Lessons Learned from IRS Audits of 401(k) Plans

The Internal Revenue Service (IRS) conducts hundreds of audits of 401(k) and other employee qualified retirement benefit plans each year. Audits can result from participant complaints, inter-agency referrals, responses contained in the plan's Form 5500 or from the random selection of the plan for audit.

There are many 401(k) plans that go decades without an audit. Some plans are never audited by the IRS; but what happens when a 401(k) plan is selected for audit?

The process begins when the plan receives an initial audit letter (generally referred to the "IDR letter") from the IRS.

The initial IDR letter asks for scores of documents. The requested documents include those that should be readily accessible such as the 401(k) plan document, amendments, the Summary Plan Description, any Summary of Material Modifications, the most recent IRS Determination Letter and the plan sponsor's relevant tax returns. The IDR also requests documents and information that may take longer to access, such as payroll information and trust account statements.

The agent will use the documents and information provided to start the audit. Frequently, the agent will prepare a second IDR letter to request additional documents/information. The second IDR letter may include specific questions or concerns the agent has regarding the operation of the plan.

In a perfect world, the documents and information provided to the agent pursuant to the initial IDR letter are sufficient and the audit is concluded with a letter from the IRS stating that no changes are required. At this point life returns to normal - or at least pre-audit status.

Unfortunately, the agent sometimes finds document or operational errors that require remedial steps, including the payment of penalties or fines. The plan sponsor must correct these errors before the audit can be concluded.

Experience has shown that there are certain aspects of a 401(k) plan's operation and documentation that are almost always examined during an audit. Below, I briefly discuss some of the issues that we have seen in our representation of plans that have undergone or are undergoing an IRS audit.

We thought this information would be helpful for 401(k) plans in the day-to-day operation of the plan and in preparing for the audit that hopefully will never occur.

Plan Documents. The IRS requires that all qualified plan documents be amended periodically to comply with changes in the tax laws. A plan that is operating under an out-of-date or non-compliant plan document is an easy error for an auditor to identify.

The consequence of a non-compliant plan document is serious: the plan could lose its tax-qualified status.

Most audits will request plan documents that go back to the most recent favorable determination letter. However, if an operational or document error is discovered, it is not uncommon for an auditor to request documents going back to the commencement of the error, which could be 5, 10, 15 years or more. I recommend that plan sponsors maintain original and electronic versions of all plan documents – including amendments. For some active plans, I have plan documents that date back to the 1970s. Hopefully, they will never have to be produced – either to the IRS or during litigation – but the best practice is to maintain the documents in perpetuity (or until the plan is terminated and the risk of audit or lawsuit no longer exists). For this purpose, plan documents include Summary Plan Descriptions, Summary of Material Modifications Determination Letters, distribution summaries and other related documents.

Employee Eligibility. The 401(k) plan document must contain the plan's eligibility requirements. Typically, a 401(k) plan will require the completion of a period of service and/or the attainment of a certain age in order to be eligible to participate. The auditor will use payroll, employee census and other employment records to ensure that newly eligible employees and re-hired employees enter (or re-enter, as the case may be) the plan in a timely manner.

One specific plan eligibility provision that the IRS finds problematic is the exclusion of employees solely on the basis of classification as a "part-time employees." An employee's status as part-time versus full-time is not a permitted eligibility provision, rather it is the hours worked (or age) that is determinative for eligibility purposes. Employers should confirm that employees are not being excluded solely on the basis of being classified as "part-time."

Operational compliance with the plan eligibility rules is a qualification requirement. If an employee does not commence or recommence participation in a timely manner, the plan sponsor will have to retroactively correct the improper exclusion. This may involve making corrective contributions on behalf of the improperly excluded employee(s). The plan sponsor should check periodically with its payroll provider and third-party administrator ("TPA") to make certain that all hours of service counted under the plan are being properly reported and that all locations are being included in the payroll and employee census information.

Definition of "Compensation." Most prototype 401(k) plan documents allow the plan sponsor to choose between several permissible definitions of compensation.

The IRS auditor will ask for payroll information and other documents to check on compensation compliance. For example, if the plan document states that bonuses and overtime are included in the definition of compensation, the auditor will review plan records to make certain that contributions are made and discrimination testing is done using the correct definition. This may be seem intuitive, but we see plan sponsors who have changed payroll companies and the new payroll provider does not key in the proper definition of compensation for salary deferral and other purposes.

The 401(k) plan sponsor should periodically check with the payroll provider and TPA to make certain that the proper definition of compensation is used for all plan purposes.

Independent Contractor versus Employee. The determination of an individual's status as an independent contractor versus an employee is generally a labor law issue. However, this determination can have 401(k) plan implications. If a plan or plan sponsor is audited, the auditor may review the work records and histories of individuals who are paid as independent contractors to determine if they are actually employees (or refer the matter to another government agency for this determination). If the IRS or other entity reclassifies an independent contractor as an employee, then the plan may be non-complaint because of the previous exclusion of the "employee" on the belief that he or she was an independent contractor. Conversely, a plan may be non-compliant if it covers an employee who is reclassified as an independent contractor. If the plan sponsor has any questions as to an individual's status as an employee or independent contractor, the sponsor should seek advice from counsel as to the correct classification.

Plan Loans. Failure to comply with the IRS rules regarding participant loans is a common error discovered during audit. There should be significant paperwork associated with each 401(k) plan participant loan. Many plans fail to retain all documentation relating to the loan such as loan terms, repayments, loan documents, collateral agreements, etc. The plan sponsor should retain loan documents for a reasonable period after the repayment of the loan. If participant loans are handled by a TPA, vendor or over the Internet, the plan sponsor should understand, and be comfortable with, the record retention policy of the TPA, vendor, etc.

Hardship Withdrawals. Many 401(k) plans allow for hardship withdrawals in the event of immediate and heavy financial need. Examples of immediate and heavy financial need include medical expenses, payments to prevent eviction, expenses for home repair and others.

In the past, auditors would ask for detailed documentation relating to the hardship event.

Earlier this year, the IRS issued a memo to its agents clarifying the documentation needed to substantiate a hardship withdrawal. The memo provides that the plan sponsor or the third-party administrator may "substantiate" that a request satisfies the safe harbor hardship requirements by obtaining the hardship substantiation or "source" documents from the participant. Source documents include estimates, contracts, bills or other statements relating to the hardship.

Alternatively, the plan sponsor or TPA may obtain "summary information" provided by the participant. The summary information may be obtained via "paper, electronic format or telephone records." In order to use the summary information, the participant must have been provided a notice containing certain required information. This information is set forth in the February 23, 2017, IRS memo and must include a statement that the participant agrees to preserve the source documents and make them available upon request. The use of summary information effectively allows for the use of a totally electronic method of processing hardship withdrawals.

The memo allows the auditor to request information in addition to the summary information. If an auditor finds that the participant notice or the summary information is incomplete or inconsistent on its face, the auditor may request the source documents. If employees have received more than two hardship distributions in a plan year, then, in the absence of an adequate explanation for the multiple distributions, the auditor is permitted to ask for source documents from the employer or TPA to substantiate the distributions.

The IRS memo potentially reduces the documentation needed to verify compliance with the hardship withdrawal rules. But the plan sponsor maintains the responsibility for providing documentation to the auditor. If the TPA obtains the summary information, it must provide a report or access to date to the plan sponsor at least once a year. The plan sponsor should maintain these reports with the plan records.

ADP/ACP Nondiscrimination Testing. 401(k) plans are subject to several discrimination tests. The IRS believes that one of the areas of greatest failures for 401(k) plans is the failure to properly apply the annual non-discrimination testing that applies to employee deferrals ("ADP" test) and matching contributions ("ACP" test). The auditor will request confirmation that the ADP and ACP tests are satisfied for each year under audit.

If the plan is not a safe harbor 401(k) plan (discussed below), the TPA should provide the employer with detailed calculations and information about how the plan passed or failed the ADP/ACP test. Plan sponsors should review and keep copies of annual test results.

401(k) Plan Safe Harbor Notice. A safe harbor 401(k) plan is deemed to satisfy the ADP test and/or the ACP test. For this reason, "safe harbor" 401(k) plans are popular with many employers who wish to try to simplify the operation of the 401(k) plan.

401(k) plan safe harbor status requires compliance with a number of conditions contained in the Internal Revenue Code and IRS regulations. One such condition is that a safe harbor plan sponsor must provide an annual notice to participants describing specified plan terms and the consequences of safe harbor status. If the content of the safe harbor notice is not compliant or if the safe harbor notice is not timely provided to participants, the 401(k) plan may not be able to rely on safe harbor status.

Employers should retain a copy of each year's safe harbor notice. The IRS auditor will ask for copies of the safe harbor notice as a part of the audit. During an audit, it is helpful not only if all relevant safe harbor notices are readily available but also if the plan sponsor can substantiate timing of distribution of the safe harbor notice, by means such as a dated and signed receipt, electronic records, etc.

Mid-Year Amendments to Safe Harbor 401(k) Plans. The IRS has traditionally been reluctant to approve any mid-year amendment to a safe harbor 401(k) plan. Recently, the IRS has loosened its (very) limited-amendments position, but only for specified amendments. If a safe harbor 401(k) plan is amended mid-year in a manner not approved by the IRS, then the plan may lose its Safe Harbor Status and have to satisfy the ADP and ACP tests based on actual deferrals or match. For many plans, this will be problematic. If a safe harbor 401(k) plan is contemplating a mid-year amendment, the plan sponsor must make certain the amendment is within the IRS limited-amendments parameters before adoption.

Vesting. Plan sponsors should periodically check a sample of current and terminated participants to ensure vesting is being properly calculated. Most auditors will request a list of participant payments during the year or years under audit. The payment list will include the participant's account balance, vested percentage and amount of distribution. The auditor will be looking for participants paid an incorrect amount caused by the plan using an incorrect vesting percentage. If the auditor needs additional information he or she will request documents to verify hours credited to a participant for the year or years in question. In addition, auditors will typically test the vesting percentages of a sample of plan participants.

Minimum Required Distributions. The IRS has identified minimum required distributions or ''MRDs,'' as an area of focus on plan audits. Most plan sponsors understand the MRD rules as they are applied to terminated participants who reach age 70½. However, there is more to the MRD rules than distributions starting at age 70 ½. The MRD rules can be complicated in the event of a participant's death or reemployment after age 70 ½ or if significant changes in stock ownership occur prior to or after a participant attains age 70½. As part of his or her review of the participant census, the auditor will review compliance with the MRD rules.

Calculation of MRD amounts is typically done by the TPA or the plan's accountants. For the plan sponsor, it is a good idea to periodically review MRDs that are taking place and overall compliance with the MRD rules. As with other items in this blog, the plan sponsor should retain records confirming compliance with the MRD rules.

QDRO Procedures. A qualified domestic relations order (''QDRO'') is a domestic relations court order that divides a participant's benefits in the event of divorce or legal separation. A plan should have a separate document setting forth the plan's QDRO procedures.

The auditor will be interested in the QDRO procedure because the acceptance of a QDRO will usually result in a non-employee (the alternate payee) being granted an interest in the plan.

The QDRO procedures should detail what the plan administrator will require in determining whether a domestic relations order satisfies the plan's QDRO requirements. Employers should retain QDRO procedures and determinations with their plan records and be able to produce them in case of a plan audit.

A Final Note: IRS Correction Programs. The IRS has programs available to plan sponsors that allow the plan sponsor to correct certain operational and document failures without having to endure a formal IRS audit. The correction may be performed by the plan sponsor without IRS involvement for relatively small errors or may be performed with IRS involvement for more significant errors. The costs and penalties under the correction programs are often significantly lower than the penalties imposed as a result of an audit. Our experience with these programs is that the IRS is flexible in accepting good-faith corrections and wishes to encourage plan sponsors to initiate the correction with IRS prompting.

Conclusion. The preceding discussion is not intended to address all issues that could arise during an IRS audit. Hopefully, the above will help to frame the importance of monitoring compliance with the myriad qualification requirements of the IRS and the importance of retaining plan documents and records.

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