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IRS Makes Employers' Internal Controls a Priority in Employee Plan Audits

For more than a decade, the Internal Revenue Service has been refining its approach to examining tax-qualified retirement plans, most recently by focusing on internal controls, according to BNA interviews with attorneys and auditors who help employers maintain their plans' tax-qualified status.

Internal controls are the documented practices and procedures that prevent errors from occurring or that quickly flag errors before the errors have large financial consequences. IRS recognizes their role in keeping plans compliant with the dozens of tax code rules that apply to plan sponsors.

''Clearly IRS has moved to the forefront their focus on specific and tangible internal controls, and that means they look for proof or evidence of actual checks and balances,'' Thomas G. Schendt, a partner at Alston & Bird in Washington, told BNA.

Practitioners need to understand that, ''as the emphasis on internal controls is being implemented by IRS, so follows the emphasis on proof or retention of records and documents that prove the internal controls have been implemented,'' Schendt said.

For example, if a plan administrator says in response to an agency query that a third party administrator was responsible for sending out safe harbor notices three years ago, the plan administrator must be able to prove that the notices were sent out, he said.

''It is not just about having internal controls but about proof that they have been implemented,'' Schendt said. Certain notices, enrollment kits, election forms, and other disclosure information should be retained as evidence for when IRS asks for proof of internal controls, he said.

Employee Plan Audits. IRS agents now begin their focused audits by asking questions about the plan sponsor's internal controls so they can quickly size up the situation and set the scope of the audit. If a plan sponsor can show checks and balances in key areas of plan operations that the IRS has identified as prone to error, then the IRS does not need to spend its time and limited resources to expand the examination, said Wayne Kamenitz, an executive director in the human capital practice at Ernst & Young in Iselin, N.J.

When IRS examines a large plan, typically one with 2,500 or more participants, it looks on a controlled group basis at the internal controls associated with the plan sponsor's human resources and payroll systems, Kamenitz said. On that basis, IRS auditors decide ''whether they need to expand the audit to other plans, other years, and other issues, or move on to the next employer,'' he said.

IRS's focused audit approach to examining plans of all types and sizes, including ''one participant'' plans, relies on an internal controls analysis and interview to determine the scope of the audit and potential compliance risks, Monika A. Templeman, director of IRS employee plans examinations, told BNA. ''The bottom line is that the strength of a plan sponsor's internal controls is a factor in plans of all sizes,'' she said.

The IRS Employee Plans Team Audit Large Case Program (EPTA) examines plans that are over 2,500 participants, Templeman said. EPTA recently completed a pilot on an audit approach centered around internal controls and the analysis of key systems (such as Human Resources and Payroll) to determine audit risks, she said.

Plan Loans. Employers of any size must exercise due diligence in administering plan loans, for example, which is one of the top five problem areas identified in IRS audits, Schendt said. Plan loans require documentation, and a residential loan for a primary residence requires proof that the loan was premised on a primary residence, he said.

To verify an employer's internal controls, IRS auditors are now requesting physical proof that the loan was initiated for a primary residence and that the employer or TPA has retained those records, Schendt said. That means, for example, having records available back to 1997 or 1998 to document a 15-year residential loan, he said.

Participant enrollment is another area of plan administration for which internal controls are necessary, Schendt said. ''Did the participant receive an enrollment package, and what was it?'' are the key questions, he said.

Good internal controls require that the physical enrollment package be retained for as long as the period is subject to audit, Schendt said. Employers should verify that the plan administrator or the TPA is retaining those records, he said.

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Plan Distributions. IRS auditors also look for internal controls that will ensure proper plan distributions, including required minimum distributions and normal benefit distributions, Schendt said. In this area, IRS is looking for proof that employers searched for missing participants and that distributions were properly made, he said.

The concept of establishing and monitoring internal controls may be somewhat foreign to small employers that sponsor tax-qualified retirement plans, but it is an important and valuable concept for those employers, too, Kamenitz said.

''It's worthwhile for employers to have strong internal controls that are monitored and reviewed,'' especially in industries in which there are frequent mergers and acquisitions and high employee turnover, Kamenitz said.

''The cost of noncompliance is really huge when it comes to employee benefit plans because there is no statute of limitations'' on fixing operational errors, Kamenitz said.

''If the IRS finds an error on examination,'' he said, ''it can go back to the beginning of time and require a correction. It could cost a very large percentage of the assets in the plan, when you consider that the employer would lose a deduction, the plan trust would become taxable, and the participants would be taxed on their vested balances in a disqualified plan,'' Kamenitz said.

Plan Disqualification. Plan disqualification does not benefit the employer or plan participants, Schendt said. ''The IRS is aware of this,'' he said, but he added that plan disqualification is the means available to IRS ''to push other levels and degrees of compliance or proof of compliance during an audit.'' Plan disqualification may not be the ultimate conclusion, but there are numerous steps along the way that can be difficult for a plan sponsor to negotiate, Schendt said.

For example, if a case is preceding down a path toward disqualification, IRS will ask for statutory extensions not only for the employer but also for potential key executives in the plan, Schendt said. ''That process of reaching out to executives to extend their statute [of limitations] is as difficult to manage as any other form of potential correction in an audit,'' he said.

Although it is rare for IRS to disqualify a retirement plan, it can happen when an employer cannot fix an error because it goes so far back that fixing it is too costly for the employer, Kamenitz said.

Instead of disqualifying a plan, IRS usually negotiates with the plan sponsor on a dollar amount to be paid as a sanction for operational errors discovered during an audit and requires that ''participants be made whole'' by restoring missed salary deferrals, employer contributions, and earnings on investments, Kamenitz said.

Templeman said ''the strength of internal controls'' is taken into account in negotiating the size of a monetary sanction for plan qualification errors when IRS signs an audit closing agreement with a plan sponsor.

''What you try to do with these internal controls is pick up mistakes quickly, so that they don't snowball into a bigger problem,'' said Kathryn J. Kennedy, professor of law and director of the Center for Tax Law and Employee Benefits at John Marshall Law School in Chicago.

Compliance Checklists. When retirement plans are ''qualified,'' they provide significant tax benefits, but at a price, said Leslie A. Klein, a shareholder at Greenberg Traurig in Phoenix. ''The price we all pay is that there are very technical requirements that need to be satisfied for these plans to be qualified,'' he said.

The technical requirements are enumerated in the tax code and regulations and in the Employee Retirement Income Security Act (ERISA) and subsequent amendments and regulations.

In addition to the proprietary checklists of requirements that attorneys can offer their clients, IRS and the Department of Labor have created a variety of freely available checklists and compliance tools, including determination letter checklists, Internal Revenue Manual checklists, and a self-compliance tool for Part 7 of ERISA, said Paul M. Hamburger, a partner at Proskauer Rose in Washington.

IRS 'Fix It' Guides. A good place to begin, especially for small-plan sponsors, is with one of the ''fix it'' guides that IRS has created for specific types of retirement plans, including tax code Section 401(k) and 403(b) plans and various small-employer plans, Kennedy said.

''I would start with the fix-it guides, because they identify the most common types of mistakes the IRS sees under those plans,'' Kennedy said.

The items on the fix-it checklists—elective deferrals, matching contributions, and plan loans, for example—correspond to technical language in the plan documents that employers adopt when they agree to sponsor a retirement plan.

Service providers, too, can be helpful in preventing certain types of errors, especially employer eligibility errors, which could cause a plan to lose its tax-qualified status, said Linda Segal Blinn, vice president for technical services at ING U.S. Retirement, in Hartford, Conn.

As part of its internal controls, the investment service provider requires any employer that asks about sponsoring a Section 403(b) plan and that is not a public school to show an IRS determination letter as evidence that the employer is a 501(c)(3) organization and, therefore, eligible to sponsor a 403(b) plan, Blinn said.

Procedures Manual. An employer that sponsors a retirement plan is required to adopt a retirement plan document that sets forth the rules for ''who is eligible, when they are eligible, what amount of contributions go in, how the money is invested, and when the money comes out,'' Klein said. An employer's internal controls for implementing those rules are described in a separate document, typically a ''procedural manual,'' he said.

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The procedural manual should summarize every legal requirement set forth in the plan document, and it should describe the responsibilities of various departments, such as human resources and payroll, for complying with those requirements, Klein said.

''The idea is that someone who hasn't read the plan document and doesn't know about the employer's internal procedures could pick up this procedural manual and see who's doing what and why,'' he said.

The other advantage of having internal controls is that IRS permits plan sponsors that maintain internal controls to ''self correct'' certain kinds of plan errors without paying a fee or submitting a correction request for IRS approval, Klein said.

''One of the requirements for self-correction is that you have practices and procedures designed to minimize the risk of failures,'' Klein said. Having a procedural manual would satisfy that requirement, he said.

Compliance Reviews. Schendt said that, although IRS encourages employers to conduct their own compliance reviews, he advises employers to consider the pros and cons of self-reviews.

The pros:

- Employers can demonstrate that they are monitoring the plan and plan administration.
- Employers can show that, notwithstanding some errors, they have established a routine, objective process for reviewing the plan.
- Employers can give IRS some assurance that, if errors occur, they are caught and corrected.

The cons:

- A self-review is expensive and should focus on key areas that IRS tends to review, such as plan loans, hardship withdrawals, and other distributions; enrollment or participant eligibility; and deferrals.
- A self-review must be done properly to retain attorney-client privilege.
- A self-review must be done strategically and be reported to a limited group of people to retain its privilege and focus.

A plan sponsor cannot strengthen its internal controls if it is unaware of errors occurring in administering the plan, Hamburger said.

When meeting with a plan sponsor to discuss internal controls, Hamburger said, his main objective is to create an atmosphere of candor that encourages everyone who has responsibility for the plan to speak up about errors.

Internal controls do not need to be automated to be effective, Hamburger said. Sometimes ''old school'' solutions work well, such as the use of paper routing slips to circulate plan amendments to representatives of human resources, payroll, finance, and other key departments before the amendments are presented to the employer's retirement plan committee for adoption, he said.

The routing slip gives ''the gist'' of the amendment in a few sentences and requires signatures from all departments involved in the operation of the plan, Hamburger said. When the amendment ultimately is presented to members of the plan committee, who are the plan fiduciaries, the members know that the amendment was ''properly vetted'' and that the departments responsible for implementing the change are aware of the amendment, he said.

Plan sponsors should review their internal controls at least once a year, Templeman said. Annual compliance reviews are especially important when plan sponsors hire outside service providers to help with administering the retirement plan, she said.

''Just because [service providers] are hired does not mean you can place internal controls on the back burner,'' Templeman said.

Weak Internal Controls. A major source of weak internal controls ''is outsourcing the plan administration and assuming that everything is being done correctly,'' Kennedy said.

''While we'd all like the IRS to chase after the third party that got us down the wrong path,'' Klein said, the party that the law and IRS hold responsible is the employer receiving a tax deduction for contributing to a retirement trust for its employees.

A major incentive for employers to review their internal control practices and procedures at least once a year is to be eligible to use IRS's self-correction program, Klein said. Under that program, plan sponsors ''can basically self-correct any operational failure within two years after it has occurred,'' he said.

An operational error occurs when a retirement plan is not operated according to the terms of the plan document and laws governing qualified retirement plans.

Correction Procedures. Schendt said all of his clients adopt a plan correction policy designed specifically for the types of problems that a particular client incurs and for the types of plans the client maintains. ''This policy is circulated to all vendors so there is complete buy-in at the vendor level and the internal plan administration level,'' he said. ''Implementing a universal policy enhances the overall 'internal controls' evidence that IRS is looking for and that clients maintain,'' he said.

Most employers prefer to use self-correction methods for bringing their plans back into compliance with qualified plan requirements, Klein said. However, some compliance errors require employers to pay correction fees and submit requests to have their corrections approved under IRS's Voluntary Correction Program (VCP), described in Revenue Procedure 2013-12 (47 PBD, 3/11/13; 40 BPR 658, 3/12/13).

Employers would rather avoid having to make VCP submissions, Klein said. However, when plan sponsors recognize they have problems and take steps to fix them, ''it's remarkable what good plan administrators they become,'' he said.

By going through the VCP submission process, employers gain a much better appreciation ''for what the plan says and for what their internal systems must do,'' Klein said. ''They understand at that point that this is pretty important stuff and that a minor mistake results in huge amounts of time to fix things, not to mention my bill or another lawyer's bill.''

BY FLORENCE OLSEN

A video on internal controls will be available in the Video Insights area of the Benefits Practice Resource Center and on Bloomberg BNA's Pensions & Benefits Blog.