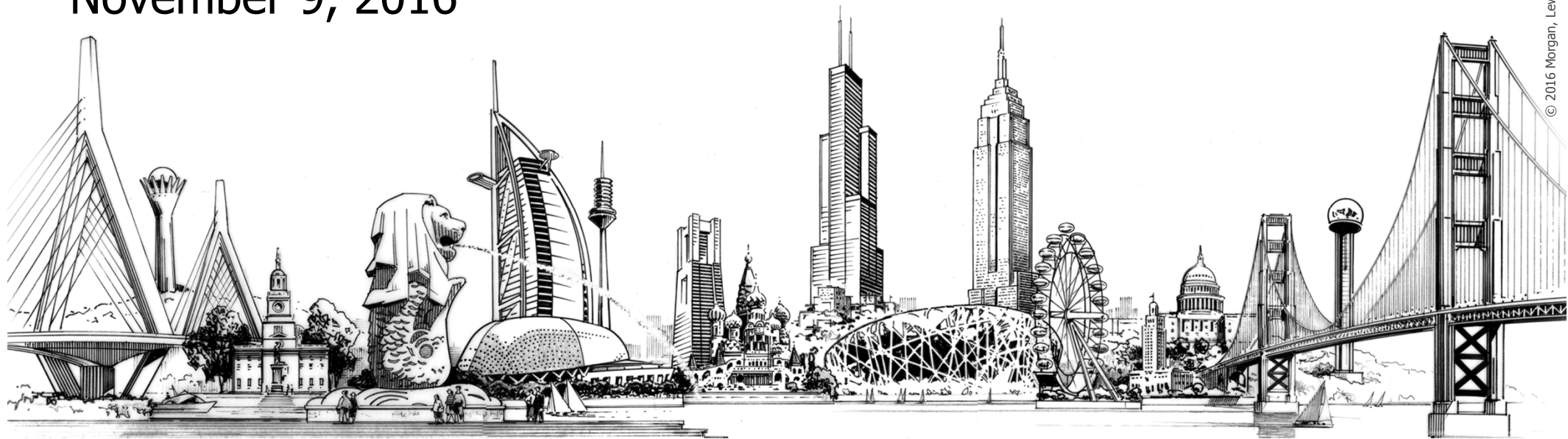


Morgan Lewis

# 2016 PLAN SPONSOR BASICS 401(k) ISSUES

Presenters: Lisa Barton and Elizabeth Kennedy  
November 9, 2016



**SECTION 01**

# **WHAT WE WILL COVER**

# Agenda

- Description of Correction Principles
  - Outline IRS/DOL correction programs
  - Discuss when self-correction is an option
- Overview of Common Failures
  - Common operational failures
  - Common areas that are the focus of IRS audit
- Methods for Correction
  - Review of ways to correct common failures

**SECTION 02**

# **CORRECTION PRINCIPLES**

# EPCRS Program

- EPCRS contains three correction programs:
  - Self-Correction Program (**SCP**)
  - Voluntary Correction Program (**VCP**)
  - Audit Closing Agreement Program (**Audit CAP**)
- Types of plans covered
  - Qualified Plans - 401(a)
  - Tax-Sheltered Annuity Plans - 403(b)
  - Governmental 457(b) plans

# Qualification Failures

- Plan Document Failure
  - Plan provision (or absence of provision) that violates the Internal Revenue Code (the Code)
    - Includes failure to timely adopt amendments or adopting amendments later than is required by law
- Operational Failure
  - Plan document complies with the Code but plan doesn't operate in accordance with its provisions
  - Includes loan failures, eligibility failures, contribution failures, distribution failures, etc.
- Demographic Failure
  - Failure to satisfy requirements of:
    - Minimum participation – 401(a)(26)
    - Coverage – 410(b)
    - Nondiscrimination – 401(a)(4)
- Employer Eligibility Failure
  - Employer was not eligible to adopt plan

# Self-Correction

- No disclosure to IRS, no fee, no sanctions
- Only operational failures
- Must have a determination letter (if an individually designed plan)
  - Will be interesting to see how this changes as the IRS determination letter program changes
- Must have established practices and procedures to ensure ongoing compliance
- Must document the correction in the event the IRS asks about the correction later

# Eligibility for Self-Correction

- Plans may “self-correct” failures that are “insignificant” at any time or that are corrected by the end of the second plan year following the plan year of the failure
- Distinction between insignificant and significant errors
  - List of factors to consider
    - Percentage of assets/contributions involved
    - Number of years involved
    - Percentage of participants affected
    - Percentage of participants who could have been affected
    - Correction within reasonable period
    - Reason for the failure
- Uncertainty for plan sponsor unless one of the correction methods on Appendix A or B is followed



# Voluntary Correction Program

- Single program and single admission process
- Process includes “proposing” correction methods to IRS and submission procedures
- Ends with a compliance statement

# Methods for VCP Correction

- Model correction methods in Appendixes A, B, and F
  - IRS also has certain corrections that it “generally” approves
- John Doe – anonymous submission is possible
- Group submissions

# VCP Fee Structure

<b>Number of Participants</b>	<b>Fee</b>
20 or fewer	\$500
21 to 50	\$750
51 to 100	\$1,500
101 to 1,000	\$5,000
1,001 to 10,000	\$10,000
Over 10,000	\$15,000

**SECTION 03**

# **OVERVIEW OF COMMON FAILURES**

# Common Failures

- Failure to include employees eligible for participation
  - Failure to automatically enroll
  - Failure to implement employee deferral elections
- Including ineligible employees
  - This could be the early inclusion of an otherwise eligible employee for any or all contribution types
- Failure to permit eligible employees to make catch-up contributions
- Excess allocations (above plan limits and/or 415 limits)
  - When is this likely to occur?
- ADP/ACP and minimum coverage testing failures
  - How to correct
- Improperly administering vesting provisions
- Incorrect definition of “compensation”

# Common Failures (continued)

- Distribution failures
  - 401(k) plans typically have in-service distribution provisions that can differ substantially based on contribution type: deferral, Roth, safe harbor match, rollover
  - Even 401(k) plans sometimes provide annuities, in which case the qualified joint and survivor annuity notice and waiver period must be provided
- Failure to timely distribute a minimum required distribution
  - IRS audit issue
- Improperly administering forfeitures
  - Discussion of issue and consequences of failure
- Failure to comply with plan loan requirements
  - IRS audit issue
  - Failure to timely repay, leaves of absence, etc.

# Common Failures (continued)

- Failure to timely transmit employee contributions
  - Review of consequences and how “timely” is determined
- Failure to timely amend plan for required legislative changes

# Common Principles for Plan Amendments

- Correction of retroactive plan document failures that are “less favorable” must typically be accompanied with some proof of the “intent” of the plan sponsor
  - Examples include loan failures, matching contribution failures, changes to the definition of “compensation,” etc.
- Plan amendments may generally be adopted (unless the changes are not favorable to participants) by the end of the plan year during which the changes occur
  - Amendments that are less favorable (such as reducing a matching contribution formula, etc.) must generally be adopted prior to the effective date of the changes



**SECTION 04**

# **DESCRIPTION OF CORRECTION ISSUES**

# Eligibility Failure

- Failure to include employees eligible for participation
  - Plan document issues
  - Operational issues
- Automatic Enrollment
  - If the plan has automatic enrollment, the correction will be discussed in the next slide relating to “Failure to Implement Employee Elections.”
- No Automatic Enrollment
  - If the plan does not have automatic enrollment, the correction is generally 50% of the ADP percentage for non-highly compensated employees, plus the full matching contribution.

# Failure to Implement Employee Elections

- The IRS has a specified correction, so long as specific Notice and time period requirements are satisfied.
- Plans with Automatic Enrollment
  - If the employee is excluded for three or fewer months and the required Notice is provided, no contribution is necessary for the employee's missed deferrals.
  - If the employee was eligible for automatic enrollment and the required Notice is provided, no contribution is necessary for the employee's missed deferrals if the correct deferrals begin on or before the first pay date on or after the last day of the 9½-month period after the end of the plan year of the failure (i.e., October 15 of the next calendar year).

# Failure to Implement Employee Elections (continued)

- Plan does not have Automatic Enrollment
  - If the employee is excluded for three or fewer months and the required Notice is provided, no contribution is necessary for the employee's missed deferrals.
  - If the plan does not have automatic enrollment and the employee is excluded for more than three months, but correct deferrals begin on or before December 31 of the second year following the year the failure occurred, and the required Notice is provided, only 25% of the missed deferrals need to be contributed. The full matching contribution must be contributed.

# Failure to Implement Employee Elections (continued)

- Failure to provide required Notice for all types of plans
  - If the required Notice is not timely provided, or if the time periods above are not met, then 50% of the missed deferral must be contributed.
- Required Matching Contributions
  - For plans with automatic enrollment, matching contributions must be provided as though the employee had been automatically enrolled (i.e., 3%).
  - For plans without automatic enrollment, if the employee made a deferral election that was not implemented, matching contributions must be made as though the employee had been contributing at the rate of the deferral election during the time the employee was excluded from participation (for example, if the employee had elected to defer 5%, his missed deferrals would be 5%).

# Including Ineligible Employees

- Generally, employee's account balance is reduced.
  - If the amount would have been allocated to other employees in the year of the failure, the amount plus earnings is so reallocated.
  - If not, the amount should go in a separate account and be used to reduce employer contributions (other than deferrals or Roth contributions).

# Distribution Failures

- Employer should attempt to have distribution plus earnings repaid by the recipient.
- If the entire amount is not repaid, the employer or another person must contribute the difference to the plan. This is not necessary if payment was made in absence of a distributable event but otherwise determined according to the plan, e.g., an impermissible in-service distribution.
- The employer must notify the employee that the overpayment was not eligible for favorable tax treatment.

# Distribution Failures (continued)

- Failure to obtain spousal consent (QJSA)
  - Give participant the choice between providing informed consent to distribution made or receiving a QJSA (which may be reduced to take into account the distribution).
  - Alternative is to give participant the choice among providing informed consent to distribution made, receiving a QJSA, or making a lump-sum payment to the participant's spouse equal to the present value of the survivor annuity benefit.



# Failure to Timely Distribute RMDs

- Required Minimum Distributions (RMDs)
  - Generally required by April 1 following the year in which a participant turns 70½
  - Plan qualification failure
  - Excise tax equal to 50% of the RMD to be paid by the participant
- Significant audit issue by IRS and DOL
  - IRS is concerned about qualification failure
  - DOL is concerned about participants not getting their full benefit
- Correction is to make RMD payments
  - IRS correction program allows for a reduced fee to correct RMD failures
  - Cannot be corrected with certainty without filing under VCP
    - Participants can submit “reasonable cause” letters with their tax returns, but IRS not required to accept

# Forfeitures

- IRS generally requires that forfeitures be “zeroed” out each year.
- Failure to do so can be a qualification failure because it allows for “unallocated” accounts to remain in the plan.
- IRS audit issue.
  - IRS has issued sanctions on audit for this issue.
- Depending on plan terms, the failure may need to be corrected under VCP.

# Compensation

- Compensation often varies in plans
  - Deferral, match
  - Profit-sharing contributions
  - Safe harbor considerations
  - Testing considerations (specific definitions for testing (ADP/ACP, etc.))
- Common failure to not use the “correct” definition of compensation

# Plan Loans

- Plan Loan Failures
  - Failure to make timely payments
    - Because payroll deduction is common, such errors are often employer errors
  - Failure to make complete payments
  - Failure to handle leaves of absence properly
  - Failure to timely default loans after end of “cure period”
- Corrections
  - Taxable in year of default
    - In order to get current taxation for a default in a prior year, VCP submission is required

# Plan Loans (continued)

- Under VCP, the IRS will allow correction where plan loans did not comply with:
  - Limit on loans pursuant to IRC § 72(p)(2)(A) (e.g., participant borrows \$60K)
  - Plan term requirements of IRC § 72(p)(2)(B) or (C) (e.g., participant borrows \$10K over six-year period; should have been five years)
  - Plan repayment terms, resulting in default of loan (e.g., loan payments never begin)
- Correction permitted where “appropriate” and where statutory term of loan (generally five years) has not expired
- Reduced fee if the following requirements are met:
  - Plan loan failure is the sole failure of submission
  - Affected participants are < 25% of total participants in any plan year
  - Error entails failure to follow IRC § 72(p)

# Failure to Timely Amend Plans

- Plans must generally be amended
  - By the end of the plan year in which the change occurs
  - Prior to the implementation of the change for eligibility and amendments that make cutbacks; or
  - By the end of the remedial amendment period for legislative changes.
- Failure to timely amend can only be corrected through VCP

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**QUESTIONS?**

# Thank You

Thank you for joining our webinar today.

Upcoming webinar in our “2016 Plan Sponsor Basics” series:

- Plan Audit Issues | Wednesday, November 16 | 12:00–1:00 pm ET

Register at <https://morganlewisevents.webex.com/>

We hope you have found this to be useful and informative. Again, if you have any feedback or suggestions, please let us know. Thank you for participating and we look forward to seeing you at future events.



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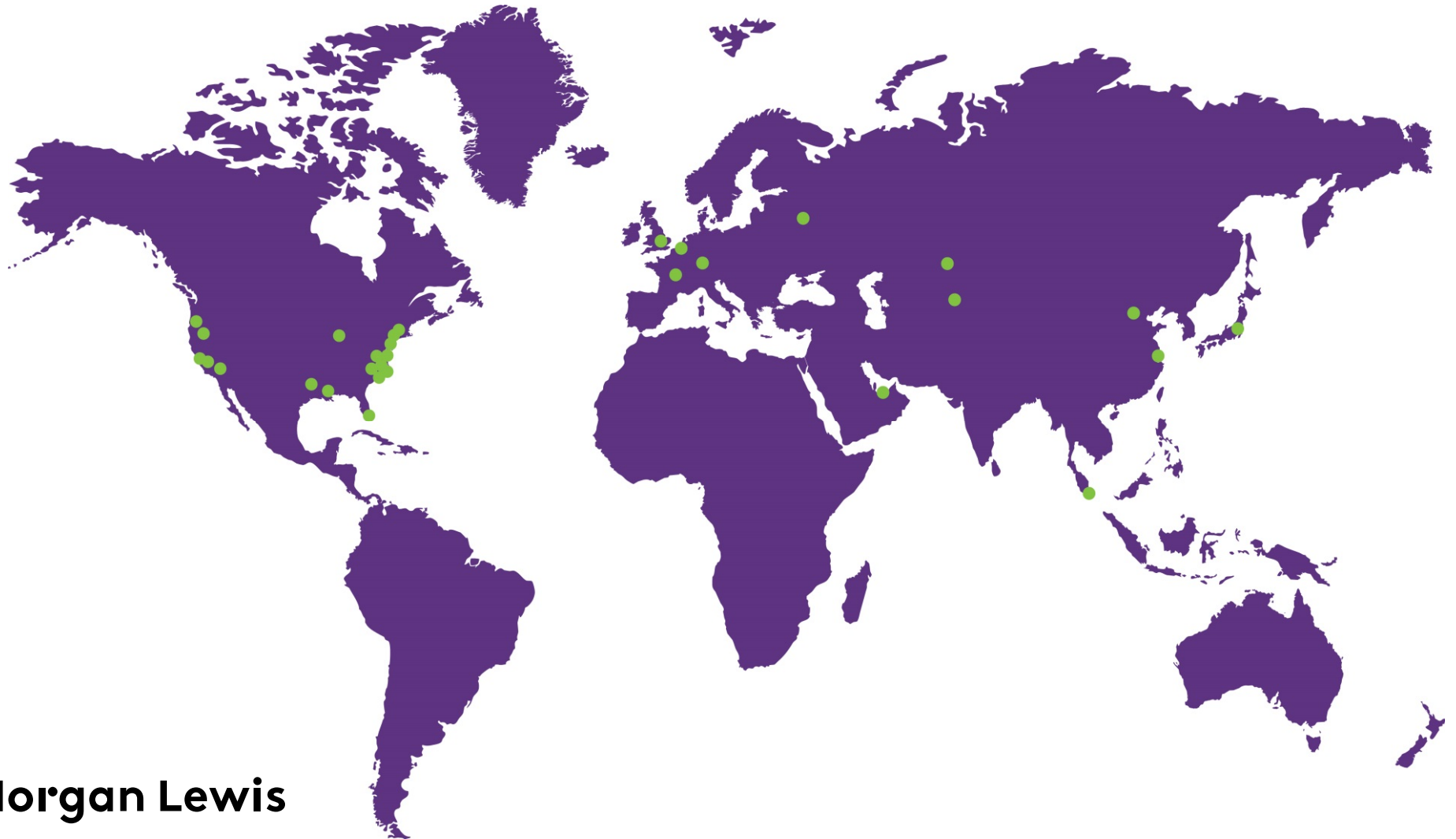
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