

# PUBLICATION

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## IRS To Focus on Qualified Retirement Plan Failures

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Qualified retirement plans are generally exempt from federal income tax, but nevertheless must comply with reporting and other requirements related to how they are administered. Further, as with individuals and entities subject to federal tax laws, qualified retirement plans are vulnerable to audits by the IRS. On its website, the IRS has clearly stated its intention to conduct audits this year to analyze operational features of retirement plans. According to Monika Templeman, the Director of Employee Plans Examinations, "There will be a prominent [employee benefit] examination presence in the Retirement Plans Community of benefits practitioners, plan sponsors/employers, and plan participants/employees." She states further that the IRS will increase its focus on enforcement this year.

When the IRS discovers plan failures through an audit, substantial penalties may be imposed on the plan sponsor, or the plan could lose its tax-qualified status. The penalties are generally paid by the plan sponsor, and no deduction is allowed for the amount of the penalty. Losing tax-qualified status can be significant, as prior corporate deductions are reversed, the plan trust becomes taxable, and all vested benefits are immediately taxable to the participants and cannot be rolled over to an IRA.

### Top Plan Failures

The IRS has listed on its website the most common failures in qualified retirement plans. The apparent purpose of the listing is to raise awareness of the more common failures so that sponsors may have an opportunity to take corrective action and perhaps begin steps towards voluntary compliance before an audit. Among the failures listed are the following:

- Failure to timely adopt required amendments
- Failure to follow the terms of the plan document, including the definition of compensation and the eligibility and vesting provisions
- Failure to satisfy rules for required minimum distributions
- Failure to follow plan document in-service distribution provisions
- Failure to provide correct distribution forms, make timely distributions, and prepare proper tax reporting of distributions
- Failure to retain records and maintain internal controls
- Failure to follow terms of qualified domestic relations order (QDRO)
- Failure to follow statutory contribution limits

### Voluntary Compliance Program

The types of failures described above are generally due to a lack of focus by the plan sponsor on the administration of the plan and may often be fixed through the IRS voluntary compliance program. In cases where the plan sponsor undertakes voluntary compliance, the typical correction method is to put the plan and the participants in the position they would have enjoyed had the plan been administered as originally written. However, in some cases it may be possible to change the plan document through a retroactively effective amendment to reflect prior administration, and thereby eliminate or reduce the need for additional corrective action and expense. The IRS puts heavy emphasis on self-audits and use of its self-correction program by plan

sponsors. In fact, even though in some cases the IRS requires a fee for using the voluntary compliance program, the fee for voluntary disclosure and correction of significant failures is generally much less costly than having the failure discovered by the IRS in an audit.

***Real Life Example:*** In a recent audit of a qualified 401(k) plan, the IRS auditor uncovered several examples of the plan sponsor's failure to focus on the plan's administration. None of the failures were egregious and none resulted in any discriminatory benefits being given to highly compensated employees. If the plan sponsor had performed a self-audit and uncovered these failures itself, it could have used the IRS voluntary compliance program and its corrections would have been sanctioned by the IRS for the payment of a modest fee. Because the failures were uncovered during an IRS audit, in addition to making the required correction the plan sponsor was required to pay a penalty that was 8 times higher than the fee which would have applied for a voluntary compliance prior to notice of the IRS audit. The pre-negotiation penalty asserted by the IRS was about 16 times the voluntary compliance fee.

If you would like to discuss the voluntary compliance program or any of the information summarized above, or if you wish to discuss any other employee benefits issues, please contact any of the following attorneys within the Firm's Tax Department.