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Department of Labor Corner (DOL) Practical Application of the Revised VFC

By Marty Heming, Esq.



On March 14, 2000, the PWBA (now EBSA) originally published the interim Voluntary Fiduciary Correction (VFC) program. Initially, VFC provided that plan sponsors, fiduciaries and parties of interest, known collectively as plan officials, could voluntarily correct specific violations of the Employee Retirement Income Security Act of 1974, as amended (ERISA).

To be eligible for the program, neither the applicant nor the plan could be under investigation by EBSA. Only those violations of ERISA listed in the program could be the subject of the application. Correction of the violations was limited to the exact methodology set forth. While there was no correction fee to use the program, the plan participants were required to be notified in writing of the breach and its correction.

In short, the way the program was established was that a plan official created an application under VFC for one of the specified breaches. He or she corrected the breach in accordance with the correction guidelines provided by EBSA. Once this was completed, EBSA would issue a no-action letter indicating that it will not pursue civil enforcement against the plan officials. Moreover, EBSA agreed not to impose the 20 percent penalty mandated under ERISA Section 502(l) when breaches of ERISA were resolved using VFC. EBSA's rationale was that, since the correction was made without negotiation, the 502(l) penalty could be avoided because there was no settlement i.e., no agreement between the plan officials and EBSA.

On April 29, 2002, EBSA adopted changes to VFC, the most important being the elimination of the prohibited-transaction excise tax for certain prohibited transactions corrected under VFC. Prior to April 29, 2002, prohibited transactions corrected under the VFC were subject to the 15 percent excise tax imposed by the IRS under IRC 4975. However, EBSA and the IRS in a coordinated effort have eliminated the excise tax, the interest otherwise payable on late filing of the Form 5330 and the late-filing penalty otherwise applicable. This waiver applies only to specified prohibited transactions that are corrected voluntarily under VFC.

The EBSA adopted a final version on April 19, 2006 of interim modifications proposed about a year earlier. Simply put, the new changes:

- Coordinated participant loan failures with IRS VCP program which were simultaneously violations of the terms of the plan document and constituted prohibited transactions;
- Added several new corrections;
- Provided a model application form;
- Provided an online calculator to permit determination of deemed lost earnings;
- Made documentation of the VFC less onerous; and
- Amended Prohibited Transaction Exemption (PTE) 2002-51 to eliminate the notice requirement for certain minor failures to timely deposit elective deferrals.

Two Cases Highlight When and How to Use VFC

CASE #1: EBSA has recently been sending pension and profit-sharing plan sponsors "friendly invitations" to use the VFC program. Although unstated in the invitation, the implication is that if the sponsor fails to accept the invitation, EBSA will open an investigation. When faced with such a letter, ERISA attorneys have generally advised their clients that they have three choices: file a VFC application; self correct the violation; or ignore the EBSA letter.

The advantage of self correction is that it will, if properly done, avoid the ERISA 502(l) penalty and be simpler, quicker and less expensive than using the VFC program. Moreover, it avoids the necessity of providing a detailed notice to the employees of the violation of ERISA.

Alternatively, using VFC has two advantages. First, the excise tax, as well as the interest and penalty for late filing the Form 5330 are avoided. Second, you know the violation was corrected to the satisfaction of EBSA because the sponsor receives a no-action letter upon which it can rely. Finally, the new streamlined VFC is easier and covers more transactions.

The most common use of VFC is for delinquent deposits. If an elective contribution to a 401(k) plan isn't deposited in the trust as soon as it can reasonably be segregated from the general assets of the employer after withholding, but in no event more than 15 business days after the end of the month in which the amount was withheld, it is a prohibited transaction, i.e., a loan from the plan to the plan sponsor.

The following example is typical of many of our clients. In this case, the plan sponsor had a 401(k) plan with less than 100 participants. The plan sponsor received a friendly letter in 2006 and decided to hire counsel to help them respond.

The plan was established in 2001 and initially had not arranged to have the amounts withheld for elective deferral or repayment of participant loans electronically deposited to the 401(k) plan. Instead, the amounts were withheld. Subsequently, the employer would write a check to the 401(k) plan.

In 2006, the employer went to a system of automatic deposit to the plan directly from payroll withholding. And the number of days from withholding to deposit was reduced to three or less. Based on a review of time from withholding to manual deposit during 2001 through 2005, we estimated that if EBSA were to investigate the plan, they would most likely determine that the feasible deposit time was seven days. There is no magic formula for making this determination. It is our experience that if EBSA were to investigate, they would review all of the elapsed time periods from payroll date to deposit date and determine the shortest period that wasn't an isolated occurrence.

The next step was to use the EBSA online calculator located on the Internet. Simply type into Google, "EBSA online calculator." The calculator requires that you do each payroll separately. You must then print out each one and move to the next payroll. Before you do this, you must know the date that the unpaid interest will be deposited.

An initial estimate of the amount of the lost earnings based on the EBSA calculator was under \$600. This type of a small number is not unusual if the number of days the deposits were late is small. Based on this, it was clear that the amount of the excise tax would be less than \$100. If the VCP was used, the excise tax would not have to be paid to the IRS as long as it was deposited to the plan in addition to the lost earnings. The client decided that it wanted to use the VFC program to make the correction so that the amount of the excise tax could be paid to the plan and no notification would be required.

An interesting twist to the correction was that the plan document mandated that the elective deferrals be made to the plan within the time required by the EBSA rules. As a result, the later deposit wasn't only a prohibited transaction but also subjected the plan to disqualification for failure to follow its operation terms. Unfortunately, neither EPCRS nor VFC provide for coordination of the correction, so that use of VFC would automatically correct the operational failure of the plan. The VFC correction should suffice as meeting the requirements for such self correction.

CASE #2: A second example involving VFC occurred when an employer had a profit-sharing plan with individual investments and one of the owner participants decided to make a loan of a part of his account to a member of his family. He was later advised that the loan was a prohibited transaction but he didn't have the money to make correction. To avoid having an incorrect Form 5500, the form was completed showing that a prohibited transaction occurred.

Once again, EBSA sent the employer an invitation to make correction. The employer sought advice of counsel as to how to proceed. Initially, it appeared that this client might be a good candidate for use of VFC. Section 7.2 states that this type of loan is eligible for the program if it was made at fair market value and if we could get a lender to verify in writing that the interest was at fair market value when the loan was made. However, even if we could meet that requirement, it wasn't possible to meet an unstated requirement of VFC, i.e., the loan had to be in the form a written promissory note when issued.

I learned from discussions with EBSA officials that any loan that was not in written form when made was not eligible for the VFC program. Of course, the late deposits are a special case because they are separately addressed. In this case, we had an oral loan. This shortcoming of the VFC program limits its usefulness. As a result, the only remaining option was to make voluntary correction and so inform EBSA. Of course, the IRC 4975 excise tax had to be paid as well as the interest. We were able to get the late filing penalty waived

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ESOP Idiosyncrasies

By Mychelle Holloway, CPC, QPA



If you are a third party administrator overseeing only a handful of Employee Stock Ownership Plans (ESOP), you may feel a little overwhelmed - and perhaps you should. Numerous federal and state agencies have gone out of their way to make the administration of ESOPs complicated. There are probably hundreds of things you need to stay on top of in order to provide quality service to clients that sponsor ESOPs.

Crucial for accurate administration and compliance testing, here are 10 ESOP idiosyncrasies:

1. Unlike other defined contribution plans, an ESOP can be leveraged or non-leveraged. A leveraged ESOP purchases shares of stock of the sponsoring company with the proceeds of a loan, whereas a non-leveraged ESOP uses other methods to acquire shares. If you have a leveraged ESOP and one of the selling shareholders elected 1042 (capital gain tax deferral), you will need to comply with IRC Section 409(n) prohibited allocation rules. Proper administration of a leveraged ESOP also requires a detailed review of the loan documents to ascertain the correct share release method, maintain the amortization schedule and properly handle pre-payments or late payments.
- 2: Whether the ESOP is leveraged or not will affect IRC Sections 404(a)(3) and 404(a)(9). Not only do you need to know if you are administering a leveraged or non-leveraged ESOP, but if the plan sponsor operates as a C Corporation or S Corporation as well. An S Corporation can deduct up to 25 percent of eligible fiscal year wages as employer contributions. However, a C Corporation sponsoring a leveraged ESOP can take an additional 25 percent deduction if that additional amount is used to make loan payments on an ESOP loan. C Corporations can additionally deduct interest payments made on an ESOP loan over and above the 25 percent.
- 3: A highlight of being leveraged or non-leveraged also affects IRC Section 415, limiting the amount each participant can accumulate in a limitation year as an annual addition. If the leveraged ESOP is sponsored by a C Corporation then the one-third test (IRC Section 415c(6)) may provide relief from the 415 limits on annual additions.
- 4: If you are administering an ESOP sponsored by an S Corporation, you must be fluent in IRC Section 409(p) and how to properly execute this test. Failure to adhere to the terms of 409(p) can be highly adverse to both the plan and the sponsor – they may face income taxes, substantial excise taxes, and possibly even plan disqualification.
- 5: IRC Section 409(o) details how and when ESOPs must make distributions of benefits attributable to employer stock acquired after December 31, 1986. 409(o)(1)(B) provides an exception for leveraged ESOPs while the ESOP loan is still outstanding (with certain parameters). ESOP participants have the right to demand their distribution in the form of company stock unless sponsored by an S Corporation or the corporate charter or by-laws restrict ownership of company stock to current employees and the trust. Because of the possibility of stock distributions, ESOPs should track the cost basis of the stock held in participant's accounts.
- 6: IRC Section 401(a)(28) details the rules of diversification of employer stock acquired after December 31, 1986 and held