Why Retirement Plans Fail – And How to Fix Them

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The webinar will start at 11:00 a.m. CT

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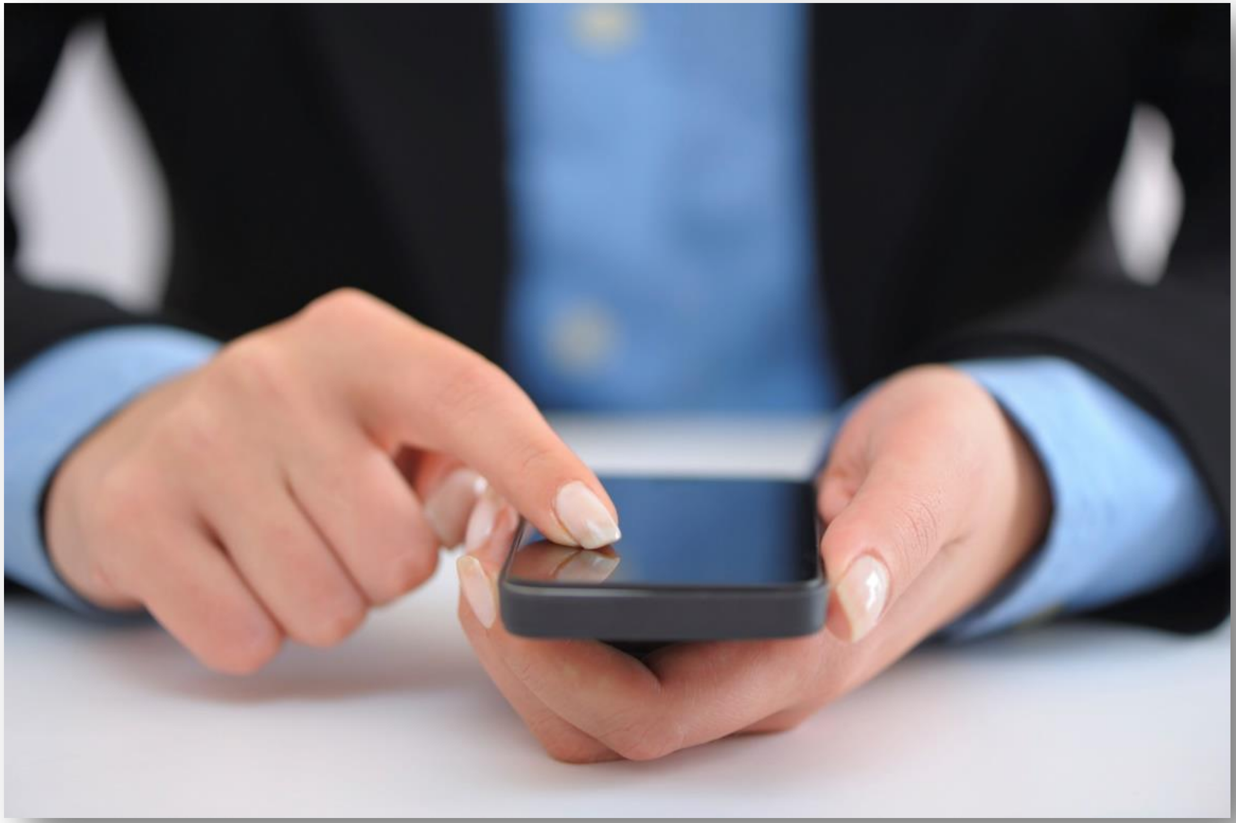

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About the Speaker

Heather Smith, QKA
Operations Manager
Employee Benefit Services

More than a decade of employee benefits experience

Qualified 401(k) Administrator (QKA)

Member of the American Society of Pension Professionals and Actuaries

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About the Speaker

Eric Namee, JD, CPA
Co-Managing Member
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More than 30 years practicing employee benefits law

Former Kansas Bar Association Tax Section President

Learning Objectives

Understand common plan failures.

Learn how to self-correct using the available IRS correction methods.

Identify the differences between correction methods and if fees are involved.

Polling Question #1

BASIC CONCEPTS

What is a Qualified Plan?

Tax-favored arrangement offered by an employer for the purpose of allowing employees to save for retirement

- Funded by employer contributions
- Held in trust
- Operated according to plan document

Advantages of Qualification

Under IRC Section 401(a):

- Employer allowed immediate deduction for contributions
- Employee does not recognize income until money is withdrawn
- Income not taxed

Remaining Qualified

Plan is not entitled to receive the benefits unless it is in compliance **at all times**.

No statute of limitations for qualification defects

Disqualification

Consequences for disqualification are severe:

- Earnings of the trust become taxable
- Deductions taken by the employer may be disallowed
- Vested account balance of participants may become includible in their gross income, exposing that amount to taxation

EMPLOYEE PLANS COMPLIANCE RESOLUTION SYSTEM (EPCRS)

Employee Plans Compliance Resolution System

IRS-established comprehensive system of correction programs for plans that have failed to comply

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EPCRS Programs

Self-Correction Program (SCP)

Voluntary Correction Program (VCP)

Audit CAP

Correction Under EPCRS

If a failure is corrected in accordance with EPCRS, the IRS will NOT treat the plan as disqualified. It is a **permanent fix**.

Qualification Failure

Qualification failure = Any failure that adversely affects the qualification of a plan

Types of Qualification Failures

- Plan document failure
- Operational failure
- Demographic failure
- Employer eligibility failure

Polling Question #2

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Correction Program Choices

Type of Qualification Failure	SCP	VCP	Audit CAP
Plan document failure	No	Yes	Yes
Operational failure	Yes	Yes	Yes
Demographic failure	No	Yes	Yes
Employer eligibility failure	No	Yes	Yes

General Correction Principles

- Full correction should be made for ALL participants and beneficiaries for ALL taxable years.
- Correction method should restore the plan to the position it would have been in had the failure not occurred.
- Correction should be reasonable and appropriate for the failure.

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General Correction Principles (cont.)

- Correction method should be applied consistently.
- Corrective allocations only from employer contributions
- Corrective allocations adjusted for earnings and forfeitures
- Failure should be fully corrected.
- Distributions should be properly reported.

SELF-CORRECTION PROGRAM (SCP)

Self-Correction Program

Available for both insignificant and significant operational failures

- Qualified plans and 403(b) plans are eligible.
- SEPs and SIMPLE IRAs are also eligible, but for insignificant operational failures only.

SCP – Insignificant Failures

Operational failures that are insignificant can be corrected at any time, even if:

- The plan is under examination
- The failure is discovered by an agent during an examination

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Determining Insignificant Failures

- Many factors, although no single one is determinative
- Failures must be insignificant in the aggregate.

Significant vs. Insignificant Failures

Things to consider:

- Whether other failures occurred during the period being examined
- Percentage of plan assets and contributions involved in the failures
- Number of years the failure occurred

Rev. Proc. 2013-12, § 8.02.

Significant vs. Insignificant Failures (cont.)

- Number of participants affected by the failure relative to the number of participants who could have been affected
- Whether correction was made within a reasonable time after the discovery of the failure
- Reason for the failure

Rev. Proc. 2013-12, § 8.02.

SCP – Significant Failures

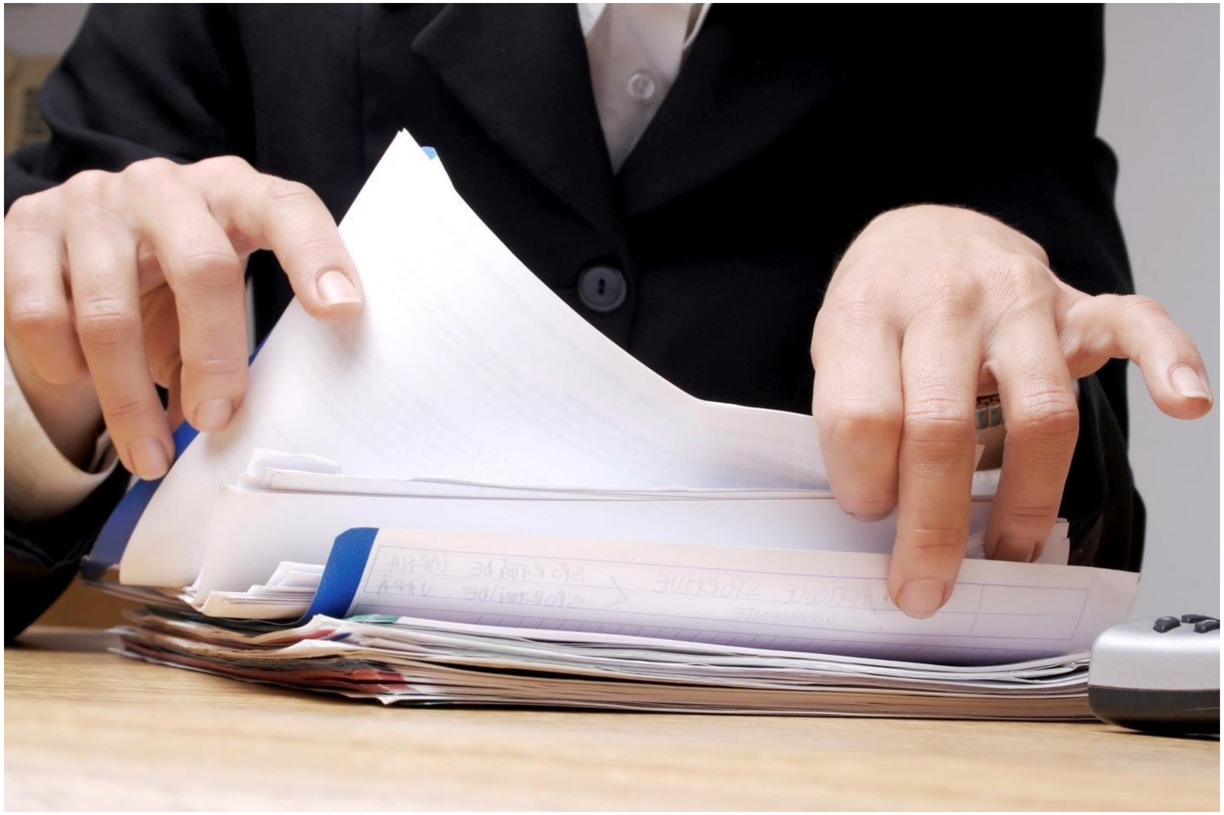
If an operational failure is significant, it may be corrected at any time before the end of the second plan year following the date on which the failure took place.

SCP: Additional Eligibility Conditions

Established practices and procedures	No egregious failures	Significant operational failure must have a determination letter.	Correction of significant operational failure must be substantially completed if plan under examination.

SCP: Approved Correction Methods

Employers eligible for SCP may self-correct the failures.[1]



[1] Appendix A and Appendix B to Rev. Proc. 2013-12

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Retroactive Plan Amendment

401(a) (17) failures

Hardship distribution failures

Inclusion of ineligible employees

Plan loans without authorizing plan language

VOLUNTARY CORRECTION PROGRAM (VCP)

VCP Overview

Plan sponsor describes qualification failure to IRS and submits proposed correction(s)

IRS consults with plan sponsor or representative

If an agreement is reached, IRS will send a compliance statement to plan sponsor

Plan sponsor must sign compliance statement, submit required fee, and implement agreed-upon corrections within 150 days of compliance statement

VCP – Forms & Procedures

- Mandatory VCP Forms 8950 & 8951
- Model VCP Compliance Statement (EPCRS Appendix C, Part I)
- VCP Schedules (Appendix C, Part II)
- Special procedures for certain types of failures:
  - Group submissions
  - Anonymous “John Doe” submissions
  - Sole failure involves participant loans

VCP Fees

Qualified plans and 403(b) plans	Depends on number of plan participants
401(a) Required Minimum Distribution failures	$500 for fewer than 50 plan participants
Non-Amenders	Compliance fee reduced by 50% if submission made within the one-year period following expiration of plan’s remedial amendment period
Group Submissions	Based on the number of plans, starting at $10,000
SEP/SIMPLE IRAs	$250

VCP Fees (cont.)

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
More than 10,000	$25,000

AUDIT CAP

Correction on Audit (Audit CAP)

- Qualification failures identified during a plan audit must be corrected under Audit CAP.
- The plan sponsor is generally required to correct the failure, implement procedures, and pay agreed-upon sanction.
    - Several factors taken into account in determining sanction amount
    - Sanction is negotiated percentage of what IRS could collect upon plan disqualification

Polling #3

Now What

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Appendix A & B

- Operational Errors
- SCP or VCP
- Details how to fix
- Describes how to calculate earnings

EXAMPLES OF COMMON PROBLEMS

Example 1: Inclusion of Ineligible Employees

ABC Company's 401(k) plan provides that an employee becomes eligible to enter the plan upon completion of "one year of service" with semi-annual plan entry dates.

ABC Company has been permitting new hires to enter the plan immediately.

Problem: This is an operational failure because the plan has not been operated in accordance with the terms of the plan document.

Example 1: Inclusion of Ineligible Employees

Solution:

Alternative #1

- The employer may retroactively amend the plan to remove the service requirement and allow plan entry on any day of the year. EPCRS, App. B § 2.07(3)(a).
- If within the appropriate time frame, this can be done under SCP.
- Otherwise, the employer must go through VCP.
- Note: The amendment can also be tailored to only apply specifically to the group of individuals with respect to whom the failure occurred.

Alternative #2

- The employer may distribute the improper deferrals and report the distribution on a current year Form 1099-R with a code E, in box 7. The distribution (including earnings) will be taxable. Improper deferrals should not be included in the plan's ADP test.

Example 2: Multiple Employer using Single Employer Plan Document

ABC Company sponsors a single employer 401(k) plan. The plan provides for elective deferrals and discretionary non-elective employer contributions.

ABC Company acquires a 46% interest in XYZ Co. and allows employees of XYZ Co. to participate in the plan.

Problem: The plan is a single employer plan, so XYZ Co. cannot be a participating employer and allow its employees to participate.

Solution:

Under VCP, ABC Company may amend the plan retroactively to conform to its operations. It would do this by adding multiple employer provisions in the document. This will permit other employers to adopt the plan. EPCRS, App. B § 2.07(3).

- The employer will have to make a submission which includes a compliance fee. The fee ranges from $750 to $25,000.

Retroactively included employees should be included in the applicable ADP or ACP test.

The amendment must otherwise satisfy § 401(a) (e.g., it cannot result in prohibited discrimination or violate § 415 limits).

Example 3: Exclusion of Eligible Employees

Employer X maintains a 401(k) plan with matching contributions for each payroll period equal to 100% of elective deferrals that do not exceed 2% of an employee's compensation during the payroll period.

The plan provides that employees who complete one year of service are eligible to participate in the plan on the next designated entry date.

The entry dates are January 1 and July 1.

Example 3: Exclusion of Eligible Employees (cont.)

Monica, a NHCE who met the eligibility conditions and should have entered the plan on January 1, 2012, was not offered the opportunity to participate in the plan.

In August 2012, the error was discovered.

The employer offered Monica the opportunity to make elective deferrals as of September 1, 2012

Example 3: Exclusion of Eligible Employees (cont.)

Monica made elective deferrals equal to 4% of her compensation for each payroll period through the end of the year, resulting in elective deferrals of $400.

Monica's compensation was $36,000 for the year ($26,000 for the first 8 months; $10,000 for the last 4 months).

Employer X made matching contributions equal to $200 on behalf of Monica. This is 2% of her compensation for each payroll period from 9/1 to 12/31.

Example 3: Exclusion of Eligible Employees (cont.)

The ADP for NHCEs for 2012 was 3%.

Problem: Monica was improperly excluded from participating in the plan for part of the plan year.

Example 3: Exclusion of Eligible Employees (cont.)

Solution:

Employer X determines Monica's compensation for the portion of the year in which she was not provided the opportunity to make elective deferrals. For administrative convenience, instead of using actual compensation of $26,000 for the period Monica was excluded, Monica's annual compensation is prorated for the 8-month period that she was excluded from participating in the plan.

Example 3: Exclusion of Eligible Employees (cont.)

Corrective contribution for missed deferral:

Because the error was discovered after 3 months, Employer X must make a corrective contribution for the period from 1/1 to 8/31. Monica's "missed deferral opportunity" is 25% of her "missed deferral."

Monica's "missed deferral" is calculated by multiplying the 3% ADP for NHCEs by $24,000 (8/12ths of her total comp of $36,000).

Accordingly, the "missed deferral" is $720.

Thus, the required corrective contribution is $180, adjusted for earnings.

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Example 3: Exclusion of Eligible Employees (cont.)

Corrective contribution for missed matching contribution:

- Under the terms of the plan, if Monica had made an elective deferral of $720 or 3% of compensation for the period of exclusion ($24,000), she would have been entitled to a matching contribution equal to 2% of $24,000 (i.e., $480).
- Accordingly, the required corrective contribution is $480, adjusted for earnings.

Example 4: Problems with “Compensation”

ABC Co.’s 401(k) plan defines “Compensation” as total compensation. Despite this, the employer fails to apply employees’ deferral elections with respect to bonus compensation.

Problem: Amounts that should have been included in “Compensation” were not included in “Compensation.”

Example 4: Problems with "Compensation" (cont.)

Solution:

The employer must determine and contribute the amount of elective deferrals which it failed to withhold from the employees' bonus compensation.

The employer must compute the earnings on the missed deferrals.

- The plan may determine actual earnings for the time period or, if the plan is participant-directed, it may use the highest earnings rate of the investment options available.

The employer must determine and contribute the matching contributions plus earnings.

Example 4: Problems with “Compensation” (cont.)

Notes regarding make-up contributions:

- The make-up contribution for the missed elective deferrals, the earnings and the matching contributions should be in the form of a qualified non-elective contribution.
- The elective deferrals for the year plus the make-up contribution for the elective deferrals should not exceed the Code § 402(g) limit.
- The make-up contribution (excluding earnings) is subject to the Code § 415 limits for the correction year.
- The make-up contributions should be deductible for the current taxable year.

Example 5: Problems with "Compensation" (Manual Paychecks)

Anne, a salesperson, is an employee of Widget Co.

Her compensation is run through payroll.

Last year, Widget Co. cut her a manual check reflecting a special sales commission that Anne had earned.

Example 5: Problems with “Compensation” (Manual Paychecks)

Widget Co. failed to allow Anne to make elective deferrals into the 401(k) from the sales commission.

Problem: Anne has not been allowed to make elective deferrals out of all of her compensation.

Example 5: Problems with “Compensation”(Manual Paychecks)

Solution:

Widget Co. must make corrective contributions, adjusted for earnings.

See Example 4 for details.

Example 6: Failure to Make Change in Deferrals

Under the Widget Co. 401(k) plan, employees can change their elective deferrals at any time, effective the next pay period.

An employee elects to increase the percentage of his elective deferral.

The employer takes 3 pay periods to implement the change.

Problem: An employee has not been allowed to change his deferrals in accordance with the terms of the plan.

Example 6: Failure to Make Change in Deferrals (cont.)

Solution:

The employer must make corrective contributions, including any missed matching contributions, for the three pay periods in which the increased deferral was not made.

Corrective contributions should include earnings.

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Example 7: Incorrect Usage of Forfeitures

The ABC Co. Plan provides that forfeitures should be used to reduce the fixed matching contribution. ABC Co., however, has been allocating forfeitures as additional employer non-elective contributions.

Problem: Forfeitures have not been allocated in accordance with the terms of the plan document.

Example 7: Incorrect Usage of Forfeitures (cont.)

Solution:

Alternative #1

- Under VCP, the document may be retroactively amended to reflect the actual operation of the plan.

Alternative #2

- ABC Co. can go back and follow the terms of the plan document. This means that the amount of the forfeitures allocated as additional non-elective employer contributions are used to reduce the future fixed matching contributions.

Example 8: Elective Deferrals Exceed Code § 402(g) Limit

An employee's elective deferrals have exceeded the Code § 402(g) limit. The employer discovers this during the calendar year. The employer wants to correct this violation by distributing the excess deferrals by the end of the calendar year and "adjusting" the employee's Form W-2.

Is this the proper way to correct this problem?

Example 8: Elective Deferrals Exceed Code § 402(g) Limit

Under SCP or VCP, the permitted correction method is to distribute the excess deferral plus applicable income to the employee and report the distribution on Form 1099-R.

If the distribution includes only the excess deferrals, and no income, the regulations treat the distribution as a pro rata distribution of excess deferrals and income. Therefore, the plan will not have distributed the entire corrective distribution amount and will have violated the qualification requirement under Code § 401(a)(30).

A distribution to an HCE is included in the ADP test; a distribution to a NHCE is not included in the ADP test.

EPCRS, App. A § .04

Example 9: Distribution Error – Calculation of Vesting

John terminates employment with his employer and is 60% vested in the employer non-elective contributions. John elects and receives a single-sum distribution of the vested portion of his account balance.

The employer, however, incorrectly determines that John was 40% vested when he terminated. Consequently, John's distribution was less than the amount to which he was entitled.

The remaining portion of John's account balance was forfeited (in accordance with the plan, which provides forfeitures to be reallocated among account balances of other eligible employees based on compensation).

Example 9: Distribution Error – Calculation of Vesting

Solution:

- The employer makes a contribution on behalf of John equal to the incorrectly forfeited amount, adjusted for earnings.
- No reduction is made from the account balances of the employees (mostly NHCEs) who received an allocation of the improper forfeiture.

Polling Question #4

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Thank you!

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