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## LEGAL DEVELOPMENTS

### *A Look at the IRS's New Employee Plans Audit Pilot Program*

*This column considers various facets of the new 90-day pre-examination compliance pilot program announced by the Internal Revenue Service in June.*

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In the June 3, 2022 *Employee Plans News*, the Internal Revenue Service (IRS) announced a new 90-day pre-examination compliance pilot program (the Program). The Program provides an avenue to streamline a retirement plan audit, and is designed to reduce a plan sponsor's burden and reduce the amount of time spent by both the IRS and the plan sponsor on retirement plan examinations. This streamlined approach requires that plan sponsors

address the specific audit issue raised in the IRS letter, as well as provide documentation that supports overall compliance. Importantly, failure to respond to the IRS letter will result in the IRS contacting the plan sponsor to schedule an exam.

Although there is very little detail available regarding the program, we consider facets of the Program in Q&A format below.

### **Q: What Plans Are Impacted?**

The guidance does not indicate that the Program is limited to a specific type of plan, or a plan with a specific plan feature. Looking at one example, the letter was issued to a profit-sharing plan and focuses on Internal Revenue Code (Code) section 415(c) limits, but we anticipate that other issues and types of plans will be part of the Program.

### **Q: Why Is It Important?**

IRS audits are a very important tool for the IRS in ensuring that plan sponsors maintain the tax qualified status of their Plans. If the IRS discovers an operational error, and it is not corrected properly in accordance with the Employee Plans Compliance Resolution System (EPCRS) [Rev. Proc. 2021-30], then a list of unfortunate tax ramifications may result, including participants being currently taxed on their plan benefits with no ability to roll over the amounts to another plan or Individual Retirement Account (IRA), the plan sponsor's loss of tax deductions and liability for employment taxes, and a taxable trust. [Tax Consequences of Plan Disqualification|Internal Revenue Service (irs.gov)]

### **Q: How Long Is the Program?**

The guidance does not indicate a particular timeline for the pilot program. It only indicates that the initial letters will be sent in June 2022, and that at the end of the pilot, the IRS will evaluate its effectiveness and determine if it should continue to be part of the IRS's overall compliance strategy. Notably, the last big program that the IRS did in this area was in 2020—the "IRS 401(k) Compliance Questionnaire." That program included 1,200 randomly selected 401(k) plans, using a checklist-type electronic survey approach to encourage broader voluntary compliance and save IRS agents time and resources, but only resulted in an audit if the plan sponsor failed to respond. This Program is different because the plans are already selected for exam, but the end result of increasing

compliance and saving IRS time and resources seems the same.

### **Q: What Is So Special about This Program (Compared to a Regular Audit)?**

Unlike a regular IRS examination, the plan sponsor is provided with a 90-day waiting period before the examination is to take place. Moreover, the sponsor may largely avoid the audit with proof of compliance with respect to the issues(s) raised in the IRS letter. Perhaps indicative of the Program, the sample letter was primarily focused on a single qualification issue (although it indicated that other issues that exist can be also reviewed). Therefore, the Program may be designed to perform a more limited audit of the plan, potentially allowing for the audit of a larger number of plans.

For example, the letter may indicate that the audit is focused on a violation of Code section 415(c). If the plan sponsor provides documentation within the 90-day window that the 415 limit was not violated by any plan participant for the tax year under examination, then it appears that the IRS will not ask for any further information and will issue a letter to close the audit with no further contact.

Moreover, the 90-day period is designed to give plan sponsors time to review their plan document and operations to determine if there is any other plan qualification failure that could be either self-corrected or corrected through the Voluntary Correction Program (VCP) (if it had been discovered prior to the audit letter). The Program importantly permits plan sponsors to (1) correct any errors that are available for self-correction (presumably insignificant errors) and have the IRS approve the correction taken; and (2) identify to the IRS any other failures that could be corrected through a closing agreement, but with the sanction imposed on such errors determined using the VCP filing fee structure (presumably not to exceed \$3,500), rather than a facts and circumstances determination of the sanction (which typically far exceeds the VCP filing fee).

### **Q: What Are My Options if I Get a Program Letter?**

The IRS is encouraging you to take this opportunity to review your plan document and operations to determine if they meet the current tax law requirements. This includes reaching out to your ERISA or tax advisor, along with a service provider that assists

in the documentation and operations of the plan. Any deficiencies should be corrected as noted above.

To the extent that a failure is discovered by the IRS as part of the examination that was not disclosed as the Program intends, then the standard sanction factors apply to determine the fee (and will not be limited to a \$3,500 cap), which include:

- The presence of internal controls designed to ensure that the plan had no failures or that such failures were identified and corrected in a timely manner;
- Number of affected employees;
- Impact on non-highly compensated employees;
- Whether it is a demographic failure or an employer eligibility failure;
- Length of time failure occurred;
- The reason for the failure; and
- The Maximum Payment Amount as defined in sections 5.01, 5.02 of Revenue Procedure 2021-30.

Therefore, the following options are generally available:

1. Review the plan and operations for compliance with the Code, disclose to the IRS any failures, and correct such failures that are eligible for self-correction within the 90-day window. A plan sponsor can seek to have any failures that are disclosed, but that are not eligible for self-correction, covered by the closing agreement, with the maximum sanction of \$3,500.

If the IRS disagrees with the method of self-correction, the plan sponsor requests a closing agreement for failures that cannot be self-corrected, or the plan sponsor has other compliance issues, the IRS will conduct either a limited or a full scope exam, at its discretion.

2. Review the plan and operations for compliance solely with respect to the particular issue that is raised in the audit letter, and provide documentation of compliance with the rule or show there was a failure. For any failure eligible for self-correction, correct the failure within the 90-day window and provide evidence of correction. (Although this is clearly not the intent of the Program, as the IRS is encouraging plan sponsors to undertake a review of their plan documents and operations, there does not appear to be a mandate to perform such task, with the understanding that if an issue is discovered by the IRS on audit, the standard sanction

– facts and circumstances test – applies, so a larger sanction is anticipated.)

If the IRS agrees with the methods used to self-correct mistakes in the plan or the plan sponsor's documentation shows no compliance issues, the IRS will issue a closing letter with no further contact. However, if they disagree with the methods of correction, or if the plan sponsor requests a closing agreement or has other compliance issues, the IRS will conduct either a limited or a full scope exam.

3. Do nothing.

The IRS will schedule the examination after the deadline has passed. It is unclear if this examination will be a limited or full scope audit.

### Q: Why the Need for the Program?

The stated reason is to reduce a plan sponsor's burden and reduce the amount of time spent on retirement plan examinations. It is true that an IRS audit, like a DOL audit, can take a year (or more) to complete. Further, it is no secret that the IRS has limited resources, and the pandemic has slowed down the standard process time for many of its functions. Moreover, a not so favorable report was recently issued by the Treasury Inspector General for Tax Administration (TIGTA) on February 2, 2022, which found that overall quality scores for IRS examinations decreased by 23 percent from 2018 to 2020 and recommended changes to improve the quality of examinations, while also noting that additional actions could be taken to improve examination quality. [See, *Employee Plans Examination Quality Review Scores Have Declined, and Efforts to Identify Trends and Implement Corrective Actions Could Be Improved* (treasury.gov)] Therefore, this creative approach of encouraging plan sponsors to take on more of the heavy lifting of discovering and correcting plan failures, although 90-days is not a lot of time to act, is a rather innovative way to focus plan audits.

### Q: Should My Attorney Respond to the Letter?

The sample letter expressly includes a reference to the Form 2848, Power of Attorney, that can be submitted with the response, if the plan sponsor elects to authorize a third party to represent them. Further, if the plan sponsor wants to give permission to the IRS to release the plan sponsor's confidential

tax information to a third party, a Form 8821, Tax Information Authorization, should also be completed and returned to the IRS with the response.

In addition, if properly structured, a law firm-assisted response to the IRS under the Program may qualify for the attorney-client privilege.

**Q: Can I Pay the Sanction from the Plan?**

No, closing agreement sanctions are not deductible, and generally cannot be paid from the plan.

**Next Steps**

If you receive a letter, check with your ERISA or tax advisor, and third party recordkeeper, regarding

the proper response in order to help minimize the time and resources of an IRS audit. Additionally, stay tuned as we learn more about the Program, and how the IRS is handling the process. Hopefully, this is an opportunity for plan sponsors to address qualification failures through a streamlined process, with reasonable fees imposed.

If you don't receive a letter during the pilot, it is still a good idea to review your plan document and operations for compliance, and consider self-correction and/or a VCP filing in accordance with EPCRS [Revenue Procedure 2021-30] to correct qualification failures, which are not subject to a statute of limitations period. ■

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