Current Issues for Tennessee Employers:

Correction of Retirement and Health & Welfare Benefit Plan Errors, and Employee Handbook Issues

Presented by:

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Retirement Plan Compliance and Correction of Errors

Definition of Compensation

- The Problem: Plan document defines compensation as all W-2 compensation, but payroll software does not withhold deferrals or calculate contributions or benefits from bonuses, overtime, sick leave payouts, etc.
  - Contributions have been incorrectly calculated for 3 years

Employee Plans Compliance Resolution System (EPCRS)

- IRS program for correction of document or operational errors in qualified plan, 403(b) plan, or governmental 457(b) plan
  - Self- Correction Program (SCP)
    - Must have established compliance practices and procedures in place
    - May self-correct insignificant operational errors at any time without reporting to IRS or paying fee
    - May correct significant operational errors within 2 years of plan year error if have favorable determination letter
  - Voluntary Correction Program (VCP)
    - Requires application to IRS for approval of correction methods and payment of fee
    - Plan cannot be under IRS or DOL audit when application is filed
  - Audit Closing Agreement Program (Audit Cap)
    - Permits correction when error is found on audit with payment of fee, which is higher than VCP fee

EPCRS VCP Fees

- IRS recently reduced fees for Voluntary Correction Program:

Number of Participants	Old Fee	New Fee
20 or fewer	$750	$500
21 to 50	$1,000	$750
51 to 100	$2,500	$1,500
101 to 500	$5,000	$5,000
501 to 1,000	$8,000	$5,000
1,001 to 5,000	$15,000	$10,000
5,001 to 10,000	$20,000	$10,000
Over 10,000	$25,000	$15,000

EPCRS Correction Principles

- Error must be fully corrected for all participants and all years, even closed tax years
- Correction method should restore plan and participants to the positions they would have been in had error not occurred
- Correction method should keep assets in plan, except to the extent the Code, regulations or other guidance provides for correction by distribution
- Correction should be reasonable and appropriate for the failure
  - Any correction method described in EPCRS is deemed to be reasonable and appropriate
  - The correction method should, to the extent possible, resemble one already provided for in the Code, regulations, or EPCRS

Adjustment for Earnings

- All corrective contributions under EPCRS must be adjusted for earnings, and may be adjusted for losses
  - If possible, actual plan earnings should be used
  - If it is not possible to make a precise calculation or if the administrative cost of determining the precise restoration is too high, then reasonable estimates may be used

Definition of Compensation

- The Problem: Plan document defines compensation as all W-2 compensation, but payroll software does not withhold deferrals or calculate contributions or benefits from bonuses, overtime, sick leave payouts, etc.
- The Solution:
  - Employer must calculate corrective employer contributions or adjust accrued benefit calculation based on definition of compensation in plan
  - Correction for missed deferral opportunity is contribution of 50% (or 25% if corrected within 2-year window) of missed deferral

Failure to Timely Amend Plan

- The Problem: The Plan Sponsor failed to adopt a required amendment to comply with law changes
- The Solution:
  - If the deadline to amend the Plan has passed, must use VCP rather than SCP
  - Adopt the required amendment and submit application to IRS through VCP, with fee
    - If only error is failure to timely adopt good faith or interim amendment, VCP fee is $375
    - If only error is failure to timely adopt an amendment upon which a favorable determination letter is conditioned and amendment is adopted within 3 months of expiration of time to adopt, VCP fee is $500
    - If only error is failure to timely adopt plan restatement, fee is reduced by 50% if VCP is submitted within 1-year of expiration of restatement deadline

Scrivener's Error

- The Problem: Four years after Plan was last restated, Plan Sponsor discovers "scrivener's error" in Plan – employer contribution had always been 5% of compensation, but document says 10%
- The Solution:
  - Make corrective contributions to participants for last four years, adjusted for earnings; or
  - Submit VCP application and request permission to retroactively amend Plan to conform to actual operations and intent
    - IRS may grant request if can demonstrate amendment is consistent with Plan Sponsor's intent and the participants' expectations
    - Retroactive amendment preserves qualified status of Plan, but does not bar participants from suing for benefits under terms of Plan
    - May seek "equitable reformation" of Plan from Court if can demonstrate clear and convincing evidence that Plan language is contrary to parties' expectations

Exclusion of Eligible Employees

- The Problem: Eligible employees were improperly excluded from participation in plan (could result from employee misclassification, such as erroneously classifying employees as independent contractors, recordkeeping errors, misunderstanding of 403(b) universal availability rule, etc.)
- The Solution:
  - For exclusion from elective deferrals (401(k), 403(b), 457(b)), make qualified nonelective contribution (QNEC) to plan to make up for "missed deferral opportunity," equal to 50% of "missed deferral"
    - "Missed deferral" is equal to the ADP percentage for the participant's classification (HCE or NHCE) multiplied by the participant's compensation
    - If a safe harbor plan, missed deferral is greater of 3% or the maximum deferral percentage that the plan matches at 100%
    - Must also make full matching contribution, if applicable
  - No correction is required if error is corrected within 3 months, but must still fully correct missed matching contribution
  - If exclusion lasts more than 3 months but is corrected before the end of the second plan year after the year of the failure and certain conditions are met, the QNEC can be reduced to 25%

Exclusion of Eligible Employees (Cont'd)

- The Problem, cont'd: Eligible employees were improperly excluded from participation in plan
- The Solution:
  - For defined contribution plans with required employee contributions, substitute contribution rate for "missed deferral"
  - For defined benefit plan, provide the accrued benefit
    - EPCRS does not provide guidance on correcting DB plans with required employee contributions – may require payment of part or all required contribution to provide accrued benefit
  - For employer contributions in a profit sharing plan (other than elective deferrals and matching contributions), either
    - Make a corrective contribution for employee equal to allocation that should have been made; or
    - Reallocate the profit sharing contribution that was made to the plan by reducing the accounts of the other participants and allocating a portion to the excluded participant

Failure to Implement Deferral Election

- The Problem: The employer failed to withhold the amount an employee elected on a deferral election form
- The Solution:
  - Make QNEC equal to 50% (or 25% if corrected within 2-year window) of missed deferral that would have been made had election been properly implemented
  - Make full matching contribution based on 100% of missed deferral, if applicable

Overpayment of Benefits

- The Problem: Employer miscalculated participant's monthly benefit in a defined benefit plan and overpaid participant $10,000 over 5 years
- The Solution:
  - Take "reasonable steps" to collect overpayment from participant
    - May reduce monthly payments until overpayment is collected
    - If reasonable steps are insufficient, employer or another person may contribute overpayment
  - New IRS guidance provides employers with more flexibility to contribute the amount of the overpayment to Plan instead of attempting to collect if reasonable for the circumstances
  - May also seek to retroactively amend Plan to conform to Plan's operations

Excess Deferrals

- The Problem: A participant deferred more than the maximum amount allowed for a plan year (currently $18,000, or $24,000 with catch-up)
- The Solution:
  - Distribute the excess deferral to participant and report the amount as taxable
    - If corrected by April 15 of the year following the year made, excess deferrals are reported as taxable in year deferred
    - If corrected after April 15, excess amounts are subject to double taxation in year deferred and in year distributed

Exceeded Annual 415 Limits

- The Problem: The total employer and employee contributions exceed the annual contribution limit under Code § 415 (currently $53,000)
- The Solution:
  - **Step 1**: Distribute unmatched elective contributions (adjusted for earnings) to the affected participant. If any excess remains, then proceed to Step 2.
  - **Step 2**: Distribute elective contributions (adjusted for earnings) that are matched, and forfeit related matching contributions (adjusted for earnings). If any excess remains, then proceed to Step 3.
  - **Step 3**: Forfeit other profit-sharing contributions.

Failure to Start RMDs

- The Problem: Participant terminated employment 10 years ago and is 76 years old, but never completed distribution paperwork and Plan never started required minimum distributions (must start the later of age 70 ½ or termination of employment)
- The Solution:
  - For DC Plan, distribute the missed RMDs with earnings from the date of the failure to the date of distribution
  - For DB Plan, distribute the missed RMDs (monthly benefit payments) plus an interest payment representing the loss of use of such amounts
  - Participant is subject to a 50% excise tax on missed distributions unless employer files VCP or participant requests waiver of tax on Form 5329 and can demonstrate a "reasonable error" for the failure to receive the RMD
    - VCP fee is $500 if 150 or fewer participants affected

Failure to Set Up Loan Repayments

- The Problem: Participant takes a loan from the Plan with payments to be made by payroll deduction, but payroll withholdings are not correctly set up, and no payments are made; employer discovers error 8 months later
- The Solution:
  - If past any cure period, loan will be treated as deemed distribution unless corrected through VCP (reduced fee of $300 if 13 or fewer loan failures)
  - Through VCP, may
    - make a lump sum payment of the missed installments and continue making the regular installment payments for the remaining period of the loan;
    - reamortize the outstanding balance of the loan, resulting in increased installment payments per month for the remainder of the loan period; or
    - make a partial lump-sum payment and reamortize the outstanding balance of the loan

Early Participation in Plan

- The Problem: Employer permitted employee to enter plan who either had not satisfied age and service requirements or became a participant earlier than the plan's applicable entry date
- The Solution:
  - Distribute elective deferrals or employee contributions and forfeit employer contributions for period employee was ineligible; or
  - Adopt retroactive amendment to change the plan's eligibility requirements to reflect the plan's actual operation
    - May amend plan to change eligibility requirements for just employees who were wrongly included so long as the amendment satisfies the qualification requirements and the employees affected are predominantly NHCEs
    - Retroactive amendment may only be adopted through VCP

Failure to Obtain Spousal Consent for QJSA

- The Problem: An employer made distributions from a plan subject to the qualified joint and survivor rules without getting spousal consent for the distributions totaling $300,000. Problem was discovered on audit.
- The Solution:
  - To avoid error in advance, eliminate the qualified joint and survivor annuity (QJSA) option from the plan unless required to have it (non-governmental defined benefit plans and money purchase plans are required to have QJSA)
  - To correct error, give each affected participant choice between providing informed consent or receiving a QJSA
    - Annuity to participant may be actuarially reduced to take into account distribution already received by participant
    - Survivor annuity to spouse upon death of participant may not be actuarially reduced for distributions to participant
      - Spouse could also choose to receive a single-sum payment equal to the actuarial present value of the survivor annuity benefit

Failure to Obtain Spousal Consent for QJSA

- Audit Cap – Sanction will be greater than VCP fee
- Is negotiated % of the Maximum Payment Amount, which is the amount that is approximately equal to the tax the IRS could collect upon plan disqualification, and which is based on the sum for all open taxable years of:
  - Tax on the trust (and any interest and penalties on the trust tax return)
  - Additional income tax resulting from the loss of employer deductions for plan contributions (and any interest and penalties on the plan sponsor's tax return)
  - Additional income tax resulting from income inclusion for participants in the plan, including the tax on plan distributions that have been rolled over to other qualified trusts (and any interest and penalties on the participants' tax return)
- Sanction should not be excessive and should bear a reasonable relationship to the nature, extent, and severity of the failures

Working with a TPA

- Although many of the day-to-day administrative functions may be delegated to a third party administrator ("TPA"), the employer and plan sponsor retains ultimate responsibility for errors
- If working with a TPA, employer should
  - Verify that all employee census data provided to TPA is correct (hours worked, compensation, dates of hire and termination, etc.)
  - Read all reports and correspondence from TPA and immediately notify TPA of any errors or omissions
  - Timely remit employee deferrals and employer contributions to Trustee or Custodian

Working with a TPA (Cont'd)

- At least annually, meet with TPA to review Plan's operations and compliance
- Areas of review:
  - Employee eligibility and enrollment
  - Recordkeeping, including allocations and investment instructions
  - Vesting of employer contributions
  - Withdrawals and distributions
  - Annual plan testing
  - Participant loans and hardship withdrawals
  - Certain government filings and reporting
  - Participant disclosure and communication of plan changes

Some Parting Thoughts

- Almost all qualification errors may be corrected through EPCRS
  - Even "egregious" errors may be corrected through VCP
- Although EPCRS correction does not eliminate potential liability to a participant, to the extent the employer puts the participant back in the position he or she would have been in without the error, any harm to a participant is mitigated
  - Open communication with participants about error and correction can ease concerns
- It is almost always cheaper and easier to correct an error when first discovered than to ignore error

Health and Welfare Plans: Common Errors

Independent Contractors Included in Health Plan

- Insurance policy language
- Common law employment test
- Creation of a Multiple Employee Welfare Arrangement (MEWA)

Discrimination: Self-Insured Plans

- Prohibition against discriminating in favor of "highly compensated individuals" (HCIs) as to Eligibility or Benefits
- HCIs are: (1) the highest-paid 25% of all non-excludable employees; (2) the five highest-paid officers; and (3) the more than 10% shareholders
- Penalty: HCIs must include the value of any **"excess reimbursement"** received in their taxable income
- Correction: prospectively amend plan (or Plan's operation) to comply with non-discrimination provisions!

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Discrimination: Self-Insured Examples

- Fail Eligibility Test
  - Excess reimbursement = benefit paid for the HCI x the following fraction:

$$\frac{Benefits\ paid\ to\ all\ HCIs}{Benefits\ paid\ to\ all\ employees}$$

  - Employer only offers health coverage to executives. The discriminatory plan pays $5,000 in benefits for Jane Executive (HCI), the benefits paid to all HCIs under the plan is $500,000, the total benefits paid by the plan is $500,000. The taxable excess reimbursement for Jane is $5,000 ($\$5{,}000 \times \frac{\$500{,}000}{\$500{,}000}$).
- Fail Benefits Test
  - Excess reimbursement = benefits available only to HCIs
  - Employer offers health plan to all employees but only offers dental insurance to its executives. Johnny Executive received dental payments under the plan in the amount of $1,000. The taxable excess reimbursement for Johnny is $1,000.
- Correction w/Gross-up
  - Assume HCI made $195,000 in 2015 (33% tax bracket) and has an excess reimbursement from a discriminatory health plan of $5,000. The federal income tax liability on the $5,000 is **$1722.50** ($5,000 x 34.45%). However, the total correction, "grossed-up" will cost the employer **$2627.77** ($1722.50/65.55% (100% - 33% - 1.45%).

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Discrimination: Fully Insured Plans

- The Affordable Care Act (ACA) subjects fully-insured plans to nondiscrimination rules similar to those applicable to self-insured plans
- Rule becomes effective upon issuance of regulations – None yet
- Penalty for failure is different!
  - Plan sponsor must pay an excise tax equal to $100 per day per non-HCI who is discriminated against (up to $500,000) per year
- Correction: prospectively amend plan (or Plan's operation) to comply with non-discrimination provisions!

Discrimination: Fully-Insured Examples

- These are proposed penalties and are not currently in effect!
- Employer pays 100% of the premium for 10 executives but only 80% for the other 100 employees. Penalty equals $10,000 per day (100 x $100) for as long as the discriminatory practice continues (50 days = $500,000, so it's capped there)
- Employer offers the same coverage to all employees and makes a uniform contribution toward coverage. For executives, coverage is offered immediately, but other employees must complete a 90-day waiting period. Penalty equals $9,000 for each nonexecutive who must wait 90 days before enrolling in the plan (90 days x $100/day)

COBRA: Failure to Provide Notice

- Plan administrator must notify each participant who will lose coverage as a result of a qualifying event of his/her COBRA rights within 14 days of receipt of notice of the qualifying event
- Election period does not end until at least 60 days <u>after</u> providing election notice
- If no notice, the participant has an open-ended right to elect COBRA
- Correction: send notice as quickly as possible!

COBRA: Failure to Offer

- Jim, the new HR specialist, did not offer Wally COBRA coverage when he terminated employment because Wally was on Medicare
- Correction:
  - Provide COBRA notice ASAP
  - Offer to pay all covered claims incurred up to the current date (or the expiration of the COBRA coverage period, if earlier)
  - In some cases, offering prospective coverage may be appropriate (e.g., if participants have not undergone treatment due to lack of coverage)
  - Be reasonable about method of COBRA premium payments (lump sum versus over time in regular intervals)

COBRA: Potential Penalties

- IRS
  - Excise tax: Generally $100 per day for each day of noncompliance ($200 if more than one individual is affected – i.e. family coverage)
  - Self-Correction relief: tax does not apply to failures due to reasonable cause and not to willful neglect that are corrected within 30 days after employer knew or (exercising reasonable diligence) should have known
- DOL
  - ERISA $110 per day statutory penalty for failure to provide notices

M&G Polymers USA v. Tackett

- Collective bargaining agreement provided that certain retirees and their spouses/dependents would receive "a full company contribution towards the cost of [health care] benefits" and that the benefits would be provided "for the duration of the agreement" and that the agreement would be subject to renegotiation in 3 years
- At expiration of the agreement, the company announced that retirees would have to contribute to the cost of their health care benefits
- Retirees sued claiming that the agreement created a vested right to lifetime contribution-free health care benefits
- District court and Court of Appeals ruled in favor of retirees
- Supreme court vacated the Court of Appeals judgement and remanded the case
  - Agreements should be interpreted in accordance with ordinary principals of contract law
  - Prior case law (Yard-Man) placed a "thumb on the scale in favor of vested retiree benefits in all collective-bargaining agreements" which "distorts the attempt to ascertain the intention of the parties"
  - Written agreement is presumed to encompass the whole agreement of the parties
  - Courts should not construe ambiguous writings to create lifetime promises
  - Contractual obligations will cease, in the ordinary course, upon termination of the bargaining agreement

Employee Handbooks

- NLRB general counsel report
  - Main concern is the "chilling" of an employee's right to concerted activity to improve terms and conditions of work
  - "Do not send unwanted, offensive, or inappropriate e-mails" – **ILLEGAL**
    - "No Threatening, intimidating, coercing, or otherwise interfering with the job performance of fellow employees or visitors" – **LEGAL**
  - "Be respectful to the company, other employees, customers, partners, and competitors." – **ILLEGAL**
    - "Employees will not be discourteous or disrespectful to a customer or any member of the public while in the course and scope of [company] business." – **LEGAL**
- Guns in parking lots
- Bullying policies
- Social Media Policies
- Benefit changes due to the ACA
- Acknowledgment of receipt

Additional Information on the Firm

Kennerly Montgomery is a general practice law firm that has provided legal advice to clients for 100 years. KM attorneys practice in a variety of areas, representing municipal clients, including local governments, agencies and public utilities.

Bill Mason, Kathy Aslinger, and Ashley Trotto practice extensively in employee benefits law, which includes design, documentation, administration, audit, litigation, termination and qualification of employee health and welfare and pension plans for public, tax-exempt and private employers. The Firm sponsors various prototype retirement plans and prepares both interim amendments and discretionary amendments for all plan types as well as counsels with fiduciaries on ERISA and Federal & state law obligations. They represent clients before various agencies regulating employee benefits.

A Little About Your Presenters

Bill Mason received his JD from Harvard Law School in 1974, and has been practicing law more than 40 years, most of that time in employee benefits for governments. He worked for the Tennessee Valley Authority from 1974 – 1986, Wagner Myers & Sanger PC, from 1986 – 1988, and William E. Mason PC from 1988 – 2009. Bill joined Kennerly Montgomery in 2009. Mr. Mason serves on the Board of Directors for the Legacy Park Foundation and the Education Subcommittee for the United Way of Greater Knoxville. He is the past Chair of the Hillcrest Healthcare Board of Directors. In 2016, Mr. Mason was appointed by the US Treasury Department to a three-year term as the IRS Taxpayer Advocacy Panel (TAP) representative for Tennessee.

As a leader of Kennerly Montgomery's employee benefits practice, Kathy Aslinger focuses on advising fiduciaries for the benefit of participants, assisting both private and governmental clients in the design, implementation and maintenance of their employee benefit plans, including 401(k), pension, cafeteria, and health plans. She commonly assists clients in maneuvering through the complex world of audits, fiduciary liability issues, DOL and IRS compliance, HIPAA, COBRA, ERISA and state law obligations, as well as Affordable Care Act compliance. Kathy has been practicing law for over 15 years and has been with Kennerly Montgomery since January 2010. In addition, Kathy serves on the Board of Directors for Uplands Village, a continuing care retirement community in Pleasant Hill, Tennessee.

Ashley Trotto joined Kennerly Montgomery as a law clerk in 2012 and as an associate attorney in the Firm's employee benefits practice in 2013. Ashley concentrates on the Affordable Care Act and has been a frequent speaker on Affordable Care Act issues. She graduated *cum laude* from the University of Tennessee College of Law in 2013, and she also earned a Bachelor of Science in Psychology, *summa cum laude*, from the University of Tennessee in 2009. Ashley serves on the Board of Directors for the Smoky Mountain Animal Care Foundation, a 501(c)(3) Non-profit organization established to introduce and promote programs to improve animal welfare in Blount County, Tennessee and the surrounding areas of the Great Smoky Mountains. She is also a member of the East Tennessee Benefits and Compensation Association, the Knox Area Urban League, and serves on the Hunger and Poverty Relief Committee of the Knoxville Bar Association. She's the energy behind the Firm's on-going kindergarten book project at Christenberry Elementary.

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