

The DOL Updates the VFC Program: What do the Changes Mean to You?

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On April 19, 2006, the Department of Labor (DOL) issued an updated version of its Voluntary Fiduciary Correction Program ("VFC" or the "Program"), adding additional transactions that can be corrected under the Program and expanding the ability to obtain relief from prohibited transactions (PTs). The expansion of VFC follows the pattern we have seen in the IRS Voluntary Correction Programs for plan qualification defects. Those Programs started out narrowly, but gradually expanded as the IRS became more comfortable with the Programs. We are now seeing the same type of expansion with VFC.

Before getting into the changes, let's look at the background. Under VFC, individuals who could be liable for a fiduciary breach can avoid a DOL civil investigation or other DOL action with respect to that breach. Under the Program, the DOL will issue a "no action" letter to the applicant if all of the conditions for relief have been satisfied. In addition, the DOL will waive any penalties under ERISA section 502(1) (which imposes a 20% penalty on the "applicable recover amount" in a civil action or settlement involving the DOL), and the civil penalties under ERISA Section 502(i) for certain prohibited transactions. Only certain types of fiduciary breaches are eligible for relief under VFC, all of which deal with transactions involving valuation and/or prohibited transaction issues under Title I of ERISA.

As explained by the DOL, the purpose behind the revised Program is to update, simplify and expand VFC. The changes became effective on May 19, 2006. Prior to that time, applicants could rely on the March 2002 version of VFC or the interim program published in April of 2005.

What are the Changes?

The 2006 update expands VFC by adding three new covered transactions:

1. Participant loans: Breach of Fiduciary Duty for Failure to Meet the Level Amortization Requirement. Under ERISA, it is a PT for any plan fiduciary to permit a loan by a plan to a participant in interest - including plan participants - unless there is an exemption. (In addition, PTs also constitute fiduciary breaches.) Loans to participants are exempt so long as various conditions, including the requirement that the loan be based on a level amortization repayment schedule, are met. Failure to do so is a prohibited transaction. By including this breach in VFC, the DOL has increased the number of covered transactions involving participant loans to 4. The other three transactions covered by the Program are (i) participant loans that exceed the maximum limit under Internal Revenue Code (IRC) § 72(p); (ii) participant loans with repayment terms that exceed the maximum under IRC §72(p); and (iii) participant loans that meet the compliance requirements at the time they were made, however, those terms were not followed due to a failure of an individual responsible for the administration of participant loans to properly withhold loan repayments from the participant's wages, as required under the terms of the loan.

What is the Correction? This defect must first be corrected under the Voluntary Compliance Program (VCP) of the Employee Plans Compliance Resolution System (EPCRS; Rev. Proc. 2006-27), since for most, if not all, plans the defect results in a failure to follow the terms of the plan and, therefore, subjects the plan to disqualification. The compliance statement issued under VCP must then be submitted with the VFC application, along with proof of payment of any penalties required under VCP.

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Comment: This change to VFC is good news, because it addresses a fairly common breach and provides for what comes close to one-stop shopping. That is, with relatively few modifications, a single application can be used to voluntarily correct both the qualification issue and the fiduciary breach, which means a savings in professional fees for the plan sponsor. The one quibble we might offer is that by having to wait for the IRS to issue a Compliance Statement, the process of fully protecting the plan and the fiduciaries can take an extended period of time. We hope the DOL will permit a simultaneous filing using a single application. Hopefully, this type of coordination between EPCRS will be expanded in subsequent restatements of the Program. We are also hopeful that the IRS will take particular note of the DOL's efforts in this regard, and adopt procedures which deem any PT corrected in accordance with VFC to be corrected for IRS purposes as well.

2. Improper payment of expenses from the plan. This violation takes place when plan assets are used to pay expenses, including commissions or fees, which should have been paid by the plan sponsor. This breach is also a PT.

What is the Correction? The fiduciary must restore to the plan the principal amount, plus the greater of the lost earnings or restoration of profits.

Comment: This is another example of a fairly common problem, which had the potential for being particularly expensive to correct due to the applicable excise tax. Previously, there was no formal mechanism for compromising the excise tax. Over the years, we have had success in obtaining a reduction of the amount of excise tax through the IRS' general power to enter into closing agreements; however, a complete waiver of the excise tax was not even close to a realistic outcome. As a result of this change to the Program and a corresponding amendment to a class exemption (discussed below), plan sponsors now have the ability to voluntarily correct the fiduciary breach, and to obtain a complete waiver of the related excise tax.

3. Illiquid assets. If a plan holds an illiquid asset that the plan fiduciary determines is an imprudent investment for the plan (i.e., it would be contrary to the best interests of the plan participants and beneficiaries for the plan to continue to hold the asset), the plan may now divest itself of the asset by selling it to a party-in-interest. To

be eligible for this relief, the illiquid asset must have been acquired under one of the following four circumstances: (i) the plan purchased the property from a party-in-interest in an acquisition for which relief was available under a statutory or administrative PT exemption; (ii) the plan paid not more than fair market value for the asset, but the transaction was nonetheless a PT because the seller was a party-in-interest; (iii) the plan purchased the asset from an unrelated third party who is not a party-in-interest but the fiduciary failed to appropriately discharge his or her duties with respect to the purchase; (by failing, for example, to conduct a prudent analysis of the purchase); or (iv) the plan purchased the asset from an unrelated third party who was not a party-in-interest.

What is the Correction? To sell the asset to a party-in-interest, provided the plan is made whole by receiving the greater of (i) the fair market value of the asset at the time of resale (without reduction for the cost of sale), or (ii) the principal amount, plus lost earnings. For this purpose, the principal amount is the original purchase price of the asset, plus any transaction costs involved in acquiring the asset. Although not specifically stated in the revised Program, presumably the principal amount would include any costs associated with holding the asset.

Comment: This is a practical approach to a problem that was previously difficult to correct. Often, the individuals in the best financial position to assist the plan in ridding itself of the imprudent illiquid investment couldn't do so because it would result in a PT. Thus, in many cases this change should facilitate a more timely correction, which will better ensure the benefits of plan participants and beneficiaries.

Additional Method of Correction

In addition to expanding relief to cover the three transactions discussed above, the 2006 update to the Program permits an additional method of correction for a plan's purchase of an asset for cash from a party in interest to which no PT exemption applies. Under the revised Program the plan may retain the asset and settle for the correction amount in cash, if an independent fiduciary determines that the plan will realize a greater benefit from this correction than it would from selling the asset.

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Expansion of Excise Tax Relief under the VFC Program

In conjunction with the revision of VFC, the DOL also revised Prohibited Transaction Class Exemption (PTE) 2002-51 to add two of the new covered transactions. They are (i) the transaction involving illiquid assets and (ii) the transaction involving the impermissible payment of certain expenses from the plan. Now, PTE 2002-51 provides a de minimis exception to the notice requirements for transactions involving delinquent participant contributions and/or the failure to transmit participant loan repayments for which the excise tax due under IRC § 4975 is less than or equal to \$100.

Concluding Comments

A number of common fiduciary breaches are not addressed in VFC, among them the potential breach that arises when a plan purchases an asset with a significant surrender charge or market adjustment provision. (Admittedly, it can be argued whether this involves a breach at all, but it would be helpful for the DOL to address this all-too-common problem.) Nevertheless, the revisions to VFC and the amendment of PTE 2002-51 are welcome because they (i) expand the Program to address additional common problems, (ii) begin what we hope will be steady progress towards streamlining voluntary compliance through coordination with the IRS under EPCRS and (iii) substantially reduce the cost of correcting the pervasive problem of improperly paying expenses from the plan. In simple terms, the revisions to VFC make voluntary compliance easier and less expensive. Thus, the

Program continues to provide greater rewards to compliance oriented, proactive plan sponsors and fiduciaries, who establish practices and procedures to identify and correct fiduciary breaches and PTs when they occur. This places a high premium on establishing internal systems and procedures designed to promote compliance with ERISA. Any such systems and procedures should include a self-auditing component to identify errors and, thus, provide those responsible for the plan with an opportunity to correct them quickly and on the most favorable basis.

Plan sponsors and other fiduciaries should keep in mind that correction under VFC is helpful in guarding against adverse DOL action and extremely valuable in defending against suits by participants, because a "no action" letter would serve as powerful evidence that there are no damages or - at the very least - the damages have been significantly mitigated. Finally, correction under VFC can be helpful in "grooming" a company for a potential acquisition. That is, to the extent VFC has been used to remediate problems prior to performance of a formal due diligence review, it will reflect positively on the character and stability of a company and, thus, make it more attractive to a potential buyer. And, ultimately, it will facilitate the due diligence process.

If you or your clients have any questions concerning fiduciary breaches and PTs, and/or the operation and advantages of VFC, please contact one of our ERISA attorneys. ❖

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