



IRS Plan Audits are on The Rise Once Again!

With the EGTRRA plan restatement process winding down, and a new focus on compliance and disclosure on the rise, the Service is dedicating resources to plan examinations. The most recent audits have been all-encompassing, reviewing every detail of plan operation and documentation. While many plan sponsors believe they are in full compliance at all times, it is often the small details that can lead to big trouble.

Three Real-Life Examples: How Much Can Non-Compliance Cost You?

Which of these scenarios do you believe the IRS would consider the most egregious? Which of these cases drew the largest IRS penalty?

- Scenario 1 – A family owned manufacturing company failed to include cafeteria (flexible spending) plan contributions in the definition of compensation when calculating 401(k) plan contributions.
- Scenario 2 – In addition to being the sole owner of his medical practice, a physician owned a local restaurant whose employees were not covered by the retirement plan of his medical practice.
- Scenario 3 – A two person law firm is unable to locate a signed copy of its GUST plan document.

When the IRS finds a compliance violation, there are NO questions about “if” it is or is not a violation. The only questions are how will it be corrected and how much will the sponsor have to pay for its violation. Sometimes the results can be surprising.

Let’s look at each scenario:

Scenario 1 - The definition of what can and cannot be counted as compensation is controlled by both the plan document and the law. Failure to follow either of these can have a significant impact. In this case, the exclusion of cafeteria plan contributions (which are not taxable compensation under either federal or state law) was not authorized by the

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plan document (as such exclusion would penalize employees who participated in the cafeteria plan). As a result, the contribution calculation shortchanged the affected employees. The sponsor must correct the failure for all applicable years, making an additional contribution together with lost earnings. In addition, the IRS will assess additional penalties.

Result of non-compliance - Even though the total amount required to be contributed to correct the failure was less than \$3,000, the potential taxes if the plan were disqualified for its operational failure exceeded \$100,000. MMG's attorneys were able to negotiate the penalty down to \$5,000.

Scenario 2 – This owner-physician was not alone in thinking his ownership of an unrelated business would have nothing to do with the retirement plan of his medical practice! However, based on the laws that were designed to prevent plan sponsors from manipulating business entities to exclude rank and file employees from participation, the physician was required to consider these employees for plan purposes. While these rules are complex, the IRS expects plan sponsors will seek necessary guidance from experts. When ignored, the impact is often significant, including funding of past contributions, lost earnings and additional IRS penalties.

Result of non-compliance – Fortunately, most of the employees of the restaurant were young and worked part-time, and therefore could be excluded under the plan's eligibility rules. But covering the otherwise eligible employees cost \$36,000, as well as an IRS penalty of \$10,000 (disqualification of the doctor's plan would have resulted in taxes of more than \$200,000).

Scenario 3 - Failure to sign required plan documents and amendments in a timely fashion is one of the most common mistakes made by plan sponsors. Unfortunately it threatens the tax qualified status of the entire plan, resulting in immediate taxation of all vested plan assets, loss of the employer's tax deduction for contributions and tax on the income of the trust for all open years.

Result of non-compliance – This two person plan had assets of less than \$2 million and disqualification would have resulted in tax of \$900,000. Through careful negotiation with the IRS we were able to reduce the penalty to \$12,000, and submit an up-to-date plan document in exchange for the IRS not seeking disqualification of the plan. While perceived by plan sponsors as no big deal, one missing plan document can be an expensive proposition (including the expenses of the legal and consulting help).

In all three examples, the employers who believed they were running their plan in full compliance were shocked to learn the extent of their problems. As you can see, the financial consequences of even a small mistake can have a devastating impact on the business, not to mention on the stress to owners!

Best Approach

The best approach is to prevent even small mistakes from ever happening. All of these were avoidable. Quality, pro-active consulting, and education of plan sponsors will eliminate many of these errors. That said, even the IRS understands no one is perfect. In response it has established voluntary correction programs which are designed to enable plan sponsors to admit their errors before they are discovered upon audit and for a low fee (and sometimes no fee) provide sponsors its blessing in correction of the mistakes. This is ALWAYS less costly than when the IRS finds even a “minor” mistake during a random audit.

MMG’s attorneys are experienced in navigating the correction programs and carefully negotiating the best result for their clients. We are glad to discuss specific situations with you in a complimentary, no obligation consultation in order to help you determine the best path forward.

Call us! You and your clients will be glad you did.

If you’d like to discuss how we might help you, call or e-mail Bob Mand, Ken Marblestone, Lori Gordon, Ian Haring or Mike O’Connell at MandMarblestone. 215-222-5000, or email us at:

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