401(k) Plan Administration: Fiduciary Responsibility and The Impact of Changes to Your Plan

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Introduction

• Our discussion today focuses on
  – Fiduciary responsibility and best practices
  – Fee disclosure requirements
  – Plan design changes to provide increased incentives/cost savings
  – Common plan administration errors/corrections
FIDUCIARY RESPONSIBILITY AND BEST PRACTICES
Introduction

- Fiduciary responsibility and best practices should be a priority for employers, plan sponsors, retirement plan committees and trustees
  - Economic environment/market volatility
  - Increased litigation
  - Declining retirement account values/poor investment returns
  - 401(k) fee disclosure requirements
ERISA Fiduciary Requirements

- The Employee Retirement Income Security Act of 1974 ("ERISA") requires that a fiduciary discharge his/her duties with respect to a plan
  - solely in the interest of the participants and beneficiaries,
  - for the exclusive purpose of providing benefits to participants and their beneficiaries and defraying reasonable expenses of administering the plan,
  - with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims,
ERISA Fiduciary Duties

• ERISA requires that a fiduciary discharge his/her duties with respect to a plan
  
  − by diversifying 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, and
  
  − in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the applicable provisions of ERISA
ERISA Fiduciary Duties

• Fiduciary Liability:
  – Fiduciaries may be held personally liable for their actions or inactions
  – It is extremely important for every fiduciary to fully understand his/her fiduciary responsibilities
Who is a Fiduciary?

- A person (or entity) is a fiduciary with respect to a plan if he or she
  - exercises any discretionary authority or discretionary control with respect to the management of the plan
  - renders investment advice for a fee or other compensation, direct or indirect, with respect to any money or other property of such plan, or has any authority or responsibility to do so
  - has any discretionary authority or discretionary responsibility in the administration of such plan, or
  - is a named fiduciary under the plan (e.g., plan administrator, administrative and investment committees, trustee)
  - a person’s title or office does not control the legal designation of a fiduciary
Who is a Fiduciary?

• Many firms establish a “committee” to act as a fiduciary with respect to a plan’s investment and/or administrative decisions

• The committee must be formally appointed usually done by the Board in accordance with the bylaws
  – Important considerations in determining the members of the committee
    o Education/Financial knowledge
    o Understanding of the plan
    o Acknowledgment of fiduciary responsibilities
  – Important considerations for the committee member
    o Fiduciary liability insurance
    o Indemnifications
Fiduciary Best Practices

• Have a working understanding of the laws that affect the plan and trust
• Read and understand the plan document
• Prepare and periodically review the plan administration to ensure it is consistent with the plan document
• Formalize and document the process for selection of investments
• Monitor the plan investments
• Prepare and periodically evaluate the investment policy statement
• Monitor service providers
• Periodically review and evaluate the fees that are charged with respect to the plan to determine reasonableness
Delegating Fiduciary Responsibility

• Can an investment fiduciary eliminate its fiduciary responsibilities by delegating responsibilities to others:
  − Discretionary Trustees and/or Investment Managers
  − Participant Directed Investments
  − Investment Advisors
Discretionary Trustees and/or Investment Managers

- A discretionary trustee and/or investment manager assumes fiduciary responsibility for the investment decisions that it makes.
- Discretionary trustee and/or investment manager usually requires that the plan sponsor or other fiduciary establish investment guidelines (e.g., investment policy) under which the trustee and/or investment manager will act.
- The fiduciary that establishes the investment guidelines/policy takes on fiduciary responsibility in doing so.
Discretionary Trustees and/or Investment Managers

- The fiduciary who has responsibility for hiring a discretionary trustee and/or investment manager has fiduciary responsibility for selecting and periodically monitoring the performance of the discretionary trustee and/or investment manager.
- The process of selecting and monitoring the performance of the trustee and/or investment manager should be fully documented.
Participant Directed Investments

- Section 404(c) of ERISA provides that plan fiduciaries shall not be liable for a participant’s investment decisions if the participant exercises control over the assets in his/her accounts in accordance with regulations issued by the DOL.
- However, a plan fiduciary retains responsibility for selecting, periodically monitoring the performance of, and replacing investment options available to participants under the plan.
Participant Directed Investments

• If a plan is intended to be an ERISA 404(c) plan but fails to comply with the technical requirements of applicable regulations issued by the DOL, then a plan fiduciary may be precluded from raising ERISA 404(c) as a defense

• Default investments (for participants who do not make an investment election) receive ERISA 404(c) protection if the default investment satisfies applicable regulations issued by the DOL and required disclosures are made to participants
Participant Directed Investments

• General 404(c) Requirements
  − Employer notification: The plan intends to comply with 404(c) and participants have control
  − Investment choices: The plan must offer at least three “core” investments
  − Transfer Flexibility: Participants can transfer between funds at least quarterly
  − Investment information: Provide participants with sufficient investment information
    o Education versus advice
Investment Advisors

- Most plan sponsors would be well advised to hire a qualified independent investment advisor to assist it in selecting, monitoring and replacing investment options available to participants under a participant directed plan.
- In the case of a plan that is not participant directed, a qualified investment advisor can assist the plan sponsor in selecting, monitoring and replacing discretionary trustees and/or investment managers.
The Role of the Fiduciary

• Fiduciaries have many roles with respect to the plan including
  – Selecting and monitoring plan investments
  – Establishment of an investment policy statement
  – Monitoring fees and expenses
  – Administration of the plan
Selecting and Monitoring Plan Investments

- Selecting and monitoring plan investments
  - Appropriate asset classes
  - Number of investment options
  - Selection process
  - Qualified Default Investment Alternative (QDIA)
Investment Policy Statement

• A comprehensive investment policy statement will set forth the process for investment related decisions, including the due diligence process in evaluating investment options and the process for selecting and monitoring investments.
Investment Policy Statement

• An investment policy statement will identify:
  – plan fiduciaries and their responsibilities
  – the acceptable asset classes
  – specific criteria for selecting and monitoring investments – qualitative and quantitative
  – default investment alternative (QDIA)
  – criteria and method for replacing investments
Plan Administration and Document Reviews

• Review plan documents and plan administration procedures to help ensure compliance with plan documents
• Review and update plan committee charter as needed
• Review service provider agreements to ensure that all services to be provided are covered in sufficient detail
• Monitor the services provided by your third party administrator, recordkeeper and trustee to ensure they are following the terms of the plan
Plan Fees and Expenses

• Fiduciaries must ensure the fees and expenses of the plan are reasonable
  – Plan assets may be used to pay for services to the plan if the services are necessary for the operation of the plan and the fees are reasonable
  – The new DOL Fee Disclosure Regulations that became effective this year will help plan fiduciaries review and analyze plan fees and expenses
Plan Fees and Expenses

• Fiduciaries must not only understand what is paid in fees but how those fees compare to similarly situated plans

• Fiduciaries must understand the following:
  – Service fees
  – Investment expenses
  – Transaction-based fees (loans, withdrawals, etc.)
  – Total plan fees
Fiduciary Responsibility and Best Practices

Process, Process, Process

- In order to demonstrate that the plan sponsor or other internal fiduciary has acted prudently (as defined under ERISA), the fiduciary should fully document in writing the process it used in making its fiduciary decisions.
- The process used is generally much more important than the results produced.
FEE DISCLOSURES
Fee Disclosures

• Plan fiduciaries are required to ensure that the fees and expenses associated with the plan are reasonable
• In prior years this has been a difficult task as in most cases it was very difficult to tell what fees and expenses were charged to the plan
• Most fiduciaries and plan sponsors did not understand what fees were paid with respect to 401(k) plans
• This topic has been discussed for years culminating in the final fee disclosure regulations issued by the DOL
Fee Disclosures

• The DOL issued final regulations to facilitate fee transparency by requiring fee disclosure by service providers and plan administrators

• Retirement plans generally must satisfy the fee disclosure requirements on the following two levels:
  – Participant Level Fee Disclosure
  – Service Provider Level Fee Disclosure
Participant Fee Disclosure

• Participant Fee Disclosure Requirements
  – The DOL regulations require that plan administrators must disclose information relating to plan fees and expenses to plan participants and beneficiaries
  – The first annual disclosure was required to be given to participants no later than August 30, 2012, and the first quarterly fee disclosure statement must be provided no later than November 14, 2012
  – Two types of disclosures are required: plan related disclosures and investment related disclosures
Participant Fee Disclosure

• Plan Related Disclosures
  – Plan related disclosures are broken into the following three categories
    o  General Plan Information
    o  Administrative Expense Information
    o  Individual Expense Information
  – Disclosures must be provided on a quarterly statement and must provide
    o  the dollar amount of the fees and expenses charged during the preceding quarter to the participants’ accounts
    o  a description of the services to which the charge relates
    o  if applicable, an explanation that some of the plan’s administrative expenses for the preceding quarter are paid from total annual operating expenses of one or more of the designated investment funds
Participant Fee Disclosure

• Investment Related Disclosures
  – On or before a participant is allowed to direct their investments and annually thereafter, the plan administrator must furnish the following information with respect to each designated investment fund:
    o Identifying Information
    o Performance Data
    o Bench Mark Information
    o Fee and Expense Information
    o Website Information
    o General Glossary of Terms
Participant Fee Disclosure

• Additional information to be provided upon request
  – Copies of prospectuses,
  – copies of financial statements, a statement of the value of a share or unit of each investment fund,
  – a list of assets in the portfolio of a designated investment fund and the value of each such asset
Participant Fee Disclosure

• Fiduciary Responsibilities: The regulations do not relieve fiduciaries of their duty to defray reasonable expenses with respect to administering the plan
  – Fees and expenses should be reviewed on a regular basis (at least annually) to ensure that such fees and expenses are necessary and reasonable for purposes of the plan
  – Review the annual participant notice (and any related change notices) for completeness and accuracy
  – Review the distribution process for the notice to ensure compliance with the regulation
  – Plan fiduciaries are liable for providing participant fee disclosure information
  – Failure to provide required information may result in a breach of fiduciary duty

• Employee Reactions
Service Provider Fee Disclosure

• Service Providers Fee Disclosure Requirements
  – By July 1, 2012, service providers were required to disclose fee related information to plan fiduciaries
  – Over the years, the DOL has issued several sets of regulations that require covered service providers to disclose fees to retirement plans (and plan fiduciaries)
  – This was in an effort to assist plan fiduciaries in determining whether the fees and expenses were reasonable
Service Provider Fee Disclosure

• Fiduciary Requirements
  – With respect to plan sponsor fee disclosure, the fiduciary should review the information received for the plan in order to make a reasonableness determination regarding fees paid for services received
  – If the plan fiduciaries believe that the value received is consistent with the fees paid, they should document their review and determination
  – If they do not believe that the plan fees are justified by the services delivered, they must take actions to align plan fees and services better (e.g., working with the provider to reduce fees or enhance services, or both)
Service Provider Fee Disclosure

• Reasonableness of fees under ERISA section 408(b)(2)
  – The determination of whether fees are reasonable depends on the relevant facts and circumstances
  – When determining reasonableness of fees, plan sponsors should consider such aspects as quality of service, costs, complexity of the plan, and needs to the participants
  – No one factor is dispositive
  – Obtaining a competitive bid, industry benchmarks and surveys are all methods that can be used to evaluate fees
Service Provider Fee Disclosure

• The plan’s fiduciary is responsible for ensuring that the service provider fee disclosures have been made

• If a covered service provider does not make the required disclosures, then the responsible fiduciary must report the failure to the DOL
PLAN DESIGN CHANGES TO PROVIDE INCREASED INCENTIVES/COST SAVINGS
Introduction

Plan design drives the level of plan participation, maximum contributions to the plan and the costs associated with the plan administration.
Introduction

• There are several ways a plan can be designed to enhance the benefits to the participants:
  – Adding a Roth elective deferral
  – Increasing matching contributions
  – Converting to a safe harbor
  – Adding or enhancing an existing profit sharing plan component
    o Integrated
    o Age-weighted
    o Cross-tested
  – Adding a cash balance plan
  – Defined Benefit 401(k)
Introduction

• The optimal plan design for a firm will depend on
  – The demographics of the participants
  – The underlying goals
    o Maximizing deferrals
    o Minimizing administrative costs
  – Owners/Shareholders
  – Funds available for employer contributions
  – Stability/profitability of the firm
  – Economic environment
ROTH Elective Deferrals

• Roth elective deferrals may be incorporated in an existing 401(k)
• Roth elective deferrals are contributions are made with after-tax dollars, and any “qualified distributions” of the contributions plus earnings would be completely tax-free
• Provides additional options to participants
Matching Contributions

• Increased matching contributions under a 401(k) plan can increase participation in the plan
• The more participation by non-HCEs, the less likely the plan is to fail ACP/ADP tests and allow the HCEs to contribute more
• The more plan assets the better the investment options and the administrative expenses will be less
Safe Harbor Plans

• Safe Harbor Plans reduce complexity because they are automatically deemed to pass the ADP and ACP Non-discrimination Tests and in some cases the top heavy test required by traditional 401(k) Plans

• Allow Highly Compensated Employees to contribute the maximum salary deferral without concern about refunds caused by the ADP and ACP tests resulting from low non-HCE participation
Safe Harbor Plans

- Safe harbor plans can include other types of contributions (e.g., cross-tested profit sharing feature) to provide for the maximum contribution permitted in a defined contribution plan.
- Contributions are required, an employer must be willing and able to fund annual contributions on employees’ behalf.
- Certain safe harbor plan designs automatically satisfy the top heavy test.
- Safe Harbor employer contributions are fully vested, these plans are attractive to employees.
Safe Harbor Plans

- Employers are required to make fully-vested safe harbor contributions on behalf of employees
- The required contribution can be structured several ways as discussed below:
  - **Matching Options** – matching contributions must be equal to
    - 100% of employee elective contributions up to 3% of compensation and 50% of employee elective contributions on the next 2% of
    - alternatively, the matching contribution can be equal to 100% of employee elective contributions up to 4% of compensation
  - **Non-Elective Option** – Employers can also choose to fund the required contribution as 3% non-elective contribution to all eligible participants including those that do not make employee contributions)
Safe Harbor Plans

• Requirements for firms considering a Safe Harbor 401(k) Plan
  – a Safe Harbor Notice must be provided to each eligible participant at last 30 days prior to the beginning of each plan year in which safe harbor contributions will be given
  – New Safe Harbor 401(k) Plans are required to have a minimum plan year of at least 3 months
  – Employment condition or hours requirement cannot be imposed on the receipt of safe harbor contribution
  – All safe harbor contributions are 100% vested, but any non-safe harbor contributions made to a Safe Harbor Plan can be made subject to vesting
Integrated Profit Sharing

• Under an Integrated Profit Sharing formula compensation is broken out into two parts; the amount above the integration level – usually the social security wage base (excess compensation) and the amount below the integration level (base compensation)
• The employer applies a lower contribution percentage to the base compensation (i.e., the base percentage) and a higher contribution percentage to the excess compensation (i.e., the excess percentage)
• The permitted disparity between the base percentage and the excess percentage depends on the integration level
• This type of allocation formula tends to favor higher-paid employees
Age-Weighted Profit Sharing

• An age-weighted allocation formula takes into account an employee’s age and compensation
• The age-weighted formula results in a significantly larger allocation of the contribution to eligible employees who are closer to retirement age – which could benefit the HCEs depending on the demographics
Cross-Tested Allocations

• A cross-tested plan allows an employer to create separate groups and provide each group with a different allocation.
• The cross-tested approach works by converting the defined contribution allocation into a defined benefit accrual rates and performing the nondiscrimination test on a benefits basis.
• Certain demographics are more favorable:
  – The non-HCEs should generally be younger and further away from retirement than the HCEs, giving the non-HCEs a longer time horizon for their benefits to accrue than the older HCEs have.
  – This does not have to be true for every employee for this design to work.
Cross-Tested Profit Sharing

• The cross-tested plan must pass two tests
  – The gateway test, which ensure a minimal allocation for all NHCEs
  – The nondiscrimination test

• Gateway test: There are two methods to pass
  – Provide a 5% gateway allocation to all non-HCEs
  – Restrict the highest allocation to any HCE to no more than three times the lowest allocation (other than zero) provided to any non-HCE

• Nondiscrimination test
  – There are a number of complex steps in the nondiscrimination testing process of converting the allocations to an equivalent benefit accrual rate and determining that the benefit accrual for each employees passes nondiscrimination
  – No guarantee that it will pass from one year to the next if the demographics change
  – Estimate prior to plan year end
Cross-Tested Allocations

• Cross-tested allocations are usually discretionary contributions determined annually by the employer
• The plan’s rate groups and allocations may be changed from year to year, providing employers with flexibility as employee demographics changes
• A defined contribution plan must have a definitely determinable allocation formula, therefore the rate groups must be spelled out explicitly in the plan document
Cash Balance Plans

• A Cash Balance plan is a type of defined benefit plan that takes advantage of age and salary differences
• A Cash Balance Plan provides a “hypothetical” account balance for the participants which accrues interest at a pre-defined government rate
Cash Balance Plans

- Cash Balance Plans work best for those firms and professional organizations where
  - Key employees are older than some staff employees
  - There is a desire to have larger contributions for certain classes of employees
  - the necessary resources are available to keep up with the required contributions
Cash Balance Plans

• Advantage
  – Depending on the demographics, a cash balance plan may provide significantly higher contributions to key employees especially when combined with a 401(k) or Profit Sharing Plan
Cash Balance Plans

• Disadvantages
  – Requires an individually designed plan document
  – There are additional actuarial and administrative costs
  – Required minimum contributions
Defined Benefit 401(k) Feature

- Combined defined benefit and defined contribution plan in a single trust
- Available to small employers averaging between 2 and 500 employees
- Nondiscrimination tests satisfied
- Uniformity
Defined Benefit 401(k) Feature

• Required contributions
  – Defined benefit
    • FACX1% YoS pr FAC x 20
    • 100% vested after 3 years
  – Defined contribution
    • 4% ACA with match equal to 50% on employee contributions up to the first 4% of compensation
    • Notice Requirements
    • Immediate vesting
COMMON ADMINISTRATION ERRORS/CORRECTIONS
Introduction

• Everybody makes mistakes
• Find and correct the before the IRS or DOL comes in as part of an audit or investigation
• IRS and DOL correction programs
  – Employee Plans Compliance Resolution System
  – Delinquent Filer Voluntary Correction Program
  – Fiduciary Correction Program
• Here is my Top Ten List of common errors
Failure to Follow the Terms of the Plan

- **Mistake:** You did not base the plan’s operations on the terms of the plan document
- **How to Find the Mistake:** Independent review of plan and its operation – often found during annual audits
- **How to Fix the Mistake:** Apply reasonable correction method that would place affected participants in the position they would have been if there were no operational plan defect
- **How to Avoid the Mistake:**
  - Communicate to make all relevant parties aware of plan changes on a timely and accurate basis (best practices)
  - Review the plan and administrative practices least annually
Incorrect Definition of Compensation

• **Mistake:** You did not use the plan’s definition of compensation correctly for all deferrals and allocations

• **How to Find the Mistake:** Review the plan document and the plan allocations

• **How to fix the Mistake:** Corrective contribution or distribution

• **How to Avoid the Mistake:** Perform annual reviews of compensation definition, types of compensation and payroll codes and ensure that the person in charge of determining compensation is properly trained to understand the plan document
Excluded Eligible Employees from Matching Contributions

- **Mistake:** Employer matching contributions were not made to all appropriate employees

- **How to Find the Mistake:** Review the plan document to determine the correct matching contribution formula and allocation formulas and compare it to what is used in operation

- **How to fix the Mistake:** Apply reasonable correction method that would place affected participants in the position they would have been if there were no operational defects

- **How to Avoid the Mistake:** Contact plan administrators to ensure that they have adequate employment and payroll records to make calculations
Eligible Employees Excluded from Deferrals

• **Mistake:** Eligible employees were not given the opportunity to make an elective deferral election

• **How to Find the Mistake:**
  – Review plan document sections on eligibility and participation
  – Check with plan administrators to find out when employees are entering the plan

• **How to Fix the Mistake:** Make a qualified nonelective contribution (QNEC) for the employee that compensates for the missed deferral opportunity (50%)

• **How to Avoid the Mistake:**
  – Monitor census information and apply participation requirements
  – Ensure enrollment kits are provided timely considering the entry dates
Failure to Timely Deposit Contributions

- **Mistake:** You have not timely deposited employee elective deferrals
- **How to Find the Mistake:**
  - Determine the earliest date you can segregate deferrals from the general assets safe harbor for small employers 7 business days
  - Compare that date with the actual deposit dates and any plan document requirements
- **How to Fix the Mistake:**
  - Through DOL VFCP for prohibited transactions
  - May also be EPCRS
  - Deposit into the plan’s trust all elective deferrals withheld and earnings resulting from the late deposit
- **How to Avoid the Mistake:**
  - Coordinate with payroll provider to determine the earliest date you can reasonably segregate the deferral deposits from general assets
  - Set up procedures to ensure you make deposits by that date
Excess Contributions

• **Mistake:** Elective deferrals were not limited to the amounts under Code Section 402(g) for the calendar year and excess deferrals were not distributed

• **How to Find the Mistake:** Inspect deferral amounts for plan participants to ensure that the employee has not exceeded the limits

• **How to Fix the Mistake:** Distribute excess deferrals and apply the appropriate tax rules

• **How to Avoid the Mistake:** Work with the plan’s third party administrators and payroll vendors to ensure that they have sufficient payroll information to verify the deferral limitations of Section 402(g) are satisfied
Failure to Update the Document

- **Mistake:** You have not updated your plan document within the past few years to reflect recent law changes
- **How to Find the Mistake:** Discuss with your third party administrator, consultant and/or attorney
- **How to Fix the Mistake:**
  - Adopt amendments for missed law changes and file under the correction program
  - A streamlined application is available
- **How to Avoid the Mistake:**
  - Use a calendar (tickler) that notes when you must complete amendments
  - Discuss with your third party/consultant
  - Review your plan document annually
  - Maintain regular contact with the company that provided or drafted the plan
Participant Loans Administration

- **Mistake:** Participant loans do not conform to the requirements of the plan document and IRC section 72(p)/potential prohibited transactions

- **How to Find the Mistake:** Review the plan document, loan policy and all outstanding loans to ensure that the loans comply with the plan’s terms and employees are repaying their loans timely

- **How to Fix the Mistake:** You may correct some failures by corrective repayment and/or modification of loan terms

- **How to Avoid the Mistake:**
  - Review and follow the plan and loan policy provisions relating to making loans, including the loan amount, terms of the loan and repayment terms
  - Make sure there are procedures in place to prevent loans that are prohibited transactions
Hardship Administration

- **Mistake:** Hardship distributions were not made properly or were not permitted by the plan

- **How to Find the Mistake:** Review all in-service distributions and determine that hardship distributions met the plan requirements

- **How to Fix the Mistake:**
  - Amend plan retroactively to allow for hardship distributions
  - If impermissible hardship distribution, have participant return hardship distribution amount plus earnings

- **How to Avoid the Mistake:**
  - Be familiar with your plan document’s hardship provisions
  - Implement procedures to ensure that you follow the provisions in operation
  - Ensure that proper back-up documentation is received
  - Ensure that your plan administrators and payroll offices share the plan’s hardship distribution information
Top Heavy Plan

• **Mistake:** The plan was top-heavy and the required minimum contributions were not made to the plan

• **How to Find the Mistake:**
  – Review the rules and definitions for top-heavy found in your plan document
  – Make a determination whether your plan is top-heavy for each plan year

• **How to Fix the Mistake:** Properly contribute and allocate the required top-heavy minimum, adjusted for earnings, to the affected non-key employees and use the proper vesting schedule

• **How to Avoid the Mistake:** Perform a top-heavy test each year and make any required contribution
Form 5500 Filings

- **Mistake:** You have not filed a Form 5500 series return and have not distributed a Summary Annual Report to plan participants this year

- **How to Find the Mistake:** Find your signed copy of the return and determine if you filed it timely

- **How to Fix the Mistake:** File all delinquent returns

- **How to Avoid the Mistake:**
  - Understand your annual filing and audit requirements and know who filed and when
  - Do not assume someone is taking care of it for you
  - EFAST filings
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