Are Paid Sick Leave Policies Subject to ERISA?

Paid sick leave – you either love it or hate it, right? As of this writing, seven states, the District of Columbia, and more than 25 cities and counties have passed paid sick (and often, family) leave laws. However, 14 states have banned cities and counties from adopting such laws. And, paid sick leave is mandatory for federal contractors, as highlighted on the next page.

Further, a mandated paid sick leave plan or policy is typically subject to the Employee Retirement Income Security Act of 1974 (ERISA), which sets minimum standards for most voluntarily established pension and health plans to provide protection for individuals in these plans.

This article will explore when paid sick leave is subject to ERISA, and how potential benefits may win you over.

Benefits Subject to ERISA
ERISA covers “any employee benefit plan if it is established or maintained by any employer engaged in commerce or in any industry or activity affecting commerce, by any employee organization [e.g., a labor union], or organizations representing employees engaged in commerce…, or by both.”

An employee benefit plan is either “an employee welfare benefit plan or an employee pension benefit plan or a plan which is both.” And since a sick pay plan is an employee welfare benefit plan, unless exempted, a mandated paid sick leave plan or policy would be subject to ERISA.

Exceptions to ERISA

Standard Exemptions
ERISA does not apply to government plans; church plans; plans maintained solely for the purpose of complying with applicable worker’s comp laws, unemployment compensation, or disability insurance laws (note that this exception does not include applicable paid state or local sick or family leave laws); plans maintained outside of the U.S. primarily for the benefit of nonresident aliens; and unfunded excess pension benefit plans that provide certain employees contributions or benefits in excess of IRC § 415 (the maximum limitation on contributions or benefits in retirement plans).

An exception also exists for 100% employee-paid voluntary group insurance programs where the employer does not endorse or administer the program, but merely permits the insurer to publicize the program to employees or members, collects and remits the premiums to the insurer, and receives no consideration in connection with the program (other than reasonable compensation for administrative services).

Payroll Practice Exception
The “payroll practice” exception from ERISA coverage is the most relevant exemption for employer-paid sick or family leave plans. Most often, sick, vacation, and other paid-time-off (PTO) compensation is disbursed from an employer’s general assets. Spared from the definition of an “employee welfare benefit plan” is the “payment of an employee’s normal compensation, out of the employer’s general assets, on account of periods of time during which the employee is physically or mentally unable to perform his or her duties, or is otherwise absent for medical reasons (such as pregnancy, a physical examination, or psychiatric treatment).”

This exemption applies only if the benefits are paid from the employer’s general assets; if benefits are paid from a trust or an insurance contract (and not merely reimbursing the employer for benefits paid from its general assets), then the benefit likely will be governed by ERISA, unless it is bound by the Fort Halifax exemption or other exceptions (discussed on the next page).

ERISA Coverage Considerations

Advantage: ERISA Preemption of State Law
Section 514(a) of ERISA preempts (i.e., overrules) “any and all State Laws insofar as they… relate to any employee benefit plan.” A state law “relates to” an ERISA plan if it “has a connection with or reference to such a plan.” A state law has such a connection (and therefore is preempted) if it:

- Mandates employee benefit structures;
- Interferes with nationally uniform plan administration;
- Creates “alternative enforcement mechanisms” for the recovery of benefits provided under an ERISA plan.
Per se preemption occurs if the state law specifically refers to a plan, which rarely occurs anymore as many state laws no longer directly reference employee benefit plans.

The congressional intent behind ERISA § 514(a) is “to enable employers to establish a uniform administrative scheme, which provides a set of standard procedures to guide processing of claims and disbursement of benefits.”

With the plethora of state and municipal laws addressing mandatory paid sick and family leave, each with their own requirements, ERISA preemption allows an employer to establish a funded PTO plan that covers all states and municipalities in which it operates without the necessity of tailoring the PTO plan to these myriad requirements.

The Fort Halifax Exception to ERISA Preemption

A Maine statute requiring employers to provide a one-time severance payment to employees in the event of a plant closing gave rise to a seminal U.S. Supreme Court case, Fort Halifax Packing Co., Inc. v. Coyne, on the question of what constitutes an ERISA plan.

The statute required any employer that terminated operations at a plant with 100 or more employees, or that relocated those operations more than 100 miles away, to provide one week’s pay for each year of employment to all employees with at least three years’ tenure.

The primary issue was whether the Maine statute required the employer to “establish or maintain” a state-mandated employee welfare benefit plan. In addressing this question, the Supreme Court stated that an employee benefit package or program will only constitute a “plan” under ERISA if it “requires an ongoing administrative program to meet the employer’s obligation.”

The court determined that the Maine statute neither established nor required an employer to maintain an employee benefit plan because “[t]he requirement of a one-time, lump-sum payment triggered by a single event requires no administrative scheme whatsoever to meet the employer’s obligation” and therefore did not constitute a “plan” under ERISA if it “requires an ongoing administrative program to meet the employer’s obligation.”

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Clearly, a paid sick and/or family leave benefit requires such an ongoing administrative scheme. The plan administrator must determine who is eligible for the benefit, whether the employee satisfies plan requirements for taking paid leave, how much leave has accrued, how much leave has been taken, and how the benefit will be calculated. Therefore, under the Fort Halifax analysis, a funded PTO plan would be regulated by ERISA, and ERISA preemption would apply.

DOL Opinion on ERISA Preemption for Vacation Benefits

Vacation benefits are similar to paid sick and family leave benefits; they are typically paid from the employer’s general assets and subject to the payroll practice exception. Per the U.S. DOL, when a trust is used to fund the benefits that would often be paid from general assets, it is “subject to further evaluation under section 3(1) of ERISA to determine whether the program includes the requisite elements to constitute an ERISA employee benefit plan.”

To date, none of the actions taken by the Trump administration or the 115th Congress directly address the paid sick leave requirement. The regulatory freeze issued on January 20, 2017, halted the publication of new regulations in the Federal Register until reviewed and approved by a department or agency head appointed by President Trump. For regulations already published in the Federal Register, those that had not taken effect were postponed for 60 days from January 20th. The U.S. DOL paid sick leave rules for federal contractors, effective November 29, 2016, were not subject to the 60-day delay and review.

Further, H.R. 743, the Davis-Bacon Repeal Act that was introduced in the House of Representatives by Representative Steven King (R-IA) on January 30, 2017, does not directly affect the paid sick leave mandate.

Paid Sick Leave for Federal Government Contractors

Executive Order 13706, Establishing Paid Sick Leave for Federal Contractors, signed by President Barack Obama on September 7, 2015, requires certain parties that contract with the federal government to provide employees with up to seven days (56 hours) of paid sick leave annually, including paid leave for family care.

With the change in the administration and President Trump’s intent to rescind most of the federal regulations adopted during the Obama administration, it is natural to wonder if the Executive Order and the Department of Labor’s regulations still apply.

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Citing the Supreme Court’s decision in Massachusetts v. Morash, the DOL Opinion states, “the discussion in Morash suggests that the mere presence of a trust or other separate account from which vacation benefits are paid should not automatically result in ERISA coverage in the absence of the trust providing genuine protections to the accrued benefits under the plan or otherwise presenting risks ERISA was intended to address.”

Consequently, the DOL established a four-part test for determining whether a separate trust for paying vacation benefits is an employee welfare benefit plan subject to ERISA. The DOL Advisory Opinions require that:

1) The trust be a bona fide separate fund;
2) The trust has the legal obligation to pay plan benefits;
3) The employer has the legal obligation to make contributions to the trust; and
4) The contributions be actuarially determined, established through collective bargaining, or otherwise bear a relationship to the plan’s accruing liability.

The “bona fide trust” requirement can be satisfied by utilizing an IRC § 501(c)(9) voluntary employees’ beneficiary association (VEBA) trust (which is tax exempt) or an irrevocable trust established under state law (which would be taxable on its income).

The trustee should be an independent party; note that the court in Airline Pilots Association International, et al. v. United Airlines disapproved of a grantor trust where the trust fund assets were accessible by the company’s creditors in the event of bankruptcy.

It is not uncommon (nor is it prohibited) for the employer to pay a benefit or plan expense directly from corporate general assets, and then request the trust to reimburse the employer from plan assets. The DOL opinions indicate that in this case, the trust would be disregarded (and therefore the plan would be considered an unfunded payroll practice).

The second DOL requirement, then, can be addressed by having the trust pay the benefit rather than reimburse the employer for paying it.

The obligation of the employer to make contributions to the trust can be addressed in the terms of the plan and trust, as well as the operation of the plan. In Advisory Opinion 2004-04A, the DOL noted that the trust was only funded when vacation benefits were due to be paid. This sort of pass-through should be avoided when providing benefits that could be subject to the payroll-practice exception.

When determining the amount of employer contributions to be made to the trust, the decision in the United Airlines case is instructive. There, the employer’s funding policy, which was based on doubling historical trends and adding an additional, fixed amount, may otherwise have been sufficient to satisfy the third requirement, but it failed because the policy was not reduced to writing, was inconsistently used, and the spreadsheet that was used to calculate the funding amounts was broken, resulting in arbitrary results.

For this and other reasons, the airline’s sick leave plan was found not to be a funded ERISA welfare benefit plan, preemption did not apply, and the plan violated § 233 of California’s Labor Law (known as the “Kin Care” law because it required that leave to care for a family member be paid, a feature that was not present in the airline’s plan).

**Disadvantage: Reporting & Disclosure Requirements**

The primary objections to establishing benefit plans that are subject to ERISA are the requirements:

- The plan must be set forth in writing and operated in accordance with its written terms;
- Participants must receive a “summary plan description” that satisfies specific regulatory requirements; and
- An Annual Return/Report on Form 5500 must be filed.

Failure to file Form 5500 can lead to significant financial penalties.

Each of these obligations are readily addressed by establishing an ERISA welfare “wrap” plan that includes all the employee welfare benefits maintained by an employer in a single plan document that has a single summary plan description and Form 5500.

**Paid Sick Leave as a Prevailing Wage Fringe Benefit**

The regulations governing federal paid sick leave for government contractors specifically disallow prevailing wage credit for the mandated paid sick leave. This does not prevent an employer from using a trust to accumulate and pay the required paid leave to take advantage of current deductibility and third-party administration of the benefit; it only means...
that additional employer contributions must be made to satisfy the mandate. Otherwise, a properly designed and funded PTO plan should meet the “bona fide benefit” requirement applicable to state prevailing wage requirements.

The Davis-Bacon Act lists “sick leave” as a common fringe benefit. The DOL Wage and Hour Division has found that a sick leave benefits plan that has been communicated to eligible employees and that operates in accordance with its terms will generally qualify as bona fide if it provides a reasonable number of absences in a year (at least five), and does not have a lengthy waiting period.30

Funded Plans

All fringe benefit plans are either funded31 or unfunded.32 As discussed previously, a funded sick leave plan may be subject to ERISA preemption, a generally positive result, especially where the contractor is performing services in multiple jurisdictions.

Funded plans are those where the contractor’s fringe benefit contributions are made irrevocably (i.e., funds cannot be returned to the contractor or its creditors for any reason) to a trustee or independent third party pursuant to a bona fide fringe benefit fund, plan, or program on a regular basis (at least quarterly, although state prevailing wage laws may have different timing requirements).

These contributions can be credited toward meeting the prevailing fringe benefit requirement without prior DOL approval. In addition, the contractor may take a deduction for the contributions to the trust when those contributions are made, not when the benefits are paid. This makes the funded program especially useful when there may be a carry-over of benefit accruals into a new taxable year.

Unfunded Plans

Fringe benefits may also be made pursuant to an unfunded plan or program. Here, the contractor funds certain benefits from the company’s general assets (rather than by payments to a trustee or third party). As previously discussed, paid sick leave is a common type of unfunded plan exempt from ERISA requirements as a payroll practice.

A contractor’s reasonably anticipated costs in providing bona fide fringe benefits under such a plan may be creditable toward meeting prevailing wage obligations if certain requirements are met, including:

- The plan can reasonably be anticipated to provide bona fide benefits as described in the Davis-Bacon Act;
- The benefit represents a commitment that can be legally enforced;
- It is carried out under a financially responsible plan or program; and
- The plan or program has been communicated in writing to the affected employees.

In an unfunded plan, the contractor’s deduction may be taken only in the taxable year in which the employee takes the benefit into income. This is unsuitable for paid sick leave when the plan provides for a carry-over of accrued but unused hours (as some state-mandated plans require).

Bottom Line

A paid sick leave program can be designed to be both an employee welfare benefit plan and a bona fide fringe benefit subject to ERISA. If properly structured, such a plan could be exempt from state and local paid leave mandates.

Author’s Note: This article may not be relied upon by third parties as legal advice.

Endnotes

5. “The terms ‘employee welfare benefit plan’ and ‘welfare plan’ mean any plan, fund, or program … to the extent that such plan, fund, or program was established or is maintained for the purpose of providing …, through the purchase of insurance or otherwise, (A) medical, surgical, or hospital care or benefits, or benefits in the event of sickness, accident, disability, death or unemployment, or vacation benefits, apprenticeship or other training programs, or day care centers, scholarship funds, or prepaid legal services…” [ERISA § 3(1), 29 U.S.C. 1 – 002(1) (emphasis added)].
7. 26 C.F.R. § 2510.3-1(j).
8. 26 C.F.R. § 2510.3-1(b)(2).
17. Executive Order 13706 on September 7, 2015, 80 FR 54697.
19. Ibid at 11.
20. Ibid at 12.
22. Ibid., citing Massachusetts v. Morash, 490 U.S. 107, 116 (1989). (“The reference to vacation payments in [the ERISA definition of an employee welfare benefit plan] should be understood to include … those vacation benefit funds, analogous to other welfare benefits, in which … the employee bears a risk different from his ordinary employment risk.”)
28. 29 C.F.R. § 2520.102-3.
29. 81 FR 67598, 67598-99, Sept. 30, 2016. (Paid sick leave required by Executive Order 13706 is in addition to obligations under the Service Contract Act and Davis-Bacon Act; no credit toward prevailing wage fringe benefit obligations under those Acts may be taken for any paid sick leave provided in satisfaction of the Order’s requirements.)
32. Ibid at § 5.28.

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