Morgan Lewis

2016 PLAN SPONSOR BASICS
PLAN AUDIT ISSUES

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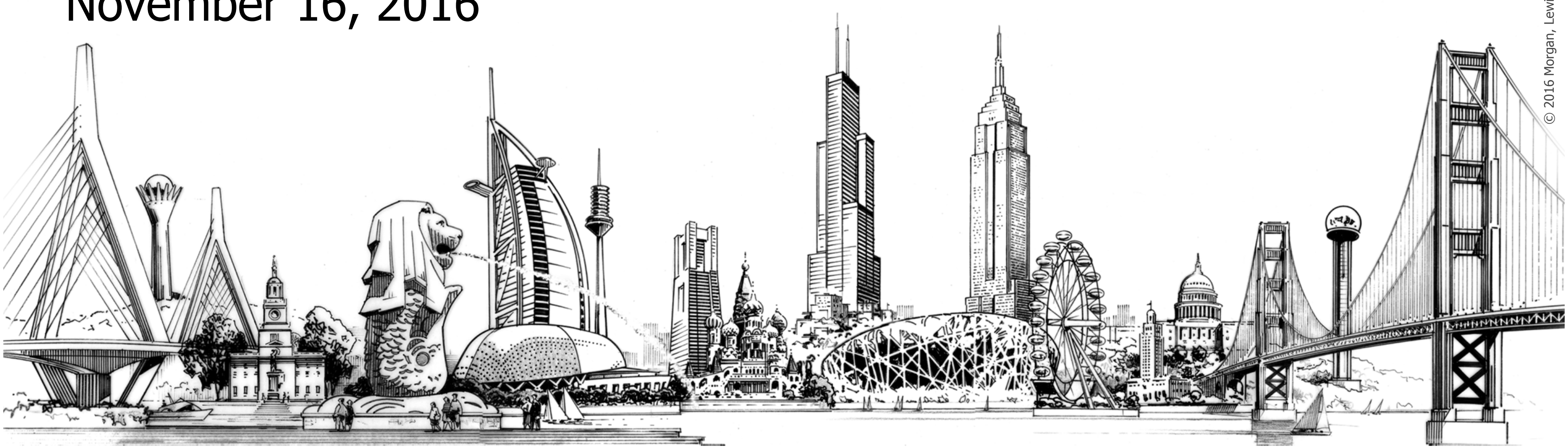

Overview of Presentation Topics

- Agency Audits
- Preparing for an Audit
- Audit Notification
- Managing the Audit Process
- Resolving Open Audit Issues
- Internal Audits
- EPCU Compliance Checks

Agency Audits

- Department of Labor (DOL)
  - Fiduciary audit
  - Health and welfare plan audit (not discussing this)
- IRS Qualified Plan Audit
  - Single plan audit
  - Group audit
- PBGC Terminated Defined Benefit Plan Audit

Preparing for an Audit

- Best preparation is BEFORE notification is received
- Consider a self-review of plan operations and documentation
  - Undergo a “mock” audit
    - Considerations regarding “attorney-client privilege” – Privilege protects communications between attorney and client only; underlying facts are always subject to disclosure
- Gather documentation, signatures, resolutions, etc.
  - Consider “cleaning up” plan documentation issues (i.e., wrap plan)

Preparing for an Audit

- Document any self-correction
- Document procedures and processes
- Review plan governance (fiduciary)
  - Understand fiduciary roles and responsibilities
  - Establish charters, procedures, etc.
  - Consider initial and ongoing fiduciary training
  - Establish fiduciary versus settlor functions
- Consider scrubbing data in advance of PBGC audit

Preparing for an IRS Audit

- IRS Resources
  - 401(k) Plan Checklist, located at http://www.irs.gov/pub/irs-tege/pub4531.pdf
  - 401(k) Plan Questionnaire, located at http://www.irs.gov/pub/irs-tege/epcu_401k_questionnaire.pdf
  - 403(b) Plan Checklist, located at http://www.irs.gov/pub/irs-tege/pub4546.pdf
  - Understanding the Employee Plans Audit Process, located at http://www.irs.gov/pub/irs-pdf/p1ep.pdf

Preparing for an IRS Audit

- Internal Control Questionnaire, located at https://www.irs.gov/retirement-plans/ep-team-audit-epta-program-internal-control-questionnaire

Preparing for an IRS Audit

- IRS will review internal controls of company to limit audit time by determining potential problem areas and scope of audit
  - IRS will make determination through interviews of personnel and review of answers to targeted questions
  - IRS will review and assess internal communication between management and day-to-day administrators
- Focus on controls is efficient way to determine what areas might need further review
- Internal controls can help mitigate audit CAP sanction for errors discovered

Preparing for an IRS Audit

- IRS will review internal and external factors that could adversely affect plan administration such as
  - Personnel turnover
  - New technology
  - Rapid expansion of company or acquisitions
  - New areas of IRS and DOL audit concern
- IRS will evaluate specific internal control activities, reconciliations, monitoring, authorizations, etc.

Preparing for an IRS Audit

- Areas Commonly Audited for 401(k) Plans
  - Compensation
    - Deferral compensation, HCE compensation, testing compensation
  - Loan administration
  - Withdrawals, especially hardship documentation
  - Forfeitures
  - Eligibility, service, and vesting
  - Required minimum distributions

Preparing for an IRS Audit

- Areas Commonly Audited for Defined Benefit Plans
  - Compensation
  - Eligibility, service, and vesting
  - Distributions
    - Eligibility for normal and early retirement
    - Late retirement, including suspension of benefits notices or actuarial increase
    - Retroactive annuity starting date
  - Required minimum distributions

Preparing for an IRS Audit

- Common Audit Topics for 403(b) Plans
  - Organization eligibility
  - Adoption of plan document by 12/31/2009
  - Universal availability compliance
  - 15-year service catch-up eligibility
  - Loans, hardship withdrawals

Preparing for a DOL Audit

- DOL Resources
  - Meeting Your Fiduciary Responsibilities, located at http://www.dol.gov/ebsa/publications/fiduciaryresponsibility.html
  - Reporting and Disclosure Guide for Employee Benefit Plans, located at http://www.dol.gov/ebsa/pdf/rdguide.pdf
  - Understanding Retirement Plan Fees and Expenses, located at http://www.dol.gov/ebsa/publications/undrstndgrtrmnt.html

Preparing for a DOL Audit

- Areas Commonly Audited for 401(k) Plans
  - Timing of deferral of contributions
    - Requirement is that contributions be deposited to the trust as soon as it is reasonably possible to segregate them from the company's assets, but no later than the 15th business day of the month following the payday
    - If employers can reasonably make the deposits sooner, they need to do so
  - Review of plan governance
    - Will request fiduciary documentation, including charter, procedures, meeting minutes, etc.

Preparing for a DOL Audit

- List of fiduciaries and service providers
  - Important to clearly understand and differentiate between “settlor” and “fiduciary” duties
- Copy of trust agreement and service provider agreements
- Recent focus on plan fees

- Areas Commonly Audited for Health and Welfare Plans
  - Plan documentation
  - Required notices
  - ACA

Preparing for a DOL Audit

- Areas Commonly Audited for Defined Benefit Plans
- Information on participants at age 70½ and at age 65
  - Forced payment
  - Schedule 8955-SSA matchups
  - Actuarial increase for delay in payments
- Lost participants
  - Process for locating
  - Forfeiture provisions

Preparing for a PBGC Audit

- PBGC audits occur upon plan termination.
  - Make sure all assets are distributed and forms are filed timely
  - Audits are comprehensive and may require historical plan documents and pay information for participants
- PBGC audits can occur with respect to premium payments.
- Proposed PBGC missing participant program would permit PBGC to audit records of participating plans and sponsors if reasonable cause to suspect noncompliance, and could share findings with DOL or IRS.

Audit Notification

- IRS Notification
  - Notification via letter or telephone
  - Typically lists "initial" documents and discussion of a kick-off meeting
  - Precluded from correcting failures following notification, unless such corrections were "substantially complete" at the time of notification

Audit Notification

- A correction is "substantially complete" if the plan sponsor had (i) identified the failure, (ii) formulated a correction method, and (iii) initiated correction in a manner that demonstrates a commitment to completing correction of the failure as expeditiously as practicable, and, within 120 days after the notification of audit, the plan sponsor completed correction.
- The IRS also considers correction of an error to be "substantially complete" if 65% of the affected participants are corrected at the time of audit notification and the plan sponsor finishes the correction relatively quickly after audit notification.

Audit Notification

- DOL Notification
  - Notification typically via letter
  - Letter will provide a certain number of days to provide documentation
  - Often involves a meeting with a DOL agent during the process

Audit Notification

- PBGC Notification
  - Following plan termination, notification via letter
  - Letter will provide a certain number of days to provide documentation
  - Mandatory audit for plans with more than 300 participants and random auditing for those with fewer than 300
  - Audits can also occur at times other than plan termination if reason to believe there is a problem
  - 4062(e) concerns

Audit Notification

- Under prior law, section 4062(e) created liability when an employer ceased operations at a facility and, as a result, more than 20% of the employees covered by the employer's pension plan lost their jobs. In 2012, responding to business concerns, PBGC began focusing its 4062(e) enforcement efforts on those cases in which there was a higher risk of substantial plan failure.
- PBGC announced a moratorium until the end of 2014 on enforcement of all 4062(e) cases. PBGC told employers that they should continue to report new 4062(e) cases, but PBGC would take no action on them during the moratorium.
- Moratorium has been lifted and 4062(e) filings can trigger PBGC contact or audit.

Audit Notification

- PBGC audits can also be triggered by reportable event notices filed by an employer or from events gleaned by PBGC through public information
- PBGC can also initiate audit regarding premium payments and accurate headcounts

Managing the Audit Process

- Decide single point of contact for auditor
- Determine how in-person meetings will be handled
- Consider how internal/external counsel will be involved
  - IRS audits may require submitting IRS Form 2848 at the beginning of the process if counsel is to be involved at all
- Different considerations for on-site auditors vs. paper/telephone audits
- Do not seat auditor in area where he or she can overhear conversations or ask questions of personnel other than point person

Managing the Audit Process

- Require governmental agencies to make requests in writing
- Expect the process to take a long time
  - May be 1-2 years
- Respond carefully and honestly
  - Answer the question asked and "own" the response
  - Consider implications of responses and prepare for follow-up questions
  - Know the "right" answer and the answer being given
- Consider disclosing "known" issues, if any
- Perform an advance self-audit for purpose of responding to documentation requests
- Don't be afraid to ask for additional time when necessary

Resolving Open Audit Issues

- For IRS audits, discuss with the agent correction of any compliance issues discovered *before* undergoing corrections
- To the extent possible, obtain any agreement to correction methods in writing from the agent
- For IRS audits of retirement plans, review EPCRS program for acceptable retirement plan corrections
  - Corrections will be made through "Audit Cap"
  - Agent may not require that all matters go through Audit Cap and be subject to sanction; however, all compliance failures should be corrected

Resolving Open Audit Issues

- For an IRS audit, the agent will issue a Closing Agreement for any issues that are subject to sanction
- The sanction is generally determined by calculating the Maximum Payment Amount (MPA)
  - Under Audit Cap, a plan sponsor is generally required to pay a penalty equal to a negotiated percentage of the MPA, in lieu of disqualification
  - The MPA is a proxy for the tax the IRS could collect upon plan disqualification, which in turn is the sum for open tax years (normally three tax years based on the statute of limitations), of the following:
    - Income tax resulting from inclusion of income on amounts deferred;
    - The tax on the trust;
    - The loss of employer deductions for contributions made to the plan; and
    - Any other tax that results from a qualification failure but for the correction under EPCRS

Resolving Open Audit Issues

- For DOL audits, the auditor could:
  - Impose a penalty for statutory breaches (e.g. failure to file Form 5500, failure to file audit report or other required items with 5500 if effect is to treat 5500 as not being filed timely)
  - Discover and require correction of fiduciary breaches
  - Discover and require correction of prohibited transactions
- Settlement with the DOL may also result in a 20% civil penalty for fiduciary violation
  - Consider self-correction and disclosure for purposes of avoiding 20% penalty

Resolving Open Audit Issues

- For PBGC audits (following plan termination), the PBGC will:
  - Ensure that all notices were provided properly
  - Ensure that participants were made whole as part of the termination
  - Review insurance contracts and annuity placement contracts to ensure that they are accurate
  - Refer plan to IRS or DOL for audit for significant issues
  - Review sample benefit calculations

Annual 5500 Internal Audits

- Review and understand "management representation letter" terms and provisions
- Provide information consistent with that letter
- Discuss audit findings and issues
- Evaluate and correct any issues identified with special attention to issues included in audited financial records
- Be aware that annual audit may not discover operational failures and is often conducted by most junior staff of accounting firm

Other Internal Audits

- Internal Audits – not related to annual 5500 audit
- Can uncover systemic operational issues
- Examples for defined benefit plans include:
  - Temporary Social Security bridge benefits never stopped when participant reached SSNRA
  - Social Security level income option for payment of benefits never adjusted after participant reached SSNRA
  - Lump sums calculated using the wrong lookback month
  - Vesting service calculated incorrectly for rehires

Other Internal Audits

– Beneficiary denied benefit when participant died after annuity starting date but before first payment had actually commenced
– Benefits of participants working past NRD not actuarially increased if plan provides for actuarial increase if better than continued accrual
– Incorrect pay used in calculations – company did not realize testing pay was different from pensionable pay
– Nonqualified deferred compensation incorrectly included in pensionable pay

Other Internal Audits

- Examples for defined contribution plans include:
  - Loan violations – loans not defaulted timely
  - No documentation for hardship withdrawals retained
  - Failure to timely enroll eligible employees
  - Incorrect understanding of coverage requirements for part-time employees
  - Incorrect pay used for deferrals
  - True-up matching contributions only allocated to participants capping out at 402(g) limit

Other Internal Audits

- Examples for all plans:
  - Governance not documented properly
  - Plan amendments executed by individuals for whom no delegation authority exists
  - Claims for benefits not treated as claims and proper response letters not sent
  - Claim appeals not handled properly and correct denial letters not sent (deference to Plan Administrator denial not afforded by court if participant sues and claims and appeals process not correctly followed)

Other Internal Audits

- Issues discovered during self-audit or normal plan operation of retirement plans
  - Correct under the Employee Plans Compliance Resolution System (EPCRS)
    - Many errors can be self-corrected
      - Document correction
    - Consider filing with the IRS to correct significant issues that cannot be self-corrected
      - The IRS cannot generally audit a plan while VCP is pending – unless it is anonymous VCP

EPCU Compliance Checks

- IRS Compliance Checks (not an audit) – letters from the Employee Plans Compliance Unit (EPCU) of IRS
- Sponsor should respond promptly to avoid an audit
- Current focus – 19 initiatives on website
- Topics include:
  - 401(k) Plans Reporting IRC 4971(a) Tax
  - Asset Mismatch Project
  - Favorable Letter/Non-Filer Project
  - Final Return with Assets Project
  - Form 5310-A
  - Data Analysis Verification Project
  - Failure to Provide Benefits Project
  - Form 5310-A Filing Project Phase 2

EPCU Compliance Checks

- Form 5500-EZ First Return Filer Project
- Form 5500-EZ Non-Filer Project
- Form 5500-EZ Excess Participant Loans Project
- Improper Deduction Project
- Multiemployer Certification Compliance Project
- Multiemployer Validation
- Nonbank Trustees and Custodians
- Non-Governmental 457(b) Excess Deferrals Project

EPCU Compliance Checks

- A Second Look: Partial Termination Project
- SIMPLE IRA Plans - Eligible Sponsors Project
- Sole Proprietor Participation Project

- A few of the more interesting ones are described in next few slides

EPCU Compliance Checks

- Asset Mismatch Project
- Reason for IRS Inquiry:
  - "You filed a Form 5500 series return which reflected a 'beginning of year' asset amount which is different from the prior year 'end of year' asset amount. In general, the dollar amount of assets on the first day of a plan year and the last day of the prior plan year should be the same dollar amount."

EPCU Compliance Checks

- Failure to Provide Benefits Project
- Reason for IRS Inquiry
  - "Our Form 5500-series return records show you didn't provide a plan benefit when it was due. See line 4l of Form 5500, Schedule H (Financial Information)
  - The Employee Plans Compliance Unit wants to understand:
    - Why you didn't provide the plan benefit when it was due,
    - Whether you've corrected the situation, and
    - If our records reflect accurate information."

    - This question is designed to determine if participants who have attained age 70½ have been paid benefits from the Plan

EPCU Compliance Checks

- For 2015 and 2016, the IRS announced that, in the absence of other guidance, filers do not need to report on Lines 4I of the Schedule H and I to the Form 5500 and 10f of the Form 5500-SF unpaid required minimum distribution (RMD) amounts for participants who have retired or separated from service, or their beneficiaries, who cannot be located after reasonable efforts or where the plan is in the process of engaging in such reasonable efforts at the end of the plan year reporting period.

EPCU Compliance Checks

- 5310-A Filing Project, Phase II
- Reason for IRS Inquiry:
  - "We want to clarify the reason for filing the form, its relationship pertaining to plan asset movement, and whether timely compliance under IRC section 6652(e) was met. In addition to timely filing, this project is focusing on trust and operational related areas of the plan based on the merger, consolidation, spinoff, or transfer of plan assets or liabilities."

EPCU Compliance Checks

- A Second Look: Partial Termination Project
- Reason for IRS Inquiry:
  - "We want to determine if the plan did experience a partial termination and did the plan administrators comply with the vesting requirements of Internal Revenue Code (IRC) section 411(d)(3). Additionally, we want to determine the accuracy of the information provided on Form 5500."
  - The EPCU will send contact letters, seeking data regarding the percentage of involuntary terminations from the plan and the circumstances which led to company downsizing and the reduction of plan participants to a selected group of Form 5500 filers.
  - "We will request an explanation or discussion of any special circumstances that may have an impact on whether a partial termination has occurred. The EPCU will evaluate the response and work with the plan sponsor to take appropriate action."

QUESTIONS?

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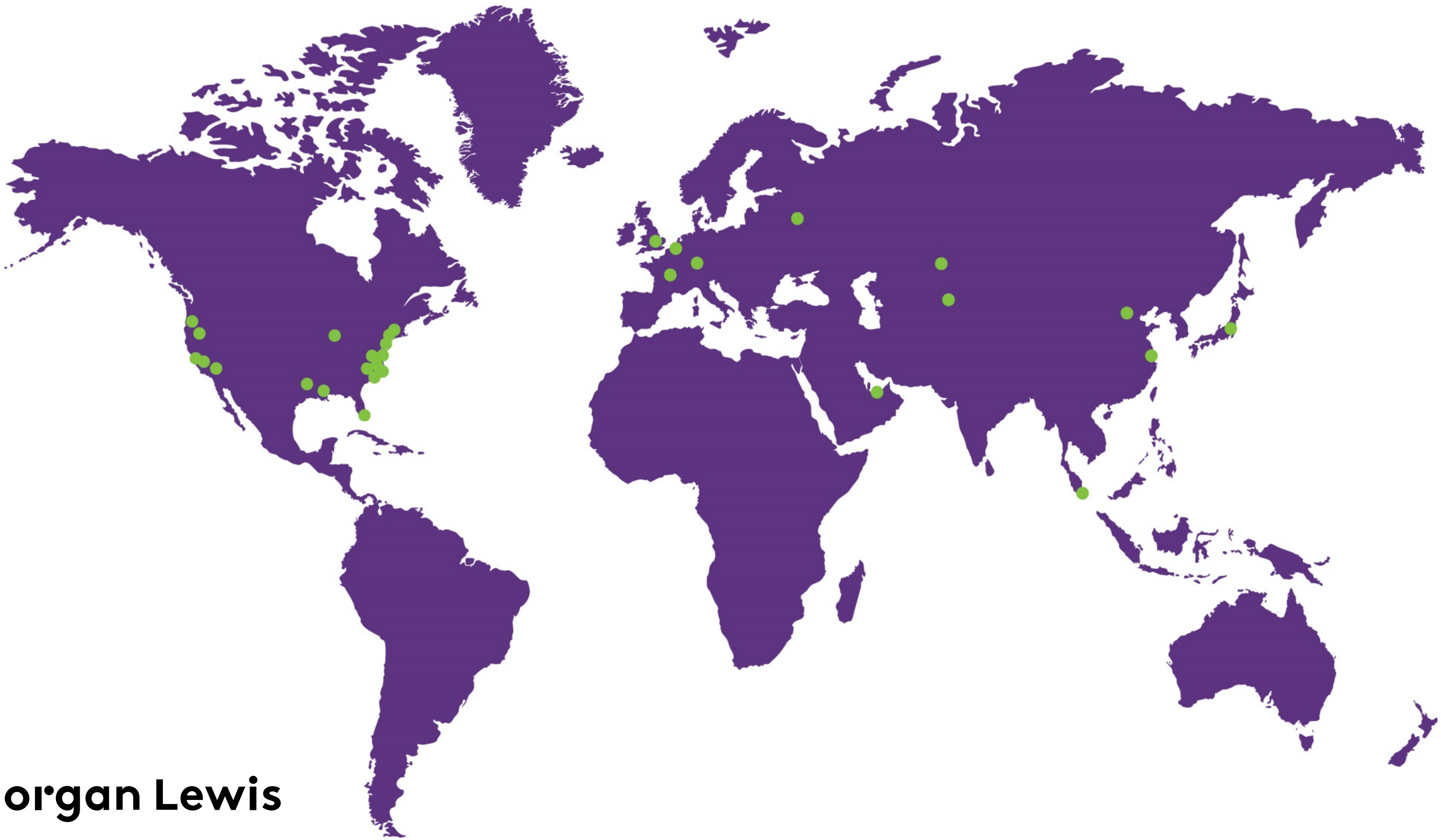

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THANK YOU