Stand by Your Plan: Disqualification for Failure To Follow the Plan Terms After *Shedco*

Old question: What if they had a war and nobody came? *New question:* What if the IRS declared war on a qualified plan under a novel theory of plan disqualification, lost the war in Tax Court, and nobody even noticed? That is just what happened last summer in a case involving a proposed disqualification of a small defined benefit plan. The case was *Shedco, Inc. v. Commissioner*, T.C. Memo 1998-295.

On its face, the *Shedco* case involved a sadly familiar issue—small businessman sets up a qualified plan and then invests virtually all of the assets in an investment that benefits the businessman/plan sponsor. The qualified plan in *Shedco* covered two individuals. One of these plan participants also served as plan trustee and also happened to be the principal shareholder of the plan sponsor. The plan participant/trustee/owner made an unsecured loan of 90 percent of plan assets to a partnership in which he had a financial interest. The plan sponsor had at one time been a partner in the partnership that received the plan loan, but the sponsor's partnership interest had been bought out a few years before the loan was made. The partnership buyout was structured as a ten-year buyout, so it appears that the plan sponsor was a creditor of the partnership when the plan loan occurred. The loan eventually went into default and the creditor/partnership filed for bankruptcy.

Enter the IRS. Based on these facts the Service argued that the plan was disqualified because the plan, through its trustee's actions, had violated the "exclusive benefit" rule. The *Shedco* case is not novel in this regard. There are a number of cases in which the courts have upheld plan disqualifications based on abusive plan investments, although they typically involved sizeable plan investments that benefited the plan sponsor. (*Central Motor Company v. U.S.*, 454 F. Supp 54 (D.N.M. 1976); *Winger's Deptartment Store v. Commissioner,* 82 T.C. 869 (1984).) *Shedco* certainly presented a less abusive case. Although the magnitude of the loan was eye-catching, the

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Shedco loan did not have quite the level of self-interest as found in the other cases. The plan sponsor apparently was a creditor of the partnership at the time that the loan was made, but no evidence was cited to prove that the partnership was in need of cash to pay off the plan sponsor.

The stunning aspect of the case focused on a second disqualification argument framed by the IRS. The plan contained the standard recitation of the ERISA fiduciary requirements, more or less repeating the fiduciary requirements of ERISA Section 404. This included a requirement that the "Trustee shall diversify the investments of the Plan so as to minimize the risk of large losses unless under the circumstances it is clearly prudent not to do so." The IRS argued that the plan loan not only violated the Code's "exclusive benefit" rule, but also that the trustee had violated the plan terms in making the loan. In short, the Service contended that the failure to follow plan terms provided a separate basis for plan disqualification. Judge Parr of the Tax Court did not buy the Service's conclusion, although the judge did agree with its premise. The judge found that the plan loan was an imprudent investment that failed to comply with the plan terms requiring diversity of plan investments, but that it constituted an "isolated violation" of the prudent investor rule, and did not warrant plan disqualification under any theory.

The *Shedco* opinion is noteworthy in a number of respects. To our knowledge, this is the first case in which the Service has argued in court that the failure to follow plan provisions results in plan disqualification. The Service's basic legal position on the need to follow plan terms is not new; the Service has taken this position for years, with roots going back at least as far as Revenue Ruling 70-315, 1970-1 CB 91.

The question of properly following plan terms also is the foundation of the voluntary correction programs of VCR and APRSC. (Rev. Proc. 94-16, 94-1 C.B. 576, §3.02; Rev. Proc. 94-62, §4.03; Rev. Proc. 98-23, §1.02.) Taken together, the VCR and APRSC procedures stand for a policy of strict liability whereby *any* failure to follow plan terms presents grounds for plan disqualification, although disqualification can be avoided if the operational failure is corrected for all years. These correction policies do not distinguish between de minimis failures and more serious failures of plan operation, other than by providing that "insignificant" operational failures may be corrected even after detection by the IRS.

Shedco stands for the broader proposition that an "isolated" failure to follow plan documents does not provide grounds for

disqualification even if the failure is left uncorrected. *Shedco* may be the first case to state this conclusion so starkly, but it is not the only such authority. Taxpayers and their advisors understandably have been reluctant to explore the outer reaches of the law on plan operational failures, but to our way of thinking the legal authorities are not as weak as many advisors seem to believe. A more careful investigation reveals numerous cases in which the courts have stated that inadvertent, immaterial errors in the administration of qualified plans do not justify the retroactive disqualification of such plans. (See *Ahlberg v. United States,* 780 F. Supp. 625 (D. Minn. 1991); *Lansons, Inc. v. Commissioner*, 622 F.2d 774 (5th Cir. 1980), affirming 69 T.C. 773 (1978); *Ludden v. Commissioner*, 620 F.2d 700 (4th Cir. 1980), affirming 68 T.C. 826 (1977); *Buzzetta Construction Corp. v. Commissioner*, 92 T.C. 641 (1989); *Ray Cleaners,* ¶ 68,006 P-H Memo T.C. (1968); *Forsyth Emergency Services, P.A. v. Commissioner*, 68 T.C. 881 (1977); *Henry T. Boggs v. Commissioner*, 784 F.2d 1166 (4th Cir. 1986), vacating and remanding 83 T.C. 132 (1984); *Martin Fireproofing Profit-Sharing Plan and Trust v. Commissioner*, 92 T.C. 1173 (1989); and *Myron v. U.S.*, 382 F. Supp. 590 (C.D. CA 1974).)

The *Ray Cleaners* opinion is a particularly strong authority for the position that plan administration failures do not make for plan disqualification. *Ray Cleaners* involved a question of insufficient plan coverage and the facts reveal that the coverage problem was exacerbated by the inadvertent failure to offer participation in the plan to three non-highly compensated employees. The Tax Court found the failure to follow plan terms "inadvertent" and held that "[w]e do not think that an inadvertent omission disqualifies a plan." By so holding, the Tax Court permitted an error rate of greater than 27 percent, when you consider the participation rate of employees who had passed the plan eligibility standards.

In holding that "isolated" plan failures do not present grounds for plan disqualification, *Shedco* can be viewed as the reflection of a general doctrine of substantial compliance, which the Service and the courts have recognized in a variety of contexts involving ERISA plans. (See, for example, Treas. Reg. Sections 1.402(c)-2, Q&A-6(b)(1), 35.3405-1, Q&A-B-5, and 35.3405-1, Q&A-B-8; *Brown v. Retirement Committee of the Briggs & Stratton Retirement Plan*, 797 F.2d 521 (7th Cir. 1986); *Sage v. Automation, Inc. Pension Plan & Trust*, 845 F.2d 885, 892, 9 EBC 1898 (10th Cir. 1988); *Wolfe v. J.C. Penney Co.*, 710 F.2d 388, 393, 4 EBC 1795 (7th Cir. 1983).) In the early 1980s, the Service embraced the notion of "substantial compliance" in the post-ERISA enforcement procedure known as ENCEP (ERISA

Noncompliance Enforcement Program, Notice 80-7, 1980-1 C.B. 598). Under ENCEP, for example, the incorrect crediting of service for eligibility and vesting purposes was not deemed fatal to substantial plan compliance. A more recent example of the substantial compliance approach is found in the notice requirements of ERISA Section 204(h). Final regulations issued by Treasury (which, confusingly, has jurisdiction) recognize that violations of the vesting rules of Code Section 411 will not result in plan disqualification where the employer acted in good faith and the errors are de minimis. (Treas. Reg. §411(d)-6, Q&A 13.)

As noted, the new APRSC program embodies a more limited notion of "substantial compliance" by allowing "insignificant" plan failures to be corrected without penalty at any time. The APRSC procedure rightly has been criticized, however, for its very narrow definition of an "insignificant" failure.

Shedco is thus consistent with the long history of the substantial compliance doctrine. In its administrative pronouncements and its litigating posture, the IRS has taken the position that failure to follow the plan terms is a strict liability error. Any failure that rises above the "insignificant" is grounds for disqualification. Not so, held the Tax Court. Like other operational failures, a failure to follow the plan terms is not disqualifying unless it rises above some threshold magnitude.

Shedco represents a solid victory for plan sponsors when it comes to plan operational failures but it also raises alarms. The plan provision that was violated involved a fiduciary provision that just repeated the general ERISA requirements. These provisions are standard fare in most plans. Is the Service prepared to argue that every fiduciary violation provides grounds for plan disqualification if the plan contains a provision parroting the ERISA requirements? Presumably not, but one can appreciate the Service's dilemma of having to distinguish between different types of failures to follow the plan document. Should a document violation by an "investment" fiduciary be treated differently than a similar violation by an "administrative" fiduciary? Does it matter if the offending party is a service provider that is unrelated to the plan sponsor? These questions remain to be answered.

Shedco should also give pause to plan drafters and force them to reconsider standard drafting techniques. At the risk of sounding heretical, we wonder if it is really necessary to repeat all of the ERISA fiduciary requirements in the plan document in the first place. After all, the law is the law and applies whether or not paraphrased in the

plan. Many plans, nonetheless, spell out elaborate fiduciary "do's" and "don'ts" and provide, for example, that plan fiduciaries should not engage in any prohibited transactions. Is this kind of directive in a plan document likely to deter any such transactions? Clearly not. So why include it if it only serves to give the Service grounds for challenging plan qualification for failure to follow the plan? Cases such as *Siskind v. Sperry Retirement Program*, 47 F.3d 498 (2d Cir. 1995) and *Amato v. Western Union International, Inc.*, 773 F.2d 1402 (2d Cir. 1985), pointed out the problems of plan "uniformity" clauses and overly-broad plan termination provisions. *Shedco* may be another such warning signal to plan drafters.

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