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EMPLOYEE PLAN IRS EXAMINATIONS

A letter from the IRS ... Your retirement plan is being audited ... Although you think you have done everything right, followed the advice of your trusted advisors and service providers, and tried to avoid all the red flags that they warned you about, you've been randomly selected. Most likely there is nothing to worry about, but you won't feel at ease until it is over.

This guide will take you through the examination process, from the receipt of the letter through the closing letter, to help you better prepare in case you get the dreaded letter saying that you've been chosen.

INTRODUCTION AND OVERVIEW

Plan sponsors must ensure that their plan documents remain in compliance with the Internal Revenue Code both in form and operation.

The IRS can audit or examine a plan at any time to ensure compliance with section 401(a) of the Code. Red flags on the 5500 or on targeted compliance questionnaires can trigger an IRS examination, but in many cases plans are randomly selected for an IRS audit.

Receipt of the IRS information request letter

The IRS examination program strives to ensure compliance with the plan qualification provisions of the Internal Revenue Code and with the terms of the plan document. As a result, the documents requested focus mainly on:

1. The plan document
2. Contributions and their allocation
3. Eligibility and eligible compensation
4. Discrimination and top-heavy testing
5. Compliance with legislative limits
6. Distributions and vesting
7. Plan loans
8. Form 5500

Upon receipt of the letter, it is important to gather all the requested documents and label them in the order in which the letter requests them. Sample IRS Examination Information Request Letters for 401(k) plans, profit sharing plans, money purchase plans, Employee Stock Ownership Plans (ESOPs), defined benefit plans, and cash balance plans can be found on the IRS website at: https://www.irs.gov/retirement-plans/ep-examination-process-guide-section-4-communications-during-examination-sample-information-document-requests.

Location and date of the Audit

If the date proposed by the IRS is not possible due to vacations, unavoidable previous commitments, or other complications, rescheduling the date is possible, as well as requesting that the audit take place at a service provider's location. If the audit takes place at a location other than the plan sponsor's place of business, the agent will need to document the reason. One acceptable reason to conduct the audit at a different location would be that the agent's presence would disrupt the business operations due to lack of space. In those cases, the IRS agent will perform the same procedures required for other field examinations and will conduct a walk-through of the plan sponsor's premises.

Power of Attorney: Form 2848

If a service provider will represent the plan sponsor during the audit, a power of attorney form must be submitted to the agent in advance. Form 2848, Power of Attorney and Declaration of Representative, is used to authorize an attorney, certified public accountant, enrolled agent, enrolled actuary, enrolled retirement plan agent or other qualified person to represent a taxpayer before the IRS. A person who has the ability to bind the plan sponsor in legal action must authorize the representation.

Scope of the examination

Generally, the agent will review the information provided and identify three areas that will be the focus of the examination, based on where the agent perceives the plan has higher risk of noncompliance. The agents are able to address up to two additional issues without managerial approval. When the agent finds an error, the agent generally opens the previous and subsequent plan years with respect to that issue only. If the scope of the focused examination needs to be expanded to more than five issues or to additional years, the agent's group manager will have to approve the expanded scope of the examination.

PROCESS AND PROCEDURES

Pre-Audit steps

The initial Information Document Request attached to the appointment letter will request certain documents be sent to the agent in advance.

Plan document

In most cases, the agent will want to review the plan document prior to the scheduled field visit. As part of the pre-audit analysis, the agent will review the adoption agreement for a pre-approved plan, the basic plan document, the opinion or advisory letter for the pre-approved plan, and all amendments in effect for the year under examination. The agent will first ascertain that the plan sponsor has adopted the plan and the required amendments by the appropriate due dates to comply with both statutory and administrative changes.

Form 5500

The agent will review the Form 5500 filing for completeness and to identify any red flags, unusual items, prohibited transactions, or indications of unrelated business income.

Initial interview

During the initial interview, the agent will obtain an understanding of the plan-related business operations and accounting records. The interviewee should be a person having sufficient knowledge of the plan's financial processes, service providers and operations. To prepare for what types of internal control questions the plan sponsor should be ready to answer, please refer to the sample IRS Internal Control Questionnaire provided in: https://www.irs.gov/retirement-plans/ep-team-audit-epta-program-internal-control-questionnaire.

The examination: Field work

The primary objective of an IRS audit is to determine if the plan is operated in accordance with the Internal Revenue Code and the plan document. Based on the initial review of the plan document, the agent will have summarized and have a good grasp on the plan provisions regarding:

- Eligibility/participation/coverage
- Contribution allocations
- Distributions and vesting
- Discrimination testing and top-heavy status
- Other plan features, such as participant loans

Based on the review of all the information provided by the plan sponsor, the agent will identify three risk areas and test a sample of the plan administration related to them.

Resolution of issues and closing the examination

When the agent discovers operational errors as a result of the examination and the plan sponsor agrees with the findings, the errors can usually be corrected under the Employee Plan Compliance Resolution System (EPCRS), which can be found at: https://www.irs.gov/retirement-plans/correcting-plan-errors. Agreeing to the issues and their resolution often results in a Closing Agreement. Insignificant errors can be corrected and sometimes result in no fines or penalties. Other errors generally result in fines that are greater than what the sponsor would have paid if it had submitted an application through the Voluntary Compliance Program (VCP) as provided in https://www.irs.gov/retirement-plans/correcting-plan-errors-fill-in-vcp-submission-documents.

If the plan sponsor and/or its representative do not agree with the agent's findings, believe the agent is being unreasonable, or otherwise believe that the agent is misinterpreting or misapplying the available IRS guidance, they can request a conference with the agent's manager. The conference provides an opportunity to revisit the facts, documentation and backup for the issue in question, and the applicable law. If the manager's objective review of the issues does not result in a resolution at the conference, the manager can request Technical Assistance, a process in which the Area Counsel will provide an interpretation of the law to advise and assist agents and managers on technical and procedural issues.

If the issue cannot be resolved through the Technical Assistance avenue because the issue is highly complex and unusual, or insufficient guidance is available, then the manager can request Technical Advice through a formal process where written guidance in the form of a memorandum furnished by the Office of Associate Chief Counsel for Tax Exempt and Government Entities. These issues tend to be of a high-profile nature and can take years to be resolved. For that reason, Employee Plan (EP) agents are required to explore all resolution processes before disqualifying the plan or submitting the case for Technical Advice. Ultimately, the goal is to preserve the plan's qualified status and the participants' retirement benefits.

When a plan is disqualified, 1) the trust loses its tax-exempt status and must file a Form 1041, U.S. Income Tax Return for Estates and Trusts, 2) must pay income tax on trust earnings, 3) employees must include in income any vested employer contributions for the years that the plan is disqualified, 4) the employer deducts vested contributions in the year that they are includable in the employees' income and also pays payroll taxes on the contributions as applicable. Any distributions from the disqualified plan cannot be rolled over to another qualified plan or IRA. However, negatively affecting participants who did not have any involvement in the plan-disqualifying errors is not the goal of the IRS. Generally, the error(s) that caused the disqualification can be corrected, and the IRS will re-qualify the plan. In many cases, the effect of plan disqualification is used only as a starting point to compute sanctions assessed to the employer for the disqualifying errors.

Qualification errors: Self-Correction, Audit CAP, Closing Agreement

Qualification errors are generally violations of IRS rules required to maintain a plan's qualified status.

Some examples of qualification errors are:

- If the employer failed to timely amend the plan for a law change
- If the plan fails to satisfy the minimum coverage requirements
- If the contributions or benefits are determined to be discriminatory in favor of highly compensated employees or owners
- If the plan fails to satisfy the minimum vesting standards
- If the contribution or benefits for the benefit of one or more participants exceed the maximum permitted levels
- Failures to follow the terms of the plan document

Qualification errors or failures can be corrected using EPCRS programs including the Self-Correction Program (SCP) and the Audit Closing Agreement Program (Audit CAP). The SCP does not involve IRS approval but can only be used to correct insignificant operational qualification errors found during an examination. There is no sanction or closing agreement involved for this. Using this method requires that the plan sponsor establish practices and procedures to ensure the plan operates properly. Audit CAP is a method of correcting qualification errors discovered by the IRS auditor that requires a sanction payment to the U.S. Treasury and that the plan sponsor enter into a closing agreement with the IRS. Audit CAP sanctions are negotiated and they are always higher than what it would have cost to voluntarily submit a VCP application to the IRS. The goal is to create an incentive for the plan sponsor to come forward rather than taking the risk of paying an Audit CAP sanction.

EMPLOYEE PLANS COMPLIANCE RESOLUTION SYSTEM (EPCRS)

In most cases, the plan sponsor and the agent take advantage of the Employee Plans Compliance Resolution System to reach an agreement that is fair and reasonable. If the plan sponsor and the agent are unable to reach an agreement, the plan sponsor can request a meeting with the manager, who has increased authority and discretion to use EPCRS to reach an agreement and a conclusion. Meeting with a manager is encouraged, but not required, before moving on to the Appeals Process. When an agreement can't be reached, the plan sponsor will receive an Issuance of Revocation or Nonqualification letter to proceed to the Appeals Process.

Appeals procedures

To request an appellate conference, the taxpayer or its representative must file a written protest stating the disputed issues. The protest should be sent within the limit specified in the Revocation or Nonqualification letter received with the examination report and contain the following:

1	Plan sponsor's name and address
2	A statement that an appeal of the examination findings is being submitted to the Appeals Office
3	The date and symbols from the letter showing the proposed changes and findings for which there is no agreement
4	The tax periods or years involved
5	An itemized schedule of the changes for which there is no agreement
6	A statement of facts supporting your position on any contested issue
7	A statement stating the law or other authority that supports the plan sponsor's position

For further information about the Appeals Process and beyond, please refer to the IRS website: https://www.irs.gov/retirement-plans/ep-examination-process-guide-section-7-appeals-appeals-procedures-appeals-process.

The Employee Plan Compliance Unit (EPCU)

The IRS uses the EPCU to reach out to numerous plan sponsors with less burden than a full examination or audit. Compliance checks are limited to a single issue and handled through correspondence. The EPCU also conducts questionnaire projects to better understand issues affecting retirement plans and identify emerging issues.

To date, the EPCU has:*

- Contacted over 37,000 pension plan sponsors
- Conducted over 70 projects and 41,000 compliance checks
- Recovered approximately $100 million in corrections
- Assessed over $15 million in taxes and sanctions
- Made over 1,300 referrals to Examinations, EP Exams or Rulings and Agreements, Large Business and International Division, Small Business/Self-Employed Division, Wage and Investment Division, Employee Benefit Security Administration or the Pension Benefit Guarantee Corporation

During FY 2018, the IRS has stated that it will continue to pursue the same issues of noncompliance identified during 2017 as part of its audit initiatives, which included:

1. Traditional Casework — involving risk-based audits and referrals
2. Specialty Programs — targeting large cases, multiemployer plans, 403(b)/457 plans, and cash balance plans
3. Focused Supplemental Work — dedicated to emerging issues, small plans and IRAs

For detail on past accomplishments and future initiatives of the EPCU, please refer to: https://www.irs.gov/pub/irs-tege/tege_fy2018_work_plan.pdf

* As of June 29, 2018.

Tipping the scales from prevention to detection: How to be ready for an IRS examination of your retirement plan

When it comes to IRS audits, "an ounce of prevention is worth a pound of cure," as Benjamin Franklin so wisely posited. The cure, in this case, most often requires restitution of deposits to your 401(k) or 403(b) plan plus earnings, and in some cases, a sanction paid to the IRS. Restitutions make participants whole by putting them where they would have been financially if the error had not occurred, but the deposit to the plan and the penalties often come as a surprise that was not in the plan sponsor's budget. Avoiding the need for a correction is the best alternative, but how does an employer keep its plan operations compliant in such a complex and regulated environment? As the African proverb says, it takes a village, and a collective effort of specialists, both within the plan sponsor's personnel and dedicated specialists, such as the third party administrator, the plan's financial statement auditor, the investment advisor, the plan's ERISA attorney, as applicable. At a minimum, the plan sponsor should ensure that through self-audit or through the specialists it engages, the following 10 items on the list of common errors found by the IRS are administered in compliance with the plan document and the Internal Revenue Code (IRC):

1. Plan document — Has the plan document been timely updated?
2. Census — Is the census information provided to the third party administrator complete and accurate?
   - a. Does the census include all employees, including those who are not yet eligible or who chose not to participate?
   - b. Do the gross wages provided in the census reconcile to the total gross payroll?
3. Definition of compensation — Was the compensation used to calculate contributions consistent with the plan document?
   - a. Have the control totals for every type of excluded compensation been reconciled to the original source payroll reports?
   - b. Has pre-eligibility compensation been properly identified?
4. Timely deposit of deferrals — Have deferrals been deposited in a consistent pattern and as soon as the dollars can be segregated from the employer's funds.
5. Contribution computation and limits — Have any annual dollar limitations imposed by the plan or by the Internal Revenue Code been exceeded?
   - a. Common ownership of separate entities is a risk area
   - b. Multiple plans sponsored by one entity is a risk area
   - c. Separate payrolls for separate locations of the employer is a risk area
   - d. Was a true-up match deposited, if required?
6. Discrimination testing
   - a. Was the discrimination testing performed with accurate payroll and contribution data?
   - b. Were highly compensated and key employees accurately identified?
     - i. Family relationships and attribution are risk areas
   - c. Was a top-heavy contribution deposited if required?

7 Eligibility

- a Have newly eligible employees been identified?
  - i Part-time employees and plan mergers are risk areas
- b Have employees been properly notified of their eligibility?

8 Participant loans

- a Does the plan permit loans?
- b Did the repayments start timely?
- c Did defaulted loans receive a 1099-R?
- d Do the terms of the loan follow IRC Section 72(p) and the plan document?

9 Distributions

- a Required Minimum Distributions
- b Hardship distributions
  - i Is there sufficient documentation for the hardship reason?
  - ii Was the maximum available participant loan taken?
  - iii Is there documentation that no other sources of financing were available to the participant?

10 Fidelity bond

- a Did the sponsor obtain the required ERISA fidelity bond?
  - i Generally for 10% of the plan assets up to $500,000
  - ii The fidelity bond is not the same as fiduciary liability coverage

Some plan sponsors are selected for an IRS audit based on red flags that result from the answers on Form 5500. Other IRS examination selection methodologies include:

- Risk-based compliance audits — based on industry and plan type for market segment specific examinations
- Learn, Educate, Self-Correct, Enforce (LESE) Projects — small projects based on judgment sampling
- Referrals from the DOL
- Employee Plan Team Audit (EPTA) — large case audit selection
- Abusive transaction projects
- The results of these EP Examination Projects in prior years can be seen at: https://www.irs.gov/retirement-plans/ep-examination-projects and https://www.irs.gov/retirement-plans/ep-examination-projects-learn-educate-self-correct-and-enforce-lese-projects.

Other than the selection methodologies above, plan sponsors can also just be randomly selected. Regardless of what you perceive your chance of selection might be, it is always better to be safe than sorry when it comes to IRS examinations. It takes a village to ensure that your plan is safe and compliant, rather than sorry, so make sure you have the right team in place to ensure that your plan is compliant. An ounce of prevention is worth a pound of cure.

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About the author

Maria has more than 20 years of public accounting experience, including two years spent with an international accounting firm in Washington, D.C. As the Director in charge of retirement plan services at Belfint, Lyons & Shuman, the largest locally owned CPA firm in Delaware, she is responsible for planning, supervising and reviewing audits of single- and multi-employer benefit plans. She also provides independent retirement plan design consultations to clients. As a result of Maria's close working relationships with local ERISA attorneys, she is frequently asked to perform the final audit of terminated benefit plan financial statements for national companies undergoing bankruptcy proceedings in Delaware.

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Maria graduated Cum Laude from Georgetown University with Bachelor of Science Degrees in Accounting and International Management.

If you have any questions on this white paper or would like more information, please contact Maria Hurd directly at 302-573-3918.

* As of June 30, 2018.