BENEFIT BYLINES

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Is Your Welfare Plan in Compliance with ERISA

Most business owners and executives are aware of the fact that employer-sponsored retirement programs, such as 401(k) plans, must comply with the Employee Retirement Income Security Act of 1974 (commonly referred to as "ERISA"). ERISA imposes a number of requirements on plan sponsors as part of a goal to protect the rights of employees and their dependents. These include standards of conduct for plan fiduciaries, the need to maintain a written plan document, comprehensive employee disclosures (such as SPDs), and governmental reporting (including yearly Form 5500 filings), to name a few.

What sometimes comes as a surprise is that ERISA also applies to most employer-sponsored Health & Welfare plans, including group term life, AD&D, medical, dental, vision, prescription, and disability insurance coverages. Additional health & welfare benefits that are governed by ERISA are employee assistance plans (EAPs), health FSAs, HRAs, severance pay plans, apprentice plans, scholarship plans, prepaid legal benefit plans, and some voluntary insurance plans.

Federal Oversight

The Internal Revenue Service (IRS) and Department of Labor (DOL) have dual jurisdiction with respect to issuing regulations and otherwise enforcing the provisions of ERISA for both retirement plans and health & welfare plans. Not surprisingly, the primary focus of the IRS tends to be in areas directly or indirectly impacting tax revenues, whereas the DOL tends to focus on fiduciary matters and issues impacting employee benefit rights. *(Continued on Page 4)*

Employer Contribution Options

401(k) plan sponsors are not required to make employer contributions on behalf of their employees. Those who want to do so have considerable latitude in determining how employer contributions are structured and administered.

Historically, employer contributions have been expressed as either Matching Contributions or Nonelective Contributions. A number of design variations have evolved within these two basic options throughout the years. The most prevalent of these are discussed briefly below.

Employer Matching Contributions

If the plan includes any form of matching contribution provision, employees must contribute (make elective salary deferrals) on their own behalf to receive employer contributions. Matching contribution formulas can be structured in the following alternative ways:

1. Fixed Formula Match (written into plan document): An infinite number of formulas can be designed under this structure. One example is "Your employer will contribute $0.50 for each $1.00 that you contribute up to the first 4% of pay". Using this contribution allocation, if an employee makes elective deferrals in the amount of 4% of pay, the employer will contribute 2% of pay on his or her behalf. *(Continued on Page 2)*

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2. <u>Discretionary Match</u>: As under the fixed match formula, an infinite number of formulas are possible here as well. But, unlike the Fixed Formula that is written into the plan document, the Discretionary Match gives the employer the option to determine on an annual basis (or more frequently), what amount, if any, and what formula it will use to calculate contributions. The formula is usually announced prior to the start of the plan year so that employees can determine what amount, if any, they would like to contribute. However, the employer is not required to decide whether or not a matching contribution will be made for any plan year until after the year is over. Further, the specific formula used to calculate the contribution can be determined after the end of the year as well. Observation: A Discretionary Match provides much greater flexibility to the employer than a Fixed Formula Match, but is likely to be less of an incentive for employees to make elective deferrals because of the uncertain employer commitment.

3. <u>Safe Harbor Match</u>: Employers who struggle with ADP/ACP discrimination testing sometimes commit to a Safe Harbor Match in advance of the plan year in order to assure that owners and highly compensated employees are able to maximize their elective deferrals. The most common Safe Harbor Match formula is "dollar for dollar up to the first 3% of elective deferrals that you contribute plus $0.50 per dollar for the next 2% that you contribute". So, if an employee contributes 5% of pay or more, the employer will make a match contribution equal to 4% of the employee's compensation.

Employer contributions made pursuant to a fixed or discretionary match formula can be subject to a graduated vesting schedule. However, employer contributions that are made as part of a Safe Harbor election must be 100% fully and immediately vested. Observation: Although potentially expensive, the Safe Harbor Match provides a substantial incentive for employees to contribute on their own behalf while guaranteeing that owners and highly compensated employees will have the opportunity to maximize their personal deferrals if they choose to do so.

<u>Nonelective Employer Contributions</u>

If the plan includes any form of Nonelective Employer Contribution provision, eligible employees will be entitled to receive an employer contribution whether or not they make elective deferrals on their own behalf. There are two basic ways to structure nonelective contributions, with variations as noted below.

1. <u>Safe Harbor Nonelective Contribution</u>: Like the Safe Harbor Matching Contribution election, the Safe Harbor Nonelective Contribution election is often an attractive design tool for employers who struggle with ADP discrimination testing. Under this version, the employer makes a 3% of pay employer contribution on behalf of all eligible employees, even those who may terminate during the year. This contribution, which must be 100% fully and immediately vested, is an alternative way for the plan to "buy out" of discrimination testing. As with any nonelective form of employer contribution, employees are not required to contribute on their own behalf to qualify for employer contributions. There are other potential advantages associated with making a Safe Harbor Nonelective Contribution, especially if it is anticipated that additional discretionary contributions will be made for the year. However, a discussion of these details is beyond the scope of this article.

2. <u>Discretionary Nonelective Contribution</u>: Employers have had the option to make nonelective employer contributions on behalf of their employees for decades, even prior to the passage of ERISA. Originally, this form of contribution was referred to as a "Discretionary Profit Sharing Contribution." Although that term is still used, it is no longer necessary to have profits for the year to qualify to make a "profit sharing" contribution. Further, the amount of the contribution does not need to have any relationship to profits. As a result, someone in Washington came up with the term "Nonelective Contribution" as the official terminology to replace the term "profit sharing" in laws, regulations and technical discussions that are released.

Today, there are three basic ways that Discretionary Nonelective Contribution formulas can be structured when part of a stand-alone "profit sharing" plan or as the "profit sharing" component of a 401(k) or 403(b) plan. These are each discussed briefly below:

A. <u>Pro-rata Formula</u>: Under a pro-rata formula, the total amount of employer nonelective contributions that the employer decides to contribute to the plan for the year is allocated pro-rata among eligible employees, based on their relative compensation for the year. *(Continued on Page 3)*

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This is sometimes also referred to as a "salary proportionate" allocation formula. For example, if participant Z's compensation represents 2% of the payroll of the eligible group for the year, participant Z would be entitled to 2% of the total contribution made by the employer for the year. Alternatively, an employer could decide to contribute a percentage of wages, say 5%, to all eligible participants.

B. <u>Permitted Disparity Formula</u>: The term "Permitted Disparity" is now used instead of "Social Security Integration." This type of formula enables the employer to allocate a somewhat greater portion of any discretionary employer contribution to participants whose wages for the year exceed a specified dollar amount, such as the Social Security Taxable Wage Base (TWB). The rationale is that employer contributions are not being made to Social Security for the portion of wages above the TWB; therefore, it is equitable to make a higher rate of contribution to the private plan for wages above the TWB or other specified dollar amount to make up for that disparity (thus, the terms "social security integration" and "permitted disparity"). Here is a simplified example of how a Permitted Disparity allocation formula works:

If a plan is using full integration with the TWB ($118,500 for 2015), it is possible for highly paid employees to receive up to an additional 5.7% contribution on any wages above the TWB. For example, if an employer provides a base contribution of 10% of wages, an employee earning $150,000 would receive a contribution of $16,795.50. This is comprised of 10% of all wages, plus an additional 5.7% of just those wages above the TWB.

C. <u>Class Allocation</u>: Although not new, one of the most exciting developments in the qualified plan area is the opportunity to separately allocate discretionary employer contributions among participants in a highly selective manner. Historically, some employers have been reluctant to make employer Nonelective Contributions to their plans because they were not able to allocate a meaningful portion of limited dollars to owners and key employees. As a surprise to some, the IRS and Congress have given their blessing to an approach that enables the employer to group employees into classes, then credit different rates of employer contributions to employees in each class. As a more recent extension of this concept, it is now technically possible to put each employee into his or her own separate class and allocate a separate rate of pay or dollar contribution to every participant. (As a practical matter, contributions are rarely fine-tuned to this extent, but it is possible to do so.) Before getting too excited, it is important to note that the relative allocations among participants must be tested to demonstrate that prohibited discrimination does not occur in favor of owners and highly compensated employees. As a result, it is not always possible to allocate contributions exactly as the employer would like. Nonetheless, using Class Allocations is the "best game in town" as it relates to flexibility and the ability to allocate limited dollars among targeted employees.

<u>Final Comments</u>

1. ABP recommends that plan sponsors consider adding the class allocation version of the Nonelective Contribution formula to their plans as part of the mandatory PPA plan document restatement process. Further, if a Class Allocation formula is already in place, we recommend that clients consider modifying it to place every participant in a separate class. If ABP is the plan's document provider, there is no cost to add or modify a Nonelective Contribution provision if implemented as part of the PPA restatement process. Further, including a discretionary contribution provision in the plan document does not obligate the employer to actually make contributions pursuant to that provision unless it chooses to do so.

2. It is possible for a plan sponsor to include more than one of the above types of employer contribution arrangements as part of its plan. In fact, it is fairly common to do so. For example, the plan could include a Fixed Formula Match and also any one of the Nonelective Contribution provisions identified above. Further, it is fairly common for an employer to make a Safe Harbor Nonelective Contribution election (3% of pay) in advance of the plan year and then decide to make additional Nonelective Contributions on a discretionary basis after the end of the year. ▪

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Common Compliance Failures

Historically, the most common compliance failures on the part of employers who sponsor health & welfare plans are (1) failure to file Annual Report Form 5500 returns when due, (2) not satisfying ERISA's written plan document requirements, and (3) not fully satisfying ERISA's SPD employee disclosure requirements. Each of these compliance items is discussed more fully below.

Annual Form 5500 Filing

With few exceptions, employers who sponsor tax-qualified retirement plans covering any number of employees are required to file a Form 5500 Annual Return with the Employee Benefits Security Administration (EBSA) each year. This filing provides plan identifying information, financial activity and compliance disclosures. It sometimes comes as a surprise that many employers who sponsor health & welfare plans are also required to file yearly Form 5500 returns. The EBSA imposes substantial monetary penalties (up to $1,100 per day) on plan sponsors who willfully fail to satisfy this requirement.

The good news is that the DOL has issued an administrative exemption from the Form 5500 filing requirement for health & welfare plans covering fewer than 100 participants. The bad news is that an unusually high number of employers do not have the annual report filing requirement on their radar screens. As a result, they often fail to submit required Form 5500 filings when they cross over the 100- participant benchmark. ABP has also been surprised by the number of employers with health & welfare plans covering thousands of employees who have failed to submit these returns.

The Fix: Fortunately, there is a practical and relatively affordable fix to this problem. A number of years ago, the EBSA developed the Delinquent Filer Voluntary Compliance Program (DFVCP). Employers can take advantage of this program by submitting past due returns, together with a monetary penalty of $2,000 or $4,000, and effectively be given amnesty for their past transgressions. While the monetary penalty is more than pocket change, it is quite low when compared to the sanctions that are applied when the EBSA identifies delinquent filers who fail to "fess up" on their own. Feel free to contact a member of ABP's professional staff for more information about the DOL's Delinquent Filer Voluntary Compliance Program.

Written Plan Document/Summary Plan Description

Every plan governed by ERISA must be maintained pursuant to a written plan document. Further, a summary of the plan must be provided to participants in the form of a Summary Plan Description (SPD). These requirements apply to **all** retirement plans and **all** health & welfare plans, not just those covering 100 or more participants.

The good news here is that it is not necessary to satisfy either the written plan or SPD employee disclosure requirements in a single document. Accordingly, the policies issued by the insurance carriers who provide health & welfare benefits go a long way toward satisfying the written plan requirement and insurer provided Certificates of Coverage help satisfy the SPD requirement. The bad news is that insurance company policies, Certificates of Coverage and other materials typically do not include all of the documentation mandated by ERISA. Common omissions include basic employer and plan identifying information such as plan name, plan ID number, plan sponsor name, address and taxpayer identification number, identification of plan fiduciaries, the agent for service of legal process, and the COBRA administrator. Some insurer provided documents also fail to fully identify the group of covered employees, eligibility criteria, waiting periods and entry dates. These and other omissions may also apply to self-insured plans, particularly where a comprehensive plan document and SPD is not in place.

The Fix is for the plan sponsor to adopt a written welfare plan "wrap" document and a "wrap" SPD. The "wrap" document and SPD supplement, but do not replace or modify, the provisions of the underlying policies and Certificates of Coverage. Rather, the documentation fills in the missing information while incorporating by reference the insurer provided documents and disclosures that are already in place. While there are advantages to a wrap document and SPD for employers of all sizes that offer comprehensive health & welfare benefits (life, medical, disability, etc.), larger employers who are required to submit Form 5500 returns each year have an additional incentive. For these employers, having a wrap plan document and SPD in place clearly evidences their intent to treat all of the separate insurance and health & welfare benefits as sub-plans that are part of a single combined plan. By doing this, the employer can minimize administrative complexity and expense by submitting only one Form 5500 return (with multiple Schedule As) each year for the wrap plan rather than separate returns for each of the sub-plans and policies.
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ERISA does not specifically require that a welfare wrap document and SPD be in place. However, most practitioners and ERISA attorneys recommend this strategy as a practical way to achieve full compliance with ERISA. ABP has been providing wrap plan document and SPD support and Form 5500 filing services to health & welfare plan sponsors for over 25 years. Feel free to contact us if you have questions. ▪

IRS Extends Pre-Approved Plan Opportunity to Cash Balance and ESOP Plans

The IRS recently issued Revenue Procedure 2015-36 announcing that Employers who sponsor Cash Balance and/or ESOP plans will soon have the opportunity to maintain those plans using an IRS pre-approved prototype, master plan or volume submitter form of document. Currently, these types of plans must be maintained using individually drafted documents.

The IRS stated that it is extending pre-approved status to Cash Balance and ESOP arrangements to make it easier for small and medium sized businesses to implement these plans. The availability of a pre-approved format should substantially reduce the cost of drafting and issuing documents. Further, plan sponsors who previously elected to file plan documents with the IRS to request a Favorable Determination Letter (FDL) will see those expenses eliminated entirely. (Given budget constraints, the IRS no longer has the staffing or resources to process high volumes of FDL requests. Offering the option for sponsors to adopt a pre-approved document appears to be part of a strategy to minimize the volume of FDL requests the Service receives during each restatement cycle and when new plans are adopted.)

Sponsors who can take advantage of the opportunity to adopt pre-approved plans will experience additional savings by reason of the timing and frequency of mandatory restatements. This is due to the fact that individually drafted plans are required to be fully restated every 5 years (staggered 5-year cycles based on the Employer's EIN), whereas pre-approved plan documents require restatement every 6 years.

The guidance provided in Revenue Procedure 2015-36 includes a list of plan design features/objectives that cannot be included in pre-approved plan documents. Accordingly, some plan sponsors will need to continue to maintain their plans using individually drafted documents. Nonetheless, ABP believes that a substantial percentage of current Cash Balance Plan clients will be able to accommodate their design objectives within pre-approved documents, when available. (ABP does not service ESOP plans, so we are not in a position to comment on the extent to which sponsors of ESOPs will benefit from the availability of pre-approved documents.)

If you currently sponsor a Cash Balance Plan or an ESOP plan, you should consult your current TPA/actuary/administrator to determine if you are able to take advantage of the opportunity to adopt a pre-approved document. If you are, you should sign Form 8905 "Certification of Intent to Adopt a Pre-Approved Plan" prior to the expiration of your current 5-year restatement cycle. Signing this form indicates your intent to adopt a pre-approved plan within the timeframe of the upcoming 6-year restatement cycle. However, it is significant to note that signing Form 8905 does not preclude the right to use an individually drafted document if it is determined that the pre-approved format does not meet your plan design requirements as you work through the restatement process.

If restating your Cash Balance or ESOP plan using a pre-approved document appears to be an appropriate strategy, you should sign Form 8905 and keep it with your plan records. The signed form does not need to be submitted to the IRS.

Closing Comment: At one time, it was necessary for sponsors of all types of retirement plans to experience the inconvenience and expense associated with individually drafted documents. However, over time, the IRS has gradually extended pre-approved status to more types of plans as they have gained experience with newer and more complex designs. Opening up the pre-approved plan opportunity to Cash Balance and ESOP plans is a welcome next step. ▪

Paying for Employee Medical Insurance Pre-Tax Requires a Section 125 Plan

Working for an employer who funds 100% of employee and dependent medical insurance is pretty much a thing of the past. Nearly all employees in the private sector now pay at least a portion of employee-only medical insurance premiums and most pay 100% of the premiums for dependent coverage.

If a Section 125/cafeteria plan is in place, employees can elect to pay their portion of premiums through pre-tax *(continued on page 6)*

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payroll deduction contributions. Paying premiums pre-tax has the effect of reducing the amount of compensation that is subject to Federal Insurance Contributions Act (FICA) tax and Federal Income Tax (FIT). The combined tax savings to the employee is typically in the range of 25-35% of the amount of premiums that are paid. The employer's share of FICA taxes is also reduced by the aggregate amount of pre-tax payroll deductions, resulting in a savings of 7-8% when compared to the FICA taxes it would pay if employees' premiums were paid with after-tax dollars. So, having a Section 125 plan in place can provide huge tax savings to both the employer and its employees.

What sometimes gets lost between the cracks is that the only way that employees can pay group medical (or other) insurance premiums on a pre-tax basis is if their employer establishes and properly maintains a Section 125 Plan. This requires having a written plan document, issuing Summary Plan Descriptions (SPDs) to employees, properly enrolling participants, and complying with Section 125 plan "change-in-status" rules.

Unfortunately, a surprisingly high number of employers are deducting employee premiums on a pre-tax basis without having a valid Section 125 plan in place. This is dangerous. If detected during an Internal Revenue Service (IRS) or Department of Labor (DOL) audit, the employer will be liable for its portion of FICA taxes that were not paid because taxable payroll was reduced without supporting documentation. Even more problematic is the fact that the employee portion of FICA would also have been underpaid by reason of erroneous pre-tax payroll deductions. To put it mildly, correcting this error would be embarrassing for the employer and a financial hardship for employees. In all likelihood, the employer would feel obliged to pay the employees' portion of taxes due as well as its own, plus applicable penalties.

On numerous occasions throughout the years, ABP has discovered that employers who thought they had a Section 125 Plan in place really did not. In some instances, they could not find the plan document and never issued SPDs to employees. In other instances, unsigned documents provided by a payroll company or insurance carrier were in the file with the word SAMPLE stamped across the front. A more common occurrence is to locate a signed document from 10 or more years ago. While having some documentation in place is better than none, a materially outdated plan document or SPD would not likely survive an IRS or DOL audit.

Observation: If new employees are not receiving Section 125 Plan SPDs and other communications, it is an indication that your Company's Section 125 Plan is not in full compliance. Further, if Section 125 plan documents have not been amended for 5 years or more, they are out of date. If either of these situations applies, you should contact your insurance broker or ABP to discuss a strategy for bringing the plan into full compliance. ▪

Associated Benefit Planners, Ltd.

Associated Benefit Planners, Ltd. (ABP) is an independent consultant and third party administrator (TPA). We specialize in the design and administration of employer-sponsored retirement/savings plans, including 401(k) arrangements. ABP also provides plan document and compliance support for Section 125 Plans and Employee Welfare Plans, operating on a fee-for-service basis.

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