WRMarketplace
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TOPIC: IRS and DOL Investigate Qualified Retirement Plans.

MARKET TREND: The IRS and U.S. Department of Labor ("DOL") have shifted their focus over time from document and reporting compliance to administration and fiduciary investigations. Accordingly, both agencies have developed detailed examination programs to review qualified retirement plan compliance. They have realigned and expanded their staff activities to conduct field audits and investigations to monitor and review the activities and operations of qualified retirement plans and their fiduciaries, and developed review programs for all forms of retirement plans that are triggered by specific activities, complaints, standard programs, and random selection.

SYNOPSIS: When either the DOL or IRS contacts a plan sponsor to begin the review process, it is imperative that the sponsor engage competent and experienced advisors to review the agency notices and assist with the process, including document and administration review, correspondence, and agency interviews. There is significant liability that can be assessed against the plan sponsor and fiduciaries for failure to comply with the requirements of the Employee Retirement Income Security Act ("ERISA").

TAKE AWAYS: The IRS and DOL are actively reviewing qualified retirement plan activities for compliance with ERISA, and the increasingly technical nature of these plans makes error-free compliance exceptionally difficult. When consulting with employer-clients, it is important for advisors to know: (1) the areas of enforcement and concern for each agency, (2) the potential liability for failing to properly operate a plan, and (3) the various programs available to correct plan errors. Plan sponsors and fiduciaries need to engage knowledgeable and experienced advisors to assist with the periodic review of plan operations and the correction of any errors to avoid the assessment of penalty and tax liabilities. The best preparation for these investigations is periodic compliance assessments with the assistance of knowledgeable advisors, and, if necessary, assistance navigating the various agency correction programs.

PRIOR REPORTS: 2012-26; 2012-29; 2013-17; 2013-26; 2013-47; 2014-09; 2014-16; 2014-38; 2015-1; 2015-30; 2015-35; 2015-39; 2015-41; 2016-05; 2016-13; 2016-22; 2016-26.

The IRS and DOL have shifted their focus over time from document and reporting compliance to administration and fiduciary investigations. Both agencies have realigned and expanded their staff activities to conduct field audits and investigations to monitor and review the activities and operations of qualified retirement plans and their fiduciaries. Each agency has its particular areas of enforcement and concern. There is significant liability that can be assessed against the plan sponsor and fiduciaries for failure to comply with ERISA requirements. The following reviews the agencies' areas of concern, the investigation processes, the potential liabilities, and the correction programs.

IRS ZEROES IN ON QUALIFIED PLANS

Focus of Examinations. The IRS is primarily responsible for the tax qualification of plans, such as eligibility, vesting, discrimination, distributions, etc. The key areas of IRS focus in its examinations include:

- Plan documentation, including required amendments.
- Plan operations and administration based on plan document terms.
- Eligible employees identified and participating (e.g., complete salary deferral elections).

- Correct use of the plan definition of compensation (e.g., for all salary deferrals and contribution allocations).
- Plan contributions made to appropriate employees (e.g., correct employer matching contributions).
- Plan satisfaction of statutory limits and nondiscrimination tests (e.g., annual contribution limits and 401(k) Average Deferral Percentage ("ADP") and Average Contribution Percentage ("ACP") tests).
- Timely deposit of employee deferrals, as soon as administratively possible but no later than seven days after withholding.
- Participant distributions meeting the plan document and statutory requirements (e.g., loans, hardships, minimum distributions, etc.).
- Annual filings completed (e.g., Form 5500 and audit, if required).

<u>EPTA Scrutiny</u>. Areas under scrutiny by the Employee Plans Team Audit Program ("EPTA") are:

1. <u>Plan Termination or Partial Termination - Potential Vesting/Distribution Issues</u>
    - A large drop in plan participants when comparing multiple years.
    - A large decrease in plan participants from beginning to end of the year.
    - Apparent "downsizing" by the sponsor.
    - When not all participants from an acquired plan continue to participate after that plan has been merged with an ongoing plan.

2. <u>Acquisitions</u>
    - With respect to employer allocations made each pay period, failure of the acquiring employer's profit sharing allocation to be timely made to the trust for employees of newly acquired companies.
    - Exclusion of the acquiring employer of matching contributions for employees of the newly acquired company.
    - Failure of the acquiring employer to offer all optional benefits on distributions of transferred assets from merged plans.
    - Use by the acquiring employer of incorrect compensation amounts when computing the matching contribution for business units of the newly acquired company.

3. Distributions and Loans

    - Large distributions on the income statement relative to plan assets or to a prior or subsequent plan year.
    - Failure of plan participants, who receive premature distributions or default on plan loans, to report the distributions and/or pay the 10% excise tax on their individual tax returns.
    - If the employer uses third party automated systems for participants to secure plan loans, or in-service and hardship withdrawals, failure to obtain and maintain required documentation (e.g., applications, support documents, notes, etc.) or spousal consents.

4. Assets

    - Large percentage of assets classified as other assets on the balance sheet.
    - Large percentage of assets in one single investment.
    - Large amounts of administrative expenses.
    - Significant changes in types of investments from one year to the next based on a comparative analysis of past plan years.

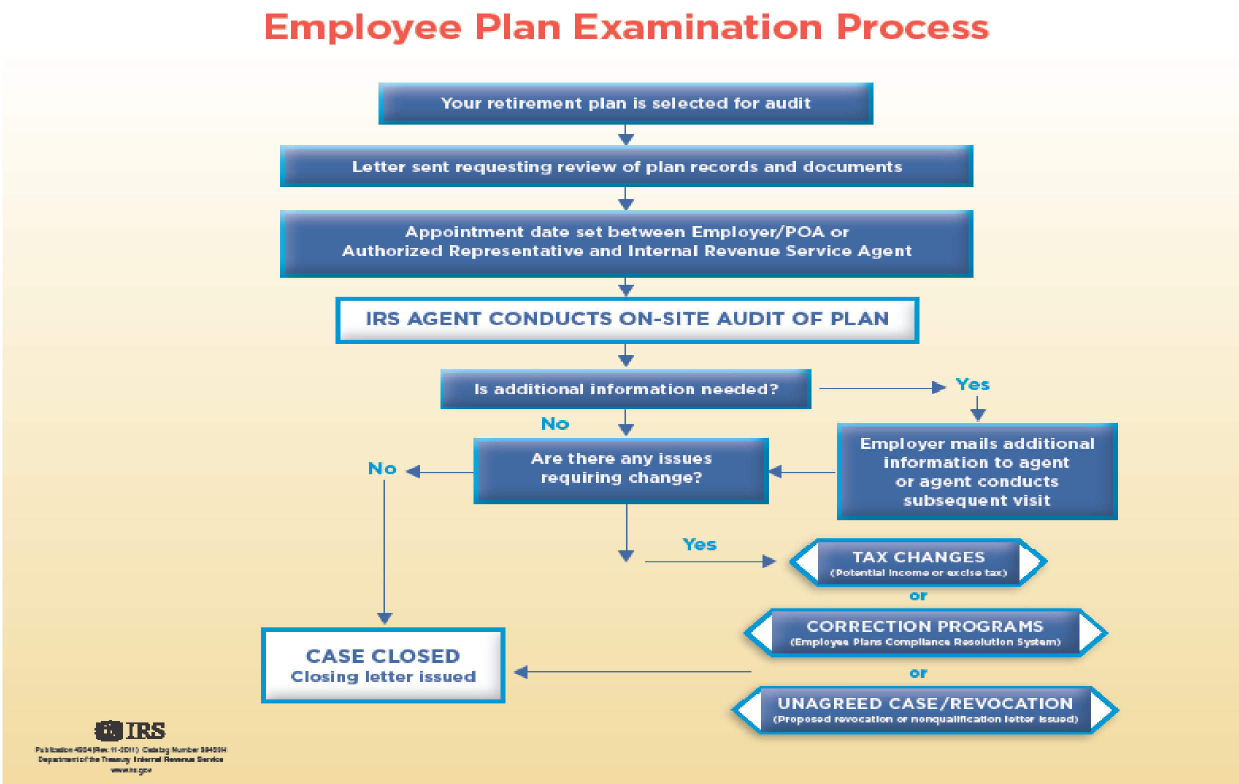
5. Administration

    - Lack of sufficient internal controls to ensure that data provided to third party record keepers/plan administrators is accurate.
    - Inaccurate data in reports and testing prepared by third parties, such as dates of hire or termination, ages of employees, amount of compensation, etc., such that the plan administrator is improperly calculating such things as vesting or employer matching allocations.

6. Special Plans

    - 403(b) plans – employer qualification, employee universal availability, and annuity contract compliance.
    - ESOPs – qualifying plan loans, employer securities, and participant distributed stock put option to plan or sponsor.

Examination Process. The IRS process for the examination of a qualified retirement plan typically proceeds as follows:



DOL ZEROES IN ON QUALIFIED PLANS

EBSA Investigation Matters. The DOL is primarily responsible for the fiduciary operation of plans, e.g., reporting, disclosure, asset management, prohibited transactions (conflicts of interest), etc. The Employee Benefits Security Administration ("EBSA") under the DOL is responsible for the administration and enforcement of DOL ERISA requirements, with a primary mission of protecting the pension, health, and other benefits of participants in private sector employee benefit plans. The EBSA conducts criminal and civil investigations, performs reviews to ensure compliance with the fiduciary provisions of ERISA, and assures compliance with applicable reporting requirements, as well as accounting, auditing and actuarial standards. The types of matters the EBSA is investigating are:

1. Civil Violations. Including:
   - Failure to operate the plan prudently and for the exclusive benefit of participants.

- Using plan assets to benefit certain related parties to the plan, including the plan administrator, the plan sponsor, and parties related to these individuals.
- Failure to properly value plan assets at their current fair market value or to hold plan assets in trust.
- Failure to follow the terms of the plan (unless inconsistent with ERISA).
- Failure to properly select and monitor service providers.
- Taking any adverse action against an individual for exercising his or her rights under the plan (e.g., being fired, fined, or otherwise being discriminated against).
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2. Criminal Violations. Violations involving employee benefit plans under the U.S. Criminal Code, including:
    - Theft or embezzlement from plans (18 U.S.C. § 664).
    - False statements or concealment of facts in relation to required documents (18 U.S.C. § 1027).
    - Offer, acceptance, or solicitation to influence operations of plans (18 U.S.C. 1954).

TROUBLE AHEAD

The effect of failing to operate or administer a qualified retirement plan according to ERISA or its terms can be as serious as disqualifying the plan or as simple as making corrections and noting them in the plan files. Plan sponsors are liable and plan fiduciaries can be held personally liable for all plan losses incurred due to violations, and there are specific penalties for certain violations. For example:

1. Failure to File or Late Filing of Form 5500. The Annual Return/Report of Employee Benefit Plan, Form 5500, which must be filed for each benefit plan of an employer, has very specific filing requirements and timing. The IRS penalties for a failure to file the Form 5500 can be up to $25 a day, capped at $15,000 per plan. The DOL also may assess civil penalties up to $300 per day, capped at $30,000 per year for the plan.

2. Failure to Correct Salary Deferral Contributions. If a plan sponsor fails to correct an employee's excess salary reduction deferrals before the end of the specified

time period, the employer will be subject to a 10% excise tax on the uncorrected amount.

FIXING THE PROBLEM

Both the IRS and the DOL have instituted correction programs to resolve plan administration issues.

IRS Programs. The key correction program for the IRS is the Employee Plans Compliance Resolution System ("EPCRS"). There are three ways to correct mistakes under EPCRS:

1. Self-Correction Program ("SCP"). Permits a plan sponsor to correct certain plan failures without contacting the IRS or paying any fee. To be eligible:
    - The plan sponsor or administrator must have established practices and procedures (formal or informal) reasonably designed to promote and facilitate overall compliance with the law. A plan document alone does not constitute evidence of established procedures. If needed, the plan sponsor should make changes to its administrative procedures to ensure that the mistakes do not recur.
    - SCP is only available for correcting operational problems (i.e., the failure to follow the terms of your plan), not for problems with the plan document, such as the failure to keep it current to reflect changes in the law.
    - Plan sponsors must follow the correction principles set forth in the applicable IRS Revenue Procedures for the particular correction being made.
    - A qualified plan sponsor (not including a SEP or SIMPLE IRA plan sponsor) may correct some significant operational failures within two years of the end of the plan year in which the operational failures occurred.
    - The SCP may be used if, considering all of the facts and circumstances, the mistakes, in the aggregate, are insignificant operational failures.
    - When using SCP, the plan sponsor should maintain adequate records to demonstrate correction in the event of an audit of the plan.

2. Voluntary Correction Program ("VCP"). Permits a plan sponsor to, any time before audit, pay a fee and receive IRS approval for correction of significant plan failures. The process includes:

- The plan sponsor makes a submission to the IRS that:
  - Includes the required completed forms,
  - Identifies the mistakes,
  - Proposes correction using the general correction principles in applicable IRS Revenue Procedures,
  - Proposes changes to its administrative procedures to ensure that the mistakes do not recur, and
  - Pays the required compliance fee.
- The IRS issues a Compliance Statement detailing mistakes identified by the plan sponsor and the correction methods approved by the IRS.
- The plan sponsor corrects the identified mistakes within 150 days of the issuance of the Compliance Statement.
- While the IRS is processing the submission, Employee Plans will not audit the plan, except under unusual circumstances.

3. <u>Audit Closing Agreement Program ("CAP")</u>. Permits a plan sponsor whose plan is under audit to pay a sanction and correct a plan failure while the plan is under audit. To be eligible:
   - The plan sponsor or plan is under audit.
   - The plan sponsor:
     - Enters into a Closing Agreement with the IRS.
     - Makes correction prior to entering into the Closing Agreement.
     - Pays a sanction negotiated with the IRS (note: the sanction paid under Audit CAP should be greater than the fee paid under VCP).
   - The sanction under Audit CAP is a negotiated percentage of the Maximum Payment Amount ("MPA") based on the sum for all open taxable years of:
     - For SEPs, SIMPLE IRA plans and SARSEPs, the:
       - Additional income tax resulting from income inclusion for employees in the plan (Form 1040), including the tax on plan distributions that have been rolled over to other IRAs (and any interest and penalties applicable to the employees' tax return).

    - Additional tax resulting from the 6% tax imposed under IRC § 4973 on excess contributions to IRAs.

  - For 403(b) plans, the:

    - Additional income tax resulting from income inclusion for participants in the plan (Form 1040), including the tax on plan distributions that have been rolled over to other qualified trusts (and any interest and penalties applicable to the participants' tax returns).

    - Any other tax that results from a 403(b) failure that would apply except for correction under the applicable IRS Revenue Procedure.

  - For 401(k) and other types of plans with a trust, the:

    - Tax on the trust (Form 1041) (and any interest and penalties on the trust tax return).

    - Additional income tax resulting from the loss of employer deductions for plan contributions (and any interest and penalties on the plan sponsor's tax return).

    - Additional income tax resulting from income inclusion for participants in the plan (Form 1040), including the tax on plan distributions that have been rolled over to other qualified trusts (and any interest and penalties on the participants' tax return).

<u>DOL Programs</u>. Like the IRS, the DOL maintains correction programs for various ERISA violations. The two main DOL programs are:

1. <u>Voluntary Fiduciary Correction Program</u> ("VFCP"). Generally:

   - The program is a voluntary enforcement program that allows plan officials to identify and fully correct certain transactions, such as prohibited purchases, sales and exchanges, improper loans, delinquent participant contributions, and improper plan expenses. The program includes 19 specific transactions and their acceptable means of correction, eligibility requirements, and application procedures.

   - The DOL will consider an application if neither the plan nor the applicant is under investigation, the application contains no evidence of potential criminal violations as determined by EBSA, and EBSA has not conducted an investigation which resulted in written notice to a plan fiduciary that the transaction, for which the potential applicant could otherwise have sought relief under the VFCP, has been referred to the IRS.

- If an eligible party properly describes the violation and documents the acceptable correction of a specified transaction, EBSA will issue a no-action letter.

2. Delinquent Filer Voluntary Compliance Program ("DFVC"). Generally:
   - The program is designed to encourage voluntary compliance with the annual reporting requirements under ERISA (e.g., late or missed Form 5500s).
   - It gives delinquent plan administrators a way to avoid potentially higher civil penalty assessments by satisfying the program's requirements and voluntarily paying a reduced penalty amount – for the DOL, a $4,000 correction fee versus a $300 per day fee with a maximum of $30,000 per year late or not filed; for the IRS, a $25 per day fee with a cap of $15,000.

EXAMPLE OF PROGRAM APPLICATION

Assume a plan sponsor is in a sale process, and the acquirer discovers during due diligence that employee salary deferral contributions have consistently been made to the 401(k) plan by the 15th of the month following the month of withholding. This is a clear violation of ERISA and must be corrected by calculating earnings on the contributions from a reasonable period after each withholding date, usually three to seven days, until the actual deposit date for each payroll, potentially back to the inception of the plan. This is generally corrected under the IRS VCP program. In addition, if the plan was specific as to when contributions are to be deposited, then an application would also be required under the DOL VFCP program because it would be deemed a violation of the plan document. While potentially not much money depending on the plan size, the cost to calculate and file the necessary applications can be substantial.

TAKE AWAYS

The IRS and DOL are actively reviewing qualified retirement plan activities for compliance with ERISA, and the increasingly technical nature of these plans makes error-free compliance exceptionally difficult. When consulting with employer-clients, it is important for advisors to know: (1) the areas of enforcement and concern for each agency, (2) the potential liability for failing to properly operate a plan, and (3) the various programs available to correct plan errors. Plan sponsors and fiduciaries need to engage knowledgeable and experienced advisors to assist with the periodic review of plan operations and the correction of any errors to avoid the assessment of penalty and tax liabilities. The best preparation for these investigations is periodic compliance assessments with the assistance of knowledgeable advisors, and, if necessary, assistance navigating the various agency correction programs.

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