

Dealing With The IRS And DOL Investigations Track 2F

Sheryl Bayani-Alzona, Esq.
Employee Benefits Law Group PC
10880 Wilshire Boulevard, Suite 1101
Los Angeles, CA 90024
(310) 571-8896
scba@seethebenefits.com
www.seethebenefits.com



Rachel Markun, Esq.
Hawkins Parnell Thackston & Young LLP
1776 Second Street
Napa, CA 94559-2405
rmarkun@hptylaw.com
www.hptylaw.com

HAWKINS PARNELL
THACKSTON & YOUNG^{LLP}

IRS And DOL ... Are Here To Help!

**I'M FROM THE
GOVERNMENT,
I'M HERE
TO HELP**



Background On The Dual Regulatory Structure For The Internal Revenue Service And The U.S. Department Of Labor Under ERISA

	Tax Matters	Fiduciary and Other Matters
Agency	U.S. Department of Treasury	U.S. Department of Labor ("DOL")
Primary Division	Internal Revenue Service ("IRS")	Employee Benefits Security Administration ("EBSA")
Primary Sources	Code (Title 26 of the United States Code) and case law	ERISA (Title 29 of the United States Code) and case law
Secondary Sources	<ul style="list-style-type: none"> - Treasury Regulations, IRS Notices, Revenue Rulings, and Revenue Procedures - IRS Technical Advice Memos, General Counsel Memos, Private Letter Rulings (Not Precedential) 	<ul style="list-style-type: none"> - Labor Regulations, Interpretive Bulletins, Field Assistance Bulletins, Administrative Exemptions (Class and Individual) - Advisory Opinions (Not Precedential)

3

Internal Revenue Service

- Tax Compliance
 - Plan Qualification Compliance
 - Prohibited Transactions – excise tax
 - Unrelated Business Income Tax
 - Deduction for Contributions – can be raised on Plan sponsor returns



4

Internal Revenue Service

- Limited Direct Audit of ESOPs in Current Years
- Direct Plan Sponsor Audits (Particularly S Corporation Audits) are ongoing

5

Plan Sponsor Audit

- Issue can potentially arise from personal audit as well
- One example:
 - Seller to S Corporation ESOP was also involved in a lot of other entities
 - IRS agent googles the companies and found all entities
 - Questions during audit were directed toward eligibility of employees in other entities

6

Plan Sponsor Audit...cont'd

- Hire an ESOP attorney or an Enrolled Agent and sign a POA
- Let IRS ask questions through the attorney
 - Do not engage in direct interviews absent sophisticated CFO-type plan sponsor representative

7

Internal Revenue Service

- **New trend:**

Filing of **Form 5310**
(Application for Determination for
Terminating Plan)
triggers audits

*Clues often derive from post-filing
information request*

8

What Does IRS Ask For?

IT DEPENDS

.....on the reason for
ESOP termination.

9

Form 5310.....

- Reason for termination:
 - Change in ownership by merger
 - Liquidation or dissolution of employer
 - Change in ownership
 - Adverse business conditions
 - Adoption of new plan

10

Form 5310.....cont'd

- IRS asks for **valuations reports, merger agreements, opinion letters**
- Bottom line:
 - *Do not send anything without talking to your ESOP counsel*

11

Form 5310.....cont'd

- 5 year participant vesting history
 - *Sometimes the IRS is so sure somebody was shorted*
- Bottom line:
 - *Send allocations report and walk them through the report*

12

Some insight on IRS...

- IRS agents are used to auditing 401(k) plans where the plan sponsor does not have a lot at stake
- IRS has a robust Voluntary Correction Program to address qualification issues



13

Voluntary Correction Programs

- **IRS: Employee Plans Compliance Resolution System (EPCRS) – Rev. Proc. 2013-12 as amended in Rev. Proc. 2016-51**
- **Self Correction Program (SCP):** A Plan Sponsor that has established compliance practices and procedures may, at any time without paying any fee or sanction, correct operational failures

14

Voluntary Correction Programs (continued)

- **Voluntary Correction with Service Approval (VCP):** A Plan Sponsor, at any time before audit, may pay limited fee and receive IRS approval for correction of all qualification failures
- **Audit Closing Agreement Program (Audit CAP):** If failure is identified on audit, Plan Sponsor may correct failure and pay sanction

15

Department Of Labor

- Fiduciary Conduct
 - Fiduciary Liability
 - Prudence of investments
 - Liability for Prohibited Transactions



16

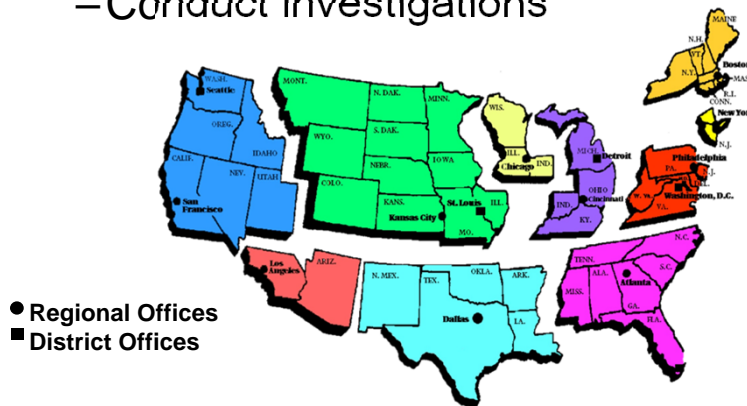
DOL Investigations

- Are **not** audits
- May not "impose" penalties
- May only ask Regional Solicitor to bring an action
- Looks for/demands voluntary compliance 99% of the time

17

EBSA – Structure

- 10 regional offices
 - Provide compliance assistance
 - Conduct investigations



18

DOL Investigations Overview

- EBSA Background
- How is a case opened?
- What should you do when you receive notice of an investigation?
- How should you handle the document production requests?

19

DOL Investigations Overview (continued)

- What is the proper way to interact with an investigator?
- What are the current "hot issues"?
- How will the case be resolved?
- New trends in DOL Litigation

20

Sources Of Cases

- Participant complaints
- Referrals from other agencies (such as the IRS)
- Media
- Institutional Referrals or Investigations (such as Trust Companies and Third Party Record-keepers)
- Form 5500 reviews

21

Top 10 Reasons Why EBSA Selects 5500 For Investigation

1. Plan indicates **loss due to dishonesty**
2. Plan indicates **non-exempt PT**
3. Plan indicates **defaulted lease**
4. Plan indicates **loan in default**
5. Plan holds **assets not readily determinable** from the report



22

Top 10 Reasons Why EBSA Selects 5500 For Investigation (continued)

6. Plan holds **real estate exceeding 25% of total assets**
7. Plan holds **partnerships that exceed 25% of total assets**
8. Plan holds **loans other than participant loans that exceed 25% of total assets**
9. Plan indicates **failure to transmit participant contributions timely**
10. Plan **unable to pay benefits**

23

Leveraged ESOPs

Note that leveraged ESOPs are often selected for investigation without further reason. The presence of leverage rather than a decline in share value is a frequent trigger because of the National Enforcement Priority



24

The Chosen One...

- You will likely receive a document request letter (usually 14 day notice)

OR:

- You may just receive a telephone call notice or e-mail of plan review from investigator/auditor

25

The Chosen One... (continued)

- Investigator/auditor cannot tell you why case was opened or if a complaint was filed...
- but if you ask nicely...



26

What Should You Do When You Receive Notice of Audit/Investigation?

- Immediately notify your legal counsel and tender the notice to your insurer
- If you need additional time to comply with document request, it is acceptable to so request

27

Handling DOL Investigations

- Know their procedure and their EBSA manual "script"
- Manage the process
- Be ahead of them on the facts and records



28

Handling DOL Investigations (continued)

- Exercise Patience
 - Even after field investigation is completed, many times the DOL will ask for additional documents over extended period of time



29

How Should You Handle Document Production Requests?

- They can have whatever they want – the DOL has broad subpoena power to enforce if not voluntarily provided
 - No attorney/client privilege for fiduciary advice (the "fiduciary exception")
 - Keep copies of everything you give them
 - Adopt a policy of document retention, or not

30

How Should You Handle Document Production Requests? (continued)

- **Document Request List** – Likely everything related to your ESOP, including plan documents, transaction documents, and trust accounting/participant records
- Sometimes the request list will provide clues regarding issues the DOL is focusing on, particularly with participant complaints

31

How Should You Handle Document Production Requests? (continued)

- **Organization:**
 - Obtain all requested documents, and inform investigator if certain information is not available
 - Label documents and compile in indexed folder for faster review and clarity
 - Provide copies, not originals. Generally documents are provided in electronic form

32

How Should You Handle Document Production Requests? (continued)

Do not provide documents not specifically requested



33

What Is The Proper Way To Interact With An Investigator?

ERISA vests in the Department of Labor the power to bring a civil suit against a fiduciary for breaches of fiduciary duty...

ERISA 101

Civil enforcement provisions aimed at assuring that plan funds are **protected** and that participants **who qualify receive their benefits**

34

DOL Interview

The investigator will schedule an interview following the document review. An interview is not an indication of a problem with the ESOP, it is standard procedure for an investigation



35

Understand Your Rights

- A. You should not have to make any statement or answer any questions. If you do not know an answer, you should state you do not know!
- B. Any statement you make or any answers you give may be used against you in a court of law or other proceedings

36

Understand Your Rights (continued)

- C. You have the right to talk to a lawyer for advice before you answer any questions and you have the right to have a lawyer present during the interview. Note the Plan Sponsor's Lawyer is not your Lawyer! Neither is the ESOP's Lawyer! Often you may seek to have the Plan Sponsor's lawyer or the ESOP's lawyer present at the interview
- D. If you answer questions without a lawyer, you still have the right to stop the interview at any time

37

How Will Case Be Resolved?

- **If Problem is Identified:**

Voluntary Compliance (VC) Letter (process can last from few weeks to many months)

- Voluntary Compliance letter is called "Voluntary Compliance (VC) Letter" – signed by Regional Director

38

How Will Case Be Resolved? (continued)

10 days to respond to VC letter by plan fiduciary, including any arguments disagreeing with findings, mistakes of fact (or even law) and proposals for correction

- DOL will usually grant at least one extension for any good reason

10
DAYS TO GO

39

How Will Case Be Resolved? (continued)

- Dialogue with DOL on follow-up after VC letter is issued; including discussion regarding possible violations and corrective steps, followed by documentary proof of correction
- Proof is reviewed by investigator, supervisor, regional director, and then Office of Enforcement in Washington DC

40

How Will Case Be Resolved? (continued)

- **"No-Action" Closing Letters:**
 - No action closing letter subsequent to VC letter -- corrections made and DOL is closing investigation with no further action
 - No action "closing VC letter" citing violations and corrections made before VC letter is issued

41

How Will Case Be Resolved? (continued)

- No action closing letter – where violations are cited, no corrections are made, and DOL does not deem case fit for further action ("warning closing letter")
- No action closing letter – no violations

42

How Will Case Be Resolved? (continued)

If a **severe problem** is identified, civil penalty may be imposed in connection with settlements DOL pursuant to ERISA § 502(I)



43

How Will Case Be Resolved? (continued)

- **Section 502(I) Letter**
 - (a) Violation of part 4 by fiduciary (§§ 404 and 406)
 - (b) "Shall" be imposed
 - (c) 20% of any applicable recovery amount
 - (d) Settlement or agreement with the Secretary of Labor
 - (e) Waiver – not easily granted or granted only on the strict standard of hardship
 - (i) good faith
 - (ii) hardship

44

What Are The Current "Hot Issues"?

- Review of plan assets: Valuation
 - Prudence, prohibited transactions, self-dealing, valuation methodology, projections, **CONTROL**



45

Will The Trump Administration Change This Pattern?



46

Will The Trump Administration Change This Pattern? (cont'd)

- Newly appointed R. Alexander Acosta, the Secretary of the DOL, **filed a complaint against Reliance Trust Company** on May 4, 2017 (**less than a week after his being sworn in** on April 28, 2017), in a stock drop case wherein the DOL has alleged, among other things, that a little over a year after the ESOP acquired shares for \$82.5 million, the stock value dropped to \$14 million and continued to decline thereafter

47

Will The Trump Administration Change This Pattern? (cont'd)

- The President of the ESOP Association has recently stated: From 2010 through 2016, suits against ESOPs filed by the Employee Benefits Security Administration (EBSA) **increased by 400 percent**. While a new Secretary has arrived at DOL, no new leaders have been appointed at EBSA. So the pace of attacks seen from the 2010-2016 era continues on in full force

48

New Settlement Agreement?

- Recall that in June 2014, GreatBanc and the DOL signed a formal "Agreement Concerning Fiduciary Engagements and Process Requirements for Employer Stock Transactions" or "Fiduciary Process Agreement"
 - Over 18 months of negotiations
 - Involved investigation of Sierra Aluminum ESOP

49

New Settlement Agreement? (cont'd)

Fiduciary Process Agreement

- A. Selection and Use of Valuation Advisor - General
- B. Selection of Valuation Advisor – Conflicts of Interest
- C. Selection of Valuation Advisor – Process
- D. Oversight of Valuation Advisor – Required Analysis
- E. Financial Statements
- F. Fiduciary Review Process – General
- G. Fiduciary Review Process – Documentation of Valuation Analysis
- H. Fiduciary Review Process – Reliance on Valuation Report
- I. Preservation of Documents
- J. Fair Market Value
- K. Consideration of Claw-Back
- L. Other Professionals

50

New Settlement Agreement? (cont'd)

- On September 21, 2017, First Bankers Trust Services, Inc. and DOL signed a formal "Agreement Concerning Process Requirements for Employee Stock Ownership Plan Transactions"
 - Involves Maran, Inc. ESOP

51

The Maran Settlement Agreement

- Generally same 12 sections as the GreatBanc Fiduciary Process Agreement
- Maran Agreement added a section on Control:
 - "If FBTS approves a Transaction in which the ESOP cedes any degree of control to which it would otherwise be entitled based on its ownership interest, including but not limited to the unencumbered ability to vote its shares (for example, by electing members of the board of directors), **FBTS must document any consideration received in exchange for such limitation on the ESOP's control** (or how the limitation on control is otherwise reflected in the purchase price) **and why it is fair to the ESOP**. If FBTS approves a Transaction in which the ESOP pays a control premium, FBTS must document why it believes that the ESOP is **obtaining voting control**, and **control in fact**, and identify any limitations on such control as well as the specific amount of consideration the ESOP received for such limitations(s)."

52

The Maran Settlement Agreement (cont'd)

- Section A – Selection and Use of Valuation Advisor
 - The DOL wants FBTS to document **what** steps FBTS took – including **who** at FBTS took those steps – to determine that the valuation advisor received **complete, accurate, and current** information and to ensure FBTS understood the advice of the valuation advisor

53

The Maran Settlement Agreement (cont'd)

- Section B – Selection of Valuation Advisor – Conflicts of Interest
 - Added that FBTS shall not use a valuation advisor for a Transaction that has previously performed work for any party to the Transaction, **other than the ESOP or its trustee.....** for or on behalf of the ESOP sponsor, **a committee of the plan sponsor.....**

54

The Maran Settlement Agreement (cont'd)

- Section C – Selection of Valuation Advisor – Process
 - In the Fiduciary Process Agreement, GBTC was required to prepare a written analysis of whether the valuation advisor was the subject of prior criminal or civil proceedings



55

The Maran Settlement Agreement (cont'd)

- Section C – Selection of Valuation Advisor – Process
 - In the Maran Settlement, FBTS is being required to also analyze whether the valuation advisor was the subject of prior **regulatory proceedings/investigations** related to its previous valuation work and the outcome of such proceedings and investigations

56

The Maran Settlement Agreement (cont'd)

- Section C
 - Previous 15-month requirement now changed to prior calendar year
 - Vendor risk management program? A new concept?

57

The Maran Settlement Agreement (cont'd)

- Section D – Oversight of Valuation Advisor – Required Analysis
 - Valuation Advisor should document:
 - A description of the risks facing the plan sponsor that could cause the plan sponsor's financial performance to fall materially below the projections relied upon by the valuation advisor

58

The Maran Settlement Agreement (cont'd)

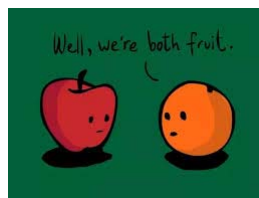
- Whether the terms of any loan the ESOP receives in connection with the Transaction are as favorable as the terms of any loans between the plan sponsor and any executive of the plan sponsor made within the two years preceding the transaction



59

The Maran Settlement Agreement (cont'd)

- Requires that the valuation report explain any differences between the proposed transaction valuation and the most recent valuation of the ESOP sponsor performed within the past 24 months by any valuation firm for any purpose



60

The Maran Settlement Agreement (cont'd)

- Section E – Financial Statements
 - If there are no audited unqualified financial statements, FBTS may approve a transaction notwithstanding the lack of unqualified audited financial statements **only if** the stock purchase agreement includes a provision requiring the selling or purchasing shareholder who is an officer, manager or member of the board of directors of the plan sponsor to **compensate the ESOP** for any losses or other harms caused by or related to financial statements that did not accurately reflect the plan sponsor's financial condition

61

The Maran Settlement Agreement (cont'd)

- Section F – Fiduciary Review Process - General
 - Ensure that the information the valuation advisor obtains from the plan sponsor and purchasing or selling shareholder includes the following to the extent it exists:
 - Prior **attempts to sell or purchase** their stock with the preceding **two years**
 - Any **prior defaults** within the past five years by plan sponsor
 - Any **management letters** provided to the plan sponsor by accountants within the past five years
 - Any **information related** to a **valuation** of the plan sponsor provided to the IRS within the past **five years**

62

The Maran Settlement Agreement (cont'd)

- Section J - Fair Market Value section is changed to **Debt** and Fair Market Value
 - "The principal amount of the debt financing the Transaction, irrespective of the interest rate, **cannot exceed the plan sponsor's securities' fair market value.** Accordingly, FBTS **shall not** cause an ESOP to engage in a leveraged stock purchase Transaction in which **the principal amount of the debt financing the Transaction exceeds the fair market value of the plan sponsor's securities acquired with that debt,** irrespective of the interest rate or other terms of the debt used to finance the Transaction."

63

Questions



64