

ERISA Newsletter

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New Plan Distribution Notices Now Required

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The Internal Revenue Code (“Code”) requires that 401(k) and other qualified retirement plans (and 403(a), 403(b), and governmental 457(b) plans) provide recipients of benefit distributions with a written explanation under Code Section 402(f). The written explanation is commonly referred to as the “special tax notice” or the “Section 402(f) notice.” It must be provided before an “eligible rollover distribution” (most often a lump sum distribution) is made, at least 30 days but not more than 180 days before the “annuity starting date” (the date generally when payment is made or begins).

The explanation must generally describe the direct rollover rules, the mandatory income tax withholding rules (for distributions that are not rolled over), the tax treatment of distributions that are not rolled over, the restrictions and tax consequences following a rollover, and other matters. The notice provides important information to the person receiving the distribution.

In September 2009, the Internal Revenue Service published two safe harbor notices that plans may provide to recipients of distributions in order to satisfy the 402(f) requirements. (See Notice 2009-68) One of the notices applies to distributions that are not from a Roth account; the other applies to distributions from a Roth account. Several years ago, in Notice 2002-3, the IRS issued a model explanation for use by plans; since then, significant changes in the law have required changes to the notice. The new explanations are intended to reflect those changes. The updated notices are also intended to be more understandable to recipients.

The new notices, modified to conform to a particular plan as appropriate, are required to be utilized beginning January 1, 2010, but should be used immediately.

The model explanations also will need to be updated for any changes in the law that become effective after September 28, 2009. Plans should check with their service providers and benefits counsel to ensure the new forms will be used.

An employer that sponsors a retirement plan is strongly advised to stack the odds in favor of retaining its qualified plan status.

New Plan Features – Look Before You Leap

There are many guiding principals regarding the proper management of any ERISA plan. One of these is that a new feature should not be added to a plan unless: (a) there is a very good reason for doing so, and (b) the feature has been appropriately analyzed by the plan providers, the employer, and experienced ERISA counsel.

Enhancing a plan's design may be laudable. At the same time, the addition of any new plan feature will increase a plan's complexity. It will always involve ERISA legal issues. A change in the plan (for example, to the plan's eligibility conditions) similarly will complicate a plan. Increased complexity increases the potential for errors, most of which will be considered to be "qualification failures" (see the Plan Qualification discussion below).

There should be careful consideration of whether a new feature is truly necessary, desired or will actually be utilized, before it is added.

Accordingly, the appropriate steps must be taken to ensure that new or changed features are properly implemented and administered. There should be careful consideration of whether a feature is truly necessary, desired or will actually be utilized, before it is added. We often see employers implementing features (like automatic enrollment or Roth contributions) without adequate consideration of the reasons for doing so or of the increased administrative costs, burdens, and legal risks. Even if qualification failures do not arise, many times the new provision fails to achieve its perceived (and often misguided or misunderstood) advantages, requiring an unwinding of the problem feature.

For example, let's take a look at "Automatic Enrollments." Under this newly popular and marketed reverse 401(k) plan feature, if a participant does not affirmatively elect a 401(k) contribution (or zero contribution), a portion of his or her compensation will automatically be reduced and be contributed to the plan for such participant each payroll period. Some plans provide that the percentage will automatically increase annually, for example by 1% per year, up to some maximum percentage of compensation.

Automatic enrollment can be an attractive feature when there is a desire to increase participation. There could be several reasons for wanting to increase participation, such as to help participants save for retirement, to increase the amount of plan assets in order to decrease investment fees and expenses, or to increase the amount of deferrals made by nonhighly compensated employees ("NHCEs") which in turn might allow highly compensated employees ("HCEs") to increase their 401(k) deferrals. (Sometimes if the deferrals by NHCEs are not adequate, the HCEs are prevented from deferring up to the maximum amount (\$16,500 for 2009 and 2010) on account of one of the required discrimination tests. Notably, there sometimes are better ways than automatic contributions to allow the HCEs to receive greater contributions.)

Although an automatic enrollment feature may offer certain benefits as mentioned above, it also gives rise to significant risks.

- For example, a common automatic enrollment violation is the employer's failure to actually implement the automatic enrollment. Often a plan states that it will automatically enroll participants and/or increase the deferral percentages annually, but then the employer fails to automatically enroll all or some of the subject participants who do not make the 401(k) deferral elections. Other times, the employer fails to increase the deferrals at the appropriate time.

- There also are specific notice requirements associated with automatic enrollment. These often are overlooked, or are legally noncompliant with respect to their content and/or timing. Annual notices with the correct current language, and sometimes midyear notices, must be sent to participants.

In situations where the requirements are not followed, the plan no longer is qualified. To recover its qualification the employer must make the plan and participants whole by contributing as employer make-up contributions the missed automatic employee contributions, the employer's matching contributions, if any, and earnings thereon, for as many years as the violation occurred.

In summary, whether it is adding a Roth feature, providing for automatic enrollment, shortening eligibility, going paperless, allowing brokerage accounts, or any other number of features which are being offered to employers, there are significant legal and practical issues that need to be considered. Absent that, the employer is likely to find itself in the growing club of plan sponsors whose plans have experienced qualification failures, the cost of corrections of which often is enormous. The old adage "look before you leap" is more true today than ever with respect to your ERISA plans.

Plan Limitations for 2010 Stay the Same

Various retirement plan limits are subject to annual cost-of-living and/or statutory adjustments. The limits are unchanged from 2009. There had been speculation regarding whether any of the limits would decrease (which would have presented some interesting issues). Here are some of the more commonly applicable limits for 2010.

Maximum Contribution to 401(k), Profit Sharing, and other Defined Contribution Plans. \$49,000 for 2010. For most plans, the limit will apply for the plan year January 1 to December 31, 2010. *Warning: Participants of small employers may not be able to receive the \$49,000 allocation.*

Pre-Tax 401(k), 403(b) or 457(b) Employee Contribution Limit. \$16,500 for 2010.

Age 50 Catch-up Contribution Limit. \$5,500 in 2010.

Maximum Annual Recognized Compensation Limit. \$245,000 for 2010. To limit retirement plan accumulations for high paid employees, as well as to increase contributions for non-high paid employees, retirement plans generally may only recognize compensation up to this limit.

Highly Compensated Employee Threshold. \$110,000 for 2010. Under ERISA's nondiscrimination rules, the employee population is divided into two groups – the highly compensated employees and the nonhighly compensated employees. A highly compensated employee generally is an employee who owns more than 5% of the employer sponsoring the plan or whose compensation in the preceding year exceeds the dollar threshold.

Defined Benefit Plan Limit. \$195,000 for 2010. In a defined benefit plan, the law limits the annual pension payable to the participant upon retirement (as opposed to limiting the annual additions going into a defined contribution plan). *If you desire to possibly accumulate significant retirement benefits over and above the \$49,000 annual defined contribution limit, a defined benefit plan should be explored.*

Social Security Tax Wage Base. \$106,800 for 2010. This figure affects the way in which employer contributions are allocated to participants in "integrated" plans.

Plan Qualification – Is Your Plan Protected?

The reason for obtaining a “determination letter” from the IRS is to help ensure that a retirement plan is “qualified” under Internal Revenue Code Section 401(a). A retirement plan must comply with numerous requirements in order for the plan to be qualified. “Qualification” allows the plan, the employer, and the employees to obtain unique significant income tax deductions and exclusions. If a plan loses its qualified status, it becomes “disqualified” which means that the tax benefits that were dependent on the plan’s qualified status are reversed and lost retroactively for the applicable open tax years.

In general, the four most direct consequences (there are additional consequential damages) of plan disqualification are (for open tax years, usually three, sometimes six or more):

- (1) the employer’s loss of deductions for employer and 401(k) contributions to the plan;
- (2) the inclusion in the employees’ taxable income of all or a portion of the employees’ plan account balances;
- (3) the employer’s and employees’ obligation to pay employment taxes (for example, social security and Medicare) on the now-disallowed contributions; and
- (4) the plan’s trust (which holds the plan assets) becomes a taxpaying trust (which is at a high tax bracket).

Also, unless the employer is willing to reimburse the employees for their tax losses, employees have a colorable cause of action against the employer and other plan fiduciaries.

Importantly, the normal application of the statute of limitations does not govern in this area of law. One dollar of mistaken money in a plan infects the entire plan forever (or until properly “corrected”), and the cancer increases with each new dollar added to the plan. For example, if a qualification failure that occurred ten years ago is discovered today, the IRS may (and often does) threaten disqualification. The tax losses cited above will be limited by the respective entity’s (employer, employee or trust) open taxable years (typically three to six years of disallowance); however, the defect that occurred at whatever point in time in the past taints all of the current and future money in the Plan forever (so long as the qualification defect is not corrected in accordance with specific government requirements). Due to IRS procedures and other considerations, most qualification failures rise to the surface more than three years after the failure occurs; some qualification failures are discovered during the determination letter process.

As you can imagine, the tax penalties and consequences that arise from plan disqualification are draconian. These potential liabilities increase as an ongoing plan’s size increases. In reality, the IRS does in fact threaten to disqualify noncompliant plans and often will impose severe penalties and conditions under its “Audit CAP” program. This program, in most circumstances, will allow the plan to retain its qualified status, but at a cost.

Determination Letter

A determination letter is a letter from the IRS which is directly addressed and written to the employer sponsoring a plan. A determination letter is different than the type of letter the IRS writes to a financial institution, recordkeeper or other provider of plan documents. Most IRS letters written to these providers are called “opinion letters.” An opinion letter differs significantly from a determination letter for many plans. In order for many plan sponsors to have a degree of comfort that their plan is “qualified,” they should not rely upon the opinion letter the provider received from the IRS. Instead, an individual determination letter addressed to the employer should be sought. Whether a particular employer should obtain a determination letter or may reasonably rely upon an opinion letter is a legal question dependent on each employer’s specific facts and circumstances (and sometimes tolerance for risk and budget).

Because of these and other risks (such as ERISA Title I exposure to the U.S. Department of Labor and/or participants) –

- obtaining the appropriate level of IRS approval of the plan,
- operating the plan in strict compliance with its terms, and
- generally acting cautiously and armed with the correct information

is strongly advised. A premium is placed on not committing qualification failures, but if such errors are made, they should be corrected in accordance with government procedures as soon as possible. A plan that properly seeks a determination letter is less likely to have a qualification failure discovered by the IRS.

Qualification Requirements

There are three broad categories of qualification requirements. First, labeled the “form” requirement, a plan must contain certain precise language. This means that the plan must be amended, typically annually or biennially, on a timely basis and with the correct, amended, current Code language. The PPA amendments required by December 31, 2009 are an example. Second, the daily and annual operations of the plan must strictly follow the terms of the IRS-approved plan document. Third, numerous Code tests and limitations must be observed. Plans regularly fail in all three categories. See the IRS-disclosed Top Ten Failures and the Ten Reasons to Correct Mistakes at the end of this Newsletter.

Firm News

John Hughes’ article “Introduction to Fixing 401(k) and Other Retirement Plan Failures and Problems” was published in the August 2009 issue of the Idaho State Bar Journal, *The Advocate*. For a copy, please visit www.erisalawgroup.com.

Jeff Mandell continues to verbalize his protest of ERISA (and today’s marketplace) to anyone who will listen.

This bulletin is intended to provide general information only and does not provide legal advice. This bulletin does not discuss potential exceptions to the above rules. The application of ERISA laws can be complex. For information regarding the impact of these developments under your particular facts and circumstances, please call us. This material may also be considered attorney advertising under court rules of certain jurisdictions.



Top Ten Failures Found in Voluntary Correction Program

1. Failure to amend the plan for tax law changes by the end of the period required by the law.

This results in a plan failing to operate in accordance with the current law because the plan document has not been amended to affect such change. Currently, the most common law changes that employers have failed to amend their plans for are GUST*, the good faith amendments for EGTRRA** and the Final and Temporary regulations under section 401(a)(9).

2. Failure to follow the plan's definition of compensation for determining contributions.

Usually, certain types of compensation are excluded, such as bonuses, commissions, or overtime, or certain types of compensation are included where they should have been excluded. This failure can result in participants receiving allocations to their accounts that are either greater than or less than the amount they should have received.

3. Failure to include eligible employees in the plan or the failure to exclude ineligible employees from the plan.

This often occurs in a controlled group situation after a merger or acquisition. Where otherwise eligible employees are excluded, the excluded employees don't receive an allocation of contributions to which they are entitled. Where ineligible employees are included in the plan, the employer has made additional contributions which it did not need to make to the plan.

4. Failure to satisfy plan loan provisions.

Loan failures often result from the plan sponsor's failure to withhold loan payments. Where a plan fails to collect loan repayments from participants, the loan is considered defaulted and the participant should be taxed on the loan in the year of default.

5. Impermissible in-service withdrawals.

These requests relate to both defined benefit and contribution plans. The law provides that distributions to participants can be made upon certain events or the attainment of a specific age. This failure involves the circumstance where a distribution is made to a participant where the law or plan terms do not permit a distribution.

6. Failure to satisfy IRC 401(a)(9) minimum distribution rules.

The law requires that a participant receive a distribution when they attain a certain age. This failure involves the plan not making distributions to participants where they have attained the age for required distributions under the law. The law requires that the participant pay an excise tax of 50% on the amount of required distribution if it is not made timely. The Service will, in appropriate cases, waive the excise tax if the plan sponsor requests the waiver in appropriate situations.

7. Employer eligibility failure.

This occurs when an employer adopts a plan that it legally is not permitted to adopt. Common situations are where a government adopts a 401(k) plan or a tax-exempt entity (other than a 501(c)(3) entity or a public educational organization) adopts a 403(b) plan.

8. Failure to pass the ADP/ACP nondiscrimination tests under IRC 401(k) and 401(m).

This failure could result from the employer not using the correct compensation or where the employer excluded eligible employees who elected not to participate in the 401(k) plan.

9. Failure to properly provide the minimum top-heavy benefit or contribution under IRC 416 to non-key employees.

The law requires that if the account balances or accrued benefits of key employees (typically, owners) comprises a substantial portion of the assets of the plan (generally, 60% of plan assets), non-key employees are entitled to receive a minimum benefit or contribution.

10. Failure to satisfy the limits of IRC 415.

The law limits the amount of contributions a participant can receive in a defined contribution plan (i.e., a 401(k) or profit-sharing plan) and the amount of benefits a participant can accrue in a defined benefit plan. This failure occurs where the employer or its third party administrator does not monitor the amount of contributions allocated or the amount of benefits accrued by participants.

* The Uruguay Round Agreements Act; the Uniformed Services Employment and Reemployment Rights Act of 1994; the Small Business Job Protection Act of 1996; the Taxpayer Relief Act of 1997; the Internal Revenue Service Restructuring and Reform Act of 1998; and the Community Renewal Tax Relief Act of 2000 (collectively known as "GUST")

** The Economic Growth and Tax Relief Reconciliation Act of 2001

Ten Reasons to Identify and Correct Mistakes in Your Retirement Plan Operations

At the IRS we hear some pretty interesting reasons for not reviewing retirement plan operations on a regular basis and not bringing those plans into compliance with the law.

- We don't have any problems with our retirement plan. (We haven't looked too closely, but we hope it's okay.)
- A close look at our plan would be expensive.
- If we find a problem with our plan it will be too expensive to fix. And how do we know what to do to fix it?
- We don't have the (insert one or more) (a) time, (b) staff, (c) money to deal with retirement plan issues on a regular basis.
- I don't want to have any contact with the IRS that I can avoid.
- If there's a problem with the plan I don't want upper management to know about it.
- I paid the accountants to do the annual financial audit so we're okay.

Here are some good reasons to identify and fix mistakes in the operation of your retirement plans.

1. **What you don't know CAN hurt you.** Hoping that your retirement plan is operating according to its terms and within the law isn't enough. A program of regular review and analysis of the plan document and its operation is essential to keeping the plan healthy. Problems in plan administration are easier - and cheaper - to fix when they're small and haven't continued over a long period of time. Without regular oversight and review retirement plans can quickly stumble into trouble - sometimes big trouble.
2. As Bob Dylan said in another context, "**The times they are a-changin'.**" And so is the law related to retirement plans. Frequently. Ten major changes in pension law in the past 25 years and numerous smaller changes mean that what worked last year may no longer work now. Or law changes might mean you can simplify some areas of plan administration or improve benefits. Changes to pension law in the future are a good bet. Plan language and operation will need to be changed to keep the plan within the law and to take advantage of increased benefit limits.
3. **An objective - and fresh - set of eyes may see problems the plan's day-to-day administrators don't.** An independent review of the plan and its operation may turn up not only problems that hide in everyday operation of the plan but opportunities for changes that will improve benefits for participants. Or even save money on plan administration.
4. **Ignorance may be bliss but it's not cheaper.** At least not with retirement plans. Mistakes in retirement plan operations seldom go away on their own. They often continue year after year unless they're found and corrected. Finding a mistake in the first year it's made will be easier and less expensive to fix than the same mistake repeated over five, ten, or fifteen years. And the correction programs sponsored by the IRS are structured to provide financial incentives for finding and correcting mistakes earlier, rather than later.
5. **Plan participants expect their retirement plan to deliver what's promised.** Mistakes in plan operation can take away from the significant employee morale boost provided by sponsorship of a retirement plan. Liability for failure to follow the terms of the plan and stay within the law is a real risk for plan sponsors. Ongoing independent review of plan operations and correcting mistakes reduces that risk.
6. **IRS retirement plan correction programs are here to help.** We've heard the joke about "I'm from the government and I'm here to help," too. But this time it's true! Our correction programs help you operate your plan within the law and protect participant benefits. These programs provide real incentives to identify and correct mistakes sooner rather than later.
7. **The IRS encourages appropriate use of its do-it-yourself correction program.** Many problems found within two years can be corrected without telling the IRS about it. And your plan's tax benefits are protected. If you're not eligible for this self-correction program read on. There's help for you in #8.
8. **The IRS offers help for other plan operation problems.** If you aren't eligible to self-correct without contacting the IRS, you can ask the IRS for help. You'll pay a small fee depending on the size of the plan, correct the mistake and receive a letter from the IRS telling you that the plan's tax benefits are intact. If you're still a little bit hesitant about working with us, use the "John Doe" program that allows you to tell us about the problem and find out what correction will be required before you tell us who you are. Asking the IRS for help in correcting a retirement plan problem won't cause an audit, either. So what are you afraid of?
9. **IRS audit of your retirement plan?** Even if a mistake isn't found until an IRS audit of your plan, in most cases we'll help you protect the tax benefits of the plan and its participants. Of course, if the mistake isn't found until an examination it will cost more than if you'd found and corrected the error earlier.

It's the right thing to do. Ensuring that the retirement plan you and your employees count on is in good running order keeps the promise you made in setting up the plan. You care about the future of your company and its employees and are committed to them.

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