

Can Your 401(k) Plan Withstand an Audit?

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In light of heightened public scrutiny of 401(k) plan management due to the financial scandals in recent years such as Enron and Worldcom, the Internal Revenue Service (IRS) and The Department of Labor (DOL) have stepped up their auditing efforts to enforce qualified employee benefit plan requirements among sponsors.

In a report published by the IRS regarding the results of a compliance profile of 401(k) plans, it found that out of 472 plans that were examined, approximately 44% of these plans contained deficiencies. In light of the results of this study, the IRS hoped that the information compiled on areas of noncompliance would help plan sponsors identify areas of potential or existing violations.

The DOL is also trying to send the clear message to employers that their 401(k) plans cannot be left on auto-pilot. Although severe penalties and plan disqualification occur only in the most extreme cases, it is still in the realm of possibilities.

For example, plan sponsors and other fiduciaries who breach their duties may be held personally liable to make the plan whole for losses caused by their breaches. Losses can include lost-opportunity costs, attorneys' fees and court costs. In addition, the IRS and

DOL can also levy civil or possibly criminal penalties for actions that violate the Employee Retirement Income Security Act (ERISA). The qualified status of the plan can also be revoked.

Some of the areas of that have been targeted include the following:

- Timely Deposit of Plan Assets
- Plan Operations
- Plan Investments

Timely Deposit of Plan Assets

This has been a hot topic during the past year. The DOL has adopted a more stringent view of the time it should take for employers to deposit the 401(k) deferrals from employee paychecks. The regulations state that participant deferrals must be transmitted to the plan as of the earliest date on which the funds can reasonably be segregated from the employers' general assets, but no later than the fifteenth business day of the month following month that the employer withheld the 401(k) plan deferrals from the participant's paycheck. The key phrase in this regulation is "as of the earliest date on which the funds can reasonably be segregated from the employers' general assets". Many employers have mistakenly interpreted this regulation to mean that they have until the

fifteenth business day of the following month to deposit the employee deferrals. The DOL has taken the position that the 15th business day standard is NOT applicable to all employers and recommends that the majority of employers should reasonably be able to segregate these funds no later than the 5th business day after the date that the employee is paid. An employer that fails to transmit participant deferrals by this deadline may have breached their fiduciary duties and have engaged in a prohibited transaction. This may require an employer to make up for the lost earnings that the fund would have earned had the deferrals been deposited in a timely manner. In addition, the plan may be subject to an excise tax on these earnings.

Plan Operations

When audits are performed of 401(k) plans, it is not uncommon for auditors to select random samples of certain administrative forms in order to ensure that the plan is maintaining proper documentation relating to the following items:

Eligibility and Enrollment Forms:

The fiduciaries of the plan have a responsibility to track the eligibility status of all employees and notify them when they become eligible. Upon eligibility, the employee should be required to complete an enrollment form.

Signed enrollment forms should be maintained for all eligible employees who wish to participate in the plan. A common mistake made by many plan sponsors is not to require a signed enrollment form from an

eligible employee who does NOT wish to participate in the plan. It is important to remember that the IRS and DOL are concerned about the rights of the employee. If an eligible employee was not given the opportunity to join the plan and begin to save for retirement, this employee will be considered to have been put at a disadvantage and, possibly, discriminated against. Therefore, the signed enrollment form serves as the plan's only evidence that the eligible participant was notified of their eligibility and declined to participate. This completed form should be saved in the respective employee's personnel file.

Loans:

Some plans may allow participants to borrow funds from their respective account balance. This feature will also be determined in the plan document.

Typically, when a participant requests a loan from the plan, they will be required to complete a loan application. Upon approval, they should be required to sign a promissory note which details the conditions and payment terms of the loan. If the individual is married, he or she must sign a *spousal consent form* where the participant's spouse agrees to the loan. The spouse must sign this form as well. The participant can forego completing the spousal consent form only if it is specifically stated in the plan document. These documents, along with a loan amortization schedule, should be maintained in the participant's personnel file. Having a standardized loan package can help plan administrators ensure that all of the required forms have been completed.

Benefit Payments:

Benefit payments will occur when (a) the participant is terminated; (b) the participant is over age 70 ½; or (c) the participant requests a hardship withdrawal.

When participants are terminated, they should be given a benefit payment package which includes: (1) benefits distribution form, which advises the plan sponsor how he/she would like the funds disbursed; (2) spousal consent form; and (3) information which explains to the participant the tax consequences of taking the distribution, as well as the differences between being paid out and rolling over the funds.

Most plans will allow a participant to request a hardship withdrawal if they meet one of the following four criteria: (a) they are being evicted from their home for non-payment of rent or mortgage; (b) they have excessive medical bills that are not covered by insurance; (c) they are paying for post secondary education for themselves or their children; or (d) they are buying a home. If the participant requests a hardship withdrawal, they must provide documentation to support the request such as a copy of eviction or foreclosure notice, medical bill, tuition bill, copy of contract or closing statement for home purchase, etc. It should also be noted that the amount of the request cannot exceed the amount of the supporting documentation.

Plan Investments

The main goal of the DOL in this area is to ensure that each plan's investments are selected with due care, skill, and prudence, as well as for diversifying investments to minimize the risk of large losses. In addition, the performance of these investments should be reviewed on a regular basis. There are many ways that employers can achieve these goals while limiting potential liability.

The plan should have a written investment policy or philosophy. Items that should be incorporated in this investment policy or philosophy include: (a) portfolio composition with respect to diversification; (b) portfolio liquidity; (c) projected return of the portfolio relative to the fund objectives; (d) document the investment selection and monitoring process of the plan. From a liability standpoint, courts have upheld cases where the operations and investments held by the plan were consistent with a preplanned written policy or philosophy.

While participants can be given control of the investments in their accounts, it is the fiduciary responsibility of the trustees of the plan to provide a broad range of investment options. The DOL requires that there be at least three investment options so a participant can diversify their investments. Participants must also be allowed to make changes to their investment portfolio at least once a quarter. More frequent changes may be necessary depending on the volatility of the investments.

How You Can Protect Yourself

An audit performed by the IRS or DOL can be extremely costly in terms of time and expense, not to mention anxiety. There are, however, many steps that a plan can perform in order to avoid being audited. For example, the plan sponsor should perform periodic self-evaluations in order to determine if the plan is compliant in its operations and ensure that all required administrative forms are complete and accurate. A self-evaluation also allows the Plan Administrator to identify potential problem areas and be proactive in correcting the problems rather than being reactive after the fact when the plan has been selected for audit.

Finally, while many employers hire benefit professionals to run their plans, many plans are administered by the controller or human resources professional, who has many job duties in addition to administering the 401(k) plan. Often, this individual has not attended seminars or outside training on the latest requirements governing qualified plans. It may be, therefore, a good idea to have a benefits professional periodically review the plan's operation and design to ensure that it is being administered according to government standards.

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