

# Morgan Lewis

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## IRS and DOL Audits

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# Summary

- Statutory Authority
- Audit Liability and Penalties
- Logistics and Preparation for an Audit
- What IRS and DOL examine
- Compliance Reviews and Self-Correction Programs

# Statutory Authority

- IRS - *Internal Revenue Code* (“IRC”)
- Department of Labor (“DOL”) - *ERISA*
- Both statutes give IRS and DOL authority to conduct investigations to determine whether any person has violated or is about to violate IRC or ERISA, respectively

# Statutory Authority

- Investigative Authority - Both IRS and DOL have authority to:
  - *Perform on-site audits*
  - *Require submission of reports, books, and records*
  - *Inspect books and records*
  - *Question individuals regarding investigation*
  - *Subpoena records and testimony in connection with investigation*
  - *Subpoena records and testimony of service providers, i.e. trustees*

# Statutory Authority

- Open Years
  - **DOL** - ERISA has 6 year statute of limitation, but *generally* DOL audits will not go back further than 2-3 years
  - **IRS** - Code generally allows for 3 year statute of limitations
  - Both DOL and IRS may attempt to *bootstrap* prior years to obtain information from those years

# Statutory Authority

- Don't be surprised if information is requested for:
  - Multiple years
  - Retirement plans other than ESOP
  - Items not directly related to ESOP (e.g., corporate tax return, financial statements)
  - Items outside statutory authority (e.g., IRS may ask to see SPD or DOL may ask to see the determination letter)

# Audit Liability and Penalties

- IRS - Disqualification
  - *Loss of tax deductions to ESOP plan sponsor*
  - *Loss of tax-exempt status of ESOP trust (earnings are then taxable)*
  - *Participants must include vested allocations as taxable income*
  - *If disqualification is pursuant to the ESOP's failure to meet the minimum coverage or minimum participation requirements, then each HCE must include all of his or her account balances as taxable income*

# Audit Liability and Penalties

- IRS - Closing Agreement Program
  - Instead of disqualifying ESOP, IRS will enter into an agreement where the ESOP sponsor pays a penalty for the disqualification defect(s) in the ESOP
  - The penalties are determined by taking the maximum tax liability that would result from disqualification and then give the ESOP sponsor the opportunity to negotiate it downward based on *equitable factors*

# Audit Liability and Penalties

- IRS - Other Penalties
  - Prohibited Transactions - *disqualified person* is liable for 15 percent of the *amount involved* (this **can** be increased to 100 percent of *amount involved*)
  - Over-Contribution to ESOP - 10 percent of the amount contributed to the ESOP that exceeds the maximum contribution limitation for the year

# Audit Liability and Penalties

- DOL - Breach of Fiduciary Duty
  - DOL may sue the ESOP's *fiduciaries* for any *loss* caused to the ESOP from any breach of the fiduciary's duty
  - Loss to the ESOP is determined by what the earnings of the ESOP would have been had the breach not occurred
  - Breach also includes prohibited transactions

# Audit Liability and Penalties

- DOL - Breach of Fiduciary Duty
  - DOL may assess additional Penalties
  - 20 percent of loss or the “applicable recovery amount”
  - May be waived by the DOL if --
    - *fiduciary acted in good faith, or*
    - *restoration of losses results in severe hardship*

# Audit Liability and Penalties

- DOL - Filing and Disclosure Penalties
  - Assessment of civil penalties for late 5500 filings of up to \$1,000/day past filing date (DOL has limited this to \$300/day)
  - Form 5500 rejected by DOL because it lacks material information is considered not filed
  - Failure to issue SPDs and SARs - \$110/day past deadline

# Audit Liability and Penalties

- DOL - Criminal Penalties
  - Willful violation of ERISA reporting and disclosure requirements - up to \$5,000 fines per individual, \$100,000 for any other entity, and possible 1 year imprisonment
  - Knowingly making false statements or concealing or failing to disclose any fact needed to prepare ERISA reports - \$10,000 fine, 5 year imprisonment, or both

# Logistics and Preparation for an Audit

- What Causes Audits?
  - Random review by geography, industry, or plan type
  - Review of Form 5500 (S corp. ESOP)
  - Participant or Third-Party Complaint

# Logistics and Preparation for an Audit

- Audit Proofing
  - Very little control over whether you will be audited
  - Key to audit is complete and accurate books and records
  - Use IRS or DOL self-correction programs to fix errors you discover prior to audit

# Logistics and Preparation for an Audit

- Audit Proofing
  - All fiduciary decisions should be documented with accompanying minutes showing fiduciary decision-making process

# Logistics and Preparation for an Audit

- What to Do if You are Selected for Audit
  - Contact counsel and plan administration record keeper immediately
  - Arrange information to track information request
  - Review books and records internally for any possible problems

# Logistics and Preparation for an Audit

- What to Do if You are Selected for Audit
  - Have counsel available and physically present, if possible, at audit
  - Do not talk to agent about ESOP informally or formally without counsel's assistance

# Logistics and Preparation for an Audit

- Appoint one spokesperson to communicate with agent
  - any communication to DOL/IRS should be made by or in coordination with the spokesperson and legal counsel
  - be reactive, not proactive - spokesperson should respond only to specific questions and should not offer information to the agent that he or she thinks may be applicable

# Logistics and Preparation for an Audit

- Establish location for the audit
  - isolated office at Company
  - no plan or personnel records should be present at the audit location other than what has already been provided to the agent
  - consider conducting audit at offices of attorney, TPA, or other service provider involved with ESOP

# Logistics and Preparation for an Audit

- Closely review DOL/IRS audit letter prior to handing over any documents to the DOL/IRS agent
- Prior to the audit, the spokesperson should prepare for questions that might be asked by the DOL/IRS agent
- The spokesperson should be --
  - familiar with all requested records, and
  - able to respond to inquiries about the ESOP's administration

# Logistics and Preparation for an Audit

- Closely review any additional documents that are requested during the course of the audit before providing them to the DOL/IRS agent
- All requested information should be organized and set out before the audit begins
- Consider reviewing documents with TPA, attorney, or other service provider before audit
- Prior to the audit, prepare a written response for any information that is not available

# What the IRS and DOL Examine

- Documents Reviewed - See Attached examples of request letter from IRS and DOL
- These are not standard letters and the items, while generally the same throughout the US, vary from district and region

# What the IRS and DOL Examine

- What DOL Looks For - General Areas of Review
  - Fiduciary Liability
  - Transactions and Administration
  - Reporting and Disclosure
  - Plan Expenses

# What the IRS and DOL Examine

- What DOL Looks For - ESOP Areas of Review
  - Focus on transactions involving the ESOP, including initial acquisition of Company stock and any revisions/further transactions
  - Information request usually oriented to transaction documents
  - Current “hot button” issues include control premiums, post-transaction valuations, revisions to ESOP note, multi-stage transactions, 409(p) compliance, and reasonable compensation and expenses

# What the IRS and DOL Examine

- What DOL Looks For - ESOP Areas of Review
  - Purchase of Company Stock
    - *Adequate consideration*
    - *Independent review and evaluation by trustee*
    - *Valuation factors (e.g., control premium, put option, minority interest discount, lack of marketability discount)*

# What the IRS and DOL Examine

- What DOL Looks For - ESOP Areas of Review
  - **Sale of Company Stock by Trustee**
    - *Similar adequate consideration concerns*
    - *Retention of independent appraiser*
    - *Payment of debt under the ESOP Loan*
    - *Use of sales proceeds to pay down ESOP Loan*

# What the IRS and DOL Examine

- What DOL Looks For - ESOP Areas of Review
  - **ESOP Loans**
    - *Primarily for the benefit of participants*
    - *Bears a reasonable rate of interest*
    - *Qualifying employer securities are sole collateral of ESOP Loan*
    - *Other DOL regulatory requirements*

# What the IRS and DOL Examine

- What DOL Looks For - ESOP Areas of Review
  - **Monitoring Management**
    - *Financial performance of the Company*
    - *Executive compensation*
    - *Management self-dealing*
  - **Voting Stock**
    - *Procedures for Monitoring Voting*
    - *Pass-Through Voting Rights*

# What the IRS and DOL Examine

- What IRS Looks For --
  - IRS reviews Company and Plan tax returns, Company payroll records & Plan books and records
  - Basic concerns include whether the contribution is timely, within the applicable limits, properly made, and title to physical plan assets with Trustee
  - IRS samples accounting for employees to demonstrate all eligible employees included and receiving allocations and that allocations are within required limitations

# What the IRS and DOL Examine

- What IRS Looks For --
- Updated ESOP Plan
  - Recently Added Features Reducing Benefits
  - GUST and EGTRRA Amendments
  - TRA '86 and GUST Determination Letter
  - Consistent Features if More Than One Plan

*(e.g., 415 limits - same limitation year, offset provisions, etc.)*

# What the IRS and DOL Examine

- What IRS Looks For --
- Eligibility Requirements
  - Who's Excludable
  - Who's Not Eligible
  - No Special discrimination in favor of HCEs

# What the IRS and DOL Examine

- What IRS Looks For --
- In-Service Distributions
  - Participant Loans
  - Hardship Withdrawals
  - Required Withdrawals at Age 55/10 Years of Participation

# What the IRS and DOL Examine

- What IRS Looks For --
- Termination Distributions
  - Retirement, Death, Disability
  - Other Termination of Employment
- Anti-Cutback Rules
- Vesting

# What the IRS and DOL Examine

- What IRS Looks For --
- S corporation ESOPs
  - Special distribution rules
  - Money purchase pension feature
  - EGTRRA anti-abuse limitations, including compliance with new Regulations

# What the IRS and DOL Examine

- What IRS Looks For -- Compliance Testing
- First point - Are you in a controlled group?
  - Parent/Subsidiary
  - Brother/Sister
- Second point - Have you considered your other plan(s)?

# What the IRS and DOL Examine

- What IRS Looks For -- Compliance Testing
- Minimum coverage testing
  - mandatory disaggregation
  - separate lines of business
- Annual Additions
- Top Heavy Testing

# What the IRS and DOL Examine

- What IRS Looks For -- Compliance Testing
- KSOPs
  - annual deferral limits
  - ADP/ACP testing

# What the IRS and DOL Examine

- What IRS Looks For --
- Prohibited transactions
- Compliance with ESOP Loan exemptions
- release of shares from suspense account

# What the IRS and DOL Examine

- What Happens After the Audit?
  - IRS will provide closing letter with any required changes to record keeping and otherwise stating whether there is any additional liability
  - DOL often provides no formal closure--audit just “fades away”

# Compliance Reviews and Self-Correction Programs

- Self-Correction Environment
- Auditing of Plans
- IRS's Correction Programs - advanced
- DOL's Correction Programs - relatively new

# Compliance Reviews and Self-Correction Programs

- IRS Correction Programs (EPCRS)
  - SCP
  - VCP
  - Audit CAP

# Compliance Reviews and Self-Correction Programs

- DOL Correction Programs
  - Voluntary Fiduciary Correction Program
  - Delinquent Filer Voluntary Compliance Program

# Compliance Reviews and Self-Correction Programs

- Compliance Review - Prevention is the Best Medicine
  - Have Your Plan(s) Reviewed
  - Determine Self-Correction Course of Action
  - Determine Disclosure or Non-Disclosure
  - Set-up Internal Self-Review Process
  - Review both IRS and DOL Compliance

# Compliance Reviews and Self-Correction Programs

- Compliance Review
  - Review all plan documents and interview employee personnel
  - Prepare a work program based on reviews and interviews
  - Sample testing
  - Prepare report and recommendations
  - File and disclose under self-correction programs, if necessary

Any Questions?