

Employee Benefit Plans Alert

IRS Examination Topics

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During 2020, our Employee Benefit Services Group represented several retirement plans that were selected for examination by the Internal Revenue Service (IRS). Types of plans included in their selection were: Employee Stock Ownership Plans (ESOPs), 401(k) and 403(b) plans, and defined benefit plans.

Recent IRS examinations usually are limited to three or four operational areas and a thorough review of the compliance with the current plan document. Operational areas that are commonly selected include: vesting and distributions, loan administration, and processing of hardship withdrawals. IRS agents are able to select other areas. These types of IRS examinations are not considered full-scope examinations even though a significant amount of documentation, analysis, and review are still required.

This article discusses one of the areas of increased IRS scrutiny: vesting. A subsequent EBP Alert will provide a discussion on the proper adoption of the plan by participating employers. The following discusses vesting requirements generally applicable to qualified defined contribution retirement plans, along with related matters.

A recording of a presentation by the Employee Benefit Services Group with a law firm discussing ESOP examinations [can be found here](#).

Vesting

This is a key provision in every plan document and affects every plan in operation. Vesting requirements are described in §411 of the Internal Revenue Code (IRC).

According to the IRS, “vesting” in a retirement plan means ownership. This means that each employee will vest, or own, a certain percentage of their account in the plan each year. An employee who is 100% vested in his or her account balance owns 100% of it and the employer cannot forfeit, or take it back, for any reason. Amounts that are not vested may be forfeited by employees when they are paid their account balance (e.g., when the employee terminates employment).

How an employee accrues vesting service is described in the plan document. There are various permitted methods – counting hours and elapsed time are the two most frequently used methods. The Department of Labor (DOL) has regulations which contain the rules pertaining to the use of “equivalencies.” The equivalency method credits employees based on the period worked (examples: 10 hours per day, 45 hours per week, 190 hours per month).

The counting of hours of service method typically requires the participant to complete a specified number of hours in a period to receive credit. Many plans require the completion of 1,000 hours of service in a plan year, whereas the elapsed time method eliminates the “counting” requirement. Crediting service is based on the period of service. An employee with hours of service in January and in December of the same year can be credited with a year of service, regardless of the number of hours worked in that 12-month period.

Employee Contributions

Voluntary contributions made by participants in a 401(k) or 403(b) plan (e.g., before or after-tax, Roth) are always 100% vested.

Employer Contributions

Typically, one vesting schedule is selected by the employer applicable to the contributions made to the plan by the employer. But a plan can have separate schedules (e.g., immediate vesting for the matching contribution, and a graded schedule 20% per year of service for a discretionary contribution) for different contribution components. Different vesting schedules apply to employer contributions depending on the type of plan the employer sponsors.

IRS Findings

The issues identified by the IRS in the 2020 examinations in which we represented our clients included:

- Not following the crediting of vesting service provision provided in the plan document;
- Unable to provide support/documentation of the crediting or non-crediting of a year of service;
- Change of record keeper or other service provider in mid-year, and the crediting of that year of service was not performed;
- Applying the incorrect vesting schedule in operation on distributions to terminated participants; and
- Errors made in the selection of the correct vesting schedule when the plan has been restated, or during the process of adopting a different plan document.

When these failures are discovered on examination, several factors [e.g., the number or errors/participants affected, the plan year(s) involved, the number of participants in the plan, etc.] need to be evaluated to determine how the corrections can be made. The IRS's [Employee Plans Compliance Resolution System \(EPCRS\)](#) provides the resources to assist with the corrections. Generally, insignificant defects are permitted to be self-corrected, but larger omissions involving many participants, plan document errors, and other situations require corrections under Audit CAP (Closing Agreement Program). This correction program requires a sanction payment to be paid to the IRS, in addition to the corrections required for the plan.

Contact Us

The Employee Benefit Services Group at PKF O'Connor Davies is available to assist employers with the various compliance reporting and other requirements imposed by federal agencies. We also provide a full spectrum of compliance services for qualified retirement plans, non-qualified deferred compensation plans, and welfare plans. For more information, please contact your client services partner or either of the following:

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