Mistakes A Plan Sponsor Should Correct Before An IRS or DOL Audit

By Ary Rosenbaum, Esq.

I have been in the retirement plan business for over 17 years and I have met too many plan sponsors who don't care that their plan isn't being run correctly. What makes them eventually care is when they are audited by the Internal Revenue Service (IRS) and/or the Department of Labor (DOL) and get penalized for those very mistakes that plan providers had already pointed out. A few years back, the DOL penalized employers $1.69 billion dollars for problems they had with their retirement plans. The point of correcting plan errors is for a plan sponsor is to correct it before the DOL and/or the IRS finds it. So this article is about plan errors that plan sponsors should correct before the government does.

Failing to timely amend plan document to comply with current law

The Internal Revenue Code and Treasury Regulations are constantly being updated and rewritten. One of the requirements for any qualified retirement plan is that they are update to comply with current law. That may mean a tack-on plan amendment or a new plan documents every 5-6 years. Regardless of the change that the IRS requires, plan sponsors have to make sure that it's done in a timely manner. One of the first thing that a government auditor wants from a plan sponsor are the copies of all plan documents and a failure to have the requisite timely adopted amendments will trigger a nice sized penalty. A plan sponsor should make sure all plan documents are up to date by contacting an ERISA attorney and/or their third party administrator (TPA).

Failing to procure adequate fidelity bonding

Every retirement plan subject to ERISA is required that every fiduciary of the plan be bonded. Except for two exceptions, the fidelity bond must be at no less than 10% of plan assets with a minimum of $1,000 and a maximum of $500,000. Plans that don't have a fidelity bond in place are supposed to note that on Form 5500 and that alone is a trigger for an audit by the government.

Not following plan terms for loan and distribution processing

Loans and distributions allow plan participants to tap their retirement plan account balance. Unfortunately, many errors by the TPA may be made. For loans, that might be an incorrect loan terms, more loans outstanding than what the plan allows, or failure to have the participant make repayments at least quarterly. For plan distributions, there may be errors in the distribution amount or it maybe in a form of payment not allowed by the plan's terms.

Neglecting to allocate contributions and forfeitures in keeping with the plan terms

Every retirement plan must have a definitely determinable formula for employer contributions and many times, the TPA will make an allocation error in how the contributions are made and who is entitled to a contributions. There also maybe be an error in failing to properly allocate forfeitures, especially when the plan requires a reallocation of forfeitures annually and they are not made.

Failure to properly run nondiscrimination tests

Retirement plan administration requires technical mathematical compliance tests to make sure that the plan does not discriminate in favor of highly compensated employees. These tests include a test for salary deferrals; matching contributions; something called top heavy; and coverage (to see how many employees benefit under the Plan). Tests can be done incorrectly based on bad data provided by the plan sponsor and/or wrong calculations by the TPA. Unless an independent ERISA attorney or plan consultant reviews the testing, this error is usually only detected on audit or when the plan sponsor changes TPAs.

Failure to deposit elective deferrals into the plan's trust in a timely manner

For the past few years, many 401(k) plans have been caught with the late deposit of salary deferrals. The reason for the error is because most plan sponsors assumed that based on a wrong reading of prior guidance,

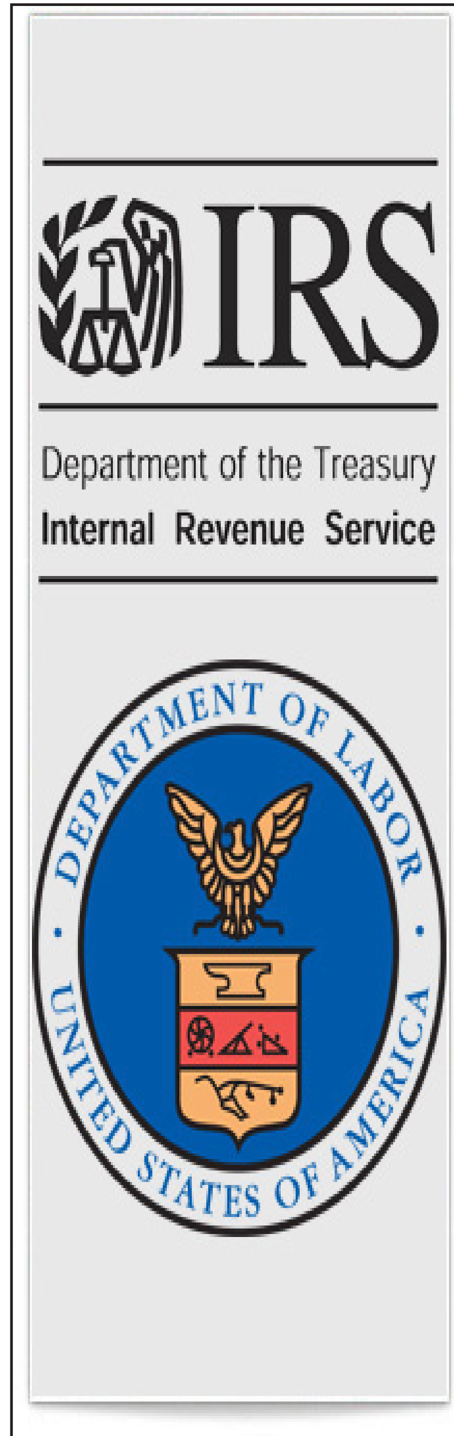
they only had to deposit the participant's salary deferrals by the 15th day of the following month. Thanks to the DOL interpretation of this rule, a plan sponsor needs to get salary deferrals into the plan as soon as possible that means the next payroll. Otherwise, the plan sponsor will get penalized and will have to adjust the deferrals to compensate for lost earnings. The DOL does have a voluntary correction program called the Voluntary Fiduciary Correction Program that will give the plan sponsor a far better result than being caught on an audit.

Using an incorrect definition of compensation per the plan terms

Retirement plans can recognize and not recognize certain forms of compensations for purposes of retirement plan contributions. A plan sponsor can decide not to recognize bonuses or commissions from a participant's compensation for purposes of plan contributions. When a plan sponsor veers from a compensation definition that is different from the typical W-2 compensation (plus adding back salary deferrals), errors by the TPA may occur where the TPA will base contributions allocation on compensation that the plan sponsor didn't want to recognize. Using an incorrect definition of compensation may result in excess deferrals, excess employer contributions, and excess employer deductions. In addition, many retirement plan compliance tests are dependent on correct plan compensation, so using the wrong definition will affect so many parts of the plan and cause so many errors. It's important for the plan sponsor to make sure that the definition of compensation is correct and that it is the term that all allocations and compliance testing is based on.

Failing to monitor plan contributions to ensure they do not exceed dollar limits or the deductible limit for employers

A qualified retirement plan is all about limits for participants. There is a limit on the compensation we recognized for them, limits on their contributions, and limits on how much a plan sponsor could deduct for the contributions they make. Unfortunately, mistakes are made in calculating allocations and the plan sponsor has allocated too many contributions to a participant and/or deducted too much on their tax return for employer contributions. Again, unless a plan sponsors has an independent plan review, the only way it is usually detected is on audit or when the TPA is replaced.



Distributions of excess deferrals are incomplete, not timely or improperly calculated.

Excess deferrals by plan participants happen when they defer more than what they are allowed by the plan document, the annual salary deferral limit for plan participants, or by the actual deferral percentage discrimination test limit. Regardless of which limit, excess deferrals need to be refunded to the participant by the April 15th of the following year. Many times excess deferrals are improperly calculated or not calculated at all because the discrimination test was done incorrectly (see above). Failure to properly determine excess deferrals and distribute them may result in unnecessary penalties if caught on audit.

Not filing the Form 5500 timely

Every retirement plan that is governed by ERISA must file an annual tax return known as a Form 5500. Failure to file the return timely or failing to file it at all will eventually trigger massive penalties from the IRS and/or the DOL. The IRS penalty for late filing of a return is $25 per day, up to a maximum of $15,000. The DOL penalty for late filing can run up to $1,100 per day, with no maximum. It should also be noted that there is no statute of limitations for the failure to file a Form 5500. If a plan sponsor notes that a return has not been filed, they must immediately contact a TPA to prepare the return and file it with the Department of Labor Voluntary Fiduciary Compliance Program where the fees for the correction program are far less than any penalties the IRS and/or the DOL may regularly assess.

If a plan sponsor gets a notification from the IRS and/or DOL that there will be a plan audit, it makes perfect to go through a mock audit with an ERISA attorney (cough, cough) and/or TPA to make sure that there are no glaring mistakes and problems that an auditor could detect. There is enough guidance from the IRS and DOL to self-correct or correct through a voluntary compliance program that would avoid unnecessary penalties if those errors were caught on audit.

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The Rosenbaum Law Firm P.C.
734 Franklin Avenue, Suite 302
Garden City, New York 11530
(516) 594-1557

http://www.therosenbaumlawfirm.com
Follow us on Twitter @rosenbaumlaw