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The Ferenczy Flash

FROM THE LAW OFFICES OF Ilene H. Ferenczy, LLC

The Latest Word in Employee Benefits . . .

FF005 – IS THE IRS BECOMING LESS KIND AND GENTLE IN AUDIT RESOLUTIONS?

Our office recently handled an IRS audit for a client that has led us to believe that resolving problems discovered on audit is becoming more costly than it has been historically. This makes pre-audit plan reviews and problem resolution even more important than they were before.

What Happens When the IRS Finds a Problem

For those who have never experienced an IRS audit of your plan, let us give a quick summary of what happens if the IRS discovers a problem with the plan. Certain plan errors (called "disqualification failures" by the IRS) threaten the plan's tax qualification – that is, they could lead to the plan losing all of its favorable tax benefits, such as deductibility (or tax deferral) of plan contributions, the tax-exempt status of the trust that holds plan funds, and the ability of terminated participants to roll over their benefits to other plans. When such an error is discovered on audit, the IRS generally offers plan sponsors an opportunity to correct the problem and to enter into an agreement – called a Closing Agreement – to retain the plan's tax-qualification. Under this agreement, the plan's problem is identified, the means used to correct the problem are outlined, the IRS agrees not to disqualify the plan, and the plan sponsor agrees to pay a penalty (called a "sanction").

When Closing Agreements (often called "CAPs" after the Closing Agreement Program) first became common in the 1990s, the sanctions were commonly quite punitive. However, changes in the IRS procedures mandate that sanctions are not to be excessive and should bear a reasonable relationship to the nature, extent, and severity of the failures. In determining the sanction, the IRS has noted that several factors are considered:

- The steps taken by the plan sponsor to ensure that the plan had no failures;
- The steps taken to identify the failures that may have occurred;
- The extent to which correction had progressed before the examination was initiated;
- The number and type of employees affected by the failure;
- The number of nonhighly compensated employees who would be adversely affected if the plan's qualification status were revoked;
- The period over which the failures occurred;
- The reason for the failures; and
- Whether the plan has received a favorable determination letter from the IRS or has adopted a preapproved plan.

In our experience in Atlanta over the past 10 years, the sanctions imposed have been reasonable in light of the nature, extent, and severity of the problem discovered. Sanctions of between $5,000 and $10,000 were pretty much universal. In fact, the largest sanction we saw for our clients during this period was $15,000.

What Changed?

Our recent case involved a company with approximately 60 participants with assets of approximately $10 million in the plan. Two errors were discovered during the audit. First, the client could not prove that it executed one of the technical amendments required since it originally received its favorable determination letter. These amendments are required for all plans because of a change in the law or a modification of regulations. As is quite often the situation, the technical amendment to the plan document in this case had no impact on actual plan operations. The second error involved an inadvertent excess allocation of matching contributions to some, but not all, of the company's highly compensated employees. The total amount of the excess allocations was approximately $7,000 over two years.

When we went to meet with the IRS (the auditing agent, his supervisor, and the CAP Coordinator for the Southeast Region), we were confident that these two errors would be looked upon by the IRS as minor, and that the sanction would fall within the normal range experienced over the last few years.

Imagine our surprise when the IRS proposed a sanction of in excess of **$35,000** for our client!

The IRS engaged in a process that is outlined in its procedures but that, in our experience, had not been used for several years. Under that process, the practitioner is required to calculate for the IRS an estimate of the taxes that would be paid by the participants, the corporation, and the trust if the plan were to be disqualified. This is called the Maximum Payment Amount or MPA. The sanction under CAP is supposed to be a negotiated percentage of the MPA. However, in our experience over the last decade, we have been asked to calculate an MPA only once, and in that situation, the calculation was basically disregarded after it was completed.

The $35,000+ figure proposed by the IRS represented 5% of the estimated MPA for our client.

When we expressed to the IRS representatives that we were appalled at this high sanction for such small, relatively minor errors, we were advised that the proposed sanction was in line with those amounts charged by the IRS across the country. Furthermore, we were told that the sanction for the failure to adopt the amendment would have been in excess of $9,000 had it been the only failure. Again, the proposed sanction was the highest amount we have seen and well in excess of what we believe has been levied in the past.

After a significant amount of work, we were able to negotiate a somewhat lower sanction. However, we were unable to get the IRS to consider a sanction comparable to the sanctions seen in years past. We find the extreme nature of the penalty for these minor errors particularly disturbing in light of the current economy and the strain small businesses are under at this time.

An informal survey of other practitioners in Atlanta and elsewhere has led us to believe that our experiences of the past 10 years are not unique. Other practitioners were equally amazed at the level of this proposed sanction.

What We Recommend:

- 1. ***Don't face an audit alone***. We strongly recommend that you notify your third party administrator, accountant, or attorney immediately if and when you receive an audit notice. Any action that can be taken in advance of the audit to minimize the outstanding and undiscovered failures will help in the audit process. The IRS has expressly stated that an atmosphere of compliance is very important in the review of the plan. Furthermore, the IRS and the Department of Labor often perceive a lay person's inability to respond properly to their requests as being a lack of cooperation (when it is often just a matter of information not being readily available or a misunderstanding of what is needed). Last, it is not uncommon for the IRS to identify something as a failure that arguably is not. (For the client we discussed above, a third issue was dismissed during the conference on the basis that it was not a qualification failure or an error of any kind.) Let the pros handle this for you.

- 2. ***Consider a triennial compliance review.*** The cost of correcting errors before an audit is an even bigger bargain now than before, compared to the cost of correcting the problem pursuant to a Closing Agreement after an error is discovered during an audit. IRS procedures provide for correction processes that can protect a plan from disqualification on audit, thereby preventing the sanctions necessary to keep the plan qualified. Consider having a professional review the plan on a triennial basis to find problems before an IRS audit is looming. These types of reviews (called compliance reviews) are becoming more common. (If your plan must be audited annually by an independent auditor, that process is not the same as a compliance review. Your accountant will focus on the financial aspects of the plan. You may want to have another professional review the plan focusing on its full and actual operations.)

- 3. ***Take compliance seriously***. We know that it may seem that you are deluged with paperwork and rules, but both the IRS and the Department of Labor are actively auditing plans to ensure that participants' benefits are not at risk. Pay attention to what your service providers tell you to do, and do it. If you have questions, ask them. If you discover an error, fix it. Do not ignore anything that has to do with your plan. The government will not excuse your mistake just because it was unintentional.

If you have any questions, please call us.

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