Are you ready for an IRS audit?

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Few things are as nerve-wracking as a request from the Internal Revenue Service (IRS) to review a plan’s historical operations and documentation. Do you know how well your plan would fare under the scrutiny of an audit? While you may not know the answer to that question until it actually occurs, as a plan sponsor, it is in your best interest to be prepared for an audit.

How are plans selected for an audit?

Generally, selection for an audit is random. The IRS may select a group of plans with similar characteristics. For example, past IRS audits have focused on plans with self-employed individuals, plans with investments in nonparticipant loans, and plans that have terminated without filing Form 5310. The IRS also has regular audit initiatives, and selection may be based on industry, geography, or plan type. The one million Forms 5500 filed each year provide the data that makes it possible for the IRS to group plans by business code, number of participants, plan assets, fee levels, and other defining characteristics.

Since selection is often random, the best way to prepare for the possibility of an audit is for plan sponsors to understand what compliance issues are currently being reviewed and documented by the IRS, how to react to a request for information from the IRS, and how best to prepare in advance.

Common compliance failures

Audits are all about compliance, and the IRS agent auditing your plan is looking for lapses in compliance. The following are the most common compliance failures identified by the IRS:

1. Documents — Plan sponsors must adopt amendments to comply with existing law within an allotted time frame. The failure to do so results in disqualification of the plan.

2. Eligibility — An IRS audit may discover groups of participants who have been improperly excluded from participation. This error frequently occurs when an employer is involved in a merger or when eligible part-time employees are excluded from a plan. When an eligible group of employees is determined incorrectly, there are likely to be issues with nondiscrimination testing and employer contribution allocations. In such cases, testing from prior years will need to be reworked, and the employer may need to make employees whole for missed contributions, including 401(k) deferrals, matching contributions, and profit sharing contributions.

3. Compensation — The definition of compensation in a plan document affects many things, including employees’ 401(k) deferral elections, employer contribution calculations, discrimination testing, and highly compensated employee determination. Dozens of components can make up a participant’s compensation, and with frequent updates to already complex payroll systems, deciding which pay fields to use when determining compensation under the plan can be challenging. Mistakes may result in IRS compliance issues.

4. Late deferral deposits — One of the most common failures seen in 401(k) plans is the late deposit of 401(k) deferrals. The regulations are clear that employers must deposit 401(k) elective deferrals to the plan’s trust by the earliest date the deferrals can reasonably be segregated from the employer’s general assets; although, determining the earliest date will vary among employers depending on the facts and circumstances. Employers that fail to segregate and deposit deferrals on a timely basis face the ire of the Department of Labor (DOL) and the IRS, as this failure:
   a) Is a fiduciary violation, which is subject to DOL civil penalties.
   b) May be a violation of a plan’s terms, which is a plan qualification issue that may be addressed by an IRS correction program.
   c) Enables the prohibited use of plan assets by the employer, a transaction that requires the filing of Form 5330 with the IRS and the payment of an excise tax.

It is possible for employers to correct late deposits using the DOL’s Voluntary Fiduciary Correction Program (VFCP) and the IRS’s Employee Plans Compliance Resolution System (EPCRS). The general premise of both programs is to restore participant account
balances to the position they would be in if the late deposit had not occurred (by calculating and depositing “lost” earnings on the late deposits). These programs have different goals, and they are not interchangeable. The goal of the DOL's VFCP is to ensure that the employer isn't subject to DOL civil penalties. The goal of the IRS's correction programs is to ensure that the plan doesn’t lose tax benefits arising from its qualified status. It is critical that an employer know what its objectives are before deciding which program to use. An employer may use both the DOL and IRS programs if it has a dual objective of avoiding the imposition of the DOL’s civil penalties and the IRS’s revocation of its plan’s qualified status.¹

5. **Vesting** — The IRS has found employees greater than 65 years old (the upper limit for Normal Retirement Age in qualified plans) who are not 100% vested, as well as the incorrect application of vesting schedules and service-counting to employees. Employees paid out under an incorrect vesting schedule will need to be made whole by the plan.

6. **Accelerated deductions** — The IRS reports a growing trend among employers claiming a deduction on a current year tax return for 401(k) contributions made in the subsequent year. The IRS classifies this as a “significant violation” and an “abusive transaction.” The IRS is focusing on unwinding these transactions.

7. **Loans** — A typical violation involves an employee not making payments after the loan is granted and not paying a 10% excise tax on the unpaid loan balance. Loans are subject to income tax in the year of default unless reported under an IRS correction program.

8. **Distributions** — Required minimum distributions (RMD) generally must be made to participants who have reached age 70½. When an RMD is not made, a 50% excise tax is assessed on the participant. In the case of hardship distributions, the IRS reports a trend among plan administrators of not receiving adequate documentation to support the granting of hardship withdrawals. In addition, plans may fail to suspend the employee's 401(k) deferrals for six months following a hardship withdrawal, as required by the regulations.

This list of common compliance failures is most likely where the IRS will start if your plan is selected for an audit. Each of the failures may cost the employer in multiple ways: It will take staff time to research, review, communicate, and correct the failure; many corrections involve restoring balances or earnings to the plan participant(s) by the employer; and certain corrections require filing fees with the IRS or payment of a penalty. A number of failures, such as missed RMDs or missed loan repayments, will also cost plan participants money in the form of taxes.

**What to do when contacted by the IRS?**

Plan sponsors should respond promptly to all IRS inquiries, even when the inquiry is not related to a plan audit. Failing to respond to requests that are not related to an audit can lead to an audit. In 2010, the IRS sent a questionnaire to a random sample of 1,200 401(k) plans. The questionnaire requested information about demographics, plan provisions, compliance testing, and other areas of plan administration. Although not an audit, many of the questions had multiple parts or asked for three years’ worth of data. Collecting the information to complete the form could easily take a full day; nevertheless, it was imperative that plan sponsors respond to the questionnaire. Twenty-four plans did not complete the questionnaire, and each was subjected to a full-scale IRS audit.²

Even when you know the notice you just received from the IRS is incorrect, you need to respond. In recent years, the IRS has sent out erroneous communications regarding Form 5500 filings to multiple plan sponsors. In 2010, with implementation of the newest version of the EFAST electronic filing system, erroneous notices were generated indicating that requested extensions for filing were declined. In 2012, there were reports of penalty notices being sent to plan sponsors in error. Whether or not a notice from the IRS is incorrect, it is important that a plan sponsor respond timely and in accordance with instructions on the notice. If you receive a notice, respond promptly, as many of these notices have specific deadlines. For example, notices regarding the late filing of Form 5500 require a response within 30 days.

**Do you have a game plan?**

If the IRS selects your plan for audit, you will be notified by a letter and a phone call. The notification may request plan documents, payroll records, and other electronic records. An initial conference between the employer and the IRS provides the opportunity for both parties to discuss the items to be reviewed and any additional documents needed, as well as the time and place of the audit.

In anticipation of an audit, a plan sponsor should take the following steps:³

1. Have all plan documents available and organized. This includes plan and trust documents, adoption agreements, summary plan descriptions, opinion or determination letters, and agreements with service providers.

2. Arrange to have appropriate plan representatives available. This may include employees, plan trustees, third party providers, or plan representatives who are qualified to represent the employer before the IRS.

3. Be prepared to explain internal processes, reviews, and controls. For example, how are changes to plan terms communicated throughout the organization, including your benefits and payroll personnel? Who verifies that participants’ deferrals are deposited in a timely manner?

4. Understand the terms of your plan. It increases the credibility of those responsible for a plan’s administration when they can...
demonstrate a good understanding of the plan’s provisions. Plan sponsors must also know how plan provisions relate to the operation of the plan. For example, how is employee eligibility determined, and how are employees notified of eligibility? How are loan and hardship distribution provisions communicated to employees, and how are they reviewed and documented by the employer?

5. Have the requested compliance testing results and backup data available. This includes tests such as IRC 410(b) coverage, ADP/ACP testing, and top heavy testing.

6. Provide information about related employers. If your company or the owners of your business have ownership interests in other entities, an IRS agent will want to determine if a controlled group relationship, a possible affiliated service group, or a qualified separate line of business exists. Making this determination requires knowledge of ownership information of each company, as well as the operating relationships between companies.

Sponsors should prepare themselves for a plan audit before being contacted for one. It is a good practice to conduct regular plan compliance reviews or self-audits. These reviews give a plan sponsor the opportunity to establish or modify internal procedures and controls and educate employer personnel about their roles and responsibilities. Self-audits may also demonstrate good faith on the part of the plan sponsor to any government agencies that might initiate an audit.

A thorough self-audit will review all plan documents, participant disclosures, and administrative forms to ensure accuracy and compliance with regulatory requirements. The items noted in the common compliance failures listed previously would be addressed, as well as government form filings. Administrative practices, procedures, and plan-related relationships among human resources, finance, and payroll staff should be reviewed. Fee agreements and responsibilities of outside vendors should also be reviewed to ensure that all required tasks are being completed by the appropriate party.

Self-audits can save money in the long run

If deficiencies in plan operation or documentation are found prior to selection for an audit, a plan sponsor has an opportunity to voluntarily make corrections at a significantly lower cost than if those same deficiencies are found and resolved during an IRS audit.

The IRS correction program, the Employee Plans Compliance Resolution System (EPCRS), is intended to promote voluntary compliance with the Internal Revenue Code (IRC). It provides for reduced fees for voluntary corrections and corrections made promptly. EPCRS also encourages plan sponsors to establish and follow administrative procedures, and the program provides for consistent remedies to some of the most common plan failures.

EPCRS is divided into three groups: the Self-Correction Program (SCP), the Voluntary Correction Program (VCP), and the Audit Closing Agreement Program (Audit CAP).

SCP is available to correct insignificant operational errors at any time and significant errors before the end of the second plan year after the error occurred. Typical errors corrected under SCP include excluding eligible participants, loan failures, and not following the terms of the plan. Determination of significance is based on the facts of the plan failure, including the number of other failures in the period, the number of participants affected, the percentage of plan assets involved, and whether correction was initiated soon after discovery.

In order to use SCP, a plan must have established procedures designed to promote compliance with the law. The IRS notes that a plan document on its own is not evidence of established procedures. Using SCP does not require a filing with the IRS, nor is any penalty paid by the employer to the IRS. Employers who self-correct should maintain documentation of the failure, the steps taken to remedy the failure, and the changes in processes or procedures implemented to avoid the failure in the future.

VCP is available to correct significant operational failures outside the two-year time frame allowed by SCP. This includes plan and document failures. VCP is also used to correct demographic failures, including plan failures of IRC 401(a)(4) general discrimination and IRC 410(b) coverage, which typically require a retroactive amendment and increasing benefits within the plan by the employer. Compliance fees for a VCP submission are determined by plan size. Small plans with fewer than 100 participants pay from $750 to $2,500, while the largest plans with more than 10,000 participants pay a submission fee of $25,000. Reduced fees are available for VCP submissions that contain required minimum distribution failures, plan document failures, and loan failures.

Audit CAP is used when the IRS identifies a qualification failure while the plan is under audit, and that failure has not been previously addressed under SCP or VCP. A sanction is levied on the plan sponsor and is based on the maximum payment amount as determined by the IRS. The maximum payment amount is the amount the IRS could collect in taxes if the plan was disqualified. If the plan is disqualified, the IRS may disallow deductions for employer contributions made in prior years, employee deferrals from prior years may be included in participant income, and rollovers out of the plan may be reclassified as income to the former participants. Even though this penalty is negotiated between the IRS and the plan sponsor, the starting point for the negotiation is so exorbitant that prudent employers should look to correct plan failures prior to those failures being found by the IRS.
In perspective

While an IRS audit may not happen to you this year, next year, or ever, being prepared will save you valuable time and money. Knowing what to look for is the first step in preparing your plan for a successful audit. The adage “practice makes perfect” applies to audits. Practice for an audit by performing a self-audit. This will replicate the process of an IRS audit before one occurs. If you are aware of the most common pitfalls in plan administration and how to correct them, it is well worth the effort to seek out and fix plan problems before the IRS finds them.

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1 https://www.irs.gov/Retirement-Plans/Voluntary-Correction-Program-General-Description

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