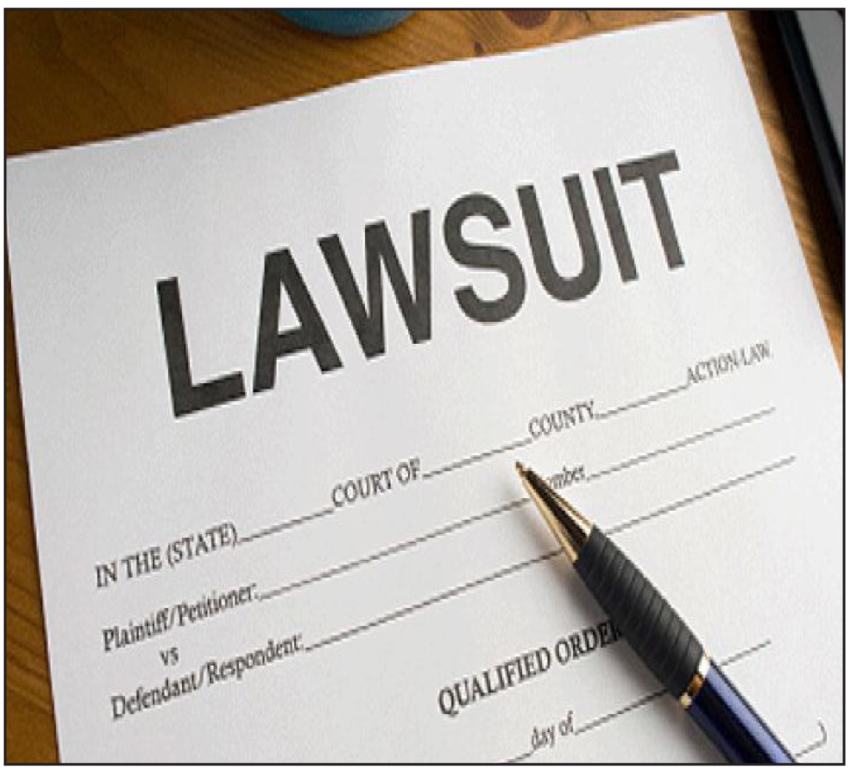
The Real And Exaggerated Threats To A 401(k) Plan Sponsor

By Ary Rosenbaum, Esq.

When I started my practice more than 10 years ago, I would post articles on some of the LinkedIn groups talking about 401(k) plan sponsor liabilities. One person who was not even a retirement plan provider accused me of spreading fear because I talked about issues such as plan costs, revenue sharing, and other fiduciary liability problems, and that was a couple of years before they became big issues. Unlike many other plan providers out there, I don't exaggerate the liability threats out there because there are several out there that have less of a chance of happening to a small or medium-sized 401(k) plan than a direct lightning strike to someone. This article is all about threats to a plan sponsor, exaggerated and not.

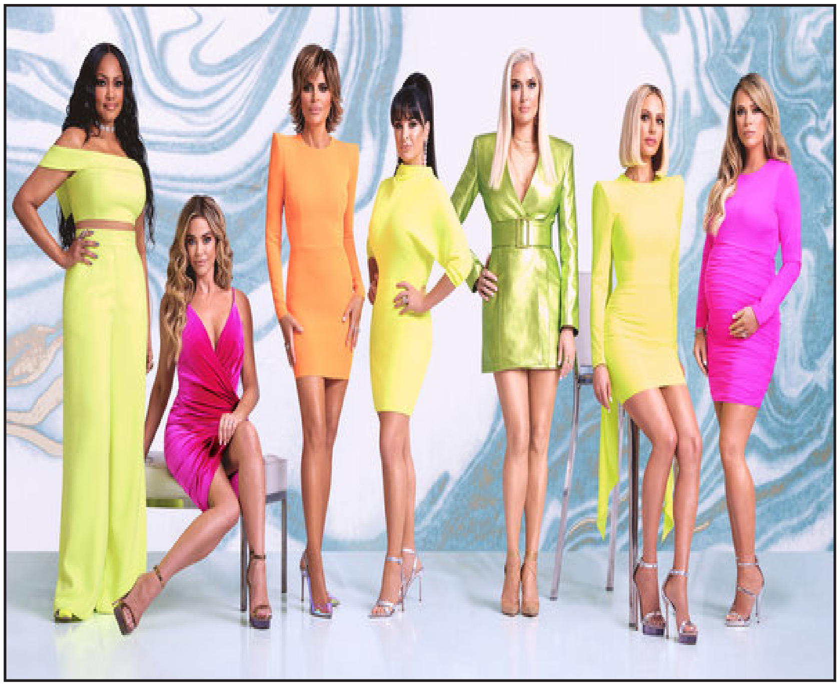


Plan disqualification

The greatest penalty that can be made to a 401(k) plan is plan disqualification. It's equivalent to a death penalty except there are no constant appeals or the last meal. A 401(k) plan is a qualified plan with trust used to preserve the tax-deferral status of employee contributions. If a 401(k) plan sponsor follows the rules set forth by the Internal Revenue Code, the plan will be qualified and used to defer income on participant contributions until distribution. If the plan is disqualified by the Internal Revenue Service (IRS), it means that the 401(k) plan and its trust is no longer qualified and immediate tax consequences will occur. An employer will likely lose the last 3 years of tax deductions made to the 401(k) plan for any employer contributions. More importantly, plan participants will have immediate taxation of their retirement savings. Plan disqualification is an actual penalty, but it's rarely used. The reason why it's rarely used because the cost is high, especially immediate taxation of retirement savings for plan participants that are likely not responsible for the errors that caused the plan disqualification. Since plan disqualification is such a drastic step taken by the IRS, it's rarely used. It's why the IRS has instituted self-correction and voluntary compliance programs to allow plan sponsors to fix errors that may lead to plan disqualification. Plan disqualifications are usually reserved for unconscionable conduct made by plan sponsors such as using a plan for benefiting the highly compensated employees by excluding the rank and file employees, as well as flouting the limits on compensation and benefits. I once represented a plan sponsor that was audited by the IRS and it was discovered that they made loans to shareholders (which was illegal at the time for S corporation shareholder before 2002) and the IRS agent would not hit them with disqualification. I had a client with a defined benefit plan that invested all plan assets with Bernie Madoff and that plan was disqualified. An IRS agent will certainly hit a plan with serious errors a pecuniary penalty, but they will reserve plan disqualification for the most egregious act by plan sponsors. The ERISA attorney who told their client that their plan might be disqualified because of the wording on a notice to interested parties (based on an old template) was making a threat that was not based in reality. In 22 years, I have never been connected in any way with a plan that was disqualified. I know the penalty happens, but the fact is that it's the last resort by the IRS.

A lawsuit

When talking about serious fiduciary issues, many plan providers will use the lawsuit card as a liability threat. No matter the error that a 401(k) plan sponsor may make, a lawsuit is always a possibility. The only problems are that if the plan sponsor is small or medium-sized, the lawsuit threat isn't likely. The reason isn't likely is because the 401(k) plan sponsor doesn't have the pockets that will interest an ERISA litigator. When it comes to 401(k) litigation, the money is in class action litigation where there is a broad class of plan participants that can serve as plaintiffs and can lead to a substantive financial settlement that an ERISA litigator could recover up to 40% of the settlement. A class-action lawsuit isn't likely against small to medium-sized plans because the settlement amount isn't going to be enough to interest an ERISA litigator who fronts the cost of litigation in the hopes of a substantive financial settlement. The participants arguing about a $60 corrective contribution isn't likely going to litigate when purchasing a court index number for a lawsuit is a lot more than any recovery. If a participant is cheated from a five to seven-figure plan distribution could always sue, but that is probably centered on identity theft. Anyone can sue anyone at any time, but the chances that it will happen to small and medium-sized plans aren't likely.



A complaint to the DOL

Many of the biggest problems that have been encountered by plan sponsors that I've represented, started with a simple complaint by a participant to the Department of Labor (DOL). The DOL's Employee Benefits Security Administration is all about enforcing participant rights under ERISA (which stands for the Employee Retirement Income Security Act of 1974) and part of their work is investigating complaints made by plan participants and former participants. Complaints that have been made are usually made by former employees who felt that they've been treated unfairly as it pertains to their retirement benefit. The DOL is very active in investigating the complaints they receive. Many complaints are dismissed because the DOL doesn't see any wrongdoing and many complaints lead to civil fines and/or referrals to the DOL's criminal investigation division. Whether a complaint is justified or not, the fact is that a participant complaint to the DOL is a serious matter that shouldn't be taken lightly. Any plan sponsor that is contacted by the DOL concerning an investigation of a participant complaint should hire an ERISA attorney as soon as possible.

IRS/DOL Audit

The IRS and DOL work on two different tracks. The IRS is concerned with plan sponsors complying with the Internal Revenue Code and the DOL is concerned with plan sponsors complying with ERISA. Since our tax system and plan retirement rules require voluntary compliance, one tool to check voluntary compliance is the use of an audit. The IRS and DOL will audit plan sponsors based on a particular plan year. The audit could be random or it could be specific to a plan sponsors, based on errors or answers to questions on Form 5500. The problem of the audit is that it could uncover errors that the 401(k) plan sponsor was unaware of. I've had IRS audits where it was discovered that the compliance testing for the year audited was incorrect and audits where it was discovered that administration of the plan was inconsistent with the terms of the plan document. However, most of the time, a 401(k) plan sponsor will get a no-change letter from the government auditor. The problem with an audit is where the plan sponsor thinks they can handle an audit themselves. That is an absolute mistake as plan sponsors are ill-equipped to handle an audit, they usually end up causing more harm than good by volunteering information that the auditor didn't request. A plan sponsor that doesn't hire an ERISA attorney to represent them and represent themselves will have a fool for a client.

Theft by plan fiduciaries

I have worked on thousands of retirement plans over the past 22 years as an ERISA attorney and I can count on one hand, how many plan fiduciaries have stolen plan assets. One was a plan sponsor who ignored my advice and ended up serving 3 years in jail. The other two were plan providers serving as plan fiduciaries and currently sit in federal prison after stealing millions. I will never understand why fiduciaries would do that since there is a trail of evidence. Theft of plan assets rarely occurs, but it happens. It happens in a situation where there is no system of checks and balances, as well as not reviewing the plan's trust statements to detect any unusual asset outflows.

Cyber theft

When I started in 1998, everything related to the plan was done on paper or by telephone. Now almost everything regarding a 401(k) plan involves the internet. Thanks to the sophistication of the internet and the sophistication of cybercriminals, cyber theft of plan assets will be a more popular crime. Cyber theft is likelier now because of identity theft. Accessing a participant's 401(k) plan and initiating plan transfers is that much easier as we rely on online access for distribution requests and plan sponsor approval of such requests. A plan sponsor needs to contact their plan providers regarding their cyber protection policies and processes to help avoid the possibility that plan assets can be stolen. Cyber theft of plan assets has become more popular of late and likelier more and more popular over time.

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