

Drinker Biddle

BENEFITS   
& BREAKFAST

**Typical Areas of Focus in an IRS Audit of a 401(k) Plan**

Philadelphia – Wednesday, June 5, 2019

## Today's Agenda

- Welcome
- Introduction to IRS Audits
  - Potential Audit Triggers
  - The Audit Process
- IRS Audit Priorities
  - Top Ten List of 401(k) Plan Errors
  - Examples of Issues Examined in an Audit
- Concluding the Audit
  - What if Changes Are Required?
  - Being Prepared for the Next Audit
- Q&A

# Introduction to IRS Audits

## IRS' Audit Authority

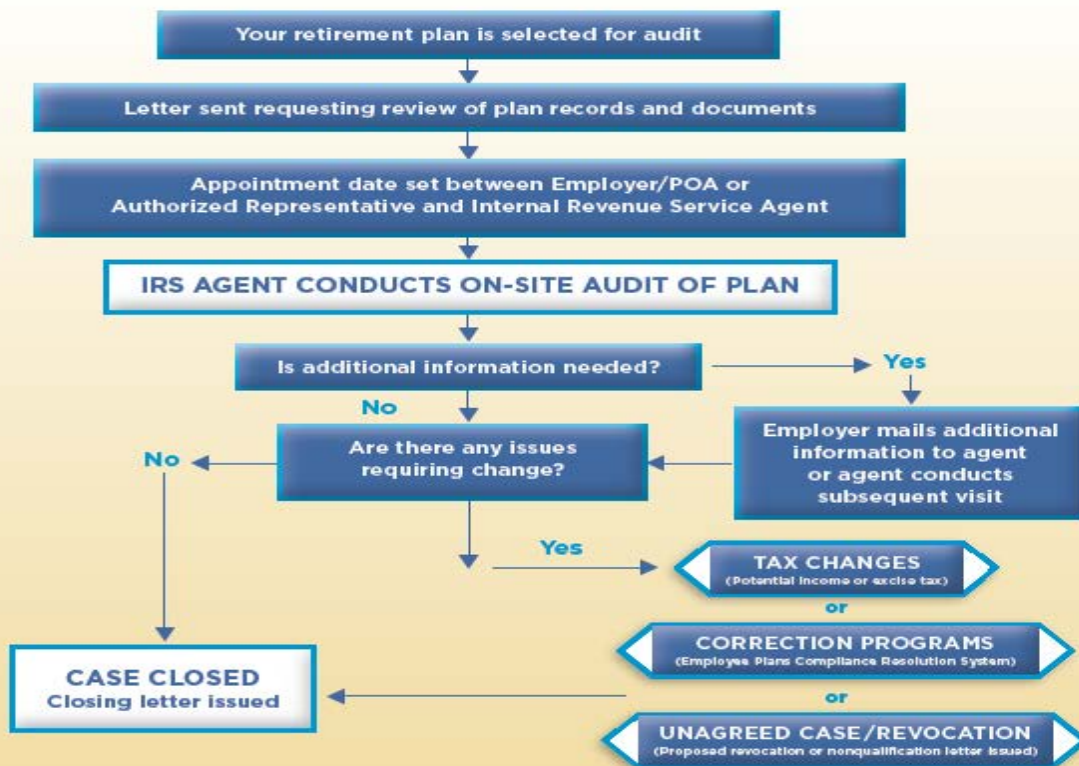
- Under ERISA, the Internal Revenue Service is granted authority and responsibility over qualified retirement plans, including 401(k) plans (alongside the DOL)
- The IRS has jurisdiction over the tax-qualified status of retirement plans, including plan examinations
- IRS audits are conducted by examiners or “agents” of the IRS from the Employee Plans (EP) section of the Tax Exempt and Governmental Entities (TE/GE) Division

## What Triggers An IRS Examination?

- Agents are not supposed to answer this question
- Informally, it seems that audits may occur as a result of:
  - Employee/participant inquiries and complaints
  - Targeted enforcement projects at the National and Regional Office levels
  - Information on Form 5500s
    - For example, the IRS may see a sharp decline in participants and want to know why
  - Referrals from other government agencies
  - News and social media – notice of bankruptcy

# Overview of the Examination Process

## Employee Plan Examination Process



 IRS  
Pub Station 4024 (Rev. 11-2011) Catalog Number 384534  
Department of the Treasury Internal Revenue Service  
www.irs.gov

## How Does an IRS Investigation Begin?

- Plan sponsor will receive a letter that the plan has been selected for an audit
- Agent will then contact the plan sponsor to schedule an initial examination appointment and to discuss the scope of the examination and the availability of the plan's books and records
  - Initial appointment may be on-site or off-site
- Prior to this initial appointment, the agent will issue a document request for certain documents and information to be made available during the examination

## The Initial Interview

- **Typically to Review Administrative Practices and Procedures**
- **Who Is Likely to Be Interviewed?**
  - Vice President Human Resources and other human resources personnel with 401(k) plan responsibilities
  - One or more members of a committee that administers the plan
  - Applicable payroll personnel
  - One or more members of a committee that selects and monitors the plan's investment options



## The Initial Interview (cont'd)

### ■ Typical Question Areas:

- What systems or procedures are in place to gather demographic data?
- Who is the person most familiar with the plan's operations?
- What outside professionals are involved in the plan's administration?
  - What reports do they provide to the plan sponsor and how often?
- Who maintains the plan's documents and records?
  - If it's the plan sponsor, may prompt questions on internal controls
- How are employees informed of the plan and any changes?
- Who determines when an employee is eligible to participate?
- Who determines benefits upon retirement or separation from service?
- Who manages plan investments?

## Information Document Request

- **Initial Request Attached to Appointment Letter**

- Request that copies of documents be provided
- May retrieve some during an on-site visit

- **Follow-up Requests**

- Ask auditor to provide follow up requests by email

- **Consider Data Privacy Issues**

- Documents that contain personal data need to be provided securely or retrieved by the auditor during an on-site visit

## Information Document Request – Plan Documents

- **Does Administration Agree with Plan Provisions?**

- For example, how is the definition of compensation or the matching contribution formula administered?

- **Has the Plan Been Amended Timely?**

- With respect to both interim and discretionary amendments?

- **Typical Request**

- Plan document and all amendments since the last determination letter
- Trust agreement and all amendments
- Most recent determination or opinion letter
- Summary plan description and all summaries of material modification

# IRS Audit Priorities

## Top Ten List of 401(k) Plan Errors

1. Failure to Amend the Plan for Tax Law Changes by the End of the Period Required by the Law
2. Failure to Follow the Plan's Definition of Compensation for Determining Contributions
3. Failure to Include Eligible Employees in the Plan or Failure to Exclude Ineligible Employees from the Plan
4. Failure to Satisfy Plan Loan Provisions
5. Impermissible In-Service Withdrawals

## Top Ten List of 401(k) Plan Errors (cont'd)

6. Failure to Satisfy IRC §401(a)(9) Minimum Distribution Rules
7. Employer Eligibility Failure
8. Failure to Pass ADP/ACP Nondiscrimination Test under IRC §401(k) and §401(m)
9. Failure to Properly Provide the Minimum Top-Heavy Benefit or Contribution under IRC §416 to Non-key Employees
10. Failure to Satisfy the Limits of IRC §415

## Issue: 401(k) Plan Document Compliance

- Individually designed 401(k) plans can no longer request periodic favorable determination letters (“FDLs”) from the IRS
  - An FDL is a formal IRS approval of the form of an individually designed plan
  - 401(k) plan FDLs are currently available only upon initial plan qualification, plan termination, and when plans merge (if certain conditions are met)
- **However, IRS audit examiners will review 401(k) plan documents for compliance with all tax-qualification requirements**

## Issue: 401(k) Plan Document Compliance (cont'd)

- The IRS has released two tools to assist plan sponsors with plan document compliance:
  - Required Amendments List – annual list of changes in retirement plan qualification requirements, includes amendment deadlines
    - Generally, amendment deadlines are the end of the second calendar year following the year in which the amendment is included on the list
  - Operational Compliance List – identifies changes in qualification requirements effective during a calendar year
    - Will reflect mandatory and discretionary plan amendments and other IRS guidance



## Issue: 401(k) Plan Document Compliance (cont'd)

### Plan Restatements

- Prior to the end of the periodic FDL program, a plan would generally be restated every 5 years during the FDL submission process
  - A restatement generally incorporates all prior amendments to the plan and additionally updates for legal changes
- 5 years is still a good benchmark for reviewing whether a restatement is needed
- Plan sponsor can rely on a prior FDL only with respect to plan provisions that have not been subsequently amended or affected by a change in the law
- Whether a restatement is appropriate may depend on the changes made to the plan since its last FDL

## Issue: IRC §410 Eligibility & Coverage Requirements

### ■ **General Rule - Minimum Age and Service Conditions**

- Plan cannot have as a condition of participation that an employee have a period of service extending beyond the later of the completion of one year of service or age 21

### ■ **General Rule – Minimum Coverage Requirements**

- Plan must pass one of the following:
  - Plan benefits at least 70% of employees who are not HCEs
  - Plan benefits a % of employees who are not HCEs which is at least 70% of the % of HCEs benefitting under the plan
  - Plan passes the average benefits test
- All employees in controlled group included (exception for qualified separate lines of business)
- Special transition rule for transactions

## Issue: IRC §410 Eligibility & Coverage Requirements (cont'd)

### ■ Typical Request

- Payroll Records Used to Determine Eligibility - Records showing dates of hire, dates of participation and hours worked during the eligibility computation period
  - Copies of Forms 940 and 941, W-2s
  - Time cards, personnel records, employment contracts
- Participant Allocation Schedules, Employee Census Reports and/or Valuation Reports
- List of Employees Participating
- List of Employees Not Participating (and the reasons why not)

## Issue: IRC §410 Eligibility & Coverage Requirements (cont'd)

### ■ **Typical Request (cont'd)**

- Controlled Group Information
- Demonstration Outlining How the Plan Satisfies the Minimum Coverage Requirements of §410(b)
  - Coverage testing
  - QSLOB filing, if any for the year under examination
  - Information regarding transactions if relying on the transition rule

## Issue: Plan Loans

- **Plan provisions and IRC §72(p) Requirements**
- **Substantiation Requirements**
  - Evidence of the loan application, review and approval process
  - An executed plan loan note
  - If applicable, documentation verifying that the loan proceeds were used to purchase or construct a primary residence
  - Evidence of loan repayments
  - Evidence of collection activities associated with loans in default and the related reporting on Form 1099-R, when applicable
- **Typical Request**
  - Plan's loan policy
  - Sample loan documentation

## Issue: Hardship Withdrawals

- **Plan provisions and (recently updated) Treasury Regulation Section 1.401(k)-1(d) requirements**
  - Hardship distribution may be taken when (1) the participant has an immediate and heavy financial need and (2) the distribution is necessary to satisfy the financial need
  - Recent changes to hardship rules in proposed regulations include elimination of six-month suspension requirement (mandatory starting in 2020) and elimination of plan loan requirement (optional starting in 2019)

## Issue: Hardship Withdrawals (cont'd)

### ■ Participant Representation

- Under proposed regulations, starting in 2020 a participant must represent (in writing or other electronic medium) that he or she has insufficient cash or other liquid assets to satisfy his or her financial need
- Plan administrator may rely on such representation unless it has actual knowledge to the contrary

### ■ Typical Request

- Review plan provisions for necessary amendments
- Hardship withdrawal documentation
- Participant representations

## Issue: Vesting & Distribution Requirements

- **Required Minimum Distribution Rules - IRC §401(a)(9)**
  - Participants/beneficiaries must timely commence their RMDs
- **Missing Participants - Memo for EP Examination Employees 10/19/17**
  - **Auditor will not challenge a Plan for failure to make RMDs to a participant to whom payment is due, provided the plan has taken the following steps:**
    - Searched plan and related or publicly-available records;
    - Used a commercial locator service, credit reporting agency or proprietary search tool to locate the participant; and
    - Attempted contact via USPS certified mail to the last known maintaining address and through appropriate means for any address or contact information (including email and telephone)
- **Typical Request**
  - Missing participant search procedures and missing participants report



## Issue: Vesting & Distribution Requirements (cont'd)

- **Qualified Joint & Survivor Annuity Rules - IRC §401(a)(11), and §417**
  - 401(k) plans may not be subject to the QJSA rules if certain conditions are met
  - Watch for protected benefits from merged plans and money purchase pension plan amounts
- **Rollover and Mandatory Distribution Rules – IRC §401(a)(31)**
  - Must permit direct rollovers to eligible retirement plans
  - No consent required for mandatory distributions under \$5,000 but between \$1,000-\$5,000 must be rolled over to an IRA if no distribution instruction is received

## Issue: Vesting & Distribution Requirements (cont'd)

### ■ Typical Request

- List of participants who were active in a prior year but not active in the year of examination
- The Form 5500 under examination will show the amount distributed to participants for the year – a request may be made for
  - A list of these participants with their hire and termination dates
  - Proof of payment or rollover
  - Spousal consent forms to waive the QJSA, if required
  - Any qualified domestic relations order requests received or distributions made during the year being examined
- Each of the Form 1099-Rs for the year under examination

## Issue: Nondiscrimination Requirements

- **IRC §401(a)(4) – contributions and benefits may not discriminate in favor of HCEs**
  - Availability of Benefits, Rights and Features
    - Current availability requirements
    - Effective availability requirements
  - Profit-Sharing Plan Contributions
    - Uniform allocation or uniform points allocation safe harbor; or
    - Pass the “General Test” under IRC §401(a)(4)
  - Definition of Compensation – under IRC §414(s) either use a safe harbor definition or it needs to be tested

## Issue: Nondiscrimination Requirements (cont'd)

- **Typical Request – Review of IRC §401(a)(4) Requirements**
  - An allocation schedule for the year under examination and the prior plan year for this plan and any other defined contribution plan.
    - Include the participant's compensation, the allocation of employer contributions, forfeitures and income
  - If compensation definition is not gross compensation, identify elements include and excluded from compensation
  - Provide a list of HCEs
  - Demonstrate how the plan satisfies either the uniform allocation or uniform points allocation safe harbor or the General Test of §401(a)(4)

## Issue: Nondiscrimination Requirements (cont'd)

- **Actual Deferral Percentage (ADP) Test and Actual Contribution Percentage (ACP) Test**
- **Safe Harbor Plan**
  - Alternatives - Safe Harbor Matching or Nonelective Contributions or Qualified Automatic Contribution Arrangement
  - Notice Requirement

## Issue: Nondiscrimination Requirements (cont'd)

### ■ **Typical Request - Review ADP/ACP Requirements**

- ADP and ACP test
  - Include all eligible employees, indicate current or prior year testing method, demonstrate how the tests correspond to compensation and deferrals listed on Forms W-2
  - Show that the definition of compensation is nondiscriminatory
  - If corrective measures were taken to satisfy the tests, provide calculations to demonstrate how correction was made
- Safe harbor notice
- Updated safe harbor notice, if required by a mid-year change

## Issue: Contribution Limitations

### ■ Annual Additions Limit – IRC §415

- Employer and employee contributions and forfeitures added to a participant's account cannot exceed the lesser of:
  - \$56,000 for 2019 (annually adjusted)
  - 100% of the participant's IRC §415 compensation for the limitation year

### ■ Typical Request

- Similar to Typical Request for review of IRC §401(a)(4) requirements

## Issue: Top-Heavy Requirements

- **Top-Heavy Rules – IRC §416**

- Not applicable to plans satisfying both the ADP and the ACP safe harbors and not providing for additional employer contributions
- A plan is top-heavy if the aggregate plan account balances of “key employees” is 60% of the aggregate plan account balances of all employees
- Top-heavy plans must meet certain vesting and minimum employer contribution requirements

- **Typical Request**

- Top-heavy ratio



## Issue: Employer's Deduction for Plan Contributions

- **Demonstrate that the IRC §404 deduction limits were met**
  - Generally, deduction for employer contributions to profit-sharing plan cannot exceed 25% of compensation paid or accrued to all participating employees for the taxable year
- **Typical Request**
  - Complete copy of the employer's tax return (e.g. Form 1120 or 1165) for the year under examination
  - Reconciliation of the deduction taken on the return to the contributions made to the plan
  - Cancelled checks/fund transfers verifying contributions made to the plan and deductions taken on the employer's return

## Miscellaneous Examination Requests

- **Evidence of fidelity bond for all people handling trust assets**
- **Supporting documents for all plan assets and liabilities**
  - Broker's statements, bank statements, insurance contracts, deeds, etc. and how assets are valued at fair value
  - Trustee or administrator reports; ledgers; journals
  - Administrative and investment committee minutes
  - Certified audit report and other financial reports for the trust, including receipt and disbursement statements, a detailed income statement and a detailed balance sheet

# Concluding the Audit

## What If Changes Are Required?

- **Auditor may require any of the following depending on the error found or change needed:**
  - Payment of excise tax
  - Correction under the Employee Plans Compliance Resolution System (EPCRS)
  - Audit Closing Agreement Program (Audit Cap)

## EPCRS

- Employee Plans Compliance Resolution System (or EPCRS) details IRS voluntary correction procedures for certain plan failures
  - Plan Document Failure
  - Operational Failure
- Operational failures are the most common
- General principles under EPCRS require the plan to be put in the same position it would have been if the error had never occurred

## EPCRS (cont'd)

- Two main components of EPCRS:
  - Self-Correction Program (“SCP”)
    - Available for common operational failures such as missed deferrals, ineligible distributions
    - No filing is submitted to the IRS but correction should be documented
    - Significant failures can be corrected within two years
    - Insignificant failures can be corrected at any time
  - Voluntary Correction Program (“VCP”)
    - VCP filing must be submitted to IRS documenting the failure and the proposed correction method
    - IRS publishes template VCP forms for a variety of common failures
    - VCP fees range from \$1,500 to \$3,500

## Audit Closing Agreement Program (Audit Cap)

- Plan sponsor corrects the errors, pays a negotiated sanction, satisfies any other applicable conditions, and enters into a closing agreement with the IRS
- Sanction Amount – based on a variety of factors such as:
  - steps taken by the plan sponsor to ensure the plan had no/identify any failures
  - the extent to which correction attempted before the audit commenced
  - the type and timing of, and number of employees affected by the failure
  - the reason for the failure

## Being Prepared for the Next Audit – Internal Monitoring

- Best defense is a good offense
- Prepare for a potential audit by engaging in periodic internal audits to confirm plan documentation and operational compliance
  - This may be incorporated into a periodic plan restatement calendar
  - If engaging an outside consultant to assist with compliance monitoring, consider how to involve outside legal counsel to strengthen protection under attorney-client privilege doctrine



# The Letter You Want

Internal Revenue Service  
TE/GE Employee Plans  
200 Sheffield Street, Room 200  
Mountainside, NJ 07092



Department of the Treasury

Date: December 15, 2017  
Person to Contact/ID Number:  
Patrick Yuen/0209647  
Contact Telephone Number:  
908-201-2645  
Form Number:  
5500  
Name of Plan:  
[Redacted]  
Plan Number:  
[Redacted]  
Plan Year(s) Ended:  
[Redacted]  
Taxpayer Identification Number:  
[Redacted]

Dear [Redacted]

Our recent examination of your return(s) for the above year(s) shows no change is necessary in the information reported. We are pleased to inform you that we have accepted the return(s) as filed.

If you have any questions, please contact the person whose name and telephone number are shown above.

Thank you for your cooperation.

Sincerely,

Lisa J. Beard-Niemann  
Director, EP Examinations

Letter 992-A (6-2004)  
Catalog Number 395602

# Questions??

## Contact Information

Philadelphia	Chicago
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