In Plain Sight: 10 Common Employee Benefit Plan Pitfalls

Mayer Hoffman McCann P.C. is pleased to present this whitepaper on the common errors that occur in employee benefit plan reporting.

Qualified retirement benefit plans are dynamic. Tax laws change. Employees enter and leave the retirement plan and make changes to their contribution levels. Qualified retirement plans must also be prepared to adapt to changes in the rules and regulations in order to stay compliant. If the array of technical requirements set forth by the Internal Revenue Service and the Department of Labor's (DOL) Employee Retirement Income Security Act of 1974 (ERISA) are not met, plan sponsors may be exposed to significant costs to correct any errors and penalties. In extreme cases, noncompliance could result in the plan losing its qualified status.

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The IRS recognizes that everyone makes mistakes. It has developed correction programs collectively known as the Employee Plans Compliance Resolution System (EPCRS) so that plan sponsors can correct errors through self-correction or, in some cases, come forward to the IRS with proposed corrections in order to retain the plan's qualified status.

By monitoring areas that can lead to a higher compliance risk, plan sponsors can mitigate the risk of errors and remedy problems before they trigger lasting consequences. Below are common mistakes that the IRS and DOL have uncovered through audits or through their correction programs. Mayer Hoffman McCann P.C. professionals in their capacity as independent auditors of large plans frequently find some of these compliance errors as well. Plan management should periodically review the following to ensure the plan's policies and procedures meet regulatory standards.

1. Eligible Versus Ineligible Employees

The failure to include eligible employees in the plan or to exclude ineligible employees ranks among the most common errors. Definitions of eligibility should consider part-time, leased or temporary employees, student interns and employees of related employers such as Controlled Groups and Affiliated Service Groups.

Other eligibility compliance problems could arise from:

- **Entry dates** – Be sure that the entry dates being used in plan operations (e.g., monthly, quarterly, semi-annually) are consistent with the dates specified in the retirement plan documents and that in a 401(k) plan or other deferral plan, eligible employees are given the opportunity to participate.

- **Automatic enrollment and escalation** – Automatic enrollment plans where employees are automatically enrolled if they do not affirmatively elect to participate or not to participate in the plan have become very popular in 401(k) and other deferral plans. Automatic increases are also popular. It is very important that these provisions be implemented in accordance with the plan document and in accordance with the required notices to participants. Failure to automatically enroll an employee could cost the employer contribution dollars. Some companies may opt for a fixed escalation date as of the first day of the plan year. Others may use the employee's employment anniversary. It is best that the plan administrator use a detailed tracking system to help monitor the enrollment and any escalation dates to ensure these features are properly administered and aligned with the plan's provisions.

- **Treatment for rehires** – Once employees satisfy the requirements for plan eligibility (e.g., waiting periods), they are generally eligible for plan participation even if they leave the company and then return. In fact, with a rare exception, rehires who previously met the eligibility conditions re-enter the benefit plan right away. To avoid mistakes in this area, the employer should understand how their plan treats re-hires and create internal procedures for how to handle a rehire's re-entry into the plan.

2. Eligible Compensation

Compensation can be defined in several ways for plan purposes. Plan sponsors should understand the plan's definition of compensation and apply it correctly to each portion of the plan. Consistency in determining which types of pay qualify for employee benefit contributions helps reduce the risk of error.

Common mistakes that arise from the definition of compensation include:

- Failure to follow the terms of the plan document. Most plans define compensation as W-2 wages adding back deferrals and other contributions not subject to taxes. Some plans exclude bonuses, overtime and commissions from compensation. These exclusions may require special nondiscrimination testing.
- Improper inclusion or exclusion of compensation prior to plan entry;
- Treatment of severance pay;
- Computation of earned income for self-employment earnings; and
- Failure to coordinate HR and payroll systems.

For best results, plan sponsors should consult with human resources personnel and other payroll specialists during the eligible compensation definition process.

3. Contributions

Employees

Employees frequently change the percentage or amount they contribute to their 401(k) or other type of deferral plan, and plans may miss when an employee requests to change the contribution. The result can be costly for the plan sponsor, especially if the mistake continues over several years. The IRS holds the plan sponsor liable for one-half of the lost deferral opportunity plus earnings during that period.

To minimize corrective contributions from a missed contribution election, plan sponsors may want to consider including language into the plan document that puts the responsibility on the employee to notify management if election changes have not taken effect within 30 days of the date he or she made the change.

Employee contributions can also be problematic with:

- **Irregular checks, Discretionary and One-Time Checks** – Monitor off-cycle paychecks to be sure employee elective deferral contributions are properly withheld (or not withheld).
- **Regular pay after severance of employment** – The IRS considers commissions, bonuses and any other pay for services performed prior to severance—including cash outs of vacation, sick and other leave time—to be regular compensation. Therefore, employee elective deferral contributions may need to be withheld from these paychecks. Compensation after severance of employment can only be treated as regular pay if paid by the later of 2 ½ months after severance from employment or by the end of the plan year in which the severance occurred. Compensation, in this definition, means the compensation that the employee would have received even if he or she had not separated from service.

In general, employee elective deferral contributions should not be withheld from true severance pay or other types of "parachute" payments. True severance pay is generally pay that the employee would not have otherwise received had he or she not separated from service. Plan administrators need to have a thorough understanding of how the plan treats compensation received after separation from service to determine the appropriate deferral withholding.

"In the IRS' 401(K) fix-it guide, failure to apply the matching formula properly is noted as the fourth most common mistake in 401(k) plans. "

Employer Matching Contributions

Verify that the calculation for employer matching contributions is both correct and in line with the employer matching definition in the retirement plan documents or the discretionary match that the employer intended. Plan sponsors must also understand the employer matching computation period. If the computation period is the plan year, plan sponsors may have to "true up" or annualize the employer match at the end of the plan year. Simply following a payroll schedule may not accurately reflect the employer match formula.

4. Vesting

Employee contributions are always 100 percent owned or "vested" by the employee. Employer contributions, however, may have a vesting schedule, which can be found in the plan document. The IRS has established minimum standards that employee benefit plans' vesting schedules must meet, so be sure the vesting schedule used by the plan complies with these requirements.

Years or periods of service generally determine an employee's eligibility and vesting. In general, there are two methods to determine years or periods of service. Under the hours method, the vesting schedule is based either on the actual number of hours worked or an equivalency method for employees whose hours are not maintained by the employer, such as full-time salaried employees. The IRS generally considers a year of service for vesting purposes as the plan year during which the employee works 1,000 hours.

If hours are not maintained, an equivalency method should be used such as crediting 45 hours per week or 190 hours per month. Plans can also use an elapsed time method, which is a period such as 12 months with no hourly requirement attached to it. Keep these definitions of service consistent to ensure benefits provided accurately reflect employees' time with the company.

5. Timely Deposit of Elective Deferrals

The DOL has placed a great deal of focus over the last several years on timely deposits of employee deferrals and loan payments. The DOL requires employee salary deferrals and loan payments be deposited on the earliest date that the deferrals can be segregated from the employer's general assets. With increased payroll technology coupled with the growth of managed 401(k) investment platforms, the DOL is looking for deposits within a few days of payroll. There may be exceptions for multiple locations, multiple payrolls, etc., but the timeframe for the deposits must be reasonable and consistent.

There is a safe harbor period for deposits for small plans[1]. These plans must make the deposit no later than the seventh business day following the date the salary deferral is withheld.

Late deposits are considered a prohibited transaction and must be reported on the Form 5500. The late deposits, including earnings, must be restored to the plan. Late deposits are subject to an excise tax equal to 15 percent of the restored earnings. Prohibited transactions are reported on the Form 5330. Relief from the excise tax may apply if the employer files under the DOL's Voluntary Fiduciary Correction Program (VFCP).

The DOL encourages employers to file under the VFCP to report and explain the late deferrals, why they occurred, how the deferrals and related earnings were restored to the plan and what procedures the employer put in place to prevent late deferrals in the future. Because the late deposits must be reported on the Form 5500 and create a “red flag” to the DOL, the DOL has indicated that this program will offer relief from a DOL audit. The VFCP may also allow the employer to avoid filing the Form 5330 to pay the excise tax by depositing the excise tax into the participant accounts.

6. Plan Amendments

Amendments to the plan must generally be adopted by the last day of the plan year for which they apply. Plan sponsors should be sure their plan amendments are adopted and signed in the proper timeframe to avoid compliance issues.

To simplify the amendment process, plan sponsors should specify who has the power to adopt benefit plan amendments, be it an amendment board, committee or officer. Plan sponsors should maintain in their permanent records all plan documents, service contracts, summary plan descriptions and material modifications as well as key participant communication documents.

7. Plan Loan Provisions

Many retirement plans allow for plan loans to participants, so long as the loan meets the terms established by the Internal Revenue Code (IRC). Employees are responsible for repaying the loan within a designated timeframe. Loan repayment deferrals are available in some cases. For example, an employee who is on an extended leave of absence may suspend repayment of the loan for up to one year, so long as that one year does not extend beyond the the repayment period designated by IRC Section 72(p).

General Plan Loan Requirements

IRC Section 72(p) defines the terms as follows:

- The loan must be repaid within five years (exception for residential loans);
- The loan must have a reasonable interest rate (i.e., a maximum of 1 to 2 percent above the market rate);
- The loan must meet the dollar limit imposed by IRC 72(p);
- Repayment of the loan must be broken up into level payments of principal and interest that are paid at least on a quarterly basis.

Military personnel may be able to suspend their loan repayment for more than a year if called to military service during their employment.

Should an employee suspend payment at any time, the repayment structure of the loan must be recalculated so that the loan balance can still be paid off in level payments within the five-year repayment window. There are special exceptions for suspensions due to military leave.

Plan sponsors may allow for a grace period for loan repayments so long as the period does not extend past the quarter following the quarter in which the payment was due.

Plan loan errors must generally be corrected under the IRS Voluntary Compliance Program. This is advisable to avoid a prior taxable event to the participant, and in some circumstances, the IRS may grant the plan relief from reporting the loans as taxable distributions if certain corrections are made.

8. In-Service Withdrawals

Plan documents may provide for distributions prior to an employee's termination. Generally, plans provide that an employee must be at least age 59 ½ in order to avoid penalty taxes.

Hardship withdrawals are also permitted under certain plans. Plans that elect to include hardship provisions must be sure the hardship provision meets prescribed regulations. In general, participants must exhaust other options such as plan loans. Many plans choose to follow the IRS "safe harbor" standards for making distributions for hardship reasons.

IRS Safe Harbor Standards for Hardship Distributions

An employee is automatically considered to have an immediate and pressing financial need for a retirement plan distribution in the following scenarios:

- ► Medical care expenses for the employee, the employee's spouse, dependents or beneficiary
- ► Costs directly related to the purchase of an employee's principal residence (excluding mortgage payments)
- ► Tuition, related educational fees and room and board expenses for the next 12 months of postsecondary education for the employee or the employee's spouse, children, dependents or beneficiary
- ► Payments necessary to prevent the eviction of the employee from the employee's principal residence
- ► Funeral expenses for the employee, the employee's spouse, children, dependents, or beneficiary
- ► Certain expenses to repair damage to the employee's principal residence

Keeping records of hardship distributions can help reduce the risk for abuse of the policy. Plan sponsors should watch for identical requests made by multiple employees and monitor the loans to ensure they were completed according to the plan's terms.

If a distribution is made and the plan does not allow for hardship distributions, plan sponsors can generally go to the IRS under its Voluntary Compliance Program and ask to retroactively adopt a hardship distribution amendment.

9. Distribution of Plan Benefits

It is very important that the employer retain the proper documentation for distributions from the plan. The plan document will define when a terminated participant is entitled to his or her benefits. The plan document may also define how and under what circumstances a participant may be required to take a distribution from the plan. Terminated participants with more than $5,000 cannot be forced to take a distribution from the plan. Written consent is required for a distribution, although there may be a plan provision that force-outs may occur when a terminated participant reaches the age of 62.

Many retirement plans are required to distribute benefits to participants in the form of a Qualified Joint and Survivor Annuity (QJSA). A QJSA provides a life annuity to the participant and a survivor annuity for the spouse's life following the participant's death.

The QJSA may be waived by the participant and the benefit may be paid under an alternative method such as a lump sum distribution. If the participant is married, the spouse must consent to the alternative form of distribution.

Sometimes, the distribution is incorrectly made without the spousal consent. This can happen when the sponsor's human resources accounting system incorrectly classifies a participant as not married. One possible correction method is to notify the affected participant and spouse (to whom the participant was married at the time of the distribution) so that the spouse can provide spousal consent to the distribution actually made.

If spousal consent to the prior distribution cannot be obtained because the spouse refuses to consent, does not respond to the notice or because the spouse cannot be located, the spouse is entitled to a benefit under the plan. This benefit is equal to the portion of the QJSA that would have been payable to the spouse upon the death of the participant had a QJSA been provided to the participant under the plan at his or her retirement. Such spousal benefit must be provided if a claim is made by the spouse.

It is also important for plans to maintain beneficiary records of all participants in the event of a participant death. Participants should be reminded to make sure that the form on file is correct. These records are binding.

Beneficiary forms may be provided by the plan document provider or they may be provided by the investment platform that holds the investments. Spouses must be named as the beneficiary unless the spouse consents to another named beneficiary. Special rules apply if the plan provides for Joint and Survivor Annuities. The plan document will also define how distributions will be made to beneficiaries and the timing of those distributions.

After plan participants who have terminated their employment reach age 70 ½, they must begin taking minimum distributions from the plan. If the participant is a more than a 5 percent owner, the participant must begin taking minimum distributions at age 70 ½ regardless of his or her employment status.

Plan sponsors must make the appropriate distribution in a timely manner to avoid compliance concerns. If participants or beneficiaries do not receive their minimum distribution on time, they (not the plan) are subject to a 50 percent additional tax on the underpayment. If the plan does not make a prompt distribution, it can correct the error through the IRS Voluntary Compliance program and request that the excise tax be waived by calculating the distribution plus the interest earnings from the date of the failure to the date of the distribution.

10. Calculation of Pension Benefit

To demonstrate pension benefits are correctly calculated, defined benefit plans need to maintain historical records that include employees' years of service and eligible compensation. Even if plan sponsors use third-party record keepers, the plan sponsors are responsible for the retention of historical records. This can be problematic when there are changes in third-party record keepers.

Issues can also arise with document retention policies. Many companies have policies where documents are disposed after a certain number of years. To ensure valuable retirement plan data are not lost, be sure retirement plan data are excluded from document disposal.

Conclusion

To mitigate the risk of penalties, plans should be regularly evaluated for mistakes. Under the Employee Plans Compliance Resolution System (EPCRS), the IRS offers three programs for correcting plan errors:

- Self-Correction Program (SCP)
- Voluntary Correction Program (VCP)
- Audit Closing Agreement Program (Audit CAP)

The SCP or VCP programs are less time-consuming and less costly than the Audit CAP program for correcting errors discovered during an audit of the plan by the IRS. The Audit CAP program typically involves sanctions with steeper price tags than correcting the error under SCP or VCP. Furthermore, errors could result in a material impact on financial statements, which could affect the timeliness of your employee benefit plan's audit. Plans with known errors will likely be asked to show more transparency in the areas where the errors occurred. Repeated noncompliance with financial regulations could cost an employee benefit plan its qualified tax status.

Plan sponsors who are concerned about whether noncompliance resulted from a weakness or deficiency within their plan documents or internal controls should consult with their auditor or third-party administrator or other service provider for further guidance. They may be able to make recommendations for ways to improve your plan and prevent future compliance errors.

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- Provide informative financial statement results reporting to your management, audit committee or board.
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- Meet all internal or external deadlines.

Endnotes

1 Small plans are plans with fewer than 100 participants. The number of participants as of the first day of the plan year dictates whether you have a large or small plan for Form 5500 purposes. Employees become includable as "participants" on the date that the employee becomes eligible to participate - regardless of whether they elect to participate. The participant count must include (1) actively participating employees, (2) retired, deceased, or separated employees who still have assets in the plan and (3) all eligible employees who have yet to enroll or have elected not to enter the plan. A special ruling (80/120 Rule) allows plans with between 80 and 120 participants, as of the first day of the plan year, to file the Form 5500 in the same category ("large plan" or "small plan") as indicated on the prior year Form 5500 filing

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