Common ERISA Mistakes
How to Avoid Them and How to Fix Them

Peter R. Wand
Lewis and Roca LLP
(602) 262-5305 (office)
(602) 855-9599 (cell)
pwand@lrlaw.com

Mistake No. 1
No Participation Agreement

• The Law:
  - A qualified retirement plan must be maintained for the exclusive benefit of the employer’s employees.
  - This concept is commonly referred to as the “exclusive benefit” rule.
  - Individuals that are not employees of the employer (i.e., independent contractors, non-employee directors, etc.) are not permitted to participate in the employer’s qualified retirement plan.
Mistake No. 1
No Participation Agreement

• The Mistake:
  – To ease administration and reduce costs, related employers (i.e., parent-subsidiary, brother-sister, etc.) often adopt a single qualified retirement plan.
  – This is only permissible if all participating employers have adopted the plan.
  – Plan adoption typically requires the execution of a participation agreement and any other documents required by the plan’s recordkeeper / custodian.

• The Fix:
  – If the mistake is caught quickly (and the plan has no other operational or plan documents failures) the plan sponsor can correct the error by executing a corrective amendment in accordance with Rev. Proc. 2013-12.
  – If the mistake occurred in multiple years (or the plan has other operational or plan document failures) the plan sponsor can correct the error by submitting a VCP application to the IRS.
Mistake No. 2
Misuse of Forfeited Plan Assets

• The Law:
  - Plans that have vesting schedules for employer contributions will necessarily have forfeited plan assets each time a participant terminates employment prior to becoming fully vested.
  - These plans will include directions for the use of forfeited plan assets. The following are permissible uses of forfeited plan assets:
    • to reduce employer contributions;
    • to pay plan administrative expenses; or
    • to be allocated to other participants.

• The Mistake:
  - Forfeitures must be used to pay plan expenses, to reduce employer contributions or be allocated to participant accounts in the plan year in which the forfeiture occurs. See Treas. Reg. 1.401-7(a) and Rev. Rul. 80-155.
  - Forfeited plan assets cannot be held in a suspense account and allowed to accumulate over several years.
Mistake No. 2
Misuse of Forfeited Plan Assets

• The Fix:
  - If the mistake is caught quickly (and the plan has no other operational or plan documents failures) the plan sponsor can correct the error by complying with the plan’s directions for the use of forfeitures and documenting compliance in accordance with the IRS’s Self Correction Program.
  - If the mistake occurred in multiple years (or the plan has other operational or plan document failures) the plan sponsor can correct the error by submitting a VCP application to the IRS and complying with the plan’s directions for the use of forfeitures.

Mistake No. 3
Cutting Back Accrued Benefits

• The Law:
  - When transitioning to a new recordkeeper / custodian, plan sponsors often amend and restate their retirement plan (i.e., execute a new adoption agreement and adopt a new basic plan document).
  - Section 411(d)(6) of the Internal Revenue Code prohibits the reduction of any participant’s accrued benefit.
  - In a defined contribution plan (i.e., a 401(k), profit-sharing, money purchase plan, etc.), this means that no employee’s account can be reduced because of the plan amendment.
Mistake No. 3
Cutting Back Accrued Benefits

• The Mistake:
  – According to the Internal Revenue Service, a plan amendment that does any of the following will be treated as reducing accrued benefits (i.e., improperly cutting back accrued benefits):
    • eliminating or reducing an early retirement benefit;
    • extending a vesting schedule; or
    • eliminating an optional form of benefit or distribution/payment option.

• The Fix:
  – If the mistake is caught quickly (and the plan has no other operational or plan documents failures) the plan sponsor can correct the error by executing a corrective amendment in accordance with Rev. Proc. 2013-12.
  – If the mistake occurred in multiple years (or the plan has other operational or plan document failures) the plan sponsor can correct the error by submitting a VCP application to the IRS.
Mistake No. 4
Failure to Timely Transfer Elective Deferrals

• The Law:
  – An employer must transfer elective deferrals to the plan on
    the earliest date the employer can reasonably segregate the
    elective deferrals from the employer’s general assets;
    however, in no event can the employer make the transfer
    later than the 15th business day of the following month.
  – The rules regarding the 15th business day of the following
    month do not provide a safe harbor for transferring elective
    deferrals; rather, these rules set the maximum deadline for
    deposit.

• The Law (cont.):
  – A 7 business day safe harbor rule applies to plans
    with fewer than 100 participants.
  – NOTE: Some plan documents contain specific
    provisions concerning the timing of elective deferral
    transfers. If your plan includes such provisions you
    must comply with these provisions and timely deposit
    elective deferrals.
Mistake No. 4
Failure to Timely Transfer Elective Deferrals

• The Mistake:
  – Failure to timely transfer elective deferrals results in a prohibited transaction. Specifically, the “use” of plan assets by the plan sponsor.
  – To avoid this mistake, employers should establish procedures so that elective deferrals are transferred to the plan coincident with payroll.

Mistake No. 4
Failure to Timely Transfer Employee Elective Deferrals

• The Fix:
  – This mistake must be reported on the annual Form 5500 and corrected through the DOL’s Voluntary Fiduciary Correction Program (VFCP).
  – While prohibited transactions often require the payment of excise tax to the IRS, correction through VFCP allows a plan sponsor to avoid paying the otherwise applicable excise tax.
Mistake No. 5
Failure to Apply Compensation Definition

• The Law:
  - Employers have broad discretion in defining compensation for purposes of elective deferrals, matching contributions and discretionary contributions.
  - In fact, most volume submitter and prototype plans provide the plan sponsor with three or more compensation definitions.
  - NOTE: The amount of compensation taken into account under a qualified retirement plan cannot exceed $255,000.

• The Mistake:
  - This mistake often occurs following a plan amendment, but some employers fail to use the correct definition of compensation from inception (i.e., using W-2 – Box 1, instead of W-2 – Box 3).
  - Employers often fail to correctly apply the definition of compensation when making percentage based contributions.
  - Examples:
    • Are bonuses included in compensation?
    • Are pre-tax health insurance premiums included in compensation?
Mistake No. 5
Failure to Apply Compensation Definition

• The Fix:
  - If the mistake is caught quickly (and the plan has no other operational or plan documents failures) the plan sponsor can correct the error by making corrective contributions (or forfeitures / distribution, as appropriate) in accordance with Rev. Proc. 2013-12.
  - If the mistake occurred in multiple years (or the plan has other operational or plan document failures) the plan sponsor can correct the error by submitting a VCP (voluntary correction procedure) application to the IRS and making corrective contributions (or forfeitures / distribution, as appropriate) in accordance with Rev. Proc. 2013-12.

Mistake No. 6
Excluding Eligible Employees

• The Law:
  - While some employers permit employees to participate upon hiring, most employers have some eligibility requirements for plan participation (i.e., age, service, residency, etc.)
  - The ability to impose eligibility requirements is strictly limited. For example, an employee who has attained age 21 cannot be excluded based on age.
Mistake No. 6
Excluding Eligible Employees

• The Mistake:
  – Many employers want to exclude part-time employees, seasonal employees and temporary employees from participating in the plan.
  – While exclusions based on job type or title are permissible (to the extent they don’t cause discrimination problems), an employee who completes 1,000 hours of service in a given plan year cannot be excluded from plan participation.

• The Fix:
  – If the mistake is caught quickly and is insignificant (and the plan has no other operational or plan documents failures) the plan sponsor can correct the error by making corrective contributions (50% of missed elective deferrals and 100% of missed employer contributions) in accordance with Rev. Proc. 2013-12.
  – If the mistake occurred in multiple years or is significant (or the plan has other operational or plan document failures) the plan sponsor can correct the error by submitting a VCP application to the IRS and making corrective contributions (50% of missed elective deferrals and 100% of missed employer contributions) in accordance with Rev. Proc. 2013-12.
Mistake No. 7
Service Provider Contracts

• The Law:
  – Plan sponsors have a fiduciary obligation to manage the plan for the exclusive benefit of plan participants. This fiduciary obligation necessarily requires plan sponsors to limit service provider fees to the greatest extent possible.
  – While great emphasis has been placed on fee disclosure / transparency in recent years, one source of service provider revenue is regularly overlooked – mutual fund revenue sharing.

• The Law (cont.):
  – Mutual fund revenue sharing payments are payments by mutual fund companies to plan service providers (i.e., recordkeepers, investment advisers, etc.).
  – A mutual fund company is willing to share its revenue because plan service providers perform valuable services the mutual fund company would otherwise have to perform (i.e., marketing, valuation, etc.).
Mistake No. 7
Service Provider Contracts

• The Mistake:
  - Mutual fund revenue sharing is often hidden from the plan sponsor and may allow a plan service provider to offer low cost services, while at the same time making substantial revenue.
  - Litigation is on the rise on this issue. At a minimum, plan sponsors must understand the amount of revenue sharing being earned by the plan’s service providers.
  - Ideally, the plan sponsor will negotiate a service agreement that mandates that all revenue sharing be remitted to the plan and used to reduce plan expenses. The plan’s service providers would be paid a fee for services provided to the plan.

Mistake No. 8
Failure to Maintain Plan Documents

• The Law:
  - All employee benefit plans subject to ERISA must be established pursuant a written plan document.
  - All employee benefit plans must also be described in a summary plan description that is distributed to all eligible employees.
  - The following are plans subject to ERISA:
    • Retirement plans;
    • Group health plans (whether fully insured, self-funded or HMO);
    • Dental and vision plans;
    • Group term life insurance;
    • Disability benefits (if insured, whether LTD or STD); and
    • Health FSAs and Health HRAs.
Mistake No. 8
Failure to Maintain Plan Documents

• The Mistake:
  – In the health and welfare context, many employers incorrectly assume that the insurance policy, coverage certificate or plan booklet they receive from their insurance carrier or third party administrator satisfies the plan document and SPD requirements.
  – While these documents often include detailed descriptions of the benefits available under the plan, they rarely identify, among other things, a named fiduciary or the procedures for amending the plan.

• The Mistake (cont.):
  – The importance of preparing a plan document and an SPD that comply with ERISA cannot be overstated.
  – Failure to provide a plan participant with a copy of an SPD within 30 days of the date the participant requests a copy can result in a $110/per day penalty. See ERISA § 502(c).
  – Additionally, criminal penalties can be imposed on any individual or company that willfully violates any requirement of ERISA – $100,000 or imprisonment for up to 10 years.
Mistake No. 8
Failure to Maintain Plan Documents

• The Fix:
  – A wrap document incorporates (i.e., “wraps around”) the applicable insurance policy, coverage certificate or plan booklet.
  – The benefits available under the plan continue to be governed by the applicable insurance policy, coverage certificate or plan booklet, while the wrap document supplements with the information necessary to comply with ERISA.
  – A properly drafted wrap document fills in the gaps left by insurance carriers and third party administrators without changing the benefits available under the plan.

• The Fix (cont.):
  – In addition to easing compliance with ERISA’s plan document and SPD requirements, wrap documents can also be used by an employer to consolidate employee welfare benefit plans into a single plan.
  – Consolidating employee welfare benefit plans into a single plan can reduce the costs associated with filing multiple annual reports, distributing multiple summary annual reports, distributing multiple summaries of material modifications, and amending multiple plans in response to legislative or regulatory changes.
Mistake No. 8
Failure to Maintain Plan Documents

• Related Mistake:
  – Cafeteria plans, which allow an employee to pay health insurance premiums on a pre-tax basis, must be in writing.
  – Pursuant to Section 125(d)(1) of the Internal Revenue Code (and IRS regulations adopted under the same), allowing an employee to choose between cash and other benefits (i.e., health insurance) without a written cafeteria plan will result in taxable income to the employees, regardless of their choice.

Mistake No. 9
COBRA

• The Law:
  – While the intricacies of COBRA can fill volumes, the most common – and potentially costly – COBRA mistake is offering COBRA when it is not required.
  – The obligation to offer COBRA only arises when a qualified beneficiary (i.e., a covered employee, the spouse of a covered employee or the dependent child of a covered employee) loses group health plan coverage as the result of a qualifying event.
Mistake No. 9
COBRA

• The Mistake:
  - If the qualified beneficiary does not lose group health plan coverage as the result of a qualifying event, there is no obligation to offer COBRA. In fact, offering COBRA in this context may result in the employer self-insuring the qualified beneficiary’s COBRA coverage.
  - Because COBRA does not apply directly to insurers or stop-loss carriers, these entities are not obligated to provide COBRA coverage (or stop-loss coverage for COBRA claims) unless they enter into a contract requiring them to provide coverage.

Mistake No. 9
COBRA

• The Mistake (cont.):
  - In addition to over-offering COBRA, group health plans can also become self-insurers by doing the following:
    * failing to satisfy a requirement of the insurance contract to “timely” provide the COBRA election notice to a qualified beneficiary;
    * continuation of an individual’s group health plan coverage after a qualifying event has occurred, if the continuation is not based on COBRA; or
    * failing to satisfy a requirement of the insurance contract to “timely” notify the insurer / stop-loss carrier of a qualified beneficiary’s COBRA election.
Mistake No. 10
Fiduciary Liability Post-Termination

• Background:
  - A surprising number of employers appoint their employees (i.e., a human resources executive, chief financial officer, etc.) as the plan administrator of their retirement plans.
  - Generally, we suggest that the employer serve as the “plan administrator” of the employer’s qualified retirement plans. This serves two purposes:
    • the fiduciary obligations and potential civil penalties for failure to comply with ERISA are born by the employer, not an employee; and
    • adoption agreements and summary plan descriptions don’t have to be revised each time a new human resources executive/CFO is hired.

• The Mistake:
  - Put simply, if an employee is named as the “plan administrator” that employee can be held personally liable for the failure to comply with ERISA (i.e., the failure to timely distribute an SPD or timely file a 5500) and could be subject to substantial civil penalties. Because the employee is simply acting at the direction of his/her employer, we think the employer should, in most cases, bear that risk.
  - The greater problem, however, lies in the potential exposure for the employee post-termination. We recently represented a former human resources executive who was sued by DOL for a breach of fiduciary duty in connection with a retirement plan of an employer she left more than 10 years ago. Resolving the matter was time-consuming and expensive.
• The Mistake:
  - IRC section 79 provides an exclusion for the first $50,000 of group-term life insurance coverage provided under a policy carried directly or indirectly by an employer.
  - There are no tax consequences if the total amount of such policies does not exceed $50,000.
  - The imputed cost of coverage in excess of $50,000 must be included in income, using the IRS Premium Table, and are subject to social security and Medicare taxes.