A Look Into a DOL Audit

Michigan Chapter of the ESOP Association
Annual Fall ESOP Conference
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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

<table>
<thead>
<tr>
<th></th>
<th>Number of Plans</th>
<th>Participants</th>
<th>Employer Securities</th>
<th>Total Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total for all ESOPs</strong></td>
<td>6,941</td>
<td>13.5 million</td>
<td>$214.4 billion</td>
<td>$942.5 billion</td>
</tr>
<tr>
<td><strong>ESOP-like plans</strong></td>
<td>1,985</td>
<td>1.2 million</td>
<td>$18.6 billion</td>
<td>$52.8 billion</td>
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<tr>
<td>(mostly profit sharing</td>
<td></td>
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<tr>
<td>plans with 20% or more</td>
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<tr>
<td>of their assets in</td>
<td></td>
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<td></td>
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<tr>
<td>company stock)</td>
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<tr>
<td>**Total for ESOP and</td>
<td>8,926</td>
<td>14.7 million</td>
<td>$233 billion</td>
<td>$995.3 billion</td>
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<tr>
<td>ESOP-like plans**</td>
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## Defined Contribution Statistics

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

<table>
<thead>
<tr>
<th>Total Plans</th>
<th>Total Participants (thousands)</th>
<th>Active Participants (thousands)</th>
<th>Total Assets*</th>
</tr>
</thead>
<tbody>
<tr>
<td>638,390</td>
<td>88,705</td>
<td>73,668</td>
<td>$3.8 trillion</td>
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*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)
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
Improper Payment or Use of Dividends or S-Corp. Distributions

- Incorrect Amount
- Improper Loan Payment
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
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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<tr>
<th>Stephen J. Lowney</th>
<th>David L. Bosch</th>
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<tbody>
<tr>
<td>Foster Swift Collins &amp; Smith PC</td>
<td>Watkins Ross</td>
</tr>
<tr>
<td>P: 517.371.8272</td>
<td>P: 616.742.9239</td>
</tr>
<tr>
<td>F: 517.371.8200</td>
<td>F: 616.456.5021</td>
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<td><a href="mailto:slowney@fosterswift.com">slowney@fosterswift.com</a></td>
<td><a href="mailto:dbosch@watkinsross.com">dbosch@watkinsross.com</a></td>
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