

## IRS's 401(k) Compliance Check Questionnaire: Endless Hours, Subtle Risks, or Opportunity for Improved Self-Correction

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The Internal Revenue Service (IRS) recently announced the 401(k) Compliance Check Questionnaire Project. Pursuant to the project, the IRS will contact 1,200 401(k) plans that filed Form 5500-series annual reports for the 2007 plan year. 401(k) plans will be contacted based on a random sampling. Once contacted, plan sponsors are required to complete an extensive and detailed online questionnaire.

### *The Questionnaire Project*

The questionnaire contains questions pertaining to the 2006, 2007 and 2008 plan years in the following categories:

- Demographics (type of plan, plan features, ongoing plan or frozen plan, other plans maintained by the plan sponsor, ongoing or frozen status of other plans maintained by the plan sponsor, historical defined benefit plan information, most recent favorable opinion or determination letter)
  - 401(k) plan participation (number of employees, number of participants, age and service requirements for various types of contributions, number of participants making elective deferrals, number of collectively bargained plan participants, number of highly compensated plan participants)
  - Employer and employee contributions (compensation and elective deferrals, flexibility in changing deferral elections, catch-up contributions, matching contributions, non-elective contributions, after-tax contributions, eligibility requirements for various contributions, reduction or suspension of matching or non-elective contributions)
  - Top heavy and nondiscrimination rules (top heavy testing, actual deferral percentage / actual contribution percentage testing and corrections, top heavy contributions, safe harbor status)
    - Distributions and plan loans (forms of distributions, hardship rules, plan loan rules, in-service distributions, involuntary cash-out distributions, corrective distributions)
    - Other plan operations (asset values, fraud or theft, employer stock, diversification rules, foreign investments, in-kind distributions)
    - Automatic contribution arrangements (type of automatic contribution arrangement, default investments)
    - Designated Roth features (number of participants making Roth contributions, rollover features)
    - IRS voluntary compliance programs (use of the Employee Plans Compliance Resolution System and 401(k) Fix-It Guide)

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- Plan administration (responsible parties, policies and procedures, amendment procedures, administrative procedures, information on person completing the questionnaire)

The full questionnaire can be found on the IRS website: <http://www.irs.gov/retirement/article/0,,id=223440,00.html>. The information gathered from the questionnaire will be used in a report published by the IRS identifying areas in which further education, guidance or outreach is needed. The IRS will also use the report to aid in its enforcement efforts with respect to non-compliant 401(k) plans.

### *The Consequences of Non-Completion*

The IRS has stated that the questionnaire is not an audit or an investigation/examination under section 7605(b) of the Internal Revenue Code, 26 U.S.C. § 7605(b), or an audit under section 530 of the Revenue Act of 1978. However, failure of a plan sponsor to complete the questionnaire will result in further enforcement action.

Further enforcement action with respect to plan sponsors who fail to complete the questionnaire could include investigations, examinations or audits initiated by the IRS. In addition, the IRS could increase scrutiny of subsequent Form 5500-series annual reports filed by non-responsive plan sponsors, which could lead to IRS penalties. For a non-responsive plan sponsor, increased scrutiny by the IRS could also lead to Department of Labor (DOL) investigations and audits and increased DOL scrutiny of Form 5500-series annual report filings. Given the potential for increased, and possibly multi-front IRS and DOL scrutiny if non-responsive, plan sponsors should carefully complete the questionnaire if contacted by the IRS.

### *The Consequences of Completion*

On the other hand, completion of the questionnaire could also result in further enforcement action. The IRS has stated that one of the purposes of the questionnaire is to identify areas in which enforcement is needed. Thus, merely by answering truthfully, the plan sponsor could provide the IRS with the grounds for an investigation, examination or audit of the plan sponsor's 401(k) plan. For example, if, pursuant to the questionnaire, it becomes clear that a plan has failed nondiscrimination testing and has not properly corrected such failure, the IRS may audit the plan or open an investigation focusing on nondiscrimination testing.

Importantly, if a plan is considered "Under Examination," it would not be able to utilize the self-correction procedures for significant operational failures or voluntary correction procedures under the Employee Plans Compliance Resolution System (EPCRS). (Self-correction for insignificant operational failures is still available even if a plan is Under Examination and self-correction for significant operational failures that has been completed or substantially completed prior to the plan being Under Examination is also still available.) For purposes of EPCRS, "Under Examination" generally means a plan that is under an Employee Plans examination (an examination of a Form 5500-series or other Employee Plans examination); a plan sponsor that is under an Exempt Organizations examination (an examination of a Form 990-series or other Exempt Organizations examination); or a plan that is under

investigation by the Criminal Investigation Division of the IRS. A plan that is under an Employee Plans examination or an Exempt Organizations examination includes any plan for which the plan sponsor, or a representative, has received verbal or written notification from Employee Plans or Exempt Organizations of an impending Employee Plans or Exempt Organizations examination and also includes any plan that has been under an Employee Plans or Exempt Organizations examination and is now in appeals or litigation for issues raised in an Employee Plans or Exempt Organization examination.

Thus, any noncompliance uncovered by the IRS in the questionnaire that leads the IRS to initiate an Employee Plans or Exempt Organization examination or audit could result in the plan sponsor being required to enter the "audit cap program" portion of EPCRS. Under audit cap, there is a negotiated penalty that generally is significantly greater than the voluntary fees/penalties paid under voluntary correction procedures. In addition, as noted above, any audit, examination or investigation activity by the IRS could lead to a DOL investigation or audit of the plan.

#### *Opportunity to Improve Plan Administration*

The practical necessity of being required to complete the questionnaire and the possible financial consequences of responses suggesting non-compliance should induce the prudent plan sponsor to consider using the process of completing the questionnaire as a roadmap for informal internal plan audit. The questions obviously have to be answered truthfully and completely, but they should also be answered (or the answers reviewed) by one or more persons familiar with the legal rules behind the questions and the legal implications of the answers – whether in-house or outside benefits legal counsel, experienced in-house benefits staff, or outside consultant.

Answers to some questions on the questionnaire may suggest possible non-compliance and a need to review calculations or the implementation of plan provisions. If such a review reveals one or more instances of actual non-compliance, the plan sponsor should consider whether to: (1) implement self-correction methods, if available under EPCRS, or (2) submit a formal "VCP application" under the voluntary correction procedures to the IRS. Under self-correction, the plan sponsor is not required to pay any penalties or submit any information to the IRS. Under the voluntary correction procedures, the plan sponsor identifies violations and proposed correction methods (and submits a prescribed application fee/penalty) and requests the IRS' approval of the proposed correction(s). Any required penalties/fees are relatively small; the plan sponsor has the opportunity to propose correction methods which it considers reasonable; and, overall, the costs are generally far less than the penalties imposed by the IRS when it identifies the violation first and prescribes correction under the audit cap program.

The important point is that once the IRS detects a violation from its review of the questionnaire and notifies the plan sponsor of an audit, investigation or examination, it is too late for the plan sponsor to avail itself of self-correction for significant operational failures or voluntary correction procedures under EPCRS. Anecdotally, it is not uncommon to encounter five- and six-figure audit cap penalties assessed for technical non-compliance. Penalties in the millions of dollars have been assessed on

occasion against very large employers, in some cases for seemingly disproportionately small violations, where the IRS discovered the violations first.

#### *Tips for Completion of the Questionnaire*

A reasonably precautionary approach to the review and completion of the questionnaire before it is *submitted* to the IRS in completed form is advisable. In Section 1, the plan sponsor should designate as the contact person" (the individual who will respond to any follow up by the IRS) a person with the same substantial degree of experience and legal understanding employed in the completion and review of the completed form prior to submission. When listing the other plans of the employer, be sure to do so on a controlled group basis. Allow enough time and allocate sufficient resources to locate or retrieve some data requested by the questionnaire that may not be easily accessed by the plan sponsor. At least on a random sampling basis, confirm that plan administrative procedures relating to questions on the questionnaire have been implemented in accordance with plan provisions and legal requirements rather than merely past practices.

#### *Conclusion*

Given the risk of increased IRS, and possibly DOL, scrutiny, plan sponsors should review the questionnaire thoroughly during completion and before submission to the IRS to determine if the 401(k) plan may have any noncompliance issues which might be far more inexpensively remedied by self correction and voluntary correction under EPCRS. With that in mind, plan sponsors should contact their regular legal counsel and correct such noncompliance under EPCRS as soon as possible to ensure that self-correction and voluntary correction procedures remain available.

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