

A Look Into a DOL Audit

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Introduction

- Survey/practical approach to discussion
- Many issues can trigger Department of Labor (DOL) audits
- Legal vs. valuation vs. administrative issues will be discussed
- Internal Revenue Services (IRS) vs. DOL Audits (focus will be on DOL, but IRS also may audit)
- Discussion of practical and legal approach to responding to DOL (see Exhibit A)
- Correction programs are available (see Exhibits B & C)
- Clients have been audited (and survived!)

Who is the Department of Labor?

- U.S. Department of Labor/Employee Benefits Security Administration ("EBSA") (Authority to investigate: ERISA Sections 504 and 506)
- EBSA field organization
 - Ten (10) regional offices / five (5) district offices
 - Cincinnati regional office jurisdiction
 - Ohio
 - Kentucky
 - Michigan; and
 - Southern Indiana
 - Cincinnati regional office contact:
1885 Dixie Highway, Suite 210
Ft. Wright, KY 41011
Phone: (859) 578-4680
Toll Free: (866) 444-3272
Website: www.DOL.gov/EBSA

ESOP Statistics

	Number of Plans	Participants	Employer Securities	Total Assets
Total for all ESOPs	6,941	13.5 million	\$214.4 billion	\$942.5 billion
ESOP-like plans (mostly profit sharing plans with 20% or more of their assets in company stock)	1,985	1.2 million	\$18.6 billion	\$52.8 billion
Total for ESOP and ESOP-like plans	8,926	14.7 million	\$233 billion	\$995.3 billion

Defined Contribution Statistics

Current Defined Contribution Plan Data Based on 2010 Form 5500 Annual Reports (released in June 2013) Updated April 2014

Total Plans	Total Participants (thousands)	Active Participants (thousands)	Total Assets*
638,390	88,705	73,668	\$3.8 trillion

**According to the most recent Federal reserve data, defined contribution plans had total assets of \$4.5 trillion as of the second quarter of 2013.*

(Information per American Benefits Council)

Additional Information

- ESOPs a DOL priority since 2005
- DOL closed 1,306 civil cases and 13 criminal investigations
- DOL Audit (and outcome) often asked about when obtaining ERISA/ESOP Fiduciary Insurance

Developments

- || DOL Proposed Fiduciary Regulation
- || GreatBanc Settlement
- || Fifth Third Bancorp v. Dudenhoeffer

What Triggers a DOL Audit?

- Filing of IRS Form 5500
- Special ESOP questions on 5500
- ENRON-like initiative
- Audit cycle

What Triggers a DOL Audit? (Cont.)

- Hard to predict
- New plans more susceptible?
- Participant complaint
- Use self correction programs to fix problems before DOL Inquiry
- Document Fiduciary decisions
- Process over results

Scope and Timeframe of DOL Audit

- Generally begins with focus on single qualified plan
- Often develops into inquiry of other qualified plans
- Significant amount of information requested (See Exhibit A)
- Audit can "drag on" for literally years
- Report findings to IRS
- No action letter (?)

Audit Issues

- Appraisal issues
- Fair market value - "adequate consideration"
- Allocation/administrative issues
- Terms and conditions of purchase agreements
- ESOP loan issues
- "Serial" transactions
- Fiduciary review of ESOP appraisals at transaction
 - ERISA Fiduciary: Individual with discretionary control over plan assets

Audit Issues (Cont.)

- Annual review of ESOP appraisal by ESOP Fiduciaries
- Miscellaneous fiduciary issues
- Prohibited transactions
- Fee and expense issues
- Reporting and Disclosure issues
- Refinancing of ESOP Loans
- Ongoing monitoring and communication with company management
- Annual Voting Procedures

Responding to DOL Request

- See attached Exhibit A for typical list of required documents
- Timeframe
- Presentation of materials
- Location of actual audit (Possibly CPA or Attorney office)
- If onsite: limit contact with other employees
- Designating a “Point Person”
- Involving professional advisors
- Careful review and response to request
- Special review of time period of request
- Developing significant support for positions taken

Responding to DOL Request (Cont.)

- Be specific
- Be organized – folders tabbed
- Prepare written response for item where information not available
- Audit with professionals before DOL inquiry
- Limit informal conversations
- React only to what is asked (no volunteering of information)

Preventative Measures

- Self audit
- Documentation
- Annual meetings with advisors

Corrections and "Fixes"

- General approach to response
- Practical approach
- Legal
- Amnesty "programs"
 - Voluntary Fiduciary Correction Program (VFCP)
(Exhibit B)
 - Delinquent Filer Voluntary Compliance (DFVC)
(Exhibit C)

Penalties

- || Loss of tax benefits (more IRS)
- || Tax on Prohibited Transactions
- || Breach of fiduciary liability
 - Personal exposure (See ERISA, Section 409)
- || DOL Penalties
 - 20% of "applicable recovery amount"
- || Waiver
 - Good faith and restoration to plan
- || Filing Penalties
 - Late 5500 up to \$1,000 a day
 - What does "filed" mean?

Common Issues in DOL Audits

- ESOP Pays too Much for Company Stock
- Improper Default Language in ESOP Loan Docs
- Improper Share Release
 - Incorrect Method
 - Incorrect Amortization
 - Math Errors

Common Issues in DOL Audits

- Improper Payment or Use of Dividends or S-Corp. Distributions
 - Incorrect Amount
 - Improper Loan Payment

ESOP Pays too Much for Company Stock

- 408(e) provides exemption to prohibited transaction rule of 406(a)
 - Requires “adequate consideration”
 - DOL gets benefit of hindsight
 - DOL can conclude stock was purchased for more than adequate consideration

ESOP Pays too Much for Company Stock

■ Ways to Avoid Issue

- Use Independent Trustee
- Evaluate Appraisal Critically and Thoroughly
- Keep Records of Evaluation

■ Ways to Correct Problem

- Seller makes Restitution to ESOP (Including Interest)
- Transaction documents may include indemnification that allows for restitution so correction without penalties may be possible

Improper Default Language in ESOP Loan Docs

■ Exempt Loan Requirements

- In the event of default, loan documents cannot provide for any payments other than actual defaulted loan payment
- Only “security” can be shares purchased with loan proceeds

Improper Default Language in ESOP Loan Docs

- ESOP Loans Sometimes Written with Commercial Loan Language
 - Commercial Loans generally have loan acceleration clause
 - Commercial Loans grant interest in all of borrower's assets in this case other ESOP assets
- Amend Loan Documents
 - Use Qualified Advisor
 - Even if “saving clause”, documents must be amended

Improper Share Release

■ ESOP Share Release Comply with

- ERISA
- ESOP plan document
- ESOP transaction documents

■ Improper Method

- Special rules for using principal only method
- Variable interest rate loan may require change in method

Improper Share Release

■ Improper Amortization

- Interest is computed on 365 day year instead of 360 or vice versa
- Shares released on original amortization schedule instead of adjusting for actual payment history

■ Math or “Arithmetic” Errors was on a 2008 list of most common ESOP Problems

Improper Share Release

- Solution to Correct is Recalculation and Reallocation
 - May have to go back multiple years
 - May require restitution to replace excess distributions
 - Depending on significance of errors correction may be able to be made in current year

Improper Payment or Use of Dividends or S-Corp. Distributions

- ESOP must be treated the same as any other shareholder with respect to dividends or distributions
 - Dividends or S-Corp distributions must be paid to ESOP at same rate as other shareholders
- Problem Arises when ESOP doesn't receive Payment at Proper Rate
 - More common in S-Corps.

Improper Payment or Use of Dividends or S-Corp. Distributions

- Loan Payments made using Dividends can only be made using Dividends on shares acquired by that Loan
 - Keep Separate Accounts
- If Dividends on Allocated Shares are used, Shares Released for Allocation must have same FMV
 - Declining Share Value may result in Additional Contributions being required

Improper Payment or Use of Dividends or S-Corp. Distributions

- Correcting Dividend Issues can be Complicated and Costly
 - Dividend rate must be recalculated and additional cash may be required from company
 - Reallocation of additional dividends or released shares must be performed
 - Prior years must be adjusted
 - Restitution may be required

Thank you

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