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Internal Controls Part 2: Operational Compliance for Eligibility Classification – Reviewing the Plan Document

Alison Smith Fay

As noted in our prior article on the subject [see *Protect Your Retirement Plan with Internal Controls* in *Benefits News,* January 2017], strong internal controls and "self-audits" are an effective way to protect your qualified retirement plan from disqualification failures and the imposition of sanctions in the event of an Internal Revenue Service examination. Internal controls can be implemented by the establishment of policies and procedures that will facilitate the detection of errors in the administration of a plan before the costs of correction become exorbitant. In order for a plan to maintain its qualified status and provide all of the favorable tax consequences that follow from plan qualification, (a) the form of the plan document must include all of the provisions required for qualification, and (b) the plan must be operated consistent with the terms of the plan document. Our prior article, which appeared in the January newsletter, focused on internal controls that help to ensure that the form of the plan document is qualified. This article focuses on operational compliance – that is, the requirement that the plan be operated in accordance with the terms of the plan document, and in particular, the terms of the plan relating to eligibility classification.

Among the suggestions for determining an employee's eligibility classification accurately are:

- First and foremost, know what the plan document says.
- If necessary, determine which related employers are members of the same controlled group.
- If you have leased employees, follow the special rules that apply to them.
- If you use independent contractors, temporary employees or you contract for workers through a staffing firm, make sure that they are classified correctly.

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- Use *Microsoft* language (but watch for coverage failures as well).

Review the Plan Document

Determining an employee's eligibility classification in a qualified plan appears to be a simple process, when in reality there are number of pitfalls that can trip up an employer. The first step in the process should be a detailed review of the plan document's eligibility provisions. To understand fully a plan's provisions, an employer will usually need to reference the definitions section of the document. If the employer uses a pre-approved plan document, often there will be two different documents to review – the adoption agreement, which includes the employer's plan design choices, and the base or basic plan document, which includes the operative provisions and often has upwards of 100 or more pages.

In reviewing the plan document, an employer should answer the following questions:

1. Which employees are eligible under the plan? Some plans cover all employees, others exclude certain groups of employees. Check the definition of "employee". Typically, it will be defined as any common law employee of the employer. If the plan excludes certain employees, check the definition of an "eligible employee". Many plans exclude employees who are union employees covered by a collective bargaining agreement where benefits have been the subject of good faith bargaining or nonresident aliens with no U.S. source income. These are called statutory exclusions because these groups can be excluded from the plan without violating the Code Section 410(b) coverage rules that require a plan to cover a nondiscriminatory group of employees. Other plans exclude employees based on their job classification, geographic location or the department or division in which they work. If the plan document excludes employees, make sure that the exclusions are being applied accurately and that the plan satisfies the coverage rules. Offering participation to employees who are not actually eligible for the plan is a qualification failure that can disqualify a plan [see *401(k) Retirement Plan Disqualification*] or result in significant penalties.

2. Which employers' employees are covered by the plan? Check the definition of "employer". Does it include only the employer who has signed the plan document, or does it allow for other employers' employees to be covered by the plan? Generally, a prototype plan, which is a type of IRS pre-approved document, automatically provides that the employees of all employers included in the adopting employer's controlled group are covered under the plan. This can be a problem when an employer acquires a wholly-owned subsidiary and does not realize that the employees of the subsidiary are then eligible for the plan. Failing to offer participation to an employee who is eligible to participate in a 401(k) plan can be an expensive qualification failure to correct. For this reason, an employer should know which employers are members of its controlled group. See *Addressing the Risks of Related Employer Status for Benefit Plan Purposes* in *Benefits News,* April 2017.

   If a plan document requires that all participating employers execute the plan document (or a separate participation agreement) in order for their employees to be covered, and plan participation is offered to the employees of an employer that fails to execute the document or a participation agreement, a plan qualification failure results. Even though the failure is advantageous for the employee, it nonetheless results in a qualification failure because the terms of the plan document have not been followed.

If the employers with employees covered under a plan are not all part of the same controlled group, that plan is a multiple employer plan. However, not all plan documents have provisions that satisfy the requirements for a multiple employer plan. Thus, a plan qualification failure can result when a qualified plan is adopted by an unrelated employer and the plan document is not intended to be a multiple employer plan. Some plans, but not all, have fail-safe language that is automatically triggered when an unrelated employer adopts the plan. Even if your plan has this fail-safe language, it is still important for an employer to know whether any related employers are part of its controlled group, since the testing for a multiple employer plan is carried out on an employer by employer basis rather than with respect to the plan as a whole.

3. What is a "leased employee" and is it an excluded category? Leased employees are important for a qualified plan because they are treated as employees in determining whether the plan satisfies the coverage rules. If too many leased employees are excluded from a plan, it may fail to satisfy coverage. When reading a plan document, employers should understand that the term "leased employee" has a very specific statutory definition. It may come as a surprise to many employers that a leased employee is not actually a common law employee of the employer receiving the services of the leased employee (the "recipient employer"). A leased employee is a worker who provides services to a recipient employer under the following circumstances: (a) the worker is not a common law employee of the recipient employer; (b) there is an agreement between the recipient employer and the leasing organization, which is the business that provides the leased employees to the recipient employer; (c) the worker provides services to the recipient employer on a substantially full-time basis for at least one year; (d) the worker is under the primary direction and control of the recipient employer. Whenever an employer receives the services of workers that are not on its payroll, the employer should consider whether those workers are leased employees, and if so, whether the plan provides that leased employees are in an eligible classification. Just because a worker is on the payroll of another employer does not mean that a plan sponsor can ignore that worker for qualified plan purposes.

   Many plan documents provide that leased employees are automatically covered by the plan; others explicitly exclude leased employees. If leased employees are eligible, once a worker becomes a leased employee after having satisfied the substantially full-time basis for one year requirement, he or she will become eligible for the plan and must be offered participation. If the plan has an eligibility service requirement (for example, a one-year service requirement), a leased employee's service with the leasing organization will count toward the satisfaction of that service requirement in the recipient employer's plan.

4. Does the plan document have *Microsoft* language? The use of *Microsoft* language in plan documents has arisen in response to the case of *Vizcaino v. Microsoft,* 120 F3d 1006 (1997, CA9). Microsoft was sued by a number of freelance workers who claimed that they were eligible for benefits under Microsoft's various employee benefit plans including its 401(k) plan. Microsoft believed they were not eligible because the freelancers had entered into contracts with Microsoft stating that they were not eligible and also because the freelancers were paid through the company's accounts payable department, not payroll. Microsoft's 401(k) plan provided that individuals who were not paid through its U.S. payroll would not be eligible. Microsoft argued that this provision in the plan document

allowed the company to exclude the freelancers even if they were determined to be Microsoft's common law employees. The court held that the eligibility issue with respect to the 401(k) plan should be determined by the plan administrator, and the case was ultimately settled.

In response to this case, many plan documents were amended to include language that excludes employees who are not treated on the employer's payroll records as subject to federal income tax withholding even in the case where the employees are later determined to be common law employees subject to such withholding requirement. This language is commonly referred to as *Microsoft* language. If a plan does not include *Microsoft* language, the plan sponsor should consider adding it to protect the employer against the claims of misclassified employees.

If a plan sponsor uses independent contractors, temporary employees, or workers contracted from a staffing agency, know that the IRS may challenge their classification. These kinds of workers may be reclassified by the IRS as employees of the plan sponsor and that reclassification may result in a qualification failure when the employees are not permitted to participate in the plan. Including *Microsoft* language in your plan may be helpful, but if there are too many misclassified employees who are excluded, the employer runs the risk of failing to satisfy the coverage rules.

If you need assistance in reviewing your plan document, you can contact any Boutwell Fay attorney. Watch for our next article in this series that will describe the policies and procedures employers should establish in order to ensure that the plan document eligibility classification provisions match the group of employees who are actually being offered participation in the plan.

To VCP or Not to VCP? That is a Plan Sponsor's Question: Part 2

Kathleen Bass

In Part 1 of this article (see *To VCP or Not to VCP? Part 1* in *Benefits News,* April 2017) we discussed the importance of correcting qualified plan failures as soon as practicable. When correcting a qualified plan failure under EPCRS, plan sponsors may have more than one option, with the primary options being: self-correction ("SCP") or voluntary correction with IRS approval ("VCP"). This article discusses the considerations of using either SCP or VCP.

Limitations of Self-Correction

If a plan meets the basic eligibility requirements for SCP (see *Self-Correction of Operational Defects in a Qualified Retirement Plan,* August 2016), the plan sponsor will also need to consider the following limitations under SCP:

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- Limitations on Timing: Insignificant failures can be self-corrected at any time. If a failure, or a series of failures, is not insignificant, SCP is only available if the correction is made within a limited period. That limited period generally ends on the last day of the second plan year following the plan year in which the failure occurred. For example, if a calendar year plan experienced a significant failure in April 2015, the last day to correct that failure under SCP would be December 31, 2017. For a more detailed discussion of the eligibility requirements for SCP and what factors are used to determine if a failure is significant or insignificant, see our previous article on this topic at the link provided above.
- No Retroactive Plan Amendments: When correcting a qualification failure, in some instances a retroactive amendment is either the required correction (such as where the defect is the timely adoption of required amendments to the plan) or the desired correction (such as when the plan was not operated according to its written terms but there is documentation establishing that the operation of the plan was consistent with the plan sponsor's intent and the participants' understanding). With very limited exceptions, correction by retroactive amendments under SCP is not permitted.
- Limited to Failures and Corrections Described in the Latest Revenue Procedure: When correcting under SCP, the IRS will not be issuing a compliance statement – the plan sponsor is taking the risk that the correction is either not eligible for SCP or is not properly corrected. However, the IRS does publish certain "safe harbor" correction methods that can be used when correcting under either SCP or VCP (see, e.g. Rev. Proc. 2016-51). The more creative or customized the correction method used, the higher the risk that the correction is not sufficient to satisfy the requirements of EPCRS.

Note – even if a failure is eligible for SCP, VCP is still always available for confirmation of the correction. A risk-averse plan sponsor may want to consider a VCP submission for peace of mind or other reasons (e.g., the plan sponsor is publicly traded).

Advantages of Filing a VCP

There are several advantages to filing a VCP:

- Cost: VCP provides a fixed filing fee, based upon the number of participants in the plan, and there is no penalty to negotiate the actual correction. While there are additional upfront costs such as the cost of legal advice and/or tpa or recordkeeper fees to prepare the submission, the IRS position is that when negotiating a sanction in an audit, the sanction should be more than the costs of filing a VCP and in nearly all cases the costs of the VCP will be much lower than the cost of plan disqualification (see *401(k) Retirement Plan Disqualification,* June 2016.)
- Insurance Coverage: Fiduciary or other liability policies may cover some of the costs of a VCP, such as the VCP fee. If an error is discovered, it is important for a plan sponsor to promptly review all applicable policies and be aware of the conditions for coverage of the costs of a VCP. Frequently these policies require the plan sponsor to report the potential claim within a short time frame following its discovery.
- Flexibility: When filing a VCP submission, a plan sponsor may propose and negotiate a creative correction method that may be different than the published correction method, or obtain IRS approval for simplifying assumptions and earnings calculation methods.
- Special Situations: Similarly, special situations can also be handled under VCP, where there is some ability to negotiate special circumstances such as business hardship, loss or unavailability of plan records or unreasonableness of full correction.
- Retroactive Amendments: While retroactive amendments are sometimes the required correction and can only be corrected under VCP, there are also situations where documents demonstrate that the intentions of a plan sponsor and the understanding of plan participants are both contrary to a plan

term but consistent with the operation of the plan. Retroactive amendments may be permitted under VCP, potentially eliminating or reducing the need for corrective contributions from the plan sponsor.

- Audit Protection: Once a plan receives a compliance statement from the IRS, the plan has audit protection on the failures covered by the compliance statement. In addition, unless the VCP was filed anonymously (see Part I of this article for more information on anonymous submissions), that audit protection applies as soon as the VCP is filed (assuming a compliance statement is eventually issued).

Disadvantages of Filing a VCP

The primary disadvantages of filing a VCP are:

- Costs. Filing a VCP requires payment of a user fee and plan sponsors also incur the cost of preparing and filing of the submission (however much of the same documentation and effort is required for SCP, as the plan sponsor and its advisors must still calculate the error and correction and document that the correction was made)
- Time. IRS often takes 6 months to a year from the filing date to respond to a VCP. Negotiations can then continue over an extended period before a compliance statement is issued.
- Failure to agree. Although rare, there may be situations where no agreement can be reached with the IRS and for this reason, a worst-case scenario should always be analyzed and prepared for before a VCP is filed. If a plan sponsor finds a worst-case scenario unacceptable, an anonymous filing can be considered.

Conclusion

There is much to consider when deciding how to correct a qualified plan failure, and in many cases self-correction is the right choice. Each situation must be carefully reviewed before making a business decision, considering the facts and circumstances of the failure and the plan sponsor, as well as the options available.

If you are dealing with a qualification failure and would like assistance with determining how best to correct the situation, the attorneys of Boutwell Fay have significant experience in this area and are available to help you.

Building Blocks of ERISA

CORRECTIONS UNDER THE IRS VOLUNTARY CORRECTION PROGRAM (“VCP”)

This month’s *Building Block* describes VCPs and answers a few important questions. Click below to read the article:

Corrections Under the IRS Voluntary Correction Program (“VCP”)

Webinar: 403(b) Update for 2017

Thank you to everyone who logged in for our June 21 webinar, ***403(b) Update for 2017: Pre-Approved Plan Documents and More.*** It was jam-packed with valuable information, presented by our own Sherrie Boutwell and Evan Giller. If you missed the live presentation, we invite you to view the recording. Register at https://attendee.gotowebinar.com/register/6947288792269314817 and you will be taken directly to the recording. We welcome you to call us if you have any questions about the information.

Firm News & Events:

Sherrie Boutwell to Present at the Western Benefits Conference Wednesday, July 12, 2017

Workshop 30: EPCRS - Advanced Case Studies, 8:00 to 9:15 a.m.

This session will use a case-study approach to demonstrate how to resolve compliance defects in the most efficient and effective manner under the IRS's updated guidance, and highlight the benefits of thinking “out of the box” when it comes to plan corrections. After attending this session, attendees will be able to: 1) Identify plan mistakes; 2) Determine eligibility for EPCRS; and 3) Formulate the most advantageous correction methodologies.

Workshop 34: Nightmares of Plan Administration, including Fiduciary Pitfalls, 9:30 to 10:45 a.m.

This session will present case studies on various plan administration nightmares, including automatic enrollment and escalation failures; misapplication of short plan year rules; “inadvertent” investment advice by plan administrators; and more. After attending this session, attendees will be able to: 1) Identify how these nightmares occur; 2) Anticipate and design practices and procedures to avoid such nightmares; and 3) Implement remedial actions.

Jay Adams Knight Has Been Chosen to be in the 2017 Edition of *The Best Lawyers in America*

Jay Adams Knight has once again been selected by *The Best Lawyers in America*, this time for inclusion in the 2017 Edition. He has been awarded this honor since 2008. He is recognized by Best Lawyers for his talent in the legal industry. Please congratulate Jay on achieving such a noteworthy accomplishment!#

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