SIMPLE FIXES FOR YOUR 401(k) PLAN

(With a Short Update on 403(b) Issues)

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I. INTRODUCTION

The following materials describe ways in which a tax practitioner can correct errors in the operation and/or documentation of 401(k) and other retirement savings plan and preserve their tax-qualified status, using programs and procedures set forth by the Internal Revenue Service and the Department of Labor. Generally these programs require business owners to bear only the cost of correction (e.g., making corrective contributions to the plan), related legal and accounting costs, and, in some cases, program application fees. This represents very significant savings over potential costs in the event an error is discovered on audit. Generally the correction programs are available only to plans and sponsors that are not "under investigation" which generally means they have not been notified by IRS or DOL of a planned audit. The materials also touch on new plan documentation and reporting compliance duties facing sponsors of Section 403(b) plans.

II. THE CORRECTION PROGRAMS

A. EPCRS.

1. **What is It?** The Employee Plans Compliance Resolution System (EPCRS) is a comprehensive system of integrated correction programs that plan sponsors may use to correct eligible "qualification failures" and to continue providing their employees

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with retirement benefits on a tax-favored basis. First introduced by the IRS in 1998, it is currently set forth in Revenue Procedure 2008-50, 2008-35 IRB 464 and periodically updated (in new Revenue Procedures).

2. **Qualification Failure:** Any failure that adversely affects the tax-sanctioned status of a qualified plan, a Section 403(b) plan, a SEP, or a SIMPLE IRA of an employer. EPCRS collectively refers to these as "retirement plans." The four types of qualification failures are:

   a) Plan document failures, such as failure timely to amend for EGTRRA.

   b) Operational failures, including failure to follow the terms of the plan as written, such as eligibility provisions or definition of compensation.

   c) Demographic failures, i.e. failure to meet nondiscrimination, minimum participation, or coverage rules.

   d) Employer eligibility failures, such as an employer with more than 100 employees sponsoring a SIMPLE IRA plan. Self Correction Program is not available to correct these types of failures.

3. **EPCRS Consists of Three Sub-Programs**:

   a) **Self Correction Program (SCP):** Employers and/or plan administrators identify and correct problems without the involvement of the IRS. There is no cost other than that of the correction, and preparation of a Self Correction Memo. SCP is available to correct "significant" errors within 2 years of occurrence, or "insignificant" errors at any time, including during audit.

      (1) Must have a current "favorable letter" i.e., a determination letter for an individually designed plan, or favorable opinion or notification letter for a prototype document.

      (2) Must have written "practices and procedures" for plan administration in place prior to the error.

      (3) Whether a plan error is "significant" or "insignificant" depends upon a number of factors including dollar amount involved, versus total plan assets, and number of participants affected, versus total plan participants.

   b) **Voluntary Compliance Program (VCP):** Employers and/or plan administrators submit their proposed or completed

corrections to the IRS for IRS approval, along with payment of a VCP fee scaled to size of plan (number of participants). Once approved, employers have written assurance that the method of correction is approved by the IRS.

(1) No favorable letter or "practices and procedures" requirement.

c) Audit Closing Agreement Program (CAP): This is essentially IRS supervised correction in the course of a plan audit. Employers and/or plan administrators correct qualification errors identified on audit and pay a sanction based on the nature, extent, and severity of the failure.

B. VFCP.

1. **What is It?** The Voluntary Fiduciary Correction Program (VFCP) is a voluntary program for disclosing and correcting certain prohibited transactions (PTs) without assessment of civil penalties under ERISA; it also provides limited relief from excise taxes resulting from same. It is set forth at 71 Fed. Reg. 75, 20262–20285, *amended at* 71 Fed. Reg. 75, 20135-20139. VFCP allows correction of 19 separate types of prohibited transactions, but over 90% of VFCP applications relate to late deposit of 401(k) deferrals and plan loan payments.
2. **Eligibility:** An applicant must meet three criteria in order to participate in the VFCP: (a) neither the plan nor the applicant is "under investigation" (e.g., IRS or DOL audit); (b) there is no evidence of potential criminal violations, as determined by the Employee Benefits Security Administration (EBSA), and (c) EBSA has not conducted an investigation which resulted in written notice to a plan fiduciary that the transaction has been referred to the IRS.
3. **Fees:** Submission of an application carries no fee other than legal or accounting costs to prepare the application; properly filed applications result in issuance of a "no action" letter from the DOL with regard to the PTs that are described; under some circumstances it is not necessary to file an excise tax return if excise taxes are under $100 and are paid to the plan.

C. DFVC.

1. **What is It?** The Delinquent Filer Voluntary Compliance (DFVC) Program is designed to encourage voluntary compliance with the annual reporting requirements under ERISA. The DFVC Notice was published in the Federal Register on March 28, 2002 (67 Fed. Reg. 60, Preamble at 15052, Notice at 15058). The program gives

delinquent plan administrators a way to avoid potentially higher civil penalty assessments by satisfying the program's requirements and voluntarily paying a reduced penalty amount. The acceptance of a filing and receipt of penalty payments does not represent a determination by the DOL as to the status or type of plan.

2. **Fees:** Failing timely to file Form 5500 can result in penalties of up to $1,100 per day. Under DFVC the daily penalty is reduced to $10 per day with the following maximums:

   a) Single Delinquent Return: $750 for a small plan (generally, a plan with fewer than 100 participants at the beginning of the plan year) and $2,000 for a large plan.

   b) Multiple Delinquent Returns: $1,500 for a small plan and $4,000 for a large plan.

   c) Small Non-Profit Plan: $750

   d) Top-Hat Deferred Compensation Plans: $750

   e) There is no per administrator or per sponsor cap. If the same company sponsors several benefits that each are subject to reporting requirements (e.g, group term life, LTD, STD, medical, dental, etc.), submitting under DFVC as a "wrapped" welfare benefit plan is a permissible strategy.

3. **Eligibility:** DFVC is limited to plan administrators with filing obligations under Title I of ERISA who comply with the provisions of the program and who have not been notified in writing by the DOL of a failure to file a timely annual report under Title I of ERISA. Form 5500-EZ filers and Form 5500 filers for plans without employees (as described in 29 CFR 2510.3-3(b) and (c)) are not eligible to participate in the DFVC Program because such plans are not subject to Title I.

D. Program Consolidation Efforts. Industry leaders, including ASPAA, are lobbying the IRS and DOL to permit self-correction under VFCP and/or to link VFCP with EPCRS to allow "one stop shopping" for plan sponsors. This would be a desirable development but may not be likely to occur due to each respective agency's protection of its regulatory "turf."

III. SIMPLE FIXES FOR THE MOST COMMON PLAN ERRORS

A. Late Deposit of Salary Deferrals/Loan Repayments. Failure to timely deposit these amounts is a prohibited transaction because the employer is effectively "borrowing" plan assets. Any late deposits

must be disclosed on the Form 5500 annual plan return/report (Schedule H or I, line item 4(a)), thus the error will not escape the attention of the Department of Labor, which has dedicated substantial resources to policing this aspect of plan compliance.

B. What is "Late"?

a) **Large Plans – 100 or More Participants.** Employee salary deferrals and loan repayments become "plan assets" under ERISA and must be deposited in the 401(k) plan (or IRA) as soon as they can reasonably be segregated from the employer's general assets, but no later than the 15th business day of the month following the month in which employee contributions are withheld from the employee's pay. DOL Reg. § 2510.3-102(a). The 15th business day rule is **not** a safe harbor.

b) **Small Plans – Safe Harbor.** In February 2008 the DOL proposed a seven-business-day "safe harbor" in which to deposit participant contributions and loan repayments under "small" pension or welfare benefit plans (fewer than 100 participants). Final regulations were issued on January 14, 2010 (75 Fed. Reg. 2068). Under the safe harbor, participant contributions, including salary deferrals, that are deposited in a plan account within the 7 business day period will be deemed to have satisfied the "earliest date of segregation" requirement under the plan asset regulations. Plans with 100 or more participants remain subject to the "as soon as reasonably segregated" standard without benefit of the safe harbor.

2. **Using VFCP to Correct.** Correction includes the following steps:

a) **Identify late deposits**. "Late" will mean outside the 7-day safe harbor (for small plans), or longer than "earliest (reasonable) date of segregation" for large plans. This is also the "loss date" for purposes of the DOL Online Calculator.

b) **Calculate earnings with the DOL Online Calculator**. For each payroll period that included late deposits, enter in the "principal" box the total amount that was deposited late, input the "loss date," the "recovery date" (the date you actually made the deposit), and the "final payment date" which is the date you will deposit the earnings the computer calculates. This requires some guesswork as to when you can make the deposit. Note: you must print out the page with the final calculations; the calculations are NOT saved online.

c) **Obtain proof of deposit of the earnings.**

d) **Complete the VFCP application and submit to the DOL with a copy of the earnings calculation and proof of the deposit.** Generally I also submit a spreadsheet showing the payroll periods involved, and the amount of the late deposits per payroll period. These numbers must "tie out" with the online calculator entries.

e) **Calculate excise taxes (Form 5330) for the year(s) involved.** Under Prohibited Transaction Exemption 2002-51, if the total excise tax (including all years) is less than or equal to $100, you do not need to notify plan participants of the prohibited transaction and can instead either contribute the calculated amount of taxes to the plan, or file the returns and pay the taxes to the IRS. Even if the excise taxes exceed $100 if you pay them and provide proof to the DOL of payment (cancelled checks) and of filing the excise tax returns, the DOL will not forward the delinquency issue on to the IRS but will close the matter out completely.

f) **Save a copy of the application, the no action letter when received, and excise tax returns and cancelled checks.**

C. Exclusion of Eligible Employees

1. **Failure to Offer or Implement Enrollment.** The proper correction is to make contributions equal to 50% of the ADP for the applicable group for the year involved (the "missed deferral opportunity cost"), or, if the employee made a deferral election that was not implemented, 50% of the rate the employee elected. Matching contributions must be replaced at 100% of whatever the matching formula was for the period involved. Earnings must be calculated and contributed. Prime plus 2% is an acceptable rate and is much easier to use that "actual" earnings with your investment provider/TPA will offer to calculate (usually charging an hourly rate for such use) or the highest rate of earnings among all investment options available for selection, which often is realized by "outlier" funds that few participants select.

2. **Using EPCRS to Correct.** Self—correction may be available if "significant" and within the 2-year period, or insignificant. If a plan has erroneously excluded a whole class of employees for multiple plan years, VCP is the best approach.

D. "Slippage" in Definition of Compensation

1. **Failure to Quality Check Payroll vs. Plan Definition.** Generally what happens is that payroll is not set up properly so that discrete

pay codes (such as overtime or shift differentials) are excluded from compensation used as a basis for salary deferrals and other plan contributions.

2. **Using EPCRS to Correct.** Self—correction may be available depending on timing, amount involved, and number of participants effected. Usually these errors affect non-highly compensated employees. The proper correction is to calculate what should have gone into the plan out of the excluded pay items (i.e., additional deferral and matching contributions), and contribute that amount, plus earnings, to the plan.

E. **Nondiscrimination Testing Problems**

1. **ADP/ACP Failure –** No Correction Within 12-Month Period

2. **Using EPCRS to Correct.** Two-year SCP period runs from the end of the 12-month correction period. Make QNECs to non-highly compensated employees or use "one to one" correction method (reallocation from HCEs to non-highlys). Calculate and contribute earnings on one to one correction amounts.

F. **Errors Specific to SEP and SARSEPs:** See Rev. Proc. 2008-50, Appendix F, Schedule 3.

G. **Errors Specific to SIMPLE IRAs:** See Rev. Proc. 2008-50, Appendix F, Schedule 4

IV. SHORT-CUT SELF-AUDIT: IRS CHECKLISTS

The IRS maintains online "Check-Up" checklists for 401(k) plans, SEPs, and other simplified plans. The checklists consist of a series of questions aimed at disclosing the top ten plan errors. Each question on the Check-Up checklist corresponds to correction guidance in IRS "Fix-It Guides," also posted online, that in turn walk through the appropriate EPCRS procedures, or link to VFCP information in the case of late deposit of deferrals. Employers or their advisors can perform a quick self-audit by filling out the appropriate Check-Up checklist and following instructions in the Fix-It guides on any checklist item with which it is not in compliance. The Check-Up checklists are found here: http://www.irs.gov/retirement/article/0,,id=117534,00.html (visited May 4, 2010).

V. UPDATE ON 403(b) ISSUES

A. **Final Regulations:** Final regulations under IRC § 403(b) went into effect for plan years beginning on or after December 31, 2008. The

previous 403(b) regulations were issued in 1964. The new regulations made a number of changes to the 403(b) landscape.

1. **Plan Document:** Old rule: no document requirement. New rule: 403(b) plans must be set forth in writing by December 31, 2009.
   - **a)** Model Language: The IRS has drafted model plan language that is located here: http://www.irs.gov/pub/irs-tege/draft_lrm_403b_prototypes.pdf. This language replaces earlier model language that was specific to public schools.
   - **b)** Determination Letter Program: no pre-approved or determination letter program is in existence. However in Announcement 2009-34 they did outline a prototype approval program that will be put into place sooner rather than later.
   - **c)** The DOL has clarified that the mere existence of a written plan does not make a non-ERISA 403(b) plan subject to ERISA.
2. **Investment Vendors:** Old rule: multiple annuity/account vendors; employees responsible for obeying dollar limits. New rule: vendor consolidation; employers are responsible for monitoring dollar limit compliance.
3. **Form 5500 Reporting:** Old rule: limited Form 5500 reporting for ERISA 403(b) plans, no independent audit. New rule: Effective January 1, 2009, full Form 5500 reporting for ERISA 403(b) plans and independent audit required for large plans.

B. Form 5500 Reporting Issues

1. **Orphan Annuity/Accounts:**
   - **a)** Problem: employer either cannot identify/locate contract/account, or costs of doing so would be prohibitive. This could result in incomplete Form 5500 reporting and/or an adverse, qualified or disclaimer opinion by the independent auditor.
   - **b)** Solution: Transition reporting relief in Dept. of Labor FAB 2009-2 for 403(b) contracts or accounts that meet each of the following requirements:
     - **(1)** The contract (or account) was issued to a current or former employee before January 1, 2009;
     - **(2)** The employer ceased to have any obligation to make contributions (including forwarding salary reduction contributions) to the contract or account and in fact stopped making contributions before January 1, 2009;

- **(3)** All the rights under the contract or account are legally enforceable against the insurer or custodian by the individual owner of the contract or account without any involvement by the employer (this may include individual certificates under a group annuity contract); and
- **(4)** The individual owner of the contract or account is fully vested in the contract/account.

c) **Scope of Relief:**

- **(1)** "Pre-2009 contracts or accounts" meeting all these requirements need not be accounted for as plan assets on Form 5500.
- **(2)** Also, participants who are invested solely in one or more pre-2009 contract(s) and who are no longer eligible to make salary deferrals need not be counted to determine whether or not the plan is a large plan for purposes of the independent audit.
- **(3)** Lastly, qualified, adverse or disclaimed auditor's opinion will not result in rejection of the Form 5500 if the negative opinion is limited to pre-2009 contract issues.

d) **Further Relief: FAB 2010-1 answers some of the many questions raised by FAB 2009-2:**

- **(1)** Does reporting relief apply prospectively? Yes. The relief set forth in 2009-2 applies to 2009 reporting requirements and to subsequent years. It also applies to 403(b) plans of any size.
- **(2)** What kind of employer involvement with the contract/account **will** result in the employer having to include the contract/account in Form 5500 reporting?
  - **(a)** Employer must consent to or makes discretionary decisions regarding enforcement of employee rights under the contract.
  - **(b)** Employer must pre-approve employee's eligibility for a distribution, including hardship distributions or loans from the contract or account.
  - **(c)** Employer transmits loan repayments to the contract or account provider.
  - **(d)** Employee exchanges a pre-2009 contract or account for a new one after January 1, 2009, if the plan

administrator's authorization or approval of the exchange is required, even for tax compliance purposes.

(3) What kind of employer involvement with the contract/account **won't** result in the employer having to include the contract/account in Form 5500 reporting if it otherwise satisfies pre-2009 requirements?

- **(a)** Employer provides factual information to the provider on the contract owner's employment status.

(4) Other reporting guidance:

- **(a)** An employer may exclude a contract/account that meets pre-2009 requirements, even if the contract or account is known to the employer and can be identified.
- **(b)** An employer may voluntarily include, in Form 5500 reporting, some pre-2009 contracts or accounts even if they meet the relief requirements.
- **(c)** IQPAs who determine that a contract/account incorrectly was excluded from Form 5500 reporting must bring this to the attention of the plan administrator and plan administrator must take reasonable steps to resolve any questions.
- **(d)** Relief includes contracts or accounts to which an employer made final 2008 contributions that physically occurred on or after January 1, 2009.

(5) Guidance on "safe harbor" for non-ERISA 403(b) plans under 29 CFR §2510.3-2(f):

- **(a)** Contracts/accounts that permit loans that are not subject to employer discretion do not defeat safe harbor; employer may prohibit use of such contracts/accounts, however.
- **(b)** Employer use of a third party administrator to make discretionary decisions (e.g., re loans) would defeat safe harbor.
- **(c)** Safe harbor arrangement must offer participants a reasonable choice of both 403(b) providers and investment products. However employers with very small plans may be able to limit provider to one where it can be shown that administrative burdens and costs of multiple providers are excessive, and where

employee can transfer or exchange their account to another provider.

(d) Safe harbor plan cannot give the employer discretion to change 403(b) providers and unilaterally move employee funds from one provider to another.