



The Ferenczy Flash

FROM THE LAW OFFICES OF Ilene H. Ferenczy, LLC

The Latest Word in Employee Benefits . . .

THE IRS'S SEP AND SIMPLE-IRA AUDIT INITIATIVE: PICKING ON THE SMALL FOLKS

The IRS has initiated an audit program to examine Simplified Employee Pensions (SEPs) sponsored by small employers. Not surprising to those of us who work with qualified retirement plans for a living, many of these plans have significant compliance problems. What is surprising, however, is the IRS's approach to resolving these problems.

When a qualified plan is audited and an error is found, the IRS offers to resolve the error under the Closing Agreement Program (CAP). A CAP resolution includes three elements: (1) correction of the error; (2) a written agreement between the taxpayer and the IRS under which the IRS agrees not to "disqualify" the plan – that is, to remove all of the tax benefits from the program retroactively; and (3) the payment of a penalty or "sanction" by the taxpayer.

The IRS is following the same process for SEPs. The IRS calculates the amount of tax that the plan sponsor would have to pay – both as a company and as an individual – if the SEP was disallowed (called the Maximum Payment Amount or MPA). The IRS then proposes to charge the sponsor some percentage of that tax to enter into CAP.

What could the damage be? In the case of one company that recently became our client, the IRS's initial offer was \$50,000. In another case, the final result after significant negotiations was \$7,000, which seems reasonable until you know one important subsidiary fact: the company owner's annual income was about \$80,000, so that this sanction was about 9% of his total annual bottom line.

In our experience, SEP sponsors try to handle these audits alone because they cannot imagine that any noncompliance exists or that the IRS will treat any inadvertent error harshly. Both of these assumptions appear to be incorrect.

Our office is lobbying to both the regional supervisors of the IRS as well as the National Office in Washington to change the tone of these reviews and to eliminate these harsh penalties. We are also asking benefits organizations to which we belong to voice objections to the IRS and the lawmakers about this problem.

In the meantime, we all need to reach out to clients that sponsor SEPs to tell them that there is a real concern about their plans being audited by the IRS, and that there are a few simple steps they can take now to make sure that their plans are in compliance. They may discover errors that can be corrected easily under the IRS's voluntary correction program immediately. Proof of such corrective procedures will protect plan sponsors even if they are later audited. If plan sponsors

receive an audit notice, they should immediately have someone with benefits knowledge pre-review the plan to identify any compliance errors that can be corrected before the auditor walks in the door. Second, they need to be advised that this is not a minor matter to be shrugged off, but one that could expose them to significant penalties.

The auditors, themselves, seem very agreeable and friendly. However, the managers that set the amount of the penalties appear to be unsympathetic, and bent on charging penalties that are commensurate with those being charged elsewhere in the country. The taxable income of the plan sponsor is not relevant, we've been told. The fact that SEPs are designed to be self-administered is also not important to the IRS. What is important is the existence of any errors and the amount of the MPA, which is generally a disproportionately large number.

In many cases, the SEP audit is initiated because of the filing of a Form 5500 that has questionable information. It is important to note that Form 5500 is commonly not required for a SEP if the plan sponsor provides certain information to the employees. Therefore, the mere filing of a Form 5500 for the plan may unnecessarily expose a client to an IRS audit. We recommend that Form 5500 preparers review the application of the filing rules to each SEP to make sure that any filing is actually necessary.

Please call one of our lawyers if you have a client who is under audit or if you would like assistance in reviewing a SEP for compliance.

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