Potter Anderson & Corroon LLP

Did the IRS Send You Its Latest Questionnaire? What You Need To Know About The 401(k) Compliance Check

June 2010

Barbara Uberti Manerchia is counsel in the Wilmington, Delaware law firm of Potter Anderson & Corroon LLP. The views expressed are those of the authors and may not be representative of those of the firm or its clients.

The Internal Revenue Service is sending letters to 1,200 randomly selected employers who sponsor 401(k) plans, instructing them to complete the 401(k) Compliance Check Questionnaire. The questionnaire must be completed on the IRS website within 90 days of receipt or enforcement action will follow. Employers who receive a questionnaire are advised to respond carefully and take certain precautions. Potential problems may be uncovered in the course of completing the questionnaire. With some advance planning, outstanding issues can be addressed before the questionnaire is returned, which can minimize future audit exposure.

The Purpose of the Questionnaire

401(k) plans are the predominant form of retirement plan for the American workforce. Based on previous work, the IRS has determined that 401(k) plans are more non-compliant than other types of retirement plans. The IRS expects to publish a report based on the responses to the questionnaire and use the results to focus its educational activities and to target enforcement action.

The Scope of the Questionnaire

The questionnaire is 46 pages long with 69 questions, most of which have multiple sub-parts. A glossary of nearly 100 terms is provided for reference. Information is solicited for 2006, 2007 and 2008. The general categories of questions are:

- Demographics
- 401(k) plan participation
- Employer and employee contributions
- Top-heavy and nondiscrimination rules
- Distributions and plan loans
- Other plan operations
- Automatic contribution arrangements
- Designated Roth features
- IRS voluntary compliance programs

Plan Administration

At first glance, the questions seem routine. As the questionnaire progresses, the IRS seeks to elicit very specific information, much of which is not readily available. For example, the questionnaire asks for the total compensation of all participants, the total compensation for participants who made elective deferrals and the total elective deferrals. The questionnaire asks for the largest loan balance during the year, the account balance of participant with the largest loan balance, the largest loan made during the year and the account balance of the participant with the largest loan made during the year. Research likely will be required to gather this information for 2006, 2007 and 2008.

1313 North Market Street

P.O. Box 951

Wilmington, DE 19899-0951

(302) 984-6000

www.potteranderson.com

Traps for the Unwary

Certain questions pointedly ask if there has been a specific violation of the Internal Revenue Code (the "Code") with respect to the 401(k) plan. For example, the questionnaire asks whether Forms 1099-R were distributed to those participants who received a plan distribution and to those participants whose plan loans went into default. The questionnaire also asks whether participants were required to obtain the maximum amount of loans before applying for a hardship distribution. Similarly, the questionnaire asks whether the plan has procedures in place to ensure that contributions do not exceed the various contribution limits under the Code and whether corrective distributions were made on time. Clearly, the IRS is looking for areas of non-compliance. Furthermore, the questionnaire probes for areas of possible oversight or abuse. Plan sponsors are asked whether the plan experienced any fraud or theft. The questionnaire requires the plan sponsor to disclose whether any rollovers to the plan were used to purchase employer stock or a franchise.

> *We recommend that the questionnaires be reviewed by counsel before they are submitted to the IRS. Employers may need to disclose potential areas of non-compliance, and should be able to mitigate penalties by using the IRS correction programs in advance. Two voluntary correction programs are available under the Employee Plans Compliance Resolution System ("EPCRS"). One method allows self-correction of errors in the operation of a retirement plan, and the other method requires that the correction be submitted to the IRS for review. Use of the EPCRS correction programs will result in far lower penalties than those imposed upon audit.*

Other Information

In addition to gathering information and checking for problems, the questionnaire solicits the viewpoint of plan sponsors on a variety of fronts. The questionnaire asks for the sponsor's opinion of the impact of recent financial conditions on the level of participation and contributions as well as on the frequency of loans and hardships. The questionnaire asks for suggestions in changing certain standard notices and in improving the EPCRS correction procedures. If a 401(k) plan does not offer Roth contributions, plan sponsors are asked to provide the reason. The penultimate question asks what difficulties the 401(k) plan faces in complying with the Code. Although plan sponsors may be tempted to vent their frustrations, restraint should be exercised to avoid exposing any specific plan shortcomings.

Action Steps for Employers Who Receive a Questionnaire

Plan sponsors who receive a questionnaire should develop a comprehensive plan with their advisors to gather the responses. Although some questions can be answered in-house, most employers will require assistance from their recordkeeper or other service provider for the more detailed inquiries. The completion of the questionnaire will in essence serve as a self-audit of 401(k) plan activities for 2006, 2007 and 2008. With this in mind, employers are encouraged to seek professional counsel with respect to any area where the plan may not have been fully compliant with the Code requirements. EPCRS can be a useful tool in correcting errors in advance of submission of the questionnaire. We remain available to support plan sponsors in responding to the IRS in all retirement plan matters.