

Federal audits and investigations of pension and retirement plans are picking up. But adequate preparation will help get the plan sponsor through the process as painlessly as possible.

In 2009, 59% of American workers over the age of 16 enjoyed the benefits of employer-sponsored pension or retirement plans.¹ These plans cover approximately 150 million workers and their dependents and include assets approaching \$5 trillion.² Plans of this nature are regulated by the Department of Labor (DOL) and the Internal Revenue Service (IRS), which exposes them to the risk of audit by both agencies. This “double threat” is why it is important for plans, administrators and trustees to understand how these audits work and how they can be best prepared when DOL or IRS knocks at their door.

John F. Kennedy once said, “[t]he time to repair the roof is when the sun is shining.” While it’s likely JFK wasn’t trying to inspire plan sponsors to prepare their plans for DOL and IRS audits, he was on the right track. An employer or board of trustees that is well-prepared for an audit will streamline the audit process, minimize paperwork, eliminate administrative costs associated with an audit and reduce the risks associated with an audit.

Ultimately, adequate preparation will get everyone back to business sooner and minimize the risk that DOL or IRS will find skeletons plan sponsors didn’t already know about. This article provides a brief explanation of how DOL and IRS audits work, what triggers them, what each agency is looking for, common results and recent statistics.

DOL and IRS Audits—One and the Same?

It is important to keep in mind that IRS and DOL enforce different laws, so the scope of their audits is different. IRS has primary jurisdiction over the tax-qualified status of retirement plans, which includes examining plans and processing requests for determination letters. This means IRS audits generally focus on compliance with the Internal Revenue Code.

In contrast, the Employee Retirement Income Security Act of 1974 (ERISA) provides DOL with the authority to conduct civil and criminal investigations of employee benefit plans. In turn, DOL audits usually focus on violations of ERISA, including fiduciary issues, prohibited transactions and reporting/disclosure problems.

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Bad Karma?

After cleansing your system of what the law refers to as “excited utterances,” your first thought when learning of an IRS or DOL audit or investigation is likely to be: “Why me?”

IRS and DOL audits can be triggered by a number of issues that vary depending on which agency is auditing your plan. In most cases, you will never be told what prompted the audit, so do not try to pry this information from the auditor. While audits are usually not entirely “random,” the fact that your plan is being audited does not necessarily mean that the agency knows you have done something wrong.

Regardless, there are several common audit triggers.

First, an audit may be triggered by participant complaints. In 2010, 1,064 investigations were initiated as a result of repeated participant complaints to DOL.³

Second, as you can imagine, there are various items on a retirement plan’s Form 5500 that tend to get the IRS’ at-

tention (i.e., a small percentage of participants compared to the number of total employees may suggest coverage issues; questionable asset concentrations may suggest unrelated business income, etc.).⁴

Third, it is important to keep in mind that DOL and IRS work together. In fact, the agencies operate under a Memorandum of Understanding that details the coordinated efforts of both agencies. As part of this agreement, DOL investigators are required to complete a checklist as part of their audit process. The checklist asks various questions aimed at identifying serious compliance issues and helps the DOL auditor identify potential issues to refer to IRS for additional investigation.⁵

Fourth, the agencies are always coming up with new audit initiatives. For instance, at the close of 2009, IRS quietly announced its largest audit initiative in years. These new audits will target approximately 6,000 employers over the course of three years and will focus on five employment tax issues: (1) worker classification, (2) fringe benefits, (3) reimbursed expenses, (4) officer compensation and (5) nonfilers.

Similarly, in 2010, DOL’s enforcement division created the Contributory Plans Criminal Project (CPCP), which is the agency’s first national *criminal* enforcement project. The CPCP targets individuals and entities perpetrating fraud against participants and beneficiaries of contributory employee benefit plans.⁶ To date, the CPCP has initiated 191 investigations and restored \$385,447 of participant assets.⁷

In conjunction with the establishment of the CPCP, DOL is rolling out another initiative examining the transmission of participant deferrals to contributory retirement plans. As part of this initiative, the Employee Benefits Security Administration, a subagency of DOL, has launched an education campaign to help participants identify plan problems. DOL even created a series of publications, including the *Top Ten Warning Signs That Your 401(k) Contributions Are Being Misused*, to help participants identify potential abuse of their 401(k) assets.⁸

Finally, audits may be triggered by an audit of your plan’s auditor. DOL’s current audit program includes audits of selected auditors’ reports. If your accounting firm is not properly auditing your plan, it could ultimately lead to a DOL audit for the plan.

Regardless of the trigger, IRS and DOL audits are on the rise.⁹ In 2008, IRS examined 334 defined benefit plans and

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5,019 defined contribution plans.¹⁰ In 2009, DOL closed 1,042 civil cases and 64 criminal cases stemming from investigations of 401(k) plans.¹¹

This Is Going to Hurt Only a Little Bit . . . Right?

DOL and IRS audits usually go back a minimum of three years and often will go back additional years if a substantial error is identified, but usually not beyond six years. Often, the agency may be willing to sign a *tolling agreement* with a plan sponsor. These agreements stop time from running on the statute of limitations. This allows the auditor to complete the audit and resolve any concerns and minimizes the risk that a plan sponsor will get stuck with penalties that could have been avoided.

Once DOL or IRS has selected a plan for auditing, the agency will send a letter to the plan sponsor with a laundry list of documents it wants to review. Initially, it will notify the plan through the mail or by phone. Generally, the auditor will establish a time to meet with the plan sponsor and plan personnel in order to conduct interviews and obtain or review additional documentation. It is important that plan personnel prepare for these interviews and carefully review plan documents and procedures in order to refresh their recollection before meeting with the auditor.

Once on site, the auditor will continue to review plan documents and likely develop an additional list of documents to review. As the auditor continues to review the plan documents and interview plan personnel, the auditor will identify issues and errors that require correction that

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may or may not result in excise taxes and other tax implications. A few things to keep in mind when dealing with an auditor:

- **Do not make up answers to inquiries because you think you “should” know the answer.** An “I am not sure” answer is often sufficient. Provide reasonable assistance and try to maintain an amicable relationship. The more help you provide, the sooner the auditor can finish and depart.
- **Determine what is being investigated.** Knowing what the auditor wants will help you gather the information you need and alert the necessary personnel to be available. Many initial letters request standard types of materials. However, unique requests may signify an area of focus for the agency.
- **Gather the requested documents and make them available during the visit.** Allow ample time to collect these documents.
- **Notify the plan’s legal counsel and independent auditors**

about the audit. They can provide invaluable assistance throughout the process. It may be advisable to have them present during the audit.

- **Designate a point person.** This should be the plan administrator, attorney or outside accountant. The point person’s duties will include coordinating with the agency on the timing of the audit, assembling and reviewing requested documentation, coordinating meetings with appropriate personnel and reporting to other plan personnel. The point person should be the only one to answer questions and provide information unless the point person and fund counsel agree otherwise.
- **Coordinate with your vendors.** Many plan sponsors outsource the administration of their retirement plan; therefore, vendors will likely play a large role in the audit process as the agencies try to understand “how things get done.”

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takeaways >>

- Audits can be triggered by a number of things; the fact that a plan is being audited doesn't mean the agency knows the sponsor has done something wrong.
- The agency may be willing to sign a *tolling agreement*, which allows the auditor to complete the audit and resolve any concerns, and minimizes the risk that a plan sponsor will get stuck with penalties that could have been avoided.
- The auditor's ultimate goal is to identify gaps in policies and procedures and inconsistencies between the plan documents and actual practices.
- Careful planning, systematic recordkeeping and efficient organization will reduce the difficulties that exist with audits.

As you prepare for the audit, gather information relating to any errors you corrected in the past. Also gather information regarding related employer and entities' information about plan mergers or significant changes. IRS and DOL offer a list of items each plan should review as part of a "mini" plan audit that may help you understand the types of information the agency is looking for.

What Is the Auditor Looking for?

During the course of an audit, the auditor will request documents and conduct interviews in order to gain an understanding of the plan policies and procedures as well as the organizational structure of the plan sponsor/board of trustees. Common areas of interest include eligibility, participation, coverage, vesting, discrimination and administrative fee issues.

The auditor will carefully evaluate plan procedures and compare them to plan documents as a means of finding discrepancies. The auditor's ultimate goal is to identify gaps in policies and procedures and inconsistencies between the plan documents and actual practices. Bear in mind that DOL and IRS regularly issue press releases detailing allegations and disseminate the (yet unproven) allegations throughout the employee benefits and union communities.

While typical findings vary based on the type of plan being audited, problems common to most types of retirement plans include a failure to:

- Amend the plan document for law changes by the end of the period required by law
- Follow the plan document's definition of *compensation* for calculating contributions
- Follow the plan document's eligibility provisions

- Satisfy the minimum distribution rules
- Follow the in-service distribution provisions of the plan document
- Correct distribution forms, make timely distributions and prepare correct tax reporting of distributions
- Follow the plan's vesting schedule
- Follow the terms of qualified domestic relations orders (QDROs)
- Timely remit participant contributions
- Secure an adequate fidelity bond
- Document relationships with service providers
- Document that fees paid for services are reasonable and prudent.

What's It Going to Cost Me?

Once interviews are completed and all document requests are fulfilled, the auditor will compile his or her findings into a final report. This report could be issued as early as a few weeks after the on-site audit concludes or as late as five-plus years from the date of the first contact.

The report will detail the auditor's conclusion with respect to the plan's qualifications or, with respect to DOL audits, whether DOL believes that ERISA has been violated. The report may indicate no further action is required because no violations were found. In other instances, the report may be more cautionary and warn the plan sponsor against minor problems or past corrections.

In instances where errors are discovered, the agency may notify the plan of correction measures it must take or, in cases where DOL is involved, that it is referring the matter to IRS.

Any issues that cannot be resolved by agreement with the auditor must be resolved using the internal mechanisms established by the auditing agency. In general, decisions may be appealed and settled through an internal appeals process without expensive and time-consuming court trials. On the other hand, there is always the risk that an audit will result in lengthy correction processes, excise taxes, criminal charges or litigation.

The Best Offense Is a Good Defense

The difficulties that exist with audits can be greatly reduced by careful planning, systematic recordkeeping and efficient organization.

First, and most importantly, organized and purposeful

documentation is essential. Document all plan policies and procedures and update them regularly. Maintain these records for seven years. With regard to DOL audits, effective meeting minutes and supporting documentation are critical. Minutes from committee meetings can help show whether plan fiduciaries have satisfied their duty of loyalty to plan participants. Courts are increasingly concerned with the process associated with fiduciary decisions; adequate documentation of the prudent processes may save plan fiduciaries from liability. Showing “procedural prudence” is critical to the timely resolution of an IRS or DOL audit.

Second, focus on internal governance structures to eliminate conflicts of interest and minimize the risk of fiduciary errors. This may include engaging outside directors and independent fiduciaries and trustees or developing committees to delineate roles and responsibilities associated with benefits plans.

Third, consider conducting an internal and preventive audit of plan vendors. If the plan sponsor is considering terminating a plan in the near future or if you anticipate an IRS or DOL audit, a vendor audit may allow you to identify problem areas and resolve them before IRS or DOL finds them. Alternatively, ask your counsel to conduct a Code and ERISA compliance audit for qualified plans to determine whether the plan meets all ERISA and IRS requirements that could potentially expose the plan to huge sums if not corrected. The benefit of this approach is that you can identify and make all necessary corrections before DOL or IRS tells you to, resulting in significantly lower penalties and stress.

Fourth, know your weaknesses. If a fiduciary is not an expert in a particular area, there is a fiduciary obligation to seek assistance from an appropriate professional (e.g., attorney, accountant, investment advisor, etc.). A fiduciary is allowed to rely on the advice of an expert if the fiduciary has investigated the expert’s qualifications, provided the expert with complete and accurate information, and made sure the reliance on the expert’s advice was reasonably justified.

Audits Happen; Be Prepared

DOL and IRS are always developing new and innovative ways to regulate employee benefit plans. As audits continue to increase, consider taking a proactive approach to protect yourself and your plan from painful audits. Know that if you receive notice of an IRS or DOL audit, you are not alone and you are not necessarily being picked on. When you receive notice, be prepared, consult with qualified advisors who have been through the IRS and DOL audit process previously, and prepare for the audit. When it comes to IRS and DOL audits, an ounce of prevention most certainly beats a pound of cure . . . especially when the government is doling out the “medicine.”

Endnotes

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