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Employee Benefits & Executive Compensation Tips and Traps

Focus on 401(k) Plans

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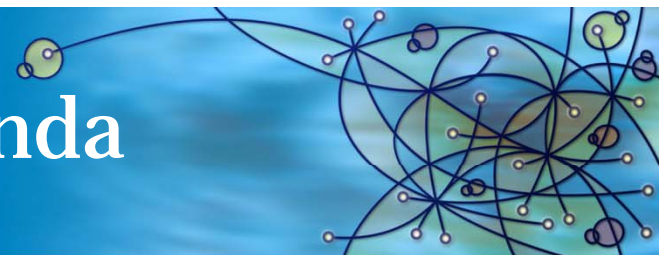
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Focus on 401(k) Plans – Agenda



DOMA: After *Windsor*, What's Next?

Fees and Expenses: Issues Arising out of
Revenue Sharing and Float

Correcting 401(k) Plan Mistakes

United States v. Windsor

DOMA: AFTER *WINDSOR*, WHAT'S NEXT?

- Overview of *Windsor*
- Implications for 401(k) Plans
- Difficult issues
- Recent post-*Windsor* IRS guidance
- Post-*Windsor* cases: *Couzen O'Connor v. Tobits*
- Take aways



DOMA: After *Windsor*, What's Next?

- Section 3 of the federal Defense of Marriage Act (“DOMA”) barred same-sex married couples from being recognized as “spouses” for purposes of federal laws, or for purposes of receiving federal benefits based upon being married
- In *U.S. v. Windsor*, 133 S. Ct. 2675 (2013), the U.S. Supreme Court ruled that Section 3 of DOMA is unconstitutional under the due process clause of the Fifth Amendment and under equal protection principles: the effect is that same-sex marriages recognized under state law are now recognized under federal law
- *Windsor* did not address Section 2 of DOMA, which provides that no state is required to recognize same-sex marriage that is recognized as a legal marriage in any other state (that is, “full faith and credit” not required)

DOMA: After *Windsor*, What's Next?

- Implications for 401(k) plans:
 - Beneficiary designations and spousal consents
 - 401(k) plans and other defined contribution (“DC”) plans require a married participant’s spouse to consent in writing to the designation of a non-spouse beneficiary for the non-spouse designation to be valid – this spousal consent requirement allows such DC plans to avoid being subject to joint and survivor annuity requirements
 - Spousal rights will now apply to persons recognized under federal law as same-sex spouses
 - Hardship withdrawals
 - The IRS safe harbor definition of hardship includes the need to pay certain expenses of a participant’s spouse (e.g., medical expenses)
 - Expenses of a same-sex spouse may now make it easier for the participant to qualify for a hardship distribution
 - Required minimum distributions
 - The rule that allows spouses to delay distribution now applies equally to same-sex spouses
 - QDROs
 - Before *Windsor*, a same-sex spouse could only qualify as an alternate payee under a QDRO if he/she qualified as the participant’s dependent – note that whether a QDRO will now be issued to a non-dependent same-sex spouse in a given state may still depend on that state’s law
 - Other special features for spouses, such as spousal rollovers

DOMA: After *Windsor*, What's Next?

- Difficult issues stemming from *Windsor* - IRS issues much-needed guidance
 - If *Windsor* were applied retroactively, there would be potential administrative challenges
 - If married same-sex couple moved from state where marriage was recognized as valid to one where it was not, what would be the effect under federal law post-*Windsor*? It may depend on the federal agency.
 - On August 29, 2013, IRS and Treasury announced adoption of “place of celebration” rule: same-sex couples who legally married in jurisdictions (domestic or foreign) that recognize their marriages will be treated as married for federal tax purposes regardless of where they reside or whether their state of residence treats their marriage as legal— this is a solution to the uncertainty that can arise from application of a “state of residence” rule in light of Section 2 of DOMA
 - Rev. Rul. 2013-17 issued concurrently with announcement formalizes the IRS position, applying it *prospectively* as of September 16, 2013 – the IRS stated its intention to issue further guidance on the *retroactive* application of *Windsor* to employee benefit plans and arrangements
 - The IRS ruling covers only marriages, not registered domestic partnerships or civil unions -- See also IRS FAQs on consequences of new rule for qualified plans - <http://www.irs.gov/uac/Answers-to-Frequently-Asked-Questions-for-Same-Sex-Married-Couples> (separate FAQs issued on civil unions/registered domestic partnerships - <http://www.irs.gov/uac/Answers-to-Frequently-Asked-Questions-for-Registered-Domestic-Partners-and-Individuals-in-Civil-Unions>)
 - Note that not all federal agencies have adopted a “place of celebration” rule – but this may change: U.S. Dept. of Labor (DOL) uses “state of residence” rule in its recently updated FMLA guidance but has not yet announced a post-*Windsor* position regarding employee benefit plans - in the absence of further DOL guidance, parallel ERISA provisions applicable to qualified plans such as 401(k) plans could be subject to inconsistent interpretation

DOMA: After *Windsor*, What's Next?

- Proliferation of post-DOMA cases
- First post-DOMA decision: *Cozen O'Connor, P.C. v Tobits, et al.* No. 11-0045 (E.D. Pa. 7/29/13) – complex and curious
 - Philadelphia-based law firm's employee who legally married her same-sex partner in Canada died while a resident of IL
 - Interpleader action brought to resolve competing claims under employer's tax-qualified profit sharing plan: same-sex spouse and named beneficiaries (deceased's parents) claimed account balance
 - DOMA was in effect when employee died but while case was pending, *Windsor* was decided
 - Court could have, but did not, look to PA law, which defines marriage as the union of one man and one woman (plan provided that PA law would apply unless preempted by ERISA)

DOMA: After *Windsor*, What's Next?

- *Cozen O'Connor, P.C. v Tobits (cont'd)*
 - Court instead looked to state of couple's residence (IL) and awarded account balance to same-sex spouse
 - Rationale: although IL does not permit or recognize same-sex marriage, IL recognizes same-sex civil unions
 - IL civil union statute (which was enacted *after* the decedent in this case had died) provides that same-sex marriage legally entered into in another jurisdiction shall be recognized in IL as a civil union
 - IL civil union statute's stated purpose is to provide parties to a civil union "with the obligations, responsibilities, protections and benefits afforded ... to spouses"
 - Although court did not apply a "place of celebration" rule, it effectively reached the same result
- The outcomes of other cases might be influenced by recent IRS guidance

DOMA: After *Windsor*, What's Next?

TAKE AWAYS

What should employers with 401(k) plans be doing?

- Keep an ear to the ground for new developments during this time of rapidly evolving guidance
- Review plan design and defined terms, particularly definition of “spouse” – while plans may eventually need to be amended, wait for further IRS and DOL guidance
- Consider the provisions of 401(k) and other tax-qualified plans that must be administered in accordance with the IRS “place of celebration” rule as failure to do so could violate tax-qualification requirements (*e.g.*, determining who is a spouse for purposes of consent and distribution requirements) – other provisions, such as QDRO rules, may still be subject to disparate state laws
- Consider communicating with employees and participants, instructing them about any change in plan administration concerning treatment of same-sex spouses – if individuals believe they have entered into a same-sex marriage that is legal in the jurisdiction where it was performed, their same-sex spouses should be listed as spouses in plan records
- Urge participants to file beneficiary designations (and review/update existing designations) rather than assume the plan’s default provisions will protect a same-sex spouse or otherwise will carry out the participant’s intent
- Consider requiring certification as to all marriages (requiring it solely for same-sex marriages could be discriminatory)

Fees and Expenses

ISSUES ARISING OUT OF REVENUE SHARING AND FLOAT

- Statutory and regulatory landscape
- Revenue sharing
- Float
- Take aways



Fees and Expenses: Issues Arising out of Revenue Sharing and Float

FIDUCIARY DUTIES

- General fiduciary duties under §404(a) of ERISA
 - Plan fiduciaries must discharge their duties solely in the interests of the plan and its participants and for the exclusive purpose of providing benefits to participants and beneficiaries and defraying reasonable expenses of administering the plan
 - Plan fiduciaries must act with the care, skill, prudence and diligence under the circumstances then prevailing and that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims
 - Plan fiduciaries must act in accordance with the plan's governing documents insofar as such documents are consistent with ERISA

Fees and Expenses: Issues Arising out of Revenue Sharing and Float

PROHIBITED TRANSACTIONS

- The prohibited transaction rules of §406 of ERISA provide that, unless an exemption is available, plan fiduciaries:
 - Are prohibited from causing the plan to enter into transactions that constitute furnishing goods, services or facilities between the plan and a “party in interest”
 - Are prohibited from causing the plan to engage in transactions that constitute transfers to, or use by (or for the benefit of), a “party in interest” of the plan’s assets
 - Are prohibited from dealing with the plan’s assets in their own interest or for their own account
 - May not act in any transaction involving the plan on behalf of a party whose interests are adverse to the interests of the plan
 - May not receive any consideration for his or her own personal account from any party dealing with the plan

Fees and Expenses: Issues Arising out of Revenue Sharing and Float

PLAN EXPENSES

- A plan sponsor's use of plan assets to pay impermissible expenses would give rise to fiduciary breach/prohibited transaction
- **Fiduciary duties:**
 - The expense must be expressly permitted by the plan's governing documents
 - A plan fiduciary must determine that the expense is a "reasonable expense" of administering the plan under the duty of prudence and the "exclusive benefit" rule

Fees and Expenses: Issues Arising out of Revenue Sharing and Float

PLAN EXPENSES *(cont'd)*

- **Prohibited transactions:**

- §§408(b)(2) and 408(c)(2) of ERISA provide exemptive relief from the prohibited transaction provisions of Section 406(a) of ERISA for the payment of expenses in connection with a service arrangement
- Per the regulations under §408(c)(2) of ERISA, the expense must be ***properly*** and ***actually incurred in the performance of duties for the plan*** and the expense must be a ***direct expense of the plan***
 - “properly incurred” – the expense must be permitted under plan documents
 - “actually incurred” – important to document and maintain invoices and other documentation relating to the expense
 - “in the performance for duties for the plan” – the expense must relate to plan administration and not “settlor” or other employer matters
 - “direct expense of the plan” – under the “but for” test, an expense is not direct to the extent it would have been sustained had the service not been provided or if it represents an allocable portion of overhead

Fees and Expenses: Issues Arising out of Revenue Sharing and Float

PLAN FEES

- Entering into a contract with a service provider and the payment of fees thereunder could give rise to a fiduciary breach/prohibited transaction unless an exemption applies
- **Fiduciary duties:**
 - The same fiduciary considerations apply to fees as to the payment plan expenses
 - In addition, plan fiduciaries have an obligation to prudently select and monitor service providers, understanding and taking into account their fees

Fees and Expenses: Issues Arising out of Revenue Sharing and Float

PLAN FEES (*cont'd*)

- **Prohibited transactions**
- § 408(b)(2) of ERISA provides exemptive relief in connection with the retention of a service provider provided that the service ***is necessary for the establishment of the plan***, is furnished ***under a contract or arrangement that is reasonable***, and is ***for no more than reasonable compensation***
 - “*necessary for the establishment of the plan*”– the service must be appropriate and helpful to the plan in carrying out purposes for which the plan is established/maintained
 - “*contract or arrangement that is reasonable*”– the contract must be terminable by the plan upon reasonably short-term notice under the circumstances
 - “*for no more than reasonable compensation*”
 - Plan fiduciaries must be able to demonstrate that the fees are reasonable relative to the market for the services provided
 - The DOL’s recent regulations require service providers to make fee disclosures that the DOL believes plan fiduciaries must consider in determining the “reasonableness” of fees

Fees and Expenses: Issues Arising out of Revenue Sharing and Float

FOCUS ON INDIRECT COMPENSATION

- Fiduciaries have a duty to understand and evaluate the reasonableness of direct and indirect compensation received by plan service providers
- Two types of “indirect” compensation are receiving increased attention:
 - Revenue sharing
 - Float

Fees and Expenses: Issues Arising out of Revenue Sharing and Float

REVENUE SHARING

- What is revenue sharing?
 - Payments that plan investment options (commonly mutual funds or their advisers) make to plan trustees, recordkeepers and other investment platform providers, including shareholder servicing fees, distribution and 12b-1 fees
- Types of arrangements:
 - All revenue sharing amounts are retained by the plan service provider as compensation
 - All revenue sharing amounts are retained by the plan service provider but the plan may receive credits
 - The plan is entitled to revenue sharing amounts that exceed the amount payable for recordkeeping and/or other specified services
 - The plan is entitled to all revenue sharing amounts
- When are revenue sharing payments “plan assets”?
 - *DOL Advisory Opinion 2013-03A* – “plan assets” are determined by applying ordinary notions of property rights to the specific arrangement

Fees and Expenses: Issues Arising out of Revenue Sharing and Float

REVENUE SHARING (*cont'd*)

- If the revenue sharing payment is a “plan asset,” the following additional considerations may apply:
 - How can revenue sharing payments received by the plan be used?
 - Credited to an unallocated plan account and used to pay ***expenses permissible under ERISA*** (e.g., recordkeeping, accounting, actuarial, legal, custodial, investment management) with the balance allocated to participant accounts
 - Credited directly to participant’s accounts
 - Allocation questions
 - Fiduciary considerations – prudence, acting “solely in the interest of participants” and acting in accordance with the plan documents
 - *Field Assistance Bulletin 2003-3* (relating to the allocation of plan expenses) – when the method of allocation is not set forth in the plan documents, at a minimum, prudence would require weighing the competing interests of various classes of participants and the effects of allocation methods on such interests
 - Pro rata or per capita
 - Consider taking into account whether a participant is invested in the fund that generated the credit

Fees and Expenses: Issues Arising out of Revenue Sharing and Float

REVENUE SHARING – OTHER CONSIDERATIONS

- Timing and accumulation of assets relating to revenue sharing
 - *IRS Revenue Ruling 80-155* – generally unallocated assets in the plan must be allocated by the end of the plan year in which they arise (see IRS publication at <http://www.irs.gov/Retirement-Plans/Fixing-Common-Plan-Mistakes---Improper-Forfeiture-Suspense-Accounts>)

Fees and Expenses: Issues Arising out of Revenue Sharing and Float

REVENUE SHARING – OTHER CONSIDERATIONS (*cont'd*)

- Prohibited transactions
 - Revenue sharing arrangements can give rise to kick-back and self-dealing concerns if the service provider is a fiduciary
 - *Advisory Opinion 97-16A* (Aetna) – the receipt of 12b-1 fees by recordkeeper does not violate § 406(b)(3) of ERISA because the recordkeeper is not a fiduciary with respect to plan investments
 - *Advisory Opinion 97-15A* (Frost) – trustee's receipt of 12b-1 fees that were fully disclosed and applied to offset plan-level fees to trustee does not violate § 406(b)(1) or § 406(b)(3) of ERISA even if trustee is a fiduciary with respect to plan investments
- Overall reasonableness of compensation
 - Evaluate whether total compensation (taking into account revenue sharing) is reasonable for services provided

Fees and Expenses: Issues Arising out of Revenue Sharing and Float

REVENUE SHARING – OTHER CONSIDERATIONS (*cont'd*)

- Prudence

- *Tibble v. Edison Int'l*, Nos. 10-56406, 10-56415, 2013 WL 3947717 (9th Cir., Aug. 1, 2013)
 - The decision to include retail share classes that generated revenue sharing (instead of institutional share classes with lower fees) was imprudent
- *Tussey v. ABB, Inc.*, No. 2:06–CV–04305–NKL, 2012 WL 5512389 (W. Dist. Mo. Nov. 14, 2012)
 - Plan sponsor was imprudent when it failed to engage in a deliberative process for determining if selection of higher cost funds as a means to pay plan expenses was prudent and in the best interest of the participants

Fees and Expenses: Issues Arising out of Revenue Sharing and Float

REVENUE SHARING – OTHER CONSIDERATIONS (*cont'd*)

- Disclosure obligations
 - §404(a) Disclosures
 - The fact that administrative expenses are paid for with revenue sharing credits does not necessarily preclude the need to disclose such expenses to participants (see *Field Assistance Bulletin 2012-02R*, Question 6)
 - Form 5500 Schedule C
 - Indirect compensation received by service providers through revenue sharing payments included in total reportable compensation

Fees and Expenses: Issues Arising out of Revenue Sharing and Float

FLOAT

- What is float?
 - “Float” is revenue earned by trustees/custodians on funds in transition that are uninvested
 - Float is typically generated:
 - Pending allocation of contributions to investment options on behalf of participant accounts
 - When money is deducted from the plan to pay expenses or to make distributions
 - If there is a settlement gap, when a participant transfers from one investment option to another investment option
- Types of arrangements:
 - Float is retained by the trustee or custodian as compensation
 - The plan maintains checking and cash sweep arrangements to minimize float and maximize plan earnings

Fees and Expenses: Issues Arising out of Revenue Sharing and Float

FLOAT (*cont'd*)

- Is float a plan asset?
 - *DOL Advisory Opinion 93-24A*
 - Float should be regarded by plan fiduciaries and service providers as part of the compensation paid by the plan for services to the plan
 - *Tussey v. ABB, Inc.*, No. 2:06–CV–04305–NKL, 2012 WL 5512389 (W. Dist. Mo. Nov. 14, 2012)
 - Trustee violated fiduciary duties by failing to distribute float income solely for the interest of the plan (trustee transferred float income to investment options instead of the plan)

Fees and Expenses: Issues Arising out of Revenue Sharing and Float

FLOAT – OTHER CONSIDERATIONS

- Prohibited transactions
 - *Field Assistance Bulletin 2002-3* – A fiduciary service provider's exercise of discretion to earn income for its own account from float will give rise to prohibited self-dealing. If a fiduciary service provider has *openly negotiated* with an independent plan fiduciary the right to retain float as part of its overall compensation, then the retention of float would not be prohibited self-dealing.
- Reasonableness of compensation
 - Evaluate whether total compensation (taking into account float) is reasonable for services provided

Fees and Expenses: Issues Arising out of Revenue Sharing and Float

FLOAT – OTHER CONSIDERATIONS *(cont'd)*

- Prudence – plan fiduciaries must carefully review circumstances that trigger float
 - In the case of float on cash pending investment, plan fiduciaries should ensure their agreements impose time limits within which contributions must be invested
 - In the case of float on amounts disbursed, plan fiduciaries should monitor reports to ensure that checks do not remain outstanding for an unreasonably long period of time

Fees and Expenses: Issues Arising out of Revenue Sharing and Float

FLOAT – OTHER CONSIDERATIONS *(cont'd)*

- Disclosure obligations
 - § 404(a) Disclosures
 - Float received by trustee/custodian is not typically part of administrative costs that need to be disclosed but should be evaluated on a case-by-case basis
 - Form 5500 Schedule C
 - Float income is specifically listed as a form of indirect compensation in the Schedule C instructions

Fees and Expenses: Issues Arising out of Revenue Sharing and Float

TAKE AWAYS

Entering Into New Contracts and Selecting Investment Options

- When requesting bids, collect all information about direct and indirect compensation
- Establish an objective process for new contracts – review all direct and indirect compensation and expenses of bidding service providers and how they relate to the services to be provided and the investments being considered
- The RFP process is the best time to negotiate revenue sharing/float arrangements and to ask for delivery of reports/data, etc.
- Make sure that the contract requires the service provider to deliver reports/information you need to assess and monitor direct and indirect compensation going forward
- The timing of any reports should fit within your internal review and disclosure schedules so that the information is helpful

Fees and Expenses: Issues Arising out of Revenue Sharing and Float

TAKE AWAYS

Ongoing Monitoring of Existing Contracts and Investment Options

- Establish an objective process for monitoring existing arrangements
- Review fees and expenses and how they relate to the services being provided
- Consider designating an annual review period
- Consider conducting periodic RFPs for plan service providers to gather relevant market data
- Consider engaging consultants to provide benchmarking services
- Review third-party data reflecting industry standards
- Consider whether service arrangements should be modified or amended to reduce revenue sharing or float generated
- Consider whether investment options should be changed to less expensive options



Correction Programs

CORRECTING 401(k) PLAN MISTAKES

- Overview of significant programs
- IRS EPCRS
- DOL VFCP
- Examples
- Take aways

Correcting 401(k) Plan Mistakes

- General overview of significant programs for correction of tax-qualified plans, including 401(k) plans
 - Internal Revenue Service (IRS) Employee Plans Compliance Resolution System (EPCRS)
 - Comprehensive system for correction of tax-qualified plan failures that permits plans to retain their tax-qualified status
 - Correction generally must put plan and participants in position in which they would have been, had failure not occurred
 - System designed to minimize costs to plan sponsor in order to provide incentives for prompt, voluntary identification and correction of errors
 - Department of Labor (DOL) Voluntary Fiduciary Correction Program (VFCP)
 - Program for voluntary correction of certain ERISA fiduciary violations
 - Provides descriptions of 19 categories of transactions and acceptable methods of correction

Correcting 401(k) Plan Mistakes

- Why Use Voluntary Correction Programs?
 - Much lower costs than if errors identified by IRS or DOL on audit
 - Audit: Errors identified by IRS may subject Plan Sponsor to taxes and penalties of Maximum Payment Amount (the amount the IRS could collect upon plan disqualification); additional fees imposed by DOL for fiduciary violations
 - Limited fees
 - No fees for correction using DOL VFPC
 - No fees for IRS EPCRS Self-Correction Program (SCP)
 - Fees for IRS EPCRS Voluntary Correction Program (VCP) set by plan size, not severity or number of errors: between \$750 (20 or fewer plan participants) and \$25,000 (more than 10,000 plan participants)
 - Even fees for correction of egregious or intentional failures corrected through IRS EPCRS VCP are limited to negotiated amount that can be no more than 40% of Maximum Payment Amount

Correcting 401(k) Plan Mistakes

- IRS EPCRS

- IRS guidance updated in early 2013 by IRS Revenue Procedure 2013-12 (see chart of significant changes from prior guidance in Revenue Procedure 2008-50, at http://www.irs.gov/pub/irs-tege/rp13_12_changes_chart.pdf)
- Program continues to be very similar to program under IRS Revenue Procedure 2008-50
- Cornerstone of program continues to be the voluntary identification and correction of errors by plan sponsor in accordance with program guidelines
 - Certain corrections require formal submission to IRS and payment of fixed fee
 - Fees and sanctions designed to encourage prompt correction of mistakes
- Also covers correction of errors identified by IRS in audit with imposition of penalties
- Provides for modifications formalizing VCP submission procedures, including requiring submission of new forms 8950 and 8952, and adds model VCP submission documents in Appendix C
- Also includes updates reflecting changes in law and various clarifications:
 - Determination of earnings for distributions and allocations for correction of operational errors
 - Meaning of “good faith amendment,” “interim amendment,” and “optional law changes” for correction of plan document failures

Correcting 401(k) Plan Mistakes

- What can be corrected in EPCRS: qualification failures
 - Most common
 - Plan Document Failures: failure to update plan document (required and discretionary changes)
 - Operational Failures: failure to operate plan in accordance with its terms
 - Less common
 - Demographic Failures
 - Employer Eligibility Failures

Correcting 401(k) Plan Mistakes

- Basic components of EPCRS
 - Self-Correction Program (SCP)
 - Available only for certain operational failures
 - Generally available only if the plan is the subject of a current favorable determination letter
 - Available even if plan (or plan sponsor, if tax-exempt sponsor) is under examination, but only as to “insignificant” failures
 - Available for “significant” failures only if corrected by end of second year following year of failure
 - No IRS submission or approval required
 - No sanctions or fees
 - Correction by plan amendment generally not available – limited exceptions
 - Factors for determining significance include (i) whether other failures occurred during relevant period; (ii) percentage of plan assets and contributions involved in failure; (iii) number of years failure occurred; (iv) number of affected participants relative to total number of participants; (v) number of affected participants relative to number who could have been affected; (vi) whether correction was made within reasonable period after discovery of failure; and (vii) reason for failure (*e.g.*, data errors, transposition of numbers, minor arithmetic errors)

Correcting 401(k) Plan Mistakes

- Basic components of EPCRS (*cont'd*)
 - Voluntary Correction Program (VCP)
 - Available for all qualification failures
 - Limited fee, based on size of plan (number of participants)
 - Requires IRS approval: description of failure and correction (or proposed correction) submitted to IRS and upon approval, IRS issues compliance statement
 - Only available if plan (or plan sponsor, if tax-exempt sponsor) is not under examination by IRS
 - In limited circumstances, can flag potential issue for IRS in determination letter application and reserve right to enter VCP

Correcting 401(k) Plan Mistakes

- Basic components of EPCRS (*cont'd*)
 - Audit Closing Agreement Program (Audit CAP)
 - Failure identified during IRS audit (other than a failure corrected through SCP or VCP)
 - Sanctions imposed by IRS intended to bear a reasonable relationship to the nature, severity and extent of the failure, taking into account extent to which correction occurred before audit
 - Failure to amend the plan to comply with statutory requirements within applicable remedial amendment period (a “nonamender failure”) is subject to a specified Audit Cap fee based on number of plan participants and statutory provisions to which amendment failure relates

Correcting 401(k) Plan Mistakes

- Effect of plan or plan sponsor being “under examination” on availability of SCP and VCP and correction methods
 - Correction of insignificant failures discovered by plan sponsor under SCP is generally available if the plan (or tax-exempt plan sponsor) is under examination
 - Correction of significant failures under SCP is not available if the plan (or tax-exempt plan sponsor) is under examination, except that corrections that are substantially complete before the plan (or tax-exempt plan sponsor) come under examination may be completed
 - VCP is not available if the plan (or tax-exempt plan sponsor) is under examination

Correcting 401(k) Plan Mistakes

- What it means to be “under examination”
 - The plan is under an IRS “Employee Plans” examination (*e.g.*, an audit of the Form 5500 for a plan year), including a plan for which the plan sponsor or other plan representative has received verbal or written notice from Employee Plans of an impending examination;
 - The plan is under investigation by the IRS Criminal Investigation Division; or
 - A plan sponsor that is a tax-exempt entity is under an Exempt Organizations examination (*e.g.*, an examination of a Form 990 series)
 - A plan is also under examination:
 - If the IRS has notified the plan sponsor that failures have been identified in the course of reviewing a determination letter application; or
 - If the plan is aggregated for certain compliance purposes* with a plan that is under examination

* For example, for purposes of satisfying Code §401(a)(4) nondiscrimination or §410(b) minimum coverage requirements

Correcting 401(k) Plan Mistakes

- Availability of plan amendment as correction method
 - Corrective plan amendment must otherwise satisfy tax-qualification requirements, including Code §411(d)(6) anti-cutback rules
 - IRS generally does not favor scrivener's error as justifying retroactive amendment
 - Available under VCP and Audit Cap for correction of plan document failures (including nonamender failures), operational failures and demographic failures; generally requires determination letter application to be submitted with the VCP application
 - Available under SCP for correction of operational failures in only very limited circumstances:
 - Maximum compensation failures (*i.e.*, contributions made on compensation in excess of the applicable dollar limit)
 - Hardship withdrawals and loans made under plan that did not provide for them
 - Early inclusion of otherwise eligible employee

Correcting 401(k) Plan Mistakes

- DOL Voluntary Fiduciary Correction Program (VFCP)
 - Program to permit correction of specified fiduciary violations under ERISA
 - No fees or penalties required, but excise taxes due unless waiver applies as a result of complying with additional requirements that include notification of participants
 - Two most common 401(k) plan fiduciary violations correctible through VFCP (in addition to correction by EPCRS):
 - Delinquent remittance of participant contributions to plan trust
 - Correction of participant loan failures
 - Actual practice with respect to correction may vary

Correcting 401(k) Plan Mistakes

- DOL Voluntary Fiduciary Correction Program (VFCP) (*cont'd*)
 - Also covered by VFCP but not the subject of this presentation:
 - Plan loans to parties in interest (non-participant loans)
 - Purchase or sale of a plan asset to a party in interest
 - Payment of benefits without proper valuation of plan assets on which payment based
 - Mistakes in payment of plan expenses from plan assets

Correcting 401(k) Plan Mistakes

- Examples of 401(k) plan errors and correction
 - Operational failures
 - Late 401(k) elective deferral contributions
 - Correction under SCP or VCP of IRS EPCRS, depending on scope of mistake and program eligibility: employer makes contribution to plan with earnings
 - Correction under DOL VFCP: employer makes contribution to plan with earnings
 - Calculation of earnings: DOL calculator versus other methods
 - Improper exclusion of employees eligible to make 401(k) elective deferrals and to receive match
 - General correction rules: employer contributes 50% of missed deferral, based on ADP for employee's group (*e.g.*, NHCE or HCE, as applicable), adjusted for earnings – and employer contributes 100% of missed match
 - Special rule if correction occurs early in year
 - Special rules for safe harbor plans

Correcting 401(k) Plan Mistakes

- Examples of 401(k) plan errors and correction
 - Operational failures (*cont'd*)
 - Auto-enrollment failures
 - Failure to give materials: employer contributes 50% of missed deferral, based on ADP for employee's group (*e.g.*, NHCE or HCE, as applicable), adjusted for earnings – and employer contributes 100% of missed match
 - Failure to implement auto-enrollment after providing participant materials: employer contributes 50% of missed deferral, based on auto enrollment %, adjusted for earnings – and employer contributes 100% of missed match

Correcting 401(k) Plan Mistakes

- Examples of 401(k) plan errors and correction
 - Operational failures (*cont'd*)
 - Overpayment of wages resulting in elective deferral contributions and matching contributions
 - Whether operational failure has occurred in plan generally depends on how overpayment is characterized (*e.g.*, category of compensation that is/is not subject to deferrals) and if/how overpayment is recouped
- Failure to suspend elective deferrals for 6 months following hardship withdrawal
 - Current taxable distribution of deferrals that should have been suspended, adjusted for earnings. If applicable, employee must also forfeit any matching contributions associated with such deferrals.

Correcting 401(k) Plan Mistakes

- Examples of 401(k) plan errors and correction
 - Operational failures (*cont'd*)
 - Plan loan failures – correction permitted only if maximum payment period has not been exceeded
 - Loans that exceed maximum dollar amount; correct by repayment of excess to plan
 - Loans with payment schedule that fails to meet time limit or level amortization requirement; correct by reamortization over correct period and in level amount
 - Defaulted loans due to failure to pay; correct by (i) repayment in lump sum, (ii) reamortization, or (iii) combination of (i) and (ii)
 - IRS EPCRS correction permitted only through VCP or Audit CAP (not SCP)
 - DOL VFCP correction permitted, with only minimal documentation required: proof of payment and copy of IRS compliance statement

Correcting 401(k) Plan Mistakes

- Examples of 401(k) plan errors and correction
 - Plan document failures
 - Nonamender failure (*i.e.*, failure to timely adopt amendments reflecting required changes)
 - Failure to timely amend plan to reflect discretionary changes
 - Correction: adopt corrective amendment, generally subject to IRS approval (some limited exceptions apply)

Correcting 401(k) Plan Mistakes

TAKE AWAYS

Be familiar with, and use IRS/DOL correction programs

- When operational and document failures are discovered, investigate facts thoroughly and make correction, looking to IRS and DOL programs for guidance as to appropriate correction methods
- Determine whether IRS and/or DOL correction programs are available and use available program(s) accordingly – for example, determine whether IRS VCP submission may be made
- Consider whether any other disclosure is required apart from participation in voluntary correction program – for example, disclosure of late deposit of employee elective deferrals is required on Form 5500 and depending on nature of operational violation (*e.g.*, late deposit of deferrals or required minimum distribution failure), excise tax payment/filing may be required (further note, however, that excise taxes may be abated by use of IRS/DOL program(s))

**THANK
YOU!**



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