

ERISA AUDIT REPORT

A newsletter for retirement plan professionals

Message From The Firm

This month, Bruce Ashton and I will be taking on new responsibilities with the American Society of Pension Actuaries (ASPA). For many years, Bruce has been an active member of ASPA, serving on the Executive Committee and as Co-Chair of the Government Affairs Committee. Now, Bruce will take on the important position of President for 2003-2004. Congratulations, Bruce! And, I will take over as Chair of ASPA's IRS Subcommittee, having served as the prior Vice-Chair of the Subcommittee. The Subcommittee monitors the audit and regulatory activities of the IRS, and provides written comment to the IRS and Treasury on those issues.

Correcting defects in qualified plans and assisting plan sponsors with IRS audits and DOL investigations continue to be an active part of our ERISA practice. In our first article, Debra Davis and I discuss a recent case in which we assisted a plan sponsor in correcting a defect regarding matching contributions. The problem is common; however, our proposed method of correction was not. And, in order to secure the desired method of correction, we had to address competing IRS correction principles.

In our second article, Nick Waddles discusses a change in the Form 5500 that may trigger more DOL investigations. The change is a subtle one, and concerns whether a plan sponsor has timely deposited employee deferrals.

Finally, we have attached to this newsletter the most recent article Fred Reish, Bruce and I wrote for the Journal of Taxation regarding the latest changes to EPCRS (also available on our web site at www.reish.com/pa/benefits/jtax_sept03.cfm).

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

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Resolving Competing Correction Principles under EPCRS

By Debra Davis (DebraDavis@Reish.com) and Nick White (NickWhite@Reish.com)



The IRS' Employee Plans Compliance Resolution System (EPCRS) consists of programs that permit sponsors of qualified plans, Section 403(b) arrangements, SEPs and SIMPLE IRA plans to correct various types of violations of the Internal Revenue Code. (EPCRS is described in

Rev. Proc. 2003-44.) EPCRS contains "correction principles" to be taken into account when correcting violations. In certain circumstances, these correction principles may appear to compete with each other. When they do, experience and a thorough knowledge of the relevant rules are crucial to achieving a good result.

A client with several thousand employees recently discovered that it had made matching contributions in a manner that conflicted with the plan's written terms. Specifically, the plan document did not provide for a match on employee deferrals attributable to overtime pay; however, in operation—and totally inadvertently—the plan matched these deferrals. Matching deferrals attributable to overtime pay caused a defect that subjected the plan to disqualification if the IRS were to audit the plan and discover the error.

This violation of the plan's terms spanned several plan years and affected thousands

of participants. Therefore, the amount of the "excess" match was substantial, and the client wanted to recover it if possible. We were consulted to determine whether this could be accomplished under EPCRS.

The traditional correction for this type of violation is for the improper matching contributions to be forfeited from participant accounts and used in accordance with a plan's forfeiture provisions (i.e., to reduce future employer contributions or to pay plan expenses). This "forfeiture" method of correction complies with the EPCRS correction principle that "[t]he correction method should keep plan assets in the plan..." [See Rev. Proc. 2003-44, Section 6.02(2)(c).] At the same time, it was not the correction methodology our client felt was appropriate in this case.

Given our extensive experience with the EPCRS programs, we are aware that the purpose of the IRS remedial programs is to ensure that the benefits contemplated by the plan sponsor, its employees and plan participants are provided in accordance with the qualified plan rules. Thus, EPCRS is not about providing for unintended results—such as "windfall" matching contributions. To that end, we submitted a voluntary application on behalf of the plan sponsor to correct the failure by having the excess matching contributions forfeited and returned to the employer.

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Will the DOL Use the 2002 Form 5500 as an Audit Trigger?



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

As this article is being written, many employers are in the process of filing their Form 5500 for the 2002 plan year. A subtle change to one question on the 2002 Form 5500 is aimed squarely at helping the Department of Labor (DOL) identify employers that have failed to timely remit employee deferrals to 401(k) plans (untimely deferrals are often referred to as “late deposits”). This article discusses whether the DOL will use employers’ responses to that question to generate audit activity. (Technically, the DOL does not “audit” retirement plans; it “investigates” them. However, in this article, the terms “audit” and “investigation” will be used interchangeably.)

What Is the DOL’s Position on the Timely Remittal of Deferrals?

The late deposit issue has been one of the DOL’s enforcement initiatives since 1995. This is also one of the most common areas of non-compliance for employers that sponsor 401(k) plans. We have extensive experience in assisting employers and service providers with DOL investigations, and the late deposit issue is one of the first issues an investigator will examine.

Employee deferrals to 401(k) plans must be remitted to the plan trust “as of the earliest date on which such contributions can reasonably be segregated from the employer’s general assets.” [29 C.F.R. 2510.3-102.] The DOL takes the position that the earliest date deferrals can be remitted to a trust is determined on an individual, case-by-case basis. Thus, the “earliest date” is different for each employer. Given that most companies have the ability to transfer funds electronically, the earliest date is often no more than a few days after payday. Further, the DOL has stated on numerous occasions that be-

cause of the “earliest date” requirement, employers may not wait until the 15th business day of the following month (the maximum time permitted under the regulations) to deposit the deferrals. The DOL knows this is an area of significant non-compliance and conducts its audit activity accordingly.

What Are the Consequences of Failing to Timely Remit Deferrals?

The DOL treats late deposits as an impermissible loan from the plan to the employer. As such, they are a prohibited transaction (for both IRS and DOL purposes) as well as a breach of fiduciary duty. Additionally, the failure violates ERISA’s requirement that plan assets be held in trust and, depending on the wording of plan, the Internal Revenue Code’s definite written program requirement.

What Is the Connection to the 2002 Form 5500?

Historically, Question 4a on the financial information schedule of the Form 5500, (Schedule H for large plans and Schedule I for small plans) asked whether employee deferrals were deposited “on time.” Beginning with the 1999 revisions, Question 4a specifically asked whether “the employer fail[ed] to transmit to the plan any participant contributions within the maximum time period described in the regulations?” This wording required a “yes” answer only from employers who deposited deferrals later than the 15th business day of the following month (the maximum time permitted under the regulations).

However, beginning with the 2002 form, Question 4a was revised to ask whether “the employer fail[ed] to transmit to the plan any participant contributions within the time period described in the regulations?” Note that the word “maximum” has been removed from the question.

Thus, the current wording of Question 4a requires a “yes” answer if employee deferrals were at all “late” as defined by the regulations—i.e., deposited any number of days beyond the employer’s reasonable time period. Consequently, any employer who remitted deferrals beyond its reasonable time period is required to answer Question 4a in the affirmative. But what difference, if any, does an employer’s answer make?

Why Are the Changes Important to You?

One of the issues currently being discussed in the retirement community is whether the DOL will use Question 4a, and employers’ answers to it, to target

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Recommended Reading

by Fred Reish

From time to time, I am asked to edit books on fiduciary prudence for investments. Where the concepts in the book are sound (at least in my opinion) and where the book is authoritative, I will edit and endorse the work. One such book is “The Prudent Investor Act: A Guide to Understanding,” by W. Scott Simon. I wholeheartedly recommend this book to any student of fiduciary responsibility.

“The Prudent Investor Act: A Guide to Understanding” describes and explains the standards of investment conduct for all fiduciaries. This book also shows ERISA fiduciaries (and the investment community that serves them) why prudence is determined not by portfolio performance, but by a fiduciary engaging in a rational decision-making process. The author of the book, W. Scott Simon, is an investment counselor with Prudent Investor Advisors. Scott is both an attorney and a Certified Financial Planner®.

Copies of his book may be ordered online at www.prudentinvestoract.com or by calling toll-free 1-888-265-2732.

Correction

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How could we do this in view of the “requirement” that assets stay in the plan? Well, we were aware of another—equally important—EPCRS correction principle that states that the “correction method should restore the plan to the position it would have been in had the failure not occurred...” [See Rev. Proc. 2003-44 Section 6.02(1)]. In addition to making this guidance the basic premise for our proposed method of correction, we submitted documentation establishing three key points: (1) the plan participants were fully aware of the manner in which the matching contributions were supposed to operate; therefore, they could not have had any reasonable expectation of receiving a match on overtime pay; (2) the amount of the excess match was substantial; and (3) if the plan were permitted to retain the excess match, it would result in an unnecessary burden on our client, given its other employee benefit obligations. After much analysis and negotiation, the IRS ultimately accepted our proposal to return the excess matching contributions to our client.

EPCRS contains another correction principle which holds that the amount of a corrective allocation or distribution must include related earnings (it may also include losses). [See Rev. Proc. 2003-44 Section 6.02(4)] With respect to the earnings on the matching contributions returned to our client, our voluntary application requested that the affected participants be permitted to retain any such amounts in their accounts. But why would our client not want to recoup the earnings as part of the amounts being returned to the plan sponsor? And, in any event, why wouldn't the failure to include earnings be inconsistent with the correction principle we had used to secure the return of the excess matching contributions (i.e., to put the plan in the position it would have been in absent the error)?

The answer is simple: the cost of calculating the relevant earnings would have

been prohibitive, and would have likely far exceeded the earnings amount at issue. The earnings calculation would have required the plan sponsor to perform numerous, separate calculations for each affected participant for each pay period during the affected plan years.

To avoid this, we argued for the application of the EPCRS correction principles stating that full correction may not be required in those situations where (i) “it is unreasonable or not feasible” and (ii) where “it is possible to make a precise calculation but the probable difference between the approximate and the precise restoration of a participant’s benefits is insignificant and the administrative cost of determining precise restoration would significantly exceed the probable difference...” [See Rev. Proc. 2003-44 Section 6.02(5)]

Although these correction principles are most often cited as a basis for using “reasonable estimates” (i.e., shortcuts in corrective calculations), we used them in this case as a basis for permitting the affected employees to keep any earnings accrued to their accounts as a result of the matching contribution defect. In addition to emphasizing and detailing the exorbitant administrative costs, we noted that all of the affected participants were non-highly compensated employees and, thus, leaving the accrued earnings in their accounts could not result in any prohibited discrimination. Again, ultimately, the IRS accepted our proposal regarding how to handle the corrective earnings adjustment.

Conclusion

Under EPCRS, plan sponsors are often faced with apparently “conflicting” correction principles. The keys to success in these cases are (i) a thorough understanding of *all* of the correction principles available, and (ii) a working knowledge of how each of these principles can best be applied under various facts and circumstances. To this end, plan sponsors should seek experienced advisors to assist them through the maze of correction guidance known as EPCRS. ❖

Form 5500

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plans for audit. More specifically, are employers who voluntarily admit to having late deposits more likely to be the subject of a DOL investigation? Similarly, will there be additional consequences for employers who answer Question 4a “no” (effectively stating they have not had any late deposits) but who are later discovered (on audit) to have in fact had late deposits?

At this point, the DOL has not released any official statements indicating how it will use the information, if at all. But considering the limited resources of every government agency, the intentional elimination of the word “maximum” from the question and the fact that late deposits are an enforcement initiative of the DOL, it is reasonable to assume that the information will be used to further investigations in some manner. What options are there for an employer that thinks it may have late deposits?

What Can You Do?

As an initial matter, employers should answer Question 4a truthfully—remember that the Form 5500 is signed under penalty of perjury. Also, we recommend that employers take advantage of the impending filing deadline to review their plan’s deposit history with their retirement plan advisors and determine whether they have had any late deposits during the year. If so, the employer should develop a strategy for correcting the late deposits. In certain cases, they may find it advantageous to use the DOL’s voluntary fiduciary correction program. Finally, employers should make sure they timely deposit employee deferrals in the future. The DOL continues to be vigilant about the timeliness of the deposit of employee deferrals—employers should do the same. ❖

Around the Firm

Speeches: Fred Reish is speaking on Key Fiduciary Issues for 401(k) Plans for 2003 at the ASPA Annual Conference, being held October 26-29 in Washington, D.C. Bruce Ashton will be a co-speaker on "Aggressive Tax Practices" at the Annual Conference. In addition, Marty Heming and Nick White are co-presenting a workshop at the Conference on "Post-Enron Fiduciary Liability in ESOPs, KSOPs, and 401(k) Plans."

Fred was one of three presenters on the topic of "Offering 401(k) Investment Advice" at an IOMA Audio Conference on September 23rd. Nick White and Nick Waddles co-presented a speech on "Plan Qualification Issues" to the Employee Benefits Committee of the Los Angeles Chapter of the California Society of CPAs on July 24th.

Articles: Fred, Bruce and Nick White co-wrote an article for the September issue of the *Journal of Taxation* on "EPCRS Streamlined to Make Voluntary Correction Generally More Attractive to Businesses." Fred's September column for *Plan Sponsor* magazine addressed "The Price of Everything and the Value of Nothing: Contemplating the Costs of Not Considering Costs." Fred, Joe Faucher and Debra Davis co-wrote their 401(k) Investment Issues column in the Summer issue of *Journal of Pension Benefits* on "The Effect Enron May Have on Fiduciaries of 401(k) Plans That Do Not Comply with ERISA Section 404(c)." Fred, Bruce and Joe co-wrote the July 21st ASPA ASAP bulletin on "Department of Labor Sues Enron."

Quotes: Fred was quoted in the October 3rd issue of USA Today in "Enron Lawsuit Go Ahead May Push 401(k) Changes." Fred was also quoted in the September 15th issue of *Barron's* in the article "Do Your Employees Know Where Their Retirement Money Is Invested?"

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