Top 10 retirement plan internal control pitfalls—and how to avoid them

Prepared by:

Eric Carroll, Partner, RSM US LLP
eric.carroll@rsmus.com, +1 212 372 1281

Bill O'Malley, Senior Director, RSM US LLP
bill.omalley@rsmus.com, +1 309 497 1407

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When it comes to benefit plans, auditors often find that there are a number of 401(k) compliance errors that companies make time and again. Following are some of the most commonly found errors in plan administration, as well as the internal controls companies can implement to avoid them.

#10: Uncashed checks and lost participants

These issues do not happen as often as they once did, but they are still prevalent. It is common to have participants who do not cash their pension checks or who do not know they have the benefits. How do plan sponsors deal with these lost participants and uncashed checks? Do they have the duty to locate these participants?

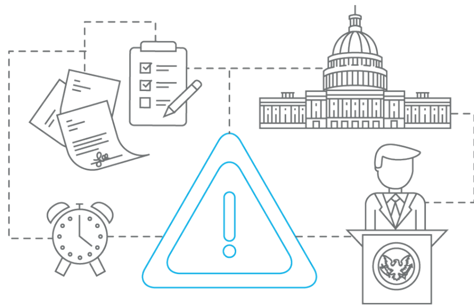
The answer is not entirely clear, but many plan sponsors are unaware of this significant issue.

There are millions of dollars in uncashed checks out there. Here is what typically occurs: An employee participant leaves a firm, and the plan sponsor approves the distribution of their account; the plan trustee or custodian sells the investment and puts the proceeds in an omnibus checking account, then sends out the check to the plan participant. But if the check remains

uncashed for a period of time, the question may arise regarding who can rightfully claim that money. In this case, it's still the plan's asset.

Plan sponsors need to have a process in place to periodically check in with the custodian to identify any uncashed checks and determine what to do about them; this should be done on at least an annual basis. Should the former employee be contacted again? Should the money be taken back into the plan and the account reinstated? Plan sponsors can post information on unclaimed retirement benefits in an online national registry.

But plan sponsors should be aware that the U.S. Department of Labor believes that those uncashed checks remain plan assets, so the sponsor has a fiduciary obligation to address them.



#9: Failure to amend a plan for legislative changes on a timely basis

Is it possible that a plan that was first implemented in the late 1980s never needed to be amended since then? Simply put, no, it is not possible. While it's rare to see plans that are so delinquent, it is not uncommon. A plan developed in the 1980s, for example, should have been restated at least four times.

How does a company address such a situation? Here are some corrective steps:

- Amend the plan: Draft a plan document that is in compliance with all current laws and regulations.
- Review prior plan administration to see if it complied with amended terms: The longer sponsors wait to take this step, the more difficult it becomes. Correct any administrative errors that may have occurred.
- File a voluntary compliance program (VCP) request with the IRS: A fee based on the size of the plan must be paid. The objective is not to disqualify the plan or unduly punish the employer, but to bring the plan back into compliance.

#8: Failure to follow participant loan rules and violations of IRC 72(p)

Perhaps the most common compliance mistake is when the employer fails to properly set up payroll to collect loan payments. An employee requests a loan through a website run by the plan record-keeper. The loan is processed, the check comes out and the record-keeper generates an amortization schedule. The schedule is then sent to the plan sponsor. Yet, due to an internal controls issue, the schedule does not get set up properly in payroll. As a consequence, the plan participant can end up incurring a taxable distribution for failure to pay back the loan, and the plan sponsor has a plan qualification error.

There is a limited cure or grace period in which the sponsor can self-correct this situation; this occurs at the end of the quarter following the quarter in which the error occurred. If the correction does not occur within this time period, the sponsor will have to file a VCP request to inform the IRS what happened. The IRS could waive the taxable income for the participant or make another arrangement. Typically, the participant will be required to make a lump-sum payment or re-amortize to make the original due date of the loan.

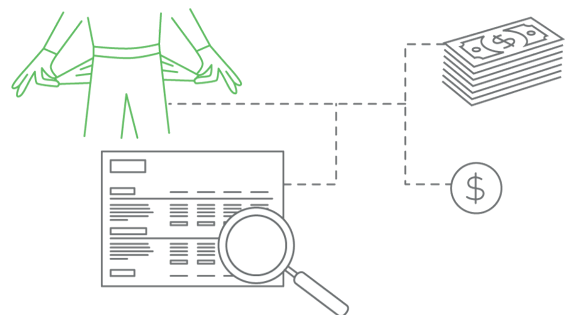
#7: Failure to issue minimum required distributions

It should be easy to program a record-keeper system to trigger reminders. For example, when someone turns 70 ½ and terminates employment, a reminder should indicate that the distribution process should begin. Yet auditors continue to see minimum required distributions missed.

There is a misconception among plan sponsors regarding who is responsible for this process. Many are under the impression that the former employee should contact them regarding the milestone and starting the distribution, as they would with an IRA. But this is not the case for a 401(k) plan.

The minimum distribution rule as applied to an employer-sponsored retirement plan places that duty to make the distribution squarely on the shoulders of the plan sponsor. A failure to meet the minimum distribution requirement could adversely affect the tax qualification of the plan.

Another misconception is that employees need to submit paperwork to consent to the distribution. But plan sponsors don't need the participant's consent; they can simply calculate the distribution and issue the check. A VCP request could get the IRS to waive the participant penalty (when can be extreme) and the plan can remain qualified—after the distributions have been made.



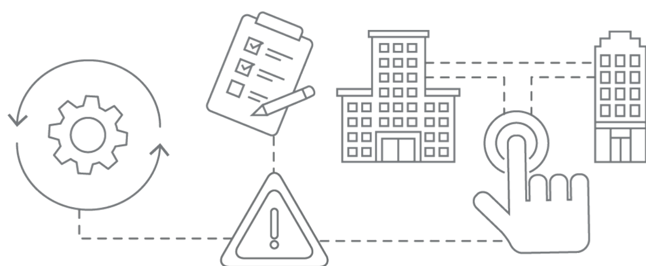
#6: Failure to follow hardship rules

Who has the responsibility for hardship distribution compliance, the record-keeper or payroll?

The record-keeper's responsibility is to process the hardship distribution and to notify the plan sponsor. Once the plan sponsor is aware that the hardship distribution has been made from the plan, it's up to the payroll department to suspend the

deferrals for the six-month required period. This does not apply to all plans, but plans that use the IRS safe harbor methodology are required to do so. Yet sometimes the deferral is not suspended; this is an internal control issue.

As a solution, albeit an impractical one, the employee could be asked to return the amount of the hardship distribution; but this money may have already been spent on the hardship event. Alternatively, the improper elective deferrals (adjusted for earnings) could be returned to the employee—this may be the most practical choice and is, in fact, the solution most plans take. Or, the IRS offers the suggestion to suspend elective deferrals for a six-month period going forward, but this seems problematic as the employee may terminate employment.



#5: Failure to properly administer automatic enrollment

Sometimes automatic enrollment is not always automatic. In one case, a plan document stated that unless an eligible employee affirmatively elects otherwise, compensation would be reduced by 5 percent. Similarly, auto increases, if not handled properly, may never reach payroll. Unless interfaces between the record-keeper and payroll provider are set up properly, there needs to be a manual intervention.

When a plan fails to enroll an employee, or to process their deferral election, that is a missed deferral opportunity. The general correction is for the employer to make a contribution equal to 50 percent of that missed deferral to compensate for that missed tax benefit. In addition, the employer must contribution 100 percent of any missed matching contributions. These contributions are all adjusted for earnings.

The IRS and the Department of the Treasury believe automatic enrollment is a very important feature of retirement plans. But in many cases plan sponsors were not finding these errors until much later, when the plans were audited or when plans were preparing non-discrimination tests. As a result, employers were recently granted significant relief for these auto-enrollment failures. There are no missed deferral opportunity costs for automatic enrollment or automatic increase failures that are found and corrected by the first payroll date after the earlier of either of the following:

- 9½ months after the end of the plan year in which the automatic contribution or increase should have occurred
- The last day of the month following the month in which the participant advises the sponsor of the problem

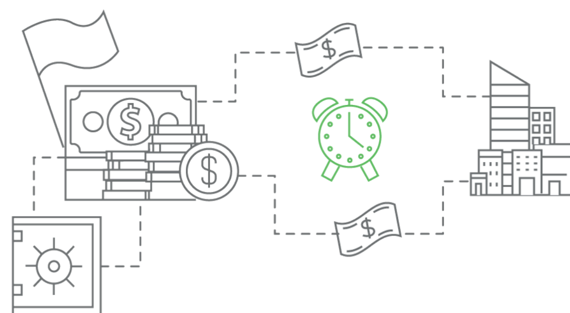
There are some requirements to meet this deadline, including notification of the participant of the error, and the costs may be reduced to only 25 percent or 50 percent of the missed deferral opportunity cost if the error is not corrected within the allotted time.

#4: Failure to include all eligible employees

How do companies and institutions avoid excluding eligible employees from their plans? The answers are somewhat similar to the automatic enrollment process, but it depends on when the fix occurs.

It's important to remember that the employee will always receive 100 percent of any missed match, without exception. There is a reduced required correction contribution, however: If the error is fixed within three months, there is no corrective contribution for missed deferral opportunity. If fixed after three months, a 25 percent corrective contribution is required. If fixed after the last day of the second year following the plan year in which the error occurred, the corrective contribution increases to 50 percent. For example, if an error occurred in March 2017, and the employer failed to fix it in 2017, 2018 and 2019, it would not be until 2020 that the 50 percent correction contribution would be required.

There has been a concerted focus by the IRS to get plan sponsors to fix errors, so they have made it a lot easier than it was in the past. They are not as concerned about why the error occurred—or how it is going to be fixed—but what will be done to avoid such an error in the future.

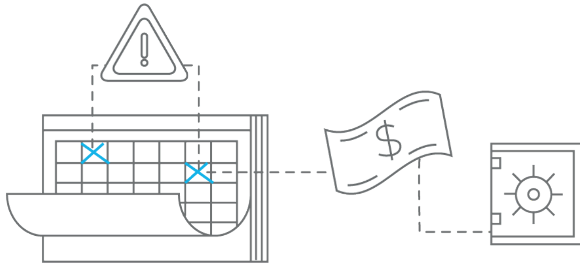


#3: Failure to timely apply forfeitures

The IRS view of accounting for defined contribution plans is that the plan needs to allocate all of the money in these plans at year-end to participant accounts; there are very few, limited exceptions to this rule. The IRS is finding that plans may have hundreds of thousands of dollars in unallocated forfeitures that are rolled over from year to year.

The general rule on forfeitures is that you use them to pay expenses or to reduce employer contributions in the plan year in which the forfeiture occurred (or add to employer contributions). That can be impractical with a daily valued plan, so you use the forfeiture in the following year.

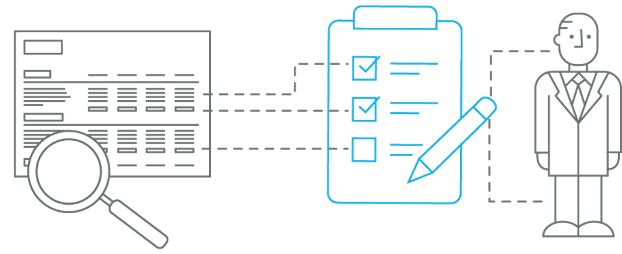
The correction is difficult. If forfeitures remain in a suspense account for too long, the plan needs reallocate the forfeiture to participants who would have been entitled to the contribution had the plan used them in a timely fashion.



#2: Failure to timely deposit deferrals

The Department of Labor focuses on this issue; the expectation under Employee Retirement Income Security Act and related regulations is that plan sponsors must make deposits on a prompt basis. For smaller plans (under 100 participants), there is a safe harbor guideline that allows seven days for money to be deposited into the plan. The expectation for larger plans is that deposits are done within three days. If it can be done sooner, it is expected to be done that way every time.

The rule applies to elective deferrals, loan repayments and participant voluntary contributions. There may be an excise tax that needs to be paid if there is a violation.



#1: Failure to use the correct definition of plan compensation

Compensation is by far the biggest issue for plans and potential compensation errors are numerous and varied. A plan sponsor must operate its plan according to the terms of its plan document. If elective deferrals are too high, the excess gets distributed to the employee. If the error results in excess matching or profit sharing, the company forfeits the excess. If the error results in an under contribution, a corrective contribution must be made for the affected participants.

As always, the plan must adjust required distributions, forfeitures and corrective contributions for earnings.

+1 800 274 3978
www.rsmus.com

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