The Real Fiduciary Threat For Smaller 401(k) Plans Is A Government Audit

By Ary Rosenbaum, Esq.

As a 401(k) plan sponsor, I'm sure you've been spoken to by a plan provider who wants you as a client and they're talking about you potential liability as a plan fiduciary. They're probably also talking about the threat of litigation and this is where I think most retirement plan providers miss the point. Unless your plan has $50 million or more in assets, the likelihood of being sued by a current or former participant is slim to none. There have been probably more men who landed on the moon than small or medium-sized 401(k) plan who have been sued in a class action claim. Good fiduciary practices are necessary, but the real fear that they should be talking about and that you're more than likely ill-prepared for is an Internal Revenue Service (IRS) or Department of Labor (DOL) audit. This article is all about the risk of a government audit and what trouble it may get you into.

Why small and medium-sized plans rarely get sued

Supposedly, noted bank robber Willie Sutton was asked why he robbed banks and it's claimed he said: "Because that's where the money is." On the flip side, the reason that small and medium-sized 401(k) plans don't get sued because they don't have enough money to sustain a lawsuit. ERISA litigators usually take on lawsuits where there is a chance of a sizeable settlement. Why? Litigation is expensive and for most of these cases, litigators take the cases on a contingency, which means they pay for the cost of litigation upfront. By doing so, these litigators are taking on the risk because if the case is tossed out on a summary judgment motion, they're out of luck and on the hook for all the costs while the plaintiffs pay nothing. So if it's a risk for reward, ERISA litigators aren't going to waste much time on small to medium-sized plans. ERISA litigators will pursue claims against companies with deep pockets, that's why they're targeting well-known, publicly traded companies and private universities and not focusing on the local bagel store or contractor. There has been litigation against small and medium-sized plans, but they are few and far between. You might get a former employee that might be aggrieved against you that they might pursue litigation against you about the 401(k) plan, but it might be a case where they're just seeking a simple settlement to make things go away. The high cost of litigation rules out most of the chances that you will be sued over your 401(k) plan by a current or former participant.

Why audits should be the real fear

A 401(k) plan is a qualified plan, which means that if you abide by the Internal Revenue Code, plan assets will be given tax-deferred treatment. In the Federal government's protection of plan participants, you also have to abide by the provisions of the Employee Retirement Income Security Act of 1974 (ERISA). These laws require voluntary compliance by plan sponsors like yourself and if the government didn't enforce these laws, many plan sponsors would ignore them. One way to make sure that plan sponsors comply with the Internal Revenue Code and ERISA is a government audit. You might be audited by the Internal Revenue Service (IRS) to check your compliance with the Internal Revenue Code and you might be audited by the Department of Labor (DOL) to check your compliance with ERISA. Audits are a tool to make sure that keep plan sponsors on their toes and as an ERISA attorney, they're very good for my bottom line. Government audits of 401(k) plans are a lot more frequent than litigation against 401(k) plans and I will say that government audits are a lot more thorough.

Why you might get audited

There are many reasons that your plan might get picked for an IRS or DOL audit. Most of the time, it's the luck of the draw. Your plan was picked randomly to ensure compliance. However, there are other reasons why you might have been picked for an audit and the problem is you might only be aware why after the audit was started. Many times, audits are started (usually on the DOL side) by a complaint from a former or current participant. Current or former participants may make a complaint if they feel they've been aggrieved through plan operations or benefits. I had one audit where a former claim they should have been covered and it led to the DOL discovering that some transfers to the owners of the company might be considered embezzlement. If you're doing something illegal with your plan, such as embezzling money, you might be audited through a complaint made to the IRS and/or DOL by your plan provider. Matthew Hutcheson, who was convicted of stealing millions from multiple employer plans was investigated based on a tip provided by a participating employer he stole money from, as well as one of the plan's third-party administrators. Your plan might be targeted for an audit because of a mistake made on your Form 5500 or an admission of something you shouldn't have done. I will assure you that if you admit that you don't have an ERISA bond in place as you're supposed to, you will hear from the IRS or DOL shortly. If you admit to a prohibited transaction, the government will eventually find you for an audit. I've had a client of mine audited over their 401(k) plan because the contributions made as reported on the Form 5500 did not agree with the reported contribution on their corporate tax return. Finally, you might be audited simply because the IRS or DOL has dedicated a certain aspect of retirement plans that they would like to focus on. For many years. now, the DOL is focused on late salary deferral deposits and any 401(k) plans that admit to depositing deferrals late at one time or another will likely face more scrutiny than a plan that hasn't been late in deposits. I assume a focus of DOL audits shortly are missing participants and former participants with assets left in the plan. How do I know this? Well, the DOL has stated that missing participants is going to be a new priority for them. Regardless of the reason for an audit, you need to understand the significance of them. 401(k)plans are legal entities that must comply with federal law. Audits are used to make sure you comply with the law and if they discover you didn't, you might be heavily penalized and if the mistakes are huge, the plan might be disqualified. So audits carry legal consequences, so the worst thing you can do is try to handle an audit yourself. You need an ERISA attorney's assistance whether it's an attorney working for your TPA or some independent ERISA attorney like me.

The problem of what audits may uncover

While you are led to believe that everything is fine with your 401(k) plan, you might have no idea what trouble lurks underneath. The problem is that the plan audit may uncover problems that have been well under the surface. I hate surprises and when I'm hired by a plan sponsor to handle an audit, I find them. When I handle an audit and a mistake it's uncovered, it always feels like it's something different. It might be incorrect testing, the wrong definition of competition, using a different eligibility period than what the plan document says, and one time, a defined benefit plan investing all their money with Bernie Madoff. IRS and DOL agents essentially have a "script" when they conduct an audit. There are certain questions they will ask you and there are certain things they are going to ask for. I haven't had an IRS audit where they didn't ask for the plan's valuation and testing reports or plan documents. IRS and DOL agents have certain areas of compliance that they focus while other areas are a focus because of a specific complaint. If a former employee is going to complain to the DOL that they weren't properly covered under the plan, clearly the focus will be the eligibility provision to see why they weren't covered and on two times, the DOL has stated that excluding employees by their actual name isn't a reasonable classification. 401(k) plans are intricate by design with so many things that could go wrong and the problem is that the IRS or DOL agent will likely find it before you do. I always say that if you what to find something wrong with a 401(k) plan, you'll find it. The problem is that the agent will find the problems before you do. Of course, if they find the error on audit, it could mean some financial penalties to you. Of course, egregious errors will either rise to penalties of tens of thousands of dollars and in rare cases, a plan disqualification which will disallow previous tax deductions for plan contributions and recognition of retirement assets as immediate income to the participants. When an agent discovers plan errors, they do play for keeps.

What you should do to avoid the horror of the audit

While you should always prepare for a plan audit when scheduled, I think it's more important for preventative care. Just like people don't like to floss, plan sponsors don't like to pay for any plan review or mock audit. Don't be stubborn and put your plan at risk because many of these administrative reviews and mock audits can be paid from plan assets. It's better to know the problems your 401(k) plan has upfront because I assure you that the costs to fix issues under the IRS and/or DOL voluntary compliance programs now are far less than what an IRS or DOL agent will impose as a penalty later. You can't afford to take a plan provider's word that everything is fine because they might unknowingly be the culprit of the errors affecting your plan. Spend a couple of bucks now and you could avoid some paralyzing penalties later.

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