Southwest ESOP Association – San Antonio
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PREPARING FOR AN IRS/DOL AUDIT

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TO BE DISCUSSED

- Overview of Benefit Plan Audits
- Retirement Plan Audits – IRS
- Retirement Plan Audits – DOL
- Best Practices
- Correction Programs
- Know Your Compliance Requirements
OVERVIEW OF BENEFIT PLAN AUDITS

- Which agencies conduct audits?
  - Internal Revenue Service (IRS)
    - Reviews both health and welfare plans and qualified retirement plans
    - Primary jurisdiction over qualified status of retirement plans
  - Department of Labor (DOL)
    - Reviews both health and welfare plans and qualified retirement plans
    - Primary jurisdiction over the fiduciary standards, ACA reporting and disclosure requirements, and non-qualification matters
  - Health and Human Services (HHS)
    - Limited to health and welfare plans
    - Primary enforcement of HIPPA requirements (Privacy, Security, and Breach Notification Rules) and ACA
OVERVIEW OF BENEFIT PLAN AUDITS

What types of plan are audited?

- Qualified Retirement Plans
  - 401(k) Plans
  - Profit Sharing/Stock Bonus Plans
  - ESOPs
  - Defined Benefit Plans

- Health and welfare
  - Medical, dental, vision, and prescription drug plans (including COBRA)
  - Life, disability, AD&D
An IRS Audit may occur as a result of:

- Random selection
- Referral from the DOL
  - Certain matters found on audit by the DOL are required to be reported to the IRS (e.g., prohibited transaction matters)
- Identification of an Abusive Transaction
- Risk Assessment Program – Industry Specific
- Participant Complaint
What is the Scope of a Typical Exam?

- Documentary and Operational Compliance Issues
  - Documentary compliance issues [Remember: Determination Letter Program is going away]
    - Signed plan documents
    - Proper and timely amendments
    - Compliance/Participation with the Determination Letter Process
    - Returns and Reports
  - Operational Compliance Issues
    - Eligibility, Participation, Coverage
    - Vesting
    - Discrimination
    - Top Heavy Requirements
    - Contribution and Benefit Limits
    - Funding and Deductions
    - Distributions
    - Trust Activities
Employee Plan Examination Process

Your retirement plan is selected for audit

Letter sent requesting review of plan records and documents

Appointment date set between Employer/POA or Authorized Representative and Internal Revenue Service Agent

IRS AGENT CONDUCTS ON-SITE AUDIT OF PLAN

Is additional information needed?

Yes

Employer mails additional information to agent or agent conducts subsequent visit

No

Are there any issues requiring change?

Yes

TAX CHANGES
(Potential income or excise tax)

or

CORRECTION PROGRAMS
(Employee Plans Compliance Resolution System)

or

UNAGREED CASE/REVOCATION
(Proposed revocation or nonqualification letter issued)

No

CASE CLOSED
Closing letter issued
The Request Letter(s) – The IRS Agent will provide a series of “Information/Document Request” letters (IDRs) that identify certain information to be provided regarding the plan and the plan sponsor

- Identification of members of the controlled group
- Identification of other plans sponsored by the controlled group
- Tax Forms (e.g., 5330, 1099-R, W-2, 990-T)
- Plan and Trust documents
- Correction applications and resolution
The Request Letter(s) (cont.)

- DC Plans
  - Information regarding eligibility (including census)
  - Distribution process

- Internal Controls Inquiry – someone must know and be responsible for certain plan processes
  - Ensure timely adoption of amendments
  - Participant communication
  - Preparing participant tax forms/reports
  - Distributions
    - In the ordinary course (e.g., upon termination of employment)
    - Hardship*
    - In-service

- Internal Audit Requirements
**Fees and Penalties**

- **Plan Disqualification!**

- The IRS almost always attempts resolution with the plan sponsor for a fee either through VCP or Audit Cap – always cheaper to correct before audit.

<table>
<thead>
<tr>
<th>VCP Fees</th>
<th>Audit CAP Fees</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong># of Participants</strong></td>
<td><strong>Fee</strong></td>
</tr>
<tr>
<td>20 or fewer</td>
<td>$750</td>
</tr>
<tr>
<td>21 to 50</td>
<td>$1,000</td>
</tr>
<tr>
<td>51 to 100</td>
<td>$2,500</td>
</tr>
<tr>
<td>101 to 500</td>
<td>$5,000</td>
</tr>
<tr>
<td>501 to 1,000</td>
<td>$8,000</td>
</tr>
<tr>
<td>1,001 to 5,000</td>
<td>$15,000</td>
</tr>
<tr>
<td>5,001 to 10,000</td>
<td>$20,000</td>
</tr>
<tr>
<td>Over 10,000</td>
<td>$25,000</td>
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</tbody>
</table>

- Company can also be liable for:
  - Improper deductions
  - Excise taxes
Surviving an IRS Exam

- Helpful IRS Publications
  - Form 5772 – Audit Plan (procedural and technical requirements reviewed by agents) [http://www.irs.gov/pub/irs-tege/form5772.pdf]
A DOL Audit may be triggered by:

- Random selection
  - A certain number of plans filing a Form 5500 are selected each year for audit
- Concerns over information included in the Form 5500
  - Identification of late contributions
  - Lack of Fidelity Bond
  - Improper completion of Schedule C identifying compensation paid to providers
- Participant complaints
  - Office of Participant Education – a DOL office allowing for complaints of possible ERISA violations
- National Enforcement Project
  - Plans using certain providers may be targeted
- Referral from the IRS
The DOL has been very active in ESOP investigations
- The DOL has **broad** subpoena and investigatory powers
- Standing is not an issue as ERISA grants Secretary of Labor standing to sue

DOL investigations can lead to criminal indictments in addition to civil penalties
- Willful violation of ERISA reporting and disclosure requirements – up to $5,000 in fines per individual, $100,000 for any other entity, and possible 1 year imprisonment
- Knowingly making false statements or concealing or failing to disclose any fact needed to prepare ERISA reports - $10,000 fine, 5 years imprisonment, or both

Statute of Limitations
- May be suspended under Tolling Agreement
ESOP AUDIT ACTIVITY

- In 2012, DOL started a campaign to address perceived abuses in ESOP transactions
- Two pronged attack:
  - Proposed fiduciary rule to bring valuators and financial advisors under the fiduciary standard
  - Initiated litigation to address perceived overvaluations of stock purchased by ESOPs
- Development of the National Enforcement Project for ESOPs

**Employee Stock Ownership Plans** - The Employee Stock Ownership Plan (ESOP) project is designed to identify and correct violations of ERISA in connection with ESOPs. ESOPs are designed to invest primarily in employer securities. Due to their unique nature, ESOPs can have distinct violations, as well as violations that might occur in any employee benefit plan. One of the most common violations found is the incorrect valuation of employer securities. This can occur when purchasing, selling, distributing, or otherwise valuing stock. Other issues involve the failure to provide participants with the specific benefits required or allowed under ESOPs, such as voting rights, ability to diversify their account balances at certain times, and the right to sell their shares of stock when received. EBSA will also review the refinancing of ESOP loans following EBSA's issuance of FAB 2002-1. (See [http://www.dol.gov/ebsa/erisa_enforcement.html](http://www.dol.gov/ebsa/erisa_enforcement.html))
Who is the U.S. Department of Labor?

- Employee Benefits Security Agency
  - Directed by an Asst. Secretary of Labor reports to Sec. of Labor
  - 10 regional offices and 5 district offices
  - 400 investigators/auditors
  - Responsible for over 700,000 retirement plans
  - Responsible for about 2.3 million health plans
  - National priorities and **broad local discretion**
  - DOL has independent authority to litigate – Solicitor of Labor

- **Regional:** Boston, New York, Philadelphia, Atlanta, Cincinnati, Chicago, Dallas, Kansas City, San Francisco, and Los Angeles

- **District:** Washington, D.C., Miami, Detroit, St. Louis, Seattle
What Is the DOL Interested In?

- Form 5500s - accurate and complete
- Participant Communications
  - Summary Plan Descriptions/Summary of Material Modifications
  - Participant-Directed Investment Information
- Reasonableness of Plan Fees
- Timely Deposits of Participant Money
- Assets Properly Diversified
- Fidelity Bond in Place
- Evaluation and Monitoring of a Plan’s Service Providers
- Review of Potential Prohibited Transactions
- Applicable legal requirements satisfied
- Fiduciary Breaches
What Is the DOL Interested In (cont.)?

- ESOP Valuations…ESOP Valuations…ESOP Valuations
  - ESOP valuations have been “an area of chronic problems” and that the DOL is pursuing a “big number” of cases for 2014. ~ Tim Hauser of EBSA at the ABA Conference, February 2014
  - “Valuation is the first, second, third, and fourth problem” of ESOP deals. ~ Tim Hauser of EBSA in the WSJ
  - Focus of DOL in ESOP Transactions
    - Was the transaction designed primarily to benefit the employees (and their retirement)?
      ~ OR ~
    - Was it merely a capital financing tool to enrich the sellers?
Common Issues Raised by the DOL (ESOP)
- Exempt Loan Document Issues
  - Forgiveness of debt as a repayment technique
  - Payment of attorneys fees and costs on an event of default
- Indemnification Agreements between company and fiduciary
- Fidelity bond
- Conflict of Interests Issues
  - Internal trustee sold to the ESOP/is also on the board of directors
- Redemptions from non-ESOP shareholders while the ESOP is in place
- Valuation issues
- Payment of plan expenses
Remedies for Failures Asserted by the DOL
- Money Awards – Recovery of money due to the plan
- Equitable remedies
- Attorney Fees
- Statutory penalties
  - Excise Taxes (Prohibited Transactions)
  - $110/day for reporting violations
  - 502(l) penalty for fiduciary breach; 20% of recovery amount
- Removal of Trustee and Bar Orders
- Report to IRS
- Criminal Liability
  - Willful violation of ERISA reporting and disclosure requirements – up to $5,000 in fines per individual, $100,000 for any other entity, and possible 1 year imprisonment
  - Knowingly making false statements or concealing or failing to disclose any fact needed to prepare ERISA reports – $10,000 fine, 5 years imprisonment, or both
SAMPLE REQUEST LETTER

1. **Signed** originals of the Plan Document, Trust Agreement, and all amendments thereto;
2. Most **recent** Summary Plan Description and any Summaries of Material Modification;
3. Summary Annual Reports;
4. Most recent IRS letter of qualification determination;
5. Most recent **Fidelity Bond Policy**, including all endorsements and riders;
6. Most recent Fiduciary Liability Insurance Policy, including all endorsements and riders;
7. Annual Reports (Form 5500 series) and any associated financial statements/schedules, accountant’s opinions and/or management letters;
8. Current detailed listing of assets owned by the Plan;
9. **Documents** regarding Plan **policies and/or procedures**;
10. **Minutes** from Trustee and/or Administrative Committee meetings;
11. Agreements or contracts between and/or among third party service providers, the Plan and the Plan’s sponsor, and all amendments to such agreements,
12. Documentation regarding any ERISA individual prohibited transaction exemptions that have been applied for;
SAMPLE REQUEST LETTER – CONT’D

13. Payroll information summarizing deductions from participants’ salaries for contributions to the Plan, including monthly, semi-monthly, bi-weekly or weekly payroll reports of participant contributions.

14. Canceled checks and/or wire transfers which verify the deposit of participant contributions made by the plan sponsor to the Plan.

15. Documentation regarding employer contributions from the plan sponsor to the Plan.

16. Correspondence between the Plan’s custodian/trustee and the plan sponsor relating to any late or delinquent contribution remittances to the Plan.

17. Organizational chart for the plan sponsor.

18. Documentation pertaining to participant loans, including the Plan’s loan policy and for each outstanding loan, the following items (for plans with more than 25 loans, a sample will be selected during the onsite visit):

   (a) Signed loan application,
   (b) Promissory note,
   (c) Collateral agreement,
   (d) Amortization schedule,
   (e) Cancelled front/back copy for the loan proceeds,
   (f) Maximum loan calculation,
   (g) Identification whether the loan is in default; and

19. Sample benefit statement distributed to participants after the close of the most recent plan year or quarter.
BEST PRACTICES – ALL THE TIME

- **Plan Governance Structure**
  - Know who is responsible for what (Board of Directors vs. Plan Administrative Committee)
    - Decisions made by the wrong authority may be disregarded entirely

- **Administrative Procedures and Monitoring**
  - Process, Process, Process!
  - Evidence of the process is vital
  - Ensure continual monitoring of the process

- **Mini Review of Compliance With Plan Terms, Reporting and Disclosure Requirements**
  - The audit requests from the IRS and DOL will ask how the plan sponsor ensures it meets certain requirements
  - Evidence of internal audit is helpful

- **Maintenance of Plan Documents**
BEST PRACTICES – ONCE AUDIT INITIATED

Organization is the Key – Top Factors in Successful Completion of an Audit

- Organize a response team (ERISA counsel, HR, benefits, consultants, etc.) to review scope of investigation
- Appoint 1 person for all contact with DOL investigator – generally ERISA Counsel
- Have ERISA Counsel serve as conduit for all information and communication
- Generally will need to seek additional time to respond; confirm in writing
- Provide only the documents requested – Keep copies and keep in order produced so you can easily access when questions
- Notify senior management and liability insurer
- Work with ERISA counsel to prep employees for DOL interviews
- Debrief employees after they meet with DOL investigator
- Keep notes of all interviews and all responses
- If agree you agree to voluntarily correct, clarify what must be done and by when
  - Develop a project plan and assign responsibility
  - Keep DOL investigator informed of progress
BEST PRACTICES – THE INTERVIEW

- Have ERISA Counsel sit in on all interviews
- Be Comprehensive
  - Provide complete information based on what has been requested
- Be Organized
- Be Cooperative and Helpful
- Answer the Question Asked…and Only the Question Asked
- Do Not Be Afraid to Respond with “I Don’t know” or “I will have to review my files”
- Do not speculate on anything that is outside your responsibility, expertise or knowledge
IRS CORRECTION PROGRAM

- Prior to Audit – Maintenance of a compliant plan (document and operation) is key
  - Self-Correction is Available
  - IRS Correction Program
    - “EPCRS” – Employee Plans Compliance Resolution System
    - Revenue Procedure 2013-12
    - Types of Failures
      - Plan Document Failure
      - Demographic Failure
      - Operational Failure
    - NOT Available if the Plan is Under Audit
IRS CORRECTION PROGRAM

- Correction Alternatives
  - Self-Correction Program (“SCP”)
  - Voluntary Correction Program (“VCP”)
  - Audit Closing Agreement Program (“CAP”)
- Correction must be reasonable and appropriate
  - EPCRS contains pre-approved correction methods
  - “Put the plan into the position it would have been in had no failure occurred”
- Consequences of Not Correcting
  - Possible Plan Disqualification
IRS CORRECTION PROGRAM

- Must correct all taxable years (even if closed)
- Restore plan and participants to position they would have been in had the failure not occurred
  - Be aware of lost earnings
- Should be reasonable and appropriate
- Appendix A/B deemed reasonable
- Consistent with IRC (don’t create another violation)
- Provide benefits to NHCEs
- Keep assets in plan
- Consideration of other agencies
Prior to Audit – Correction of Fiduciary Failures is Possible

- DOL Correction Program
  - Voluntary Fiduciary Correction Program
    - Self-correction of ERISA compliance issues
    - Applicable to fiduciary violations only
  - Requires filing with the DOL
    - No applicable filing fee
    - Unlike EPCRS correction under the DOL’s VFCP is limited to certain identified transactions
Covered Transactions

- Delinquent Participant Contributions and Participant Loan Repayments to Pension Plans
- Delinquent Participant Contributions to Insured Welfare Plans
- Delinquent Participant Contributions to Welfare Plan Trusts
- Fair Market Interest Rate Loans to Parties in Interest
- Below Market Interest Rate Loans to Parties in Interest
- Below Market Interest Rate Loans to Non-Parties in Interest
- Below Market Interest Rate Loans Due to Delay in Perfecting Security Interest
- Participant Loans Failing to Comply with Plan Provisions for Amount, Duration, or Level Amortization
- Defaulted Participant Loans
- Purchase of Assets by Plans from Parties in Interest
- Sale of Assets by Plans to Parties in Interest
- Sale and Leaseback of Property to Sponsoring Employers
- Purchase of Assets from Non-Parties in Interest at More Than Fair Market Value
- Sale of Assets to Non-Parties in Interest at Less Than Fair Market Value
- Holding of an Illiquid Asset Previously Purchased by Plan
- Benefit Payments Based on Improper Valuation of Plan Assets
- Payment of Duplicate, Excessive, or Unnecessary Compensation
- Improper Payment of Expenses by Plan
- Payment of Dual Compensation to Plan Fiduciaries
DOL CORRECTION PROGRAM

- Required Steps
  - Identification of all violations
  - Determination as to whether VFCP applies
  - Follow the VFCP process for correction
  - Calculate and restore any losses or profits with interest
  - Distribute any supplemental benefits to participants
  - File an application with the appropriate EBSA regional office
    - Include documentation showing evidence of corrective action taken
    - Include required plan documents
Important Dates and Things to Remember (Calendar Year Plan)

- Jan. 1 – Diversification notices must be provided to participants eligible to diversify in the ESOP (generally age 55 plus 10 years of plan participation). Participants have 90 days to make their election
- Jan. 31 – Form 1099-R must be mailed to participants who received a distribution in the prior calendar year
- Jan. 31 – Form 945 must be filed, but only if there was Federal withholding from distributions paid during the year.
- Jan. 31 – Form W-2 must be mailed to participants
- Jan. 31 – Form 5500 must be approved for filing
- Jan. 31 – Summary Annual Report (SAR) must be approved for distribution
- Feb. 28 – Form 1096 must be sent to IRS for participants who received a 1099-R
- Mar. 15 – Corporate tax return due & plan contributions must be deposited unless tax return is put on extension
- Mar. 15 – ADP test must be done for 401(k) plan and refunds must be made for failed test results
- Apr. 1 – Required Minimum Distributions (RED) must be paid to certain participants who have attained age 70½
- Apr. 15 – Extended deadline for Form 5500 approval for filing
Important Dates and Things to Remember (Calendar Year Plan)

- Apr. 15 – Extended deadline for SAR approval for distribution
- July 31 – Form 5500 due unless deadline is extended (to extend, Form 5558 is due on or before July 31)
- Sept. 15 – Extended deadline for corporation tax return due & plan contributions must be deposited
- Sept. 30 – SAR must be distributed to participants unless Form 5500 filing deadline was extended
- Oct. 15 – Extended deadline for Form 5500 filing
- Dec. 1 – Deadline for safe harbor and qualified default investment alternative (QDIA) notices
- Dec. 15 – Extended deadline for distributing SAR to participants
- Dec. 31 – Deadline for certain discretionary amendments
- Dec 31 – Annual required minimum distributions from retirement plans are due to be paid
Internal Controls

- Provide census & trust data to your TPA
- Discuss compliance/discrimination test completion with your TPA
- Participant loan repayments (if applicable)
- If your plan requires an auditor’s opinion to be attached to the Form 5500
  - Provide financial information to audit firm
  - Coordinate with your TPA and auditing firm as to completion dates
- Once plan administration is completed, determine participants eligible to receive distributions under the plan(s) and establish when the distribution forms need to go to the participants and plan for dates to cut checks
- Monitor hardship distribution requirements
- Review your fidelity bond to insure that it is enough to cover all plans as required
KNOW YOUR COMPLIANCE REQUIREMENTS

Internal Controls

- Review your plan documents for any necessary (or desired) amendments (coordinate with ERISA attorney).
- Ensure participants receive required notifications.
- SAFE HARBOR NOTICE
  - Strict compliance with timing requirements.
  - The notice must contain:
    - Safe harbor contribution formula
    - Any other contribution to the Plan and the conditions under which such contributions are made
    - The plan to which the safe harbor contribution will be made
    - The type of compensation that can be deferred
    - Information on how to make elective deferrals, including the periods available for making such election
    - Withdrawal provisions of the Plan
    - Vesting provisions of the Plan
    - Information on how to easily obtain additional information
Internal Controls

More SUMMARY PLAN DESCRIPTION

- A new participant is required to receive a Summary Plan Description ("SPD") within 90 days after becoming a participant.

- In the case of a participant’s death, the spouse and/or designated beneficiary is required to receive an SPD within 90 days after first receiving benefits.

- For a NEW plan, the last date for distribution of an SPD is 120 days after the adoption date (or if later 120 days after the plan’s effective date).

- For an AMENDED plan, the last date for distribution of a Summary of Material Modifications ("SMM") or an amended SPD is 210 days after the end of the plan year in which the amended or restated plan is effective.

- Some practitioners are of the opinion that the SMM or SPD should be provided no later than 60 days after the later of the adoption date or effective date of the amendment, so be sure to check with your advisors.

FORM 1099-R/1096

- Any participant who receives a distribution of more than $10 from a qualified retirement plan is required to be reported on Form 1099-R. The Form must be mailed to the participant no later than Jan. 31 following the year of the distribution.

- The Form 1096 is used to transmit the Forms 1099-R to the IRS. This Form must be postmarked by Feb. 28.
Internal Controls

- **FORM 5500**
  - The Form 5500 (except Schedule E and Schedule SOSA) must be open to inspection by Plan participants. Participants may also request copies of the Form.
  - Participants may also view prior year’s Forms online at www.freeerisa.com.

- **SUMMARY ANNUAL REPORT**
  - The Summary Annual Report must be furnished to all participants of the Plan within nine months after the close of the plan year or two months after the close of the period for which an extension of time to file the Annual Report was granted.
  - According to the Department of Labor regulations, the Summary Annual Report must be distributed to active participants, terminated participants with beginning or ending balances and beneficiaries receiving or entitled to receive benefits from the Plan.
  - If there are fewer than 100 participants, 25% of which are literate in the same non-English language, or more than 100 participants, 10% of which are literate in the same non-English language, you must provide these participants with an English language Summary Annual Report along with a common non-English language notice outlining the procedures to follow in order to obtain assistance in translating the Report.