PUBLICATION

Defective Retirement Plans

October 27, 2011

Generally

A retirement plan which is intended to be tax-qualified, such as a 401(k) plan, is subject to a variety of requirements which must be satisfied in order to preserve the tax-qualified status of the plan. The purpose of this Alert is to discuss tax-qualified status and some consequences of losing such status.

Tax-qualified status is important to both the employer and the plan participants. For the employer, the timing of the deduction for contributions depends on the plan's status. An employer's contribution to a tax-qualified plan is deductible when the contribution is timely made, even if the plan benefits are not vested. However, for a funded non-qualified plan a deduction is allowed only when the benefit vests, which may be years after the contribution is made. As a result, if a plan is disqualified based on circumstances which occurred in prior years, the employer may be required to file amended tax returns for those prior years to revise the timing of deductions for contributions made to the plan.

For a participant, the benefit of a tax-qualified plan is the deferral of income tax on their benefit under the tax-qualified plan until the time when the benefit is paid and not rolled over to another tax-qualified arrangement. On the other hand, a benefit under a funded non-qualified deferred compensation plan is taxable when it vests, whether or not any payment has been made. In addition, a trust which holds the assets of a non-qualified plan is also taxable, requiring trust income tax returns and payment of applicable taxes on the trust income.

Some Disqualification Causes

Complex Rules. As the rules relating to tax-qualified retirement plans become increasingly complex, it is more difficult to comply with all requirements. Some operational or administrative aspects of the rules are especially likely to cause errors. For example, "compensation" as defined in a plan may be different from the total amount of compensation which is used for payroll processing purposes. If not properly coordinated, the wrong amount of compensation may be used by a payroll department for purposes of making employer or employee contributions to the plan. Other common errors include waiting too long to deposit employee contributions into the trust, exclusion or delayed eligibility of eligible employees, or improper calculation of vesting service. Mistakes such as these, along with any other administrative errors, may technically cause a loss of tax-qualified status.

Form Errors. There are also "form" defects which may occur with respect to a tax-qualified retirement plan if a required amendment is not adopted by the plan sponsor within the time permitted by the IRS. Even if adopted within the time permitted, the IRS may challenge an amendment if the date of execution is not written on the amendment, or if the appropriate procedure for approval of the amendment is not followed.

IRS Action. Although in practice the Internal Revenue Service (IRS) rarely disqualifies a plan, it has the authority to do so. More typically, if the IRS discovers an operational or form defect, it will assess a penalty in lieu of plan disqualification. However, because the IRS has established procedures for voluntary disclosure and correction of administrative or form errors, as discussed below, the penalty for correction of an error that is discovered by the IRS may be quite significant, and could theoretically be as much as all the tax revenue which would be realized by the Treasury Department if the vested benefits under the plan were all taxed, the employer deductions for affected years were modified, and the trust which holds plan assets was taxable. Such a penalty could be devastating to a plan sponsor.

Voluntary Correction Program

Generally. Fortunately, the IRS has a program for plan sponsors to correct these types of errors without exposure to the potentially dramatic consequences of a plan disqualification or significant penalties. Under the Employee Plans Compliance Resolution System (EPCRS), more commonly referred to as the Voluntary Correction Program (VCP), an employer can disclose the errors to the IRS, propose a corrective action to put the participants and the plan in the position they would have held in the absence of the error and, with the payment of a relatively modest fee, avoid plan disqualification. The fee for a VCP application is generally based upon the number of participants in the plan, and ranges from $750 for small plans with fewer than 20 participants to $25,000 for plans with more than 10,000 participants. For late amendments required by legislative or regulatory changes, the fee can be as low as $375.

Full Correction Required. Any correction under the VCP must be a full correction, generally for all affected persons in all affected years. Standard correction methods are published by the IRS for particular types of errors, though an employer may propose an alternate correction method. However, depending upon the circumstances, the employer's cost of making the correction may be significant. For example, if a group of employees was incorrectly excluded from participation in a 401(k) plan or the employee's contribution elections were not properly applied, the standard correction would be for the employer to establish accounts for those individuals and contribute one half of the amount each employee would have contributed, plus all of the matching contributions which would have been made on the full employee contribution amount, plus any other missed contributions (such as profit sharing contributions), plus a lost earnings amount on all of these contributions. In addition to the corrective contributions that must be made, the administrative burden of collecting records and making the necessary calculations can be significant.

Compliance Statement. In some cases, the only way to preserve a plan's tax-qualified status is to make an application to the IRS under the VCP. If a VCP application is made, the correction approved by the IRS, and the approved correction then made within the time allotted by the IRS, a "Compliance Statement" issued by the IRS as part of the VCP would prevent the IRS from disqualifying the plan for the disclosed and corrected errors.

Significant/Insignificant Operational Errors. Operational errors are generally divided into "significant" and "insignificant" errors. Whether an error is significant or not is a fact and circumstance issue, taking into account factors such as the number of years involved, the number of individuals involved, the dollar amount involved, etc. If an error is significant, it generally may be "self corrected" without a VCP application to the IRS, provided the correction is made by the end of the second year following the year in which the error occurred. However, if a self correction is made without a VCP application, the employer will not receive a Compliance Statement from the IRS and must rely on a full and appropriate correction. For insignificant errors, an employer generally may make a full correction at any time without a VCP application, but again the absence of a VCP application would mean that no Compliance Statement would be issued by the IRS.

U.S. Department of Labor

Generally. Of course, the IRS only addresses the tax-qualification of the plan, and does not preclude action against the plan sponsor or the plan administrator by the Department of Labor (DOL) or the plan participants. Under the Employee Retirement Income Security Act of 1974 (ERISA), the DOL administers and enforces laws which are designed to protect participants, whether or not a plan is tax-qualified. ERISA includes rules regarding fiduciary responsibility in the administration of a plan, including a requirement that the plan fiduciaries follow the terms of the plan unless those plan provisions are contrary to the requirements of ERISA. For purposes of this discussion, an operational error will almost always result from a failure to follow the terms of a plan, which could make the responsible plan administrator personally liable for any losses to the plan or the participants. Thus, with regard to these errors there is another exposure which is personal in nature, whether or not the plan is disqualified by the IRS.

Voluntary Fiduciary Compliance. The DOL also has a correction procedure, known as the Voluntary Fiduciary Compliance (VFC) program. The VFC requirements generally conform to the VCP requirements, with some minor differences. As is the case for the VCP, there is no legal requirement that an employer submit an operational error and correction method to the DOL under the VFC program. However, a VFC program submission, if approved, provides protection against further DOL action against the employer and the responsible plan fiduciaries with regard to further action related to errors which are disclosed and corrected. Although plan participants still have a right of action, an error which is corrected under VCP, VFC, or both may offer little additional recourse to plan participants, as the federal regulatory agency(ies) will have already approved the corrections as adequate and complete.

Summary

In summary, there may be few, if any, retirement plans which have no errors in operation or form and which, therefore, are not subject to disqualification by the IRS, regulatory action by the DOL, and/or enforcement action by plan participants. However, the VCP and VFC programs provide an opportunity to correct errors with little or no additional cost beyond the VCP application fee and the cost of putting the plan and participants in the position to which they are entitled in any event under federal law.

The exposure in the event an error is discovered on audit by the IRS or DOL will almost certainly be far greater and, given the sharing of information between the IRS and DOL, the discovery of an error by one agency will likely be addressed by both agencies. As a matter of compliance with federal law, fairness to employees and cost control, it is in the interest of employers that sponsor retirement plans to seek good advice, to obtain quality service providers, and to audit the plan administration regularly in order to remedy errors voluntarily and before discovery by the IRS or DOL.

Should you have any questions regarding your retirement plan, the VCP or VFC, or any other employee benefit issues, please contact any one of the attorneys within the Firm's Tax Department.