

June 8, 2010

MEMORANDUM TO CLIENTS

RE: IRS Launches 401(k) Compliance Checklist

On May 17th, the IRS launched its 401(k) compliance check of 1,200 plans and impacted plans should have been notified by mail. As promised, a copy of the comprehensive survey – 45 pages with 69 questions – is available on the [IRS Employee Plans website](#). The information collected reportedly will be used to influence future IRS efforts on guidance and outreach – as well as possible enforcement activity. The results are expected to be summarized in a report next year.

Plan sponsors were randomly selected based on 2007 plan year filings. The checklist covers three plan years (2006-2008) and requires extensive data to be gathered, much of which may not be readily available in existing administrative reports/Form 5500. It also requires a rather detailed review of the plan document and existing operational provisions, and addresses the key IRS requirements for 401(k) plans. The checklist even addresses such far-ranging subjects as the unrelated business income tax and FBAR filings for foreign investments. Importantly, the IRS cover letter clearly states that failure to respond or provide complete information may result in an IRS audit. In addition, several questions seek more information where an answer indicates non-compliance with the 401(k) plan rules, and others involve fine distinctions between plan features. Therefore, before submitting responses, we recommend review by legal counsel.

The topics covered by the checklist are summarized below.

- **Section 1 – Demographics:** This section asks questions regarding (1) type of plan (e.g., profit sharing, money purchase, multiemployer, pre-approved), (2) ongoing or frozen, (3) number and type of other qualified and nonqualified retirement plans, (4) was a defined benefit plan terminated since 1995, (5) latest determination/opinion letter, and (6) controlled group membership. We recommend that an attorney be listed as the contact person for any IRS follow-up.
- **Section 2 – 401(k) Plan Participation:** This section focuses on data gathering on who is participating in the plan and the eligibility provisions for different types of contributions. This data will likely be used to confirm compliance with Code section 410(a) (minimum participation) and 410(b) (minimum coverage) provisions. It also asks what impact various listed factors may have on the participation rates (e.g., economy, match, age, compensation level, access to funds).
- **Section 3 – Employer and Employee Contributions:** This section asks for detailed data regarding contributions made to the plan, including amount, frequency of deferral election changes, types of contributions (after-tax, catch-up,

match, nonelective), eligibility, and changes in employer contributions (suspension, reduction, discontinuance).

- **Section 4 – Top-Heavy and Discrimination Rules:** This section focuses on top-heavy and nondiscrimination testing provisions, including top heavy minimum contributions, and ADP and ACP testing (data, testing method, corrective measures). For SIMPLE 401(k) plans, it reviews the various requirements, types of contributions, and participant notices.
- **Section 5 – Distribution and Plan Loans:** This section focuses on the distributions available under the plan, including (1) distribution forms (including 1099-R reporting), (2) plan loan details to confirm compliance with section 72(p) of the Code (loan term, repayment schedule, maximum limits, interest rate, 1099-R reporting of defaults), (3) hardship distributions (number of distributions, hardship events, eligible participants, loans taken before hardship, suspension period), and (4) mandatory cashout details. It also covers elective deferral (§ 402(g)) and annual addition (§ 415) limits and related corrections.
- **Section 6 – Other Plan Operations:** This section covers a variety of plan operations including (1) whether financial conditions impacted plan operations, (2) any plan losses due to fraud or theft, (3) investment in employer stock (total value, diversification notice, type of contributions and frequency of sales permitted, amounts rolled over to purchase employer stock for start-up businesses), (4) FBAR compliance for direct foreign investments, (5) unrelated business income tax (and related 990-T filing), and (6) types of in-kind distributions permitted (and any discount taken for lack of marketability or minority interest) if any.
- **Section 7 – Automatic Contribution Arrangement:** This section focuses on various types of automatic contribution arrangements, including QACA and EACA, starting deferral rate, increasing and maximum deferral rates, eligibility, change of deferral election, and participant notices (distribution method, default investment option, and format of notice).
- **Section 8 – Designated Roth Features:** This section focuses on whether the plan has Roth 401(k) deferrals and, if not, the reasons for not offering them. It includes detailed data on the use of the feature and whether the plan has initiated a rollover from the Roth account.
- **Section 9 – IRS Voluntary Compliance Programs (EPCRS):** This section compiles data on whether the plan sponsor is aware of the various correction education materials and whether it has used such materials or correction programs, and asks for feedback on the same.
- **Section 10 – Plan Administration:** This final section reviews the operations of the plan (and asks for feedback on compliance with Code requirements), including (1) plan policy and procedures, (2) who is the plan administrator, (3)

who has plan amendment authority and responsibility for timely amendments (4) prior changes in administrators, (5) use of IRS resources, (6) who prepares the Form 5500, and (7) who completed the questionnaire (which should include legal).

Action Steps – The unlucky plan sponsors who receive this letter should (1) organize an internal team to be responsible for the response, (2) coordinate with your third party administrator to provide as much assistance as possible, (3) prior to submission, provide a copy of the checklist for attorney review to assist in identifying issues and considering any corrective action that may be appropriate to maintain the tax-qualified status of the plan (EPCRS) (and to minimize the risk that the submission will trigger an audit due to inadequate responses), and (4) retain a copy of the checklist with the plan records.

Other plan sponsors may want to review the checklist and perhaps perform a mini compliance review to assess whether the plan would "pass" the requirements covered by the checklist (at least with respect to the current year).

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