

## **Transcript for 401(k) Questionnaire Interim Report Phone Forum.**

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Moderator: Ladies and gentlemen, thank you for standing by. Welcome to the 401(k) Questionnaire Interim Report Phone Forum. At this time all participants are in a listen-only mode. As a reminder, today's call is being recorded.

I would now like to turn the conference over to Miss Karin Old.

K. Old: Hello, everyone. I'm Karin Old, Acting Staff Assistant for IRS Employee Plans, Customer Education and Outreach. Welcome to our Phone Forum on the 401(k) Questionnaire Interim Report.

Today we will be hearing from Monika Templeman, Director of Employee Plans Examination, along with Employee Plans Managers Janice Gore and Rhonda Migdail.

Before we start, I'd like to point out a couple of things. Everyone registered for this Forum will receive a certificate of completion by e-mail approximately one week after the Forum. You must attend the entire live Forum to receive a certificate. Enrolled agents, enrolled retirement plan agents and enrolled actuaries are entitled to continuing professional education credit for this session. Other types of tax professionals should consult their licensing organization to see if this session qualifies for continuing professional or educational credit.

As with all of our presentations the comments expressed by our speakers should not be construed as formal guidance from the IRS. For more information on this topic please visit our retirement plans website at [www.irs.gov/retirement](http://www.irs.gov/retirement). You can also get there by going to the main IRS Web page and clicking on the retirements plan community tab along the top. To find more about the 401(k) Interim Report enter the search term 401(k) compliance check questionnaire.

While visiting our Website you might also want to subscribe to our free electronic newsletters. The link for the newsletters is in the left navigation bar. We have two newsletters, The Retirement News For Employers and The Employee Plans News For Retirement Plan Professionals.

And now here are Monika, Janice and Rhonda.

M. Templeman: Thank you very much, Karin. Hello, everybody. It's a pleasure to be here to tell you about the Interim Report and a little bit about the 401(k) arena and what we're finding and what we're planning on doing.

As you are aware, the 401(k) Interim Report was prepared and published by the Tax Exempt and Governmental Entities Division, which is TEGE, IRS and it was prepared to share relevant information from the 401(k) Compliance Check Questionnaire and it was very important for us to share this information with the retirement plan community and other interested parties about the most prevalent form of retirement plans in the United States.

So, I'd like to begin by explaining a little bit about the 401(k) Questionnaire Compliance Check project. It was a pivotal part of EP's 401(k) operating priority and it's continuing this year and into the future because of the importance of 401(k) plans. The Questionnaire is the result of a collaborative effort that included TEGE Research and Analysis, Employee Plans Examinations, Rulings and Agreements, Customer Education and Outreach and the Employee Plans Compliance Unit, better known as the EPCU. The Questionnaire was designed to gather necessary information regarding the form and features, and operation of, existing 401(k) plans and it was an electronic online questionnaire project that was administered by the EPCU and analyzed by research in a collaborative effort.

Our main focus today will be to share the recently published Interim Report and also to summarize the results of the responses, but we're going to be generalizing the findings because that's what the report did to the 401(k) population that files Form 5500.

Now, the Report itself explains the sampling and selection analysis method, so you'll find that right in the Report. There were also some open-ended responses to narrative questions and those are also summarized in the Report.

I should point out that the Interim Report includes information on many of the responses, but not all the questions from the Questionnaire. Now, information on some of the questions not discussed in the Interim Report is likely to be included in the final report.

Now, also, please keep in mind that the responses to the Questionnaire consist of self-reported data and we're going to continue – we being Tax Exempt Governmental Entities Employee Plans Division – to analyze results and compare them with examination and voluntary compliance data to validate issues and trends and decide how best to address them.

We'll also continue to dialogue with stakeholders to clarify any anomalies and to get your input. And with that, I'd like to ask Rhonda to give some comments before we get into the gist of the report.

R. Migdail: Thanks, Monika. I just wanted to mention that the Questionnaire was done as a holistic approach, so not only examination issues were included, but there were questions directed to guidance and other offices like R&A Determinations, Voluntary Compliance and Guidance as well.

I also wanted to note that in advance of this session we have received some questions, which we'll try to address at the end, and also we received a number of suggestions for future outreach and we will be looking seriously at those suggestions as we finalize the reporting moving forward.

M. Templeman: Thank you, Rhonda. Now if you look at slide three, the Overview section, 401(k) plans are the fastest growing market segment and they're the preferred type of retirement vehicle for a significant majority of employers, so accordingly they have a huge impact on the health of the private retirement system in America.

There are currently more than 500,000 section 401(k) plans covering approximately 60 million Americans, and we think there are far more than 500,000, but of the approximately one million retirement plans out there, well more than half are 401(k) plans.

Until the mid-1980s defined benefit pension plans were the predominant type of pension arrangements in the U.S. A defined benefit plan provides for a specified benefit upon the employee's retirement. Now, although many Americans continue to be covered under DB pension plans, they have become far less common and 401(k) plans have become much more common.

Beginning in 1989, participation in defined benefit plans really began to decline and participation in defined contribution plans far exceeded DB plans. Most private retirement programs in the United States include a section 401(k) arrangement and many Americans rely solely on section 401(k) plans as their private retirement fund when they retire.

And I also think, very significantly, that the responsibility of saving for retirement has definitely and dramatically shifted from the employer to the employee, so it's more crucial than ever that we are proactively working to keep these 401(k) plans compliant. And the IRS devotes a substantial amount of resources to provide user-friendly, Web-based products, outreach, guidance and correction programs to help plan sponsors keep the 401(k) plans qualified.

The EPCU, which is the Compliance Unit that administered the Questionnaire, is part of this ongoing effort to work with the community and the Compliance Check Questionnaire itself is part of our effort to increase voluntary compliance in the 401(k) sector. It's important for us to see how our programs and products are working to help foster compliance.

Now, on slide four I'd just like to very quickly go over a brief timeline of the progression. As I mentioned at the onset, there was a continuation from the last fiscal year when we started this to right now where we are working toward the final report. But before we do that, Rhonda is going to tell you a little bit about the overall objectives of the project.

R. Migdail: As Monika just indicated, 401(k) plans are the most prevalent type of retirement plan in the United States and a key focus for us at the IRS has been in ensuring compliance with these plans and we've worked diligently to provide guidance and tools to try to foster that compliance.

We developed this online compliance check to take the temperature of these plans; in other words, to determine their overall health. The Questionnaire was designed to gather necessary information regarding the form, features and operations of existing section 401(k) plans. Are these 401(k) plan features complying with the tax qualification requirements, both in plan form and operation? Have our efforts to assist in voluntary compliance been effective? Are people aware of and using our voluntary compliance programs? Do they know about the tools available on the IRS Web, including the Fix-It Guide? Have those tools been effective?

We're also trying to educate ourselves as to how to optimize our outreach and compliance efforts going forward. Are there areas or issues where we need to provide further guidance and tools?

So, with that, I'm going to turn it back to Monika.

M. Templeman: Thank you, Rhonda. So, now let's take a quick look at that timeline on slide four. Now, when we say 2009, 2010, we're referring to fiscal years and for the Service the years begin in October and end the end of September, so just keep that in mind.

In fiscal year 2009 and 2010 the Questionnaire was developed, as I mentioned, by that multi-functional team comprised of managers and technical employees from the various functions in Employee Plans, Exams, Rulings and Agreements, Customer Education & Outreach and the TEGE Commissioner's staff, but most importantly we had TEGE Research with us every step of the way to ensure the validity of the data and how it's projected out to the 401(k) community, the plans as a whole.

In May 2010, the IRS sent a 401(k) Compliance Check Questionnaire to a random sample of plan sponsors who filed Form 5500. Janice will give you some of the specifics of the background in a little while, but that's the overall action that took place then. And plan sponsors were instructed to complete the Questionnaire online by visiting a secure Website and using a PIN provided in the cover letter.

The compliance check was not an audit. Now, failure to complete the Questionnaire because it was a compliance check, would result in a follow-up and I have said in many outreach presentations that if plan sponsors were not willing to give us the data this way we'd be more than happy to visit. And we did make good on that in the sense that while most--we had an excellent response rate, over 98%--did give us the data requested which we needed, those who did not, we did follow up with and if it was a deliberate desire not to respond, we followed with an examination to get the data needed.

But, more importantly, the Questionnaire made a wonderful internal control tool and we encouraged folks to use it that way to find and fix mistakes before the IRS ever came looking for them. And because it was not an audit, they could use self-correction or voluntary compliance submissions to find, fix and avoid mistakes and they could use that wherever, as I mentioned, applicable self-correction as long as they fit the parameters of self-correction.

Now, in FY2011 we spent a lot of time analyzing the data and we followed up on those non-responders, including the examinations of the few that didn't give us the data that was requested in the compliance check. On February 3<sup>rd</sup>, we posted the Interim Report and released it to our stakeholders. And now this year we're working very busily to put the final report together and with a goal of having it out by the end of the calendar year, that's December of 2012 or around that time frame and we're preparing this final report with comparisons based on the stratification of the plan sizes, detailed explanation of the sampling method and identifying some differences in what we're seeing in the plans based on their size and market segment.

So, with that, I am going to turn it over to Janice Gore to talk more about the background.

J. Gore: Thank you, Monika. If you want to look at slide five, this Questionnaire was sent out by the Employee Plans Compliance Unit, a group located in Chicago. And it was sent out in May of 2010 to 1,200 randomly selected plan sponsors who filed a 5500 in 2007.

Not only were they given a specific PIN number and password to access this online Questionnaire, they were also provided the name of a person in this EPCU group to contact if they had any questions or if they needed any assistance in accessing the questionnaire or understanding any of the questions.

If you look at page 12 of the Interim Report it shows how the plans were broken down by plan size and we did select plans from every different plan size, it was broken down into four different strata and because the number of plans in each of those strata is not identical, our research folks did a weight for each stratum so that they'd be able to analyze it properly.

And if you go next to slide six, as Monika mentioned, we had a 98% response rate, which is tremendous. For those plan sponsors who did not access the Questionnaire during the 90 days requested, the EPCU employees followed up with a reminder letter and, in some cases, phone calls to provide assistance.

If the Questionnaire was still not completed we did initiate these examinations, which included completing the Questionnaire and a full scope exam. And, Rhonda, is going to make some comments about the next bullet.

M. Templeman: No, actually, Janice, it's Monika and the comment is that we gave individuals two choices to follow up on those exams. One was that if they wanted to give us all the data that was necessary, we had them put it in a separate database and that was to keep the validity of the data received, and with a one-year full scope audit.

If they still didn't want to cooperate, and that was very few, then it was a two-year full scope audit and agents put in the information to the database for two years, but most took the one-year deal. But, again, I want to reiterate that 98% gave us the data we needed and we're very thankful for those plan sponsors who complied.

And now, to Rhonda, for what the categories of the Questionnaire were.

R. Migdail: What I wanted to do was just to give you a quick overview of the various categories that appear in the Questionnaire and just a little bit of information as to why each was included, what our thinking was behind the development of the Questionnaire.

So, the first area was demographics and we basically just wanted an understanding of the universe of plans and we also wanted to ensure the plans we were looking at were, indeed, 401(k) plans.

So, for example, question 1A asked whether this was a defined contribution plan--intended to weed out any plans that may have mistakenly identified themselves as a 401(k) plan on the Form 5500.

We also asked questions about the underlying plan, whether it was profit-sharing, money purchase, stock bonus, etc., whether it was pre-approved and whether the plan had requested a determination letter. And, importantly, to gather some information on retirement security for participants, we wanted to know whether the plan was ongoing, frozen or terminated.

We asked whether the plan sponsor sponsored any other retirement plans, either qualified or non-qualified or whether the 401(k) plan was the only retirement vehicle by which employees could save for their retirement.

With respect to plan participation, we wanted to know the number and categories of employees eligible to participate and those who were excluded, the number of employees making elective deferral contributions and we asked plan sponsors to give us a sense of certain factors that they believed impact participation.

We then went to contributions, both employer and employee, and looked to the nature, amount and frequency of permitting changes, questions related to matching, non-elective and discretionary employer contributions, suspensions or reductions.

With respect to top-heavy and non-discrimination rules--basically some of the testing requirements--we wanted to determine whether plan sponsors had an understanding of the rules and their operation and we wanted to get a sense of whether appropriate corrective actions were being taken in a timely fashion and whether plan sponsors were taking advantage of the Safe Harbor rules.

With respect to distributions and plan loans, we wanted to determine the types of distributions that were permitted under 401(k) plans and their prevalence. We wanted to determine how plan loans were being administered, to look at hardship distributions and other in-service distributions, cash-outs and, again, looking at corrective distributions.

With respect to automatic contribution arrangements, the IRS had begun issuing some guidance related to these types of arrangements in the late 1990s and early 2000s and there was some evidence that their existence led to higher participation rates among low and middle income employees because participants are automatically enrolled unless they explicitly elect out or elect a different deferral amount.

And that led to the Pension Protection Act of 2006 enacting some provisions that encouraged these kinds of arrangements, including a new Safe Harbor. So, this section of the compliance check asks whether the plan sponsor has adopted such an arrangement, the deferral rates if elected, how participants reacted, did they participate, opt out or elect a different percentage and some questions related to the notice requirements.

With respect to other operations we asked about the impact of the economy on plans. Were there increased in-service withdrawals and where were assets invested? With respect to Roth, we wanted to know whether and when the plan included them and participant statistics.

With respect to voluntary compliance, the EPCRS program, we wanted to know whether plan sponsors were aware of the program and whether they had used the program and we solicited

suggestions for improvement and other issues that could be addressed and we also asked about familiarity with the 401(k) Fix-It Guides.

And, finally, with respect to plan administration, we wanted to know whether plans had implemented policies and procedures and the person responsible for different aspects of the day-to-day operations of the 401(k) plan, including who was primarily responsible for plan administration, who has authority to amend the plan and ensure it's amended timely, who prepares the Form 5500, how many changes in administrators there had been over the three-year period of the survey, what difficulties plan sponsors face in administration and whether our IRS resources are helpful.

M. Templeman: Thank you, Rhonda. And at this point I would like to draw your attention to the project purpose, just basically summarizing it, which is on slide eight. And we talk about frequently measuring the health of 401(k) plans, what we're basically looking at is overall compliance levels, again, keeping these plans qualified and are there qualification issues that are threatening these plans?

We're also identifying principal tax compliance issues affecting these plans so that we can best address how to deal with them and be proactive in the kinds of soft and hard guidance and outreach tools that we give plan sponsors and their representatives to utilize and help to effectuate compliance.

We're also evaluating the effectiveness of our voluntary compliance programs and our tools and determining best how we can foster compliance, particularly in market segments and the small plan employer market where we need to reach people sometimes in unique ways, making sure that every size plan and plan sponsors--no matter whether they have the smallest or the largest plans--have access to the most up-to-date information to help them with compliance.

So, it's a two-way street. We want to see how well these plans are doing and how well we are giving information relevant to keeping these plans in compliance.

And with that, we will start looking at the Questionnaire data and I will turn it back over to Janice.



J. Gore: Thanks, Monika. We're going to start looking at the highlights of the Interim Report. Forty-three percent of plan sponsors responded that their plan was a Safe Harbor plan. We were surprised by that result and we have begun an exam project as a follow-up where we're looking at plans that identify themselves as Safe Harbor plans, but there were no contributions made.

If a plan did suspend a Safe Harbor contribution, we want to make sure they did it properly with the proper notice and that then when they were no longer a Safe Harbor they did conduct the ADP or ACP test.

Five percent said that they were a simple 401(k) plan and 85% said that they adopted a pre-approved plan document and Rhonda is going to comment on the determination letter part of this slide.

R. Migdail: Thank you, Janice. To maintain the qualified status of the plan, the plan must meet certain statutory requirements contained in the Internal Revenue Code. The Employee Plans determination letter process permits plan sponsors to submit their plan document to the IRS for a determination that the plan language meets those applicable statutory requirements in form.

Determination letters are voluntary not mandatory. Based on the responses to the 401(k) Questionnaire, only 23% of 401(k) sponsors have requested a determination letter from the IRS. But maybe this isn't a surprising result when you look at the percentage of 401(k) plans that are pre-approved plan documents.

J. Gore: Okay, we're on slide 10 and just to point out when I said we are doing an exam follow-up project that is not on the employers from the Questionnaire, it's a separate project to check on those Safe Harbor plans. Regarding slide 10, we didn't think it was a big surprise that 96% of plans allow catch-up contributions, but it does show that employers support employees over age 50 having an opportunity to make additional deferrals.

Twenty-two percent of plan sponsors allow Roth contributions and 41% of employers allow changes in the amount of deferrals at any time, while only 2% restrict these changes to only once a year.

With that, I'm going to turn it back over to Monika.

M. Templeman: Thank you, Janice. Okay, on slide 11 we're going to look at employer contributions, as you know, under section 401(k) plans may be either matching contributions or non-elective contributions. Now, matching contributions generally match a percentage of an employee's elective deferral contributions. Non-elective contributions to the plan which the employee may not elect to receive in the form of cash or other benefit.

The Questionnaire included questions related to employer contributions. Specifically, plan sponsors were asked questions as to the offering and eligibility requirements of matching contributions, the offering and eligibility requirements of non-elective contributions, and employer contributions under top-heavy plans.

So, let's look at the results here. Many section 401(k) plans, namely, 68% provide for matching contributions on elective deferrals. Of those providing matching contributions, 88% match on the basis of the percentage of deferred compensation. The remaining 12% match on the basis of dollar amount deferred.

The majority of 401(k) plans that provide for matching contributions, 64% match elective deferral contributions without requiring employees to complete any separate or additional service requirements. Now, 58% require one-year service for matching and when you're looking at providing non-elective contributions we have 65%.

We also are looking at suspended and discontinued match, and here we're looking at a progression from 1% in 2006 to 4% in 2008. And just a couple more things on matching contributions. The percentage of plans that have an age requirement for eligibility to receive matching contributions is also quite interesting; 23% have none, 13% have 18 years, 3% have 19 to 20 years and 61% have 21 years for the age requirement.

Also the percentage of 401(k) plans that mandate the service requirements for eligibility to receive a matching contribution is interesting. And I just mentioned the 58% for the one year, but 13% have none, 2% have one month, 14% have six months and the other, the amorphous other, is 14%, again, the big number being 58%.

So, very interesting information and we'll go on to Rhonda with employer contributions on suspended and discontinuing non-electives.

R. Migdail: Thank you, Monika. So, now we're on slide 12 and consistent with the trend that we saw on suspension or discontinuation in matching contributions, there were similar statistics for non-elective suspended and discontinued and reduced contributions. There was a significant increase in the percentage of all section 401(k) plans in which employer non-elective contributions were suspended or discontinued each year from 2006 through 2008.

In 2006 it was 2%; it rose in 2007 to 3% and then in 2008 up to 5%. And similarly, there was a significant increase in the percentage of 401(k) plans that reduced their non-elective contributions between 2006 and 2008, 1% in 2006, up to 2% in 2007 and then a very significant rise in 2008 up to 5%.

I'm going to turn it back to Janice now.

J. Gore: Thanks, Rhonda. We're on slide 13. And this slide covers the participation in elective

deferral contributions. A small percentage of plans allow participation without any service requirement while 54% require a year of service and 64% require employees to be age 21 before making deferral contributions. Some of the plans that require one year of service could also be those that require age 21.

And I'm turning it back to Rhonda.

R. Migdail: Okay, I'm going to talk a little bit about what the Report found with respect to top-heavy plans and remember I mentioned previously this is one of those kind of testing requirements.

So, under section 416 of the Code, a section 401(k) plan is top-heavy if the aggregate amount held in the accounts of key employees under the plan exceed 60% of the aggregate amount held in the accounts of all employees. And key employees generally are defined as an officer of the employer with annual compensation greater than \$160,000 as adjusted for increases in cost of living, a 5% owner of the employer or a 1% owner of the employer that has annual compensation more than \$150,000.

So, we found that 20% of the plans that were included in the Questionnaire were top-heavy plans in 2008 and that 70% of those provide non-key employees with minimum contributions.

With that I'm going to turn it back over to Monika to talk about some of the results on non-discrimination testing.

M. Templeman: Thanks, Rhonda. And this is a very important area, ADP and ACP testing, and we're going to focus in on ADP testing right now. A couple of the questions that we received for the Phone Forum that dealt with the types of errors we're seeing and Janice and I are going to cover a little later on in the presentation some of these things that we're seeing in the field. But we're seeing a lot of issues with ADP and ACP testing, so I just wanted to kind of give you a heads up on that.

And, in general, as you're probably aware, 401(k) plans are required to demonstrate that they do not discriminate in favor of the highly compensated employees and they do this by running the actual deferral percentage test, which is better known as ADP. And the ADP is an objective test that provides a limit on the amount of elective contributions that may be made to the plan on behalf of highly compensated employees, as we call them HCEs, as compared to the amount of elective contributions that can be made to the plan on behalf of the non-highly compensated employees, or NHCEs.

And ADP testing is not required – this is just a note for you – for SIMPLE section 401(k) plans. Now, plan sponsors were asked on the Questionnaire about applying the ADP test, correcting ADP test failures and the timing of the ADP test correction distributions. And under the ADP test, the average of the actual deferral percentage for highly compensated is compared to the average of the actual deferral percentage for the non-highly compensated. And effective for plan years beginning December 31, 1996, plan administrators are permitted to apply the ADP test using prior year data in determining the actual deferral percentage for the non-highly compensated employees.

For those plan sponsors that made corrections in 2008, according to our Questionnaire, 60% of the 401(k) plans apply the ADP test using the current year testing method; 31% performed the test under the prior year method and 9% reported that they considered themselves exempt from ADP testing.

Now, we got some questions about why the information here was different than our information that we reported in the Interim Report on the ACP testing and, Rhonda, did you want to comment on that?

R. Migdail: Yes, we discovered that in the Questionnaire that there were some questions we used as filters to ensure that people weren't overloaded with the number of questions that they needed to respond to and so with respect to the ADP test, there was not a filter for those who responded that they weren't subject to the ADP test, but there was such a question on the ACP side, so when you look at the statistics for ACP test and who used the current year or the prior year method it totaled 100%; I think the percentages were 69% for current year and 31% for prior year and there was no one that showed up as not having to apply the ACP test and, again, that was because of the filter question.

M. Templeman: Thank you. And that explains why you have 100% for one and you show 9% exempted for ADP. Just a couple of more words on the ADP; if a section 401(k) plan fails the ADP test, corrective actions must be taken to protect the qualified status of the plan. An amount of elective deferral contribution allocated to the plan account of the highly compensated, that is greater than that permitted under the ADP test is referred to as an excess contribution.

And a plan sponsor may correct excess contributions in one of the following ways. The employer may make additional contributions to the NHCEs in the plan in the form of a qualified, non-elective contribution or a QNEC or a qualified matching contribution, a QMAC, that are treated as elective contributions for the purposes of the ADP test.

The excess contribution may also be recharacterized as employee after-tax contributions or the excess contributions together with any corresponding earnings may be distributed to the highly compensated employees or a plan sponsor may use a combination of those correction methods. I just wanted to let you know that.

Also, with respect to correcting the ADP test failures, the majority of 401(k) plan sponsors corrected ADP failures by distribution of excess contributions and related earnings, in 2006 that was 61%, in 2007 58% and in 2008, 67%. The next most popular method is recharacterizing elective deferrals as employee after-tax contributions, and this comes in as a distant second. Again, the stats there are in 2006 23% used it, in 2007, 26% and in 2008 only 17%.

And, finally, as to non-discrimination testing of elective contributions, the majority of 401(k) plans correct excess contributions within the two and a half months following the end of the plan year of the excess and looking at non-discrimination testing of matching contributions more than three-quarters of 401(k) plan sponsors correct non-discrimination testing failures by distributing excess aggregate contributions.

Okay, and now we're going to take a quick look at distributions on slide 16 and here we're looking at such things as loans and hardships. Qualified retirement plan rules generally restrict participant access to account balances before they cease employment. But in the case of 401(k) plans there are two exceptions to this general principle.

And that's for participant loans and hardship withdrawals, but certain very strict rules apply. So, let's look first at the loans. 401(k) plans may generally allow participants to borrow from their vested account balances, however, those loans are subject to a number of rules and restrictions. And 401(k) plans are not required to provide participant loans. Oddly enough, on examination, we see some plans that don't have language allowing for loans, but they still have loans.

Now, 65% of section 401(k) plans permit participant loans and that's quite a statistic and appears to be consistent with what we are seeing on audit and also what we're seeing in the VC program. So, again, we're comparing all our data. But the majority of the plans do allow for loans.

We're also seeing hardship withdrawals and we're seeing a lot of issues with loans and hardship withdrawals and, again, we'll get to that in a little while. A hardship withdrawal is a distribution to a participant from their vested account balance in the event of an immediate and heavy financial need. And, again, there are some very strict rules about what's an immediate and heavy need. You might need a vacation, but that's not an immediate and heavy need for the hardship requirements.

And a section 401(k) plan is not required, again, like with loans, to allow hardship distributions. Rather, the plan language has to allow for that. Seventy-six percent of 401(k) plans do permit

hardship distributions and of the plans that provide for hardship distributions, 99% allow all participants to receive one. The key areas for hardship distribution that the plans reported they're making them for are payment of medical expenses, 98%; purchase of a primary residence was 93%; payment for education expenses 92%; prevention of foreclosure, 94%; payment of funeral expenses, 86%; and making repairs to a residence, 73%.

And with the economy the way it is and the issues that have been of late, there have been a lot of issues around both the hardship and loan distributions. There are also a lot of issues that we're seeing as far as questions on the retirement plan participant loans-- what is the reasonable rate of interest? And, again, we refer to the website of the Department of Labor, their regulation section, and a plan loan's interest rate is reasonable if it's equal to commercial lending interest rates under similar circumstances.

And so, a lot of questions have revolved around that, but even if you're looking at, and some folks have been using prime, prime itself is not by itself considered reasonable because that's for the most favored customers with the best track records. However, prime plus one or prime plus two might be the reasonable rate, the going rate in a particular local lending situation under similar circumstances for a reasonable rate. Again, we're getting behind that question to see for those who looked at prime and those who looked at what the local lending rates were. If those were one and the same. So, a lot deeper dive on what the answers were with respect to loans.

Then as far as allowing in service distribution withdrawals, 62%; those permitting rollovers was 79% and, of course, the most common form of benefit that we saw was lump sum, 99% of the plans had lump sum benefits. Less common are installment payments, 38%; J&S, joint and survivor, 19%; and life annuity, 11%. And Rhonda is going to talk a little bit about some guidance on lifetime annuitization.

R. Migdail: Thank you Monika. The determination from the Questionnaire that the most common form of benefit was lump sum was not surprising to us, but it does raise a retirement security concern with regards to making sure that individuals don't outlive their retirement savings.

So, as many of you may be aware, on February 2<sup>nd</sup> of this year there was a quartet of guidance issued on lifetime annuitization and the main import of those guidance projects was to find ways of making it easier to provide lifetime income options from defined contribution plans. There were two Revenue Rulings, Revenue Ruling 2012-3 and 2012-4 and then two sets of proposed rulemaking that were issued on longevity annuity contracts, and on modification to the minimum present value requirements for partial annuity distribution options and the Revenue Rulings dealt

with the application of the QJSA and QPSA requirements when a deferred annuity contract is purchased under a profit-sharing plan and self-annuitization through eligible rollover distributions from a defined contribution plan to a defined benefit plan

So, I just wanted to mention those so that all of you are aware and I'm going to go on to slide 17 and talk a little bit about investments. We were looking at some of the less traditional kinds of investments and we found that 1% of the plans included in the Questionnaire had investments in employer securities.

I also wanted to mention with respect to that, that Code Section 401(a)(35), which was added by the Pension Protection Act, mandates diversification requirements applicable to certain defined contribution plans' holding publicly traded employer securities and in the Questionnaire we found that 98% of section 401(k) plans not invested in employer stock in 2006, 2007 or 2008 offered diversification rights to participants. We're not sure where the other 2% are; we'll be looking at that.

And we also found that 1% had investment in foreign investments. So, with that I'm going to turn this back to Janice.

J. Gore: Thanks, Rhonda. We're on slide 18. With respect to plan administration based on the responses it appears that third party administrators have a significant role in plan administration, especially when it comes to amending the plan and preparing the Form 5500. A smaller percentage reported using a third party administrator for plan administration.

This is one of the findings that may be interesting when broken down by plan size in the final report. And, Rhonda, do you want to comment on some anomalies regarding this information?

R. Migdail: Thank you. When you look at this slide and you look at what third party administrators are used for, we have 53% for plan administration, about 83% for Form 5500 preparation and some people have commented on that anomaly and what I would just suggest is the question asked for primary responsibility in each of these functions so there may have been some difference of interpretation with respect to that.

M. Templeman: Thanks, Rhonda. The next slide is on IRS resources and I just wanted to make a very quick comment on this. This is a section where we actually had some surprises. For use of our [www.irs.gov/ep](http://www.irs.gov/ep) and our wonderful tools and electronic media, we are finding 57% of respondents who are actively using it. Also, our Employee Plans Compliance Resolution System, 65% were aware of it.

Now, that was a surprise for us because while 57% is good, we really would love to have everyone take advantage of the great tools on [www.irs.gov/retirement/ep](http://www.irs.gov/retirement/ep). And with 65% of plan sponsors being aware of our correction programs, which allow a non-draconian way of

fixing mistakes and using self-correction, you don't pay a fee and you don't have to report it, you do have to have practices and procedures in place, we were seeing real opportunities to be able to spread the word and reach out to those market segments, market segments being plan industry types within the 401(k) plan type and industry type equate to a market segment, so, those that were not actually utilizing our systems and tools. So it does give us an opportunity by analyzing this data to see where we can better target our educational outreach opportunities and our programs and also get the word out about the website. So, again, that was sort of a surprise to us.

And that leads me into next steps on slide 20. Very simply put we're going to use the Questionnaire findings to be able to improve our compliance tools, improve our outreach strategies and outreach itself, and improve voluntary compliance programs. Initial data will be used and then vetted further for guidance opportunities, both soft and hard guidance, defining upcoming projects and enforcement activities.

And, as Janice mentioned, plan sponsors who filled out the Questionnaire could find themselves in a compliance check not from the Questionnaire, but because of looking at the prevalent type of 401(k) plans issues, you could find yourself in some kind of compliance check. If you use the Questionnaire as an internal control tool, you should have been able to find, fix and avoid mistakes and not have a problem if we're checking for compliance in particular arenas.

Then we're going to prepare that final report with a lot of additional information and stratification and that should be out to the community some time, hopefully at the end of this calendar year. And what I'd like to do now, with Janice and I, is on slide 21 because we got so many questions about the types of errors, we're going to relate them more to what we're seeing in the examination arena and as we drill down into the data from the Questionnaire we'll also drill correlations for the final report.

So, I'm going to start out with the most prevalent type of errors we're seeing, which are non-amenders. And based on our audit data, these are the most prevalent types of mistakes, both non-amenders and failure to follow the terms of the plan and a plan document is required to be compliant with current and prior law.

So, in examinations we are seeing many representatives, the employers and their reps who are unable to locate the necessary documentation to prove that the plan was timely amended. And we often see working copies that were never executed and no proof that they were ever adopted, like, you know, board of director resolutions and plan minutes. And it's very important to keep the original plan and all subsequent amendments and your opinion and advisory letters and the board of director resolutions I referred to, to be able to show that your plan was timely amended. Reviewing the plan document annually and noting any changes and changes to the summary plan description, making sure that anyone administering the plan has all the latest information is really crucial.



And you can use the EPCRS Revenue Procedures 2008-50 to correct any problems with timely amendments. You cannot use self-correction for document failures.

Quickly, did you want to talk about failure to follow the terms of the plan, Janice?

J. Gore: Sure, Monika. Thanks. This is a very common error, failure to follow the terms of the plan document. It's important to share any changes made to the plan by amendment or restatement with all persons that provide services to the plan.

For example, if the definition of compensation has changed, this change needs to be communicated to anyone involved in determining deferral amounts, performing non-discrimination tests and allocating contributions. Using a definition of compensation that is not correct can affect many plan operations and correcting those errors can be costly. Also, changes to the plan document should be changed in the summary plan description and if they materially modify the plan they need to be communicated to plan participants.

To avoid this mistake, be familiar with your plan document and how definitions in plan sections affect the plan in operation. Review the plan document annually to ensure the plan is operating according to its terms. Compare the summary plan description to the plan document to make sure they agree and develop a communication mechanism to make all relevant parties aware of changes on a timely basis and refer to Rev. 2008-50 to correct an operational error.

M. Templeman: Speaking of failure to use the plan's definition of compensation correctly, it's the multiple types of definitions and the complexity of those definitions and how they're used that's causing a lot of consternation and problems and those who provide services to plans need to be aware of the definitions of compensation for different plan purposes and apply them accordingly. A simple and straightforward definition of compensation for all purposes would greatly simplify plan operations and reduce the risk of failures.

If that's not possible, communicate any changes to the plan's definition of compensation to those who administer the plan and provide the compensation totals to avoid these errors.

Janice, do you want to talk a little bit about excluding and including employees?

J. Gore: Sure. Another prevalent error we find is failure to include eligible employees in the plan or the failure to exclude ineligible employees from the plan. This can be happening when there's controlled group situations or mergers and acquisitions. It's a common error and usually there is a misunderstanding of the plan's definition of eligibility and entry dates.

Sometimes there are different requirements for deferrals and non-elective contributions or matching contributions. It is common to find that the plan has operated the same as the prior

year without reviewing the plan document annually to verify that the method is correct, or if the language has been amended.

So, it's really important to make sure all employees are included in the information so that you determine the eligibility properly. Monika, do you want to talk about loans?

M. Templeman: Yes, just very quickly. We talked about loans before, but loans are becoming very prevalent as far as errors and some of the errors we're seeing are loans in excess of the \$50,000 maximum allowed, treatment of outstanding loan balances when participants terminate employment and the account balance is distributed. We're finding documents that limit the number of loans, let's say no more than three outstanding, but the agent finds many more loans, or loans that are longer than five years, but it's not for the purchase of a primary residence.

We're also finding plans that don't allow loans, but they're giving loans anyway. Now, good news, they can be corrected by retroactive amendment under the self-correction program. That's one of the few areas where you can correct with retroactive amendment. But, again, it has to match the terms of the plan and you have to adhere to the loan rules.

And with hardship distributions also we're finding a lot of issues. And, again, I talked about the heavy financial need, it must match that, but it has to match the terms of the plan. We're finding some hardship distributions where the plan doesn't allow for them.

We're also finding PIN numbers where people put things in and there's no verification of a heavy financial need. Ultimately the plan sponsor is responsible, so watch out for those issues.

So, let's go on to slide 22 and very quickly on matching contributions, Janice?

J. Gore: Yes, this is, again, failure to follow the plan's provisions regarding matching. It's a common error and it's often caused by the plan sponsor or the plan administrator not using the proper entry dates or using an incorrect definition of compensation. Also, plans generally define the matching contributions as annual amounts and percentages. If the plan administrator calculates the match on a payroll basis then the total match for the year may not comply with the plan terms.

M. Templeman: And the next one is ADP and ACP testing and we talked about some of those problems, but what we're really seeing on audit is not properly identifying highly compensated employees, excluding those who elect not to defer salary from the test, not using the correct definition of compensation and not using the testing method defined by the plan document.

The plan document tells you whether it's current or prior year and you have to follow these terms. Again, these failures can be corrected under the Employee Plans Compliance Resolution

System and based on the facts and circumstances you might be able to use self-correction, voluntary compliance and during an audit you can use audit CAP.

To avoid the error be sure to provide the correct information to the plan administrator and be familiar with the terms of the plan. And for excess elected deferrals, Janice?

J. Gore: During our EP examinations we're finding that there's a failure to limit elective deferrals to the IRC 402(g) limit and that continues to be a very costly error. To avoid this mistake you should have procedures in place to ensure the participants will not exceed that limit. There should be checks and balances to alert the plan administrator if the limits are exceeded so corrective action can be taken timely.

M. Templeman: And just a final word about the timely deposits for elective deferrals, very big issue with the Department of Labor as well, and DOL requires that the employer make the payment to the plan on the earliest date that the employer can segregate the amount of the employer's general assets with a maximum deadline of the 15<sup>th</sup> business day of the following month. That is not a Safe Harbor.

For plans with less than a hundred participants, there is a seven day business rule Safe Harbor. Keep in mind that if the plan contains specific language stating when the deposits need to be made, let's say weekly from payroll it is important that the plan be operating according to its terms, again, EPCRS for correcting those errors.

And then, Janice, let's talk a little bit about the Questionnaire as an audit tool.

J. Gore: Okay, Monika. If you want to access the actual Questionnaire and you can get it as a printed copy not electronic at this point you can go to [www.irs.gov/ep](http://www.irs.gov/ep) on the left side you can look at types of plans, then choose 401(k) plans, then choose operate and maintain.

Reading through this Questionnaire can serve as a really good reminder of certain plan administration requirements and be a great internal control tool. Remember, during all of our examinations we consider the strength of the internal controls over plan administration and it can set the tone of the audit.

M. Templeman: And when I said audit tool, I meant self-audits for you to use to prevent errors. And now, Rhonda, how about the Fix-It Guide?

R. Migdail: Thank you, Monika. The Fix-It Guides, again, they can be found on the website, correcting plan errors on the top left side, click Fix-It Guides. The Fix-It Guides give you some of the most common potential mistakes in 401(k) plans, how to find the mistake, fix the mistake and avoid the mistake. So, it is a very useful tool and with that I'm going to turn it back to Monika to conclude.

**INTERNAL REVENUE SERVICE**

**Host: Teresita Laureano**

**March 6, 2012/2:00 p.m. EST**

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M. Templeman: Yes, I'd like to draw your attention to slide 25 and this is a snapshot of the Retirement Plan Community landing page that Karin mentioned and the main page headline is on the 401(k) Compliance Questionnaire Interim Report. So, check it out, again, [www.irs.gov/ep](http://www.irs.gov/ep).

And our final slide, slide 26, provides what's up on the website concerning the 401(k) Compliance Check Questionnaire Interim Report. There's a link to the PDF file that has 65 pages that I mentioned earlier, so did Janice and Rhonda. Print that and use it as a great internal controls tool. There are also some comments from me about the Questionnaire itself and frequently asked questions. And, of course, we're always interested in hearing from you.

And stay tuned because December or thereabouts at the end of 2012 we are targeting to have the final report, which will have much more detailed information, including stratification. Thank you so very much for being part of this Phone Forum today and I'll turn it back over to our folks on the Phone Forum.

K. Old: Thank you for participating in our Phone Forum on the 401(k) Questionnaire Interim Report. And thank you to our speakers, Monika Templeman, Janice Gore and Rhonda Migdail. Have a good day, everyone.

Moderator: That does conclude our conference for today. Thank you for your participation and for using AT&T Teleconference Service. You may now disconnect.