

INTRODUCTION TO FIXING 401(K) AND OTHER RETIREMENT PLAN FAILURES AND PROBLEMS

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Introduction

This article will describe the basics regarding retirement plan failures, the potential consequences associated with such failures, and the Internal Revenue Service's correction program that is available to fix certain failures. The correction program allows employers to avoid potentially substantial tax consequences and other liabilities.

Most Employers and Employees Maintain or Are Participants in Retirement Plans

Involvement with retirement plans is far reaching. Anyone reading this article is likely a retirement plan participant, plan trustee, plan sponsor, plan fiduciary, and/or represents clients that maintain a retirement plan (and/or act in the foregoing capacities). There are trillions of dollars invested under the umbrella of retirement plans. Almost all employers, big and small, private and public, maintain some kind of retirement plan. Retirement plan participants range from the lowest of wage earners to the highest.

Compliance with the Law Requires Vigilance

The laws and regulations governing retirement plans are excessively complex and everchanging. The majority of plans maintained by private employers are "qualified" plans.¹ A plan is considered qualified by the Internal Revenue Service when it complies with the litany of requirements that are set forth in Section 401(a) of the Internal Revenue Code ("IRC") (and underlying official guidance; *i.e.*, Treasury regulations, Revenue Procedures, *etc.*).²

Qualified status provides significant tax advantages. When a plan is qualified, it generally allows the employer that sponsors the plan to deduct the contributions it makes to the plan. It also allows the plan participants to delay paying taxes on the employer's contributions (*e.g.*, profit sharing and matching contributions), as well as the contributions the participants themselves make by salary deferral (commonly referred to as "401(k) contributions"). The earnings thereon grow tax-free until distributed.

The Potential Consequences Associated with Plan Failures Are Disastrous

If a qualified plan does not operate in accordance with the maze of requirements under IRC Section 401(a) (and the associated guidance), it will suffer a qualification failure. If a qualification failure is discovered by the IRS, *e.g.*, on audit or through the reporting of such by a disgruntled or concerned employee, the potential results can be disastrous – plan disqualification.

If a plan is disqualified, the tax benefits that were enjoyed by the employer and the employees cease to exist. Taxes are owed, going back, on the amounts that were deducted by the employer and also on the amounts that the employees did not include in their income. Additionally, penalties and interest will be owed on these amounts. Distributions will not be eligible for favorable tax treatment (*i.e.*, rollover), trust earnings will not be exempt from taxation, and social security taxes will be owed. Finally, the employer, as a plan fiduciary, will face increased exposure from the now disgruntled participant employees relative to the employer's fiduciary breaches (for which there is personal liability – not only for the employer, but for anyone else exercising discretion over plan assets; *e.g.*, an employee who handles administrative plan matters as part of his or her job or an investment consultant involved with the plan). Short of these consequences,

the IRS may negotiate the payment of a penalty that is based on the amount of taxes that might be owed if the plan were disqualified (see Audit CAP below).

Common Plan Failures

There are four primary ways in which a plan suffers a qualification failure.

First, a plan will suffer a qualification failure if it is written in such a way that it violates IRC Section 401(a). This type of failure can also occur if the written plan document is not appropriately or timely amended to reflect changes in the law. This often happens if a new legal requirement is overlooked altogether or if an amendment is not signed or dated by the employer for some reason.

Changes in the law requiring mandatory plan amendments generally are made approximately every year or two. For example, this year most qualified plans must be amended to reflect the provisions of the Pension Protection Act of 2006 and the Heroes Earnings Assistance and Relief Tax Act of 2008. Also, employers sometimes make changes in the design of their plans. For example, an employer may decide to implement a "Roth" feature to a plan, implement an automatic contribution feature, or change the identity of the related employers that are participating in the plan. These discretionary changes also require timely execution of properly drafted amendments. In short, sometimes the language of the plan is wrong or missing, or mandatory amendments reflecting changes in the law are not timely executed.

Second, a plan will suffer a qualification failure if it is not operated in accordance with the plan terms. For example, a plan might state that hardship distributions are not available to participants; however, in operation the plan makes a hardship distribution available. This would also be a qualification failure – the failure to follow the plan terms.

Third, a demographic failure will occur if there is a failure to satisfy IRC Sections 401(a)(4), 401(a)(26), or 410(b). These IRC sections serve to ensure that a plan does not discriminate in favor of highly compensated employees. Specialized tests are run every year by the plan's service providers ensuring that the plan is satisfying these and other IRC sections and thus not discriminating.

Fourth, a qualification failure will occur if an employer adopts a type of plan that it is not eligible to adopt in the first place. Different types of plans are available to different types of employers.

All four of these types of failures are common given the complexities associated with the laws that require plans to change their terms, and also the complexities associated with operating a plan and ensuring operation conforms to the complicated and many terms contained in the plan (most qualified plans are approximately 100 pages in length and include much technical-speak).

More specifically, the IRS has identified the 10 top failures:³

1. Failure to amend the plan for tax law changes by the end of the period required by the law.
2. Failure to follow the plan's definition of "compensation" for determining contributions.
3. Failure to include eligible employees in the plan or the failure to exclude ineligible employees from the plan.
4. Failure to satisfy the plan loan provisions.
5. Impermissible withdrawals from the plan while

the participant is still employed.

6. Failure to satisfy minimum distribution rules (*e.g.*, at age 70½ or death).
7. Employer eligibility failure (*i.e.*, adoption of the wrong kind of plan).
8. Failure to pass the ADP/ACP nondiscrimination tests under IRC Sections 401(k) and 401(m).
9. Failure to properly provide the minimum “top-heavy” benefit or contribution for “non-key” employees.
10. Failure to satisfy the annual contribution and benefit limits.

The IRS Allows Plans to Correct Failures Under “EPCRS”

The good news is that the IRS maintains a correction program that allows plans to fix qualification failures. An employer that properly participates in this program upon discovery of a qualification failure will retain its qualified status and avoid the adverse tax consequences and other liabilities mentioned above.

The program is called the Employee Plans Compliance Resolution System (commonly referred to as “EPCRS”).⁴ EPCRS in its current form is set forth in IRS Revenue Procedure 2008-50. EPCRS is updated every few years to clarify certain provisions and to broaden the available corrections. EPCRS generally consists of three correction programs that are titled as follows: Audit CAP, Voluntary Correction (“VCP”) and Self-Correction (“SCP”).

Audit CAP

Audit CAP is mentioned above. A plan will generally find itself in Audit CAP if a failure is identified during the course of an IRS audit or the IRS’s routine review of a plan’s amendments. Audit CAP involves taking actions to correct the failure and paying a penalty to the IRS. The penalty is a negotiated percentage of the “Maximum Payment Amount.” The Maximum Payment Amount is the amount that is approximately equal to the tax the IRS could collect upon plan disqualification, which, in turn, is the sum of the open taxable years of the tax on the trust, income tax resulting from the loss of employer deductions for contributions it made to the plan, income tax resulting from inclusion of income for participants on amounts that were deferred, and “any other tax that results from a Qualification Failure that would apply. . . .”

If an Audit CAP negotiation is unsuccessful, the plan will be disqualified. Clearly, the goal is to avoid Audit CAP. This is achieved through proper participation in SCP or VCP upon the discovery of a problem by the employer, third party administrator, legal counsel, recordkeeper, investment consultant, *etc.*

Voluntary Correction Program

VCP generally requires the preparation of a formal application for submission to the IRS along with the payment of a fee. A successful application will result in the IRS issuing a “compliance statement.” The compliance statement will summarize the failure and the agreed-upon method of correction. The compliance statement will state that the IRS will not pursue the sanction of disqualification on account of the failure.

The VCP application must include specified information such as general information about the plan (plan type, number of participants, *etc.*), a description of the failure, a description of the proposed method of correction, a description of the administrative procedures in place aimed at preventing future failures, and statements regarding whether the plan is under examination or whether the plan or sponsor have been parties to abusive tax avoidance transactions.

The current version of EPCRS also includes streamlined VCP applications that may be used for specified failures. A plan that was not timely amended for a recent change in the law would likely be eligible

to utilize this streamlined procedure; for example, if an employer did not timely amend its plan to reflect the Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”). Similarly, EPCRS will likely be modified to allow a streamlined fix for employers that fail to timely amend for the Pension Protection Act of 2006 this year.

The VCP fees vary based on the type of failure and the number of plan participants identified in the most recently filed Form 5500 (Annual Return/Report of Employee Benefit Plan). Generally, there are eight categories of fees ranging from \$750 (20 or fewer participants) to \$25,000 (over 10,000 participants). A chart of the eight fee categories is set forth in Revenue Procedure 2008-50.

Discounted fees are available for specified failures including those failures eligible for the streamlined procedure mentioned above. Increased fees may apply if the failure is egregious or where the failure is not the result of mistake or oversight.

VCP applications may be submitted on an anonymous basis. This option can be very useful when the failure is not one for which the method of correction is entirely clear or if the IRS and the applicant potentially might not agree on the appropriate correction. In this instance, an application is submitted with redacted information and documents. Thereafter, if the negotiation is successful, the employer and the plan identities are later disclosed to the IRS.

Self Correction Program

SCP generally involves correcting the failure without submitting an application or a fee to the IRS (hence “self-correction”). Only certain failures are eligible for SCP.

SCP eligibility requires that the failure be an “operational” failure. An operational failure arises from a failure to follow plan provisions. Accordingly, many failures, like the failure to timely adopt a plan amendment, are not eligible for SCP.

Eligibility for SCP also requires that the operational failure must have occurred through an oversight or mistake in applying established practices and procedures reasonably designed to promote and facilitate compliance with the IRC, or because the established practices and procedures were not sufficient to prevent the occurrence of the failure. The established practices and procedures may be formal or informal.

SCP provides for the correction of both significant and insignificant failures; however, the availability of each has certain limits. The correction of a significant failure must be completed by “the last day of the second plan year following the plan year for which the failure occurred.” In contrast, insignificant failures may be corrected at any time. Also, insignificant failures may be corrected under SCP even if the Plan is “under examination” or if the operational failure is discovered on examination.

Correction Principles

EPCRS contains several provisions that provide detail on how to correct specified failures. Often, EPCRS will describe a specific correction methodology for a particular failure. However, often it will be the case that an employer will be faced with a problem that is not specifically addressed in EPCRS. In that case, EPCRS also describes correction principles of general applicability.

The general correction principles include the following:

1. The failure should be fully corrected with respect to all participants and all years (whether or not a taxable year is closed).
2. The correction should restore the plan and its participants to the position they would have been in but for the failure (including former participants).
3. The correction should be reasonable and appropriate for the failure (and, if possible, resemble one already provided for in the IRC).
4. The correction should keep plan assets in the plan.

5. The correction should provide benefits to non-highly compensated employees if the failure relates to a nondiscrimination issue.
6. The correction should not violate other requirements or cause additional failures.
7. The correction should be applied consistently.

Corrections oftentimes require additional deposits or distributions to participants which, consistent with the above principles, will require a measure of lost earnings on the amounts. In certain circumstances it will be difficult or impossible to identify the precise amounts. EPCRS contains provisions regarding appropriate calculations and the use of estimates and reasonable interest rates.

Conclusion

Proper maintenance of a retirement plan requires constant vigilance. Plan failures are very common and the consequences associated with plan failures can be severe. The IRS has established a program that allows plan sponsors to correct many plan failures and thus retain their qualified status and continue to enjoy the associated tax benefits (and avoid other potentially significant liabilities). EPCRS itself is complex and does not cover all instances of failure. Practitioners in the retirement plan arena, as well as plan sponsors, should recognize the complexities and know where to look for guidance when problems arise so that the plan's qualified status is not jeopardized.

About the Author

John C. Hughes is an attorney with *The ERISA Law Group, P.A.* in Boise, Idaho. His practice is devoted exclusively to issues involving employee benefits/ERISA. He is primarily involved in assisting employers in designing and operating all kinds of retirement plans within the confines of the law. John is the President of the Boise Chapter of the Western Pension & Benefits Conference.

Endnotes

- ¹ This article focuses on corrections to qualified plans.
- ² EPCRS is also available to correct failures of SEPs and SIMPLE IRA plans, 403(b) plans, 403(a), and, provisionally, governmental 457(b) plans.
- ³ See <http://www.irs.gov/retirement/article/0,,id=156774,00.html>
- ⁴ There are various other governmental correction programs aimed at different aspects of plan related problems. Those programs include the Department of Labor's Delinquent Filer Voluntary Compliance Program ("DFVC") and the Voluntary Fiduciary Correction Program ("VFCP").

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