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Managing an IRS Audit

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Overview

Over the past number of years, the Internal Revenue Service has put significant resources into refining and improving its efforts to implement "focused audits." This is evident in what appears to be an increase in the intensity of reviews as well as the potential increase of sanctions that are being imposed on employers.

An example that has continued to flourish over these past years is the methodology that the IRS is looking at with respect to both defined benefit and defined contribution plans as it relates to distributions. More specifically, in auditing plans the IRS has looked with a focused eye on minimum required distributions and whether they have been timely paid. The result of untimely payment is not just an operational error but a significant excise tax that can be imposed on a participant, which increases the potential sanction that the IRS will impose on employers. Therefore, in looking at examining plans and preparing for or managing an IRS audit, a more diligent approach by the employer is necessary to meet the standards of the diligence of the IRS audit as it has developed since 2006.

In January 2006, the Internal Revenue Service's Employee Plans division began to implement a "focused audit" approach to plan audits. Under this method, IRS agents limit examinations of plans to those issues that are relevant to a particular market segment, and only expand audits based on the results of its examination of those key issues.[1]

Under this focused approach, an agent will first identify the type of plan or industry under examination, and then look at the data that shows which issues have typically occurred in that type of plan and examine those predetermined issues. In each type of plan that goes under examination, the audit is primarily focused on three specific predetermined issues. The agent performs a pre-audit analysis selecting two additional issues; solicits only documents required to resolve those issues; uses targeted interview techniques; evaluates the plan sponsor's system of internal controls; and expands the audit scope only if supported by the facts and circumstances. If the agent finds the plan is in compliance as to the core issues, the agent will close the audit. If the plan is not in compliance, the agent may expand the initial examination to other issues.[2]

In 2012, the IRS said Employee Plans was focusing on implementing case-processing efficiencies to increase determination case movement and addressing issues impacting the governmental plan community. In addi-

[1] Michael Julianelle, IRS director, EP Examinations, speaking at ASPPA Webconference, "Examining IRS Examinations and Enforcement: How to Get Out of an IRS Plan Audit Alive," June 29, 2006.

[2] IRS "Employee Plans FY 2009 Workplan - Operating Priorities."

tion, the EP Determinations division established an accelerated processing group, eliminated demonstrations as part of the submission package and expanded business rules to allow increased closures of Form 5307 applications (Application for Determination for Adopters of Modified Volume Submitter (VS) Plans).[3]

In February 2014, the IRS updated its frequently-asked-questions and answers on the Employee Plans Team Audit program, saying that a review of internal controls was the "heart" of the EPTA process. EPTA audits involve employers with assets greater than $10 million and with at least 2,500 pension plan participants.

It is clear from analyzing this evolution that the audit will continue to become a more powerful compliance tool for the IRS and therefore employers needs to begin their diligence before an audit commences.

Emphasis on Internal Controls

The IRS began as a pilot program a review of a plan's internal controls when conducting an audit. The IRS wanted to know if an employer had good internal controls that maintained the viability of its plan. The IRS's focused audit approach to examining plans relies on an internal controls analysis and interview to determine the scope of the audit and potential compliance risks.[4]

As the pilot program became formalized, the IRS released in February 2014 its EPTA FAQs that said when deciding whether to expand an investigation, a key element was whether agents were able to conclude from the initial audit that the employer had sufficient internal controls in place to avoid major mistakes and to identify and correct quickly any mistakes the internal controls revealed.[5]

The IRS said in the FAQs that when conducting an audit, IRS agents generally interview an employer's human resources staff, payroll staff, plan administrators and other responsible parties, such as record keepers and paying agents. They also gather information with respect to electronic records and computer systems, and as to how one system interrelates to another. This process gives the agents a good idea of what problems are likely to exist and forms the basis for the initial focused review, the FAQs said.

As part of the emphasis on internal controls, the IRS said it looks at whether employers maintain their records, including proof that the employer has notified participants of various events. For example, in reviewing a plan's loan program, the IRS may ask for documentation of the loan's inception, or the IRS may request proof that the plan administrator notified participants of their required minimum distribution, in particular for missing participants that still have an account balance.

[3] IRS "Employee Plans FY 2013 Annual Work Plan," available at http://www.irs.gov/pub/irs-tege/ep_wrkpln_fy13.pdf.

[4] Florence Olsen, *IRS Makes Employers' Internal Controls a Priority in Employee Plan Audits*, 71 Pens. & Ben. Daily, April 12, 2013 (71 PBD, 4/12/13).

[5] IRS FAQs Regarding the EP Team Audit (EPTA) Program, February 2014.

One challenge is the problem of changing record keepers and keeping track of all of the documents. The Employee Retirement Income Security Act provides that any person required to report information to the government (Form 5500 and related schedules), or anyone who would have reported but for a specific exemption, must maintain records for six years after the filing. The retained records, which must have enough detail and information to enable the government to verify the accuracy of the returns, include vouchers, worksheets, receipts and applicable resolutions.[6]

The types of plan records that must be maintained and updated frequently include:

- documentation proving adequate notices provided (e.g. annual safe harbor notice);
- proof of offers to enroll;
- notices on minimum required distributions;
- proof and documentation of attempts to locate missing participants as well as uncashed checks;
- proof and verification of satisfying hardship distribution criteria;
- proof and verification of loan terms including the viability of a loan to qualify as loan for a primary residence;
- proof of timely deposits of elective deferrals (including pre- and post-tax contributions as well as loan repayments);
- information on current plan participants;
- dates of termination and reason (death, disability retirement, early or normal retirement, termination of employment or job elimination), plus dates for terminated and rehired employees;
- determination of employees eligible to participate as of an entry date, and notation of prior years of service for vesting purposes;
- determination of hours worked for participants, for vesting purposes;
- compensation for all employees for allocations and nondiscrimination testing, and compensation of some family members of highly compensated employees;
- compensation codes to determine benefits-eligible compensation; and
- for a § 401(k) plan, deferrals and employer matching contributions for each participant.

In addition to the specific employee information above, the Forms 5500 (the tax return/report for employee benefit plans), their related schedules and all of the "backup" information used to fill out those forms should be retained by the plan administrator.

Practice Tip: Every couple of years, employers should do a "mini-audit review" to make sure everything is working the way it should. By doing such reviews, the employer is demonstrating its ability to triage issues and to monitor is plan processes on an ongoing basis.

[6] ERISA § 107, 29 U.S.C. § 1027.

Key Audit Phases

The IRS has identified three key phases of employee plan audits:

- the initial interview, where IRS agents review issues about the employer's plan and business operations;
- the examination of internal controls (e.g., who is receiving money, the separation of duties, and the policies in place to allow for a final product that is in compliance);
- the audit of the key issues that have been identified. This is considered to be the most time consuming.

Engaging Counsel

When plan sponsors receive audit requests from the IRS, they may decide to engage counsel experienced in IRS audits. Among the factors to consider in deciding whether to do so are the complexity of the plan; the plan sponsor's knowledge of the audit process; the objectivity of counsel or other professional in dealing with agents; the need for document review; and the significance of any problems the agent may find in the audit. (These factors are discussed in greater detail later in this report.)

Anyone who represents a plan sponsor in an audit must be designated on IRS Form 2848, and must be licensed to practice before the IRS. This includes attorneys, actuaries, enrolled agents and licensed third-party administrators. In 2007 the IRS expanded the categories of persons that can talk to the IRS on behalf of plan sponsors by creating a new category of professionals who are allowed to deal with the IRS if they meet certain testing requirements. These individuals, designated by the IRS as Enrolled Retirement Plan Agents (ERPAs), are able to represent clients in employee plan audits, among other limited representations.[7]

Not Quite an Audit

Section 401(k) Compliance Questionnaire: In May 2010 the IRS sent to 1,200 plan sponsors the 401(k) Compliance Check Questionnaire, which requested information from plan sponsors in the areas of demographics, plan participation, employer and employee contributions, top-heavy and nondiscrimination rules, distributions and plan loans, other plan operations, automatic contribution arrangements, designated Roth features, IRS voluntary compliance and correction programs and plan administration. The compliance check was administered by the Employee Plans Compliance Unit (EPCU). Ninety-eight percent of plans receiving the questionnaire responded. The IRS initiated follow-up action on all non-responders. EP agents nationwide conducted full-scope examinations of 401(k) plans of sponsors who did not complete the 401(k) Questionnaire in order to gather the information that the IRS requested.[8]

EPCU Compliance Checks: The IRS has EPCU to accomplish "soft contacts"—those through telephone or mail contact rather than a field office exam. The IRS uses EPCU compliance checks to assess how plan sponsors are resolving certain situations to lessen the need for full examination audits. These compliance checks fall short of an audit and allow the IRS to fish for particular problems without going through the formality of an audit. The IRS said that as of December 2013, it had conducted over 30,000 compliance checks.[9]

Review of Withdrawn VCPs: The IRS also looks at withdrawn applications to the Voluntary Correction Program. These withdrawn VCPs go on the IRS's list of potential reviews.

Areas of Audit Activity

There are certain issues and events that will often trigger an audit, as well as several recurring issues that arise in IRS audits.

Certain form filings with the IRS may contain information that might trigger audits, including:

- Form 5500
- Form 5330
- Form 5310

An audit may also be triggered by news stories about mergers and acquisitions and plan terminations; information from plan participants, particularly regarding employers that hold onto salary deferrals rather than immediately transferring those amounts into participants' § 401(k) accounts; and semiannual meetings of IRS audit staff and Labor Department officials, which help alert the IRS to the types of noncompliance on which to focus its audit program.[10]

The IRS has stated that it is optimizing its case selection methodology for audits through the use of information technology and business rules that identify risk factors for noncompliance. Using that approach, the IRS has found the "most productive targets" to be § 401(k), profit-sharing, and money purchase plans.[11]

Among the issues that arise most often are those concerning:

- plan documents;

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[7] 72 Fed. Reg. 54,540 (Sept. 26, 2007), 2007-45 I.R.B. 931. Qualification tests for the ERPA designation began in January 2009.

[8] "Section 401(k) Compliance Check Questionnaire, Final Report, March 2013," Internal Revenue Service , TE/GE Employee Plans, Employee Plans Compliance Unit (EPCU), available at http://www.irs.gov/pub/irs-tege/401k_final_report.pdf.

[9] See http://www.irs.gov/Retirement-Plans/Employee-Plans-Compliance-Unit-(EPCU).

[10] Cathy Jones, IRS area manager, Employee Plans Team Audit Program, Mid-Atlantic Tax Exempt and Government Entities, remarks at a BNA conference Nov. 18, 2008 (35 BPR 2636, 11/25/08).

[11] Monika Templeman, IRS director of EP Examinations, remarks at BNA conference, Washington, Nov. 17, 2008 (35 BPR 2637, 11/25/08).

- employees/plan participants (coverage and participation issues);
- assets and liabilities;
- contributions and distributions;
- plan terminations; and
- abusive tax avoidance transactions.

Practice Tip: In most of the items that the IRS has identified as triggering an audit found on the Form 5500, it appears that the IRS focuses on consistency within a particular year of reporting as well as consistency over a period of a number of years. For example, major fluctuations that occur during the course of a year as it relates to either participants or plan assets as well as inconsistencies from one year to the next seem to be a common element among the factors.

See also, Internal Revenue Manual 4.71.1, *Employee Plans Examination of Returns, Overview of Form 5500 Examination Procedures*, which provides guidance to IRS auditors on the basic auditing techniques used in conducting Form 5500 examinations.

Plan Documents

According to the IRS, one of the most common issues found with regard to the plan document is that the plan sponsor does not timely adopt amendments to comply with the current law. The failure to do so results in disqualification of the plan. Another frequent issue is plan administrators not following the plan terms when performing their duties. Especially common are failure to follow plan document provisions that define compensation and participant eligibility rules, and that govern plan loans to participants.

Employees/Plan Participants—Coverage and Participation Issues

The most common issues in this category are:

- Improperly excluding employees who are later determined to be eligible for the plan. Many factors can contribute to this error, including part-time employees who become eligible for the plan, and the administrator including employees in the plan after a company merger.
- Misclassifying employees as either highly compensated or nonhighly compensated employees in determining whether the plan meets the discrimination testing required for plans.
- Low percentage of participants compared to the number of employees. (§§ 410(b) and 401(a)(26) discrimination issues.)
- Fluctuation in plan participants. ***Practice Tip***: The IRS focuses on work force reductions that may occur over a period of multiple years (typically three) or during the course of a particular year. The rationale for this review item is the nexus that a drop in work force is so significant that it may result in a partial plan termination. If it is determined that a partial plan termination has occurred, individuals that are affected become fully vested to the extent funded. Therefore, for example, employees who may have forfeited their employer matching component would be entitled to have that amount reinstated and distributed to them. In the IRS's (as well as the courts') view the applicable period of time to determine whether a reduction occurred can extend beyond a single year period and indeed may extend up to three or possibly more years. Although the IRS and the courts apply a "facts and circumstances" test to determine whether a partial plan termination has occurred, a practical factor that is considered is whether there is a reduction of approximately 20 percent. Determining what is in the numerator and denominator of that 20 percent is subject to negotiation.
- Separated participants. ***Practice Tip:*** This item focuses on either voluntary or involuntary terminations of employment and the group of people affected by forfeiture of some portion of their benefit. This may bring into question possible vesting issues as well as a possible partial plan termination. At a minimum, if this issue is identified, the IRS would be compelled to review the filing further.
- Consistent reporting of participant data. ***Practice Tip:*** Consistent reporting on a year-to-year basis is a basic premise to determine whether the underlying numbers of participants are valid. For example, the number of participants listed at the end of a prior year should, in most cases, be relatively similar to the number of participants in the beginning of the succeeding year. Any variance should be justified. Such justifications can be terminations of employees as well as new hires. Please note this applies to plan assets.

Other issues that may arise include:

- ineligibility of an employer to sponsor a plan;
- the lack of proper notification to employees informing them of the existence of a plan, what the plan offers, and changes to the plan; and
- failure to obtain spousal consents when an employee elects to receive a benefit in a form other than a joint and survivor annuity.

Assets and Liabilities

- An underfunded plan will often be audited, whether a defined benefit or a defined contribution plan.[12] In a defined benefit plan, a funding deficiency as indicated on a Schedule B will result in assessment of an excise tax under I.R.C. § 4971. An audit of a defined contribution plan may be triggered by a funding discrepancy on the Form 5500.
- Percentage of loans to participant compared to total assets or large dollar amount of loans. If the percentage of loans to a particular participant or group of participants compared to the total assets is large, this may indicate either a potential prohibited transaction or

[12] The IRS analyzes pension funding data and when it notices underfunding, it contacts the plan to ask what the plan is doing or will be doing about the underfunding. This is not considered to be a procedure "under examination" or "under audit." "About half of those we contact provide valid explanations for the underfunding. Those who do not respond are then converted to the examination process." Michael Julianelle, then IRS director, EP Examinations, speaking at an American Institute of Certified Public Accountants (AICPA) national conference, Baltimore, MD, May 10, 2006 (33 BPR 1218, 5/16/06).

a potential failure under I.R.C. § 72(p). This may result in excise taxes under I.R.C. § 4975 as well as income inclusion to participants, including an excise tax under I.R.C. § 72(t) for early distributions.

- Investment of plan assets. A review of the total plan assets (not taking into account distributions during the course of the year to participants) indicates a significant loss or reduction for the year as compared to other years. This review might indicate that a potential investment was imprudent.

- Fluctuations in plan assets. ***Practice Tip***: As with fluctuations in plan participants, the IRS reviews significant changes in plan assets (both in amounts and in underlying investments) during the course of a particular year and over a period of several years. A significant drop in plan assets may indicate participant termination and a possible plan termination. In addition, the shifting of underlying investments should be reviewed so that amounts in employer securities, real estate, or unmarketable securities are not significant so as to raise a concern.

- Administrative expenses. ***Practice Tip***: The IRS (as well as the DOL) places significant efforts in reviewing both the amount of plan expenses and the underlying reason for particular expenses. This extends to amounts of money that are reimbursed for service providers that must be separately listed on a particular schedule for the Form 5500. Given DOL guidance in this area, employers should pay particular attention. In addition to DOL's audit initiatives, it appears that plan participants are focusing more on the amount of plan expenses that results from the administration of the plan.

- Investments in real estate. ***Practice Tip:*** Depending upon the amount of assets invested in real estate, the resulting unrelated business income may be a factor for concern.

- Plan liabilities. ***Practice Tip:*** Employers should be able to justify the reason for the existence of large plan liabilities.

- Classification of assets as "other assets." (The IRS indicated informally at one time that this was one of the five most common audit triggers on the Form 5500.) ***Practice Tip***: This particular balance sheet item is very troublesome for the IRS. The problem that it brings into question is what type of asset is it and why is there so much of it. The IRS views this as either an area to hide questionable assets or a dumping ground for assets that cannot be slotted into some other portion of the balance sheet. At a minimum, plan sponsors should be diligent about organizing their assets into identifiable areas and monitoring fluctuations in the percentage of total assets going into this category from year to year.

- Consistent reporting of assets. ***Practice Tip***: Consistent reporting on a year-to-year basis is a basic premise to determine whether the underlying amount of assets is valid. For example, the amount of assets listed at the end of a prior year should, in most cases, be identical to the amount of assets in the beginning of the succeeding year. Any variance should be justified.

See Internal Revenue Manual 4.72.8, *Employee Plans Technical Guidelines, Valuation of Assets*, which provides guidance to IRS auditors on valuing assets in a qualified retirement plan.

Contributions and Distributions

- With regard to employer contributions, common problems are not using the plan definition of "compensation" when administering the plan; not applying the correct amount for the matching contribution; or not making the match at all.

- For both employer and employee contributions, typical problems are limitations on contributions and elective deferrals, and awareness of when these limitations are violated.

- Distributions upon plan termination. ***Practice Tip:*** To effectively terminate a plan, assets must be distributed as soon as administratively feasible. The benchmark for determining this period of time is typically one year. Accordingly, if a plan sponsor terminates a plan but has not distributed most or all of the assets within the period of time indicated above, the IRS considers the plan ongoing and therefore reviews the current status of the plan (e.g., applicable plan amendments).

- Distributions on income statement. ***Practice Tip:*** The focus is on large distributions relative to either prior year distributions or total assets for that year. One particular point that is reviewed is whether applicable early distribution tax (I.R.C. § 72(t)) is paid. This assists the IRS in its overall initiative under § 72(t).

- Plan loan violations, including employees failing to repay loans and failure to pay the 10 percent excise tax for not repaying the loan.

- Hardship or emergency distributions. Violations in this area would involve the failure of a plan administrator to obtain adequate documentation from the employee of a hardship or emergency.

Abusive Tax Transactions

The IRS is engaged in extensive enforcement efforts to curb tax shelter schemes, which it has labeled abusive tax avoidance transactions (ATATs).

The IRS listed on its website the following transactions involving employee benefit plans as listed (abusive) transactions:

- Deductions for excess life insurance in a Section 412(i) or other defined benefit plan,

- S Corporation ESOP abuses—certain business structures held to violate Section 409(p),

- S Corporation ESOP abuse of delayed effective date for Section 409(p),

- 401(k) accelerated deductions,

- Collectively bargained welfare benefit funds under Section 419A(f)(5),

- Certain trust arrangements seeking to qualify for exemption from Section 419

- Abusive Roth IRA transactions,

- Abusive transactions that affect availability of programs under EPCRS,
- Notice 2006-65 (Excise taxes with respect to prohibited tax shelter transactions to which tax-exempt entities are parties and related disclosure requirements).[13]

The IRS program that allows plan sponsors to correct plan failures before or during audit, the Employee Plans Compliance Resolution System (EPCRS), provides that if a plan sponsor has been a party to an ATAT, the self-correction program is not available to correct any operational failure that is directly or indirectly related to the abusive transaction.

Preparing for the Audit

Notification of Audit/Document Request

Under the IRS's EP examination process, after a plan is selected for audit, the IRS will:

- *Notify the plan sponsor of the audit.* A plan sponsor (as indicated on the Form 5500 for the year or years involved in the audit) will be notified by the revenue agent either by phone or by an "appointment letter" that a particular plan (as noted by relevant plan number, e.g., 001,002, 003, 501, etc.) is under audit for a particular tax year or years. The appointment letter will state a date that the agent will come on site to review documents and/or interview specific personnel. Agents may be flexible as to the date or dates on which they come on site.
- *Send a letter requesting review of plan records and documents.* This letter will contain an information document request specifying exactly which documents the plan sponsor should supply. ***Practice Tip:*** The initial request can be burdensome and broad-based, but has become less so since the advent of the focused audit approach. A discussion with the agent prior to document production to determine whether specific documents are more relevant than others is beneficial. Generally speaking, documents such as annual reporting forms (Form 5500), a copy of the most recent favorable determination letter, plan documents, summary plan descriptions, summary of material modifications (if applicable), and summary annual reports are always required. However, other documentation, such as trustees' reports, ledgers, participant account records, or applicable loan documentation, may be burdensome or excessive and may not be requested at the outset. Accordingly, to provide applicable materials in a cost-effective manner, an inquiry to the agent as to particular types of documentation may expedite a plan's processing of the request as well as provide some insight as to the specific reasons that triggered the audit. It may be that a particular plan was selected randomly, but it is more likely that the audit was triggered by a certain event or facts that were reported.
- *Set up an appointment with the employer and/or its representative.*
- *Conduct the audit of the plan.*
- *Request more information.* [14]

Location of Audit

Where the audit takes place is an important part of the audit process. Most benefits practitioners prefer that audits be conducted at plan counsel's office, but the IRS has stated a policy that audits should take place where the records pertinent to the audit are maintained. This is usually the plan sponsor's principal place of business. However, the IRS has acknowledged there are exceptions if an audit at the business is not reasonable.[15] For example, an audit at a doctor's office might not be reasonable because there is no place for an agent to work. In addition, an audit at a third-party administrator's office may be reasonable if that is where all the records are kept.

Even if the audit is done offsite, the examiner will still want to conduct a site visit to get a sense of the business and to see if what the employer is claiming is reasonable, according to the IRS.[16] For example, if an employer says it has six employees, but the agent sees three buildings, then something may be wrong.

The Role of Counsel in an Audit

Plan sponsors must do both a cost-benefit analysis and a risk assessment as to whether counsel should be engaged in an audit. When making that determination several factors become relevant. These factors include, but are not limited to:

- The complexity of the plan involved. ***Practice Tip:*** Sometimes employers do not assess the potential risks that are associated with the audit until the audit is underway and all documentation requested has been provided. At other times, what appears to be a "plain vanilla" or standard type of plan in fact might have undisclosed problems associated with it or problems that the plan sponsor might think are minor. Not all audits need counsel at every step of the audit. However, all audits, at a minimum, need an assessment before any interaction with the auditor occurs.
- Knowledge of the audit process. ***Practice Tip:*** The level of IRS employee plan audit experience that a plan sponsor has determines the reliance on outside counsel. For example, a plan sponsor can inadvertently volunteer and disclose facts or issues to the IRS that might not have been raised by the IRS. In addition, such comments are not privileged.
- Objectivity. ***Practice Tip:*** During a plan audit there is no substitute for the ability to provide counsel that is objective and focuses on the facts involved. This

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[13] EP Abusive Tax Transactions, at http://www.irs.gov/Retirement-Plans/EP-Abusive-Tax-Transactions.

[14] The IRS website, http://www.irs.gov, has extensive information on audit procedures under its "EP Examination Process Guide."

[15] Preston R. Butcher, Director, EP Examinations, *Employee Plans News*, Vol. 4/ Spring 2004, available at http://www.irs.gov/pub/irs-tege/spr04.pdf.

[16] *Id.*

is not to say that advocacy is not important. Indeed, the best advocate is one who presents arguments that cannot be thwarted by their being subjective in nature. Whether right or wrong, plan sponsors may feel personal involvement in the operation of the plan. This might be accompanied by an emotional (indeed argumentative) response to a generic and fair question by the auditor, thereby impeding resolution. If a third party plan administrator is involved, counsel can provide objective assistance when the TPA and plan sponsor blame each other for the plan's problems.

- Document review. ***Practice Tip:*** Before any document is provided to the agent, the plan sponsor should have counsel review the document for consistency of reporting and for legal sufficiency. Particular attention should be paid to the items on the Form 5500 that are listed above as audit triggers. In addition, this review will assist in establishing attorney-client privilege as well attorney work-product privilege. This may be crucial if plan participants become aware of the audit and begin to inquire about the events surrounding the audit.

- Routine audit or not? ***Practice Tip:*** To assist the plan sponsor in determining whether the audit will proceed on a routine basis or not, experienced counsel will identify potential qualification errors (both operational and plan-document related). Early detection of qualification errors isolates and minimizes the exposure. The IRS permits self-correction of insignificant operational failures after the plan is under audit. Counsel may assist in determining relevant factors for making the case to the IRS that a plan problem is insignificant.

Presentation of Data

The plan sponsor should provide the plan documents to agents in advance of the audit so the documents can be reviewed prior to the first meeting. All other information subsequently provided should be presented in a consistent way at the audit, clearly labeled.

IRS officials have expressed concern that exam agents may become overly dependent on copies of plan documents for their audit work papers. The IRS says it prefers that agents look at the originals, which facilitates and expedites the exam process if agents can get answers to their questions while in the presence of the plan sponsor or administrator.

Behavior During an Audit

If an agent is being hostile or abusive, the plan sponsor or its representative should conclude the audit and contact either the agent's group or area manager separately.

In situations where the sponsor or representative and an agent cannot agree on a policy or sanction, the plan sponsor should seek additional input from the agent's manager while including the agent in those discussions.

The Issue Review Process

In general, an audit of a plan consists of three phases: (1) plan document review; (2) review of certain transactions; and (3) analysis of discrimination tests. How the auditor proceeds through these three phases depends on the materials provided, the types of issues perceived, and the nature of the particular plan's operations (including demographics as well as plan features). For example:

- If during the process of Phase 1, the auditor reviews loan documentation and the documentation appears either inconsistent or legally insufficient, it is more likely than not that during Phase 2 selected loan transactions will be requested.
- In the area of elective deferrals, assume an auditor requests benefit election forms and compares actual election forms with payroll records. If discrepancies exist, the auditor will most likely follow up on Phase 3 by asking for the results of the ADP test.
- Say the auditor notes that the plan permits safe harbor hardship distributions. If the processes used to facilitate these distributions are detailed and complete, the auditor is less likely to request a sampling of them.

Corrections

The plan sponsor must correct all plan qualification failures that are found before or during an audit, for all participants and all taxable years.

Failures Discovered Before Audit

If a plan sponsor or its representative discovers failures before the audit, the sponsor can usually correct those failures through EPCRS. [17] EPCRS is not available for correction of a plan failure, however, in cases where the plan sponsor has been a party to an abusive tax avoidance transaction and the failure is directly or indirectly related to the transaction.

The IRS recommends that if the time for correcting failures under EPCRS has passed, plan sponsors should still correct the failures because, first, it shows good faith, and second, sanctions under Audit CAP (see discussion below) might be lower. In addition, the IRS advises that if a sponsor or its representative discovers a failure on the eve of an audit, they should be forthcoming with the agent. According to the IRS, this fosters good will during the audit and can be a factor in the amount of the sanction.

Failures Discovered During Audit

The Audit Closing Agreement Program (Audit CAP), which is part of EPCRS, permits a plan sponsor to correct a failure that is identified on audit and pay a sanction that is reasonably related to the nature, extent, and severity of the failure. The Audit CAP sanction also takes into account the extent to which a correction was

[17] See the reports,The EPCRS Self-Correction Procedures and EPCRS: Correcting Plan Qualification Failures for more detailed discussion of correction procedures.

made before the audit. The plan sponsor can negotiate with the agent about the manner of correction, and can always ask for a different way of doing something.

Sanctions

A sanction under Audit CAP is a negotiated percentage of the maximum payment amount. Sanctions should be reasonably related to the nature, extent, and severity of the failures, depending on a number of factors, including:

- steps the plan sponsor has taken to ensure the plan had no failures or corrected any failures through the Self-Correction Program or the Voluntary Corrections Program, including how far corrections had progressed at the time of examination;
- the number and type of employees affected by the failures;
- the period of time over which the failure occurred; and
- the reason for the failure.

The sanction must be paid by certified or cashier's check when the closing agreement is signed. The closing agreement may be conditioned upon implementation of administrative procedures and the plan sponsor could be required to obtain a favorable determination letter.

A plan sponsor or its representative may negotiate with an IRS agent about the manner of correction. Although there is a minimum and maximum sanction, there is a wide range in between.

Closing Agreement

If the IRS and the plan sponsor agree, the IRS will prepare a closing agreement, which is a legal contract between the sponsor and the IRS. If the sponsor has not engaged counsel, someone with a legal background should review the agreement for the sponsor to ensure it covers all issues. For qualified plans, the sponsor may be required to obtain a favorable determination letter before the closing agreement is signed. If such a letter is required, the plan sponsor must pay a user fee to obtain the letter. If the IRS and the plan sponsor cannot reach an agreement on failure corrections and the amount of sanctions, the plan will be disqualified.[18]

Post-Audit Action

- First-line administrative resolution. Assuming the auditor has concluded its review of documents and has obtained enough information to begin to formulate whether issues exist, the plan sponsor has the right to request that the agent identify the issues found and the rationale and support for those issues. Depending upon whether resolution is possible, plan counsel may want to request that other IRS personnel become involved with the case. This can include staff at both the field offices and IRS headquarters. Taking this approach depends on the viability of the auditor's arguments, as well as the experience of the plan's counsel. This approach will also depend on the facts and circumstances of the particular case, including the issue at stake and the relationship that counsel has with the IRS agent and the agent's reviewers.
- Second-line administrative resolution: 30-day letter. If the plan sponsor and IRS agent are unable to agree to an amenable resolution of the case, the IRS will issue a letter (the "30-day letter") that states the pertinent facts and provides both the IRS's and plan sponsor's positions as to the issues still in dispute. This letter will also provide for the amount of tax that will be assessed. Within 30 days the plan sponsor must either acquiesce and pay the tax or decide to appeal by formally filing for such an appeal with the IRS Appeals Division.
- Third-line administrative resolution: 90-day letter. Failure to appeal the case within the applicable 30-day period results in the assessment of the tax and the issuance of the "90-day letter." The 90-day letter enables the plan sponsor to file a petition in Tax Court to address the issues outside of the administrative process. Alternatively, the plan sponsor has the right to pay the tax and submit a claim for refund with the IRS.

[Updated March 2014]

[18] See also, Internal Revenue Manual 7.2.1, *Rulings and Agreements, TE/GE Closing Agreements*, for IRS procedures relating to closing agreements.