

Transcript for SCP / CAP EP Phone Forum

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Moderator: Welcome to the Self-Correction Program and Audit Closing Agreement Program Phone Forum. At this time, all participants are in a listen-only mode. As a reminder, today's conference is being recorded.

I'd now like to turn the conference over to Mr. Mark O'Donnell.

M. O'Donnell: Hi, everyone. I'm Mark O'Donnell, Director of Customer Education and Outreach for IRS employee plans. Welcome to our Self-Correction Program and Audit Closing Agreement Program Phone Forum. Today we'll be hearing from Michael Sanders. Mike is our Mid-Atlantic Area Manager. He champions our Employee Plan Self-Correction and Audit Closing Agreement programs. We'll also be hearing from Kathleen Schaffer, who is our Mid-Atlantic Area Coordinator for the Self-Correction and Audit Closing Agreement Program cases.

Before we start, I'd like to point out a couple of things. Everyone registered for this forum will receive a certificate of completion by e-mail approximately one week after the forum. You must attend the entire live forum to receive a certificate. Enrolled agents, enrolled retirement plan agents, and enrolled actuaries are entitled to continuing professional education credit for this session. Other types of tax professionals should consult their licensing organization to see if this session qualifies for continuing, professional, or educational credit. As with all of our presentations, the comments expressed by our speakers should not be construed as formal guidance from the IRS.

For more information regarding Self-Correction and Audit Closing Agreement Programs, please visit our Retirement Plans website at www.IRS.gov/ep. You can also get there by going to the main IRS web page and clicking on the "Retirement Plans Community" tab along the top. Look to the left-hand navigation bar and select "Correcting Plan Errors."

While visiting our website you might also want to subscribe to our free electronic newsletters. The link for newsletters is also on the left-hand navigation bar. We have two newsletters, The Retirement News for Employers, that's for small employers sponsoring retirement plans, and the Employee Plans News for retirement plan professionals.

Without further ado, here are Michael and Kathy.

M. Sanders: Thank you, Mark. Good afternoon, everyone. Thanks for tuning in for today's forum. Today Kathy and I will be covering some common issues that we're finding in our examination cases that we're correcting through SCP and the Audit CAP Program. We'll also be discussing some procedures and requirement for participating under EPCRS during the examination process, and we'll talk about how the CAP sanctions are determined and negotiated under the Audit Cap Program.

I thank those folks who sent in the questions. Kathy and I attempted to incorporate some of the questions received into our talking points. For those questions that we're not going to address today, we'll be issuing e-mail responses to.

The first slide we're going to talk about and that we're going to go through is the current examination issues found in SCP, which covers slides three through eight. What I'm going to go over now are the four common issues found during the examination process for all plans. These are for all plan types.

The number one failure that always seems to be is the nonamenders. Currently the most common law changes that the employers fail to amend their plans ..., the good faith amendments for EGTRAA, and the final temp regs under Section in 401(a)(9).

The second common problem we see is the definition of compensation. Usually certain types of comp are excluded, such as bonuses, commissions or overtime, or certain types of compensation are included where they should have been excluded. This failure can result in participants receiving allocations to their accounts that are either greater than or less than the amount they should have received.

The third one is excluding eligible employees, including ineligible employees. This often occurs in controlled group situations after a merger or acquisition. We see this a lot with our EPTA cases, or Employee Plans Team Audit Examinations, where otherwise eligible employees are excluded. The excluded employees don't receive an allocation of contribution to which they're entitled. Where ineligible employees are included in the plan, the employer has made additional contributions, which did not need to be made to the plan.

The fourth one I have here listed is the failure to satisfy plan loan provisions. Loan failures are often results in the plan sponsor's failure to withhold loan payments. Where a plan failed to collect loan repayments from participants, the loan is considered defaulted and the participants will be taxed from the loan in the year of the default.

Kathy, being the Closing Agreement Coordinator for the Mid-Atlantic Area, are there any other common errors that you've been seeing in these particular plan types?

K. Schaffer: Well, Mike, yes there is another one. Not making timely required minimum distributions is an error that we see often across all types of plans. And that's just a matter of maybe the census not being correct or not keeping track of the ... sum of the participants and when they need to start taking their distribution.

M. Sanders: Okay, so basically we're talking about the lack of controls there that have been placed to see that these don't happen.

K. Schaffer: That's true, yes.

M. Sanders: Also, when we talk about the failure to amend to the plans, do you see a lot where the tax payer's unaware of the plan provisions, as far as the restatements and so forth?

K. Schaffer: That is correct. We do, sometimes, especially with smaller plan participants where they don't have someone who is keeping their plan up to date on a constant basis. That sometimes they'll find a plan document and maybe just put it in the drawer and think that everything is fine with it and go about running their business until the agent gets out there and advises them that there should be some updates to the plan that haven't been made.

M. Sanders: Right. And then any updates they're unaware of, the best way to handle that is if the plan administrator and the employer sit down and talk about the plan provisions so they know exactly what features are in the plan and how to operate the plan in accordance with the document.

K. Schaffer: Yes, absolutely.

M. Sanders: Very good. Okay, let's move on to slides four and five. These are some common issues found in a 401(k) and (m) examinations. Right now, 401(k) plans make up a large portion of our examination inventory, and that's both in the general program and/or Employee Plans Team Audit cases.

The first one I'll talk about is incorrect employer matching contributions. In this situation, the employer and plan administrators need to be familiar with the terms of the plan and implement procedures to ensure that the plan operates in accordance with the document. Employers should work with the plan administrators to ensure that the administrators have sufficient employment and payroll information to calculate the employer matching contribution described under the terms of the plan document.

The second one is the failure to correct or timely correct ADP and/or ACP failures. I'm kind of amazed when I see some of these problems with these. We're seeing that tests have actually been performed, but there was no action taken to correct the test. Again, the problem with that is disqualification to plan will apply not only for the plan year for which the excess contributions were made, but it will also include all subsequent plan years during which the excess contribution remain in the trust.

Another common problem in the 401(k) plans is the deferrals made or in excess in the 402g limits. Employers need to ensure that they have a system in place to monitor salary deferrals for those employees who participate in more than one plan of the employer.

The fourth one is late deposit of 401(k) deferrals. Again, employers need to implement procedures to ensure that the salary deferrals are deposited timely. The failure to deposit these salary deferrals on a timely basis constitutes a prohibited transaction, which is subject to excise tax under 4975. In addition to that, the employer must make correction and pay any additional transfers that are owed to the plan or the participants for those delinquent contributions.

And you have to keep in mind that in some plans containing specific ... stating that deposits will be made on a certain date, failure to follow the terms could be a disqualification issue, which would need to be corrected through EPCRS. We get a lot of referrals from DOL on this particular issue. This is a very hot issue also with DOL.

Five is failure to use the correct compensation. This is very similar to the other plan types, all the other plan types we were talking about, and it's important to know what types of comps are included or excluded for plan purposes, for testing purposes, the plan year versus the calendar year and so forth.

Six is improper exclusion of eligible employees for purpose of ADP and ACP testing. Employers and plan administrators need to implement procedures to ensure that the administrators have sufficient employment and payroll records to identify all eligible employees, and that these employees are properly included for purpose of the ADP and/or ACP testing. Common problems include omitting those who are not deferring and other part-time employees.

And the seventh one I have listed is the misclassification of highly compensated and non-highly compensated employees for purpose of the ADP and ACP testing. Again, employers need to work with their plan administrators to ensure that both parties are familiar with the terms of the plan, the plan administrators are provided with all the information needed to make the proper determination of each employee status, and we need to pay special attention to the attribution rules related to the ownership when identifying the 5% owners.

That will lead us into the next slide, which is slide six. Kathy will talk about some current examination issues found in SCP and CAP cases for our 403(b) plans.

K. Schaffer: Thank you, Mike. Some of the SCP and CAP issues that we find in the 403(b) arrangements are excess elected deferrals made to the 403(b) arrangement. And they could be made because there's actually maybe more than one W2 that we're not aware of and the person taking care of the arrangement doesn't know that, or specifically with the 403(b) plans we have the improper use of the 15 year of service, the catch-up rules. And the catch-up rules for the 403(b) arrangements are a little complicated and there are limits and there are overall limits, and sometimes those limits are not put into place when the extra catch-ups are being made by those employees that have the 15 years of service.

Really the most common issue is the universal availability in the 403(b) plan, because it differs so much from the 401(a) plan where any employee who is expected to work at least 20 hours a week is entitled to participate in the 403(b) arrangement and make elective deferrals. A lot of times this is misunderstood and we find that certain groups of participants are not afforded the opportunity to participate.

Sometimes, other than teachers, we might have cafeteria workers. We might have custodians. We might have coaches that aren't there on a full-time basis, but yet they're there more than 20 hours a week and should be able to be allowed to participate. And we see that issue very often.

M. Sanders: Is that because a lot of times the sponsor of the plan is unaware of the plan provisions?

K. Schaffer: It is. These are usually not for profits, a lot of schools, and they actually don't have dedicated staff to send in the elective deferrals and run the plan. So it's usually someone that has other duties as well and isn't familiar with the rules as they should apply.

M. Sanders: And I know there's a big push on this through our EPCU Unit, Employee Plans Compliance Unit, they have numerous mail outs—

K. Schaffer: I understand that that is—

M. Sanders: —checking the universal eligibility on various universities and so forth.

K. Schaffer: It is a very widespread problem.

Moving on to slide number seven to talk about our multiple employer cases, our MAP cases, which are the big union plans. Some of the issues that we find here, the most common is the

participation agreement issue where we don't have participation agreements for all the groups of employees that are participating in the MAP plan.

A lot of times we have support staff, secretarial staff, union staff, not exactly the rank-and-file union members, but the people that support them are actually making contributions to the MAP plan and are having contributions made for them, but they are not eligible to participate because an agreement has not been signed. What we do is we get a participation agreement signed and give it retroactive effect under Audit CAP, and that's how we resolve that.

We see a lot of errors with benefit calculations, mathematical errors, not following the formula in the plan document. And this also has to do with the large number of employees that go through a plan. A union plan is usually large, and a lot of participants come and go through the plan and their records are not always maintained to be able to provide the proper accrual.

We sometimes see funding deficiencies. When a participating employer in a MAP plan leaves for whatever reason and the remaining employers have to make up the contribution, that causes problems with minimal funding, in both the DB and the Money Purchase MAP Plan. And the actuarial adjustments for participants who continue to work after their normal retirement date. Again, it's a calculation issue and we do see that very often in these types of plans.

M. Sanders: Let me ask you a question about the—how do we handle it when there are conflicts between the union agreements and the plan document itself?

K. Schaffer: The plan document always supercedes any other agreements or site agreements. What's written in the plan document is what we go by when we do the examination. We hope that when there are new union agreements signed that they are incorporated into the plan document and someone is checking the agreement against the document to make sure that the language is proper, to be able to provide for what both the collective bargaining agreement is looking for and the plan document.

M. Sanders: Okay. Very good. That is a common problem we see with a lot of our MAP cases.

K. Schaffer: It is, yes.

M. Sanders: Okay, then moving on to slide eight, this will wrap up the current examination issues found. I just want to point out that there are some really terrific tools on our IRS.gov web page. We have the Fix-It Guides for the 401(k) plan. We have Fix-It Guides for the IRA-based plans, which are our Simple ..., and I know there was phone forum back on October 21 where we shared the 401(k) compliance check questionnaire. That's a great tool for internal controls. So there is a lot of great stuff out there.

Then we'll move on and we'll talk about the procedures and the requirements for participating under EPCRS during the examination process. As everyone knows, right now we're still operating under Rev. Proc. 2008-50, which is generally effective 1/1/2009. It is our understanding that the next Rev. Proc. should be issued shortly, but we've been hearing that for the last year or so, so we're not sure when it's going to come out, but soon.

The biggest change you're going to see in there will be a provision to address the written plan requirement under the 403(b) regulations. Right now the Rev. Proc. is broken into various categories of failures. The four are broken out into plan document compliance, plan document failure form. We have the operational failure, which is the failure to comply with the terms of the plans. We have the demographic failure, which is the failure to satisfy coverage and/or non-discrimination rules even after following the terms of the plan. And we have the employer eligibility failure. It's important to note that EPCRS (Employee Plans Compliance Resolution System) is not available for any abusive tax avoidance transactions, diversion, or misuse of plan assets.

Kathy, why don't you talk about the three correction principles under SCP?

K. Schaffer: Okay. The three main programs that are discussed in Rev. Proc. 2008-50 are the Self-Correction Program, which we referred to as SCP, the Voluntary Correction Program, which we refer to as VCP, and the Audit Closing Agreement Program, which is Audit CAP.

Some of the general principles of the EPCRS Rev. Proc. that apply to all the plans that we just talked about, all the programs, are that when we work on a plan and use EPCRS our objective to restore the plan to a position it would've been in if the failure had not occurred. All years should be corrected regardless. Once we find an error, the plan's deemed to be non-qualified, and we do seek full correction. The corrections should be reasonable and appropriate. And again, we look at every case with facts and circumstances to determine what that should be.

Some of the principles we use under reasonable and appropriate is we like to keep the assets in the trust. We don't like to make corrections that take assets out of the trust. The corrections shouldn't violate another code section. So we shouldn't be making some sort of contribution that might cause a 401(a)(4) failure.

And in regards to 401(a)(4) failures, our correction for that is to give NHCE the additional benefits. We wouldn't allow a retroactive amendment of a plan that was failing 401(a)(4) to conform the operation of the plan to the plan document. We want to use the same method in all the tax years when we make the correction. And the corrective allocation should be based on the plan and come from the employer contributions.

M. Sanders: Kathy, let me ask you a question regarding this correction. When you look at the correction that needs to be done, how do we handle those years where the statute has expired?

K. Schaffer: Well what we do is, as I said, when we find an error in the plan, an operational or a form error, as of the date of the error the plan's disqualified because it's no longer qualified once something like that happens. It hasn't followed the terms of the plan. So we look for correction from the date of the first error up through the current year.

M. Sanders: Okay, so if the error happened in 2001 we'd expect them to make the correction from 2001 all the way through to right now?

K. Schaffer: Yes, we would.

M. Sanders: Where we're at now?

K. Schaffer: Yes, we would.

M. Sanders: Very good. So it has nothing to do then with the statute of ... taxable return?

K. Schaffer: No it does not. It has to do with when the plan first became nonqualified.

M. Sanders: Okay, very good. Thank you.

K. Schaffer: Okay, the EPCRS revenue procedure also has Appendix A, in the back, and Appendix B, and these are very useful tools for correcting your plans under SCP or VCP because all the corrections set forth in Appendix A and B are accessible under SCP and VCP. So these we refer to as Safe Harbor Corrections, and they're the preferred corrections for those types of errors that we like to use if at all possible.

And in addition to Appendix B containing correction methods, it also does contain earnings calculations that you can use should you have some questions about how to calculate earnings. And we didn't discuss it earlier, but we also do allow you to calculate losses when you're formulating the dollar amount of the correction required to put the plan back into the place that it was before the error occurred.

We deem the Appendix A and B corrections to be reasonable. And in terms of Audit CAP, when we make corrections under Audit CAP we've also used the Appendix A and B corrections. And those are our preferred corrections, but it does require the approval of the area coordinator in formulating a correction for an Audit CAP case.

M. Sanders: Excellent. Thank you, Kathy. Let's move on to slide 13. We're going to talk about some advantages of the Self-Correction Program. What's great about this is you can focus on the correction of ... cost of the processing time associated with the voluntary compliance initiative or through the time it takes to have the examination. And the employer then has deemed reliance if corrections are made using Appendix A and B as a Rev. Proc. 2008-50.

Also, this program, the Self-Correction Program, is also used by our field agents. They can apply this also while they're in the field or for these situations that fall into the Self-Correction Program. We can use the Self-Correction Program basically for any operational issues that are not egregious. There has to be practices and some procedures in place.

Generally there's a two-year limit if the failure is significant. If the failure is significant, you have to have a ... determination letter or opinion letter. Usually the deadline to correct the significant failure must be made by the end of the second plan year following the plan year in which this failure occurred. SCP is off the table in that situation if the plan comes under an IRS examination, assuming that the correction has not been substantially completed.

Moving on then to slide nine, as we talked about before, insignificant failures can be corrected at any time to SCP. Okay, we talked about there has to be, again, some type of practices and procedures in place. Kathy and I will talk about some informal procedures, ... and so forth that we look for, for SCP. Again, you can also—what's great about this Rev. Proc. is that there are also provisions in here that have limited use of correction by plan amendments. And these were reflected in slides 20 and 21.

The first one pertains to the IRC ... (a)(17) and the other ... employee needs to receive an additional allocation equal to the HCEs using (a)(17) Comp. The other two pertain to hardship distributions and loan provisions. This allows a plan sponsor to adopt amendments in cases where they were allowed but the plan did not provide them. And the other one is that there is an inclusion of ineligible employees, which allows the employee to adopt amendments, allow these specific employees to enter ... Section 410 is satisfied.

We talked about some of the egregious failures. Examples are when the plan only covers highly compensated employees or that the plan provides benefits to highly compensated employees that are several times greater than the 415 limit. And then obviously in that situation, when it's an egregious failure, like those two examples we just gave you, SCP is off the table.

K. Schaffer: On slide 16 now I'm going to begin talking about why is the correction period so important under SCP. If we have a significant operational failure, the operational failure needs to be corrected, and the correction needs to be either completed or substantially completed by the last day of the correction period. Mike referred a little bit to what the correction period is, but for significant failures, the correction needs to be—the last day of the correction period would be the last day of the second plan year following the year for which the failure occurred.

And we do have a special rule for satisfying 401(k)(3) and (m)(2), which is our ADP and ACP testing, which allows an additional year to be able to make the correction. It's significant under SCP, due to the 401(k) regulations, which gives everyone an additional year to begin with.

Moving on to slide number 18—when we talk about the correction period, the correction period for an operational failure that occurs, for any plan year, ends in any event on the first date the plan or the plan sponsor is under examination for that plan year. And that means that even if you're within your initial two-year period, if you've been contacted that you're under exam, your correction period stops at that time and that's when it would be determined whether or not you had completed it in a proper manner.

M. Sanders: That under examination is an issue that we see a lot here in the field. The definition of that is in Section 5.07 of the Rev. Proc. Basically any plan for which the plan sponsor or representative has received verbal or written notification is when the notification of the examination—because right now we have a lot of agents who call the plan sponsor before they send out the appointment letter.

K. Schaffer: Yes we do.

M. Sanders: Okay, so that's how that works there.

K. Schaffer: On slide 19 we actually talk about the completion. And there are two tests, and you only need to satisfy one of them for substantial completion of correction. The first would be that within 120 days after the last day of the correction period, the plan sponsor completes correction. Or the second one would be, during the correction period, correction is completed with respect to 65% of all affected participants. And under this Rev. Proc. 2008-50, as we know, we've become more generous with both our days and our percentage so that more people can use this for significant operational violations.

M. Sanders: Okay let's move on to slide 22 and talk about some SCP practices and procedures. Again, Self-Correction's only available if the plan has practices and procedures reasonably designed to promote compliance. The plan document itself is not enough. These procedures don't have to be formal and they should be in place before the failure. The operational failure should have occurred because of an oversight or a mistake in applying the procedures.

Kathy, can you give us some examples of some informal procedures?

K. Schaffer: Sure. One of the things that we would look at when we went out on an audit would be every agent will ask for an employee census. And one of the things that the agent will do with that census when it's provided is they will test the census by requesting the source documents that back it up. And one of the things that we would look at, as good practices and procedures, would be that when we tested that census we found all the information to be accurate and timely, which tells us that we have the correct years of service, the correct compensation, the correct eligibility for that particular employee and we know then that we can rely on that.

Another thing would be the actual plan document itself. During the initial interview with the employer, an agent can get a pretty fair reading as to whether or not the employer or the person responsible for the plan has actually read the plan document. Do they know what the allocation schedule is? Do they know what the vesting schedule is? So a really important thing would be to, not only for the employer but anyone he has designated to be responsible for the plan, to read the plan document and know what's in there.

M. Sanders: Right. And you could have different people who have different responsibilities with the employer who need to know the plan provisions.

K. Schaffer: Exactly. And it's very important. So often we'll hear someone—we'll ask and they'll say, "Oh well, the prior administrator told me to allocate 3%," and they've never seen the plan document. So that would be another practice and procedure.

Another thing that we might look at as having practices and procedures in place, for example for a 401(k) plan, would be timely records and contemporaneously kept accurate records of the elective deferrals that were made by all the participating employees. Was everything written down? Do we have copies of the checks? Do we know that everything went on a timely basis? Again, to have people working in the plan and knowing what's going on, on a day-to-day basis, goes along way in practices and procedures.

M. Sanders: Very good. And participant statements are accurate and things of that nature is also—

K. Schaffer: Very important, yes.

M. Sanders: There might be something else in place besides an actual administrative manual. Very good.

Okay, let's briefly talk about the VCP Program, Kathy. I noticed we just have one slide on it, but I think it's important we do talk about some of the situations that we might come across when we're doing field exams.

K. Schaffer: This is slide 24, the Voluntary Compliance Program. A lot of people use it; it's become extremely popular. Basically what happens is that an employer, at any time before they're notified for an audit, can pay a fee, which can be found in the Rev. Proc. 2008-50, and receive the Service's approval for a correction. So they basically come in and tell us about the problem. We approve the correction. Send them a compliance statement. They're not required to make correction before they receive the compliance statement. It's sent out with the understanding that correction will be made.

M. Sanders: And that's a big difference compared to all the Audit CAP programs.

K. Schaffer: That's a huge difference, because under the Audit CAP program, we require full correction before we will execute a closing agreement. So under VCP, they do have special procedures for anonymous submissions. I'm not going to go into detail, but I just wanted to make everyone aware that if you're using the procedures for an anonymous submission, to sort of get a feel of whether your correction's okay or not, this won't provide you any protection from an audit should you receive an audit letter while you're in the middle of the anonymous procedure.

M. Sanders: Kathy, how do we handle a situation where the taxpayer indicates there has been a voluntary compliance submission and the agent has sent out the appointment letter for the examination ... employer?

K. Schaffer: And we do have this happen. What you need to do if you or your client is in that situation, and you have filed a voluntary compliance package with the Service and you do get an audit letter after you filed that, you need to make the agent aware of that. That it's been filed. And also provide the agent with the verification, either if it was sent certified mail, you have a certified mail receipt or something. And then what will happen is he will then speak to his supervisor, who will then speak to Mr. Sanders, and then we can find out from them and work out whether or not this was filed before the audit or not.

And then if so, might you want to explain what happens then if the voluntary compliance package has been filed first, what we do in exam?

M. Sanders: Well in a situation like that then we won't do the examination or we'll either hold the exam off until the submission has been completed. Usually what we'll do then is we'll audit maybe another year and not the year that was initially selected.

But what we have in place to avoid this though is that a lot of our 5500 Series Returns are coded for a voluntary compliance submission. Somehow they do know, the classification knows, that a VCP submission was mailed in and they received it and they updated the system so that way we avoid those types of situations where we're actually knocking on their door when there is a VCP submission out there. The problems we run into at times is that cases are assigned to agents or they're pulled before the notification of the examination, and that's what happens a lot of times when you see these types of crosses in the path and so forth.

K. Schaffer: Because we don't see this very often, but we do see it occasionally.

M. Sanders: Right, it's very infrequent, but we do run into them though. Okay, so let's move on then to slide 25, Kathy. You can talk about the Audit CAP Program.

K. Schaffer: All right, I'm going to talk about the Audit CAP Program. As Mark indicated, I am the area coordinator for the Mid-Atlantic Area. So every Audit CAP case in this area comes through me. So basically what happens is that the agent will come out and they'll identify some failures, and what they will do then at that point is discuss with you whether or not you would like to participate in the Audit CAP Program.

Audit CAP is a voluntary program. And what we do in the Audit CAP Program is we secure correction of the failures that have been found and we require a payment of the sanction. Now the benefit of this is that the plan remains qualified, and that's really what we're trying to do here, and that's why we have the Audit CAP Program. We don't automatically come out and say, "You did not follow the terms of your plans, your plan's disqualified." This gives us a vehicle that we can put the plan back into qualified status with correction and a sanction.

And moving on to slide 26—the Rev. Proc. indicates that the sanction will bear a reasonable relationship to the nature, extent, and severity of the failure, taking into account the extent to which correction occurred before audit. And that being said, that is true. What we do is when we formulate a sanction, and we'll talk about sanctions a little later in the presentation, what needs to be understood is that the sanction and the correction have to be acceptable to both you, as the tax payer or the client, and to the Service. So everyone has to be able to live with what we come up with. No one is required to participate in Audit CAP if they don't choose to or don't like the terms.

Nonamender cases will always be Audit CAP cases because we retroactively amend the plan to allow for the missed law. And Audit CAP is only offered during the employee plans examination period. So it's something that we do here in EP. It's not offered after the case has gone unagreed from our area to either Appeals or to Tax Court. Then it's basically just decided on the law only. But we have the ability to be able to make the correction and put the plan back, which is a very good thing.

M. Sanders: I've seen situations where the Appeals did work the case through a CAP, but their sanction was 100% of the maximum payment figure to bring the plan back into the

K. Schaffer: It's much, much different.

M. Sanders: Yes, their sanctions are different. They will do that, but it's definitely to everyone's advantage to try to settle this on the first level.

K. Schaffer: I agree.

M. Sanders: Okay, Kathy, let's move on to slide 27. In this we're talking about significant and insignificant failures. Again, these types, depending upon if they are significant or insignificant, are going to be processed under SCP or on a CAP.

K. Schaffer: That's correct.

M. Sanders: The first one is the number of failures in each year. If you see numerous failures in each year, that's a good indication that there are no internal controls there and that you're going to have some problems, not just in numerous years, but also with numerous issues. Also, it's the percent of assets and contributions involved in the failure; the number of years affected, the number and percent of participants affected. Was the violation corrected? What's the reason for the error?

Others include maybe coverage or discrimination, but based upon this though the bottom line is—Kathy, if you agree this is basic—facts and circumstances are different for each case.

K. Schaffer: Absolutely.

M. Sanders: Okay. So you have to look at everything. It's not cut and dry in this situation.

K. Schaffer: Every case is different.

M. Sanders: And every case is different. All of these significant versus insignificant, these all have an impact on the negotiation of the sanction, the sanction amount, correct?

K. Schaffer: They do, yes. Yes they do.

M. Sanders: So it's best then to have controls in place to prevent a lot of these from happening. Like we talked about before, practices and procedures are so important, because once we see they are there that's considered the whole way through the process of the examination.

K. Schaffer: It is. Yes it is.

M. Sanders: And that ... concludes even when we do the examination of the plan. When the employees go out there, they just go out there and they do the initial interview, what they're basically doing during that interview is assessing the internal controls.

K. Schaffer: They are.

M. Sanders: And at that point in time, they know if they're going to expand or shut the audit down at a certain point and move forward. So it is important that we do have these practices and procedures in place.

K. Schaffer: That's right.

M. Sanders: So, Kathy, let's move on now and let's go over some significant and insignificant failures, some examples.

K. Schaffer: These are just basically for explanation purposes to see if we can try to give everybody an idea of what we look at in terms of significant and insignificant failures, and on slide 28 we talk about ADP testing.

Something that may very well be deemed significant by itself, not in conjunction with other errors, would be maybe a one-year failure due to a misclassification of an HCE. The big issue that would make this insignificant would be in the subsequent year, when it happened again, that someone caught that error and corrected it so that we only had a one-year error.

Now that same misclassification could become significant if it from one year went to say four years and it wasn't caught by the employer, but wasn't found until the Revenue agent went out and reviewed the testing and identified that there was an error on a number of ADP tests. We would then determine that to be significant.

M. Sanders: And when we're talking about HCEs and we're talking about family members here. Are we not, and lot of time that's the problem?

K. Schaffer: A lot of times that is the problem, yes.

M. Sanders: The family member, either a son-in-law or daughter-in-law or something of that nature, had been misclassified?

K. Schaffer: Not readily identifiable by names and things like that. That only when you get behind it and they start to do the audit do they find out that these people are related and should then be HCEs rather than NHCEs.

Another significant error would be, and Mike talked about this a little bit, sometimes we go out and they've never done the test. For a number of years they just don't do the testing, and then when they do do the testing, we find out that the test fails. And again, that would be a significant error that would need to be corrected under Audit CAP.

M. Sanders: And we see also where they've done the test and they have not made the correction, the distribution of the excess contributions or excess aggregate... contributions also. So they are not taking it to the next step to—

K. Schaffer: complete what it is that's required to be done in terms of their testing.

M. Sanders: Correct. Okay.

K. Schaffer: Moving on to Slide 29, we talk about vesting failures. An insignificant vesting failure may be an erroneous vesting calculation for a terminated participant. For instance, that terminated participant was really 80% vested but maybe someone didn't calculate it correctly and only calculated it at 60% and paid them out that way. So they'd be doing an additional contribution. That would be something that we would consider to be insignificant.

Where it would become significant would be that if we looked over a number of years we saw that every vesting calculation, distributions for terminated participants, had been done incorrectly. And I think, Mike, you and I talked a little bit about what we would do if we didn't in fact have terminated participants but just had a paper error. Would that have the same impact?

M. Sanders: Right. We see that quite a bit also when these agents go out into the field. The vesting calculations are incorrect, but fortunately there hasn't been any payouts or terminations or anything of that nature. And if that is the case, then that is not even an issue where we would bring it to a CAP or anything of that nature, correct?

K. Schaffer: No, we would address it with the employer to make sure that we got it corrected before a termination occurred. But we wouldn't, for that issue alone, we would not—

M. Sanders: But that's also an indication of poor controls and would be considered possibly if there were other issues that were brought forward during the examination.

K. Schaffer: Absolutely.

M. Sanders: Okay, so even though there was no one who was specifically impacted directly it is an indication though that the controls or the procedures or practices in place are insufficient.

K. Schaffer: That is true.

Moving along to slide 30, talking about erroneously excluded employees, which is one of our most common errors. Something that would be determined to be insignificant would be an employee that was excluded from a contribution for a year. It could even be for more than one year. It could be for two years. Maybe they came in the middle of the year or something like that. We would determine that to be insignificant. One of the things we would look to see is was it found before we got there?

What might make that significant would be if we had multiple employees excluded. Specifically, if we had a specific group of employees, such as part-time employees or employees from a certain employer within a controlled group, that has been overlooked for a period of time and maybe not found until the agent came out to do the audit.

M. Sanders: And again, we see this a lot with the Employee Plans Team Audits where another company is acquired and they are excluded from the plan and they should be included based upon the plan provisions.

K. Schaffer: That is absolutely correct. We do see it there especially.

M. Sanders: And again, any practices and procedures in place are considered for this when we say it's insignificant. I mean there has to be other practices and procedures in place. We take into consideration everything when we do this. It's not just the one issue itself.

K. Schaffer: With the erroneously excluded employees, the practice and procedure we would look for would be that they were found before we got there.

M. Sanders: Right. How about in a situation where we found that that employee was omitted for two years and we also found one employee who had a problem with the vesting of other issues throughout the plan? We see that quite a bit, also, even though the true financial impact isn't that great on the employer, but it could be for the participant and so forth.

K. Schaffer: Yes we do. And as the issues begin to melt we find, we sort of start to go to, "Do we have poor internal controls and practices and procedures?"

M. Sanders: Right. So it's important here in this particular section that the employer has practices and procedures in place, and even to process the case while it's under examination for CAP or SCP that all corrections are made prior to us moving forward to the next case or whatever else.

K. Schaffer: That is correct.

M. Sanders: Okay. Thank you, Kathy. And that concludes that particular section.

Now let's move on to how CAP sanctions are determined and negotiated under the Audit CAP. Again, a sanction under Audit CAP is a negotiated percentage of the maximum payment amount. Kathy will talk about how we compute the maximum payment amount and what's considered and not considered in that calculation. Again, when we talk about the sanctions, you know the sanctions are not intended to be excessive and will bear a reasonable relationship and the nature ... to failures based upon the factors that are outlined throughout the Rev. Proc. itself.

So moving on then, how are sanctions determined and negotiated under Audit CAP? Factors that we consider are the equities of the employer. What steps were taken by the plan sponsor to ensure that the plan had no failures? Are there steps taken to identify failures that may have occurred? To extent, which correction had progress before the examination was initiated, including full correction, the number and type of employees affected by the failure, the number of non-highly compensated employees adversely impacted?

We also look at and see if whether the failure to satisfy the requirements of Section 401(a)(4), discrimination or participation of coverage under 401(a)(26) and 410(b). And also was the reason for the failure a transcription of data, transposition of numbers, or minor arithmetic errors? All this is considered when we're talking about negotiating the sanction and so forth.

Another thing we talk about, Kathy, is the cost of correction. You talked about before there are different modes of corrections that could be made by the employer based upon what's reflected in the Rev. Proc.?

K. Schaffer: Yes there is.

M. Sanders: Is that also considered in the sanction?

K. Schaffer: We do consider the cost of correction. We do need to look to see the dollar amount, because sometimes the corrections can be prohibitively expensive, and we can't bankrupt an employer. We have to come up with a correction that will keep the plan qualified. We want to keep the employer in business at the same time.

So we do what we can, and that's why each case is really based on its own facts and circumstances. And why it's really important with the financial issues, especially in these times, that if there are financial issues to be considered, they need to be brought forward to the agent and to myself. We need to know those things.

M. Sanders: What would you be looking for? What are the types of records that you look for to confirm the financial condition of the employer and so forth? I mean you want something obviously that's more than verbal. You'd like to see something a little bit more concrete.

K. Schaffer: Yes. A lot of times what we'll look at is we will look at prior year tax returns. Mainly to confirm that yes, the business has been losing money on a regular basis or has become—

M. Sanders: ... things of that nature.

K. Schaffer: Right. We look at those things. We look at salaries. Whatever the employer wants to provide to us, we will be more than glad to look at and make a determination as to what we can do here. It is important that we look at as much as possible. So whatever they're willing to provide to us is fine.

M. Sanders: Okay. Very good. So equities play a major role in the CAP sanction itself. The more equities presented the better off the employer will be.

K. Schaffer: That is true.

M. Sanders: So they definitely want to demonstrate that they have practices and procedures in place and that they are being utilized and so forth.

Okay. Then moving on let's have you briefly talk about the maximum payment amount, Kathy, since this is a consideration for the sanction itself.

K. Schaffer: Okay. We've talked about the sanction being a negotiated percentage of the maximum payment amount, and the big mystery, I think, sometimes is how the maximum payment amount is calculated. It's basically a monetary amount that would be approximately equal to the tax the Service could collect, if we disqualified the plan. So the agent will look for the open tax years to see what the tax would be on the trust if we converted the qualified trust to a taxable trust. So we would look at the tax on the trust—

M. Sanders: Okay, so when we're talking about the tax on the trust though, are we talking about unrealized earnings or realized earnings or both?

K. Schaffer: Realized earnings. It would be realized earnings. Just like it would be if it were a taxable trust. And we would also look at any additional income tax that resulted from the loss of the employer deduction for plan contributions. So if we would disqualify the plan they would not get the benefit on their business return of the contribution that they made to the employees.

M. Sanders: So you're referring to anything there in this situation that is non-vested.

K. Schaffer: Non-vested, that is correct.

M. Sanders: So anything that is non-vested would be taxable to the employer on their corporate or whatever—

K. Schaffer: As a disallowance of the deduction—

M. Sanders: —whatever taxable return they file.

K. Schaffer: That is correct, yes.

M. Sanders: Okay, so we have the tax on the trust, which are the realized earnings, and then the loss of the employer deduction on the taxable return.

K. Schaffer: And then the third portion would be any additional income tax that would be due to the participant from having to include the income that they received as taxable-earned income for the years that would be open under audit. Now this would also include any distributions that have been made from the plan and rolled over to another qualified plan, because if the plan were not qualified they couldn't do that rollover. So that would become a taxable event to them also.

M. Sanders: Okay, so in this situation—earlier we talked about how correction has to be done for all years. We go back to 2001 until whatever we're working on right now. Is that philosophy also considered when we calculate the maximum payment amount?

K. Schaffer: When we calculate the maximum payment amount it would only be on the open taxable years itself.

M. Sanders: Okay, so generally that's three years we do these examinations. Generally it is three years in that situation.

K. Schaffer: Three years, yes.

M. Sanders: Okay, very good. So it looks like we know how the maximum payment amount is calculated. I can tell you though from my experiences that this is not a science when the agents do this. So it would also be beneficial for the employer sponsor, at times, to calculate their maximum payment figure.

Or they can ask the agent what the amount was that they came up with, what that's based upon, and how that was determined. And they can ask the agent for this, "Hey, how did you calculate this maximum payment figure? Show me what it is," because it's definitely going to have an impact along with any other facts and circumstances on the sanction.

K. Schaffer: Absolutely. And if there would be any disagreement they would be more than welcome to submit their version of the maximum payment calculation for the agent to review.

M. Sanders: Very good. Okay, thank you. Let's move on then since our time's getting short here. We only have a couple of minutes left. Let's move on here to the sanction for nonamender issues, Kathy.

K. Schaffer: The sanction for nonamenders, we talked earlier that all nonamenders had to be Audit CAP. And there is a fee schedule in the Revenue Procedure 2008-50 that applies to nonamender issues discovered during the determination process, and everyone looks to that fee schedule.

Now in the new Revenue Procedure 2008-50 there has been a sentence added that says, "That if one of the failures discovered during the examination includes a failure to amend the plan for relevant legislation, it is expected that this sanction will be greater than the applicable fee described in Section 14.04."

And I get this question often, when someone gets a sanction they'll say, "Well how come it isn't the amount on the determ fee schedule?" The reason for that is the people who come in for determinations come in voluntarily, and we find this on audit. So, therefore, in order to protect that determination fee schedule and that whole program and the Voluntary Compliance Program, our sanction will be higher.

M. Sanders: So it's higher for the fact that we want to maintain the integrity of the Voluntary Compliance Program. It's a great program. It's utilized more and more each year. It's the way to go if you can't correct under SCP.

K. Schaffer: Absolutely. We encourage everyone to do that under Voluntary Compliance.

M. Sanders: And the sanction is generally—you're better obviously coming under VCP, making the correction, paying whatever fee they want than coming through the Audit CAP Program.

K. Schaffer: Absolutely. You can go to the Revenue Procedure and see the voluntary compliance fees for the size of your plan.

M. Sanders: Right. Okay, and let's move on then to the final slide. You should begin negotiating the sanction as soon as basically the examination is complete. We talked about all the equities and mitigating factors and circumstances that have to be considered for the sanction itself. I mean it's very important that the agent knows these.

I recommend that the employer or sponsor provide them in writing to the agent when they come back with the sanction, the proposed sanction, that they think is fair and reasonable for them to consider for the fact that that is given to you also, which is considered. And you and I at times sit down and discuss these and make that determination.

K. Schaffer: We do.

M. Sanders: And again, I know there are times when the negotiations break down with the agent, and at that point in time it's best to either to call the agent's manager or call me. We'll find out what the problem is. Usually it's just a communication problem. We'll get it together and we'll get this resolved.

As you can see from what we went through so far that the negotiation of this sanction isn't a science. I mean there are factors that we consider the whole way along through the process. I mean there's nothing that's engraved in stone or anything of that nature. You won't find in the next Rev. Proc. where there's actually going to be amounts for Audit CAP or something like that for operational issues.

I just wanted, again, to bring everyone's attention to go into our Retirement Plans Community web page under the irs.gov website. That is such a great resource. There are all types of Fix-It Guides in there, newsletters, and things of that nature.

INTERNAL REVENUE SERVICE

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Right now that will conclude this phone forum. Any questions that we did not get to or incorporate into our presentation, we will see that those responses are emailed back to the folks who submitted them.

We thank you for your time.

K. Schaffer: Thank you.

Moderator: That does conclude our conference for today. Thank you for your participation and for using AT&T TeleConference Service. You may now disconnect.