



403(b) PLANS

The More Things Change . . .

By ILENE H. FERENCZY

The new TVC program has gotten off to a slow start, and some TSA issues remain unresolved.

A little more than a year ago, this column was created to discuss the enormous changes that were happening with tax-sheltered annuity or 403(b) programs. (I've come to like calling these things "TSAs," because it's so nice and easy to type. Try typing "403(b)" over and over again!) At that time, the IRS was beginning to publicize an unprecedented interest in ensuring that TSAs were complying with tax law requirements. As part of the IRS's new concentration on TSAs, we were told that proposed audit guidelines were being issued and that there was some potential for a voluntary compliance program directed at TSAs.

Those promises have come true. Proposed IRS Examination Guidelines were issued in May 1995, [IRS Notice 95-33, 1995-19 IRB (5/8/95)] and at nearly the same time, the IRS released its Tax-Sheltered Annuity Voluntary Correction Program (TVC). [IRS Rev Proc 95-24, 1995-18 IRB] With these changes have come even more questions and issues than were present a year ago.

In this column, I will examine the "state of the TSA" vis-a-vis the government, and outline

some of the issues that remain.

HOW IS TVC DOING?

Although many practitioners waited for TVC with bated breath, not everyone has been pleased by the way the program developed. In particular, the mix of VCR-type principles with CAP-type sanctions looks to many practitioners like the worst of both worlds. TVC is like VCR, because it is administered by the IRS Headquarters Office (in fact, by the same folks who handle VCR), its procedures are similar, and it requires the payment of a user fee based on the number of participants in the program. On the other hand, TVC mirrors the CAP, because TVC allows the IRS to charge the employer a nondeductible sanction (or fine) that could be as high as 40 percent of the estimated taxes that would be due if the program lost its tax-exempt status. Although IRS representatives have been on the lecture circuit, encouraging employers to take advantage of TVC, things have been slow. At last count, TVC submissions to the IRS Headquarters number 25.

What appears to be the hold-up? It seems to be two-fold. First, the IRS's audit initiative has been off to a slow start, and many tax-exempt employers remain unconvinced that the IRS will audit them at all and, if they do, that TSA noncompliance will be a major issue in that audit. Second, many employers are frightened away from TVC by the threat of

a 40 percent sanction. IRS representatives verbally reassure employers and practitioners that the 40 percent sanction level is reserved for only the most egregious of cases. In fact, sanctions of that level have been relatively rare for qualified plans in the walk-in CAP program, as well. There may be a third consideration that has narrowed TVC's popularity: the limited scope of the defects that may be corrected in the program. In particular, "ineligible employers"—that is, non-501(c)(3) tax-exempt organizations that have authorized TSAs but are not legally allowed to do so—anxiously await a program that will allow them to voluntarily correct this problem, which is specifically excluded from TVC.

Let's face it: it is hard to be the guinea pig for any program. One of the main impediments to people using TVC has to be the IRS's slowness to process the submissions that they have and to publicize the results. TVC has been around for nearly a year, and not one TVC compliance statement has been issued. This means that all that anyone has to demonstrate the IRS's fairness and reasonableness in resolving TSA compliance programs—and the affordability of the sanctions—is the Service's own representations in speeches. In fact, what people want to see is proof that the program is working and that employers do not come out at the tail end too bruised and battered for the experience—and

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certainly substantially better off than they would have been had an audit occurred while the TSA was out of compliance. Until such time as cases are closed and results are publicized, only the stoutest of heart, the most concerned, or the most trusting appear to be sticking their necks out.

So, what does the future hold? IRS representatives have indicated that the first batch of cases should be finalized (and, we hope, publicized) in the next few weeks. In addition, despite warnings that practitioners must use TVC or they will lose it, the latest prediction from the IRS is that TVC will be renewed before it expires in October 1996. It is our experience that the preliminary negotiations with the IRS on a TVC case have been quite reasonable, and we've heard similar reports from other practitioners.

TITLE I IN RELATION TO TVC

One of the most controversial parts of TVC has to do with the level of involvement and responsibility required by the employer to fashion and ensure correction and proper future administration. This particularly concerned employers that were trying (hope against hope) to have such limited involvement with their employees' TSAs as to avoid compliance with ERISA Title I requirements. How could such an employer assist employees with their TSA problems without incurring the cost and responsibilities of Title I? [See, Reish and Ferenczy, "The Overlooked ERISA Dilemma," 2 *J Pension Benefits* 4 (Summer 1995) 82, for an outline of those obligations]

The Department of Labor recently issued two almost identi-

cal letters that address this issue. [Letter to Evelyn A. Petschek from Robert J. Doyle, Feb 23, 1996 and letter to Lewis A. Siegel from Susan G. Lahne, Feb 27, 1996] These letters were both reassuring—for the most part.

First, the good news. The letters make it clear that applying for TVC, helping structure a correction, obtaining the cooperation of the fundholders, paying the compliance fee and any sanction, and even making a corrective contribution do not necessarily invoke Title I coverage. The last of these items is the most surprising and favorable, since employer contributions normally create immediate Title I coverage of the program.

Now the bad news: the letters contain some ambiguity, stating that, "to the extent that the TVC Program requires an employer to conduct administrative reviews and to fashion remedies to correct past defective administration of *its responsibilities*, those activities are 'subsumed in regulation section 2510.3-2(f) . . .'" [Emphasis added.] But, what if the error is arguably not caused by defective administration of the employer's responsibilities, but of those of another entity, such as the fundholder or the participant him or herself? For example, what if the fundholder fails to make minimum required distributions or allows distributions in absence of an allowable event? Does the DOL mean that, if the employer undertakes to correct these types of defects—which are customarily out of its control—that Title I responsibilities would attach? The answer to this question is not clear from the letters.

In addition, the letters note that the flexibility of correction

that is available through TVC may also cause an employer to "cross the line" separating non-Title I plans from those that are subject to that title. The letters say that:

[A]n employer may assume direct responsibilities, under the auspices of the TVC Program, either to correct actions of third parties that are not the employer's responsibility under a tax sheltered annuity program, or to undertake on-going duties with regard to a tax sheltered annuity program. . . . Whether the undertaking of any such responsibilities by an employer will cause the employer to be considered to have established or to maintain a plan that is covered under Title I of ERISA must be analyzed on a case-by-case basis, applying the criteria set forth in 29 C.F.R. 2510.3-2(f).

So, while getting into TVC generally won't cause the TSA to be covered by Title I, how one styles the correction and the means of maintaining compliance in the future can. What kinds of things can cause a problem? Again, the letters don't say. However, it stands to reason that an employer can't be doing anything after the TVC is completed that it couldn't do in the first place without causing Title I coverage. It is also a good idea to have the compliance statement carefully worded, so that it is clear that the employer is not accepting ongoing maintenance of the TSA as part of the TVC resolution. But if the employer takes no initiative to make sure that the TSA stays clean, what will

prevent the problem from recurring?

The upshot is that it is more likely that an employer maintaining a Title I plan will make a TVC filing than will an organization that simply makes a non-Title I program available to its employees. When a non-Title I program is submitted, it is more likely than not that the defect will be one that is within the ambit of the employer—such as a nondiscrimination problem or a failure to limit deferrals to \$9,500 per year.

On the other hand, the above quoted language from the Lahne and Doyle letters does make it clear that any exception to Title I coverage applies only if the TVC program is used. Therefore, self-correction by the employer outside TVC may be sufficient to cause a plan to be covered under Title I. This should encourage employers with non-Title I plans to use TVC, if voluntary compliance is important to the employer and its employees.

How can this “to be or not to be Title I” problem be resolved in the TVC context? It’s a difficult question to answer, because TVC is just a symptom of the overall problem: the nebulous nature of Title I coverage in the TSA context. One possibility is to allow non-Title I program *participants* apply for voluntary compliance on their own, effectively carving the employer out of the loop. This would be more consistent with the concept that the employee is the real sponsor of the TSA. However, it is doubtful whether participants have (or ever will have) sufficient sophistication to identify that their TSA has problems, much less to go forward to the IRS to make voluntary correction.

Another possibility would be for the DOL to change its outlook on what makes a TSA subject to Title I. If no employer contributions are being made to the program, and the employees are allowed to choose the annuity or custodial account, perhaps this should be sufficient to establish limited employer control for Title I exclusion purposes. This more narrow definition of a covered program would allow an employer to assist its employees through application to TVC without being concerned that it would engender inadvertent Title I coverage.

FUTURE PROSPECTS

Several organizations submitted comments to the IRS on the 403(b) Examination Guidelines. It appears that these comments are being taken seriously as the IRS looks toward finalizing the guidelines sometime during this year. IRS representatives have also stated that they are working on new regulations for TSAs, and are considering eliminating the one-deferral-election-per-year rule in favor of a practice more closely aligned with that of 401(k) plans. Finally, everyone anxiously awaits the issuance of more concrete nondiscrimination rules to replace Notice 89-23.

The IRS announced in 1995 that every Exempt Organizations audit of a tax-exempt entity will include an examination of any TSAs made available to the organization’s employees. Earlier this year, approximately thirty Employee Plans examiners spent time at the IRS Headquarters learning how to review TSAs, so that they will be in position to handle EP/EO coordinated audits of TSAs. It is expected that these individuals will, in turn,

train additional TSA specialists in their key districts. So, despite its slow start, the IRS audit initiative directed at TSAs is alive and well, and expected to work up a head of steam in the future. And, as mentioned already, the TVC program is likely to be extended, and will be available for a time when employers’ concerns about compliance and audit increases and distrust of TVC decreases.

So, to a large extent, the more things change, the more they stay the same. We are still awaiting more guidance on many issues and are not quite sure when a TVC application causes a TSA to be covered by Title I.

AS WE GO TO PRESS . . .

In the last few weeks, the IRS completed three TVCs and issued compliance letters to the employers. One of the cases involved two defects: allowing distributions in violation of the access restrictions, and exceeding the maximum exclusion allowance. The required correction was surprisingly flexible: the IRS required that the employer educate the fundholder and the employees so that future impermissible distributions were avoided. No refund of the excess contributions was required, nor were employees who exceeded the exclusion allowance required to recognize the excess as income. The second case involved a violation of the \$9,500 salary deferral limitation by one participant in a very small TSA. In that case, the participant was in pay status at the time of the TVC filing, and the IRS agreed to consider the distributions made to the participant to be a “correction” of the defect. In both cases, the taxpayer agreed to a 20 percent sanction. The third case involved a deferral

only, non-Title I TSA with more than 100 participants. The defects involved were violations of the maximum exclusion allowance and Code Section 415 limitations. Again, the employees were not required to disgorge the excess or to treat it as taxable income. The

sanction was 10 percent.

What do these two cases tell us? First and foremost, the IRS may allow very creative methods of correction under TVC (which is generally not the case in VCR for qualified plans). Second, the method of correction may not

involve action or the inclusion of income by the participants. In addition, although the sanction was 20 percent in two of these cases, we hear that it may not be indicative of the standard amount the IRS will require under the TVC—even in similar situations.