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is presented by Spencer Fane Britt & Browne LLP
in conjunction with United Benefit Advisors

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Best Practices for 401(k) Plan Sponsors

Presented by:

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October 11, 2011

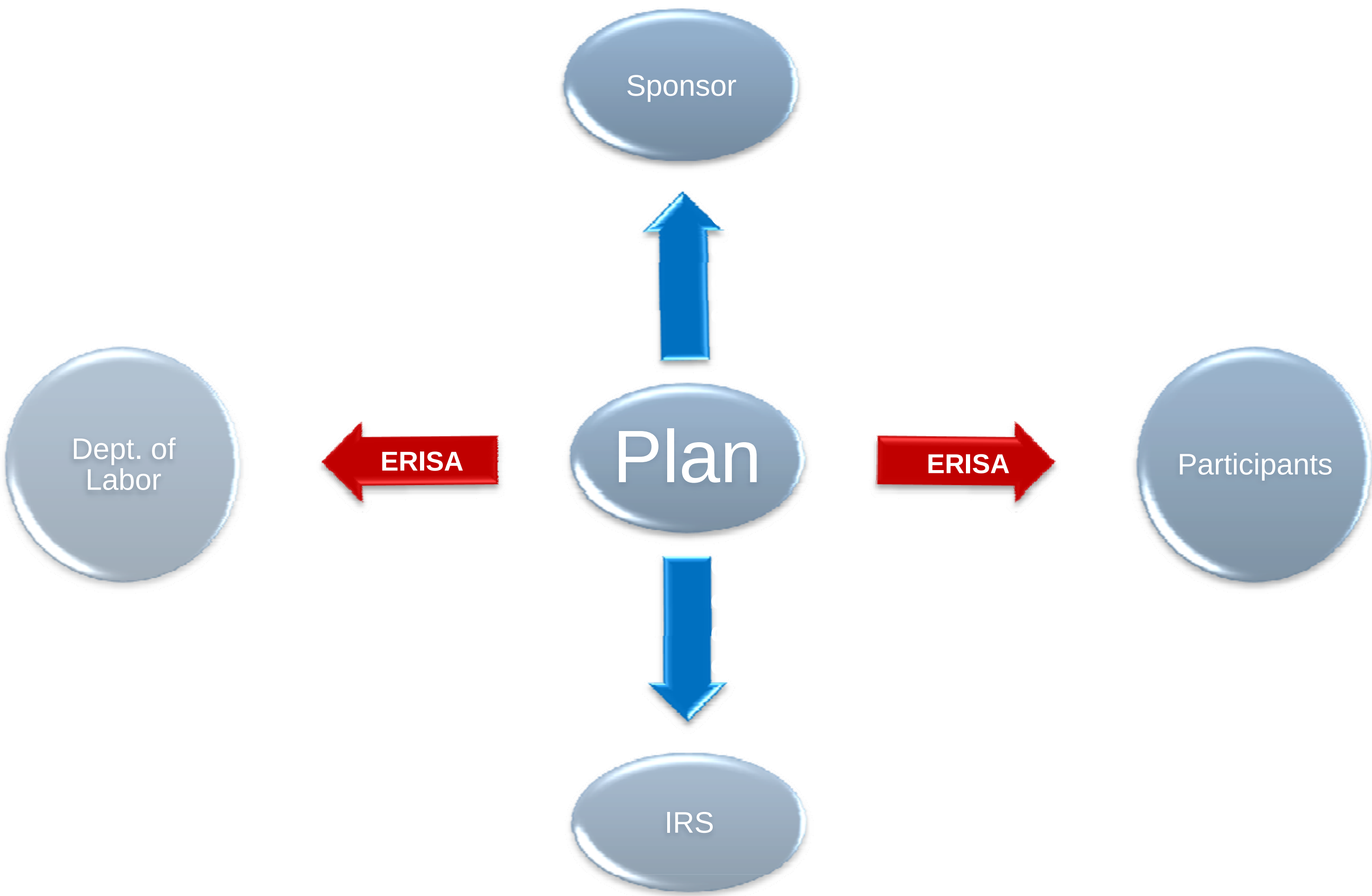
Agenda

- ERISA fiduciary risk – 401(k)/403(b) plans
- Tax Code “qualified plan” risk
- Identifying problems before an audit
- Error correction alternatives
- “Best practices”

Three “Take-Aways”

- This economy requires a reevaluation of 401(k)/403(b) plan practices
- Preventative measures can increase plan sponsor security
- Common errors can be corrected at little cost

ERISA/Code



ERISA Issues

- ERISA governs relationship between plan participants and fiduciaries
- It’s a tough time to be a fiduciary
  - Heightened scrutiny
  - Increased incidence of litigation
  - Easier access to courts – *LaRue*
  - More remedies – *Amara*

Economy and Markets Affect ERISA Fiduciary Duties

- Poor economy and volatile markets require reevaluation of fiduciary practices
- Stock market turbulence affects plan investments
- Heightened prudence standard

Fiduciary Duties

- ***Prudent Expert Rule*** ... fiduciaries must discharge their duties:
  - With the care, skill, prudence, and diligence under the circumstances then prevailing 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

Prudence is Contextual

- “Under the circumstances then prevailing”
  - Duty to understand the market
  - Take current conditions into account

- “Familiar with such matters”
  - Duty to stay informed or seek help

S&P 500 INDEX
($US:INX)

1,131.42 ▼**-28.98 -2.50%**

Open: **1,159.93** High: **1,159.93** Low: **1,131.34**

Previous Close: **1,160.40** Volume: **unch**

Eastern Time

ERISA Best Practices

- **Monitor Plan Investments**
  - Get reports from consultants
  - Review 404(c) compliance
  - Fee benchmarking
  - QDIA issues – target date funds
  - Participant education
  - Delay fund/plan design changes?
    - Auto enrollment, fund changes
    - Blackout notice critical
  - Ask about cheaper share classes
  - Take advantage of 404(c) when "mapping" to new funds

ERISA Best Practices

- **Revisit investment policy statements**
  - DOL looks for such statements during audits
  - IPS should be carefully drafted to work as a shield for fiduciaries, not a sword against them
  - Market turmoil may have made asset allocation targets inappropriate today

ERISA Best Practices

- **Evaluate financial stability of insurance companies**
  - Especially insurers who provide guaranteed or stable value investment funds for retirement plans
  - Assets in such funds are subject to creditors of the insurer

ERISA Best Practices

- **Control the fiduciary ranks**
  - Identify the best people to serve
  - Avoid giving the “Company” a role
    - Carefully read prototype documents
    - Who is the named fiduciary and administrator?
  - Educate fiduciaries about their role
  - Conduct a fiduciary process review

ERISA Best Practices

- **Hold regular meetings**
  - At least twice per year
  - Circulate a written agenda in advance
  - Review investment funds and plan operation
  - Prepare detailed meeting minutes

ERISA Best Practices

- **Pay the plan first**
  - DOL actively pursuing asset mismanagement claims
    - Civil prohibited transaction penalties
    - Criminal prosecutions

ERISA Best Practices

- **Add a brokerage window?**
  - Recent judicial decisions enhance ERISA § 404(c) protection to plans with windows
  - More choices = better chance for participants to prudently invest

- **Process is the key . . .**

  "[ERISA's] test of prudence ... is one of conduct, and not a test of the result of performance of the investment. The focus of the inquiry is how the fiduciary acted in his selection of the investment, and not whether his investments succeeded or failed."

  Donovan v. Cunningham, 716 F.2d 1455, 1467 (5th Cir. 1983)

Tax Code Issues

- The Code governs relationship between the plan sponsor (employer) and IRS
- IRS audits are biggest danger
  - Penalties
  - Excise taxes
  - Disqualification and loss of deductions

In Pursuit of the Perfect Plan

"This is too difficult for a mathematician.
It takes a philosopher."

Albert Einstein, on the U.S. Tax Code

Audit Risk

- Historically, risk of retirement plan audit is low, but has been increasing
  - 1997 – 1.05% of returns examined
  - 2002 – 0.56% of returns examined
  - 2007 – 0.80% of returns examined
  - 2010 – 1.36% of returns examined
- IRS announced an audit initiative in 2009, signaling increased enforcement activity
  - "There will be a prominent [employee benefit] examination presence in the Retirement Plans Community … ." Monika Templeman, Director of Employee Plans Examinations, IRS

Identifying Problems Before an Audit

- Sponsors can’t rely on corporate auditor to discover errors
- Periodic “self-audits” can:
  - Facilitate less costly error correction
  - Enhance sponsor’s negotiating power if there is an IRS audit

Self-Audits

- Questionnaires used by IRS auditors can form the basis of a self-audit checklist
- Questions auditors direct at various points of plan compliance, including HR, payroll, plan administration, and internal controls

The Importance of Self-Audits

- Auditors focus on whether errors sponsor previously identified have been corrected
  - "If errors are found during the administrative process, what is the process for resolving such errors?" IRS Plan Administration Questionnaire, Q-16

- IRS takes self-correction into account when assessing audit sanctions
  - "[T]he Service will be particularly interested in your responses [to questions concerning self-correction of errors] when determining whether any sanctions are appropriate … ." IRS Internal Controls Questionnaire

Common Traps

Four Common 401(k) Plan Errors

1. Failure to count vesting and/or eligibility service for part-time or temporary employees
2. Failure to abide by the “universal availability” rule for catch-up contributions
3. “Pay-period” vs. “true-up” errors for matching contributions
4. Failure to timely adopt required amendments

Failure #1: Counting Service

- Sleepy Co. employs 20 full-time employees and 5 part-time employees, and 3 leased employees. It also sponsors a 401(k) plan. The plan has a 6-year graded vesting schedule: 0%, 20%, 40%, 60%, 80%, 100%. Sally, one of the part-time employees, earns 1,200 hours of service under the plan during 2009 and 2011. Bob, a leased employee, earns 1,400 hours of service during 2009 and 1,001 hours in 2011. Sally and Bob are both hired as regular employees in November of 2011. Both quit in May of 2013. The plan treats them as 0% vested.
- The plan has violated the vesting rules: Sally and Bob have 2 years of vesting service each and are therefore 20% vested.

Failure #2: Catch-Ups

- Beetle, Inc., has 22 employees. Its parent company, Bug, Inc., has 255 employees. The terms of Bug's 401(k) plan provide for catch-up contributions, but the terms of Beetle's plan don't.
- Consequences:
  - Beetle's plan has a document failure
  - Both plans fail the 401(a)(4) nondiscrimination test
- What if Beetle's plan provides for catch-ups but they aren't provided for operationally
  - Beetle's plan has an operational failure
  - Both plans fail the 401(a)(4) nondiscrimination test

Failure #3: Matching Contributions

- "Pay Period" vs. "True-Up"
  - A 401(k) plan must define the compensation included for purposes of employee salary deferrals and matching contributions
  - If compensation is calculated **pay-period by pay-period**, no true-up is necessary at the end of the plan year, but
  - If (as is more common) it is based on compensation for **the entire plan year**, the administrator must true-up allocations to the participant's matching contribution account

Example

- Oops, Inc.'s plan says that Oops will match 100% of the first 4% deferred. The definition of compensation takes into account deferrals for the entire plan year. Matching contributions are made every pay period. Sally, who makes $50,000 during the plan year, contributes 6% for the first nine months of the year. However, because she's saving up for a vacation over the holidays, she contributes nothing for the remainder of the year.
  - **Sally's deferrals for the year**: 4.5% of annual compensation (6% x 9/12) = $2,250
  - **Sally's match under the terms of the Plan**: $2,000 (4% x $50,000)
  - **Matching contributions**actually made on Sally's behalf as of September 30: $1,500 (4% x $37,500)
  - **Shortfall**: $500
- If Oops doesn't "true-up" Sally's matching contributions, it has violated the terms of the Plan.

Failure #4: Nonamenders

- The IRS issues regulations requiring plan amendments by the end of the 2010 plan year.
- The plan year for GoLately, Inc.'s 401(k) plan is the calendar year. GoLately doesn't amend its plan until July 3, 2011.
- The plan has a nonamender failure.

Correction Programs

EPCRS

- Employee Plans Compliance Resolution System ("**EPCRS**")
- Most recently issued in Revenue Procedure 2008-50
- Specific correction methodologies and "general correction principles" for "Qualification Failures"
- Effect: the IRS will not treat the Qualification Failure as disqualifying the plan

The Three EPCRS Programs

- **Employer-Initiated Programs**
  - **SCP** (“Self Correction Program”)
  - **VCP** (“Voluntary Correction Program”)
- **IRS-Initiated Program**
  - **Audit CAP** (“Audit Closing Agreement Program”)

Audit CAP

- Requires:
  - Correction of the failure
  - Payment of sanction
- Upon resolution – “closing agreement”
- Sanction based on percentage of the “maximum payment amount,” i.e., additional taxes if plan were disqualified, including those from:
  - Loss of employer’s deduction for plan contributions
  - Trust recognizing earnings as taxable
  - Participants recognizing income on vested portion of benefits, as if immediately distributed
  - Plus penalties and interest

Types of Qualification Failures

- **Plan Document Failure**
  - The plan terms violate Code requirements
- **Operational Failure**
  - A permissible plan term has been violated in operation
- **Demographic Failure**
  - A minimum coverage, minimum participation, or nondiscrimination Failure
- **Employer Eligibility Failure**
  - The employer cannot sponsor the type of plan

Failures Not Covered in EPCRS

- “DOL” issues
  - Delinquent contributions
  - Funding shortfalls
  - Prohibited transactions
  - Reporting and disclosure Failures (e.g., late Forms 5500)
- These are covered under DOL correction programs

General Correction Principles

- Full correction required for:
  - All tax years (including closed years)
  - All participants and beneficiaries
  - But not necessarily all Failures
- The correction should:
  - Restore plan to the position it would have been in, but for the Failure

General Correction Principles

- Restore to participants all rights and benefits they would have had, but for the Failure
- Resemble a method already provided in the Code, regulations, or other guidance
- Keep assets in the plan
- Provide benefits to NHCEs, in the case of nondiscrimination Failures

SCP Advantages

- Simplest and cheapest program
  - No IRS filing
  - No compliance fee
  - No sanctions

SCP Drawbacks

- But:
  - No Compliance Statement
  - No negotiations with IRS (e.g., for less-than-full corrections)
  - Less certainty correction will stand
  - No protection on audit if IRS disagrees with correction method or employer does not preserve sufficient records to prove correction was permissible

SCP Restrictions

- Operational Failures only
- 401(k) plan generally must have:
  - Favorable determination letter
  - Established practices and procedures
- Amendment to conform to practice is generally <u>not</u>available

SCP Restrictions

- Limited availability for “Significant Failures”
  - Only until the end of the second plan year after the year in which the Failure occurred
- Seven-factor test for “significance” of the Failure

SCP "Significance Test"

1. Other Failures during period examined
2. Percentage of plan assets involved
3. Number of years the Failure occurred
4. Number of participants, relative to total
5. Number of participants, relative to number who could have been affected
6. Whether correction was made in a reasonable time
7. Reason for the Failure

VCP Advantages

- Available for all Failures (and all plan types)
- IRS issues a Compliance Statement
  - Written guarantee that IRS will not disqualify the plan
  - Typically includes 150-day deadline for implementing a proposed correction

VCP Advantages

- Permits retroactive amendments to conform to practice
- Includes negotiations with the IRS (e.g., exceptions to full correction)
- Anonymous submissions permitted
- Allows sponsor to propose correction methodologies **before** taking action

VCP Drawbacks

- Requires IRS filing
  - Streamlined procedures available for certain Failures
- Compliance fee
  - Varies, depending on:
    - Number of participants in the plan (<u>not</u> the number affected by the Failure)
    - Type of Failure (e.g., reduced fee for § 401(a)(9) Failures)

VCP Fees for 401(k) Plans

Number of Participants	Fee
20 or fewer	$750
21 to 50	$1,000
51 to 100 $	$2,500
101 to 500	$5,000
501 to 1,000	$8,000
1,001 to 5,000	$15,000
5,001 to 10,000	$20,000
Over 10,000	$25,000

VCP Bargains

- Appendices and Schedules offer streamlined correction methodologies and reduced fees
- E.g., for certain nonamender failures, the compliance fee is flat $375 (up to 98.5% off)
- Can cover multiple failures with one fee
- “Check the box” corrections

Audit CAP

- Applies when IRS discovers Qualification Failure on audit
- Requires:
  - Correction of the Failure
  - Payment of sanction
  - If IRS decides:
    - Change in administrative procedures
    - Determination letter application

Audit CAP

- Upon resolution:
  - “Closing Agreement”
  - Payment of sanctions
- Consequence of Failure to reach resolution: <u>disqualification</u>

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