is the Office Managing Shareholder of the Minneapolis office. If you would like further information, please contact your Littler attorney at 1.888.Littler, [info@littler.com](mailto:info@littler.com), or Ms. Andrioff at [jandrioff@littler.com](mailto:jandrioff@littler.com), Mr. Congiu at [mcongiu@littler.com](mailto:mcongiu@littler.com), Ms. Barrett at [mbarrett@littler.com](mailto:mbarrett@littler.com), Mr. Friedman at [sfriedman@littler.com](mailto:sfriedman@littler.com), Ms. Hoffman at [shoffman@littler.com](mailto:shoffman@littler.com), Ms. Kimberlin at [dkimberlin@littler.com](mailto:dkimberlin@littler.com), Mr. Peters at [apeters@littler.com](mailto:apeters@littler.com), Ms. Thomas at [mpthomas@littler.com](mailto:mpthomas@littler.com), or Mr. Wood at [gwood@littler.com](mailto:gwood@littler.com).