When setting up a qualified retirement plan, an employer looks forward to delivering a service to its employees and qualifying for tax benefits in the form of employer deductions and tax-deferred savings opportunities for plan participants. With those benefits, however, comes the responsibility for the plan sponsor to ensure the plan is maintained in accordance with the tax laws and fiduciary regulations that apply to qualified retirement plans. Failure to meet the standards dictated by the Internal Revenue Code (IRC) and Employee Retirement Income Security Act (ERISA) can have dire consequences both for the plan sponsor and for the plan participants.

As a result, plan sponsors should develop practices and procedures that seek to minimize risks that may make them vulnerable to an Internal Revenue Service (IRS) audit or Department of Labor (DOL) investigation. In this article, we review common, and often inadvertent, violations by defined contribution (DC) plan sponsors and highlight potential procedures that may help to mitigate the risk of noncompliance that may be discovered during a plan audit.

Common IRS and DOL violations – and how to mitigate audit risk.
What’s the difference?
IRS audit and DOL investigation overview
Adopting a retirement plan is a balancing act. The benefits must be balanced against following the rules set out in the IRC and enforced by the IRS, such as passing certain compliance tests, and meeting the fiduciary responsibilities under ERISA, enforced by the DOL.

The IRS is responsible for enforcing the tax laws relating to retirement plans.
The IRS strives to make voluntary compliance with the rules easier through educational programs and self-audit tools it has developed for plan sponsors. However, it has combined these voluntary compliance efforts with an aggressive and effective enforcement strategy aimed at identifying noncompliant plans. If a plan is not in compliance, the primary IRS goal is for the plan sponsor to make the necessary changes to bring the plan back into compliance. However, the IRS also has the authority to assess penalties, taxes, interest charges, and even to invoke plan disqualification.
The IRS audits plans for violations of the IRC. Most often, those fall into one of two categories.

1. Plan qualification defects
Plan qualification defects occur when the plan has violated one of the technical requirements for the tax benefits of a qualified plan. That has potentially disastrous results. For example, the disqualification of a plan can result in immediate taxation of benefits, taxation of trust investment earnings, and loss of deductions for contributions. If a plan has a disqualifying defect, the plan sponsor may be able to negotiate a penalty instead of disqualification; unfortunately, though, that penalty can sometimes be substantial.

2. Prohibited transactions
Prohibited transactions encompass areas where the plan has engaged in a transaction that is prohibited by law. The remedy is to reverse the transaction, with interest, and to pay excise taxes. Plan sponsors need to be aware of disqualifying defects and prohibited transactions, and have procedures designed to address these potential issues.

The DOL is responsible for enforcing the fiduciary rules and participant protections set forth in ERISA.
In recent years, the DOL has increased the volume of compliance guidance on fiduciary responsibilities and regulations, most notably with a three-part fee disclosure effort. At the same time, it has increased its enforcement staff to ensure compliance with ERISA mandates, which usually fall into two categories.

Both the IRS and the DOL have jurisdiction over prohibited transactions, and they share information discovered in their respective examinations.

1. Fiduciary breaches
Fiduciary breaches often occur when the plan sponsor mismanages the investments, expenses or administration of a plan. That fiduciary responsibility, and potential liability, often falls on a group of company officers or managers who serve on the plan’s committee.

2. Prohibited transactions
The DOL enforcement of prohibited transactions is similar to that of the IRS. Both agencies look for prohibited dealings and, if found, the agencies require that they be reversed (and interest and penalties are imposed).
Ways plan sponsors may seek to mitigate their DOL or IRS audit risk.

DOL investigations

The DOL often focuses on financial transactions — for example, investments, payment of expenses and transfers of money. With that in mind, here are several areas that plan sponsors and fiduciaries can monitor closely.

Deposit of deferrals

The DOL’s position is that employee deferrals must be deposited into the plan as soon as reasonably possible. The DOL also imposes an outer limit, which is that it is never reasonable to deposit the money later than the 15th business day of the following month. (But, keep in mind, that’s an outer limit. The DOL still says that the money has to be deposited as soon as reasonably possible.) And, for plans with fewer than 100 participants, the DOL says that the deferrals must be paid into the plan no later than the seventh business day following withholding by the employer. The failure to make those deposits on a timely basis is both a fiduciary breach and a prohibited transaction. It can result in personal liability for the person who made the decision to delay the deposit of deferrals. The DOL treats this as a serious matter.

The money should be deposited within those time limits. To make sure that it is, employers should educate their personnel on the issues and should have policies in place requiring that the money be deposited on a timely basis. It’s one of the first things that the DOL looks at in any investigation.

Classification of employees

The DOL is concerned about whether all employees are being properly classified as employees and included in the plan. For example, are some workers being treated as independent contractors even though they satisfy the legal definition of “common-law employee”? If the DOL finds out that those workers are not being included in the plan, they may require that they be included and that money be placed in the plan to cover the benefits they would have had if they had been included along the way. In some cases, that could be very expensive.

This is a complicated issue. It’s not always clear whether a worker is an employee or an independent contractor. In addition, workers can be given different labels, such as provisional employees, leased employees, contract employees, etc., but are actually common-law employees. It’s critical to re-examine and check their status.

Many employers may not have the in-house expertise to make those decisions. It is a matter that should be discussed with an experienced employment lawyer. From time to time, the IRS and the DOL decide to focus on this area and, when they do, the downside can be significant. So, it’s important that workers be properly classified and, if they are employees, that they be treated as employees for plan purposes. Plan sponsors should consider meeting with their employment lawyers and discuss the different categories of workers at the company, and who should or should not be classified as a common-law employee.

Mutual fund share classes

For many years now, the DOL and plaintiffs’ attorneys have been concerned about the underlying expenses of the investments in retirement plans, and particularly in 401(k) plans, such as the expenses of the mutual funds offered. To help plan sponsors evaluate their mutual fund expenses, some advisors and providers have given benchmarking reports to plan sponsors about the average expense ratios for comparable investments.

However, mutual funds often have a number of share classes, with the main difference between those classes being the level of fees and expenses attributable to each class, including revenue sharing that may be paid to a plan’s service provider by a fund’s advisor or distributor. For example, it wouldn’t be uncommon for a single mutual fund to have four or five (or more) share classes. Each of those share classes may have a different expense ratio and each share class might pay different amounts of fees to a plan’s advisor and the plan’s recordkeeper. Accordingly, plan sponsors need to understand which share class the plan owns, why it owns that share class, who is paid revenue sharing, and whether the payments are reasonable. We have seen the DOL raise that issue in recent investigations.

While plan sponsors make the decision about the share classes to be included in their plan, it is an issue that may require additional guidance. As a result, plan sponsors should consider working with a knowledgeable advisor to discuss these issues about share classes, expense ratios and revenue sharing. The advisor should give the plan committee a written report (or summary) that covers these issues, and the report should be kept in the plan’s due diligence files.
**408(b)(2) disclosures**

ERISA requires plan fiduciaries, when selecting and monitoring service providers and plan investments, to act prudently and solely in the interest of the plan’s participants and beneficiaries. Responsible plan fiduciaries also must ensure that arrangements with their service providers are “reasonable” and that only “reasonable” compensation is paid for services.

Fundamental to the ability of fiduciaries to discharge these obligations is obtaining information sufficient to enable them to make informed decisions about an employee benefit plan’s services, the costs of such services, and the service providers. As such, the DOL issued its “Final Regulation Relating to Service Provider Disclosures Under Section 408(b)(2)” in February 2012, establishing specific disclosure obligations for plan service providers to ensure that responsible plan fiduciaries are provided the information they need to make better decisions when selecting and monitoring service providers for their plans. The plan sponsor — or its committee, as fiduciaries — are required to review those disclosures to:

- Assess the reasonableness of total compensation, both direct and indirect, received by the covered service provider, its affiliates and/or subcontractors;
- Identify potential conflicts of interest; and
- Satisfy reporting and disclosure requirements under Title I of ERISA.

As part of an investigation, the DOL can review whether plan sponsors assessed and considered the reasonableness of the fees — and any conflict of interest — included in those disclosures. These disclosures are typically on the list of materials that the DOL asks for. As a part of those investigations, the DOL may also ask for copies of service provider agreements.

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**What can plan sponsors and committees do to try to mitigate the risk of claims of fiduciary breach or prohibited transactions in this area?**

**Step 1:** Make sure that you have the 408(b)(2) disclosures and agreements from your service providers. The disclosures must include a description of the provider’s or advisor’s services, compensation and fiduciary status (if the service provider is a fiduciary). Make sure you have that information in your files.

**Step 2:** Evaluate your service providers. A common way of evaluating service providers is to obtain a benchmarking report for each provider. A benchmarking report will show the customary compensation for each type of provider and for the services being rendered. Make sure to assess whether the amounts being paid to those service providers is reasonable.
Your retirement plan is selected for IRS audit.

Letter sent requesting review of plan records and documents.

Appointment date set between Employer/Power of Attorney or Authorized Representative and IRS Agent.

IRS AGENT CONDUCTS ON-SITE AUDIT OF PLAN

Is additional information needed?

Employer mails additional information to agent or agent conducts subsequent visit.

Are there any issues requiring change?

TAX CHANGES
Potential income or excise tax

CORRECTION PROGRAMS
Employee Plans Compliance Resolution System

UNAGREED CASE/REVOCATION
Proposed revocation or nonqualification letter issued

CASE CLOSED
Closing letter issued

IRS audits

The IRS tends to look for technical violations of detailed rules (while the DOL usually follows the money). As a result, plan sponsors often hire service providers, such as recordkeepers or third-party administrators (TPAs), to provide technical compliance services. However, certain qualification and prohibited transaction violations can result from employer decisions. As a result, plan sponsors should examine their internal practices, with a focus on the following activities, and consider whether to make changes.

Participant loans

Surprisingly, the handling of participant loans is a common violation found by the IRS. This seemingly innocuous transaction can potentially cause issues for plan sponsors.

Common failures related to plan loans include:

- **Loans that exceed the maximum dollar amount.**
  
The IRS imposes limits on the maximum amount that a plan can permit as a loan. In addition to possible plan disqualification, this type of violation can result in a taxable distribution to the employee.

- **Loans for the purchase or improvement of residences without adequate documentation.**
  
  Residential loans can have longer repayment periods than participant loans for other purposes, which can potentially be beneficial for a participant. The IRS takes the position that the plan sponsor must obtain documentation of the residential purpose of the loan (and must retain it, so that it is available for audit). The consequences of a violation are that the amount of the loan may be immediately taxable to the participant and the plan may lose its tax qualification. The IRS has, in some cases, also imposed substantial penalties for this type of violation.

Loans where the plan does not have a provision that allows participant loans.

Some plan sponsors may mistakenly believe that all plans permit participant loans. However, that is not the case; it depends upon the wording of the plan document. Where a plan document does not permit loans, but the employer inadvertently authorizes loans, it can result in both a taxable distribution to the participant and the loss of the plan’s tax qualification. Plan sponsors can mitigate this risk by working with their providers and advisors to understand the terms of a plan document before authorizing transactions. Simply stated, don’t authorize participant loans without knowing that the plan document permits them and without understanding the rules and limitations.

- **Allowing a participant to take more loans than the plan document authorizes.**
  
  This is another example of the importance of knowing what a plan document says. Some plan documents permit participants to have only one outstanding loan at a time. However, in some cases, the sponsors of those plans have authorized two, three or more outstanding loans to participants. It is a common violation that can be avoided. Plan sponsors should make sure that they and their providers understand the plan’s provisions and limitations on participant loans and that there are written procedures in place to ensure that those provisions are followed. Make sure to obtain copies of the written procedures.

Hardship withdrawals

The issues for hardship withdrawals are similar to those of participant loans. While it is surprising to many plan sponsors that simply satisfying an employee’s request to give them their money to help with a financial difficulty can result in plan disqualification, it is critical to know that it can.

As with participant loans, it is important to review the plan document to understand its requirements, as shown in the following examples that highlight potential issues:

- **The plan document does not permit hardship withdrawals.**
  
  Before approving any hardship withdrawals to participants, plan sponsors should review their plan documents and coordinate with their recordkeepers or TPAs. It’s important that there be agreement about the transactions that are permitted by the plan and those that are not, including both hardship withdrawals and participant loans. The risk of these types of potential violations can be mitigated in cases where the plan sponsor has reviewed the plan document or has explicitly discussed the issues with its service providers. The problems are avoidable, but only if attention is paid to the plan provisions. 
Hardship withdrawals without adequate documentation.

Unfortunately, some providers and some employers may believe that employees can self-certify their hardship needs. However, the IRS disagrees, and takes the position that plan sponsors, as fiduciaries, need to review the participant’s documentation of the existence of a hardship and need to determine that the documentation satisfies the requirements in the plan document. (And plan sponsors must retain that information, so that it is available to be audited.)

This is another example where plan sponsors and their service providers need to coordinate. Hardship withdrawals should not be granted without the plan sponsor understanding the requirements in the plan document and the law, and without knowing what is needed to satisfy those requirements. In any event, there needs to be a conversation about those responsibilities and, hopefully, a set of written guidelines for the plan sponsor to follow.

Eligible employees

For an employee to become eligible to participate in a plan, the employee must usually satisfy an “eligibility waiting period” (for example, three months or a year), and then must wait until the next “entry date.” As an example, if a plan had a three-month eligibility waiting period, and the employee entered the plan on the first day of the next calendar quarter, an employee who was hired on February 1 would satisfy the eligibility period on May 1, and would be entitled to enter the plan on July 1.

However, IRS audits often find that employers inadvertently misapply those rules. As a result, employees may be brought into the plan at a later date, which could be deemed a disqualifying defect.

What can an employer do to minimize eligibility risk?

Step 1: Make sure that its benefits and payroll personnel understand the eligibility requirements of the plan and how they work. That should be done in collaboration with the plan’s recordkeeper or TPA to make sure that all key parties are reading the plan the same way.

Step 2: Determine whether their internal procedures for monitoring hire dates, eligibility periods and entry dates are adequate. Those procedures should be documented in writing and provided to the employees who implement the procedures.

Step 3: Confirm — and put in writing — the coordination between the employees who track the eligibility criteria and those who are responsible for providing eligible employees with required disclosure materials and procedures for joining the plan and making deferrals. The materials must be given to newly eligible employees on or before the date on which they can first direct their investments.

Compensation

Much of the technical compliance work done by service providers uses compensation information received from the plan sponsor. While it may seem straightforward for an employer to provide compensation information to service providers, it can be a source of ongoing problems. For example, rather than using Total Compensation, some plan sponsors use a limited definition of compensation for plan purposes, perhaps excluding bonuses, commissions, overtime or other payments. The compensation information given to the service providers must be consistent with what is specified in the plan document.

This is a common mistake discovered by the IRS; however, it can be avoided. The key is to make sure that the company’s benefits and payroll personnel are coordinating with the plan’s service providers, so there is agreement on the information being provided and agreement on what the plan document requires. As this is an area where misunderstandings can easily occur, it is important to record that understanding in writing so that the providers and payroll employees all sign off on the definition of compensation to be used for plan reporting and testing.
Plan sponsor next steps

In addition to the points outlined previously, the broader steps below may help reduce the risk of noncompliance that may be discovered during a plan audit.

Be Proactive: Plan sponsors should take steps to improve plan effectiveness and control risk.

1. Access the expertise of financial advisors and other retirement professionals to develop a strategy.
2. Evaluate options for improving participant outcomes in the plan.
3. Assess the plan’s operational compliance health.
4. Implement best practices for controlling fiduciary risk.

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BNYMR-MIDAHO-0617 MARK-2017-03-13-1301