Retirement Plan Catastrophes That Should Be Avoided

By Ary Rosenbaum, Esq.

I've lived a while and I have certainly seen a lot of epic disasters and catastrophes. I'm not talking just about real life but about retirement plans. There are many errors that retirement plans can have, such as failing to make timely deposits that can be easily corrected but that's different than catastrophic errors that could cost plan sponsors a bundle and/or threaten the tax qualification of their retirement plan. These are some catastrophes that you should be avoiding.

Errors and plan disqualification

Retirement plans have to abide by the Internal Revenue Code to maintain tax-exempt status. By abiding by the Code, the retirement plan will offer tax-deferred savings for its participants and tax deductions for employer contributions made by the plan sponsor. Catastrophic errors can lead to plan disqualification, which is the most severe punishment that the Internal Revenue Service (IRS) can slap a retirement plan with. Plan disqualification will cause the plan's trust to owe taxes on its earnings. The bigger ramifications are that participants will have to declare immediate income in their retirement savings and the plan sponsor will lose the tax deductions that they previously took (but will take them when the participant is taxed).

Failure to timely restate and amend your plan document

Every qualified plan under the Internal Revenue Code needs to be written. The plan document is a legal document, so it needs to be signed contemporaneously and kept. Every few years (usually 6 years), the IRS will require you to amend and restate your plan to a new plan document. This amendment and restatement aren't optional, it must be done when the IRS says it needs to be done. The new plan document will contain all the necessary provisions to reflect the changes in the law and regulations that the IRS requires for that particular restatement. Also, the IRS may require a certain amendment to the plan to reflect a change in the law or regulations that they want all plan documents to incorporate besides the scheduled restatement. So while it seems that the restatement and amendment requests seem to be a great way to feed TPAs and ERISA attorneys, I assure you that these amendment and restatement directives aren't requests, they are mandated by the IRS. If you fail to amend and/or restate your plan at the time subscribed by the IRS, that might be a disqualifying event. The IRS does have a Voluntary Compliance Program to correct these plan document amendments and restatement failures that can be corrected with thousands of dollars paid to the IRS for the compliance program fee. So it's important that when your TPA or ERISA attorney tells you it's time to amend and/or restate, you should get it done.

The Controlled and Affiliated Service Group Rules

To remain qualified, retirement plans must meet the requirements of the Internal Revenue Code. The Code holds that retirement plans need to provide lower-paid employees with retirement benefits and not discriminate in favor of highly compensated employees and business owners. To be qualified, the plan must cover a minimum number of lower-paid employees, as compared to highly compensated employees. The plan also must pass certainty compliance tests, that if failed, must be corrected. To close loopholes and potential abuses, controlled and affiliated service group rules were implemented to treat multiple related employers as one employer. Usually, if there is 80% or more overlapping ownership among entities, they are generally a Controlled Group (CG). This can be a parent-subsidiary relationship or just common ownership of at least 80% among five or fewer individuals (brother-sister controlled group). There are stock attribution rules that can assign individuals ownership stakes that they don't have, because of a family relationship like a spouse or child. An affiliated service group (ASG) determination is more subjective than a controlled group, it's based on facts and circumstances, rather than straight ownership numbers. Two or more service companies with some shared ownership, no matter how small, provide significant services to each other or are associated with providing services to others from an ASG. Furthermore, if a

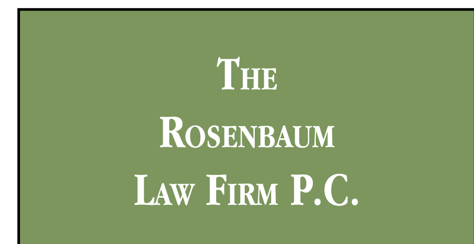
significant portion of a company's business offers management services to another company (even if not a service company), they are also an affiliated service group. If it's determined that companies are part of a CG or ASG, they are treated as one employer for all purposes. Failing to cover one or more companies through a retirement plan, can lead to a catastrophic result where the plan fails coverage and employees who weren't covered, will have to be, with corrective contributions. Many employers try to hide ownership stakes, but most of the time, incompetent plan providers may have never asked, and/or employers may have not volunteered any other entity ownerships in the annual census questionnaire. Failure to cover employees without corrections, especially with defined benefit plans, will get the plan disqualified.

Theft by plan fiduciaries and plan providers

While it doesn't happen often, the theft of plan assets by a plan fiduciary or plan provider can happen. I know two plan providers who spent time in our Federal prison system because they felt, they were entitled to steal retirement plan assets from their plan sponsor clients. Fiduciary liability insurance is a need for plan sponsors to protect plan fiduciaries from liability, but it doesn't protect them from theft by plan fiduciaries. An ERISA bond is required for any ERISA-covered plan. An ERISA bond is to protect plan assets from theft by a plan fiduciary. It is legally required and if you answer that you don't have an ERISA bond on Form 5500, I will attest that may be an error that the DOL will use to conduct a random plan audit. Even if you have an ERISA bond, one of the issues is that since plan assets increase, your coverage no longer fits the applicable coverage. The bond must provide coverage for persons handling plan funds in an amount no less than 10% of the number of funds handled by the person in the previous year. The bond amount cannot be less than $1,000 and does not need to be more than $500,000 per plan official per plan (or $1 million for plans that hold employer securities). While an ERISA bond will provide some relief, what happens if a plan fiduciary steals millions beyond the amount of the maximum coverage of the bond? I had a client who originally lost millions with Bernie Madoff. Thanks to the work of the bankruptcy trustee, handling the Madoff mess, the plan sponsor was made whole. The problem is that with most fiduciary thefts, the plan sponsor is usually holding the bag for much of the theft, which is beyond the ERISA bond coverage.

Incorrect compliance tests

One of the big hallmarks of solid retirement plan administration is that the compliance tests are actually done and done correctly. Many times, compliance tests are either done incorrectly or not done at all. To maintain qualified status under the Internal Revenue Code, a retirement plan has to go through annual compliance tests to show that the plan doesn't discriminate in favor of highly compensated employees. Tests such as coverage, actual deferral percentage test (ADP), actual contribution test (ACP), and top-heavy test are just some of the compliance tests that a plan may have to complete annually. Many times, a simple test such as coverage (which needs to show that non-highly compensated aren't discriminated against in being covered under the plan) may not be completed by the TPA just because they forgot, which is a big issue if the plan fails. I remember working on a union staff 401(k) plan where a big index fund bundled provider thought that the plan offered a safe harbor contribution and didn't have to satisfy an ADP and ACP test. The problem was the plan offered no safe harbor contributions, so the plan sponsor had to hire an outside TPA to perform the tests that they luckily passed. Even if compliance tests are done, sometimes they are done incorrectly. This may happen because the TPA may have coded some employees incorrectly as non-highly compensated employees when they should be coded as highly compensated employees, which happens often. After all, the TPA neglected to complete a stock attribution analysis. Errors to fix compliance tests can be costly especially when an employer contribution may be the only way to correct when it's discovered years later. They can be corrected through the IRS' voluntary compliance program or self-correction at times. If caught in an IRS audit, the costs and penalties will be higher. If there is an ADP testing failure, a plan sponsor can refund money to highly compensated employees. If the errors are discovered later, the plan sponsor would have to make corrective contributions. I have seen plan sponsors need to make corrective contributions in the tens of thousands of dollars because a mistake in the compliance tests was discovered years later in an IRS audit.



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The Rosenbaum Law Firm P.C.
734 Franklin Avenue, Suite 302
Garden City, New York 11530
(516) 594-1557

http://www.therosenbaumlawfirm.com
Follow us on Twitter @rosenbaumlaw