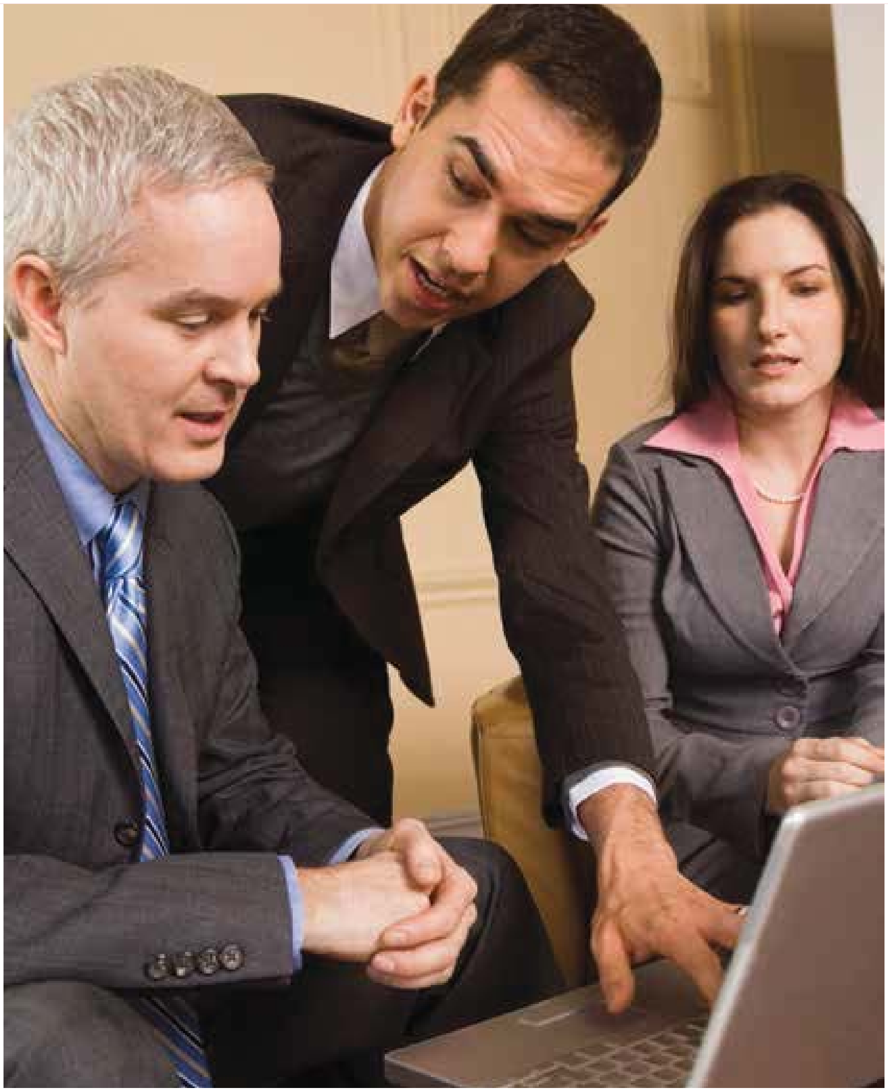
COMPLIANCE



A dive into the operational issues and problematic consequences of errors in administering CODAs, using three examples.

The Ominous Cash or Deferred Arrangement

BY JJ MCKINNEY

A qualified cash or deferred arrangement (CODA) has a distinct set of characteristics and a laundry list of rules to follow to maintain the tax advantages of being qualified. Practitioners tend to work more often with intentional qualified CODAs and navigate the myriad requirements to prove ongoing compliance with the tax code and IRS regulations. An examination of the specifics in defining a CODA and the accompanying requirements to maintain qualification reveal operational issues and problematic consequences.

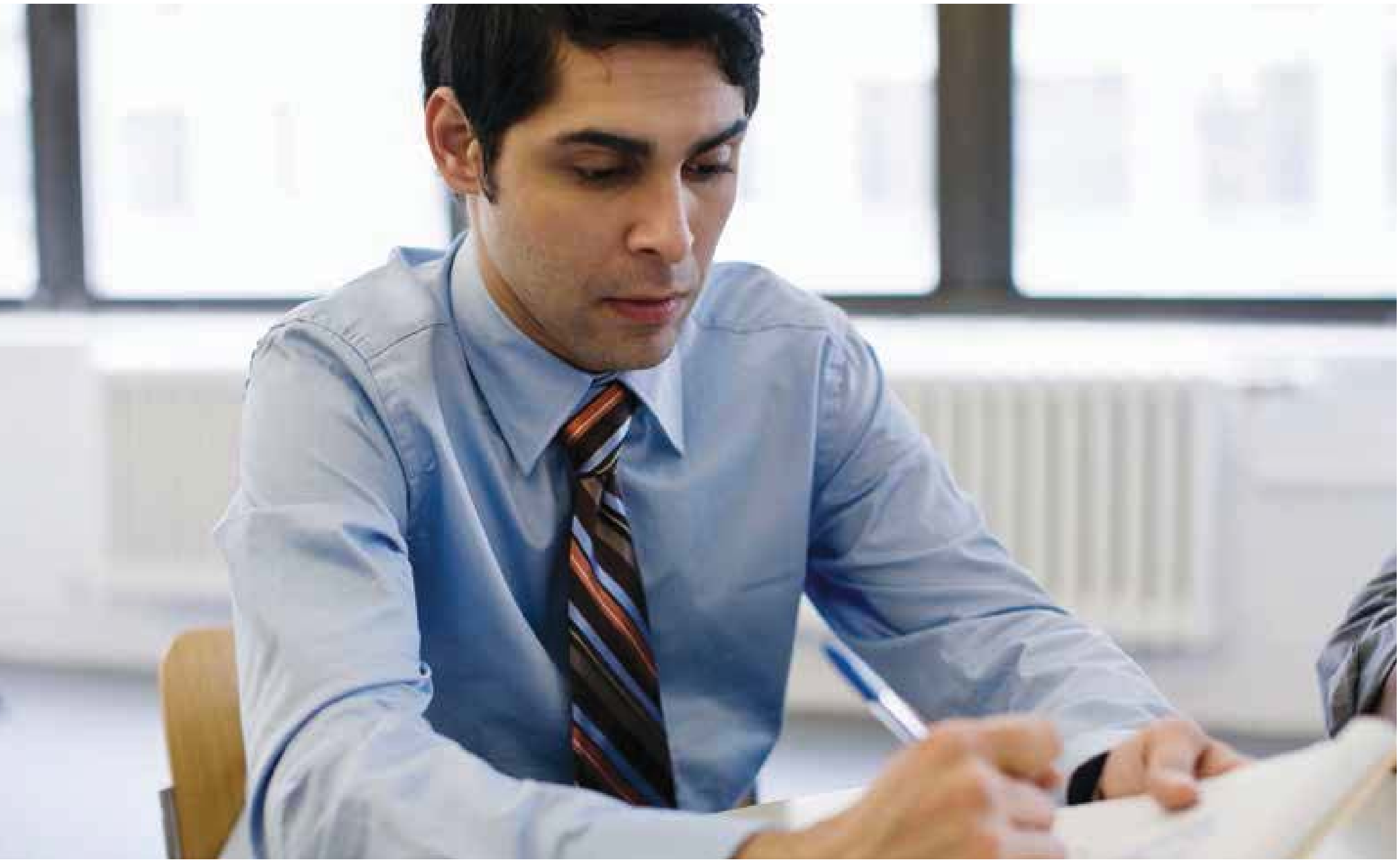
A CODA is any direct or indirect election made by an employee to the employer to either receive an amount in the form of cash or other taxable benefit or contribute the amount to a trust, thus deferring the receipt of compensation. (A Roth 401(k) also qualifies as CODA.) The election generally remains in force until the participant either changes the election through written or approved electronic means or ceases to be an employee of the employer that sponsors or adopted the plan.

EXAMPLE OF A NON-QUALIFIED CODA

In this hypothetical example, Elsinore Brewery sponsors a calendar year, trustee-directed profit sharing plan providing an allocation to all participants based on classification. The class or grouping methodology allows the individual participants to constitute a class of their own. The Elsinore profit sharing plan is top heavy, and the owners of the company generally receive allocations to the maximum annual additions for the plan's calendar limitation year. The compensation definition has no exclusions, and the plan uses a five-year graded vesting schedule.

> "Timely documentation is the best defense against misinterpreting the actions of the plan sponsor and its participants."

Elsinore designed the plan to cover both top-heavy contributions for non-key employees and gateway minimum contributions for all non-highly compensated employees as of the last day of the fiscal year ending on October 31. The plan satisfies coverage and nondiscrimination beginning with a contribution of at least the gateway minimum. Each November for the past five years, during employee performance reviews Elsinore has given bonuses and allowed participants to either receive the bonus as pay or use part or all of the bonus as an additional contribution to the profit sharing plan, up to the maximum annual addition. If the bonus is paid, it is reported as compensation for plan purposes; however, if the bonus



is contributed, it is not included in compensation. The plan has no CODA provision.

Elsinore provides a substantial benefit for its participants and uses a favorable methodology for the morale of the staff by giving a choice on how to utilize the bonus. Unfortunately, the election by each employee to receive the bonus or have the company contribute to the plan is a CODA. Without a CODA provision in the plan, the result is a nonqualified CODA with potentially costly ramifications.

Elsinore Brewery illustrates one side of the CODA issue. The company will need the help of a competent service provider to identify and correct the violations through EPCRS or VCP before the IRS audits the plan.

EXAMPLE: PARTNERSHIPS AND SOLE PROPRIETORS

Any contribution to an employer sponsored retirement plan from the partnership or sole proprietorship to a partner or sole proprietor is a CODA. The employer contribution is a tax deductible expense for the employer; however, the tax deductible contribution comes directly from the income that is payable to the partner or sole proprietor if not paid to the plan. Furthermore, the decision to make the contribution is typically the partners' or sole proprietor's as plan sponsor, administrator and trustee.

Code Section 1.401(k)-1(a)(6)(iii) specifically provides that a partner in a partnership or a sole proprietor must make the election to defer before the end of the partnership tax year or the individual tax year respectively as compensation is deemed earned income as of the last day of the applicable tax year. An election or decision to defer after the tax year closes is problematic and changes to nature of the contribution.

Consider two hypothetical examples. In the first example, Bob and Doug, partners in a partnership, filing on calendar tax and plan years 2012, each make the decision and subsequent election to make a portion of their annual contribution as 401(k) as well as a resolution to fund non-elective contributions and determine the staff contribution under a new comparability allocation provided in the plan document. They make a resolution on the first Monday of December each year at the final partner meeting, providing each partner with annual additions appropriate to their personal cash flow needs and a 5% of pay allocation to eligible staff members to be increased as necessary to satisfy the nondiscrimination rules. Bob and Doug have exercised their decisions appropriately whether their contributions change or remain constant from year to year.

In the second example, Laverne and Shirley are in a partnership arrangement similar to Bob's and Doug's, except that Laverne and Shirley send emails independently to their service provider each February providing the amount of contributions they want in the plan for the previous plan year without consent of action, resolution or deferral election on file. The Laverne and Shirley plan is either characteristically all CODA, or more likely not CODA. Laverne's or Shirley's annual additions are effectively all employer non-elective contributions resulting in an increased staff cost to satisfy rate group testing.

The repercussion of the timing error may require amended partnership and individual tax returns including adjustment of FICA/FUTA and income taxes paid on top of the additional staff cost.

MITIGATING AND PREVENTING VIOLATIONS

The consequences of CODA violations reach across several aspects of qualified plan regulations, and the preeminent prevention is fundamental to appropriate fiduciary standards.

Timely documentation is the best defense against misinterpreting the actions of the plan sponsor and its participants. It's best to designate a decision making body to approve, ratify and aggregate the individual members elections on employer contributions. That way, employer contributions are resolved by group consensus consistent with other plan related decisions. Since contributions are often made in the tax year following the deduction, documentation of the committee's decision also supports the intended year of funding and deduction. The amount may not be determinable before the tax year ends, but the committee may still provide a decision to make or not make an employer contribution.

To avoid late and potentially harmful decisions, maintain electronic or hard copy deferral elections for all participants including partners and sole proprietors. Affirmative election for a zero deferral is as important as an election to defer especially in a safe harbor plan where notification is a key component to the safe harbor status. Partners who choose to wait until the end of the year to contribute should review the election each year before the tax year ends and either make a new election or leave the election in place.

A linguist can appreciate that facts and circumstances define terms like employer, employee and CODA. When auditing or examining the behavior of a plan sponsor and its participant the processes and procedures should present a clear line between the employee making an election and the employer resolving to act. PC

JJ McKinney, CPC, ERPA, QPA, QKA, is a principal and COO of Retirement Strategies, Inc., a service provider for employer sponsored retirement plans in Atlanta. Plan consulting, education and advocacy for the private pension system are his professional passions.