

401(k) Questionnaire: The Final IRS Report

Millions of Americans participate in 401(k) plans, making them the most common type of retirement plan. Not surprisingly, the IRS is concerned about whether plans are in compliance with the Internal Revenue Code, with IRS regulations, and with each individual plan's document.

Those concerns led to the 401(k) Compliance Check Questionnaire, which was created to help the IRS understand the compliance challenges facing plan sponsors and then determine the best ways to allocate IRS resources in promoting voluntary compliance. In 2010, the electronic questionnaire was sent to randomly selected 401(k) plan sponsors (chosen from the 2007 Form 5500 filings) and completed by 1,060 of them. The questionnaire was administered by the IRS's Employee Plans Compliance Unit (EPCU), responses were analyzed by the Tax Exempt and Government Entities Division (TE/GE), and the final report was published earlier this year.

Objectives

There were several key objectives: to measure the health (overall compliance levels) of 401(k) plans, identify the principal tax compliance issues affecting 401(k) plans, evaluate the effectiveness of the IRS Employee Plans Compliance Resolution System (EPCRS) voluntary compliance program (VCP) and tools, and determine how the IRS can foster greater compliance.

Information was gathered in the following areas: participant demographics; plan participation; employer and employee contributions; top-heavy, actual deferral percentage (ADP), and actual contribution percentage (ACP) testing; distributions and plan loans; other plan operations; automatic contribution arrangements (ACA); designated Roth features; plan amendments; Form 5500; plan administration; and the plan sponsor's awareness of the IRS compliance and correction programs.

Data Grouped in Four Strata Based on Plan Size (Number of Participants)

Plan Size	Number of Participants	Reported Number of Plans	Proportion of 401(k) Segment	Percent in Questionnaire
Small	1 – 5	77,154	17%	14.20%
Medium	6 – 100	319,026	70%	58.33%
Large	101 – 2,500	56,465	12%	10.83%
Very large	2,501+	3,235	1%	16.67%
	Total	455,880	100%	100%

Results

The IRS will use the questionnaire findings to modify and improve 401(k) plan compliance tools, produce outreach materials to benefit plan sponsors, improve the VCP, assess the need for additional guidance, and define upcoming projects and enforcement activities. Following are several key findings:

Top-heavy plan issues. Twenty percent of the 401(k) plans in the survey were top heavy. Of those, 79% provided nonkey employees with top-heavy contributions and 19% admitted they do not provide a top-heavy contribution. This leads one (and the IRS) to wonder: Why are there so many employers who are not making the required top-heavy contribution? This is not entirely surprising. The IRS did a study several years ago and found the two most common failures employers make are 1) failure to obtain a bond and 2) failure to comply with the top-heavy rules. Between the research a few years ago and the recent final 401(k) questionnaire results, it would not be surprising if the IRS decides to focus on providing outreach and education about the top-heavy rules. It is also notable that 2% of the top-heavy plan sponsors indicated they satisfied the minimum contribution requirement in another plan.

Employee Plans Compliance Resolution System. Sixty-five percent of plan sponsors are aware of EPCRS, and 6% of plan sponsors have used it. Sponsors of very large plans are more likely to be aware of or use EPCRS than small, medium, or large plan sponsors. Because these results indicate that 35% of plan sponsors are not aware of EPCRS, the IRS may become more proactive in educating small, medium, and large plan sponsors about the benefits of EPCRS and encouraging the overall retirement plan industry to file under EPCRS.

Nondiscrimination testing. The majority of 401(k) plan sponsors correct excess contributions within 2½ months following the end of the year of the excess, thus avoiding IRS penalties for issuing late test refunds. More than three quarters of 401(k) plan sponsors correct nondiscrimination testing failures by distributing excess contributions instead of making additional contributions to avoid refunds. 60% of plans used current year ADP/ACP testing, while only 31% used prior year ADP/ACP testing. The remaining 9% answered that they were exempt from testing.

Hardship distributions and loans. Seventy-six percent of the 401(k) plans responding to the questionnaire permit hardship distributions, and 65% allow participant loans. Sponsors of very large plans are more likely than small, medium, or large plan sponsors to offer hardship distributions and loans.

Self-audits

The IRS recommends that sponsors periodically perform an internal self-audit of plan operations and administration to ensure their plan is compliant with applicable requirements and the plan document. Self-auditing typically results in establishing internal controls and practices to help avoid failures and to provide prompt correction for failures when they do arise. Performing self-audits may also help demonstrate to the IRS (in the event of an examination) that the plan is being operated with a concern for compliance.

To help plans stay in compliance, the IRS has announced that additional internal control questions will be added to the 401(k) questionnaire later this year, and it will be repackaged as the Questionnaire Self-Audit Tool (QSAT). The QSAT will help plan sponsors find, fix, and avoid costly mistakes and will ultimately strengthen internal controls over plan operations.

The full 401(k) Compliance Check Questionnaire Final Report can be found at www.irs.gov/pub/irs-tege/401k_final_report.pdf.

Percentage of Safe Harbor 401(k) Plans

Plan Size

Small 67% Medium 43% Large 15% Very large 23%

Percentage of Plans That Allow Loans

Plan size

Small 53% Medium 66% Large 75% Very large 88%