WHAT, ME WORRY?

The Top Ten Consequences of Careless 401(k) Compliance

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Introduction

[This Benefits Practitioners' Strategy Guide report was written by Martha Jo Wagner of Griffith & Wheat PLLC, Washington, D.C., and Bruce G. Gabler, Allison D. Warden and Jennifer M. Gardner of Cohen & Grigsby P.C., Pittsburgh, Pa.]

Many common errors made in tax code Section § 401(k) plans can be easily avoided if plan sponsors and administrators simply pay attention to the details. This report addresses the ten most common current 401(k) plan compliance errors. It provides examples of the problems, concise explanations, and practical solutions. While it is specifically directed to employers who sponsor employee benefit plans, the concepts have broader application and should be taken into consideration by anyone who advises plan sponsors on compliance issues or on plan administration or operation.

Error #1. "Don't worry . . . about a written service provider contract, you know what the deal is."

The Problem. As the plan sponsor or administrator, you believe that you and the service provider see eye to eye about the terms of your arrangement. You agreed to a per employee per month fee. You agreed to all the great services and deliverables the service provider talked about in rosy but rather vague terms. You talked about the administrator's fee disclosure obligations, so you are sure they will handle everything. The fact that you and the service provider have never discussed many of the contract terms in detail is not a problem, nor is the fact that your agreement is not in writing. Or so you think until problems arise when, for example, you order a service you thought was included at no extra cost, you cannot get the participant data you need, you do not receive any fee disclosure information, or you want to terminate the relationship.

The Explanation. Most 401(k) plan sponsors hire a service provider to assist with 401(k) plan administration. Often, however, plan sponsors fail to negotiate sufficiently detailed contract terms and fail to enter into written contracts with the service provider. Without such a contract, you may not be able to tell exactly what services and deliverables are covered by the negotiated per employee per month fee. Similarly, you and the service provider may have different opinions regarding who owns and controls participant data and what costs, if any, are associated with transferring such data. While you may have a legal right to fee disclosure information, without a similar contractual right, a vendor's refusal to provide it may leave you without a contractual remedy. Because exit strategies are often not even considered when a service provider is being hired, contract termination can be extremely problematic.

The Solution. Get the service provider contract in writing, make sure it is executed by both parties, and make sure the contract terms are detailed enough to protect your interests. For example:

- What are you really paying for the services and deliverables provided?
- What benefits and services are being provided at no extra cost?
- What happens in the event the service provider makes erroneous payments to participants?
- What fee disclosures is the vendor responsible for?
- Is the service provider responsible for maintaining participant records for a period of time after contract termination?

Legal details are also important and must be addressed in the contract. For example:

- How much notice must be given to terminate the contract?
- Must the notice be in writing?
- Who must receive that notice for it to be effective?
- What happens to fees already paid when the relationship terminates?
- Are there contract termination fees?
- Who owns and controls the participant data upon termination?

While vendor contracts may seem set in stone, with the proper leverage any contract term is negotiable, and it is much easier to negotiate contract terms at the beginning of a relationship than at the end. Vendors often proffer their "standard" contract and demand that you sign it or, at the very least, use it as the basis for negotiation. These "standard" contracts are often drafted totally in favor of the vendor and include outrageous terms and conditions leaving you with little or no protection. A model contract, drafted to protect your interests based on the service provider's responses to the request for proposal, is a much better place to start.

These simple precautions can save significant time and money by addressing problems and aligning the expectations of both you and the service provider at the beginning of the relationship.

Error #2. "Don't worry . . . about employee contributions, there's still time."

The Problem. You do not timely forward employee contributions to the 401(k) plan. Instead, you mistakenly view those contributions as company assets and use them to pay the office rent, make a payment for a company car, or cover a margin call on your stock portfolio. Or, forwarding employee contributions falls to the bottom of your to-do list when you get busy, staff is on vacation, or other things come up. You plan to forward the contributions within a few weeks, next month or, at the latest, a month or two after that.

The Explanation. It may be tempting for the employer to use employee contributions for other pressing obligations or to fail to make timely employee contributions, with the expectation that those contributions can be made up at a later date. However, as harmless as the practice might seem, it is a violation of one of ERISA's most basic rules: the *exclusive benefit* rule.

The exclusive benefit rule mandates that "the assets of a plan shall never inure to the benefit of any employer and shall be held for the exclusive purposes of providing benefits to participants. . . ."[1] According to the regulation issued by the Department of Labor, employee contributions become plan assets as of "the earliest date on which such contributions can reasonably be segregated from the employer's general assets."[2] This date can be no later than the fifteenth business day of the month after the month in which the amounts are withheld from the employee's wages.[3] However, the DOL has stated that if the contributions can be deposited earlier than this maximum allowable time, then contributions must be deposited sooner.[4] Therefore, contrary to popular belief, most employers do not have 15 days to deposit employee contributions and many employers are required to make such deposits within a day or two after employee contributions are withheld.

The DOL provides a safe harbor for small plans (defined as fewer than 100 participants at the beginning of the plan year) that provides for a seven-day window to deposit employee contributions to the plan.[5] The safe harbor window begins on the first business day after the amounts were withheld from the employee's wages. Currently, there is no safe harbor for large plans.[6]

Not only is the failure to timely contribute employee contributions a fiduciary violation, but to the extent the contributions are held in the employer's general assets beyond the allowable time, that failure is also an inadvertent prohibited transaction—or worse if not inadvertent.[7] The consequences can range from potential excise taxes for the prohibited transaction to civil penalties for the prohibited transaction and the fiduciary violation.[8] In addition, the fiduciary will face personal liability for the lost earnings associated with the delay in depositing their contributions.[9] Finally, criminal sanctions are available in the most egregious circumstances.[10]

Failure to contribute employee contributions on time is an extremely common problem and constitutes the vast majority of violations corrected under the DOL's Voluntary Fiduciary Correction Program.[11] It is also one of DOL's enforcement priorities. However, this error is easy for employers to avoid, so long as they have adequate cash reserves and personnel are properly trained to immediately forward employee contributions every pay period.

The Solution. Review your process for depositing employee contributions to your company's 401(k) plan and determine whether the Department of Labor would consider your deposits timely. You should also coordinate with your payroll provider to determine the earliest date the employee contributions can reasonably be segregated from general assets and deposited in the plan, and then set up procedures to ensure that deposits are made by that date.

Error #3. "Don't worry . . . about the definition of compensation; it's intuitive."

The Problem. The human resources, payroll, and legal departments all have different ideas about what that intuitive definition is.

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[1] ERISA § 403(c)(1).

[2] 29 C.F.R. § 2510.3-102(a)(1).

[3] 29 C.F.R. § 2510.3-102(b)(1).

[4] Preamble to Regulations Relating to Definition of "Plan Assets"—Participant Contributions, 61 Fed. Reg. 41220, 41223 (Aug. 7, 1996)("[T]he maximum period does not operate as a safe harbor. . . . [F]or many plans, participant contributions will become plan assets well in advance of this applicable maximum period."); Dep't of Labor, Frequently Asked Questions - Voluntary Fiduciary Correction Program, http://www.dol.gov/ebsa/faqs/faq_vfcp.html (last visited Feb. 23, 2012).

[5] 29 C.F.R. § 2510.3-102(a)(2).

[6] Amendment of Regulations Relating to Definition of "Plan Assets"—Participant Contributions, 75 Fed. Reg. 2068 (January 14, 2010).

[7] I.R.C. § 4975(c)(1), (e)(2)(C).

[8] I.R.C. § 4975(a), ERISA § 502(i), (l).

[9] ERISA § § 409(a), 502(l).

[10] 18 U.S.C. § 664.

[11] DOL, Fact Sheet—Employee Contributions (October 2011), http://www.dol.gov/ebsa/newsroom/factsheet/fsecp.html.

The Explanation. Although everyone understands the intuitive definition of the term "compensation" to mean payment for services rendered, that level of detail does not suffice when administering a 401(k) plan. You need to know precisely how the 401(k) plan defines compensation and what is included in the definition, acknowledging that within a single plan different definitions of compensation may be used for different purposes.

The Solution. There are several steps you can take to avoid this problem:

- Read the plan. It is important to understand each definition of compensation and when and how each definition is used under the terms of your 401(k) plan.
- Educate your benefits department staff, payroll department staff, and anyone who services your 401(k) about the different definitions of compensation and the necessity of reading the plan. The person who is in charge of determining compensation must be properly trained to understand the plan document and its specific definitions.
- If your plan is not operated in accordance with its terms, amend the plan's definition of compensation to reflect the plan in operation, if possible. Otherwise, you will need to modify how you operate your 401(k) plan.
- Consider an annual review of the compensation definitions used in your 401(k) plan and their application. The IRS has suggested that periodic reviews of compensation definitions and spot checks of actual deferrals and allocations should be performed in order to ensure that the plan's compensation definitions for all deferrals and allocations meet all applicable legal requirements and are applied correctly.[12]

Error #4. "Don't worry . . . about reality, just put the data in."

The Problem. Your company has a large work force and multiple divisions. Data, such as dates of hire and individual employee contributions, is inputted into different systems for different divisions. Data from every system is then outsourced to a service provider who administers the 401(k) plan covering all of the divisions. The service provider has no idea whether the data provided is reasonable and handles the data "automatically."

The Explanation. When company-provided data is reviewed only by service provider personnel who do not understand the company, the company's workforce, or the terms of the company's 401(k) plan, it is easy for errors to go unnoticed until they become huge problems.

The Solution. To avoid this common error, set up a procedure for someone who is familiar with the 401(k) plan to periodically review a sample of the data and consider what is involved prior to sending the data to a service provider. Familiarity with the company, the company's workforce, and the terms of the company's 401(k) plan should help that person to determine whether there are any obvious problems. This responsibility should probably not be delegated to the payroll department, as payroll personnel often do not have enough familiarity with the terms of the 401(k) plan to successfully complete this review.

Error #5. "Don't worry . . . about reviewing Form 5500, just sign it."

The Problem. The Form 5500 for your company's 401(k) plan is due. You have already gotten every possible extension. It has to be mailed today, or it will be delinquent. You are the only person who has authority to sign the form, but you have been in meetings all day, you have not had a chance to even glance at the form, you are exhausted, and the person making the last mail pickup is waiting anxiously outside your door. You sign the form, figuring you can read it later.

The Explanation. Employers who maintain a 401(k) plan are required to file the annual Form 5500.[13] As the plan administrator or sponsor signing the form, you are attesting to the truthfulness of all the information on the form and its schedules, including the financial information. As a result, it is not sufficient to simply sign it once it has been prepared by your service provider or accountant. It is imperative that you understand each question and answer on the Form 5500 you are filing.

As an example, the current Form 5500 requires the preparer to attest to the timely remittance of participant contributions.[14] As discussed earlier in this report, failure to contribute employee contributions in a timely manner is a common error. This seems rather straightforward, but as discussed in greater detail above, determining whether contributions were segregated as soon as they reasonably could be is subject to differing opinions.

In addition to criminal penalties for willful Form 5500 violations, the DOL can assess penalties of up to $1,100 per day against the plan administrator for failure to timely file a complete Form 5500.[15] Filing an incomplete or otherwise materially deficient Form 5500 is the same as failing to file a Form 5500.[16] The IRS can also impose penalties of $25 per day, capped at $15,000, for failing to timely file a Form 5500.[17] These penalties are personal liabilities of the plan administrator and cannot be paid with plan assets.[18]

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[12] I.R.S., 401(k) Fix-It Guide, 401(k) Plan Checklist, 20—22 (June 17, 2014), http://www.irs.gov/pub/irs-tege/401k_mistakes.pdf.

[13] ERISA § 104(a); I.R.C. § 6058(a).

[14] *See* DOL, 2014 Form 5500, Schedule H, question 4a, http://www.dol.gov/ebsa/pdf/2011-5500inst.pdf.

[15] ERISA § 502(c)(2); 29 C.F.R. § 2575.502c-2.

[16] ERISA § 502(c)(2).

[17] I.R.C. § 6652(e).

[18] DOL Information Letter from John J. Canary, Chief, Division of Reporting and Disclosure, to Mark H. Sokolsky, Esq., 1996 WL 34451618 (Feb. 23, 1996) ("A penalty that is imposed on a plan administrator as a personal liability, rather than on the plan itself, is a liability of the administrator and not a liability of the plan.").

The Solution. File a timely Form 5500 after thorough and thoughtful review. Remember that you are attesting to the truthfulness of all information contained in the form, which covers not only the answers to the questions but also detailed financial information. Understanding the questions and the answers is critical.

Error #6. "Don't worry . . . about updating the plan for legal changes, you can do it later."

The Problem. Your service provider sends you amendments for the 401(k) plan, noting that they need to be executed before the end of the month. You are in the middle of due diligence for the biggest acquisition your company has ever undertaken. You drop the amendments in a drawer for safekeeping, promise yourself you will deal with them next week, and promptly forget they exist.

The Explanation. Failing to timely update the 401(k) plan to reflect statutory and regulatory changes or required IRS restatements is a common administrative error which can cause significant compliance problems.

The Solution. There are simple methods by which you can avoid this frequent error:

- Designate someone within your benefits department who understands the importance of plan amendments as the "point person" responsible for ensuring that plan amendments are signed in a timely fashion. Incorporate this responsibility in the person's job description to enhance accountability and to ensure that the person who holds the job next understands the extent of his or her duties.
- Calendar amendment due dates when you first learn of them. Because the deadlines can sometimes be years away, it is very easy to forget about them. You should also calendar reminders leading up to the amendment deadline to allow yourself enough time to have the amendment drafted and executed and to implement any necessary operational changes.
- If you utilize a pre-approved plan, make sure that you are in regular contact with the company from which you purchased the plan. A good relationship with your service provider can be quite helpful when it comes to plan amendments.
- When choosing a service provider, a consultant, or an attorney, make sure that you select someone who will follow up with you—because it never hurts to have an established safety net—and be attentive when they do.

Error #7. "Don't worry . . .about SPDs and SMMs; nobody reads them anyway."

The Problem. You do not have a summary plan description (SPD) or the one you have is almost five years old, never has been distributed or updated, and no longer accurately reflects the plan's terms.

The Explanation. ERISA requires plan sponsors to create an SPD containing specific information about the plan and its terms and participants' legal rights.[19] Upon hire and again every fifth year, SPDs must be distributed automatically by a method reasonably calculated to ensure delivery, not merely provided upon request.[20] If a participant requests an SPD in writing, and you do not provide it within 30 days, you may be subject to civil penalties of up to \$110 per day.[21] If you materially change the plan, you must distribute a summary of material modifications, or SMM, within 210 days of the end of the plan year in which a material change is adopted.[22] It is crucial that the SPD and any SMMs accurately reflect the terms of the plan, since these are the documents to which participants have access.

The Solution. If you do not have an SPD, have one drafted as soon as possible. If your SPD needs to be updated, have SMMs written. Make sure your SPDs, SMM, and plan terms match and all required information is included. If it has been several years since you have had a new SPD or you have several SMMs attached, consider revising the SPD to incorporate all changes. If it has been more than five years since you issued an SPD and the plan terms have changed, you must issue a revised SPD. Finally, once you have put in all this effort, make sure you actually distribute the SPDs and SMMs you created.

Error #8. "Don't worry . . .about the notices; they can go out later."

The Problem. There are notices for automatic contribution arrangements. There are notices for blackout periods. There are notices for qualified default investment alternatives. There are rollover notices. In fact, there are more notices than you can shake a stick at—and almost every notice has a deadline.

The Explanation. ERISA has a multitude of required notices that must be given to participants,[23] and almost every notice has a deadline, as well as a penalty for an untimely notice. For example, blackout notices must be provided at least 30, but not more than 60 days in advance of the last day before the blackout, unless certain technical exceptions apply.[24] If the blackout notice is not provided within the specified time, a plan administrator may be fined up to \$100 per day per affected participant or beneficiary.[25] For a 401(k) plan with 1,000 participants and beneficiaries and a five day blackout

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[19] ERISA § 104(b)(1); 29 C.F.R. § 2520.104b-2(a).

[20] 29 C.F.R. § 2520.104b-2(a), § 2520.104b-1(b)(1).

[21] ERISA § 502(c)(1); 29 C.F.R. § 2575.502c-1.

[22] ERISA § 104(b)(1)

[23] For a chart of required notices to plan participants, see DOL Reporting & Disclosure Guide for Employee Benefit Plans in the Practice Tools section, and the DOL website at http://www.dol-.gov/ebsa/pdf/rdguide.pdf.

[24] ERISA § 101(i)(2)(B)-(C); 29 C.F.R. § 2520.101-3(b)(2).

[25] ERISA § 502(c)(7); 29 C.F.R. § 2560.502c-7(b) (noting that the penalty assessed shall be determined by taking into account each separate violation and considering the degree and/or willfulness of the failure or refusal to provide a notice of blackout period).

period this could amount to a fine of $500,000. It is also worth noting that the plan administrator is personally liable for this penalty.[26]

The Solution. To avoid missing a notice or its related deadline, make sure you have processes in place to track what notices must be sent and when those notices must be sent. Moreover, since many, if not all, of these notices have content requirements, you should make sure that processes are also in place to meet these requirements. Just as with plan amendments, designating a specific person to be responsible for notices and incorporating the duties into the person's job description is recommended.

Error #9. "Don't worry . . . about plan terms, they're simple and easy to administer."

The Problem. You don't need to worry about plan terms because you administer a bare bones 401(k) plan with terms you know like the back of your hand. There are no eligibility waiting periods for any employees in your 401(k) plan, right? Matching contributions are always the same for every business unit or division under your 401(k) plan, right? No one has to be a participant at the end of the year to qualify for the match under your 401(k) plan, right? Entry dates, hours of service, and break-in-service provisions are easy to apply, right?

The Explanation. Too often, plan administrators feel they do not have to worry about plan terms, because they believe they are simple. Unfortunately, seemingly simple plan terms can present extremely complicated questions of plan interpretation and even the simplest 401(k) plan contains some quirky provisions. ERISA requires that a plan be operated in accordance with its plan terms.[27]

[26] ERISA § 502(c)(7).
[27] ERISA § § 402(a)(1), 404(a)(1)(D).

The Solution. Read your plan. Read your plan. Read your plan.

Error #10. "Don't worry . . . about the participant's question, just answer it."

The Problem. Just because you are the general manager of the factory does not mean you do not know about benefits. You can read the summary plan description as well as anyone else can. And if that booklet is not available, you can just shoot from the hip. No one will be the wiser.

The Explanation. In an effort to cross a task off the proverbial to-do list, you may feel that you should just answer whatever participants' questions come your way. This is a mistake. Answers to benefits questions are often extremely complex and should be provided only by appropriate company personnel.

The Solution. Best practices include:

- Reviewing the plan document, the summary plan description, and any applicable policies before answering a participant's question.
- Encouraging a corporate culture that sends benefit questions to the benefits department at headquarters or to the benefits hotline, where the staff should know the answer or have easy access to the correct information.
- Training the people who answer questions to avoid answering a question until they know the correct answer.
- Treating questions as being subject to the claims and appeals process where appropriate.
- Understanding that the right answer may seem unfair, because tax laws and the government's interpretation of those laws are often unfair. In such a situation, it may be preferable to blame the law or blame the government, which is easier for participants to understand than saying, "the plan says you can't do it."
- And, most importantly, remembering that shooting from the hip often results in shooting yourself in the foot.

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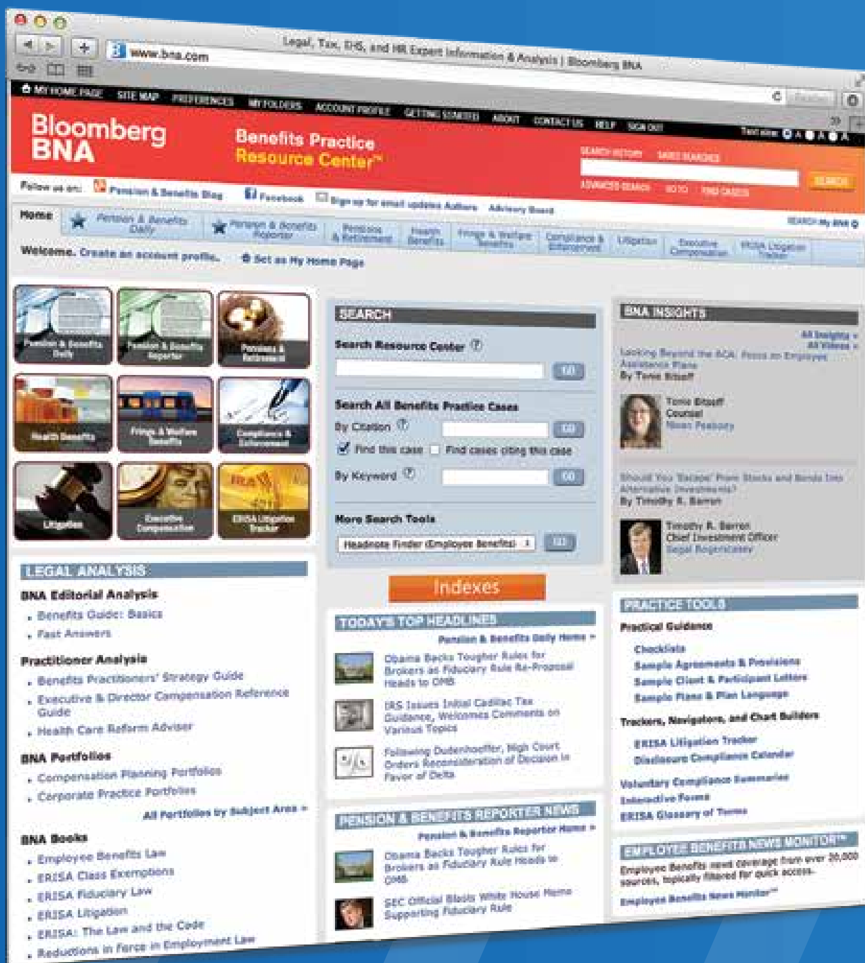

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