

# Benefit Plan Audits, Information Flow, And Plan Drafting

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## Increase In Audits Of Tax-Qualified Plans

In a series of meetings with benefit professionals during the past month, the Internal Revenue Service described current and upcoming audit activity for tax-qualified retirement plans, including proposals to increase the number of agents conducting audits. In addition to the traditional full scale audits and a new program of intensive audits for certain larger plans, IRS has added a program of limited scope audits which focus on a few selected issues based on the market segment and region involved. In addition to those specific issues, the limited scope audits look for evidence of proper "internal controls." These controls include procedures for ensuring the information flow necessary to identify eligible employees and enroll them at the right time, as well as for ongoing administration.

## Information Needed For Plan Drafting

Plan sponsors generally understand the need for an information flow among human resources and other operating personnel, the payroll department, and internal and external plan administrators, in order to administer the plan in accordance with its terms and legal requirements. However, the same need for input from all relevant sources is essential if the plan document is to reflect the intended operations of the plan, both at its inception and over time. In a May 28, 2004 speech on the responsibilities of ERISA fiduciaries delivered at the Yale School of Management, Secretary of Labor Chao noted the requirement for "updating plan documents" to "reflect corporate changes," and that DOL plan audits had uncovered with surprising frequency "inconsistent provisions," attributable in part to a failure to do so.

Since plan documents create legally enforceable rights, language that fails to reflect the desired plan design can result in benefit entitlements never intended. Failure to follow the plan document can also lead to plan disqualification and loss of the attendant tax benefits. While IRS does not want to disqualify plans because of the harm disqualification causes to innocent parties, its procedures for preserving qualification generally require prompt "correction" of the failure upon discovery. As a rule, this requires that participants be put in the same position as if the plan administrator had followed the language of the plan document in a timely fashion. For example, if a defined contribution plan provides for the inclusion of bonuses in eligible compensation, a failure in operation to include such bonuses will require

that plan participants be made whole not only for the additional contributions that would have been made based on the bonuses, but on the earnings those contributions would have generated within the plan.

In order to create a plan document that both encompasses all of the sponsor's design choices and which will be complied with in operation, the drafter must go beyond the summaries of a proposed plan or amendment that are typically prepared by benefit consultants or human resources staff. Extensive dialogue with those responsible for plan design and implementation will be necessary on all aspects of plan operations. To illustrate the problem, the following paragraphs describe some of the specifications that must be developed before drafting the plan provisions on eligibility and includible compensation.

## Beware: Waiting Period Rules Can Determine Who Is Eligible, As Well As When Employees Can Participate

If an employer chooses not to impose a one-year waiting period, as is increasingly common for 401(k) plans (or at least the 401(k) component), care must be taken not to inadvertently admit part-time, temporary or other casual employees whom it wishes to exclude. While tax-qualified plans may exclude employees based on bona fide job categories, employees distinguished solely by the fact that they are not full-time cannot be excluded on that ground alone. For retirement plan purposes, the only authorized ground for excluding such employees is imposition of a one-year waiting period, with the required "year" defined as a 12-month period in which the employee has at least 1,000 paid hours of service. Plan drafters who are asked to allow for immediate eligibility (or a relatively short waiting period) should determine whether the employer has – or may in the future have – employees who are not full-time and whom it wishes to exclude. If so, the plan should waive the one-year wait for persons whose service is regular or full-time enough to warrant accelerated eligibility, and impose the 12-month/1,000 hours requirement on the part-time group which it intends to exclude. Then, as an operating matter, care must be taken to ensure that records of paid hours are maintained and accessed as needed to administer the provision.

The foregoing rules do not apply to welfare plans, which may define eligibility based on full-time or part-time status. To avoid disputes, however, the criteria for assigning an employee to ineligible status should be clear so that if a claim is made for benefits (or the right to participate), authoritative language demonstrating ineligibility is readily at hand.

## "Over There"

If the employer has international operations, the plan drafter must determine whether employees assigned to foreign locations are or remain eligible under the plan. Employees of foreign subsidiaries that have not adopted the plan will generally be ineligible because employed by a nonparticipating subsidiary. However,



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employees of a U.S. parent (or U.S. subsidiary participating in the plan) will be eligible unless excluded based on location or some other ground. Frequently, this language will require much fine-tuning, since distinctions may be appropriate depending on how long the foreign assignment will be, whether the employee is a new hire or has already been in the plan while working in the U.S., whether the employee can participate while abroad without adverse income tax treatment in the foreign location, and whether the employee is a U.S. citizen. Those working with prototypes (or other "standard language") should be aware that the typical boilerplate exclusion of nonresident aliens is frequently not adequate for the purpose.

The treatment of foreign-based employees is a good example of the need cited by Secretary Chao for vigilance in updating the plan document to reflect corporate changes. For example, an employer that traditionally puts all foreign-based employees (whom it intends to exclude) on the payroll of foreign subsidiaries should coordinate with plan administrative personnel before placing foreign employees on the payroll of participating U.S. entities, whether by formally opening a branch or more casually.

## Employees You Didn't Know You Had

Both IRS and state audit activity has long been directed at determining whether purported independent contractors are actually "employees" based on the standard common law criteria. Plan documents should accordingly contain provisions to make sure that individuals reclassified as employees do not thereby become entitled to benefits on a retroactive basis. Typical language for this purpose provides that individuals treated as independent contractors (or employees of another entity) will not be eligible employees even if they are reclassified as employees under common law standards or for tax or other regulatory purposes. Such provisions are now common in well-drafted individually designed qualified plans, and prototype plans often have language for this purpose which is serviceable even if not ideal. However, welfare plans generally lack the formal integrated plan documents that are required for qualified plans, and care needs to be taken that the necessary language is in those plans as well.

## Adopting A Prototype – Do You Understand It?

While large employers regularly use individually designed plan documents, some mid-size employers opt for prototype plans with a view to minimizing the costs of updating the document for legal changes and of obtaining the associated determinations of continuing tax qualification. An employer that opts for this must, of course, be satisfied that the prototype accommodates the particular plan design desired. If the prototype does not, the employer must decide whether to forego the special features that it prefers, but that cannot be accommodated by the prototype.

Assuming that the options afforded by the prototype meet the employer's needs, adoption of the prototype is done by completing an adoption agreement that sets forth a wide range of choices on various plan design particulars. However, many of the line items setting forth choices for the plan sponsor are phrased in technical lan-

guage that often is not readily understood by the employer personnel responsible for completing the adoption agreement, while personnel assigned by the prototype sponsor to assist in the process fail to give the necessary guidance. Subjects frequently mishandled include the following:

**Treatment of "Controlled Group."** Since all employers in the same controlled group (whether a parent and 80% or more subsidiaries, or equivalent brother-sister configurations) are treated as a single employer under tax-qualified plans, the adoption agreement should specify whether employees of various controlled group members are to eligible to participate or not. Carelessness in this regard can lead to a plan document mandating eligibility for employees of entities not intended to be covered (whether existing at the time of adoption, or acquired later).

**Defining "Eligible Employees."** "Leased employees" (employees of another entity who have been with the employer on a substantially full-time basis for 12 months or more) are treated as employees of the employer, but need not be covered unless they are so numerous that the plan will otherwise fail requirements for nondiscrimination in coverage. Prototype plan adoption agreements typically have line items asking whether leased employees are eligible, and similar line items regarding bargaining unit employees and nonresident aliens. Generally, all these groups should be excluded.

## What Pay Is Counted?

Assuming that plan benefits are pay-based, the drafter should coordinate with human resources to ascertain the different forms of compensation arrangements in place, and make sure that the plan definition of compensation excludes anything not intended to be included. One relevant consideration is ease of administration – if the definition is not all-inclusive, procedures must be in place either to track the includible items, or back out the excluded items from the all-inclusive (e.g., W-2) compensation. However, many employers believe that certain types of compensation by their nature should not generate additional benefit entitlements. In addition to taxable expense reimbursements or other fringe benefits, a plan sponsor may wish to exclude compensation attributable to the exercise of nonqualified stock options or similar equity compensation arrangements and certain formal incentive plans, prizes and awards. Where formal incentive plans coexist with bonus arrangements and are treated differently, the plan language should make the necessary distinctions. If care is not taken, disputes may arise as to whether an exclusion of "bonuses" extends to "incentive pay," whether an exclusion of incentive pay extends to equity compensation incentives, and the like.

## Amending For Regulatory Changes Is Not Enough

Plan sponsors know that they must periodically revise their plan documents to reflect new legislation and regulations. However, the need to review the consistency between the plan document and actual or intended operations is less frequently recognized. The purpose of this article has been to emphasize the need to do so. To conclude with an understatement: correcting the "operating defects" that arise where the plan document and operations differ is not fun.

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