

The IRS Has Recently
Increased Its Resources and Changed Its Focus on
Qualified Retirement Plan Audits...

Are You Prepared?

Presented by HRH & Sunlin Consulting
April 5, 2006



The New IRS Audit Approach - WHAT IS THE IRS GOING TO DO?

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Expand Compliance Contacts

- Available data - Form 5500s, 5330s and follow-up on all prohibited transactions, etc.
- Increased resources
 - ◆ Economists
 - ◆ Statisticians
 - ◆ Computer geeks
 - ◆ Revenue agents
 - ◆ Focused training
- More focused use of resources
- "Soft contact" or "howdy" letters

Focused Examinations

- Sample all plan types, sizes, industries, & geographic areas
- Issue selection - comprehensive analysis to determine what to focus on; top ten issues deemed important
- Field auditor's decision to expand or close audit early in the process
 - ◆ Auditor's judgment valued
 - ◆ Opening interview most important
 - ◆ Assessment of internal controls/compliance level of plan administration
 - ◆ Conduct audit at sponsor's location - IRS view that audit issues come up by going on-site

How to Deal with Any Issues Found

- EPCRS - Employee Plans Compliance Resolution System
- IRS will treat plan as if it continuously complied with IRC provided EPCRS requirements are met
- EPCRS Programs
 - ◆ Self Correction Program ("SCP")
 - ◆ Voluntary Correction Program with Service Approval ("VCP")
 - ◆ Correction on Audit Program ("Audit CAP")

Correction Principles

- Full correction even after a year is "closed"
- Exceptions when:
 - ◆ Admin cost exceeds benefit
 - ◆ Benefit is \$50 or less
 - ◆ Recovery of \$100 or less of overpayments
 - ◆ Participants can't be located after reasonable efforts
- Correction should:
 - ◆ Restore plan and participants' financial positions
 - ◆ Be reasonable and appropriate to the failure
 - ◆ Be consistent with IRC rules
 - ◆ Keep assets in the plan

SCP - Self Correction Program

- Insignificant errors can be fixed at any time
- Correction of significant operational failures:
 - ◆ Not available while under IRS exam
 - ◆ Substantial completion by the last day of the 2nd plan year after the failure (for ADP & ACP, after correction period)
 - ◆ For "Transferred Assets" the correction period is the last day of the first plan year that begins after the merger, acquisition, etc.
 - ◆ No retroactive plan amendments except for:
 - Additional allocations when compensation limit exceeded
 - Hardship distributions
 - Ineligible employees

SCP - Self Correction Program

Documenting SCP Corrections

- Description of administrative procedures
- Summary of changes made to administrative practices
- Description of failure
- Correction methodology
- List of participants affected and how contacted
- Corrections made to participants, including dates
- If insignificant failure, describe why it qualifies
- If significant, date on which correction began and ended
- For Transferred Assets - date of merger, acquisition, etc.

VCP - Voluntary Correction Program with Service Approval

- Used to correct all qualification failures
- Fee is fixed - based on number of participants
 - ◆ Under 20 participants - \$750
 - ◆ Over 10,000 participants - \$25,000
- Anonymous submissions

Audit CAP (Correction on Audit Program) vs. Disqualification

- Sanction negotiated as part of the examination process
- Sanction will be a percentage of the Maximum Payment Amount - approximation of the taxes that could be collected if the plan is disqualified
- Sanctions will bear a reasonable relationship to the failures and not be excessive
- Correction consistent with EPCRS

Expected EPCRS Changes

- Excise tax on:
 - ◆ Corrective contributions for exceeding deductible limit
 - ◆ ADP/ACP corrections, reasonable effort made to correct within the 2 $\frac{1}{2}$ mo.
- Fee reduction for minimum distributions if 50 or fewer employees (\$500)
- Elimination of determination letter requirement with certain operational failures corrected by retroactive amendments
- Excluded employee failures
 - ◆ 50% ADP % for elective deferrals plus earnings
 - ◆ 40% ACP % for after-tax contributions

The New IRS Audit Approach

WHAT IS THE IRS LOOKING FOR?

IRS Top 10 Audit Issues

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Top 10 List

- Deferral Percentage Test
- Compensation
- Assets
- Limits
- Miscellaneous (Data)
- Vesting
- Termination or Partial Termination
- Acquisitions
- Plan Document
- Distribution and Loans

Data

- Inadequate or overly complicated database structure
- Lack of coordination between sponsor, payroll provider, record-keeper and divisions
- Failure to reconcile current data feed and year-end totals

Eligibility and Vesting

- Terminations and rehires
- Temps and leased employees
- Transfers between divisions and states
- HCE identification

Compensation

- Plan document definition not followed
- Compensation in excess of \$220,000 limit used to determine benefits or contributions
- Incorrect treatment of bonuses, overtime and fringe benefits
- Causes of failure:
 - ◆ Administrative limitations
 - ◆ Internal communications
 - ◆ Initial payroll feed set-up
 - ◆ Payroll feed not updated
 - ◆ Non-cash payments
 - ◆ Rehires
 - ◆ Transfers between divisions
 - ◆ Transfers between states
 - ◆ Multiple definitions in plan

Plan Limits

- \$44,000 DCP 415 limit
- \$175,000 DBP 415 limit
- \$15,000 402(g) deferral limit
- 415 limits exceeded when employees participate in multiple plans maintained by same employer/controlled group
- 402(g) deferral limit exceeded when participants participate in multiple 401(k) plans, whether or not maintained by same employer

Plan Limits

- Causes of failures:
 - ◆ Administrative limitations
 - ◆ Rehires
 - ◆ Transfers between divisions and states
 - ◆ Multiple Plans and payrolls
 - ◆ New hires with deferrals in prior employer plan(s)

ADP & ACP Testing

- Information to a third party is incomplete or incorrect (e.g. failure occurs when testing is completed by vendor with no oversight by the employer)
- Tests could fail if a benefit is provided only to selected participants
- Newly acquired employees not permitted to make elective deferrals and/or included in testing

Termination/Partial Termination

- Large drop in plan participants (over multiple years)
- Large decrease in active participants from beginning to end of year
- Large number of separated participants during year
- Low percentage of participants compared to the total number of employees relative to other plan years
- Organization appears to be "downsizing"

Acquisitions

- Late plan contributions for newly acquired employees not yet part of the acquirer's payroll system
- Acquirer omit matching contributions for newly acquired employees
- Inadequate communications regarding new/old plan
- Termination of old plan

Acquisitions

- Missed/incorrect matching or profit sharing contributions due to incorrect payroll feeds
- Predecessor service issues
- Merging plans with different vesting schedules
- Non-compliance with 411(d)(6)
- Merger of predecessor plan prior to analysis of old plan issues
- Multiple employer plan/control group issues

Plan Documents

- Documents not amended to comply with all applicable laws before merger
- GUST & "Good faith" EGTRRA amendments not adopted timely
- Documents and/or Adoption Agreement not adopted by all participating employers
- No executed trust document
- Plan provisions are:
 - ◆ Not administratively feasible
 - ◆ Not consistent with actual administration
 - ◆ Not in compliance with plan's testing procedures

Distributions and Loans

- Large distributions relative to plan assets
- Failure to suspend "salary deferrals" after hardship distributions
- Incorrect reporting of distributions on Form 1099 causes improper tax treatment (including 10% excise tax) by plan participants receiving distributions or defaulting on plan loans

Distributions and Loans

- Form 5500 indicates Plan terminated long time ago, but distributions not yet completed
- Automated systems for plan loans and distributions could lead to significant compliance issues if documentation or spousal consents are not secured and maintained
- Distributions understated due to inaccurate valuations of employer real property or closely held employer securities

Assets

- Providing wrong statistical information to IRS
- Large distributions can:
 - ◆ Create significant actuarial losses
 - ◆ Indicate termination or retirement of owners
 - ◆ Indicate partial plan terminations
- Imprudent fiduciary actions
- Lack of investment diversification
- Charging Settlor expenses to plans

Plan Compliance Coordination

Between: HR, payroll, tax, finance, legal, vendors, brokers, auditors, etc.

- Plan design
- Documents
- Investments
- Education & communication
- Payroll feeds
- Data integrity
- Reporting & disclosure



Conclusion: *Structural Integrity is Important*

Plan administration systems are like the structure of a house -

- With solid foundation, sound framework, electrical, plumbing & a good roof... a house becomes a home - a platform for living and a source of pleasure
- Without a well-designed structure, problems keep coming up and you are constantly worrying and spending time, energy and money fixing things.

