IRS ISSUES 401(k) QUESTIONNAIRE AS PART OF COMPLIANCE CHECK; IRS TO FOCUS ON CERTAIN COMPLIANCE ISSUES IN PLAN EXAMINATIONS THIS YEAR

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The Employee Plans Examinations group (the "EP Examinations Group") within the Internal Revenue Service is responsible for overseeing compliance with the retirement plan provisions of the Internal Revenue Code, including the protection of plan assets and of the interests/rights of participants. This is accomplished by conducting examinations of retirement plans. Periodically, EP Examinations focuses on particular areas of noncompliance. This year, the IRS is focusing on 401(k) plans in general. As part of its enforcement efforts, on May 17, 2010, the IRS sent out a letter with instructions to 1,200 randomly selected employers with 401(k) plans requiring them to timely complete a 401(k) compliance questionnaire. The purpose of the questionnaire is to gather information on various compliance issues.

In addition to the focus on 401(k) plans, the EP Examinations Group is targeting several issues ranging from plan coverage and participation issues, to issues affecting plans of multi-national corporations. To keep plan sponsors abreast of the EP Examinations Group enforcement efforts, this client alert provides an overview of the issues being targeted. In the event that a plan is subject to an examination, these issues will likely be reviewed by the agent. If a plan has a potential compliance issue in any of these targeted areas, it is imperative that the problem be properly identified and corrected before an examination occurs.

401(k) COMPLIANCE QUESTIONNAIRE

The EP Examinations Group of the IRS is conducting a compliance check of 1,200 plans as part of ongoing efforts to increase voluntary compliance in the 401(k) plan sector. The compliance check, which is being conducted through the distribution of a 401(k) Compliance Check Questionnaire to randomly selected plan sponsors, is a comprehensive look into 401(k) plans to determine: (1) potential compliance issues, (2) any plan operational issues, and (3) additional education and outreach guidance that may be helpful for the IRS to provide to plan sponsors to improve compliance. While a compliance check is neither an audit nor an investigation, the IRS has indicated that failure to respond to the questionnaire or to provide complete information will result in further action which could include a full examination of a plan. Information gathered from the 401(k) Compliance Check Questionnaire will be used in future compliance efforts. The questionnaire must be completed within 90 days from the date the plan sponsor is notified by the IRS.

The questionnaire categories are:

- Demographics
- 401(k) plan participation
- Employer and employee contributions
- Top heavy and nondiscrimination rules
- Distributions and plan loans
- Other plan operations
- Automatic contribution arrangements
- Designated Roth features
- IRS voluntary compliance programs
- Plan administration

Based on the information gathered from the questionnaire, the IRS will issue a public report summarizing the data collected, but will not include names, locations, or other identifying information of any respondents. The report will describe the responses and identify those areas where additional education, guidance, and outreach is needed; and how the IRS can focus its enforcement efforts to address and/or avoid non-compliance related to 401(k) plans.

While only 1,200 employers are being selected to complete the questionnaire, all plan sponsors should view the IRS efforts as a reminder to conduct a compliance review to determine if their plans meet the requirements of the Internal Revenue Code and ERISA and to take corrective action, if necessary.

IRS TARGETED COMPLIANCE ISSUES

The compliance issues being targeted by the EP Examinations Group include the following:

Internal Controls

In addition to a review of actual plan operations, the internal controls surrounding a plan will also be reviewed as part of an IRS examination. An IRS auditor will interview key company personnel who work with the plan and plan data, review data flow, and evaluate a plan's processes and procedures. Interaction between the plan sponsor and third-party service providers will also be reviewed. The IRS will inquire about payroll and tax compliance procedures, and Human Resources and personnel responsibilities, including worker verification. The IRS has stated that any non-plan related issues will be referred within the IRS, or to the Department of Labor ("DOL") or state agencies.

Abusive Transactions and Promoter Investigations

The IRS continues its efforts to curb abusive tax shelter schemes and transactions involving retirement plans. The Tax Exempt and Government Entities Division of the IRS, including the office of Employee Plans, participates in this IRS-wide effort by devoting substantial resources to the identification, analysis, and examination of abusive tax shelter schemes and promotions.

The IRS continues to develop strategies to identify and address new schemes, and share information with the general public as new schemes are identified.

International Tax Issues and Plans of Multinational Corporations

The IRS will focus on multi-national corporations and international tax issues to determine if there are issues affecting retirement plans. This will include determining whether a domestic trust is being maintained by a foreign entity sponsoring a qualified retirement plan. The IRS will also verify that all applicable taxes are being paid on distributions to individuals with foreign addresses. The IRS will develop strategies and capabilities to address key international issues impacting the Employee Plans sector.

Employee Plan Team Audit Top 10 Issues

The Employee Plans Team Audit (EPTA) program comprises broad-scope examinations of employee benefit plans with 2,500 or more plan participants by a team of specialists. The plan is identified and selected for examination by the EPTA Case Selection Committee. The examination is conducted by a team comprised of the Case Manager, Team Coordinator and, as appropriate, additional team members, such as EP revenue agents, computer audit specialist, actuary, attorney, engineer, employment tax specialist, etc. An EPTA examination focuses on an analysis of electronic data, including data from both the plan sponsor and third-party administrators.

The following are the top 10 issues, and related sub-issues, that arise during an EPTA audit:

1. Termination or partial termination-

   -Vesting or distribution issues may arise when a company downsizes

2. Acquisitions-

   -Failure to continue to offer all of the optional forms of benefit following a transfer of plan assets due to a plan merger

   -Failure to make a profit sharing contribution timely for newly acquired employees due to administrative delay

3. Deferral Percentage Tests-

   -ADP or ACP tests performed incorrectly by a third-party administrator

   -Use of faulty data when performing the ADP or ACP tests

   -Providing benefits to a select group of participants that results in a testing failure

4. Compensation-

    -Use of an incorrect definition of compensation

    -Excess contributions due to a inclusion of income in excess of the Code Section 401(a)(17) annual compensation limit

    -Failure to recognize income from stock option exercises or early sales from a stock purchase plan when calculating 401(k) deferrals

5. Plan document issues-

    -Failure to timely amend the plan for required law changes

    -Failure to amend a plan to comply with the law prior to a plan merger

6. Vesting-

    -Improper calculation of vesting service

    -Improper administration of break-in-service rules

    -Forfeiture of amounts from plan accounts of participants 65 and over

7. Distributions and loans-

    -Proper documentation, including spousal consents, not obtained for loans and distributions

    -Failure to suspend salary deferrals of participants receiving hardship distributions

    -Use of incorrect distribution code on Form 1099, resulting in incorrect tax treatment

8. Plan assets-

    -Large percentage of "other assets" on the plan's balance sheet

    -Large percentage of assets in a single investment

    -Large administrative expenses

9. Plan limits-

   -Excess deduction taken due to "accrual" of a pension expense without a corresponding Form 5500 Schedule M-1 adjustment

   -A participant exceeding the Code Section 415 or 402(g) limits, usually due to participation in more than one plan

10. Miscellaneous-

   -Insufficient internal control of data provided to third-party service providers

   -Use of inaccurate data by third-party service providers resulting in improper calculation of benefits

<u>Contact Information</u>: If you have questions regarding this alert, please contact Janice C. Baldwin or Elisa A. Cawood, the principal authors of the alert. You may also contact the Womble Carlyle attorney with whom you usually work, or one of our Employee Benefits attorneys.

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