Tax Talk Today
June 13, 2006
Show Questions

The following questions and answers are based on an oral presentation made by IRS officials at the June 13, 2006 Tax Talk Today Program - "Why Fix Mistakes in Retirement Plans Now Rather than Later?" The questions were submitted by the attendees and the responses were given at such meeting. These responses reflect the unofficial, individual views of the government participants as of the time of the discussion, and do not necessarily represent agency policy.

Question #1

Is there a specific procedure that should be followed if a taxpayer misses the deadline for the deposit of salary reduction contributions (i.e., funds are not deposited by 30 days after the end of the month for which the contributions are made) related to a SIMPLE IRA plan?

<u>Answer</u>: The failure to timely deposit elective deferrals causes the plan to violate one of the administrative requirements of section 408(p)(5)(A) of the Internal Revenue Code. Steps need to be taken to make the participant whole. If amounts were withheld from the employee's salary but not deposited, then the employer needs to contribute that amount to the employee's SIMPLE IRA. In addition, the employer should contribute an amount equal to the earnings that the salary reduction contribution would have earned from the date that the deposit should have been made until the date of correction. If the failure is insignificant, then the employer may be able to take advantage of the Self-Correction Program (SCP) described in the Employee Plans Compliance Resolution System (EPCRS) revenue procedure. (See section 8 of Revenue Procedure 2006-27.) SCP requires correction, and does not require approval from the Internal Revenue Service. If the failure is significant and the SIMPLE IRA is not the subject of an IRS examination, then the employer may consider making an application under the Voluntary Correction Program (VCP) described in the EPCRS revenue procedure. (See sections 10 and 11 of Revenue Procedure 2006-27.) If the application, which would include a description of the failure and the proposed correction, is approved then the SIMPLE IRA program would not lose its tax favored status on account of the failure. There is a $250 fee for this application. (See section 12.05 of Revenue Procedure 2006-27.) If the SIMPLE IRA plan is the subject of an IRS examination (See definition of "Under Examination" in section 5.03 of Revenue Procedure 2006-27.), then the plan sponsor would have to work matters out with the agent examining the plan and enter into a closing agreement under the EPCRS revenue procedure's Audit Closing Agreement Program (Audit CAP). In that case, the employer will be required to pay a sanction that is higher than the VCP fee. (See sections 13 and 14 of Revenue Procedure 2006-27.)

Question #2

What can be corrected under EPCRS? If I didn't make a timely deduction, can it be fixed under EPCRS? Also, if I failed to file a Form 5500, can it be fixed under EPCRS?

Answer: Generally, EPCRS provides an avenue for employers to correct failures that could jeopardize the tax favored status of their retirement plans. These include qualified plans (described in section 401(a)), SEPs, SIMPLE IRA plans and 403(b) plans. For details see Revenue Procedure 2006-27. Section 1 of the revenue procedure provides an overview of EPCRS. Under certain circumstances, EPCRS will waive excise taxes under IRC §4974, §4972 or §4979. However, the failure to make a timely contribution under §404 for deduction purposes cannot be corrected under EPCRS. Relief from penalties arising from the failure to file a Form 5500 cannot be fixed under EPCRS. You may, however, be able to correct the failure to file a Form 5500 by taking advantage of the Department of Labor's Delinquent Filer Voluntary Correction Program (DFVCP). Details on this program can be found on the DOL's web site at: http://www.dol.gov/ebsa/compliance_assistance.html#section8.

Question #3

Can I fix a prohibited transaction?

Answer: A prohibited transaction needs to be corrected in accordance with the provisions of section 4975(f)(5) of the Internal Revenue Code (Code). Relief from the excise tax imposed by section 4975(a) (and where applicable, section 4975(b)) is not available under EPCRS. However, excise tax relief may be available if you participate in the Department of Labor's Voluntary Fiduciary Correction Program (VFCP), receive a no action letter, and satisfy the conditions of the related Prohibited Transaction Class Exemption (PTE) 2002-51. Details on PTE 2002-51 can be found on the DOL's web site at: http://www.dol.gov/ebsa/faqs/faq_vfcp.html#section2

Question #4

How many plans does the IRS audit every year?

Over the last several years we have been increasing our examination coverage from a little over 6,000 in FY 2003 to 8,000 in FY 2006. The increase has been a result of changing the examination process and additional staffing. We continue to look for alternative ways to increase our contacts with the EP community. With the creation of the EP Compliance Unit (EPCU), more EP plan sponsors are being contacted through Compliance Checks, a review to determine if a plan sponsor is adhering to recordkeeping and information reporting requirements. During the first full year of operations, the EPCU contacted 1,800 plan sponsors. This is expected to increase to more than 2,600 in the coming fiscal year.

Question #5

Is there any type of program whereby an individual who has failed to file Form 5500-EZ in prior years can come forward and get caught up?

Over the years I have come across, more than once, a situation where the value in the one person Keogh plan went over the $100,000 threshold several years earlier, however, the taxpayer had never filed Form 5500-EZ. If only a current year Form 5500-EZ is filed, the entry on the form for assets at the beginning of the plan year being greater than $100,000 would presumably trigger an inquiry as to prior year tax returns not being filed. Since this type of plan has no filing requirement until the asset value reaches $100,000 it is easy for things to slip through the cracks.

Answer: A taxpayer cannot correct a failure to file a Form 5500-EZ through EPCRS. The IRS also does not have any program to correct the failure to file a Form 5500-EZ. However, IRC §6652(e) permits the IRS to waive the penalty associated with the failure to file a Form 5500-EZ if the taxpayer shows that the failure was due to reasonable cause.

Question #6

If a plan defines compensation as gross comp net of deferrals (both 401(k) and 125), and the plan for the last two years has been matching on total gross comp, so participants have been receiving an excessive match (more than 6% of comp as defined in the plan), would you consider the correction for this error significant or insignificant?

Answer: The only instance where the Service will determine whether a failure is significant or insignificant is upon examination of the plan where the agent must determine whether the failure was eligible for self-correction. The IRS will not predetermine whether a failure is significant or insignificant. The factors to be considered in determining whether or not an operational failure under a plan is insignificant include, but are not limited to:

1) whether other failures occurred during the period being examined (for this purpose, a failure is not considered to have occurred more than once merely because more than one participant is affected by the failure);
2) the percentage of plan assets and contributions involved in the failure;
3) the number of years the failure occurred;
4) the number of participants affected relative to the total number of participants in the plan;
5) the number of participants affected as a result of the failure relative to the number of participants who could have been affected by the failure;
6) whether correction was made within a reasonable time after discovery of the failure; and
7) the reason for the failure (for example, data errors such as errors in the transcription of data, the transposition of numbers, or minor arithmetic errors).

Question #7

Is there a questionnaire that can be provided to plan administrators/trustees/custodians to determine that something is not slipping through the cracks because one party thinks another party is handling a particular area?

Answer: The Employee Plans web page "Correcting Plan Errors" has a number of tools to help a plan sponsor identify plan qualification failures.

Question #8

If top heavy testing has not been done for several years, is top heavy plan testing included in this voluntary program?

Answer: Yes. The employer should run the top heavy tests for the prior years, and if the plan is top heavy, ensure that the minimum benefits/allocations and vesting percentages for affected employees are adjusted to comply with top heavy rules. EPCRS' voluntary programs (SCP or VCP) may be used for the purpose of correcting the plan's failure to comply with the top heavy rules in prior years. See Revenue Procedure 2006-27 for details regarding the eligibility of plans for EPCRS' voluntary programs. See, also, Appendix A, section .02 for a sample correction method for this failure that is deemed to be acceptable by the IRS.

Question #9

How can a plan participant check on whether the plan is in compliance?

Answer: The participant needs to carefully review all communications provided with respect to the plan. For example, the Summary Plan Description is a quick way for a participant to get familiar with the benefits provided by the plan. The annual statements provide a way for participants to keep track of benefits accumulated under the plan. If something does not make sense, the participant should ask questions from the employer sponsoring the plan.

Question #10

Are there penalties passed on to the plan participants if the plan becomes non-compliant over time?

Answer: Generally, no; it is the employer's responsibility to ensure that the plan is administered in accordance with the terms of its plan document and applicable legal requirements. However, there are certain excise taxes that may be imposed on a participant for failure to satisfy a qualification requirement, such as the section 4974 excise tax for failure to distribute to a participant a minimum distribution as required by section 401(a)(9). If a plan ultimately becomes disqualified by the IRS, participants may be taxed on certain benefits; however, the EPCRS correction programs, in most cases, can be used to avoid that result. Under the VCP, relief may also be obtained from the imposition of certain excise taxes, such as the excise tax under section 4974.

Question #11

Can sanctions be paid from trust assets?

Answer: No. Sanctions or compliance fees cannot be paid from trust assets.

Question #12

Are there any IRS booklets that are written in "layman" terms for the "non-tech" small employer to explain what they need to do and NOT TO DO in the administration of plans?

Answer: The IRS Employee Plans web site has many tools designed specifically to educate plan sponsors about the tax laws related to tax-qualified plans. See, http://www.irs.gov/retirement/sponsor/index.html. You may consider ordering the Retirement Plans Corrections CD-ROM. You can do this online by (1) going to http://www.irs.gov/retirement/index.html, (2) on the left hand side among the menu of Retirement Plan Community topics, select "Educational Services." Then scroll and look for the Retirement Plans Correction CD-ROM, and click on that link for details. You can also call 1-800-829-3676, select option 2 for ordering forms & publications, and when prompted request Publication 4050. Topics of interest include: Maintaining your Plan, Common Qualified Plan Requirements and many others. Also there is a lot of other useful information on the Retirement Plans Community section of the IRS web site, including a link for EP Forms and Publications. Some of those publications might also be useful to the small employer.

Question #13

What types of things will trigger an audit?

<u>Answer</u>: Examinations can be initiated through several different approaches. For several years, EP Examinations has been conducting research projects into the various plan types and industry codes utilizing random sampling of returns within the specific market segments. We have been analyzing the results of those audits and identifying trends in plan features or industry codes which have resulted in non-compliance. These indicators are then applied to the total population to identify returns with similar features which may also have potential non-compliance issues.

Examinations can also be coordinated externally with on-going Department of Labor and PBGC actions and internally with Small Business/Self-Employed (SB/SE) and Large/Mid-Sized Business (LMSB) Divisions.

We are expanding our examination activities of potential abusive tax avoidance transactions. Currently there are two projects underway that will continue into next fiscal year: IRC 412(i) plans and S-Corp ESOPs. We continue to work with the SB/SE Lead Development Center on the identification of additional arrangements promoted by abusive practitioners.

Question #14

My client's plan administrator recently died (Aug 2005), and with him much of the documentation that evidences my plan was amended over the years (since 1991) according to the legislative changes enacted since then such as:

CRA	199?
UCA / OBRA	1992 / 1993
GUST/	September 30, 2003
EGTRRA	September 30, 2003

and the Minimum Distribution Rules of Section 401(a)(9)

All else was properly done and documented. He would like to submit a VCP with what documents he does have as well as the new plan that will be adopted which is up to date with these amendments - is this an operational failure or?

How would you advise he proceed?

<u>Answer:</u> The failure to update the plan document for the above-referenced law changes is a “plan document” qualification failure, which causes the plan to be disqualified. In order to correct this failure, the employer would need to submit under VCP and specify the failures that it is coming in for (e.g., lack of written plan documents, plan not being timely amended for certain pieces of legislation) and show that the new plan documents being adopted adequately address those issues. The submission should also include a determination letter application, sent with and to the same address as the VCP submission. Please review section 11 of Revenue Procedure 2006-27 for the items needed in a VCP submission.

Question #15

What if an employee is in the plan but shouldn't be because the employee has nontaxable income, such as a priest in a Catholic hospital?

Answer: Generally, if an employee has been covered by a retirement plan when the employee is not eligible for benefits under that plan, employer contributions made for the employee (including applicable earnings) should be forfeited; contributions made by that employee to the plan (including elective contributions under a section 401(k) plan) may be distributed to the employee (along with earnings on such contributions).

Question #16

Does this qualify for VCP?

- Employer adopted volume submitter PSP and MP plans (10 years)
- Two years later, changed to a practitioners who only filed 5500's, performed compliance but assumed that plan amendment requirements were being handled by prior practitioners
- Has now changed to new practitioner who discovers the lack of updated/amended plans and need to review prior compliance issues, if any.

Answer: Yes. If the plan or plan sponsor is not "Under Examination" (as defined in section 5.03 of Revenue Procedure 2006-27), the plan sponsor may correct the failure to amend its plans timely under VCP.

Question #17

Can one use a reasonable method of correcting a participant excluded under a 401(k) plan (i.e., allocate 3% Safe Harbor and 3% PSP plus 5 % earnings rate)?

Answer: Yes, a reasonable method can be used. Please refer to section 6.02(7), Appendix A .05, and Appendix B, section 2.02 for sample acceptable correction methods for employees erroneously excluded from a 401(k) plan. Also, please see section 3 of Appendix B for possible ways to calculate the earnings adjustment.

Question #18

Is there any guidance on what the IRS will accept to correct various common types of failures under the Self-Correction Program?

Answer: Please refer to Appendices A and B of Revenue Procedure 2006-27. The appendices provide for corrections that are deemed to be acceptable (for all EPCRS programs including Self-Correction) for fixing certain failures.

Question #19

The plan is supposed to correct an operational failure to put everyone in the position they would have been in had the failure not occurred. But when rules change and current rules are different from those in effect when the failure occurred, what rules are followed?

For example, a participant should have been cashed out in 2001 with a benefit of $3,000. Today, the plan does not allow cash-outs over $1,000. What should the correction methodology be in this case? Do we cash-out the person since they should have received their money and the plan should not have had to keep them as a terminated vested person? Or, does that violate today's rules?

<u>Answer:</u> The overriding correction principle under EPCRS is for the plan and plan participants to be placed in the situation they would have been had the failure not occurred. In the situation described above, that would mean that the participant should be cashed out of the plan.

Question #20

If a plan is being audited under the Audit CAP program and the audit begins in February 2006 and a sanction amount has not been negotiated before May 30, 2006, does Rev. Proc. 2006-27 Sec. 14.04, regarding to Audit CAP sanction fees, apply to the audit in determining the minimum sanction amount? (Section 16 of Rev. Proc. 2006-27 states that section 14.04 is effective May 30, 2006)

<u>Answer:</u> Section 14.04 applies to nonamender plan document failures discovered by the IRS during the review of a determination letter application and is effective immediately. Although the effective date of the rest of the changes made to section 14 by Rev. Proc. 2006-27 is deferred (the rev. proc. is generally effective with respect to examinations begun on or after September 1, 2006), all relevant facts and circumstances are taken into account in determining the appropriate sanction under Audit CAP. Rev. Proc. 2003-44, which is still currently in effect with respect to section 14, contains a factor relating to the applicable VCP fee. The purpose of that factor is to indicate that employers who make submissions voluntarily to the Service should be in a better position that those who don't. The addition of a factor in Rev. Proc. 2006-27 relating to the new section 14.04 fee structure is consistent with this principle.

Question #21

How do you go about correcting a late payment into a 401(k) plan (over 45 Participants)? It was late by two days because of accounting staff illnesses and mailed on the 17th of the month. Deposit was only $2,300 and no other violations noted. What fees and what penalties are associated with voluntary compliance on this issue?

Answer: The DOL's Voluntary Fiduciary Correction Program (VFCP) gives plan sponsors and service providers the chance to correct nineteen specific transactions that violate ERISA, such as delinquent participant contributions. There is no fee for participating in the VFCP, but the VFCP requires payment of the appropriate correction amount to the plan. In addition, relief from the excise tax may be available if you satisfy the conditions of the related Prohibited Transaction Class Exemption (PTE) 2002-51; otherwise, a Form 5330 must be filed and any applicable excise taxes must be paid. PTE 2002-51 also provides a limited exception to the excise tax in circumstances when the excise tax otherwise payable for delinquent participant contributions would be equal to or less than $100. See http://www.dol.gov/ebsa/compliance_assistance.html#section8 for copies of the VFCP and PTE 2002-51.

If the plan had language relating to the timing of the contributions being deposited, there may be a qualification failure as well for failing to follow the terms of the plan. The correction would be to make the contributions with earnings up to the date of correction. Earnings should be based on the actual earnings of the participant's account, whenever possible. This failure can be corrected under SCP as well as VCP.