

Updated Safe Harbor Explanation for Eligible Rollover Distributions

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Practice Area: Compensation and Benefits/ERISA

Pursuant to section 402(f) of the Internal Revenue Code (the "Code"), a qualified retirement plan is required to provide a participant or beneficiary receiving a distribution that qualifies as an "eligible rollover distribution" with a written explanation of certain tax rules that are potentially applicable. The plan must provide this explanation to the participant or beneficiary within a reasonable time (i.e., generally no less than 30 and no more than 90 days) before the date the distribution is made. Previously, the Internal Revenue Service ("IRS") issued a model explanation (the "Safe Harbor Explanation") to assist plans in satisfying the requirements under Code section 402(f). On January 24, 2000, the IRS issued an updated Safe Harbor Explanation.

The Safe Harbor Explanation may be customized by omitting any portion that could not apply to the plan. For example, if the plan does not hold after-tax employee contributions, the paragraph of the Safe Harbor Explanation headed "Non-taxable Payments" could be eliminated. In addition, a plan administrator may provide additional information with the Safe Harbor Explanation so long as the information is accurate and not inconsistent with the Safe Harbor Explanation.

Although a plan administrator must provide plan participants and beneficiaries the explanation mandated by Code section 402(f), the plan administrator is not required to use the Safe Harbor Explanation to satisfy that requirement. Any explanation designed by the plan administrator, however, must contain the information required by Code section 402(f) and must be written in a manner designed to be easily understood by the participants and beneficiaries.

Also, as the tax laws change, a plan administrator must review its Code section 402(f) explanation and update the explanation, as necessary, to accurately describe the relevant law.

Application of Increase in Compensation Limit for Highly Compensated Employees

Qualified retirement plans and certain other employee benefit programs are prohibited from providing benefits that discriminate in favor of "highly compensated employees," as that term is defined under section 414(q) of the Internal Revenue Code of 1986 (the "Code"). Pursuant to Code Section 414(q)(1), a "highly compensated employee" is generally defined as an employee who (i) at any time during the year or the preceding year was a 5% owner of the employer maintaining the plan, or (ii) earned compensation in excess of \$80,000 for the preceding year. This \$80,000 compensation threshold is adjusted periodically for increases in the cost of living.

Previously, the Internal Revenue Service ("IRS") announced that the compensation threshold used for determining whether an employee is "highly compensated" increased from \$80,000 to \$85,000 effective January 1, 2000. How this increase was to be implemented, however, was not completely clear. As noted above, the compensation threshold is applied to compensation for the preceding year. This preceding year is referred to as the "look-back year." Therefore, if an employer were determining who is "highly compensated" for the 2000 plan year, must an employee who is not a 5% owner have earned \$80,000 or \$85,000 in the 1999 lookback year to be considered "highly compensated"?

In a recent letter, the IRS clarified the application of the increase in the compensation threshold. Generally, if a plan year begins in 2000, the look-back year would begin in the 1999 calendar year. Therefore, according to the IRS, the compensation threshold applicable to that 1999 look-back year would be \$80,000. For a plan year that begins in 2001, the look-back year would begin in 2000, and the compensation threshold applicable to that 2000 look-back year would be \$85,000.

A special rule would apply, however, if a plan that is not operating on a calendar year has made a special calendar year data election. In that case, the compensation limitation for determining highly compensated employee status is \$85,000 beginning with the 2000 plan year.

IRS Increases Focus On Cafeteria Plan Compliance

Cafeteria plans, described under section 125 of the Internal Revenue Code of 1986 (the "Code"), are receiving greater Internal Revenue Service ("IRS") attention because the IRS is concerned that many cafeteria plans fail to comply with the applicable legal requirements. As a result, the IRS is in the process of educating agents and taxpayers on areas of confusion surrounding cafeteria plans. Unfortunately, for many employers this education takes place during a general company audit. Accordingly, employers who sponsor cafeteria plans may want to review their cafeteria plans now for compliance with Code section 125 instead of waiting for an IRS audit to discover deficiencies.

Under a cafeteria plan, an employee is generally allowed to choose between cash (or other taxable benefits) and receiving certain nontaxable benefits, such as health and accident insurance, group term life insurance and adoption assistance. A cafeteria plan also may have a flexible spending account feature which allows an employee to elect to contribute pretax dollars for medical or dependent care expenses. If a cafeteria plan qualifies under Code section 125, the nontaxable benefits will not be taxable to the employee when received.

If a cafeteria plan fails to meet the Code section 125 requirements, (other than the nondiscrimination requirement) a participant would be taxed as though he/she elected to receive the available taxable cash benefit regardless of the type of benefit he/she actually received. If the IRS finds that an employer's cafeteria plan violations are egregious or violate nondiscrimination rules, the employer may be on the hook for inadequate tax withholding for all participating employees, adjustments to workers' tax returns and penalties.

While the IRS states it is not singling out cafeteria plans, examiners may review the cafeteria arrangement when general audits are conducted. Documents that the IRS may request during an audit include:

- IRS Form 5500s for the cafeteria plan and the related schedules for these plans
- Plan documents for any benefits offered under the cafeteria plan
- Summary plan descriptions, enrollment packages and other communication materials
- Election forms
- Administrative committee minutes
- A worksheet of eligible and ineligible employees
- Nondiscrimination test results

The IRS may also request a W-2 reconciliation reflecting employees' pretax reductions; a claims register for flexible spending account benefits; an annual claims denial report; plan bank account information; copies of insurance policies; and documents reflecting the plan's treatment of forfeitures.

According to the IRS, the most frequent problem among many audited employers is the failure to file an IRS Form 5500, the annual report form. Unlike pension plans, an IRS Form 5500 is required to be filed by every employer, regardless of the number of employees/plan participants, even if the employer is a church or governmental entity. Failure to file an annual report subjects the employer to penalties from both the Department of Labor ("DOL") and the IRS.

To encourage employers to file delinquent annual reports, the DOL has a Delinquent Filer Voluntary Compliance Program ("DFVC"). Under DFVC, the employer's daily penalty for its failure to file a particular year's IRS Form 5500 is reduced from \$300 to \$50. Additionally, the maximum penalty that may be assessed is reduced from \$30,000 to either \$2,500 or \$5,000, depending on when the IRS Form 5500 was due. DFVC is not available, however, if the DOL informs the employer, in writing, of its failure to file an IRS Form 5500.

Unfortunately, DFVC does not mitigate penalties that the IRS may charge for delinquent IRS Form 5500s, and the IRS does not have a corresponding program. The IRS penalty for a delinquent IRS Form 5500 is \$25 per day, to a maximum of \$15,000, which is due upon notice and demand of the IRS. This penalty may be avoided, however, by showing that the failure to file was due to reasonable cause.

At this time, the IRS does not have a program for correcting cafeteria plan deficiencies. Even so, you, the employer, should review your cafeteria plan and correct any deficiencies prior to an audit by the IRS. To assist you, we have attached a Cafeteria Plan Compliance Checklist that you can use to begin your review of your cafeteria plan for compliance with Code section 125. Please remember that this Checklist is only a starting point. Although the Checklist addresses some of the significant requirements applicable to cafeteria plans, it is not exhaustive. Some requirements, such as the nondiscrimination rules applicable to cafeteria plans, are quite complex and are beyond the scope of the Checklist.

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