

# Employee Benefits Corner

*By Elizabeth Thomas Dold and David N. Levine*

## A Look at What's Coming from the IRS 401(k) Compliance Check

In May 2010, the IRS launched an electronic 401(k) compliance check program, which was the debut of their soft-audit approach that uses electronic survey technology to identify potential plan document and operational failures. In February 2012, after review and analysis, the IRS has issued an Interim Report on the 401(k) compliance check program. This article takes a careful look at the interim report and the lessons learned in the process, and what may be coming down the pike for 401(k) plans as a result of the compliance check, and the issuance of the pending final report (which is expected as early as December 2012).



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### The 2010 401(k) Plan Compliance Check

The 401(k) Plan Compliance Check Questionnaire was a comprehensive survey that covered 69 questions and was 45 pages in length that was sent to 1,200 selected plan sponsors. It focused on 2006–2008 data, and was divided into ten sections, with the objectives of (1) looking at plan form and operational issues, (2) learning how IRS outreach and compliance programs are working, and (3) optimizing future IRS outreach and compliance efforts. Moreover, the purpose of the checkup was to (1) measure the health of 401(k) plans, (2) identify compliance issues, (3) evaluate effectiveness of voluntary compliance tools and programs, and (4) determine how the IRS can foster greater compliance. For each of the 10 sections, we will summarize the scope of the questions; the findings



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in the interim report are largely limited to statistical findings.

### Section 1–Demographics

This section focused on the overall demographics of the plan, including questions on (1) type of plan (e.g., profit sharing, money purchase, multiemployer, pre-approved), (2) ongoing or frozen plan, (3) number and type of other qualified and nonqualified retirement plans that the plan sponsor maintains, (4) whether a defined benefit plan was terminated since 1995, (5) the date of the latest determination/opinion letter, and (6) the controlled group membership.

Not surprisingly, 401(k) plans are the most popular plans in the United States, with more than 500,000 401(k) plans that cover over 60 million participants. The 86 percent for pre-approved documents supports the IRS’ focus on these types of plans and the actions of prototype sponsors. See Table 1.

**Table 1. Interim Report–Type of Plans**

Safe harbor 401(k) plan	43%
SIMPLE 401(k) plan	5%
Pre-approved plan document	86%

### Section 2–401(k) Plan Participation

This section focused on plan participation and eligibility provisions, and the various types of plan contributions. This data could likely be to confirm compliance with Code Sec. 410(a) (minimum participation requirements) and Code Sec. 410(b) (minimum coverage) provisions. It also reviewed the various factors that impact plan participation rates, such as the economy, the employer matching contribution rate, the age of the participant, compensation level of the participant, and the ability to access plan funds. See Table 2.

**Table 2. Interim Report–Participation Requirements for Elective Deferrals**

No service requirements	13%
One-year service requirement	54%
Age 21 restriction	64%

### Section 3–Employer and Employee Contributions

This section focused on detailed data for contributions made to the plan, including amount, frequency

of deferral election changes, types of contributions (e.g., after-tax, catch-up, match, nonelective), eligibility provisions, and changes in employer contributions (suspension, reduction or discontinuance).

The data in Table 3 gives plan sponsors a sense of whether certain contribution types and restrictions are commonplace, and the more common provisions are likely to be the subject to additional education and potential audit outreach.

These numbers in Table 4 demonstrate that little reduction of employer contributions was implemented during the 2006–2008 period. Presumably, reductions in employer contributions increased in the 2008–2010 period.

**Table 3. Interim Report–Employee Contributions**

Participants may change elective deferrals at any time	41%
Participants may change deferral elections only once a year	2%
Catch-up contributions allowed	96%
After-tax contributions (other than Roth contributions)	4%
Elective deferrals—increase in per-participant dollars from 2006-2008	58%
Elective deferrals—decrease in per-participant % of compensation	52%

**Table 4. Interim Report–Employer Contributions**

Provide matching contributions	68%
Require 1 year of service to be eligible for match	58%
Provide nonelective (profit sharing) contributions	65%
Suspended or discontinued match in 2006	1%
Suspended or discontinued match in 2008	4%
Suspended or discontinued nonelective contributions in 2006	2%
Suspended or discontinued nonelective contributions in 2008	5%
Reduced nonelective contributions in 2006	1%
Reduced nonelective contributions in 2008	5%

### Section 4–Top-Heavy and Discrimination Rules

This section focused on top-heavy and nondiscrimination testing provisions, including top-heavy minimum contributions, and ADP and ACP testing (e.g., data,

testing method, corrective measures). For SIMPLE 401(k) plans, it reviewed the various requirements, types of contributions, and participant notices.

For the 20 percent of the plans that are top-heavy, the contribution levels varied, with eight percent less than the typical three-percent minimum, which may raise some additional IRS focus on compliance. As such, plan sponsors would be well served to review their current top-heavy process to ensure that it complies with applicable Code requirements. See Table 5.

**Table 5. Interim Report—Top-Heavy and Discrimination**

Plan was top-heavy in 2008	20%
Resolve top-heavy issues by making minimum contribution to non-key Employees	79%
Correct excess contributions within 2½ months following year-end	50%
Correct ACP testing by distributing excess aggregate contributions	59%
ADP test—current year method	60%

## Section 5—Distribution and Plan Loans

This section focused on the distributions available under a plan, including (1) distribution forms (including 1099-R reporting), (2) plan loan details to confirm compliance with Code Sec. 72(p) (e.g., loan term, repayment schedule, maximum limits, interest rate, 1099-R reporting of defaults), (3) hardship distributions (e.g., number of distributions, hardship events, eligible participants, loans taken before hardship, suspension period), and (4) mandatory cashout details. It also covered elective deferral (Code Sec. 402(g)) and annual addition (Code Sec. 415) limits and related corrections.

As direct rollover distributions are required for eligible rollover distributions, this 79-percent rate may indicate over 20-percent noncompliance and accordingly an area for future education and examination. The IRS also gathered information of the plan loan interest rates charged, where the IRS importantly noted that the Internal Revenue Code does not mandate the use of any specific, stated interest rate.<sup>1</sup> The rates in the report support that a variety of rates are used: prime rate (16 percent), prime rate plus one (46 percent), and prime rate plus two (19 percent) and local bank rate (11 percent). See Table 6.

**Table 6. Interim Report—Distributions**

Allow in-service withdrawals	62%
Permit hardship distributions	76%
Permit direct rollover distributions	79%
Most common form of benefit	Lump sum
Permit participant loans	65%
Provide qualified joint and survivor annuity	19%
Provide installments	38%
Cashout Limit—\$1,000 (avoids automatic roll to IRA)	58%
Plan didn't violate 402(g) limit	94%
Comply with Form 1099-R reporting for distributions	99%

## Section 6—Other Plan Operations

This section covered 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 (UBTI) (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. The UBTI results may well trigger some additional education in this area. See Table 7.

**Table 7. Interim Report—Investments**

Investments in employer stock	1%
Assets held in foreign investments	1%
Permit in-kind distributions	2%
Diversification rights of employer stock	98%
Assets giving rise to UBTI	0%

## Section 7—Automatic Contribution Arrangement

This section focused 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 (e.g., distribution method, default investment option, and format of notice).

It appears that this issue was largely reserved for the final report, which we anticipate will be an area for additional guidance and education, based purely on the complexities of the rules.

## Section 8—Designated Roth Features

This section focused on whether a plan has Roth 401(k) deferrals and, if not, the reasons for not offering them. It included detailed data requests on the use of the feature and whether the plan has initiated a rollover from a Roth account. See Table 8.

The reasons for not offering the Roth included (1) employees would not be interested (65 percent), (2) administrative burdensome (44 percent), and (3) rules are too complicated (26 percent), which largely explain their limited use.

**Table 8. Interim Report—Roth**

Designated Roth contributions allowed	22%
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## Section 9—IRS Voluntary Compliance Programs (EPCRS)

This section compiled data on whether the plan sponsor is aware of the various correction education materials (e.g., employer fix-it guideline) and whether it has used such materials or correction programs, and asks for feedback on the same. Failure to follow the plan terms or have other compliance defects can be corrected through EPCRS and preserve the tax-qualified status of the plan.

The data in Table 9 makes it clear that the “word is still not out” regarding the purpose and use of EPCRS and the other IRS materials, which will likely spur increased education efforts. The report also included helpful comments on improving the self-correction program under EPCRS, including (1) create compliance forms and checklists, (2) allow more self-corrections by plan amendment, and (3) expand to correct more significant failures (e.g., removal of the two-year correction window). One point that was not raised in the report, but is a long-favorite among the retirement community, is to expand the self-correction program to cover loan failures.

**Table 9. Interim Report—EPCRS**

Plan sponsor is aware of EPCRS	65%
Used EPCRS and found it helpful	75%
Plan sponsor is aware of 401(k) fix-it guide	41%

## Section 10—Plan Administration

This final section reviewed the operations of the plan (and asked 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 consider legal counsel). Some of this information may extend to areas of interest under the Department of Labor, and it is possible with the cross-agency focus noted above that future surveys may be shared (or jointly structured) with the Department of Labor or Pension Benefit Guaranty Corporation. See Table 10.

Given the 86-percent usage of pre-approved plans, the fact that 73 percent of amendments are prepared by a third-party administrator, plan sponsors may want to focus on who is responsible for preparing their plan amendments.

**Table 10. Interim Report—Plan Administration**

Use of third-party administrator for plan administration	53%
Third-party administrator responsible for plan amendments	73%
Third-party administrator responsible for Form 5500 preparation	83%

## Lessons Learned

### Next Time Complete the Survey!

The IRS materials made it clear that although participation in the survey was voluntary, failure to fully and timely complete the survey would likely result in further IRS activity with respect to this plan. The IRS stayed true to their word, and the two percent of plan sponsors that did not complete the survey learned their lesson. The consequence was either a one-year comprehensive audit and submit the survey late, or the IRS completed the survey for the plan sponsor after a full three-year comprehensive full-scope examination of the plan. So for those that took the survey seriously, and hired advisors to help with the submission (as necessary), the investment was sound.

### Use the Survey as Internal Control Tool

If you haven't done so yet, we (and the IRS) encourage plan sponsors that were not selected to participate in the survey to use the questionnaire as an internal control tool to review your plan for compliance issues. If you find mistakes, you can use the IRS website—[www.irs.gov/retirement](http://www.irs.gov/retirement)—to help with the corrective steps. It is important to understand that failure to comply with the plan terms



can result in plan disqualification, and therefore a periodic review of the plan and its operations is encouraged.

## What Is Still to Come

The interim report was just the beginning. The IRS is analyzing the questionnaire data to identify potential compliance problems, design future compliance efforts, and improve case selection models. Therefore, the next step from the IRS is to use the questionnaire and other data to complete and publish the final report (which will include more in-depth information, including identifying the differences between large and small plans, and more information on questions not analyzed in the Interim Report), design and improved case selection strategies, develop follow-up compliance projects, and develop outreach materials. More specifically, the IRS intends to improve compliance by (1) enhancing the IRS 401(k) plan administration compliance tools, (2) producing outreach materials for plan participants and plan sponsors, (3) improving the IRS voluntary correction program (which the latest version of EPCRS is expected shortly), (4) assessing the need for further formal guidance, and (5) defining future projects and enforcement activities.

Notably, the IRS has announced that one of its follow-up examination focuses will be on safe-harbor 401(k) plans. Specifically, the project will take a closer look at plans that suspended their safe-harbor 401(k) contributions to ensure that they complied with the IRS requirements, including advance participant notice and nondiscrimination testing. Therefore, we recommend plan sponsors with these plans that have suspending matching or nonelective contributions ensure that the documentation is in place to support meeting the IRS requirements.

Moreover, down the pike we anticipate increased education and examination focus on common 401(k) errors that the IRS finds on examination, which include nonamenders (e.g., late plan amendments), definition of “compensation” (where there is a disconnect between the plan definition and actual operations), excluding eligible employees, including ineligible employees, plan loans (including failure to withhold loan payments), matching contributions not made (including failure to properly count hours of service, and incorrect plan entry date), ADP and ACP testing failures (including not completed or not passed), and excess elective deferrals.

### ENDNOTES

<sup>1</sup> This issue has been the issue of some recent discussions with the IRS. See [www.irs.gov/retirement/article/0,,id=253975,00.html](http://www.irs.gov/retirement/article/0,,id=253975,00.html).

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