“Early Bird” Session

FLUSTERED BY 401(K)S?

KEY TIPS FOR HR PROFESSIONALS

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I. Background and Legal Framework

A. What is a “401(k)” Plan? As a technical matter, a “401(k)” plan is a type of tax-qualified retirement plan – a defined contribution retirement plan with a “cash or deferred” feature. The term “401(k) plan” is a common shorthand way of referring to this specific kind of qualified retirement plan. A “qualified retirement plan,” along with its accompanying trust, is authorized under Section 401(a) of the Internal Revenue Code of 1986, as amended (the “Code”), to provide certain tax benefits to both employers and employees in exchange for employers’ providing retirement benefits to employees. To secure these benefits, a qualified retirement plan must satisfy a lengthy and rigorous menu of tax requirements.

Code Section 401(k) allows eligible employees to elect to make contributions from their pay to a plan if certain requirements relating to eligibility, contributions, vesting, distribution, and nondiscrimination are satisfied – these are the qualification requirements. This elective feature is referred to as a cash or deferred arrangement or “CODA” because the employee has the choice of taking the amount in cash or deferring the amount into the plan as a contribution. Employee deferrals can either be made as directed by employees themselves or automatically as directed by the plan terms.

B. History of 401(k) Plans. The tax principles underlying the modern 401(k) plan existed prior to the formalization of the cash-or-deferred concept, but in practice, plans that used this approach prior to 1978 tended to operate as supplemental retirement savings vehicles for highly paid employees. To impose limits on the use of CODAs for this purpose, the Revenue Act of 1978 amended the 1954 Internal Revenue Code to incorporate Section 401(k). At the time, there was little sense that 401(k) plans would become the predominant employer-based retirement savings vehicle available to employees. Ted Benna, a financial planner in California, is generally credited as the original popularizer of 401(k) plans, but the concept caught on quickly after the IRS issued implementing regulations in 1981; within two years, a majority of large US employers had incorporated CODAs into their defined contribution plans.

C. Legal Landscape.

1. ERISA. 401(k) plans and other retirement plans are regulated by the Employee Retirement Income Security Act of 1974, as amended, or “ERISA”. ERISA imposes standards of conduct on fiduciaries (i.e., persons or entities with discretionary authority to manage or handle plan assets), provides rules for plan administration and governance, mandates annual reporting and certain disclosures to plan participants, and prescribes administrative claims resolution procedures, creates various federal causes of action to enforce plan terms. There is significant overlap between ERISA and the Code where qualified plans are concerned: Title II of ERISA is functionally identical to Section 401(a) of the Code.

2. Code. The Code prescribes detailed rules for 401(k) plan design and operation that are intended to ensure that these plans are provided on a broad basis that does not unduly discriminate in favor of highly paid employees.
II. Basic Design Considerations for 401(k) Plans

A. Documentation Options – 401(k) and other qualified plans can be memorialized in three main formats: individually-designed documents, volume submitter documents, and prototype documents. Individually-designed documents are essentially bespoke – customized for the plan sponsor – but require more up-front cost and ongoing management and a greater degree of responsibility by the plan sponsor. Volume submitted documents are pre-approved as to their form by the IRS but typically offer reasonable customization options and require somewhat less frequent management by plan sponsors. Prototype documents are also pre-approved as to form by the IRS but tend to offer more standardized options and less design flexibility, factors than can be helpful for newer plans and plan sponsors.

B. Eligibility Rules – Only common-law employees can participate in a 401(k) plan, but within that broad requirement, many variations are possible to target a plan’s benefits at specific populations.

C. Types and Sources of Contributions – By definition, 401(k) plans permit contributions by employees, but a variety of different types of employee and employer contributions are permitted, and the plan sponsor must decide which options will be made available.

D. Vesting Rules – Employee contributions to 401(k) plans are always fully vested, but employer contributions may be subject to any number of vesting schedules depending on the design of the plan and the employer’s business needs.

E. Investment Alternatives and Approaches – The typical 401(k) plan now includes self-directed investments (i.e., the participants themselves specify how to invest their plan accounts) but even within that model, there are a variety of choices to be made by the plan sponsor and managed by the plan fiduciaries.

F. Accessing Plan Funds – Distributions from 401(k) plans are generally limited to termination or retirement, but the forms in which distributions will be made and the impact of triggering events (e.g., death or disability) must also be considered. In many cases, participants may borrow money from their plan accounts or receive in-service distributions to address financial hardship, and other events (e.g., divorce, military service, natural disasters) may permit or require distributions as well.

G. Plan Administration – A key set of decisions for the plan sponsor involves how the plan will be administered. Beyond internal personnel – who typically have the laboring oar on plan administration – a variety of ancillary service providers are available to assist the plan sponsor with investment management, participant communications and engagement, payroll administration, and other services. Selecting the appropriate assistance and monitoring its performance is a key component of any 401(k) plan’s administrative regime.

III. Plan Eligibility and Participation. 401(k) and other qualified plans can only cover common-law employees and certain types of “leased” employees. Within that broad rule, plan sponsors have significant discretion to design eligibility rules to suit their business needs. For example, a plan could be designed to cover only certain categories
of employees, such as hourly or salaried employees, union employees, or employees at a certain location or with a certain job description. Note that there are tax rules that may limit eligibility classifications that tend to favor highly paid employees. Plans may also limit participant based on age and length of service, subject to some notable limitations. Specifically, a plan may restrict participation to those who have reached a certain age (generally not over age 21) and who have completed a certain amount of service (generally not more than one “year of service”). For service requirements, ERISA and the Code prescribe detailed rules for determining which service “counts” and what limits may be placed on employees as a condition of participation. For example, a plan cannot generally require completion of more than one “year of service” as an eligibility condition. For this purpose, one “year of service” is typically a 12-month period where the employee completes 1,000 or more hours of service; there are specified methods for counting hours of service, and, with appropriate plan terms, hours can be determined using certain equivalencies or by an elapsed time method.

Once an employee has satisfied a plan’s eligibility requirements, when does participation actually commence? Generally, participation can be delayed until specified “entry dates” to facilitate plan administration, with the caveat that most plans are required to have at least two entry dates per year. More commonly, plan entry is permitted no later than the first payroll cycle in the month following the month when employment commences.

Plan sponsors have wide latitude to exclude employees by employment classifications of various kinds, but exclusions that act as direct or indirect age or service conditions are prohibited if they go beyond the limits discussed above. In addition, eligibility exclusions that have the effect of excluding large populations of less highly-paid employees are often problematic under the Code’s minimum coverage requirements. In general, these requirements mandate that 401(k) plans be open to a broad cross-section of an employer’s workforce. Plans are subject to an annual coverage testing requirement to demonstrate compliance with this requirement.

An increasingly common eligibility provision for 401(k) plans is an automatic enrollment feature. There are various alternative designs for automatic enrollment, but all generally adopt an “opt out” approach to eligibility, meaning an otherwise-eligible employee will automatically be enrolled in a plan at a specified contribution level until he/she affirmatively elects a different contribution level or waives participation.

IV. Types and Sources of Contributions

A. Employee Contributions – The key distinguishing feature of 401(k) plans is the fact that they allow participants to may voluntary contributions from their own pay. By design, all 401(k) plans allow for these “elective deferrals,” but even here, there can be some choices to make. In most cases, 401(k) plans permit pre-tax elective deferrals (i.e., the deferrals are excluded from the employee’s taxable wages for income tax purposes), but Roth deferrals are also permitted – these deferrals are made on an after-tax basis but earnings accruing on them are not taxable. Participants over age 50 may make additional elective deferral contributions (“catch up contributions”), and typically, participants with prior retirement savings in other employer plans may transfer those savings into a plan maintained by their current employer (“rollover contributions”). Elective deferrals contributions are subject to certain nondiscrimination testing requirements to demonstrate that both lower and higher paid employees are benefitting from the plan.
B. Employer Contributions – Most 401(k) plans also require or permit contributions by plan sponsors, typically in the form of “matching” contributions calculated by reference to the amount of elective deferral contributions a participant makes (e.g., 100% of a participant’s elective deferral contributions that do not exceed 3% of her pay). Plan sponsors may also make “profit sharing” or non-elective contributions in addition to or in lieu of matching contributions. Note that “profit sharing” contributions do not require than a plan sponsor have “profits” – this is simply a historical short-hand used to generically refer to employer contributions that are not matching participant deferrals. As with elective deferrals, employer contributions are subject to nondiscrimination testing requirements to ensure rough parity between contributions made for the highly and non-highly paid groups of participants.

C. Payroll Administration – “Compensation” – For most 401(k) plans, both employee and employer contributions are determinate by reference to “compensation” as defined by the plan terms. There are extensive nondiscrimination rules in the Code relating to the definition of compensation, but plans do have some flexibility to tailor their definitions to suit the details of their participant group. Proper administration of a 401(k) plan’s contributions requires tight and disciplined integration between the plan sponsor’s payroll system and the plan’s trustee or custodian. Errors in this pipeline of contributions are common and often create significant problems for plan sponsors.

A related issue involves the timing of remittances of amounts withheld from participant paychecks. The Department of Labor generally expects withheld deferrals to be transmitted to the plan’s trustee or custodian within a period of a few days following each payroll cycle. Failure to meet this expectation results in a deemed loan from the plan to the plan sponsor, a transaction that is prohibited by both ERISA and the Code. This issue is one of the more common compliance errors experienced by 401(k) plan sponsors and is a common subject of discussion during both IRS and Department of Labor compliance audits.

V. Limitations on Contributions

A. Plan Limits – Many 401(k) plans impose specific limitations on the amount of contributions participants may make or receive. For example, a plan might limit elective deferrals by participants to less than 50% of eligible pay or might cap employer matching contributions at 3% of eligible pay. In some cases, these limits are intended to cap an employer’s potential financial obligations under a plan but they might also be used to avoid potential issues with tax withholding (e.g., if too large a percentage of pay is deferred by a participant, there could be insufficient wages left over to satisfy income and employment tax withholding requirements) or to mitigate the impact of contribution-based nondiscrimination testing.

B. Code Limits – The Code places a number of express interlocking limitations on contributions to 401(k) plans, as well as other indirect limitations.

1. Elective Deferrals – The amount of elective deferrals a participant may make under all 401(k)-type plans in which he/she participates during a single year cannot exceed an annual limit (e.g., $19,000 for 2019). For participants who are age 50 or older during a particular year, this limit is
increased to allow for “catch up” contributions (e.g., an additional $6,000 for 2019). Elective deferrals in excess of this limit must be refunded to participants.

2. **Eligible Compensation** – The Code places a limit on the maximum amount of “compensation” that can be taken into account under a 401(k) plan during any single year. For 2019, that cap is $280,000. In practice, this means that any compensation over the annual limit must be disregarded for purposes of calculating elective deferrals and employer contributions, even if the contributions at issue do not otherwise exceed applicable limits.

3. **Annual Maximum** – Combined contributions (employer plus employee) to defined contribution plans cannot exceed the lesser of 100% of annual pay or a specified dollar amount (e.g., $56,000 for 2019). In practice, this limit generally only impacts 401(k) plans that receive substantial employer contributions in addition to matching contributions and elective deferrals.

4. **Top Heavy Plan Limits** – Certain plans that cover a disproportionate number of “key” employees (e.g., owners of the business, officers with high pay, etc.) are subject to additional limits on contributions intended to ensure that the non-key employees are able to meaningfully participate.

C. **Indirect Limitations** – Beyond the many express limitations on plan contributions, one additional indirect limitation can be found in the Code’s “ADP” and “ACP” testing requirements. The “average deferral percentage” and “actual contribution percentage” tests assess the ratio between the contributions made or received by highly paid employees and those made or received by non-highly paid employees to ensure rough parity between the two groups. The contribution limits implicitly applied by these tests supersede the other limits described above, with the effect that contributions by or for highly paid employees may be less (perhaps much less) than what would otherwise be permitted.

VI. **Vesting Rules** – The Code regulates the process by which 401(k) plan contributions are earned by participants (i.e., not forfeitable). Historically (i.e., prior to 1986), much longer vesting schedules were permitted and common, but more recent changes in the Code have significantly limited the length of vesting schedules in 401(k) and other qualified plans. Note that vesting schedules only apply to employer contributions – employee contributions of all kinds must always be fully vested.

A 401(k) plan could be designed to require a participant to complete a certain number of years of service to become vested in employer contributions, including matching and profit-sharing contributions and earnings on those amounts. Some plan designs (e.g., “safe harbor” plans and certain kinds of plans using automatic enrollment features) require full vesting of all employer contributions or else significantly limit the maximum vesting period that can be imposed. Regardless of a plan’s vesting requirements, employer contributions become fully vested and nonforfeitable at normal retirement age or upon plan termination.

Whether to implement a vesting schedule is left to the plan sponsor’s discretion: there is no requirement that a plan have a vesting schedule at all. Typically, plan sponsors use a vesting schedule as a way of form of retention incentive, but for some types of
employers (e.g., those with highly transient workforces), a vesting schedule can result in significant cost savings. Note that amounts forfeited as a result of a vesting requirement do not revert to the plan sponsor – there are specific prohibitions in both ERISA and the Code against such employer reversions. Instead, the forfeited amounts remain in the plan and can generally be used to fund future employer contribution obligations, provide additional benefits to the remaining participants, and/or fund certain expenses of plan administration.

If a plan does impose a vesting schedule, it must comply with the Code’s limits on the number of years of service that may be required for vesting. The Code permits two types of vesting schedules: cliff and graduated. “Cliff vesting” means that employer contributions are completely forfeitable until the participant completes the required years of service; then the contributions are fully vested. Under current law, a cliff vesting schedule for employer contributions cannot impose a years-of-service requirement of more than three years. This limit on cliff vesting applies to most employer contributions, including profit-sharing, non-safe harbor matching, and top-heavy contributions. A two-year cliff vesting limit applies to certain safe harbor matching contributions. Another permitted vesting schedule incrementally vests employer contributions over time. Under current law, a so-called “graduated” vesting schedule for employer contributions must vest participants, at a minimum, at the following rate: 20% after two years, 40% after three years, 60% after four years, 80% after five years, and 100% after six years.

The determination of vesting service is subject to detailed rules under both ERISA and the Code; these rules generally track the service rules used to determine plan eligibility.

VII. Plan Investments

A. Who Manages – Plan Sponsor or Participants? Historically, plan sponsors (either directly through internal fiduciaries or with the assistance of an appointed investment advisor or manager) retained responsibility for determining how plan assets would be invested, and participants were simply along for the ride. In this setting, the individuals or entities with investment responsibility were also liable directly to the plan participants if their actions were adjudged to be imprudent or otherwise violated the standards of conduct for fiduciaries. However, as individual investing became more commonplace, 401(k) plans began to adapt, to the point where the typical 401(k) plan now reposes full responsibility for making investment decisions in the participants themselves. Plan fiduciaries remain responsible for prudently selecting the menu of investment funds made available to participants, but the participants must generally allocate their account balances to one or more of the funds on offer.

B. Self-Directed Investments and ERISA Section 404(c) – With the increasing prevalence of participant-directed investments in 401(k) plans, plan fiduciaries would rightly be concerned about their potential liability for investment results they do not control. Enter Section 404(c) of ERISA. Section 404(c) offers protection to the fiduciaries of participant-directed plans such that the participants, not the fiduciaries, are responsible for their own investment outcomes as long as the fiduciaries provide sufficient information to the participants to allow for informed investing decisions, at least three diversified investment alternatives are provided, participants actually exercise control over their investments, and certain disclosures are made to participants.
C. Default Investments and Automatic Enrollment – As 401(k) plans increasingly implement automatic enrollment provisions, a question arises about how the deferred amounts should be invested. After all, by definition, the participant has not supplied any elections regarding his/her participation, and in the absence of such direction, Section 404(c) relief would not be available to fiduciaries. Relatively recent amendments to ERISA solve this problem by allowing fiduciaries to limit their liability for the investment of participant accounts when participants fail to give investment instructions. This relief is the same as that available under Section 404(c), but it can be provided regardless of whether a plan satisfies Section 404(c)’s requirements. Under the default investment provisions, participants who do not give investment instructions and whose plan assets therefore flow to “qualified default investment alternatives” will be treated as exercising control over the assets in their accounts. As a result of this deemed investment direction, plan fiduciaries will not be responsible for any loss or breach that results from the application of the default investment provision. Note that plan fiduciaries are not entirely off the hook: they remain responsible (and potentially liable) for their selection of the default investment alternatives themselves.

D. Investment Vehicles – Common, Esoteric, and Impermissible – Selecting and managing the investments available under a 401(k) plan is usually one of the bigger challenges plan sponsors and fiduciaries face. In most cases, 401(k) plan investments are limited to publicly-traded open-end investment companies (a/k/a mutual funds) but it is not uncommon to encounter more esoteric assets, some of which are permissible under ERISA and others of which are definitely not. Even where an investment vehicle may be permitted, there can be solid practical reasons to steer clear (e.g., illiquid real estate investments in plans that require cash flow to fund distributions). Most “collectibles” are impermissible investments (e.g., art works, rugs, antiques, precious metals or gemstones, alcoholic beverages, etc.) as are investments that are not under the jurisdiction of the US courts. Beyond those categories of investments, many investments that are facially permissible may also be prohibited due to the relationship between the plan sponsor, the plan fiduciaries, plan service providers on one hand and the seller or manager of the investment on the other. For some larger companies, employer common stock may also be available as an investment; employer stock investments present a host of initial and ongoing administrative and fiduciary issues.

E. The Helping Hand – What Assistance to Offer? While participants often desire to have control over their own 401(k) investments, many lack the background or training to truly make informed decisions. Plan sponsors and fiduciaries have historically desired to help address this knowledge gap but have been reluctant to provide actual investment “advice” out of fear of possible liability if investment results are not up to par. There is no duty under ERISA for fiduciaries to provide investment advice to participants. ERISA does offer some limited relief for certain kinds of investment guidance (or education) to plan participants which, if implemented correctly, will avoid the perceived risks of providing investment-related help to participants.

F. The No-Go Zone – Prohibited Transactions – Both ERISA and the Code prohibit broad classes of transactions (“prohibited transactions”) by fiduciaries and/or other individuals connected to plans (“parties in interest” or “disqualified
persons”) that present the risk of conflicts of interest or self-dealing. Even if a proposed investment is otherwise permitted by ERISA, if the transaction by which the plan acquires the investment is conflicted, that particular investment is prohibited and subjects all involved to the risk of excise taxes and potentially to the risk of liability for breach of fiduciary duty.

VIII. Plan Distributions. Plan sponsors have a variety of choices for plan distributions, but the circumstances when elective deferrals can be distributed are more limited.

A. Distribution Rules — As a general rule, elective deferrals cannot be distributed before a participant experiences a “severance from employment”. Elective deferrals can also be distributed when a participant dies, becomes “disabled,” reaches age 59½, experiences a financial hardship, qualifies for a distribution relating to military service or disaster relief, or when the plan itself terminates. In contrast, other types of contributions (including both employee and employer contributions) can generally be made either during or following a participant’s period of employment, subject to certain limitations. Rollover contributions are generally distributable upon request, and non-safe harbor matching and profit sharing contributions that have either been held in the plan for two or more years or that were allocated to participants who participated in the plan for at least five years can be distributed prior to termination of employment. Note that safe harbor matching contributions are subject to the same limitations that apply to elective deferrals. It is not uncommon for a 401(k) plan to limit distribution of all contributions to the circumstances when elective deferrals are permitted.

B. Required Minimum Distributions — Qualified retirement plans are subject to additional rules that mandate distributions after a certain point. Specifically, a participant who has terminated employment and reached age 70½ is required to begin taking periodic “required minimum distributions” based on his/her life expectancy. Failure to receive at least the minimum required distributions will subject the participant to a substantial excise tax. Note that most employees who remain in service after age 70½ can delay the beginning of distributions until his/her eventual termination.

C. Forms of Distribution — In most cases, 401(k) plans permit participants to receive their account balances in a single lump sum, but it is not uncommon for plans to permit periodic installment payments as well. Somewhat less frequently, some 401(k) plans may also provide for one or more forms of annuity distribution; this is more common for plans that use insurance-based investment products and in some cases, may be required depending on the plan’s design.

D. Involuntary Distributions — Paired with the limitations on plan distributions, participants often cannot be forced out of a 401(k) plan upon their termination. Participants with account balances of $5,000 or more are permitted to leave their assets in a plan until minimum distributions are required, but participants with smaller balances may be subject to forced “cash-out” or automatic transfer of their accounts to an individual retirement account. However, when a 401(k) plan is terminated, all account balances can be forced out, regardless of their amount and regardless of whether the participants consent.
E. Other Distribution Issues.

1. **QDROs** – Except in limited circumstances, both ERISA and the Code forbid the assignment or involuntary transfer of 401(k) plan accounts by either participants or their creditors. One key exception to this general rule involves “qualified domestic relations orders” or “QDROs”. QDROs are used to facilitate the division of retirement assets upon a participant’s divorce or legal separation and allow a court to assign all or a portion of a participant’s account balance to his/her spouse (the “alternate payee”). Plans are required to maintain QDRO administration procedures. Following implementation of a QDRO, the alternate payee is essentially established as a non-employee participant in the plan, and his/her account can then be handled in the same manner as any other account.

2. **Plan Loans** – 401(k) plans can permit participants to borrow money from their own accounts in certain circumstances. Although plans are not required to permit participant loans, this is a fairly common feature because it allow participants to have access to a part of their account balance without triggering the adverse tax consequences associated with hardship distributions (as discussed below). Both ERISA and the Code include rules for participant loans, and the failure to adhere to these rules is a common source of compliance issues for 401(k) plans. The loan rules generally (1) limit the amount of all loans taken out by a participant to the lesser of 50% of the vested account balance or $50,000, (2) limit the repayment period to five years in most cases, (3) require loan repayments on a quarterly (or more frequent) schedule, (4) require loans to bear a reasonable rate of interest, and (5) require loans to be adequately secured, usually by the remaining account balance. Plan loans are generally repaid via periodically payroll deductions.

3. **Hardship Distributions**. Although in-service distributions of elective deferrals are not generally permitted, where a participant experiences a financial hardship, he/she may be able to withdraw money from the plan to address that hardship. As with plan loans, there is no requirement for plans to permit hardship distributions, but their availability is often seen as a helpful tool for encouraging participation by lower-paid employees because it allows for a financial “safety valve” in case of emergencies. To limit the circumstances when participants can access their plan accounts, the hardship distribution rules are fairly exacting in their requirements. Specifically, a participant must experience an “immediate and heavy financial need” and must lack access to other sources of funding to address that need. There are specified situations where a participant will be deemed to have experienced an immediate and heavy financial need (e.g., prevention of foreclosure or eviction from principal residence, payment of uninsured medical expenses, payment of tuition for post-secondary education, etc.). Unlike participant loans, hardship distributions are subject to tax and if the recipient is under age 59½, a 10% early distribution penalty.
IX. Reporting and Disclosure

A. Annual Reporting – Qualified retirement plans are required to file an annual report (Form 5500) with the Department of Labor each year. For plans that cover 100 or participants during the year, this reporting process is more complex and requires a financial audit by an independent public accountant. These forms are filed electronically through the Department of Labor’s “eFast” filing system and contain important information about plans. Filing an incomplete report or failing to file at all can trigger sizable penalties (i.e., up to $2,140 for each day late), and there is no statute of limitations on these assessments. Technically, criminal penalties can also be assessed for the willful failure to comply the ERISA’s annual reporting requirements. The Code also prescribes a penalty ($25 per day up to $15,000) for annual reporting failures. Fortunately, the Department of Labor rarely imposes penalties at this level, and as discussed below, there is a voluntary correction program for incomplete or delinquent annual reports that dramatically reduces the cost of compliance.

In addition to the annual report, plan sponsors are also required to provide a “summary annual report” to participants each year. The “SAR” provides a brief summary of the contents of the Form 5500.

B. Required Disclosures – Plans are required to provide a “summary plan description” or “SPD” to employees within ninety days of their initial eligibility to participate. SPDs are intended to provide a simplified and non-technical explanation of the plan’s key terms and conditions. SPDs generally must be updated on a 5-year schedule to incorporate any plan amendments that were adopted since the last revision and in all events every ten years (where no plan amendments have been adopted). Interim updates to the SPD can be made by distributing a “summary of material modifications” in lieu of a restated SPD. ERISA does mandate certain content for SPDs, and careful drafting of these documents is crucial to avoiding misunderstandings and participant claims. However, ERISA does not require a particular form for SPDs, and plan sponsors have considerable discretion regarding the format of their SPDs. That said, an SPD must be sufficiently accurate and comprehensive to inform plan participants and beneficiaries of their rights and obligations under the plan and must be written in a manner understandable to the average plan participant. Any description of exceptions, limitations, reductions, and other restrictions of plan benefits must be apparent in the SPD.

C. Disclosures Upon Request – Participants and beneficiaries of ERISA plans may make written requests for copies of the most recent SPD (or SMM), the most recently-filed Form 5500 (and attachments), any collective bargaining agreement applicable to participants, the plan’s trust agreement, and any other contract or instrument under which the plan is operated. The latter category of documents is not necessarily as broad as some participants may think and has been narrowed by courts over the years. However, it is generally agreed that it extends to service contracts with third-party administrators, investment guidelines, and meeting minutes. Under ERISA, a plan administrator must respond to such requests with thirty days or they can be assessed a penalty of up to $110 per day. Plan administrators may also make plan documents and other materials available for inspection at its principal business office. In most cases, the documents participants may request most commonly are made available.
electronically and on demand, meaning issues involving requested disclosures may resolve into disputes about which ancillary documents must be provided.

D. **Other Disclosures – Based on Plan Features.** Depending on the design of a 401(k) plan, various other disclosures to participants may be required.

1. **Investment Information –** As discussed above, to secure protection under Section 404(c) of ERISA, plan fiduciaries must provide or make an assortment of information available to participants regarding the investment alternatives available under the plan. This might include documents like prospectuses and other disclosures explaining.

2. **Auto Enrollment/Default Investments –** Plans that include automatic enrollment features and/or specify default investments are required to provide more detailed information regarding these provisions to participants.

3. **Safe Harbor Notice –** Plans that use a “safe harbor” design to avoid annual nondiscrimination testing are required to provide an annual notice to participants prior to the beginning of each year to explain the contributions available under the plan, the vesting rules applicable to the contributions, and any other related terms and conditions.

4. **Blackout Periods –** If a plan experiences a “blackout period” (i.e., generally, a period of three or more business days during which participants are not able to request distributions or make changes to their investment elections), the plan administrator is required to provide at least thirty days’ advance notice to participants. Blackout periods most commonly occur when changes to a plan’s investment menu are made or when a plan is transitioned to a new recordkeeper.

5. **Tax Notice –** The Code requires plan administrators to issue an explanation of the tax effects of distribution alternatives (i.e., direct rollover, indirect rollover, payment to participant) at the time a participant becomes entitled to a distribution.

E. **Electronic Disclosures –** The IRS and Department of Labor have taken different approaches to the electronic disclosure of plan-related information, with the IRS generally being somewhat more flexible. As a general rule, both agencies want to ensure that plan communications are distributed via channels that are reasonably designed to ensure actual receipt by the intended audience. The Department of Labor generally permits electronic disclosure of ERISA-required notices and documents where the recipients have ready access to computer terminals as a result of their job duties. For all other participants – including those with access to electronic resources through a kiosk or shared terminal – the Department of Labor requires notice and consent before electronic communications will be effective.

X. **Fiduciary Duties Under ERISA.** ERISA imposes certain duties and responsibilities on the persons and entities that oversee the operation of 401(k) and other employee benefit plans – these persons and entities are referred to as fiduciaries. Fiduciaries generally include any person or entity that exercises discretionary authority or control over the
administration of a plan or over the disposition of a plan’s assets. A person who provides investment advice for a fee is also generally a fiduciary for ERISA purposes. With a few notable exceptions, fiduciary status under ERISA is based on the particular function a person or entity actually performs. In other words, the presence or absence of the fiduciary label does not necessarily control whether a person or entity is, in fact, acting in a fiduciary capacity. It is also possible for a person or entity to act in multiple capacities relative to a 401(k) plan (e.g., an employer might be a plan sponsor – a non-fiduciary role – and the “administrator” of the plan – a fiduciary role).

As discussed below, ERISA imposes four primary duties on fiduciaries. Fiduciaries are generally held to a higher standard of conduct than might normally apply to routine business activities. Where a fiduciary fails to fulfill its duties under ERISA and that failure causes harm to the plan, the fiduciary (or fiduciaries) are personally liable to restore any losses or otherwise correct the harm. Plan participants, the Department of Labor, and co-fiduciaries can bring claims to prevent harm to a plan or to seek recovery for losses caused (or impermissible profits made) by a breach of fiduciary duty.

A. Duty of Prudence – Under ERISA, a fiduciary must act with the care, skill, prudence, and diligence under the prevailing circumstances that a prudent person knowledgeable in such matters acting in a similar situation would use. This standard focuses on procedural prudence. Satisfying ERISA’s prudence standard is less focused on the outcome of the fiduciary decision-making process than on the process itself. The prudence standard impacts most aspects of 401(k) plan administration, from interpreting and applying plan terms to selecting and monitoring plan investments and service providers.

B. Duty of Loyalty/Exclusive Benefit – Fiduciaries are expected to discharge their responsibilities solely in the interests of plan participants and beneficiaries and to use plan assets for their exclusive benefit. The exclusive benefit rule impacts many key aspects of plan administration. For example, the vendors selected to provide services to a plan and the associated costs must both satisfy this standard. Communications to plan participants must be accurate and complete and cannot be misleading. Plan assets cannot be used for the benefit (direct or indirect) of the plan sponsor or fiduciaries, and fiduciaries cannot act with divided loyalties (e.g., a fiduciary who selected a plan vendor to secure a better deal for the plan sponsor on services unrelated to the plan would violate the exclusive benefit rule).

C. Duty to Diversify Plan Investments – Fiduciaries are expected to diversify plan investments to minimize the risk of large losses unless circumstances dictate otherwise. The diversification duty generally requires fiduciaries to provide a range of investment alternatives for plan participants (although query: how many option are sufficient and how many are too many?) and dovetails with both the prudence and exclusive benefit standards. Plans that include esoteric or illiquid assets can present heightened concerns under this standard, and plans that permit or require investment in employer stock can cause many thorny diversification issues for fiduciaries.

D. Duty to Follow Plan Terms – Fiduciaries are obligated to strictly adhere to the terms of their plans provided that doing so is consistent with ERISA and other applicable law.
E. **Prohibited Transactions** – Both ERISA and the Code broadly prohibit certain types of transactions between 401(k) plans and persons or entities with close relationships to them. ERISA defines these persons and entities as “parties in interest” and the Code refers to them as “disqualified persons” – these terms are not identical, but they are fairly similar. In general terms, the transactions prohibited by ERISA and the Code involve the potential (or reality) of self-dealing or conflict of interest. For example, parties in interest/disqualified persons are not allowed to engage in sale or lending transactions with plans to which they are connected, even if the transactions are objectively reasonable and beneficial to the plan involved. Fiduciaries are subject to additional prohibitions on conflict of interest transactions, self-dealing transactions, and transactions involving their receipt of direct or indirect benefits (i.e., kick-backs). ERISA requires prohibited transactions to be unwound with any losses (or profits) restored to the plan by the fiduciaries, and the Code imposes excise taxes on fiduciaries and other parties in interest/disqualified persons who participate. Note that ERISA includes some useful statutory exemptions to the prohibited transaction rules (e.g., to allow a service provider that is a party in interest with respect to a plan to perform services for reasonable compensation provided on reasonable terms) and the Department of Labor can issue administrative exemptions on a class or individual basis.

XI. **Tax Qualification and Plan Corrections**

A. **Qualification – Getting It and Losing It** – As indicated previously, 401(k) and other “qualified” plans are required to satisfy a litany of technical requirements specified in Code Section 401(a) and must strictly comply with their terms. As a technical matter, the IRS takes the position that even the most trivial instance of noncompliance with the applicable qualification requirements or the plan terms will result in loss of a plan’s favorable tax status, with disastrous effects on both the plan sponsor and plan participants. Fortunately, the IRS recognizes the magnitude of this sanction and for many years has encouraged plan sponsors to voluntarily correct any compliance issues they discover. There are generally still consequences for compliance errors, but the IRS’s voluntary correction program substantially mitigates them while preserving a plan’s tax qualification.

The Department of Labor also encourages voluntary compliance by plan sponsors and fiduciaries and offers two correction programs of its own, one to address annual reporting issues and the other to address common fiduciary compliance matters.

B. **Voluntary Correction Programs**

1. **IRS – EPCRS** – The IRS’s primary voluntary correction program is referred to as the Employee Plans Compliance Resolution System or “EPCRS” and is documented in periodic guidance documents (the current EPCRS guidance can be found in Revenue Procedure 2018-52). This guidance applies to all kinds of qualified retirement plans, and outlines three types of corrective programs: self-correction, “VCP”, and “audit CAP”. For many smaller-scale compliance issues (e.g., inadvertent exclusion of an eligible employee from participation), the EPCRS guidance prescribes a standard methodology for self-correction, and if the plan sponsor follows that methodology, the IRS will regard the corrected
error as fully corrected. For more substantial compliance issues or where a proposed correction is more “creative” than the standard provided in the EPCRS guidance, a plan sponsor can elect to use the voluntary compliance program or “VCP”. Corrections through VCP tend to be more complex, costly, and time-consuming than self-corrections, but VCP allows for direct negotiation with the IRS over the details of correction and at the conclusion of the process, the plan sponsor receives what is effectively a “no action” letter from the IRS that is effective in any subsequent audit of the plan. Finally, for compliance errors that are discovered by the IRS on audit – or during some other review of a plan – the audit CAP (closing agreement program) is available. The sanctions imposed under audit CAP are generally significantly higher than under the other two correction programs, but they are much less than the consequences of plan disqualification.

2. **DOL – DFVCP** – To mitigate the potentially-harsh consequences of annual reporting noncompliance, the Department of Labor allows plan sponsors to submit delinquent or incomplete Forms 5500 through the Delinquent Filer Voluntary Compliance Program or “DFVCP” at a much-reduced penalty. For larger plans (i.e., those with 100 or more participants), the maximum penalty that can be assessed under DFVCP for any number of late or incomplete reports is $4,000 (for smaller plans, the cap is $2,000).

3. **DOL – VFCP** – The Department of Labor also operates the Voluntary Fiduciary Correction Program or “VFCP” through which fiduciaries may correct any of seventeen types of fiduciary breaches, including things like impermissible plan or participant loans, impermissible transactions involving plan assets, and unreasonable or excessive vendor expenses. Through VFCP, a fiduciary can correct a fiduciary breach by restoring any amounts needed to make the affected plan whole and documenting the correction, with input from the Department of Labor. Notably, VFCP can be used to correct delinquent remittances of elective deferrals and avoid excise taxes under the Code. VFCP can also be used in some circumstances to allow a plan to divest an illiquid asset in a sale to a party related to the plan.
Flustered by 401(k)s? Key Tips for HR Professionals

Presenters
Ruth Michels (Atlanta) and Timothy G. Verrall (Houston)

Moderator
Joel A. (Buddy) Daniel (Greenville)

Agenda

- What is a 401(k) plan anyway?
- What are the basic design considerations for 401(k) plans?
- How do 401(k) plans work?
- What happens if my 401(k) plan breaks?
- Maximizing your 401(k) investment
How Were 401(k) Plans Created?

a) Handed down to first Internal Revenue Commissioner George S. Boutwell from Mount Olympus in 1863.

b) Enacted as part of Revenue Act of 1978 to limit nontaxable deferrals by executives.

c) Created by IRS regulations adopted after enactment of Tax Reform Act of 1986.

d) Devised by “Uncle Ted” Benna in 1979 to assist his financial planning clients to save more money.

e) Borrowed from Régime Fiscal Sournois concept under French tax law as part of Economic Recovery Act of 1981.
What is a 401(k) Plan Anyway?

A tax-qualified defined contribution profit-sharing plan with a cash-or-deferred feature

A Brief History of the “CODA”

- Formalized with adoption of Section 401(k) in 1978 Act
  - Also created 457 plans and FSAs!
- First available January 1, 1980, with IRS regs following in 1981
- Ted Benna implemented first “401(k)” plans
  - By 1983, half of larger U.S. companies offered a DC plan with a CODA
- “Negligible effect on Budget Receipts”
  - FY 2019: DC plans = ~$121.5b tax expenditure
Legal Landscape

- Employee Retirement Income Security Act of 1974
  - Fiduciary conduct, plan governance, reporting and disclosure, claims and appeals
- Internal Revenue Code of 1986
  - Tax “qualification” requirements
- Much overlap between ERISA and Code
  - Title II of ERISA = Subtitle A, Chap. 1, Subchap. D

Basic Design Considerations

- Type of document?
- Who holds the money?
- How is the money invested?
- Who runs the show?
- Who’s in and who’s out?
- What goes in and from whom?
- Who gets what?
- When do contributions vest?
- When and how are distributions made?
The Sky is the Limit?

Anyone can participate in a 401(k) plan, including employees, consultants, contractors, directors, and family members.

☐ True
☐ False
Eligibility – Who’s In and Who’s Out?

- Common law employees only but much flexibility (and *strings*, too)
- Eligible classifications – job types, divisions, departments, locations, salaried/hourly, union, etc.
- Age and service: more complicated
  - Not more than 21 (for most)
  - Not more than 1 “year” (for most)
- Entry dates and rehires
- Automatic enrollment
- Exclusions – yes, *but*...

Types of Contributions

- **Employee contributions** – pre-tax deferrals, Roth deferrals, after-tax contributions, rollover contributions, catch-up contributions
- **Employer contributions** – matching, “profit sharing”/non-elective
- Contributions and “compensation”
- Timing is everything
Limits on Contributions

- Plan-based limits
- Code-based limits
  - Elective deferrals
  - “Compensation” limit
  - Overall limit
  - Top heavy limit
  - Indirect limits – nondiscrimination and safe harbor

Vesting

- Vesting provisions determine the portion of employer contributions that each employee “owns” at any given time
- Employee contributions (including rollovers) are always fully vested
- Pre-TRA ’86, lengthy vesting schedules were permitted, but TRA ’86 and PPA ’06 have reduced the maximum vesting periods
- Plan design can impact vesting provisions (e.g., “QACA” or safe harbor)
- Elaborate rules for crediting vesting service
Which of the following are valid plan investments?

a) Shares of open-end registered investment companies
b) A case of 1975 Weingut Egon Müller Riesling Scharzhofberger Trockenbeerenausle Goldkapsel
c) Private equity funds
d) Limited partnerships
e) A “primo” plot of land in downtown Hoboken purchased from the CEO’s brother-in-law
f) Publicly-traded common stocks
g) A promissory note from the plan sponsor to temporarily cover some “irregularities” the auditor noticed
h) (a), (c), (d), and (f)
Investments – Choose Your Adventure

- Employer managed vs. participant directed
- Self-directed investments and ERISA section 404(c)
- Default investments
- Common vs. esoteric investments
- Ongoing duties to select and monitor – funds, managers, and advisors
- Investment “guidance” vs. “advice”
- Prohibited transactions

Distributions – All Things Must Come to an End

- Types and forms of distribution
- Plan limits and Code limits
  - Elective deferrals generally must stay in the plan until separation
- In-service distributions – loans, hardships, and age 59½
- Distribution triggers – separation, death, disability, plan termination
- Special situations – QDROs, military service, disaster relief
- Required minimum distributions
Spilling the Beans – Reporting & Disclosure

- Participants (active and would-be) are entitled to a variety of automatic and upon-request disclosures:
  - Automatic – SPD/SMM, 5500/SARs, annual fee/cost disclosure
  - Upon request – Plan document, 5500, trust agreement
- Other disclosures required based on plan features
  - Investment-related information
  - Auto enroll/QDIA notices
  - Safe harbor notice
  - Blackout notice
- Electronic disclosures – “it’s complicated!”

Pop Quiz!
Which of the following is not a fiduciary duty under ERISA?

a) Duty to Mitigate
b) Duty to Follow Plan Terms
c) Duty of Exclusive Loyalty
d) Duty to Prevent Loss
e) Duty to Diversify
f) (a) and (d)
g) None of the above

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ERISA 101 – Fiduciary Duties

- Duty of Prudence
- Duty of Loyalty
- Duty to Diversify
- Duty to Follow Plan Terms

- Avoid engaging in prohibited transactions
Plan Corrections – If It’s Broke, Fix It!

- IRS expects plans to include correct provisions at the correct time and expects strict compliance with plan terms
- Not all bad: IRS encourages voluntary compliance through “EPCRS” program
  - Current iteration: Revenue Procedure 2018-52
- Both self-correction and IRS-guided correction available at relatively modest cost
- DOL has two voluntary correction programs as well

Maximizing Your 401(k) Investment

- 401(k) plans are complex and expensive to operate but provide a unique retirement savings opportunity for employees
- Thoughtful design and disciplined administration are the keys to successful 401(k) sponsorship
- Careful selection of and work with vendors to supplement internal HR can make the difference between 😊 and 😞
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