Avoid An IRS Audit Surprise By Checking These Areas Of Your 401(k) Plan

By Ary Rosenbaum, Esq.

I don't like surprises and when a 401(k) plan gets a notice about an impending Internal Revenue Service (IRS) audit, the best thing to do is not sit back and do nothing. In addition to collating all the materials that the IRS asks for, there are certain points within your 401(k) plan to make sure you can spot and correct the errors before they do. If you get a notification from the IRS that there will be a plan audit, it makes perfect to go through a mock audit with an ERISA attorney (cough, cough) and your Third Party Administrator (TPA) to make sure that there are no glaring mistakes and problems that an auditor could detect. There is enough guidance from them to self-correct or correct through a voluntary compliance program that would avoid unnecessary penalties if those errors were caught on audit. This article is all about the areas within your 401(k) plan to find any problems before the IRS agent does.

Make sure your plan document was timely amended and restated to comply with current law

The Internal Revenue Code and Treasury regulations are constantly being updated and rewritten. One of the requirements for any 401(k) plan is that they are updated to comply with current law. That may mean a tack-on plan amendment or 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 promptly. One of the first things that an IRS agent wants from a plan sponsor is the copies of all plan documents and a failure to have the requisite timely adopted amendments will trigger a nice sized penalty. Even passing the amendment and restatement deadline by a few days can cause grief. A plan sponsor should make sure all plan documents are up to date by contacting an ERISA attorney and/or their TPA.

Make sure the ERISA bond is correct

Every retirement plan subject to ERISA requires 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 or don't have enough coverage are supposed to note that on Form 5500 and that alone could be a trigger for an audit by the government by the IRS or Department of Labor.

Not following plan terms for loans and distributions

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 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 may be in a form of payment not allowed by the plan's terms.

Make sure the plans allocate contributions and forfeitures according to plan terms

Every retirement plan must have a 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 contributions. There also may be an error in failing to properly allocate forfeitures, especially when the plan requires a reallocation of forfeitures annually and they aren't made. The IRS issued guidance that forfeitures need to be dealt with annually, and you can no longer use forfeitures by building up a war chest as so many plan sponsors did in the past.

Make sure the nondiscrimination tests are done correctly

401(k) 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 just 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. So make sure they have been done correctly.

Make sure elective deferrals are deposited into the plan's trust promptly

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 that 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, you need to get salary deferrals into the plan as soon as possible which 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. While the DOL is more focused on late deferrals than the IRS, they will ask for payroll and deferral deposit information for an audit.

Make sure you're using the right definition of compensation

401(k) can recognize and not recognize certain forms of compensation for purposes of retirement plan contributions. As a plan sponsor, you can decide not to recognize bonuses or commissions from a participant's compensation for purposes of plan contributions. When you veer 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. That is a lot of headaches for you. So make sure you're using the right definition of compensation so that there is one term for the plan document and administration. In addition, many 401(k) plan compliance tests are dependent on correct plan compensation, so using the wrong definition will affect so many parts of your plan and cause so many errors. You need to make sure that the definition of compensation is correct and that it is the term that all allocations and compliance testing are based on.

Make sure plan contributions don't exceed dollar limits or the tax deduction limit

A 401(k) plan is all about limits for participants. There is a limit on the compensation we recognize 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 plan sponsors have allocated too many contributions to a participant and/or deducted too much on their tax return for employer contributions. Make sure that's not you. Again, unless you have an independent plan review, the only way it is usually detected is on audit or when the TPA is replaced.

Make sure distributions of excess deferrals are complete, timely, and properly 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 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.

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