

# Staying Out of Trouble: How to Avoid IRS and DOL Audits

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- Overview of Benefit Plan Audits
- IRS Audit Triggers and Process
- DOL Audit Triggers and Process
- If Your Plan is Audited
- Avoiding Audits and Compliance Issues
- Common Retirement Plan Compliance Issues
- Common Welfare Plan Compliance Issues
- Questions?

## ■ Which agencies conduct audits?

### – Internal Revenue Service (IRS)

- Reviews both health and welfare plans and qualified retirement plans
- Primary jurisdiction over qualified status of retirement plans

### – Department of Labor (DOL)

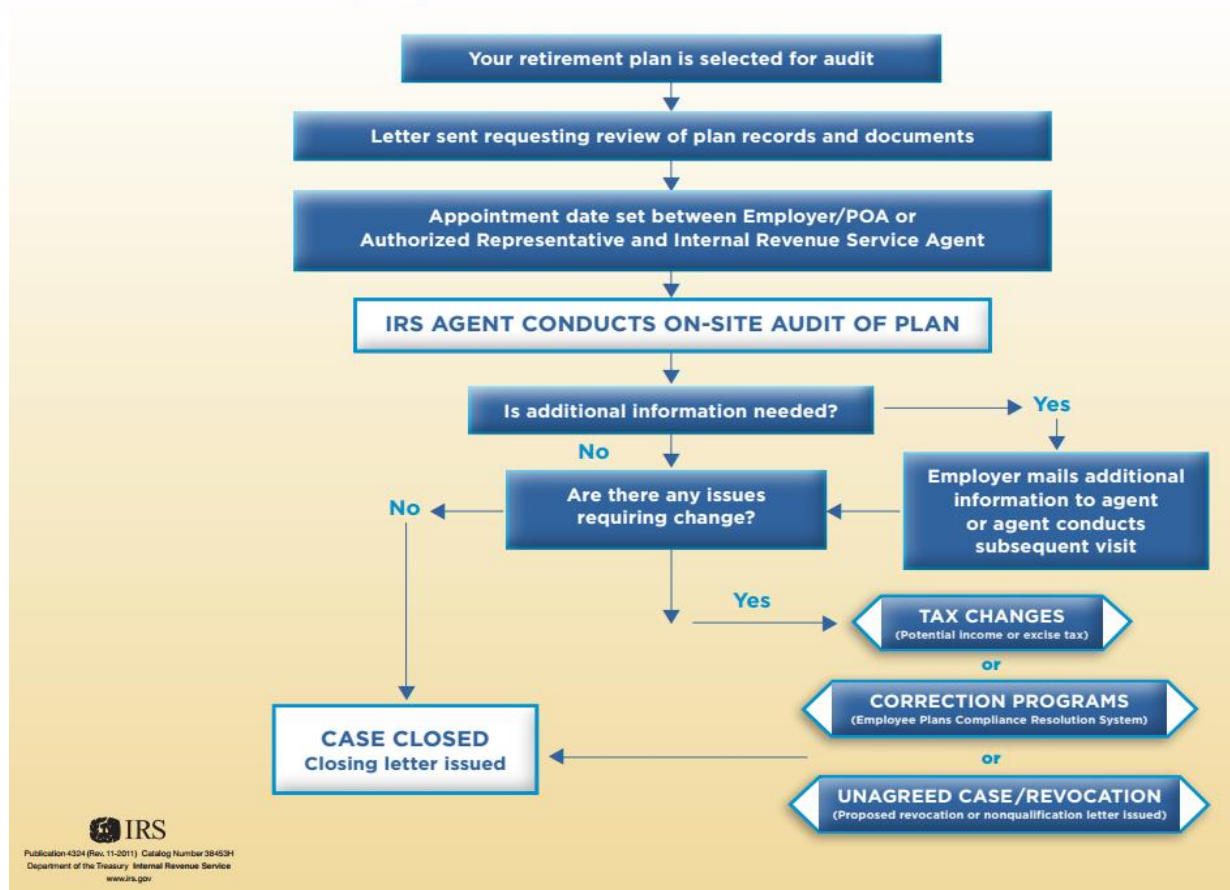
- Reviews both health and welfare plans and qualified retirement plans
- Primary jurisdiction over fiduciary standards, ACA reporting and disclosure requirements, and general reporting and disclosure requirements

- What types of plans are audited?
  - Qualified Retirement Plans
    - 401(k) Plans
    - Profit Sharing/Stock Bonus Plans
    - Employee Stock Ownership Plans (ESOPs)
    - Defined Benefit Plans
  - Health and welfare
    - Medical, dental, vision, and prescription drug plans (including COBRA)
    - Life, disability, AD&D

- An IRS Audit may occur as a result of:
  - Random selection
  - Referral from the DOL
    - Certain matters found on audit by the DOL are required to be reported to the IRS (e.g., prohibited transaction matters)
  - Identification of an Abusive Transaction
  - Risk Assessment Program – Industry Specific
    - <http://www.irs.gov/Retirement-Plans/EP-Examination-Projects---Risk-Assessment---Results-of-Plan-Examinations-by-Industry>
  - Participant Complaint

- Scope of a Typical Exam
  - Documentary compliance issues
    - Signed plan documents
    - Proper and timely amendments
    - Compliance/Participation with the Determination Letter Process (may phase out over time)
    - Returns and Reports (e.g., Form 5500s, 1099s)
  - Operational Compliance Issues
    - Eligibility, Participation, Coverage
    - Vesting
    - Discrimination
    - Top Heavy Requirements
    - Contribution and Benefit Limits
    - Funding and Deductions
    - Distributions

## Employee Plan Examination Process



- The Request Letter(s) – The IRS Agent will provide a series of “Information/Document Request” letters (IDRs) that identify certain information to be provided regarding the plan and the plan sponsor
  - Identification of members of the controlled group
  - Identification of other plans sponsored by the controlled group
  - Tax Forms (e.g., 5330, 1099-R, W-2, 990-T)
  - Plan and Trust documents, including amendments to confirm timely adoption and legally required changes
  - Correction applications and resolution



- The Request Letter(s)
  - Information regarding plan eligibility/enrollment
  - Participant communications and tax forms/reports
  - Distribution records
    - In the ordinary course (e.g., upon termination of employment)
    - Hardship
    - In-service

## ■ Fees and Penalties

- The IRS almost always attempts resolution with the plan sponsor for a fee through Audit Cap. The Audit Cap fee is a negotiated percentage of the sum of the following for all open taxable years (generally 3, can be 6):
  - Tax on the trust (Form 1041)
  - Additional Income tax resulting from the loss of employer deductions for plan contributions
  - Additional income tax resulting from income inclusion for participants in the plan (Form 1041), including tax on plan distributions that have been rolled over
  - Interest and penalties on the foregoing
- The company can also be liable for improper deductions and excise taxes
- Plan disqualification is remote but possible in extreme cases

## ■ DOL Audit Triggers

- Random selection
  - A certain number of plans filing a Form 5500 are selected each year for audit
- Concerns over information included in the Form 5500
  - Identification of late contributions, lack of fidelity bond, improper completion of Schedule C identifying compensation paid to providers
- Participant complaints
  - Office of Participant Education – a DOL office allowing for complaints of possible ERISA violations
- Referral from the IRS
- National Enforcement Priorities/Projects
  - See: <https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/enforcement>

- Scope of a Typical Exam

- National priorities, but broad local discretion
- DOL investigations can lead to criminal indictments in addition to civil penalties (See [http://www.dol.gov/ebsa/erisa\\_enforcement.html](http://www.dol.gov/ebsa/erisa_enforcement.html))

## ■ Fees and Penalties

- Monetary awards – recovery of money due to the plan
- Equitable remedies
- Attorney fees
- Statutory penalties
  - Excise taxes (prohibited transactions)
  - \$110/day for reporting violations
  - 502(l) penalty for fiduciary breach; 20% of recovery amount
- Removal of trustee and bar orders
- Report to IRS
- Criminal liability
  - Willful violation of ERISA reporting and disclosure requirements – up to \$5,000 in 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 years imprisonment, or both

## **SAMPLE REQUEST LETTER**

1. Signed originals of the Plan Document, Trust Agreement, and all amendments thereto;
2. Most recent Summary Plan Description and any Summaries of Material Modification;
3. Summary Annual Reports;
4. Most recent IRS letter of qualification determination;
5. Most recent Fidelity Bond Policy, including all endorsements and riders;
6. Most recent Fiduciary Liability Insurance Policy, including all endorsements and riders;
7. Annual Reports (Form 5500 series) and any associated financial statements/schedules, accountant's opinions and/or management letters;
8. Current detailed listing of assets owned by the Plan;
9. Documents regarding Plan policies and/or procedures;
10. Minutes from Trustee and/or Administrative Committee meetings;
11. Agreements or contracts between and/or among third party service providers, the Plan and the Plan's sponsor, and all amendments to such agreements,
12. Documentation regarding any ERISA individual prohibited transaction exemptions that have been applied for;

## SAMPLE REQUEST LETTER – CONT'D

13. Payroll information summarizing deductions from participants' salaries for contributions to the Plan, including monthly, semi-monthly, bi-weekly or weekly payroll reports of participant contributions;
14. Canceled checks and/or wire transfers which verify the deposit of participant contributions made by the plan sponsor to the Plan;
15. Documentation regarding employer contributions from the plan sponsor to the Plan;
16. Correspondence between the Plan's custodian/trustee and the plan sponsor relating to any late or delinquent contribution remittances to the Plan;
17. Organizational chart for the Plan sponsor;
18. Documentation pertaining to participant loans, including the Plan's loan policy and for each outstanding loan, the following items (for plans with more than 25 loans, a sample will be selected during the onsite visit):
  - a) Signed loan application
  - b) Promissory note
  - c) Collateral agreement
  - d) Amortization schedule
  - e) Canceled front/back copy for the loan proceeds
  - f) Maximum loan calculation
  - g) Indication of whether the loan is in default
19. Sample benefit statement distributed to participants after the close of the most recent plan year or quarter.

## ■ Surviving an IRS Exam

### – Helpful IRS Publications

- IRS Revenue Manual – EP Examination Guidelines (broken down by technical topics) (<http://www.irs.gov/Retirement-Plans/EP-Examination-Guidelines>)
- Form 5772 – Audit Plan (procedural and technical requirements reviewed by agents) (<http://www.irs.gov/pub/irs-tege/form5772.pdf>)
- Employee Plan Examination Process Brochure (identification of other helpful publications and common areas of review) ([http://www.irs.gov/pub/irs-tege/exam\\_overview.pdf](http://www.irs.gov/pub/irs-tege/exam_overview.pdf))
- 401(k) Plan Checklist (identifies requirements for a 401(k) qualified plan) (<https://www.irs.gov/pub/irs-pdf/p4531.pdf>)



- Once the audit is initiated – organization is key
  - Organize a response team (ERISA counsel, HR, benefits, consultants, etc.) to review scope of investigation
  - Appoint 1 person for all contact with DOL investigator – generally ERISA counsel
  - Have ERISA counsel serve as conduit for all information and communication
  - Generally will need to seek additional time to respond; confirm in writing
  - Provide only the documents requested – keep copies and keep in order produced so you can easily access when questioned
  - Notify senior management and liability insurer
  - Work with ERISA counsel to prep employees for DOL interviews
  - Debrief employees after they meet with DOL investigator
  - Keep notes of all interviews and all responses
  - If you agree to voluntarily correct, clarify what must be done and by when
    - Develop a project plan and assign responsibility
    - Keep DOL investigator informed of progress

- Interview with auditor
  - Have ERISA counsel sit in on all interviews
  - Be comprehensive
    - Provide complete information based on what has been requested
  - Be organized
  - Be cooperative and helpful
  - Answer the question asked...and only the question asked
  - Do not be afraid to respond with “I don’t know” or “I will have to review my files”
  - Do not speculate on anything that is outside your responsibility, expertise or knowledge

- It's always cheaper to correct errors before audit
- Self correction (in certain cases) and voluntary correction program options are available, but only before plan is subject to audit. Once plan administrator is notified of audit, voluntary correction is no longer an option

Voluntary Correction Program Fees (effective for submissions on or after January 1, 2017)	
Number of Participants	Fee
20 or fewer	\$500
21-50	\$750
51-100	\$1,500
101-1,000	\$5,000
1,001-10,000	\$10,000
More than 10,000	\$15,000

- Independent public accountant audits can be helpful but are not enough
  - The DOL’s Employee Benefits Security Administration (EBSA) recently issued a report reviewing the quality of audit work performed by independent qualified public accountants
  - A substantial portion (almost 40%) of such audits contained “major deficiencies with respect to one or more relevant Generally Accepted Auditing Standards (GAAS) requirements” which “would lead to rejection of a Form 5500 filing”
  - Common audit deficiencies include insufficient review of plan documents and administration, failure to obtain evidence of required communications to participants and adequate internal controls, and inadequate review of employee eligibility, participant accruals, and nondiscrimination testing
- Plan sponsors have a fiduciary obligation to ensure their plans are properly maintained and administered beyond what is required to complete the annual audit

- IRS Elimination of Determination Letter Program
  - More resources devoted to audits?
  - More focus on administrative compliance versus plan document compliance?
- Internal Controls
  - Auditors at both the IRS and DOL are increasingly focused on the internal controls employers maintain
  - Documented practices and procedures to prevent errors and quickly flag errors before they result in large financial consequences
  - The agencies want to see evidence of actual checks and balances, specific and tangible internal controls, and proof that internal controls have been implemented
- Monitoring
  - Continual monitoring of the processes that have been implemented
  - Monitoring of vendors is also important

- Maintenance of plan documents
- Records retention
- Plan governance structure
  - Know who is responsible for what (Board of Directors vs. Plan Administrative Committee)
    - Decisions made by the wrong authority may be disregarded entirely
- Self-audit of compliance with plan terms and reporting and disclosure requirements
  - The audit requests from the IRS and DOL will ask how the plan sponsor ensures it meets certain requirements, and evidence of self-audit is helpful

- Due to the myriad IRS and DOL compliance requirements for retirement and welfare plans, we have found that employers need help prioritizing their efforts in establishing and maintaining internal controls
- The following slides outline the retirement and welfare plan compliance issues that employers should prioritize based on a review of recent IRS and DOL data requests and issues the agencies themselves have identified as areas of recent focus in seminars, speeches, and on their websites

- **Definition of Compensation:** Failure to follow plan's definition of eligible compensation
  - The definition of compensation is important for several purposes: (1) determining an employee's allocation in a defined contribution plan or benefit accruals in a defined benefit plan, (2) complying with IRS limits on deferrals and benefits, (3) performing nondiscrimination tests (e.g., ADP/ACP), and (4) determining whether a plan is top-heavy
  - IRS suggests annual self-audit of payroll codes, annual check-in with service providers
  - Many failures can occur for large corporations with numerous payrolls resulting in inconsistent application of a compensation definition
  - Confusion for employers regarding equity compensation (e.g., exercise of stock options or early sales in 423 stock purchase plan generates W-2 income – does your plan require you to take deferrals from ALL W-2 income?)
  - **Action Steps: Review payroll codes and compare to plan document definition of eligible compensation on an annual basis**



- **Updating the Plan Document:** Failure to amend plan document for design or tax law changes
  - IRS suggests annual review of plan document
  - “Discretionary” amendments (amendments that are not legally required) must be adopted by the end of plan year in which the amendment is effective
  - Interim amendments (amendments that are legally required) generally have a specific deadline for adoption
  - Prototype or other preapproved plan? Keep signed copies and sign and date all amendments
  - Merged-in plan? Be sure to amend to update before merger to avoid tainting surviving plan
  - Be sure that plan document and SPD match. If plan is amended, don’t forget to update the SPD
  - Likely to be even more significant now that the determination letter program has been curtailed
  - **Action Steps: Review plan amendments and SPDs with your legal advisors. Maintain copies of all legal plan amendments, particularly for merged-in plans**

- **Employee Eligibility:** Failure to follow plan's eligibility or enrollment rules
  - Improper exclusion of part-time employees or a merged-in group of employees
  - Misclassification of independent contractors
  - Controlled group employee errors (for example, standardized prototype plans may cover ALL employees of all controlled group members – is that too broad?)
  - Failure to adhere to Hours of Service counting rules, or Elapsed Time alternative
  - Rehire failures – failure to re-enroll rehired participants without delay
  - Failure to automatically enroll all eligible employees timely or failure to provide automatic enrollment notice
  - Failure to provide complete enrollment package materials – examples should be retained for demonstration of compliance on audit
  - **Action Steps: Periodically pull representative sample of employees (new hires, transfers, rehires, part-time) and review eligibility procedures. Maintain file of enrollment packets**

## ■ **Loans:** Failures on plan loans

- Failure to maintain a loan policy
- Failure to give complete loan paperwork to participants, including:
  - loan agreement
  - promissory note
- Failure to obtain required documentation from participants (proof of need for longer residential purchase loan, for example; records must be kept for entire period loan is outstanding – can be as long as 15 years)
- Failure to properly administer loans for employees on leave, including military leave
- Failure to timely default unpaid loans
- Loan interest rate unreasonably low? (IRS has informally stated that 2 points over prime is appropriate)
- **Action Steps: Review loan policy. Review loan paperwork for representative sampling of employees with loans, including defaulted loans. Maintain file of loan applications until expiration of loan term**

- **Minimum Required Distributions:** Failure to make age 70-1/2 minimum required distributions timely and properly
  - Correspondence to participants suggesting distributions be requested is NOT sufficient – checks must be distributed with no participant consent required
  - Make sure any 5% owners are tracked
  - After participant's death, failure to properly and timely distribute to beneficiaries
  - Proof that the employer searched for missing participants
  - **Action Steps: Identify all terminated employees approaching age 70-1/2 or older, and notify or check that distributions have commenced. If you have any 5% owners of the employer who are age 70-1/2, check that distributions have commenced for them even if still actively employed. Review benefits for deceased participants to ensure distributions are made to beneficiaries**

- **Late Payroll Deposits:** Late deposit of participant contributions to 401(k)/defined contribution plans
  - DOL will look at all your payrolls, when contributions were made, what was the fastest you were able to get contributions to the trust, then use that as your maximum deadline
  - DOL has informally indicated that they think 3 (or 4) days should be the maximum, despite 7-day safe harbor for small plans (fewer than 100 participants), and would often like to see as short as 1 day
  - **Action Steps: Review payroll records and determine the reasonable timeframe to make contributions to the trust, particularly when changes are made to payroll systems or providers. Work with payroll and recordkeeper to make sure that deposits are made within that timeframe**

- **Target Date Funds:** DOL issued guidance (February 2013) for plan sponsors on reviewing their plans' Target Date Funds
  - Fiduciaries must engage in a process to obtain information to evaluate their TDF
  - Fiduciaries must understand the differences among TDFs
  - Fiduciaries must document their selection and review process and how they reached their decisions on the TDF selected
  - **Action Steps: Prepare (or have counsel/advisors prepare) TDF checklist and periodically review TDF checklists. Document review in Committee minutes**

- **Consultants and Investment Managers:** Failure to adhere to DOL recommendations regarding hiring plan consultants or investment managers
  - Does the consultant/advisor have a conflict of interest?
    - Does advisor get bonus based on business placed with particular firm or have preferred vendors because they get additional compensation?
    - Does advisor have a policy on receiving gifts from vendors?
  - Fiduciary
    - Is the advisor a fiduciary, and is this documented in writing?
    - Background check?
    - Adequate insurance coverage?
    - Fees reasonable?
  - Are consultants and investment managers reevaluated every 3-5 years?
  - **Action Steps: Review agreements with plan consultants and investment advisors to ensure they contain appropriate disclosures. Periodically monitor and reevaluate consultants and investment managers**

- **Float:** Failure to review “float” received by trustee or custodian (see DOL Field Assistance Bulletin 2002-3)
  - Float must be transparent in TPA agreement:
    - Must be considered when weighing alternatives
    - Should be compared to other service providers
    - Must be reasonable
  - **Action Steps: Review all new or updated agreements with trustee or custodian to make sure compensation is understood**



- **Revenue Sharing/12b-1 fees:** Are there extra funds in your plan’s “ERISA account”? What are you doing with those extra funds?
  - In 2013, DOL released Advisory Opinion 2013-03A, which indicates that, depending on the circumstances, revenue sharing payments may constitute “plan assets” under ERISA
  - **Action Steps: Consult legal counsel for complete review of your revenue sharing arrangement**

- **In-Service Distributions:** Failure to follow plan's in-service distribution rules
  - Distributions made for impermissible reasons under the plan, or made too early
  - Failure to follow hardship withdrawal procedures, e.g.:
    - 6-month suspension of future deferrals
    - establishing procedures and explaining them in SPD (proof/documentation of hardship, for example)
    - Failure to sufficiently document hardship
      - If relying on a participant-provided summary of financial hardship, summary must include certain information specified by IRS ( See <https://www.irs.gov/pub/foia/ig/spder/tege-04-0217-0008.pdf>), including an explanation for multiple hardship distribution requests in one plan year. Underlying documents must be retained, and participant must receive a notification of their obligations with respect to the distribution
      - If hardship substantiation is outsourced to a third party administrator (TPA) and the TPA relies on a summary, the TPA must provide the plan sponsor, at least once a year, with a report describing the hardship distributions made during the plan year, or with access to the summary information
  - Failure to permit “special” in-service distributions as a result of a protected benefit from a merged in plan
  - **Action Steps: Pull representative sample of employees receiving in-service distributions and hardship withdrawals and review reasons for withdrawal, proof of hardship, and explanation in SPD. Maintain file of hardship withdrawal paperwork for 4 plan years**

- **Distribution Paperwork:** Failure to provide correct distribution paperwork to employees
  - Failure to provide correct options (installments, annuities, lump sums) in paperwork
  - Spousal consents – some plans require spouses to consent to ALL distributions. Does your paperwork match your plan rules?
  - Cashing out \$1001-\$5,000 lump sums without participant consent but failing to roll over to auto-rollover IRA:
    - Failure to negotiate and keep appropriate contract paperwork with auto-rollover IRA vendor (specific DOL fiduciary guidelines on contracting with auto rollover vendors)
    - Failure to make timely de minimis cashout sweeps when provided for in plan document
  - **Action Steps: Review distribution paperwork and compare to plan document rules. Review auto-rollover IRA contracts with vendors. Pull representative sample of employees receiving small lump sum cash-outs and check for proper consent, or auto-rollover to IRA. Review frequency of cash-out sweeps and compare to plan document rules**

- **ERISA fidelity bond:** Missing or inadequate ERISA fidelity/fiduciary bond/fiduciary insurance policy:
  - Failure to keep copy of certificate
  - Failure to comply with ERISA bonding requirements. ERISA bond must:
    - Contain no deductible
    - Name plan as insured
    - Be in an amount equal to a minimum of 10% of funds in the plan (with a maximum of \$500,000, or \$1 million if plan contains employer securities)
    - Include a discovery period of at least one year after the termination or cancellation of the bond
    - Cover all individuals who handle plan assets
  - **Action Steps: Make sure you have a copy of your ERISA fidelity bond and fiduciary insurance policy. Review to ensure compliance with ERISA/DOL requirements**

- **Blackout Notices:** Failure to provide blackout notices for individual account plan participants undergoing investment fund changes in participant-directed individual account plans
  - **Action Steps:** Monitor all investment fund changes and ensure that blackout notices, if required, are properly provided and contain the proper information for participants. Keep copies of notices provided to participants

- **Investment Policy:** Failure to adopt or adhere to Investment Policy/Guidelines
  - **Action Steps:** Review your plan's Investment Policy annually with your investment advisors and plan committee members. Always refer to the Investment Policy when discussing any changes to plan investments. Keep records in Committee minutes

- **Committee Minutes:** Failure to keep minutes of plan committee meetings, or incomplete minutes that raise additional questions that are not answered in those minutes or the following meeting's minutes
  - **Action Steps:** Keep regular minutes of all plan administration or investment committee meetings, and retain in permanent files. Review minutes to avoid unanswered questions, conflicts of interest, etc. Review prior year's minutes before each meeting to make sure any tasks documented in prior minutes are completed or addressed

- **Suspension of Benefits:** Failure to follow suspension of benefits (SOB) rules in defined benefit pension plans upon attainment of normal retirement age
  - Failure to give SOB notice to post-normal retirement age active employees
  - Failure to appropriately calculate actuarial increases
  - **Action Steps: Identify all active employees who are close to retirement age and ensure that SOB letters were sent. Check with plan's actuaries to ensure appropriate actuarial increases are made for all participants regardless of SOB letters**



- **Vesting:** Vesting errors:
  - Failure to provide for 100% vesting at normal retirement age
  - Failure to properly account for vesting for employees with breaks in service, inter-company transfer employees, and employees formerly employed by acquired companies
  - Failure to timely sweep forfeitures from terminated participant accounts
  - Failure to calculate and vest employees affected by partial terminations
  - **Action Steps: Pull representative sample of employees, especially those with breaks in service, those who transferred between companies, and those formerly employed by acquired companies, and confirm that vesting was calculated appropriately. Review plan document rules on when forfeitures are removed from participant accounts or accrued benefits**

- **ADP/ACP Test:** Failure to properly pass ADP/ACP test in 401(k)/(m) plan – usually due to incorrect compensation or ineligible employees
  - Alternatively, failure to provide required ADP/ACP safe harbor notice
  - **Action Steps: Review with third-party administrator to ensure that testing has been timely done, that plan passes, and that correct compensation and employee population was used in testing**

- **Top Heavy Testing:** Failure to test or provide top-heavy benefit (Internal Revenue Code Section 416), if applicable (typically more of a problem for smaller plan populations with preponderance of long-service, highly compensated participants)
  - **Action Steps:** Review with third-party administrator to ensure that testing is done timely and passed

- **Coverage Testing:** Failure to perform testing to ensure plan is benefiting 70% of non-highly compensated employees (410(b)), especially a concern for partially-frozen plan or when there are multiple plans that must be aggregated for testing purposes
  - **Action Steps:** Review with third-party administrator or legal counsel to ensure that testing has been timely done and passed

- **QDROs:** Failure to maintain or adhere to QDRO procedures
  - **Action Steps:** Review with third-party administrator or legal counsel to ensure that QDRO procedures are maintained and are being followed

- Documentation versus administration
- Plan documents and amendments
- List of service providers and contracts
- Employee communications (SPDs and SMMs)
- Form 5500 filings
- Eligibility and coverage issues
- Nondiscrimination testing

- Disclosure and reporting
  - Compliance required even if documents are provided by TPA or insurer
  - COBRA, CHIPRA, Exchange Notice, Medicare Part D Disclosure Notice, Women's Health & Cancer Rights Act Notice, HIPAA Notice of Special Enrollment Rights, HIPAA Privacy Notice
- ACA Compliance
  - Waiting periods
  - Annual and lifetime limits
  - Appeals processes
  - Coverage of dependents
- HIPAA compliance
  - OCR can audit separately

# ■ Questions?