Oregon Business Lawyer

Oregon State Bar Business Law Section Newsletter • March 2024

ERISA at Fifty: An Employee Benefits Attorney's Perspective

Christine Zinter, Schwabe Williamson & Wyatt PC

The landmark Employee Retirement Income Security Act of 1974 (ERISA) marks its fiftieth anniversary this year. The statute that began as a reaction to the 1963 Studebaker automobile bankruptcy, which left thousands of workers under the age of sixty with no pension benefits, has since evolved into a pervasive set of regulations impacting nearly all provisions of employer-sponsored benefit packages. Yet, after fifty years of amendments and extensive federal case law, ERISA remains an enigma. Though exploring the scope of ERISA would require a treatise (and a bottle of Excedrin), attorneys and their clients should understand certain basics of ERISA.

ERISA, despite beginning as a law to ensure the financial safety of employer-sponsored retirement plans, is not just a law about pensions and 401(k) plans. Over the years, Congress has expanded ERISA's reach over health and welfare plans by amending ERISA to include sweeping protections such as the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA), the Health Insurance Portability and Accountability Act (HIPAA), the Mental Health Parity and Addiction Equity Act (MHPAEA), and the Patient Protection and Affordable Care Act (ACA). Signs suggest that for at least several of the next fifty years, Congress will be focusing ERISA on employer-sponsored health care rather than retirement plans; the House of Representatives Committee on Education and the Workforce, which has jurisdiction over employer-sponsored health coverage, is requesting feedback from the employee health benefits community on "ways to build upon and strengthen ERISA."

Whether a retirement plan or group medical package, ERISA requires that all employee benefit Plans must have

- a Plan Document, the written instrument setting forth all the minutiae of the benefit program(s) offered under the Plan;
- a Plan Sponsor, the employer or entity standing in the shoes of an employer such as a union or association; and
- a Plan Administrator, the person designated by the Plan Document with the ultimate fiduciary responsibility to the Plan.

The Plan Administrator, in turn, is responsible for

- ensuring all participants and beneficiaries receive sufficient Plan information (for instance, the provisioning of ERISA-compliant Summary Plan Descriptions, or SPDs);[1]
- disclosing and reporting Plan information to the government (Form 5500 Annual Return filed with the Department of Labor); and
- adhering to fiduciary conduct standards—specifically, acting in the sole interest of the Plan

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participants with the exclusive purpose of providing benefits to them, to carry out all Plan duties prudently, to follow Plan Documents, to hold Plan assets in trust, and to pay only reasonable Plan expenses.

Who is the Plan Administrator?

Unfortunately, many employers mistakenly believe that the service provider or providers they hire to administer the day-the-day functions of the plan are the default ERISA Plan Administrator. This is almost never the case. Unless a service provider (like a third-party administrator (TPA), investment advisor, trustee, or insurer) contractually agrees to accept the fiduciary responsibilities belonging to the Plan Administrator, the employer will always be responsible for those Plan Administrator duties when it comes to remedying ERISA violations. While the plaintiff in an ERISA complaint will name the employer (Plan Sponsor), Plan, Plan Administrator, and every service provider that works on the Plan, whether these service providers have any liability under ERISA depends on their extent of their discretion or control over the Plan.

It is common for retirement plan investment advisors to contractually agree to take on some, but not all, of the fiduciary responsibilities assigned to the Plan Administrator. Ideally, an employer should seek a 3(16) Plan Administrator contract, wherein the investment services firm takes on the maximum personal liability for the administration of the plan. Nevertheless, even with a 3(16) arrangement, the employer retains personal liability under ERISA to monitor the service provider.

A designation similar to 3(16) is not found in the health and welfare plan setting. It is understood that insurers of group medical or disability plans take on at least some of the fiduciary duties of the Plan Administrator, such as the obligation to comply with HIPAA, the ACA, and MHPAEA, and to adjudicate claims in a nondiscriminatory manner and adhere to certain timelines and appeals procedures. However, the employer generally retains the responsibility of communicating Plan information with participants, filing annual reports, and ensuring the service providers' fees are reasonable.

Suing the Plan Administrator

As an ERISA attorney, often my first introduction to a new client will start with an employer's completely warranted frustration that something has gone wrong with their employee benefit plan and they want my help to sue the "Plan Administrator." That leaves me with the unenviable job of explaining the difference between an administrator and an ERISA Plan Administrator. While investment advisors and insurers often contractually agree to some fiduciary responsibility, most TPAs acting in a recordkeeping capacity (i.e., eligibility tracking or account balance reporting) or ministerial capacity (i.e., adjudicating claims for a self-insured medical plan) have service contracts that specifically disclaim all fiduciary liability. The same service contracts usually include a limitation of liability clause, limiting any damages to no more than the service provider invoices for a year of services.

A 401(k) TPA made eligibility mistakes and now an employer owes potentially tens of thousands of dollars to correct the oversight using the IRS's Voluntary Fiduciary Correction Program? A self-insured health plan TPA did not adjudicate mental health claims in compliance with the MHPAEA, and a Department of Labor auditor is requiring the Plan to re-adjudicate thousands of participant claims going back several years? An ERISA attorney can guide employers through the correction process and assist with ERISA litigation when plaintiffs claim an ERISA violation. However, any claim the employer has against the TPA that made the mistake to begin with will likely find itself litigating a breach of contract claim in state court after the TPA requests removal from any federal ERISA litigation.

Employers must educate themselves

Mistakes happen and they can be costly. It is imperative for employers to understand their role and liabilities as Plan Administrators and their responsibilities under ERISA. Fortunately, there are literally hundreds of web articles meant to advise employers of their fiduciary responsibilities. I personally recommend everybody start by reviewing the Employee Benefits Security Administration's (EBSA) "Fiduciary Responsibilities" web page.

Of course, the easiest way to limit employer liability is to, whenever possible, set up employee benefit plan service contracts such that the service provider assumes liability for selected fiduciary functions. If a servicer will not accept such liability, the employer should be certain to understand where it needs to pick up the slack. A common example: most TPAs (retirement or group health plan) will provide an employer with an ERISA-compliant SPD as part of their service package, but the TPAs do not accept responsibility for the delivery to

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A self-admitted "benefits geek," Christine has been actively engaged in the world of employee benefits since the early 90s. Over the years, she has worked for insurers, a regional bank, and a Big 5 consulting firm, and she ran her own boutique benefits consulting firm. She went to law school in 2012 after her husband got sick of listening to her exclaim, "I should have gone to law school!" She has been practicing in the area of ERISA and health law compliance, with a smattering of executive comp and employment law, since 2016.

ERISA

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participants. An employer needs to understand its obligation to get those documents delivered in an ERISA-compliant fashion.

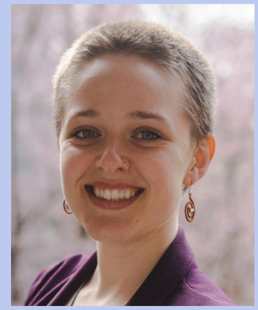
Because it is not possible to contract away all ERISA liability, employers should also (1) be aware of every entity servicing its Plans and what those entities' service contracts say about fiduciary liability and limitations of liability, (2) create a plan to fulfill any Plan Administrator duties not contractually accepted by the service providers, and (3) actively monitor the service providers.

Monitoring service providers requires additional work on the part of the employer; it is no longer acceptable to set up an employee benefit plan and assume it will run itself. In addition to the recent wave of class action lawsuits holding 401(k) Plan Sponsors (employers) responsible for poor investment choices and unreasonable retirement plan fees, Congress's new focus on ERISA fiduciary duties in group health and welfare plans means an employer needs to be knowledgeable not only about retirement plan issues but also the myriad of amendments to ERISA that concern group health and disability plans. At the very least, a wise employer will take a few moments to review the Department of Labor's Fiduciary Education Campaign page to learn how to mitigate a costly fiduciary liability mistakes. ◆

Endnote

1. A summary plan description is an understandable summary of a participant's rights and obligations under the Plan and must contain certain specific information in order to be an ERISA-compliant document. [29 U.S.C. §1022](), [29 CFR §2520.102-3]()

Introducing Jackie Krantz, the new editor of the Business Law Section's newsletter!



Jackie earned her Master of Science in Book Publishing from Portland State University in 2023. During her time in the program, she received a well-rounded education, learning the ins and outs of editing, marketing, and digital skills. Since then, she has been working as a freelance editor and book marketer for a variety of clients. Her favorite thing about editing is the fact that she gets to learn as she edits. She is excited to work for the OSB because she will be able to learn more about the law in Oregon. Welcome, Jackie!

Professional Liability Fund: Do I Need Coverage?

From the OSB Professional Liability Fund website as of April 1, 2024

Who qualifies for PLF coverage?

Any OSB member engaged in the private practice of law whose principal office is in Oregon is required to maintain malpractice coverage with the PLF. The PLF provides coverage of $300,000 aggregate of all claims plus an additional $75,000 claims expense allowance as provided in the 2024 Primary Coverage Plan. In 2024, the assessment for this coverage is $3,500 for each OSB member.

Complying with the PLF coverage rules is an OSB licensing requirement for each individual Bar member. Each year OSB members must pay their assessment in full or installments or complete a request for exemption by the default date on their billing statement.

Am I exempt from coverage?

You are exempt from PLF coverage if you do not engage in private practice of law (such as serving as in-house counsel for a company, working as a licensed paralegal exclusively for a nonprofit, or if you are retired), or if your principal office is outside of Oregon. You must request an exemption from PLF coverage each year, even if the nature of your exemption status has not changed.

If you claim exemption from the PLF, you are not permitted to engage in any private practice in Oregon beyond the permitted scope of your exemption, whether or not you are paid for the work. If you claim exemption in error, you will be required to pay all past due assessment amounts with late payment charges.

You can request an exemption from PLF coverage by (1) completing the Request for Exemption form emailed with your yearly PLF assessment notice or (2) submitting your Request for Exemption electronically via the website. [Follow this link for more information.]() ◆

Business Law Section 2024 Subcommittees

Congratulations to the newly elected members of the 2024 subcommittees!

Continuing Legal Education

Melissa Jaffe
Chair

One of the most important things we can do as a section is help each other be better lawyers and stay on top of changing laws in our area. Our CLE subcommittee has organized some great events over the last year and is looking at ways to incorporate technology to reach members outside of the major metro areas. This subcommittee also organizes our annual fall CLE.

Members: Kimberly Boswell, Melanie Choch, Tim Crippen, Jennifer Nichols

Legislative

Leigh Gill
Chair

The mission of this subcommittee is business law improvement in Oregon.

Members: Blake Bowman, Matt Larson, Michael Walker

Outreach

Krista Evans
Chair

The Outreach Subcommittee plans and carries out education programs and social events aiming to expand the reach of the Business Law Section to Oregon's professional communities in the Portland metropolitan area and statewide. The Outreach Subcommittee also organizes the Section's annual planning retreat for executive committee members.

Members: Joe Cerne, Berit Everhart, Leigh Gill, Will Goodling, Melissa Jaffe, Matt Larson, Jennifer Nicholls, Ben Pirie

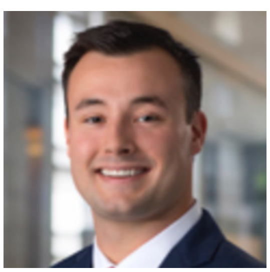
Nominating and Member Recruitment

Michael Walker
Chair

This subcommittee encourages active membership in the Business Law Section.

Member:
Will Goodling

New Business Lawyers



Joe Cerne
Chair

The New Business Lawyers Subcommittee engages new(er) lawyers who practice transactional business law and provides an opportunity to network, mentor law students and new members of the Business Law Section, and participate in community engagement events.

Members: Kimberly Boswell, Melanie Choch, Krista Evans, Berit Everhart, Will Goodling, Melissa Jaffe, Ben Pirie

Castles Leadership Award

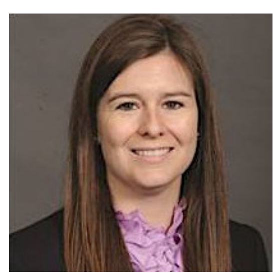
Will Goodling
Chair

The award was established in 1998 to recognize an Oregon lawyer for excellence in the practice of business law, professionalism among fellow business lawyers and outstanding community leadership. This subcommittee receives and reviews nominations for the award and recommends a recipient to the Executive Committee.

Member: Michael Walker

Newsletter and Communications

Tim Crippen
Co-Chair



Berit Everhart
Co-Chair

The Newsletter and Communications Subcommittee solicits and reviews articles from attorneys and publishes Oregon Business Lawyer, the quarterly Business Law Section newsletter.

Members: Adam Adkin, Blake Bowman, Jay Brody, Melissa Jaffe, Justin Monahan, Michael Walker, Meghan Williams

Sale of the Closely Held Business: Tax Considerations

Kate Roth, Tonkon Torp LLP

Kate Roth is a tax associate at Tonkon Torp LLP. She advises on a wide range of federal, state, and local tax issues of business transactions, and represents clients in tax controversies before the U.S. Tax Court and the Internal Revenue Service.

Congratulations on the sale of your business! Now it is time to pay the tax man. Oftentimes, business owners and corporate counsel are so intently focused on finding a buyer and agreeing on the terms of a sale that the tax implications of the deal are either overlooked or addressed late in the negotiation process. Structuring the sale of a closely held should always include a tax analysis early in the process to avoid potential pitfalls and traps for the unwary. Doing so may save the seller money when the tax man comes calling.

The first step in the business sale process should always be determining (1) the business entity type under state law, i.e., a sole proprietorship, a partnership, an LLC, or a corporation, and (2) whether that entity has made an election to change its classification for federal tax purposes. For tax purposes, a domestic LLC with only one member is a disregarded entity by default, whereas a domestic LLC with two or more members is a tax partnership. 26 CFR §301.7701-3(b)(1). Under the check-the-box regulations, an LLC (regardless of the number of members) can elect to be treated as either a C or an S corporation. 26 CFR §301.7701-3(c)(1)(i), (c)(1)(v)(C). A state law corporation is, by default, a C corporation for tax purposes. However, it can elect to be treated as an S corporation under 26 USC 1361 et seq.

If a business entity elects to be treated as something other than its default classification for tax purposes, seller's counsel should confirm the validity of the election during the initial due diligence. That election filing should be part of the entity's business records. If there is doubt about the validity of an election, confirmation can be made by inquiring with the IRS. Although an entity may elect to be an S corporation under federal tax law, certain states do not recognize an entity's S corporation election. For entities that operate in multiple states, buyer's counsel will likely request confirmation of all material tax filings in each state where the entity operates.

An entity's tax classification will impact, and in certain cases dictate, the structure of the sale and its tax implications for the seller(s). Thus, the second step of the sale process is determining what type of sale transaction the business owners are trying to achieve and whether that can be accomplished given the entity type and its potential tax classification. For example, the sale of a disregarded single member LLC is treated as a sale of assets for income tax purposes, regardless of the language used in the purchase agreement. This is because, for tax, the activities and assets of the entity are treated as if those activities were conducted by and the assets were owned directly by the LLC's owner. 26 CFR §301.7701-2(a), (c)(2)(i), (c)(2)(iv)(C)(2). Given that the tax treatment is likely to be identical, the parties should consider whether there is a business or legal reason to prefer an asset or entity sale.

The types of assets sold by a disregarded entity will determine the tax characterization of the gain or loss realized—ordinary or capital, but there are exceptions (discussed below). Gain or loss on the sale of inventory items generates ordinary income or loss. IRC §1221(a)(1). The sale of capital assets, including goodwill, generates capital gain or loss. The client's inventory accounting method will impact how gain or loss is calculated. IRC §471. The purchase agreement or other transaction documents should specifically allocate the purchase price among each asset sold to generate the best tax results for the seller. IRC §1060.

For tax purposes, buyers and sellers will have different objectives for the outcome of the transaction; most commonly, sellers want to sell interests or stock whereas buyers want to purchase assets.[1] Often, when parties agree upon a price for the transaction, they do so without considering the tax differences between an asset or stock/equity sale and, accordingly, may need to renegotiate price as tax effects are addressed.

Generally, interests in a partnership and corporate stock are considered capital assets, the sale of which generally produces capital gain or loss. IRC §741, IRC §1221(a). The length of the holding period determines whether that gain or loss is characterized as long- or short-term capital. IRC §1222. As discussed below, even if interests in a partnership are sold, sellers will be required to recognize ordinary income for certain depreciation recapture items. IRC §751.

Sale of partnership interests

A partnership interest has an adjusted, or outside, basis in each partner's hands that is separate from the aggregate adjusted, or inside, basis of all of the assets inside the partnership. IRC §705; IRC §723. When a partnership is formed, the aggregate of the

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partners' outside bases generally equals the inside basis of the all of the partnership's assets. Over time, disparities between the two develop.

When partners sell their interests in the entity (including LLC members selling their membership interests), each calculates gain or loss on the sale separately. That gain or loss is equal to the amount realized by the partner minus the partner's outside basis. IRC §741. Although the partnership interest is a capital asset, the partner may recognize ordinary income on inventory items and depreciation recapture, if any. IRC §751.

Buyers of partnership interests have a cost basis in the interest acquired equal to the amount paid. IRC §741; IRC §1012(a). This amount is usually different than the seller's outside basis. The acquisition can (and in most cases does) produce a mismatch between all of the new partners' outside bases and the aggregate inside basis of the partnership's assets. This mismatch distorts the timing and amount of tax the new partners will be subject to when partnership assets are sold. To mitigate against the potential tax consequences of this mismatch, buyers will want the partnership to make an election under Code Section 754 in the year the partnership interests are acquired. This election adjusts the inside basis of each of the partnership's assets equal to the fair market value of each. IRC §743.

Buyers will typically negotiate for a purchase price adjustment when no Code Section 754 is currently in place or will be made as part of the transaction. The election has no effect on the seller's outside basis. As such, it is important to understand whether the operating agreement allows the current partners to make the election and, if not, whether that agreement can be amended before the sale occurs to enable the election.

Sale of corporate stock

For C corporations, consideration should always be given to whether the stock is Qualified Small Business Stock ("QSBS"), which has become a common tax topic in recent years due to the ability to exclude up to 100 percent of the gain on the sale of stock (up to the greater of $10 million or ten times the adjusted basis of the stock). There are quite a few requirements that must be met to qualify for the exclusion. Among the most important are (1) the (non-corporate) shareholder must have acquired the stock directly from the corporation in an original issuance and held that stock for at least five years before the sale occurs, and (2) the corporation must be a C corporation. IRC §1202(a)(1), (c). Certain business types cannot be Qualified Small Business Stock, including restaurants and financial advisors.

To preserve the benefits of a stock sale intended to qualify for the QSBS exclusion, pay attention to the consideration received by seller in the transaction. If the consideration consists of cash and rollover equity in the buyer and the buyer is not a C corporation, the parties should probably negotiate for an all-cash deal to ensure the entire amount of the gain realized by the seller(s) will be shielded by Code Section 1202. An all-cash transaction allows the non-corporate sellers to avoid paying tax on the gain of the sale of stock and gives them cash to use to invest in the acquiring company.

A stock sale can be treated as an asset sale for federal income tax purposes in certain cases. To qualify for this treatment, among other requirements, the buyer and seller must both be corporations. This treatment is available for both C and S corporations so long as all of the requirements are met. IRC §338. Similar principles are available to the sale of LLC interests under Code Section 336. However, under Code Section 336, the purchaser does not need to be a corporation. The tax consequences for sellers in these transactions mirror that of a true sale of assets, discussed below. But to avoid assigning contracts or permits or retitling assets, it is often prudent to preserve the entity even if the parties prefer different tax treatment.

Sale of partnership assets

Partnerships are not subject to an entity-level tax. Instead, all items of income, gain, loss, deduction, and credit are determined at the entity level and allocated to the members of the partnership each year. IRC §701. The partners report these allocations on their respective federal income tax returns and pay tax on the allocations at their respective federal tax rates. IRC §702. Generally, allocations are made in accordance with the entity's operating or partnership agreement.

When a partnership sells its assets (rather than the partners selling their interests), gain or loss on each asset sold and the character of that gain or loss must be determined at the entity level. Those gains and losses are then reported by the partnership to the partners based on the allocations required by the company's operating agreement, and the partners pay tax on their allocable shares.

After the assets are sold, the partnership makes liquidating distributions of the sale proceeds to each of the partners. The partners will recognize gain on the distribution to the extent the money distributed exceeds the outside basis of their interests. IRC §731(a)(1); IRC §736(b)(1). Loss may be recognized when the outside basis exceeds the amount of distribution proceeds received in the liquidation. IRC §731(a)(2).

Sale of corporate assets

In the corporate context, selling assets takes two different forms: (1) directly selling the corporation's assets and (2) merging the corporation into an acquiring corporation. An asset sale has significant tax implications—i.e., it is subject to double taxation. First, the corporation is subject to tax on the sale of its assets. Second, the shareholders are subject to tax at their respective income tax rates when the corporation distributes the sale proceeds and liquidates. IRC §331(a). A corporate shareholder that owns at least 80% of the voting power and 80% of the value of the corporation being sold may, in some instances, avoid recognizing gain on the distribution and liquidation. IRC §332(a), (b);

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IRC §1504(a)(2). The same results occur if the transaction is structured as a merger that is not a tax free reorganization under Code Section 368(a); the transaction is treated as if the corporate assets were sold followed by a distribution in liquidation of the corporation. Rev. Rul. 69-6, 1969-1 C.B. 104.

Code Section 1202 may apply to exclude all or a portion of the gain realized on the sale by the shareholders because the liquidation is treated as an "exchange," which is required for the exclusion under the Qualified Small Business Stock rules. IRC §1202(a)(1). However, there is no guidance on this issue.

Other considerations

Here are a few other things to consider when a closely held business is sold:

• In an asset sale, regardless of the type of business entity that sells its assets, the purchase price is allocated and reported to the IRS based on the provisions of Code Section 1060. These allocations should be described in the asset purchase agreement and mutually agreed to by buyer and seller.

• When only part of the closely held business is being sold, consider whether a pre-transaction reorganization needs to be accomplished. These types of reorganizations are generally tax efficient vehicles to restructure how the entity holds certain assets and what types of interests or stock the equity owners hold.

• Are any of the owners foreign persons? If so, those foreign persons may be subject to backup withholding. IRC §1441. Buyers will typically ask for a Form W-9 from each owner to confirm whether backup withholding is required.

• In certain states and in Washington County (but no other counties) in Oregon, transfer taxes can apply to the sale of real estate. Generally, the tax is based on the property's fair market value or the selling price.

• Oregon state and local taxes should not be overlooked in sale transactions of Oregon-based businesses. Washington residents selling Oregon-based businesses, and vice versa, are common and analysis of these multi-state taxation issues is commonly missed by counsel from outside the region. ◆

Endnote

1. Unless otherwise indicated, throughout the remainder of this article I assume that an LLC is a tax partnership and has not made an election to be treated as a corporation. For simplicity, I use the term "partnership" to refer to LLCs.

Oregon State Bar Business Law Section

The mission of the Oregon State Bar Business Law Section is to provide excellent service to the diverse group of business law practitioners throughout the State of Oregon by providing regular, timely, and useful information about the practice of business law, promoting good business lawyering and professionalism, fostering communication and networking among our members, advocating improvement of business law, and supporting Oregon's business infrastructure and business community.

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