

403(b) PLANS

"Washington, We Have a Problem..." *403(b) Programs and Voluntary Compliance*

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How viable is the new TVC program for employers? Like the other voluntary compliance programs initiated by the IRS, it is an amalgam of good news and bad. On the one hand, it helps employers to clean up their 403(b) programs, and to go forward knowing that they are not at risk for large taxes and penalties in the event of an IRS audit. On the other hand, TVC contains requirements with which some employers cannot reasonably comply and which may be too costly an option for some tax exempt entities.

At long last, after months of anticipation, the IRS issued Revenue Procedure 95-24, enabling 403(b) arrangements (also called tax sheltered annuities or TSAs) to enter the happy realm of voluntary compliance with the IRS. This new program, dubbed TVC, allows employers of individuals covered by a TSA to correct operational defects in the arrangement, thus preventing the drastic tax

ramifications that can occur when such problems are discovered on audit.

HOW DOES TVC WORK?

TVC combines elements of both the Voluntary Compliance Resolution (VCR) and voluntary, or "walk-in," Closing Agreement Programs (CAP) that have become familiar to those who consult in the qualified plan arena.

Under TVC, the employer identifies the defects, works with the IRS to craft the correction, and exchanges written documents with the IRS outlining the terms of the agreement. The correction principles for TVC parallel those of VCR, requiring correction for all plan years (not just those still open to audit for tax purposes), restoring the plan and the participants to their respective positions had the defect not occurred, and expressing a preference for correction methods that keep the assets in the plan.

TVC, like VCR, is administered solely by the IRS Headquarters in Washington, D.C., and requires that the employer pay a "voluntary correction" or user fee. The fee is based on the number of employees, ranging from \$500 for less than 25 employees to \$10,000 for 10,000 or more employees. However, unlike VCR but similar to CAP, the IRS under TVC may also require the employer to pay a nondeductible sanction or penalty. This sanc-

tion may range from zero up to 40 percent of the Total Sanction Amount. The Total Sanction Amount is an estimate of the income taxes that would be paid by the participants and the custodial accounts if the defect caused the individual contract or the entire program (whichever is appropriate) to lose its 403(b) status. The Total Sanction Amount depends on whether the defect is a "plan defect" or a "contract defect."

The difference between a plan defect and a contract defect was first outlined in the proposed Audit Guidelines to Tax Sheltered Annuity (TSA) Programs [IRS Ann 95-33, 1995-19 IRB] [See also, Reish, Tenenbaum, and Ferenczy, "The 403(b) Examination Guidelines: A Road Map" 3 *J Pension Benefits* 1 (Autumn 1995) p. 3] Plan defects are those that are so endemic to the program, that all participants' accounts can lose their tax-sheltered status. For example, the failure of a TSA to meet the nondiscrimination requirements is a plan defect, affecting all participants' accounts in the program. On the other hand, contract defects are considered to affect only the participant whose account contains the defect—such as a given participant's failure to limit contributions to the exclusion allowance or Code Section 415 maximum.

For plan defects, the Total Sanction Amount equals the sum

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of:

1. The income tax on earnings in the custodial accounts (but not annuity contracts) for open tax years;
2. The federal income tax on the amount that should have been included by highly compensated employees (HCEs) in income for all open tax years; and
3. The income tax that should have been withheld by the employer on amounts that were contributed to the TSA by non-highly compensated employees (NHCEs) for all open tax years.

For contract defects, the tax on the custodial account earnings is not included, and taxes are calculated only for affected participants (that is, those whose annuity contract or custodial account is defective).

For purposes of the determination of the Total Sanction Amount, it is assumed that the HCEs would be otherwise taxed at the rate of 28 percent, and that withholding on taxable amounts to NHCEs would be at a 20 percent rate.

This assumed rate of tax for purposes of the sanction is unique to TVC, and has no roots in CAP. While it makes the determination of the maximum sanction an easier calculation (particularly if it is a plan defect and there are many affected employees), it also precludes the employer from doing a detailed tax calculation to show that all or some of the affected employees would actually pay tax at a lower rate if the program lost its 403(b) status.

For example, assume that the defect at issue is that an HCE

obtained life insurance in an annuity contract that exceeded the incidental death benefit limitations. This is a contract defect, potentially causing that participant's TSA to lose its 403(b) status. Under TVC, the Total Sanction Amount would be 28 percent of the contributions made on behalf of the HCE to the TSA during the three open tax years. However, if the HCE had sufficient personal tax deductions, the effective tax rate on those contributions could be less than 28 percent, if the HCE's Form 1040 were actually amended.

NEGOTIATION OF THE SANCTION

As is the case with walk-in CAP for qualified plans, the actual sanction charged by the IRS for a given case will often be much less than 40 percent of the Total Sanction Amount, depending on the equities of the situation. As part of the negotiations with the IRS, the employer or its representative will argue the reasons why a lesser sanction should apply. This process is very subjective in nature, requiring the negotiator to convince the IRS Headquarters of the employer's relative innocence and good intent, the harm to the employer or employees that would result if a large sanction were charged, and other factors that may generate compassion for the taxpayers' dilemma. Often, the equities have their basis in legal arguments—for example, the taxpayer may argue that the defect is one isolated error not serious enough to merit harsh treatment. On other occasions, the taxpayer will argue more personal issues—such as the reliance on advice given by product vendors or other TSA profes-

sionals, or the good mission of the tax exempt that would be harmed if a large sanction were charged.

Needless to say, the sanction is one of the two key elements that may make or break a TVC situation. If the cost of the TVC sanction is too high, the employer may decide it is more cost-effective to play audit roulette, and hope that the defect is not discovered. Therefore, the negotiation of the sanction amount is often the most critical phase of the process.

CORRECTING THE DEFECT

The second key issue to be negotiated is how the defect is to be corrected. In some situations, the cost of correction may be too expensive for the employer to afford. For example, if a TSA fails the nondiscrimination testing, the employer may not be in a financial position to contribute make-up amounts to the accounts of the NHCE participants. In these situations, discussions regarding alternate forms of correction will be crucial to a successful TVC outcome. The employer in the above example could argue that an alternate correction would be to refund or forfeit contributions and earnings to HCEs in order to meet the nondiscrimination testing. Although the IRS prefers to keep the money in the plan, this solution may be acceptable if it is the only realistic way that the employer can effect correction.

Correction Paperwork

Once a deal is struck, the IRS Headquarters prepares a correction statement which outlines the defect, the proposed correction, and the sanction to be paid. Any changes the employer has agreed

to make to its procedures to prevent a recurrence of the defect are also outlined in the correction statement. The IRS then requests that the employer sign an acknowledgment letter, agreeing to the terms of the correction statement. When the employer signs the acknowledgment letter, and accomplishes the correction, the TVC is complete and the TSA is considered to be in compliance with the law for the period of time and for the issues covered by the TVC.

Revenue Procedure 95-24 clearly contemplates that the preparation of the correction statement is the last phase of the TVC negotiations. Once the statement is sent by the IRS to the employer, the employer has only 25 days to sign the acknowledgment and return it to the IRS. Once the correction statement is issued, the employer cannot request modifications without paying *another* user fee. If the requested modification is minor, the maximum new user fee is the lesser of the original user fee or \$1,250. Therefore, the issuance of the correction statement is, to a large extent, the point of no return, and the employer must be sure that all the terms of the TVC are fully agreed upon before this happens.

TVC ALLOWS A TSA TO COME CLEAN AT A SUBSTANTIALLY REDUCED COST

Like the other IRS programs for voluntary compliance, TVC gives employers and their employees an opportunity to resolve many retirement plan problems. Since all indications point to the fact that most TSAs are out of compliance with the law, this result should not be understated.

It is important to remember that TSAs are often the employees' only retirement savings. Having those funds at risk to premature and punitive taxation is no less frightening for employees of tax exempt entities than is disqualification for their for-profit counterparts. Similarly, tax exempt employers are as concerned about allowing their employees to retire with some financial security as are for-profit companies. TVC allows those concerns to be assuaged.

Under TVC, the *worst* that the sanction could be is 40 percent of the taxes that potentially would be charged if the IRS audited the program and found it to be out of compliance (except for the employment taxes, which must be paid in full). Therefore, the program guarantees a 60 percent savings over what the employer and employees might have paid in taxes in an audit situation. In addition, the sanction negotiation process may reduce the sanction substantially. TVC makes good economic sense when the TSA falls within the scope of TVC, and when the tax exempt employer is in a financial position to pay the employment taxes, the sanction, and the user fee.

WHAT ARE THE PROBLEMS WITH TVC?

Although it is a step in the right direction, TVC is not a panacea for all 403(b) problems. Tax exempts that are run on a shoestring may not be financially able to pay the costs of the program. In addition, the following issues must be considered.

TVC has a limited scope. The first problem with TVC is the scope of the program. Not every defect may be corrected through

TVC, although the program covers a wide range of the potential defects that are likely to be discovered if the IRS audits the plan. The defects that may be corrected through TVC are:

- Discrimination problems
- Distribution problems (including violations of the limitations on distributions, failure to make minimum required distributions, or failure to provide direct rollover options)
- Excess contribution problems (including excess deferrals, violations of the exclusion allowance, and violations of the Code section 415 limitations)
- Defective salary reduction agreements
- Violations of the incidental death benefit limitations
- Failure of annuity contracts to be nontransferable

Conspicuously absent from the list of correctable defects is the "ineligible employer" situation, in which a non-501(c)(3) tax exempt organization has improperly established a TSA. IRS representatives are assuring practitioners that a program to resolve this particular defect is forthcoming.

Similarly, covering individuals who are not eligible employees of the employer cannot be corrected through TVC, nor can situations in which an annuity contract or custodial account was not properly established. Egregious defects, misuse of assets, or defects that have only excise or penalty tax ramifications are not eligible for TVC.

TVC fails to recognize that an employer may have limited involvement with the 403(b) program, and may be considering TVC as an accommodation to its

employees. The TVC Program fails to acknowledge the unusual relationship of employer, employee, and fundholder in the 403(b) setting. Many 403(b) programs are contracts between the employee and the fundholder, with very little involvement by the employer other than to forward salary deferral contributions. These employers allow employees to contract individually with TSA annuity companies or custodians. TVC's approach is to treat the employer as the sponsor of the 403(b) program, which may be quite contrary to reality. This effectively pushes employee-sponsored, non-Title I TSAs out from under the TVC umbrella. [See, Reish and Ferenczy, "The Overlooked ERISA Dilemma (Title I)" 2 *J Pension Benefits* 4 (Summer 1995) p. 82]

For example, TVC requires that the employer contact other involved entities and secure their cooperation. Often, the employer has no ability or standing to accomplish this task. One of the Department of Labor requirements for avoiding Title I coverage of a TSA is that only the employee or his beneficiaries are entitled under the terms of the annuity contract or custodial agreement to enforce its terms. TVC injects the employer into this circumstance, requiring it to negotiate for the participation of the fundholders in the correction process. Even if the fundholders are cooperative—which they may not be—there may be as many of such companies as there are participants in the program. TVC also requires the employer to initiate administrative procedures to ensure that the operational defects will not recur. This may be outside the employer's ability, if the defects were caused by the

fundholder. These types of issues may deter many otherwise willing employers from entering the program.

Similarly problematic is the requirement under TVC that correction be made through employer contributions. If the defect was the fault of the fundholder—which was chosen by the employee—and the employer was innocent, the employer may be disinclined to spend its money making things right. TVC ignores the fact that an individual employee may find his or her TSA to be defective, and have no means by which to correct this problem without the cooperation of the employer.

Finally, an employer hoping to avoid Title I coverage of its plan may find that entering the TVC program, in itself, crosses the "limited employer involvement" threshold, invoking Title I coverage. Therefore, the price of entering the TVC program may far exceed the sanction amount and user fee—it may include the future costs of compliance with Title I of ERISA (such as filing Form 5500 returns, preparing and distributing summary plan descriptions and summary annual reports, and providing for QJSAs if the program has annuities). The DOL has acknowledged this problem—its representatives have stated informally that participation in the TVC will *not* cause the program to be covered by Title I. However, there is no written guidance on point.

As a result, it is possible that only Title I plans will contemplate TVC, leaving employees participating in the other 403(b) programs—which some IRS officials estimated to be 85 percent of the total TSA population—without any practical means of

voluntary compliance.

TVC has no *de minimis* program for small defects. The IRS *Administrative Policy Regarding Sanctions* outlines the circumstances under which a qualified plan defect is considered to be *de minimis*, and can be corrected without the payment of a sanction. 403(b) programs—particularly those not covered by Title I—cry out for similar consideration.

The success of TVC will be dependent on the flexibility of those in the IRS who administer the program. Under the Revenue Procedure, a TVC submission cannot be on a "no-names" basis. In practice, it is possible that some of the "negotiations" for a given TVC may take place prior to the actual submission. However, Revenue Procedure 95-24 provides a fairly rigid procedure under which the employer makes its submission and recommendations for correction and sanction, and the IRS is not bound to accept any of these recommendations. If the employer withdraws from TVC, or if the IRS discovers a defect that was not within the scope of TVC, the case may be forwarded to the Key District Office for examination. It appears—at least on paper—that once the submission is made the employer is faced with a Hobson's choice—take the IRS's offer or be audited.

In order for TVC to work effectively, an employer or its representative must be able to engage in preliminary discussions with the IRS to determine if TVC is an acceptable forum for resolution of the compliance problems. If employers find that the IRS is inflexible and punitive in its approach to this program, they may conclude that there is little incentive to involve the IRS

in the compliance process.

It is important to note that IRS officials are emphatic that the program (and the level of sanctions) will be *very* flexible in practice. TVC representatives have said in both public speeches and private discussions that only the most egregious cases will be charged the maximum sanction. In addition, preliminary conversations with the IRS about our own clients have been very productive and encouraging.

TVC requires complete payment of all employment taxes. Under TVC, "the Service must be assured that the employer has initiated or will initiate procedures for paying the appropriate employment tax obligations." The TVC reviewer has no authority to waive or alter these employment taxes.

It is not entirely clear what this requirement really means. For example, suppose several employees deferred amounts in excess of their exclusion allowance. Without TVC, these excess amounts would be taxable to the employees, and would be subject to FUTA taxes (FICA is always due on deferrals, whether or not they are in excess of limitations). If, however, the case is handled

through TVC, the excess amounts may be allowed to stay in the program, with no taxation of the employee, in exchange for the payment of a sanction by the employer. In that event, are the FUTA taxes still due?

We understand that there is a split of opinion at the IRS on this issue. Some representatives argue that full employment taxes are due even on amounts resolved through TVC; other IRS people believe that cases like the one illustrated above do not give rise to any additional employment taxes, since there is no taxable income to the participants. It is likely that this disagreement will not be resolved until some of the currently pending TVC cases are actually completed.

In a situation in which it is determined that employment taxes in arrears are substantial, a tax exempt employer may find that the TVC price tag is too high. Such an employer will have no choice but to correct the problem prospectively, and hope that the TSA is not audited.

CONCLUSION

Although it is not without flaws, the TVC Program is a good, solid

step in the right direction—even if its applicability is limited to certain types of programs and defects. TVC is a pilot program scheduled to end in October 1996, unless it is renewed. As of this writing, the IRS reports that it has received between 10 and 20 TVC submissions. This is not unlike VCR, which also had a slow start. Practitioners generally wait to see how flexible and workable a new IRS program will be before jumping in with both feet. If the IRS wants TVC to work effectively, it must be very flexible in crafting corrections and sanctions. If the program proves to be too punitive, tax exempt employers will be slow to come forward and apply for voluntary compliance.

Whether or not a tax exempt employer chooses to enter TVC, we strongly recommend that any defects be corrected to the extent possible—at least prospectively. The worst mistake a tax exempt entity can make is to decide that, if TVC is not a viable alternative, it will proceed to make the same mistakes in the future as it has in the past. By correcting the defects and operating in compliance for future years, the employer shows good faith and limits its exposure on audit.