REISH LUFTMAN REICHER & COHEN
ATTORNEYS AT LAW

ERISA AUDIT REPORT

A newsletter for retirement plan professionals

July 2004
Vol. 14, No. 1

Message From The Firm

It's Summer 2004, and for our ERISA Department that means Bruce Ashton is three quarters of the way through his term as President of the American Society of Pension Actuaries (ASPA). We congratulate Bruce on a successesful term thus far, and particularly on his ability to balance both the demands of ASPA and a substantial ERISA practice. I am also at the three-quarters point in my initial year as Chair of ASPA's IRS Subcommittee. This October, I will take a one-year leave of absence from this position to serve as General Chair of ASPA's Conferences Committee. Of course, I will continue to serve on ASPA's Board of Directors.

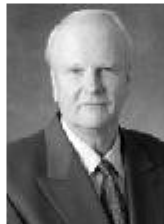
Correcting defects in qualified plans, 403(b) arrangements and SEPs, and assisting plan sponsors with IRS audits and DOL investigations, continue to be an active part of our ERISA practice. In our first article, Marty Heming addresses the IRS' recent issuance of guidance and establishment of an examination program designed to crack down on 412(i) plan "schemes." Marty discusses a 412(i) plan that violated the rules and came under an IRS examination, and the analysis he undertook to formulate and implement a successful method of correction under the Audit Closing Agreement Program.

In our second article, Nick Waddles discusses how to analyze and voluntarily correct GUST non-amender defects under the Employee Plans Compliance Resolution System (EPCRS). Nick explains that failing to timely file for a favorable determination letter ruling does not necessarily mean the plan is subject to disqualification.

As always, we welcome your comments and questions. Please let us know if we can be of assistance to your and/or your clients.

Nick White
NickWhite@Reish.com

412(i) Plan Audits -- The IRS' New Target



By Marty Heming (MartyHeming@Reish.com)

February 13th, 2004 marks the beginning of a new era for 412(i) plans. A 412(i) plan is a defined benefit pension plan that meets the specific requirements of Code Section 412(i), which generally requires that the plan be funded exclusively with individual insurance contracts. A 412(i) plan is exempt from the normal funding rules for defined benefits plans.

For several years, some promoters touted 412(i) plans that were primarily funded with life insurance specifically designed for the 412(i) marketplace. These policies had high loads, high mortality charges and high initial surrender charges. Consequently, the policies had low initial cash values, high premium costs relative to their cash surrender value and high death benefits. In general, these types of plans were designed to create large deductions for about the first five years the plan was in existence. Thereafter, the policies would be sold to the participant at a low cash surrender value, and later, converted to another type of policy. Because the beneficiary of the policy was the plan, the restrictions of the "incidental benefit rule" were not violated. In addition, the deductions were several times larger than could have been realized in any other type of qualified plan, and when the policy was purchased, the taxable cost was much less than the amount of the premiums paid and previously deducted.

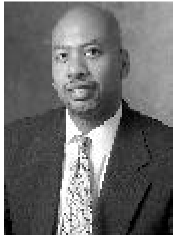
In short, these types of 412(i) plans achieved the ultimate goal of all taxpayers —they provided for large deductions with no comparable tax cost at a later date and without an adverse economic cost. Promoters described these arrangements as "almost too good to be true."

On February 13th, the IRS struck down this "scheme" with four items of new guidance. In a nutshell, the IRS guidance attacks these arrangements by (i) eliminating the deduction for the portion of the premium in excess of what was needed to purchase insurance not in excess of the incidental benefit rules; (ii) requiring that the true fair market value of the policy be included in income at the time the policy is sold to the participant; and (iii) requiring that all participants in the plan have identical types of insurance policies. Because "fair market value" is sometimes elusive, the IRS has provided a safe-harbor definition that permits fair market value to equal cash value if the amount is at least equal to the sum of the premiums paid, less mortality cost and reasonable expenses. To enforce this new guidance, the IRS is currently targeting 412(i) plans for audit.

One of our clients established a 412(i) plan in 2001 and is currently being audited. The plan had purchased a cash suppressed life insurance policy with a death benefit of $2 million payable upon death of the company's sole shareholder. The plan is

(Continued on page 3)

Fixing GUST Non-Amenders Under VCP



By Nicholas J. Waddles (NickWaddles@Reish.com)

Pursuant to Revenue Procedure (Rev. Proc.) 2001-55, the GUST remedial amendment period (GUST RAP) for qualified retirement plans ended on the later of the end of the first plan year beginning in 2001 or February 28, 2002. However, Rev. Proc. 2000-20, (modified by Rev. Procs. 2002-73 and 2003-72) extended the GUST RAP for adopters of certain master and prototype and volume submitter plans—or plans which certified that they would adopt one of those types of plans— to the later of (i) September 30, 2003; or (ii) the end of the twelfth month following the issuance of the opinion letter on the master and prototype plan, or the advisory letter on the volume submitter plan. Further, Rev. Proc. 2003-72 extended the favorable determination letter filing date for plans that had a September 30, 2003 GUST RAP to January 31, 2004.

Now that the GUST RAP has ended for most plans, correcting plans that failed to timely amend for GUST becomes an important issue. In this article, we examine two scenarios you may encounter with your plan or the plans you service, and suggest methods for resolving them.

Scenario 1: *You've recently taken over a plan and discovered that no GUST amendment was ever signed.*

The failure to amend a qualified retirement plan before the expiration of an applicable remedial amendment period results in a Plan Document Failure, as defined in Section 5.01(2)(a) of Rev. Proc. 2003-44. This type of defect can be corrected under the Voluntary Correction Program (VCP) portion of the IRS' Employee Plans Compliance Resolution System (EPCRS). According to Rev. Proc. 2003-44, a Plan Document Failure is properly corrected by making a VCP submission that requests the IRS to allow the sponsor to retroactively adopt an amendment that meets the requirements of GUST. Unless the employer is adopting an approved prototype or volume submitter plan, the VCP submission will have to accompanied by a request for a determination letter, including the applicable user fee. [See, Section 10.06 of Rev. Proc. 2003-44.]

Scenario 2: *You've recently taken over the document and administrative services for a plan and it appears that the employer adopted a GUST document before the expiration of the GUST RAP; however, the employer never submitted the plan for a favorable determination letter ruling.*

The failure to request a determination letter ruling does not necessarily mean the plan is subject to disqualification. If the plan meets all of the requirements of GUST (i.e. it is "perfect" in form), then it does not need an extension to the GUST RAP, because there is nothing to correct. Thus, if you've recently taken over a plan that was never submitted for a determination letter, you may—or may not—have cause to make a submission under VCP.

If the employer timely amended the plan but did not submit for a determination letter request, and you discover that the plan fails to meet one or more of the requirements of GUST, the prudent approach is to voluntarily correct the plan document failure through filing a VCP submission. Ignoring the problem and hoping it will not be discovered by the IRS places the plan at risk for disqualification or a substantial sanction if the non-amender defect is resolved under the IRS' Closing Agreement Program.

What is the VCP Compliance Fee?

According to Section 12.03 of Rev. Proc. 2003-44, the VCP Compliance Fee for plan sponsors that fail to timely amend their qualified plans is determined in accordance with the normal VCP Fee schedule. [See, Section 12.02, Rev. Proc. 2003-44.] However, the Compliance Fee is reduced by 50 percent for non-amenders that file a VCP submission within a one-year period following the expiration of the plan's remedial amendment period. For example, an employer with 700 participants who files a VCP submission would normally be subject to a Compliance Fee of $8,000. However, the Compliance Fee for a non-amender made within the one-year period after the expiration of the plan's GUST RAP would be reduced to $4,000. Of course, this does not include the user fee for the determination letter application. ❖

IRS Audit Activity

At a recent conference, an IRS official explained that IRS audit activity of retirement plans will be increasing. Much of the focus will be on 401(k), 403(b) and 457 plans, multi-employer plans and very large plans.

For 401(k) plans, the audits will focus on, among other things:

- the failure to properly follow the terms of the plan;
- the improper exclusion of employees from participation in the plan;
- contribution and/or allocation errors;
- failure to make top-heavy minimum contributions; and
- the proper identification of highly compensated employees for testing purposes.

Because of the IRS audit activity, plan sponsors are well advised to review their procedures to ensure that they are properly gathering information and correctly applying the terms of the plan to that information. As a suggestion, plan sponsors should pick one or two areas each year and internally audit their procedures in those areas to ensure that they are complying with the rules. (In many of these cases, there are internal IRS guidelines or training materials which can assist in the self audits.) The list above is a good starting point for deciding the areas to self audit.

Fred Reish

412(i) Plan Audits

(Continued from page 1)

the sole beneficiary of the policy and the premiums, all payable within 5 years, are well in excess of the amount that could be contributed to a non-insured plan. The other three participants in the plan have annuities but no life insurance, and the plan permits participants whose lives are covered by insurance to purchase the policy from the plan for its cash surrender value. At the time of the audit, the policy had not been purchased from the plan.

Because the plan provides the sole shareholder with the ability to purchase his life insurance policy but doesn't offer the same ability to the rank and file participants, the plan is subject to disqualification. [See, Rev. Rul. 2004-21.] Therefore, we must negotiate an audit CAP sanction under Rev. Proc. 2003-44. Of course, audit CAP requires the payment of a sanction and correction of the defect. In this case, the client has opted to purchase life insurance policies for the other participants with provisions identical to that of the sole shareholder. Depending on the insurance company and the characteristics of the other participants, this may not be a viable correction. The only other possible correction is to amend the plan to prohibit purchase by the sole shareholder.

In addition to correcting the disqualification defect, a portion of the premiums paid for the last three years will be considered a non-deductible contribution to the plan. Accordingly, the company's Form 1120 federal income tax return must be amended to include that additional income, and the company must pay additional tax, interest and penalties. In addition, the 10 percent excise tax on non-deductible contributions must be paid using a Form 5330. One must remember that the excise tax calculation pyramids every year until the excess deduction is eliminated. This means that the client not only has a problem for the past three years, but also for all future years until the policy is converted to a different type, sold or distributed.

One issue that remains unresolved is how to calculate the premium on the portion of the insurance deemed to be in excess of the incidental benefit limitation. In this case, the incidental benefit limit is about $800,000. Thus, $1.2 million is the excess portion. We are taking the position that the portion of the premium equal to the cost of a one-year term on the $1.2 million using the tables provided in Rev. Rul. 55-747 is the nondeductible portion of the deduction paid. However, this aspect of the case has yet to be negotiated with the IRS agent.

The change to the regulations which mandates sale at "fair market value," doesn't yet affect the plan because the policy has not been sold. However, it will eventually have to be faced. The fair market valuation rule has two consequences. The price to be paid to the plan for the policy under the DOL class exemption PTE 92-6 is the cash surrender value. The recent guidance makes no change to PTE 92-6. However, for tax purposes, the person buying the policy will be paying less than fair market value, thereby creating a bargain element. This means (i) tax must be paid on the bargain element and (ii) if there is no distributable event, such as attainment of normal retirement age or termination of the plan, the bargain element is treated as an impermissible in-service distribution that will disqualify the plan. Thus, even after the audit is over and a successful audit CAP negotiated, there still remains the unsolved problem of how to get rid of the life insurance.

How is this case important to you?

This case is important if you or your clients have taken advantage of the cash suppressed life policies in 412(i) plans offered by the insurance industry over the past several years. Now is the time to consider self correction before that plan is audited. Finally, you should realize that most of these rules are not limited to 412(i) plans. Cash suppressed life insurance policies in profit sharing plans must be sold out of the plan using fair market value. Moreover, key man life insurance in a defined benefit plan may create a non-deductible employer contribution. ❖

Plan Fees and Expenses

by Fred Reish
(FredReish@Reish.com)

The Employee Benefits Security Administration (EBSA) of the U.S. Department of Labor (DOL) has recently released several publications intended to help plan sponsors and fiduciaries understand and fulfill their duties.

Since this newsletter focuses on IRS audits and DOL investigations, I particularly recommend that you review the new publication "Understanding Retirement Plan Fees and Expenses." You can download a copy of this report at www.dol.gov/ebsa/pdf/undrstndgrtrmnt.pdf.

The brochure does a good job of discussing the types of fees involved in retirement plans—and particularly in participant-directed plans, such as 401(k) plans. It also details a series of steps that fiduciaries can take to better understand and evaluate their fees. I recommend that you read the publication and work with your financial advisor or investment consultant to go through those steps, including the disclosure form discussed in the brochure.

It appears that the EBSA is continuing to focus on plan fees and expenses. As a result, I believe that you can safely assume that, if your plan is investigated by the DOL, they will look at the expenses being paid by your plan—both directly and through your investments. Since fiduciaries have a duty to know the fees being paid and to understand both the amount of those fees and the services being received for those fees, ignorance and lack of effort are tantamount to breaches of fiduciary duty. You should have information in your files that shows an investigation of the fees and costs, as well as an analysis or comparison to what is generally available in the marketplace. Without that information, you can't show that your plan has been managed prudently.

Will the DOL Use the 2002 Form 5500 as an Audit Trigger? (Part II)

By Nicholas J. Waddles (NickWaddles@Reish.com)

In our last Audit Newsletter, we wrote to you about certain changes to the 2002 Form 5500 and whether these changes—specifically, the wording of Question 4a of Schedules H and I—would lead to increased investigative activity by the Department of Labor (DOL). You will recall that Question 4a asks whether the employer transmitted any employee deferrals to the plan beyond the time permitted in the DOL regulations. The point of that article was to raise the issue of how the DOL planned to use that information, and if it would be used to trigger investigations.

Although we have not heard directly from the DOL on this point, it appears that at this time the DOL may be using that information to encourage employers to correct the delinquent deposits through the Voluntary Fiduciary Correction (VFC) Program. That is, some of our clients who answered "yes" to Question 4a have received letters from the DOL inviting them to make a submission under VFC to correct the late deposits and receive a no-action letter. Generally, VFC is not available once a sponsor is under investigation. And, the letters we have received suggest that the failure to make a VFC filing—or at least demonstrate to the DOL that the delinquent deposits have been corrected—may lead to an investigation.

If you or one of your clients answered yes to Question 4a and have not corrected the delinquent deposits under VFC or other method, you should do so immediately.

If you or one of your clients has received a "warning" letter from the DOL, you should start planning your response strategy with qualified ERISA counsel. Act quickly before you hear from the DOL again, because the next letter might be the start of an investigation. ❖

Fred Reish to Receive ASPA's Eidson Award

Fred Reish will be presented with the American Society of Pension Actuaries' (ASPA) prestigious Eidson Founder's Award at the ASPA Annual Conference in Washington, D.C. in October.

Established in 1995 to honor ASPA's founder, Harry T. Eidson, the award is given each year to an individual who has made a "lasting, positive" influence on the organization or the private pension system. The honoree is chosen for his or her contribution over a period of years involving time "above and beyond reasonable expectations" to ASPA and to the pension community.

In addition to receiving an award at the ASPA Annual Conference, Fred's name will be engraved, alongside past recipients, on a permanent plaque displayed in the ASPA National office.

We congratulate Fred on this well-deserved recognition!

Around the Firm

Speeches: Fred Reish is co-presented a session regarding "Mutual Fund Scandals - How They Will Affect You and Your Clients" at the ASPA Summer Conference, held July 18-21 in San Francisco. At the same conference, Fred presented a workshop on the "Top Ten Fiduciary Problems," Joe Faucher presented a workshop on "Claims, Litigation and Risk Management," and Marty Heming spoke on "Abusive Retirement Programs." At the NIPA Annual Conference in Palm Springs in May, Nick White was a co-presenter at the opening session entitled "Plan Document Symposium" and Bruce Ashton gave a presentation on "What 404(c) Can Do for You... and What It Can't." Nick also spoke on April 12th at the Annual Conference of the Council on Education and Management regarding "Successfully Navigating Mandatory Benefits Laws." Nick Waddles co-chaired the Western Pension & Benefits Conference's Los Angeles Chapter 2004 Spring Summit in April and gave a presentation to 401(k) brokers on the topic of fiduciary liability in May.

Articles: Fred and Joe co-wrote their quarterly 401(k) investment issues column in the Spring 2004 issue of *Journal of Pension Benefits* addressed the topic of "Responding Prudently to the Mutual Fund Scandal." Fred and Bruce co-wrote "Avoiding Investments Advice Hazards" in the March-April 2004 issue of *The ASPA Journal*.

Quotes: Marty was quoted in the June 12th *Orange County Register* in the article "Early Pension Action Advised for Boomers." Fred was quoted in the May 17th issue of *Pension & Investments* in the article "In Whose Interest?" Fred was also quoted on April 21st on CBS.MarketWatch.com in the article "Dilemma for Employers Offering Investment 'Guidance.'" Bruce was quoted in the March 9th issue of *DC Plan Investing* in "Update of EGTRRA Legislation."

©2004 Reish Luftman Reicher & Cohen. All rights reserved. *THE ERISA AUDIT REPORT* is published as a general informational source. Articles are general in nature and are not intended to constitute legal advice in any particular matter. Transmission of this report does not create an attorney-client relationship. Reish Luftman Reicher & Cohen does not warrant and is not responsible for errors or omissions in the content of this report.