

How to Prepare for a Department of Labor or IRS Qualified Plan Audit

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Do Not Take a Qualified-Plan Audit Lightly

Regardless of the quality or performance of your plan's investments, the qualified status of your retirement plan is its most precious and important asset. When a plan is "qualified", the employer can deduct certain contributions made to the retirement plan (including employee 401(k) contributions), the assets within the plan grow tax free, and distributions from the "qualified" plan can be rolled to an IRA or another "qualified" retirement plan. When a plan is "disqualified", the employer loses its deductions for prior employee and employer contributions, the trust must pay income tax, and any distributions from the retirement plan are not eligible for rollover. This means that, if the plan is disqualified, the employer (the plan sponsor) may have to amend prior corporate tax returns and pay additional taxes, penalties, and interest. It also means that the retirement-plan trust itself must usually file an income tax return (Form 990-T) and pay back-taxes, interest, and penalties, and any participants who received distributions during the period of disqualification should be notified that their distributions were not eligible for rollover to another qualified plan or IRA.

Further, the Department of Labor ("DOL") has the authority to seek criminal penalties (maximum penalties of \$100,000 or 10 years in prison) against any person who willfully violates certain provisions of ERISA. Criminal penalties can also apply to someone who embezzles 401(k) assets, or fails to transmit employee 401(k) deferrals and instead intentionally uses those deferrals to pay other business expenses. (See *U.S. v. Eriksen*.)



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It is important to realize that when you receive the dreaded audit letter, the DOL or IRS auditor is often beginning a long investigative process that may not conclude for twelve to eighteen months and could have a significant financial impact on both the plan and the employer (the plan sponsor).

Anticipate the Audit's Focus

Audits are usually precipitated by information contained on Form 5500 and the attachments or by phone calls to the DOL by disgruntled plan participants. However, some audits are simply random audits. Former DOL officials have confided that when employed by the DOL they would identify a potentially problematic retirement plan for audit but then randomly pick other retirement plans for audit in the same geographical region so as to maximize their time and resources. The DOL or IRS official will never tell you exactly why your plan was selected for an audit, but after reviewing your plan records and reports, an ERISA professional may be able to pinpoint the issue.

IRS and DOL auditors are highly trained to identify areas of noncompliance. Although audits by the two agencies cover many similar areas, each agency tends to have a different audit focus.

The DOL will primarily examine areas of potential participant discrimination, prohibited transactions, prudent investment processes, the proper engagement of service providers, plan distributions, required employee notices, beneficiary designations and consents, and plan documents.

Areas of DOL examination include:

- Have Form 5500s been filed?
- Have the Summary Plan Description and the Summary of Material Modifications been provided to all participants, as required?
- Are employees receiving benefit statements?
- If the assets are participant-directed, have the annual and quarterly fee disclosures been made to plan participants as required under ERISA regulation 404a-5?
- Have all deposits of employee 401(k) or 403(b) deferrals and loan payments been made in a timely manner?
- Have any plan assets reverted back to the employer?
- Have the plan fiduciaries determined that the plan fees are reasonable as required under ERISA regulation 408b-2?

- Has the plan trustee followed a process to determine the value of hard-to-value assets?
- Is the plan complying with section 404(c) of ERISA?
- Are the plan assets properly diversified?
- Is there a process in place to evaluate the appropriateness, cost, and effectiveness of the plan's chosen investments?
- Have any plan fiduciaries engaged in any self-dealing?
- Are the necessary fidelity bonds in place?
- Is there a process for evaluating and monitoring the plan's service providers, including the plan's record keeper, administrator, and investment professional?
- Has the plan engaged in any prohibited transactions?

The IRS auditors focus on potential issues that will generate additional tax revenue through the assessment of penalties and interest. Consequently, the IRS audit may concentrate directly on areas of potential plan disqualification.

Areas of IRS examination include:

- Is there a plan document and is it properly drafted, signed and dated?
- Have plan amendments been properly drafted, signed and dated ?
- Is there an IRS Letter of Determination? Prototype and Volume Submitter plan documents typically can rely on the IRS Opinion Letter obtained by the Prototype or Volume Submitter Master Plan Sponsor. Individually designed plan documents have no such reliance and should obtain their own IRS Letter of Determination.
- Have the required coverage tests been run?
- Is there a controlled group or affiliated service group? If so, is this reflected in the plan's nondiscrimination and coverage testing and on Form 5500?
- Did the plan distributions and plan loans properly follow the required forms and notices? Are any loans in default?
- Where applicable, have participants received Qualified Joint and Survivor Annuity paperwork?
- Where applicable, have the required Qualified Pre-retirement Survivor Annuity notices been provided to the plan participants?
- Has the plan complied with all the limits under Section 402(g) (\$17,500 limit for 2013), Section 415, and Section 404?
- Have the plan's eligibility provisions been properly followed?

- Have there been significant involuntary terminations resulting in a “partial plan termination”?
- Has the annual top heavy test been properly calculated? If top heavy, have minimum contributions and benefits been provided, if required?
- Are the vesting schedules being followed and are plan participants accurately receiving vesting credit, as required in the plan document?
- Are the required minimum distribution rules being adhered to?
- Is employee compensation, as reflected in the plan’s allocations and testing, being limited to \$255,000 (for 2013)?
- Have all highly compensated and key employees been identified, including anyone who would fall within a family grouping?
- Have there been any impermissible distributions from the plan or has the plan failed to make certain payments?
- Are any employer contributions, including employer matching contributions, being allocated in accordance with the plan document?
- Are the employer contributions to the plan being properly deducted?
- If a non-safe-harbor 401(k) plan, has the plan properly run and passed the ADP test and, if applicable, the ACP test? If necessary, have any excess contributions been distributed to the highly compensated employees?
- Do contributions, benefits, rights or features of the plan improperly favor highly compensated employees? (For example, are only certain individuals allowed to maintain self-directed brokerage accounts?)
- Are the plan’s trustees operating the plan for the exclusive benefit of the plan participants and in accordance with ERISA’s expert, prudent-man fiduciary standards? How has this compliance been documented?

Engage an ERISA Professional to Assist You with the Audit

Unless you have an extensive ERISA background in qualified retirement plans, you should engage an ERISA professional to assist you with this audit. If you do not understand the legal nuances of each and every item in the above DOL and IRS lists, you should not attempt to handle the audit yourself.

The ERISA professional whom you engage must be qualified to formally represent you before the IRS. This means that you must be able to grant him or her a limited power of attorney, using Form 2848 and following the IRS rules. Generally, attorneys, accountants, enrolled actuaries, and ERISA professionals that have earned the IRS “ERPA” professional designation



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are qualified to act as your representative. If this is a DOL audit, it may be advisable to also engage an ERISA attorney.

Make sure that the professional you engage has an extensive ERISA background and actively works in this field on a fulltime basis. Simply because someone is an attorney, accountant, or a CPA does not itself make him or her an ERISA professional. Before engaging an ERISA professional, here are some questions you can ask:

- What ERISA professional designations do you hold?
- Are you actively engaged in industry-specific ERISA continuing education? If so, what classes, seminars, or conferences have you taken or attended in the last 12 months?
- How many IRS and DOL audits have you been involved in?
- How many years of experience do you have working in the qualified plan, ERISA field?
- Have you created a specific, written pre-audit process and compliance checklist?
- How do you bill your time for the audit preparation, the audit itself, and any audit follow up work?
- Have you assisted any clients through the IRS Employee Plans Compliance Resolution System (“EPCRS”) either through the Voluntary Correction Program (“VCP”), the Self-Correction Program (“SCP”), or the Audit Closing Agreement Program (“Audit CAP”)?

Here is a summary of the ERISA professionals you can turn to for help and the professional designations you should look for:

- Attorney: most attorneys do not specialize in the qualified retirement plan field; however, in any major city there will be highly qualified attorneys that work fulltime in this specialized area of ERISA law. Large law firms usually have an ERISA department. Some small law firms or sole practitioners work only in the ERISA field. Attorneys with at least three years of ERISA experience can apply to be an “Associated Professional Member” (APM) with ASPPA.
 - Advantage: often the best ERISA resource available
 - Disadvantage: \$\$\$\$. Expect to pay \$200 - \$500 per hour for their services
- CPA: most CPAs do not specialize in the qualified retirement plan field. Nevertheless, some CPAs are a source of excellent ERISA expertise. Asking the above questions of your CPA will help you to determine his or her level of ERISA knowledge. CPAs with at least three years of ERISA experience can apply to be an “Associated Professional Member” (APM) with ASPPA. Qualified retirement plans with 100 or more plan participants must usually file a CPA audit report along with the annual Form 5500. CPAs

that specialize in this audit field can also be a good resource for assistance with an IRS or DOL audit. Some CPAs have also earned additional professional designations in the ERISA field. See the list below.

- Advantage: usually a good, highly organized ERISA resource. If the CPA already provides an annual audit for your plan, he or she will be familiar with it and have many of the reports, documents, Form 5500s, and other information requested by the IRS or DOL readily available.
- Disadvantage: \$\$\$. Depending on your CPA's billing rate, cost may be an issue.
- Actuary: actuaries are used in many different fields. For example, an actuary set the life and health insurance premium rates that you pay. Some actuaries specialize specifically in the ERISA, qualified retirement plan area. However, actuarial services are only required (by the IRS) of qualified defined benefit retirement plans. If your plan that is being audited is a defined benefit or cash balance plan, the services of your actuary will be required, at least to some extent, because certain audit reports required by the IRS must be prepared by your actuary. However, hiring an actuary to assist you with the entire audit may be a little like hiring a rocket scientist to fix your broken model-Estes rocket. Most actuaries are mathematical geniuses or they would not be working in the field. However, generally speaking, communicating with an actuary usually requires you to be bilingual in English and "actuarial-eze". Actuaries who work on ERISA retirement plans must hold certain professional designations. See the list below.
 - Advantage: highly knowledgeable in ERISA
 - Disadvantage: \$\$\$\$. Actuarial services are in high demand and their billing rates reflect that reality. Most actuaries focus exclusively on defined benefit plans and therefore may not be technically knowledgeable in the nuances of defined contribution plans, such as 401(k) plans.
- TPA (Third Party Administrator): A TPA is an entity that specializes in the consulting and administration of qualified retirement plans. They have actually prepared and completed the Form 5500; performed the required ADP/ACP test; conducted the required coverage and nondiscrimination testing under Internal Revenue Code sections 410(b) and 401(a)(4), respectively; and may have assisted with the design of your plan and prepared the plan's Adoption Agreement and Summary Plan Description. A great TPA has an excellent understanding of ERISA, knows how to practically apply the rules and regulations, and can effectively communicate these rules to the client in an understandable way. But, be careful. There are no industry certifications or credentials that are required of a TPA. Anyone can "hang up a shingle" and claim to be a Third

Party Administrator. Great TPAs will have the industry credentials, reputation, and experience to back them up. It is important that your Third Party Administrator has earned professional, ERISA designations that help to assure you that his or her skill-set is sharp and current.

- Advantage: \$ Hiring a TPA to assist you with your audit is often the solution that provides the best and most affordable services. The TPA can also function as an audit coordinator if additional services are needed from the plan's actuary or ERISA attorney.
- Disadvantage: Vet your TPA carefully. It could be that errors in his or her work (i.e., mistakes on Form 5500) actually precipitated the audit, in which case it would be unwise to engage that same TPA to assist you with your audit.

Here is a list of professional ERISA designations you should look for.

- Membership with the American Society of Pension Professionals and Actuaries (**ASPPA**) and/or membership with the National Institute of Pension Administrators (**NIPA**). Further information is available at www.asppa.org and www.nipa.org.
- **CEFEX-Certified**. Fi360 and ASPPA joined forces to create the CEFEX designation for registered recordkeepers and Third Party Administrators. Per the CEFEX website, a CEFEX certification “provides an independent recognition of a firm’s conformity to a defined Standard of Practice. It implies that a firm can demonstrate adherence to the industry’s best practices, and is positioned to earn the public’s trust.” The CEFEX credential is rare, indeed. As of this writing, only 40 TPAs in the nation have attained this high standard.
- Individual, professional designations:
 - Actuaries must have either the **ASA** (Associate of the Society of Actuaries) or the higher, **FSA** (Fellow of the Society of Actuaries) designation. Other actuarial certifications are **MSPA** (Member, Society of Pension Actuaries) and **FSPA** (Fellow, Society of Pension Actuaries).
 - **Enrolled Retirement Plan Agent (ERPA)**. This ERISA professional credential was created by the IRS. According to the IRS website,

“An Enrolled Retirement Plan Agent is a person who has demonstrated competence in qualified retirement plan matters, allowing that individual to represent taxpayers before the Internal Revenue Service. An ERPA has earned the privilege of representing clients with respect to issues involving the following programs: the Employee Plans Determination



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Letter program; the Employee Plans Compliance Resolution System; and the Employee Plans Master and Prototype and Volume Submitter programs. In addition, ERPAs may represent clients with respect to 5500 and 5300 series forms, but not with respect to actuarial forms or schedules.

A person wishing to become an Enrolled Retirement Plan Agent must pass a two-part ERPA Special Enrollment Examination (ERPA-SEE) as well as tax compliance and background checks. The ERPA candidate must apply for enrollment with the Internal Revenue Service and follow renewal and continuing education requirements. ERPAs will be held to professional and ethical standards of conduct.”

- **APM.** This professional credential from ASPPA is available to attorneys and Certified Public Accountants who apply and have a minimum of three years experience in retirement plan related matters. No specific ERISA testing is required.
- **Certified Pension Consultant (“CPC”).** This is the highest, non-actuarial, credential offered through ASPPA. It can only be earned after successfully passing two non-proctored exams, five proctored ERISA exams, and the completion of four ERISA consulting modules. A minimum of three years of retirement plan related experience is also required.
- **Qualified Pension Administrator (“QPA”).** This is the second highest, non-actuarial, credential offered through ASPPA and requires the successful completion of two non-proctored exams, four proctored examinations, and a minimum of two years of retirement plan experience.
- **Qualified 401(k) Administrator (“QKA”).** This ASPPA credential requires the completion of 2 non-proctored exams, two proctored exams, and two years of retirement plan experience.
- **Accredited Pension Administrator (“APA”).** To earn this NIPA credential, one must complete four ERISA study courses and examinations, two of which are proctored.

If you engage an ERISA professional by completing and executing Form 2848, he or she will work with you on the remaining audit steps.

Respond in a Timely Manner to the IRS or DOL Audit Letter

The IRS or DOL audit letter will contain a required response date, usually ten days from the receipt of the letter. Within that timeframe, you or your designated representative should call the IRS or DOL auditor to schedule the audit and confirm the location of the audit.

Provide Exactly the Information Requested

The IRS or DOL audit letter will contain a list of documents that must be provided to the auditor at the time of the audit. Photocopies of these documents should be provided to the auditor in an organized manner, preferably a tabbed, three-ring binder. The documents should be placed in the same order as listed in the audit letter. All documents should be reviewed ahead of time by a competent ERISA professional to ensure accuracy and completeness. DO NOT simply hand over to the auditor all your plan records and expect him or her to locate the needed documents, for this will needlessly waste the auditor's time and expose him or her to unrequested documents (and potential issues). Give the auditor exactly the documents that are requested—nothing more and nothing less. But, have readily available additional plan documents that the auditor may request during the audit.

Choose the Audit Location Carefully

The IRS guidelines state that the examination generally will take place at the address of record on the Form 5500 because it assumes that is the location of the plan's books, records, and source documents. However, another location may be more appropriate if those plan records are more easily accessed. For example, holding the audit at the TPA's office could be the most expeditious location since almost all the plan records, with the exception of company payroll records, should be readily available. Holding the audit at the TPA's office has the added benefit of not inadvertently exposing the auditor to the plan sponsor's employees making unwise comments and may reduce the audit cost since the TPA can be available on demand to the auditor. If the TPA and the client are not within a certain physical proximity, the IRS or DOL auditor may insist on performing the audit at the address of record on the Form 5500.

Know the Auditor Process and Protocol

Auditors will bring their own computer, supplies, food, and drinks. As a matter of courtesy you can offer them coffee or soda, offer to stamp their parking ticket, etc.; however, government protocol requires them to refuse many polite gestures. Don't be offended; they are simply doing their job. Inform them of the location of the restrooms, and help to ensure that they are comfortable.

Begin the engagement with appropriate small talk and then review the order of the audit materials you have provided in the audit binder. You will be asked to explain the plan's administrative practices and procedures, as well as the general organization structure and operation of the taxpayer's business.

The examiner will analyze your information, perform tests, and sample data for particular compliance issues. Based on this review the examiner may expand the analysis to include additional details and larger samples. The agent is expected to continue the examination until it is reasonably certain that the operation of the plan satisfies the legal requirements.

When the initial field work is concluded, the examiner will explain the areas that may require your attention or correction action.

Make Sure You:

- DO NOT be adversarial or antagonistic towards auditors. Rather, treat them kindly. They are public servants doing what they can to ensure the public complies with ERISA.
- DO NOT make any false statements or provide to them any false documents. Remember, they have the power to refer you for criminal prosecution.
- DO NOT make up any answers. If you do not know the answer to an auditor's question, write it down and ask for permission to respond as quickly as possible at a later date.
- DO NOT offer up more information than the auditor requests. Answer the auditor's questions directly and completely but do not embellish with further information.
- Before the auditor, DO NOT blame your attorney, CPA, TPA, or record keeper for any of the issues the auditor discovers. Remember, ultimate compliance with ERISA rests with the plan sponsor, trustee, and plan fiduciaries. If any of your service providers (attorney, CPA, TPA, or recordkeeper) have made errors that resulted in disqualification, fines, or penalties by the IRS or DOL, you may have legal recourse against those entities; however, any IRS or DOL enforcement proceedings will be solely with you, the plan sponsor.

In Conclusion:

Although the auditor may be physically present for just a few days, the audit will likely not be concluded for several months. The auditor may request additional information and/or the auditor may conduct a second visit. The audit may result in:

- Corrections to the plan which also entail penalties, interest, and excise taxes
- Plan corrections using the IRS Self Correction Program ("SCP")



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- Plan corrections using the IRS Audit Closing Agreement Program (“Audit CAP”). If a qualification failure has not been corrected and is not eligible for correction under the SCP, the plan sponsor may be able to enter into an agreement with the IRS regarding correction of the failure and payment of a sanction. It is always advisable to engage an ERISA attorney before entering into any Audit CAP negotiations and agreement with the IRS.

The final step is a Closing Letter—a letter that explains the conclusions reached by the examiner. Issues that arise are usually resolved at the examination level. Any issues that cannot be resolved by agreement may be appealed. (See IRS Publication 1020, *Appeal Procedures for Employee Plans Examinations*.)



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