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How to Get the Most Out of Your Employee Payroll Audit:

Avoiding Discrimination Under the California Fair Pay Act and in Employee Benefit Plans

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Presented by:

Kate Gold, Partner, Labor & Employment

Heather Abrigo, Counsel, Employee Benefits & Executive Compensation

Moderated by: Philippe Lebel, Associate, Labor & Employment

CaliforniaHR

Learning Objectives

- What the CA Fair Pay Act requires of employers in terms of employee compensation
- Which employees you can and cannot exclude in your employee benefit plan under the Internal Revenue Code and why
- Planning and conducting your audit to make the most of the time and effort
- What to do for ongoing compliance

California's Fair Pay Act - Requirements

- **Labor Code section 1197.5 amended as of January 1, 2016.**
- (a) An employer shall not pay any of its employees at wage rates less than the rates paid to employees of the opposite sex for **substantially similar work, when viewed as a composite of skill, effort, and responsibility, and performed under similar working conditions**, except where the employer demonstrates:
 - (1) The wage differential is based upon one or more of the following factors:
 - (A) A **seniority system**
 - (B) A **merit system**
 - (C) A **system that measures earnings by quantity or quality of production**
 - (D) A **bona fide factor other than sex, such as education, training, or experience**. This factor shall apply only if the employer demonstrates that the factor is not based on or derived from a sex-based differential in compensation, is job related with respect to the position in question, and is consistent with a business necessity. ...This defense shall not apply if the employee demonstrates that an alternative business practice exists that would serve the same business purpose without producing the wage differential.
 - (2) Each factor relied upon is applied reasonably
 - (3) The one or more factors relied upon account for the entire wage differential

CA Fair Pay Act - Business necessity defense

- If relying on factors above, employer must show:
 - the factor is job related for the position and consistent with business necessity
 - "*Business necessity*" – the factor fulfills the intended business purpose, and there is no other business practice that would serve the same purpose without resulting in any difference in wages
- Legal authority under the prior version of the act applied a more lenient standard
 - *E.g., Hall v. County of Los Angeles*, 148 Cal. App. 4th 318 (wage disparity between predominantly male county counsel and predominantly female auxiliary legal services corporation established to assist county counsel did not violate California law since cost-saving purpose for corporation's existence was legitimate and nondiscriminatory)

What's Different? Prior CA Law:

- Previously, section 1197.5 prohibited employers from paying employees of one sex less than employees of the opposite sex for “equal work” at the “same establishment”
- **“Equal work” v. “substantially similar work”** – new standard is not defined, except that it should be viewed as a composite of skill, effort, responsibility and performed under similar working conditions – can be applied to different job titles
- **Elimination of “Same Establishment” requirement** – claims can arise based on employee wages at a different worksites
- Pay disparities may be the result of a seniority system, merit-based pay system, piece-rate system or “any bona fide factor other than sex” (*e.g.* education, training, years of experience), **BUT the employer must show the factors are “applied reasonably” and “account for the entire wage differential”**
- Recordkeeping 3 years, instead of 2
- Transparency, retaliation, remedies

Other Reasons to Gather Pay Data – Equal Pay Act

- The federal Equal Pay Act provides that employers may not pay unequal wages to men and women who perform jobs that require substantially equal skill, effort and responsibility, and that are performed under similar working conditions **within the same establishment. (EEOC Facts About Pay and Compensation)**
 - **Skill** – Measured by factors such as the experience, ability, education, and training required to perform the job
 - **Effort** – The amount of physical or mental exertion needed to perform the job
 - **Responsibility** – The degree of accountability required in performing the job
 - **Working Conditions** – This encompasses two factors: (1) physical surroundings like temperature, fumes, and ventilation; and (2) hazards
- **Establishment** – An establishment is a distinct physical place of business rather than an entire business or enterprise consisting of several places of business
- Pay differentials are permitted when they are based on seniority, merit, quantity or quality of production, or a factor other than sex. The EPA has been interpreted to mean that the jobs do not have to be “equal” but rather “substantially equal”
- In correcting a pay differential, no employee’s pay may be reduced. Instead, the pay of the lower paid employee(s) must be increased

Other Reasons to Collect Pay Data – State Statutes

- Many states have equal pay laws modeled on the federal Equal Pay Act.
- In 2015, however, several states followed California's lead and enacted new laws or amended their equal pay laws:
 - New York significantly amended its equal pay law to:
 - Narrow employer defenses
 - Broaden the geographic scope of equal pay analysis
 - Prohibit employers from barring employees from discussing wages; and
 - Increase damages
 - Several states have enacted legislation to permit employees to discuss wages, with equal pay in mind. *E.g.*, Oregon, Connecticut
 - Other states further limited employer defenses and/or increased employers' burden in justifying unequal pay. *E.g.*, North Dakota
- *And...this is just the beginning. More legislation is likely to come in 2016.*

Other Reasons to Collect Pay Data

- **Revised EEO-1 Form** - Will likely require pay data in September 2017.
 - Likely will apply to all federal contractors or employers with over 100 employees
 - W-2 wages to be reported:
 - Aggregate W-2 data in 12 pay bands for the 10 EEO-1 job categories
 - Employers will need to collect and report total hours worked in each EEO-1 pay band
- EEOC and OFCCP plan to use new data to analyze pay disparity (among other types of discrimination):
 - EEOC and OFCCP envision developing software to analyze pay distribution within single firms/businesses as well as comparing one business' data to aggregate industry or metropolitan-area data

Other Reasons to Collect Data: Employee Benefit Plans

- Use this Data to satisfy Discrimination Rules
 - Health & Welfare: Pending Discrimination Rules
 - Subject to Rules under 105(h) of the Internal Revenue Code (“Code”)
 - Qualified Retirement Plans must satisfy discrimination testing:
 - Code section 410(b) Coverage: The plan must satisfy a “coverage” test by demonstrating that it does not favor highly-compensated employees in terms of plan participation; and
 - Code section 401(a)(4) Non Discrimination testing: The plan must demonstrate that it is not providing disproportionate benefits to highly compensated employees

Other Reasons to Collect Data: Employee Benefit Plans

- What is an HCE versus NHCE
 - HCE:
 - Owned more than 5% of the interest in the business at any time during the year or the preceding year, regardless of how much compensation that person earned or received, or
 - For the preceding year, received compensation from the business of more than \$120,000 and, if the employer so chooses, was in the top 20% of employees when ranked by compensation
 - NHCE: everyone else

Certain Data is Important for Retirement Plan Purposes

- The importance of the data depends on whether the employee is included or excluded from the Plan
 - You can exclude some employees from the Plan and from certain discrimination tests
- Who is eligible to participate?
 - A plan is not required to restrict eligibility to “employees”
 - If there are restrictions, then those restrictions must meet certain minimum age and service standards (*See* IRC § 410(a))
 - Plan cannot require that employees be older than age 21 or complete more than 1 year of service, whichever is later

Certain Data is Important for Retirement Plan Purposes: Exclusions

- Who can you generally exclude from the Plan?
 - Reasonable classification of employees UNLESS subterfuge for excluding “part-time” and similar workers
 - Exclusions which are generally allowed:
 - Non resident aliens
 - Collectively bargained employees
 - Leased employees
 - Highly compensated employees
 - Exclusions are allowable but you will still need the data from these employees for testing purposes!

Certain Data is Important for Retirement Plan Purposes: Exclusions

- Who can you NOT exclude?
 - Service Based Exclusions
 - Part Time Employees: “Regularly scheduled to work 20 hours per week”
 - Temporary employees;
 - Seasonal employees; and
 - On-Call Employees
 - UNLESS you provide that if they meet the 1,000 hours of service they are eligible to participate in the plan or provide other basis for exclusion

The Audit – Step by Step

- Audit to be done with review and consultation of attorney
 - Audit is subject to attorney client privilege and/or work product protection
- Work with IT to determine best database/software for this purpose
- Coordinate with your plan's service provider on testing (Note: Not privileged)
- Consider all job titles/descriptions across all geographic regions
- Gather job descriptions/responsibilities
- Consider data relevant to the EEO-1 form (*e.g.*, W-2 wage data and pay bands)
- Set up database to enter and capture information relevant to your organization (non-exhaustive list) – consider how to identify or sort based on disparate geographical locations

The Audit – Step by Step (Compiling the Data)

- Name of employee (ID Number)
- Name of employer (e.g., controlled group/affiliated service group considerations)
- Date of hire
- Title
- Date of birth
- Gender
- Types and amount of compensation:
 - For CA Fair Pay Act/EEO-1 Purposes:
 - Total monetary compensation
 - EEO-1 requires examining W-2 earnings
 - For Employee Benefit Plan Purposes:
 - 12 month salary total excluding bonuses
 - Cafeteria plan 125 contributions
 - 401(k) deferrals
 - Moving expenses
 - Fringe Benefits

The Audit – Step by Step (Compiling the Data)

- Full/part time
 - Hours worked per week
 - How many hours of service did they complete in the year?
 - Alternative Uses: Compliance with Affordable Care Act and determining FTE status
- Breaks in service
- Exempt/non-exempt
- Education (high school, college graduate, graduate degree, other licenses, certificates)
- Other relevant training or experience
- Ever demoted? Promoted? Change in job responsibilities and compensation?
- Performance reviews (scaled/scored)
- Employee supervises any other employee (yes/no)
- Location of job (at business location/headquarters, 50 miles away; 100 miles away, etc.)
- Market data used to set compensation (yes/no)

Audit- Step by Step – Identify Potential Problems

- Compare the positions that have “*substantially similar work*”
 - Substantially similar work = “a composite of skill, effort and responsibility and performed under similar working conditions”
- For each group with “substantially similar work,” identify the process by which the decisions for pay are made, *e.g.*, at hire and thereafter
 - Includes collecting and reviewing written or unwritten, internal or external, policies and procedures for pay increases, promotions, etc.
- For each group of substantially similar positions, compare pay by gender (the overall average and median of compensation)
- For the job titles with “substantially similar work” that have significant differences in the average or median comparison of compensation, proceed with next step

Audit – Step by Step- Explanations for Disparities?

- Determine if the statutory exemptions apply:
 - (A) a seniority system
 - (B) a merit system
 - (C) a system that measures earnings by quantity or quality of production; or
 - (D) a “bona fide” factor other than sex, such as education, training or experience. (Note that these subsection D factors must not be the result of a sex-based differential in compensation, and must be job related to the position and consistent with business necessity)
- The statute defines “business necessity” as “an overriding legitimate business purpose such that the factor relied upon fulfills the business purpose it is supposed to serve”
- Consider that an employee could defeat this defense by proving that an alternative business practice exists that would serve the same business purpose without producing the wage differential
- Also if there are exemptions, assemble documents that support them, such as performance reviews, experience, etc. The more objective, the better.

Audit – Step by Step – Address Disparities That Cannot be Explained Adequately or Need to be Corrected

▪ For CA Fair Pay Act

- In a suit, an employee receiving less than the wage to which the employee is entitled (*i.e.*, unequal pay) may recover in a civil action the balance of the wages, including interest thereon, and an equal amount as liquidated damages, as well as attorneys' fees. Cal. Lab. Code 1197.5(g)
- To remedy, employers cannot reduce pay; must increase to accomplish equal pay, if necessary

▪ For Retirement Plans:

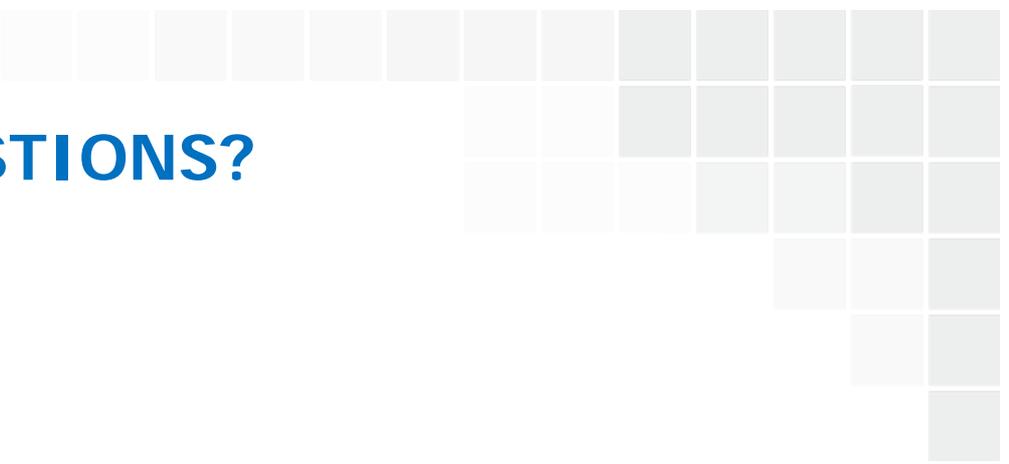
- Failure of discrimination testing:
 - One correction example is to make additional contributions to NHCE
- Worst Case: Disqualification of the Plan
- Good News! The IRS has a way to correct these problems:
 - Employee Plans Compliance Resolution System (EPCRS)
 - Voluntary Correction Program and Self-Correction Program
 - Eg., Improperly excluding an Employee: Employer might need to make a Qualified Non-Elective Contribution + Earnings; or
 - Improperly including an Employee: Fact Sensitive but if just early inclusion might be able to amend the Plan retroactively

Ongoing compliance – CA Fair Pay Act

- Update handbooks and policies to remove outdated references to “equal” work
- Eliminate policies preventing employees from discussing or asking about other employees’ compensation
- Review how compensation decisions are made and adjust if necessary
- Review and update job descriptions – comprehensive as possible
- Keep records for three years
- Train HR personnel, senior management on the new law and how it should be applied in setting compensation at hiring

Ongoing Compliance and Avoiding Retirement Plan Issues

- Conduct a review of the plan document and compare it to the operation of the plan
- Regularly audit payroll to ensure that compensation codes are being used in accordance with the terms of the Plan
- Communicate with your record-keeper regarding terminated and new-hire employees
- Have policies and procedures in place, when possible
- Seek experienced ERISA counsel when you find a problem before “fixing” the problem



QUESTIONS?



Kate Gold

1800 Century Park East,
Suite 1500
Los Angeles, CA 90067
(310) 203-4029 ❖
(310) 229-1285 [fax]
Kate.Gold@dbr.com



Heather Abrigo

1800 Century Park East,
Suite 1500
Los Angeles, CA 90067
(310) 203-4054 ❖
(310) 229-1285 [fax]
Heather.Abrigo@dbr.com



Philippe Lebel

1800 Century Park East,
Suite 1500
Los Angeles, CA 90067
(310) 203-4091 ❖
(310) 229-1285 [fax]
Philippe.Lebel@dbr.com

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