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VOLUNTARY COMPLIANCE RESOLUTION AND CLOSING AGREEMENT PROGRAM

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This panel will examine the voluntary compliance resolution (VCR) program and closing agreement program (CAP) of the IRS. How workable are they? What is the range of experience encountered? How are penalties negotiated under CAP and how variable are they? What plan problems are most easily resolved? How should proposed correction procedures be documented to ensure quick review?

MS. KAREN FIELD: For those of you who don't know me or aren't familiar with the topic, I spent 11 years with the IRS. I'm now with KPMG Peat Marwick. I designed the VCR program and the walk-in CAP and also the program that's recently come out for the 403(b) plans.

Let me start with a description of the programs or the opportunities for correction that are available. The first array of programs is called the administrative policy regarding sanctions (APRS) program. This is not an official program, but it's something to use if your clients find out that they have a problem with a plan, generally a small defect. Under the APRS, a de minimus defect can simply be corrected. This would apply to a defect that only happened in one year; for example, a computer glitch or something such as that. It's for a small dollar amount, or perhaps it only affected a few participants. You don't have to come into the IRS. You don't have to talk to the IRS. You simply correct the program. You document that you corrected it under APRS. You try to be as favorable to the rank-and-file employees as possible because you don't have any paper to rely on from the IRS.

You can also use APRS if the client is picked up on audit. If the IRS audits a plan and finds fairly small defects, it's always useful to argue that they fit within APRS and, therefore, the IRS shouldn't think in terms of charging a sanction. It's always a good place to start with the IRS. Say that this is a very small defect. It's de minimus and because it is de minimus it shouldn't cost the employer much. One of the key things about this program is that you have to actually correct. You can't just say it's little, so you're not going to worry about it.

The second program is the VCR program. VCR means voluntary compliance resolution, and under that program you do take defects to the IRS. You work with the IRS, and you get them fixed. VCR is for operational defects. It's a relatively narrow program.

The third program is the walk-in CAP. The walk-in CAP is for defects that don't fit within the VCR. You take them to the IRS, but it's somewhat more serious. You take it to the

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local office, and you are treated almost as if you're under examination. But you do work with the IRS; get the defects fixed. You get a piece of paper saying that they're fixed, and you go on with life.

Finally, if a client has a situation that doesn't seem to fit any of the programs that are out there, there's always the possibility of going on your own to the IRS's national office, and working with the IRS to correct the defect. Many clients are scared of this option, but the truth is that the IRS is very willing to work with volunteers, people who come into the national office, admit they have a problem, and want to work with the IRS for a solution. Peat Marwick had a fairly large client that was running a number of plans for all kinds of different employers, and it discovered that it had minimum distribution problems in an array of these plans. Rather than ignoring it, rather than having each employer take in the plan to the VCR program or CAP, Peat Marwick approached the national office to fix the problem all at once. The IRS was able to work with Peat Marwick, fix the problems, reassure all the employers, and it was able to do it at a very low user fee, only slightly above a user fee level. This was a very clean way to bring in a client that deals with multiple plans in multiple parts of the country. If a client has a simplified employee pension (SEP) plan, and the SEP has problems, the IRS is accepting informal closing agreement requests at the national office level to fix SEPs.

Let me just go into how to use each of these programs, show what you should be doing to get into these programs, and focus on each of them in detail. The first is the APRS; it is for operational defects only. It covers a very small, very narrow area of employers' problems. However, because it is cheap, there is no fee, there is no sanction, and you don't even go into the IRS, it's definitely worth looking at for small defects. As a general rule, we suggest that if you do use APRS, go out of your way to design a conservative correction, a correction that's very favorable to the rank-and-file employees. All questions shouldn't be decided in favor of the employer. The reason for this is you don't come out with any reliance, anything from the IRS. You're just making a guess on what you think the correction should be, and the IRS can second-guess you on this if it comes out on an examination. And so the better a correction looks—the closer it is to something the IRS would do under VCR—the better off you are. We have been able to successfully argue APRS on a number of examination cases, even when they are slightly outside the narrow borders of the program.

If a client is under examination and it has defects that happened in three years or two years instead of one, it's also worth saying that the theory of APRS should apply and that the IRS should not levy a sanction. All we have to do is correct this problem for all the past years and let us get on with life without a correction. APRS is definitely a good option. People will call the IRS (particularly the local office because the local office is more likely to do the examination if something ever happens), talk to the closing agreement coordinator or someone such as that who has worked with programs such as these, and ask the person what he or she thinks is an acceptable correction. It doesn't take long on the phone to figure out what the person is and is not comfortable with. It's not something that you can use against the person—because it's a phone call—but it does give you a little bit more reassurance. Other than that, you get no paper under the APRS option, nothing in writing from the IRS. Many employers want something official and decide to go into the VCR program.

VCR PROGRAM AND CAP

The next area is the VCR program itself. For those of you who aren't familiar with the VCR program, it's described in Revenue Procedure 94-62, and it is a program, again, that corrects operational defects. That means that the plan has a determination letter or some other letter saying that the document is all right, but in operation, that plan has not been followed. Technically, if there is a disqualification issue, and you come into the IRS, and you fix the problem. You fix it for all years, not just for open years, and generally you use something as close to a statutory fix as possible. You try to go back to what the plan said. For example, if it turns out that you've been using the wrong formula, which is fairly typical, you go back and give the employees what they should have gotten under the original formula.

When I was at the IRS, we confronted a number of issues in which, for example, the plan was integrated but the employer hadn't realized that. It was using a different formula. In other cases, there were problems in which an entire division should have been covered but wasn't. It's something you can bring into the IRS, bring into the VCR program, and fix. The fixes are generally between you, your clients, and the IRS. To fix it you must go back and use the right formula. For the most part, the IRS will say, "Fine, that sounds good. That's giving the employees what they deserved in the first place."

In some cases this creates some strange issues; for example, the one I just raised. A plan should have been integrated, but instead the employer used a straight 6% formula. Well, money could be taken away from nonhighly compensated employees, and in some cases, it could be given to the highly compensated employees; that is, you must redistribute it. It's perfectly legitimate to do that, and the IRS is not going to object if you redistribute the money to what the plan says, but the IRS has also been fairly sympathetic with employers that say they know they shouldn't have given this money to these people, but they already have it; it's in their benefit statements, and they're going to scream bloody murder if the employer tries to take it away. Can we leave it there at least for the nonhighly compensated employees? The IRS has been fairly sympathetic with that idea. The IRS would not be happy if you tried to leave extra money for the highly compensated.

Another big problem has been money being put in excess of the Internal Revenue Code (IRC) Section 415 limit. A standardized voluntary program (SVP) says that you can put the money in a suspense account, or under the regular VCR program you can reallocate it. You can do all kinds of things with this excess money, but usually the one thing the IRS doesn't want is for that money to come out of the plan. The employer may want the money refunded. I would dissuade the employer of that idea quickly. Anything within the plan, if you're in the regular VCR program, will probably be acceptable. If you go into the SVP the employer only pays a $350 user fee, but there are very rigid corrections. If you have a problem that fits into the SVP, the correction is specified, and then you're done.

One thing that we found helps sell the VCR program, besides the obvious fact that you're correcting something, is you're getting a piece of paper. The VCR program is set up so that while your employer has an application for the program filed with the IRS, that plan cannot be audited. You're sort of on a freeze, which employers tend to find very reassuring. In fact, some of them have said to just take as long as you like. "If I can go three or four years without any threat of an examination on this plan, I'm not going to fuss too much." The VCR program has been taking quite a bit of time, depending on the issues. It's been taking between six months and one year to get a fairly complex problem through the IRS. Much of the problem can be fixed by setting up the application correctly. This is something that you can and should be very much involved with. The more information that you give to the IRS upfront, and the more you've given the right kind of information, the faster your application is likely to be processed. Also, the higher the chance is that the correction you've suggested will be accepted.

The IRS expects you to actually tell it what your correction is, not just in writing but also with numbers. You have to show what the effect will be for each of the affected employees. Where you have to redistribute money, you're going to have to say that "Here's the list of employees; here's what they received before; here's what they have now; here's the interest they're going to get for any amounts that they should have gotten three years ago but didn't; here's the interest rate; here's why we picked this interest rate; and here's what the interest is for each person." It's quite a bit of number crunching, and you're going to give it to the IRS one way or another. Either you can send it in ahead of time, in which case you have a fairly clean application and it can move very quickly, or when somebody finally gets to your case he or she will look at it and say, "I need more information." The person will call you up and ask for the same information. That's one of the things that's often been slowing down applications and it's something that you ought to be involved in.

The 401(k) and 401(m) defects have worked very well with the VCR program and are, in fact, listed as standardized defects that can be corrected under the less expensive SVP program. For those of you who do work with 401(k) and 401(m) problems, it's basically a reality that the employer is going to end up paying money to correct the problem. If the average deferred percentage (ADP) test or average contribution percentage (ACP) test has been failed, the IRS prefers to see that failure corrected by adding enough money for the nonhighly compensated employees, the average percentage, until the test is passed. Many employers will come in and say that if this had been three years ago, and if it had been done at that time, the employer could just distribute money and that would have fixed the problem. The IRS's general response will be that that was three years ago. The employer didn't choose that option, and now the employer is sitting there, and the IRS wants to see something that helps the rank and file. There are some exceptions to that, and if you're in this situation, it's something you may want to talk to your client about. If your client has a huge disparity, say 4:1 or 5:1, between the amount that corrects the problem, the amount that could be distributed to highly compensated, and what it would take to correct that problem by adding qualified nonelective contributions, then you can talk to the IRS about using a distribution rather than a contribution to fix the problem. But it is rare. It's also true that if an employer is truly in a hardship position and the contribution would affect the viability of the company or affect jobs, the IRS becomes much more sympathetic to some other correction. If you're going to argue hardship, you have to show that the company will have hardship. Some companies have been shocked to find that they're supposed to send in tax returns. They suddenly decide that they don't have that much of a hardship after all.

If you go into the regular VCR program rather than the standardized program, one way to make the ADP correction easier and less expensive is to pick only a group of employees. It has to be a group that you can segregate; for example, clericals, a business grouping of some sort, or some other group that you can segregate fairly easily and who are fairly low paid. Make additional qualified nonelective contributions to these employees rather than to all nonhighly compensated employees. If the group has a fairly low pay scale and you have targeted a fairly narrow group, you may find that, because it's a limited number, you can give them a large percentage of salary and pull up the ADP test rather quickly without it costing all that much. The IRS has allowed this. The IRS has not generally allowed employers to say they will pick all the people who left this year and give them higher percentages, or pick all the people who make less than $10,000. That's not a business classification, but if you have a believable business classification, it's something worth exploring.

The next area is the walk-in CAP. The walk-in CAP is much scarier to employers. I worked on a number while I was at the IRS, and I've also worked on some for Peat Marwick. Usually the employers go in knowing that they have fairly large defects. They have defects that don't fit within the VCR program, and they go in quaking in their boots. The walk-in CAP is on the local level and is run by the examiners. They are not always thrilled to see the big problems that come in on walk-in CAP. The walk-in CAP is available to any plan (1) that doesn't have a determination letter and opinion letter (so that's one reason to go into the walk-in CAP rather than the VCR program), (2) that has an egregious defect, and (3) that has a form defect. For example, if a new client has a plan that hasn't been amended for TEFRA, DEFRA, and REA, you can correct that. You should seriously consider helping your clients correct that. The IRS would rather have corrected than not, obviously, but these are sometimes very painful plans to deal with. Come in with egregious defects, and the examiner would much rather have picked this up on examination. But the walk-in CAP is there to encourage people to come in voluntarily. Because you come in voluntarily, the employer ends up with a fairly significant decrease in what the employer would pay compared with would be paid upon examination.

At an IRS examination, if the IRS finds problems, it can disqualify the plan. It has been told by Congress that in certain cases it should be disqualifying. After many years of not disqualifying, the IRS is more serious about it nowadays and more serious about getting plans back into shape. It has gone from examining, say, 12,000 plans per year to up to 30,000 in the last couple years, which is a significant increase. It does increase your chances of being picked up on audit, particularly if your employers' plans happens to fit one of the focus areas that the IRS has now. An example might be 401(k) plans or a plan that is terminating and doesn't have a determination letter. That is an area of focus, and so it's something you want to look at very closely.

Once the IRS picks those plans up on audit, if it finds problems, it could disqualify. But its general first step is to say, "We could disqualify you, the code says we should disqualify you, but we'd rather not hurt your participants. Instead, we're going to offer you an option, and that option is the CAP. Under the CAP you correct the defects for all years, you fix up your administration going forward, and you pay a sanction." The sanction starts at 100% of what the IRS could collect if the IRS did disqualify the plan. That means taxing gross income to the employees, a loss of tax deductions to the employer, and tax on trust income. All of those go into it.

Then the IRS works with the employer to reduce that sanction from the 100% number down to a more reasonable range. I've seen sanctions from 98% down to 9% of the maximum amounts. They tend to stay above, say, 50–60%, depending on the issues. That's what the employer is facing if it just sits in the tall grass and is picked up on audit.

With walk-in CAP, the IRS, because you voluntarily come in, starts with that 100% figure and does two things. First, it cuts out all the non-highly-compensated employees in figuring out the sanction. It takes a large number of employees out of the mix in figuring the maximum sanction, and then, on top of that, it gives you a 60% discount. You start at 100%, and you take 60% off the top just because you came in voluntarily. So now you start at 40%. That's your worst case figure, which, for an employer, is much more reassuring than starting at 100%. Then you, the accountants, the employer, or whoever is involved with the client, would work to negotiate down from that 40% level to a lower level. In walk-in CAP, the sanctions are averaging at about 20%. Some sanctions have been incredibly low. There have been sanctions of $1,000, which is the minimum sanction, and there have been sanctions that are at 4% or 5%. There are also sanctions that are right at 40%, particularly nonmember plans, so that is something that you want to talk over with your clients. Help them feel comfortable with the program. If you have a defect that you feel uncomfortable with, you're better off going into one of these programs than letting your employees or your client sit out there completely exposed and risk paying some of the penalties that other employers have paid.

MS. JUDITH E. LATTA: To amplify on the maximum sanction, it's applied to all open taxable years, and for the employees it's on all years. It's not absolutely clear, so when you work up any of these maximum amounts, they tend to be very large. At that point you certainly have the attention of the employer. It's scary when you realize that something is wrong and you could actually get zapped with this huge penalty. On the other hand, it was hard to submit plans for the Tax Reform of 1986 when you found out that the client hadn't done its prior amendments. Part of the package you sent was the prior letter of determination, so you are faced with a tough choice. Do you wait and tell management about this problem as a result of audit and being found, or do you identify the problems and say that here's a way to limit losses and get management and legal counsel involved, in deciding whether to go ahead. When employers realize that there's a high probability of being found out, the decision is easier. I've had only one client go in under CAP, and the sanction was more like 10% of the maximum sanction. It was a nominal amount. The fees for the attorneys and the actuaries were much more than the sanction itself.

MS. FIELD: If your employer does decide to go with walk-in CAP, again you need to be very involved in what goes into CAP. You'll be crunching all the numbers and getting all that ready, but you also may want to be involved in figuring out what the correction will be. In some cases the employer just knows that it needs to be fixed. It's not as easy as VCR in which you go back and follow the plan. For some cases, there is no easy fix, so this is where you want to get creative. I don't mean that in a bad sense. I'm working on a couple of closing agreements right now. We're trying to balance the interests of the employees and the employer and the IRS in a way that's not going to cost the employer too much money, but this also treats the employees fairly in any way, and that's the key focus. The IRS wants to know that the employees are being treated fairly. When sending information, the more obvious you can make it that the employees are being treated fairly, the better off you are. It's also true that the IRS is very interested in future compliance. If, as part of your submission, you can say here's what the employer's going to do in the future, we're putting in all these new systems, we've designed a new program, we've purchased software, we've done things that will keep this from happening in the future, again that will improve the employer's chances of getting the sanction reduced and of getting the correction accepted.

The easy way to do corrections is to go and figure out what has already happened in the VCR program. Many people would like to see the VCR letters or see closing agreements publicized. But for now, you can call the local CAP coordinators at the IRS. Each key district office has a CAP coordinator, and then the national office has people who've dealt with the VCR cases. They're all very familiar with all sorts of questions by now. I took those calls for that for two-and-a-half years and ended up with all kinds of strange facts. If there were very unusual questions, two or three of us would sit down together and try to figure out something that would work. In many cases, you could easily design a fair correction. Again, the IRS tilts toward being especially fair to the nonhighly compensated employees. The closer you can come to that, the easier time you're going to have with the IRS.

Having designed your correction and having had the IRS approve that correction or refine it slightly, you have gotten to the point where you know what you're going to be doing to correct it. The next step is this sanction. You start with a 60% discount, and then it's your job to convince the IRS that the employer's a good guy and doesn't deserve to pay 40%. Here are some of the better equity arguments. The correction itself is going to cost a lot, and therefore the sanction should be lessened. The employer is already putting a lot of money into this plan to get this right. The employer has come in voluntarily, so it shouldn't have to pay a whole lot more. That tends to be a good argument. The existence of a compliance and review system helps. If there's something that the employer has in place that found this defect, it's a routine check on the system that is evidence that the employer cares a lot about this plan and that the plan isn't generally haywire. That is very reassuring to the IRS. If you can say, "Well, there has been a compliance review done in the past few years, and it picked up this problem," or "We check these defects every year, and unfortunately this was a computer glitch or something weird happened that we didn't find," it at least appears that you're trying to find most things. In general, any evidence you have that the plan is being well run is very helpful to your negotiation, even if it didn't catch this particular defect. Another point is that the less harm to nonhighly compensated employees, the better off you are. You should certainly argue that point if it happens to work in your case.

The fact that the employer covers a large number of nonhighly compensated employees tends to be a very useful factor. The reason for this, obviously, is that the IRS would rather keep these plans around, particularly if there are many nonhighly compensated. It would do almost anything not to disqualify this type of plan. If a plan has 60%, 70%, or 80% nonhighly compensated employees, you could argue that this is a good plan, that the employer's a good employer. It may be that that employer is vital in its town as a source of employment. Those arguments tend to help.

The simpler your plan is, the better you look. For those of you who are helping employers choose a new kind of plan or make changes along the way, simpler plans not only have a higher chance of being run correctly, but they also look better to the IRS. If a plan is integrated, there is some feeling at the IRS that the employer is trying to maximize the deductions or maximize the contributions for the highly compensated and minimize them for the nonhighly compensated. It doesn't look as good as a straight career-average plan. If you happen to have the right facts for it, it's good to argue that this employer cares about and is paternalistic toward all its employees, rather than putting the minimum in for its nonhighly compensated. It helps if you have other plans for those same employees, particularly if they're generous. Again, it's evidence that this is a good guy. Good guys should pay less, bad guys should pay more; it's sort of a simple formula.

The size of the defect will influence the severity of the sanction. The smaller the percentage of employees who were hurt by this, or the smaller the percentage of people affected over time by this, the smaller the sanction. On the other hand, is this a defect that's so bad that it is ridiculous? Then you're likely to be looking at larger sanctions. Is this a defect that's sympathetic, hard to find, or almost APRS program? The closer something is to the APRS program, the better off you are, and the more you should argue. Even if you don't get into APRS, you may get a sanction of 1%, 2%, or 3%.

MS. LATTA: I work with an employer that sponsors a defined-benefit (DB) plan that was running well. However, it had chosen to use a bundled approach on the defined-contribution (DC) side. That trustee had gone out of the recordkeeping business, and the employer didn't realize that it wasn't keeping up its prototype plan document. Nothing had been amended for about ten years. As its actuary, I reminded the employer to make sure the DC plan amendments were filed. This was a situation in which there was a change in management. (An amazing number of defects come out when there is a change in management. All of a sudden management is willing to take a fresh look at things, it is willing to let you take a fresh look at things, and obviously it doesn't have any vested interest.) New management did not accept the fact that the determination letter couldn't be found or that the amendments were not made. As we dug further, they just didn't exist. We did spend a lot of time talking about the correction. The attorneys tend to be very conservative and want to do the most conservative thing that's possible. You should go in and know what all your options are. You have to go in saying that you will do absolutely everything possible to correct this. Obviously, if the IRS doesn't like what you suggest, you may eventually get to the most conservative option. But why start there? We had quite a lot of discussion making sure we had equities balanced. We were looking at the total package because there were several defects as a result of all this lack of compliance. We balanced what we fixed over here and learned how much that cost to decide that when it comes to fixing another defect, we didn't have to pay anything here, we just fixed it prospectively. The process seemed to work well. When I get to my talk, I'll talk a little bit more about VCRs and some plan sponsors that are considering VCR solutions to their problems.

FROM THE FLOOR: What's the downside of the walk-in CAP? What is the worst that can happen if you voluntarily go into the IRS and say you have this plan with all these disqualifying defects in it?

MS. FIELD: If the IRS decided that this was bad, something so bad that it couldn't stomach it, it could pull you over into examination. The chances of that happening are close to nil. If it pulled you into examination, you now have a bad plan, probably facing disqualification, certainly facing 100% sanctions instead of 40% sanctions. The IRS makes it clear that this isn't likely to happen, but it is a possibility. The IRS always leaves an out for itself, so that if the wildly discriminatory, fraudulent plan comes in, it is not locked in. But if you look at the walk-in CAP document, it says that egregious defects can come in and that they will pay the 40% sanction. You wouldn't want to bring in a plan if the employer has stolen from it.

On the other hand, even in VCR, to go back a step regarding the stealing from the plan, what if the money just landed in the wrong place? You have what is technically a major problem. No the contribution wasn't properly made. The money may not even have reached the trustee. It hasn't even been sitting in a trust. I know of one case in which, for reasons nobody ever figured out, money was sent to a major mutual company, and instead of being put into a big plan where it belonged, it was put into an IRA. It was just the way it was coded. The VCR program permitted that employer to move the money from that pseudo-IRA back to where it belonged. It was a very clean fix. It was rather surprising that the IRS was willing to do that. It was willing to take something that could be called an exclusive benefit problem and take the nice, fast, clean solution, which is to get the money where it belongs and get out of here. So, even in cases that look severe, you're better off at least calling the IRS, talking to the CAP coordinator, talking to the VCR coordinators, and seeing how they feel about something. If they react adversely, maybe you don't want to come in that way.

Examination CAP happens if everything else has failed, and where the IRS has picked you up on audit. This is a situation where the IRS is least sympathetic. All the other programs are for a volunteer, somebody who has found the problem on his or her own, who has shown the problem to the IRS and is asking for help. Here you have someone who sat back in the tall grass, either knowingly or otherwise, and has been caught. The IRS has charged sanctions that go from 98% of the maximum sanction down to very small numbers. The small numbers are not typical. If your client is suddenly facing an audit (and I'm working with a number of clients who are suddenly facing audits), you want to be proactive. You want to get out there and help the employer design solutions. You want to make sure that the IRS knows that the employer wants a closing agreement because the IRS always gives the employer the other choice. The IRS is very willing every once in a while to have a test case or just disqualify, and there are employers, particularly smaller employers, that will want to disqualify. There aren't very many of them because most of them would face very unhappy employees. I do know of a couple of situations in which the employer just said these are temporary employees. The employer couldn't care less if the IRS blows up the plan. The IRS always reserves that as an option if the employer is interested.

Otherwise, you're talking about a closing agreement of some sort. The IRS may be very comfortable with a large sanction, and you will have to go charging in there with your client to try to work out a fairly generous solution in return for paying a smaller sanction. You'd rather be paying the money to the employees than to the IRS. It makes you look better. It tends to show good faith. If you're willing to put more in for the employees you can argue, "Well, because we've put in a great deal for employees, give us a break on the sanction." Let's head for below 40%. Let's head for 20% if we can get it. I do know of an examination of a plan covering doctors, which tends to be a suspect group from the IRS point of view, that because of many sympathetic factors the final sanction was 11%. One of the doctors was actually running the plan and actually had done all the numbers right for about 15 years and had complete documentation. However, the group had just missed something entirely top-heavy—that's a big thing to miss. There was the one glaring error. They were picked up on examination. It was a very large doctors' group. It took much arguing and some very generous interest assumptions and all sorts of things, but they got it down to 11%. It would not have been at 11% if the accountants and actuaries hadn't been working very hard with the IRS because the original offer from the IRS was well above

40%. You can see it's worth your client's while for you to get out there and argue everything you can find, even if it's the fact that this poor senior doctor has been doing his own paperwork all by himself without much help.

FROM THE FLOOR: I have just one thing to reinforce. Work with the IRS. Don't work against the IRS.

MS. FIELD: Oh, absolutely.

FROM THE FLOOR: I know of one situation in which I think a chief counsel, in so many words, told the IRS to take a hike and then was negotiating penalties about whether it was going to be in eight figures or nine figures.

MS. FIELD: It does raise a good point. If you head for the IRS and start begging for breaks, sometimes it doesn't work. You might also tell your clients this, and it is a good sales pitch for the walk-in CAP versus the examination CAP. Some of the closing agreements, even though they were small percentages, have been massive amounts of money. I think some of these have been reported over time. In fact, a couple have been over $15 million. It tends to make for some very unhappy boards, especially because the money is not going anywhere productive.

One more option is the option to go to appeals. When you are picked up on examination, and if you have refused to go to CAP, and the IRS thinks you should be disqualified, you can appeal any of these decisions as long as you haven't signed a closing agreement. In some cases going to appeals can be a good idea, but it's not a good idea as often as some people like to think it is. Some people say to skip the employee plans division and go straight to appeals. When they get to appeals, they're facing a major problem. The major problem is that the only job of appeals is to decide whether this case and these facts could win in court. What are the hazards of litigation? If you have a case and the statute has been absolutely failed, you ignore the statute or quite clear regulations, appeals may not be able to give it away. Appeals cannot look at all these equity factors that you can use on the employee plan division side. Appeals also can't give away or work with you on anything that it has already won, and the obvious ones are not member. The IRS has won a number of nonmember cases. The last thing you want to do is take a nonmember case to appeals. The same thing goes for Section 415 violations. The IRS has won two or three very solid cases on 415 issues, and it is not about to give those cases away. If someone on the team says to just punt this and go straight to appeals, make sure the person knows what the risks are first. Appeals has sometimes called the IRS national office or even the local employee plan areas and indicated that it is just going to have to let the plan get disqualified. "Can you take it back?" The IRS doesn't want to disqualify the plan but it knows it can't do anything with it.

FROM THE FLOOR: I was just curious. Is the IRS less sympathetic to a plan that has to come back to VCR for another defect two years after the first time?

MS. FIELD: Well, if it's the same area, you have a big problem. Basically, if you have the right facts, it would probably be OK. If you have a plan and you know it's being well run, and if you have a computer problem that happens and another defect arises, the IRS has said, and I think it will continue to believe, that even the best-run plan is going to have problems on a recurring basis. It's so complex. But if you came back with the same defect, it would be awkward.

MS. LATTA: Karen has gone through the various programs. I will back up and discuss how you can avoid getting into these programs. At a minimum, we'll discuss how you can do your homework well in advance so that you can decide whether you should take advantage of any of these programs. Just to get a sense, how many of you in the audience have gone through what I'll call diagnostic reviews, not necessarily applying, or taking programs in under VCR or CAP, but reviewing the operational compliance at some level of your plan sponsors? Quite a few. I'll venture a guess that not any of those were absolutely and completely squeaky clean. Therefore, I'll ask the next question, which is how many, after having done the review, ended up trying to use one of the remedies? There's a show of a handful of hands.

To give you some idea of numbers, the numbers are growing. About a year ago, about 500 programs had been submitted to the IRS. Now the number is up to 1,800. Six weeks ago, the number was 1,600. I think that we'll find that it becomes more and more "acceptable." I think we all do agree, and it's becoming widely understood by managements as well, that it's almost impossible to run these plans perfectly. Therefore, it's not a big reflection on the plan sponsor to take to management that this is something that needs to be remedied. Maybe half of the 1,800 going in for VCR have been resolved at this point. Based on our show of hands, I bet there were more than 5:1, if not 10:1, as far many plan sponsors who've gone through some sort of diagnostic review. This is an assessment as to how well they are doing, and from our perspective, that is the first step that plan sponsors should take. I think as fiduciaries operating in the interest of the plan participants, a plan sponsor should not assume that this plan is operating the way it is supposed to.

The first thing that plan sponsors should do is assess how they are doing. The way to do that is to do a preemptive diagnostic review. On the other hand, if you know there are problems going in, then do a full compliance review to determine the degree of the problems. Then go from there, but at least understand what the landscape is. To do that, you can simulate an IRS compliance audit. If a plan sponsor has over 100 employees, annual audits have been performed, and shouldn't that mean it has gotten a clean bill of health? The answer is absolutely not. The plan audits are financial audits, and what they track is the flow of the money. It's the investment of the plan assets, it's the contributions, it's the benefit payments, it's making sure that participant data in records match what the actuary has or what the recordkeeper has, but it's very much financially oriented. Often the IRS will make sure you have a letter of determination, basic documentation. It is not checking to see whether you send out a joint survivor notice. That's the type of focus that the IRS is bringing when it performs a compliance audit.

To simulate an IRS audit, first you perform a documentation review. Ask for all the information, plan documents, summary plan descriptions, summary annual reports, benefit statements, 5500s, administrative manuals, and PBGC filings. Again, someone will say, "Why do I have to do all that? I have my determination letter." Your determination letter just means you amended the plan to say you were going to do things a certain way. It doesn't necessarily mean that you're actually operating in the correct fashion.

For example, I have a plan that's considering going in under VCR because when the General Agreement on Tariffs and Trade (GATT) came out with higher lump-sum cash-out interest rates and we looked at using them, we found that this plan, for whatever reason, just hadn't been processing lump sums under $3,500. The plan said that it was supposed to be mandatorily cashing out under $3,500. That plan would clearly get a determination letter, and who would know necessarily that this client was not cashing out people under $3,500? Because what was under $3,500 three years ago is not necessarily still under $3,500, you can't "fix it" within the existing legal framework. This is a straightforward case; nobody was hurt, but the plan sponsor is caught between a rock and a hard place. This is a candidate for a VCR as a result of operational issues.

The next thing is to understand the business process. In different companies you'll find that centralized benefit processing tends to be more controlled than decentralized. Many companies believe the way to make money is to let companies run themselves and be responsible for their own bottom line. Well, obviously it means that you are expecting that all the notice requirements are satisfied every time someone retires or is terminated from one of 30 locations. All the notice requirements are fully documented. In a centralized environment you will tend to see tighter controls; people are more likely doing this as a significant portion of their job. You need to understand that business process and the division of it. What's being done in the human resource department? What's being done by the comptroller's group? What's being done by legal? And how are all those working? And then, of course, how does the payroll process interact with these? Until you understand the business process, you can't tell whether it has defects or weaknesses and where the weaknesses might be that could very easily, if identified, be corrected. So that's the next level of assessing compliance.

Next you need to check and see whether that's the way it actually works. We have done more than 100 of these types of reviews, and we have never found a one-to-one correlation between what the clients think they're doing and what is actually being done. There are just too many details. Decisions are made at various line levels and they don't understand the full ramifications. They don't recognize that there was a statutory reason that it had to be handled in a particular way. Certainly, I think all of us have dealt with service calculation issues, rehires, all those types of difficult determinations like counting hours. We know that there's a lot of room for judgment, and the easy way is often not the compliance way. So you need to do plan participant file reviews. One approach is to do a preemptive diagnostic review without checking the facts. However, we have found that there is never a one-to-one correlation between what people think is happening and what is actually happening and that a participant file review is essential.

You look at eligibility, rehires, service, and minimum distributions. The larger employers have set up procedures to handle minimum distributions, but for the most part, the smaller employers haven't. Defined-contribution plans seem to be doing it more often than defined-benefit plans. Then there are the more difficult issues, like the 415 calculations; also, the highly compensated employee determination. Unless you are using safe harbors, it is a complicated determination with respect to understanding it, making sure that it's being done right, and that you have the entire controlled group in. Finally, the standard coverage and nondiscrimination tests are also things that you want to be checking. You also want to check if you've had mergers, acquisitions, downsizing, rightsizing, or if you've changed from decentralized to centralized, if you've outsourced, and if you've changed recordkeepers or actuaries. All those changes in procedures have what I'll call weaknesses in the process, and, therefore, are areas where deficiencies may be identified.

Finally, there are confidentiality issues. Recognize that besides the regulatory agencies and the plan sponsor, the plan participants could also be interested in this review. The plan sponsor may want to form a steering committee for your review. Get all the major players at the employer (legal, payroll, financial) involved as a steering committee. You want to operate under the protection of confidential and privileged information, none of which is airtight. Nevertheless, in some cases people say, why not? It just puts another level of protection for the employer depending on what you might find. You may decide you don't want to have a written report, that in fact all you want is an oral report back.

If you establish a steering committee upfront, your preliminary findings can be presented to this steering committee. Then the committee, looking at all the issues from a variety of perspectives, makes a decision as to whether anything actually gets reported on paper. All the interested parties within the company understand what the findings were, what kind of deficiencies exist. In all cases, regardless of whether you decide to go in under one of the corrective programs, I haven't yet seen an employer that doesn't fix these things prospectively and try to fix, where it's possible, things retroactively from a benefit perspective. The real issue here is whether the employer goes in at risk of significant sanctions. In my experience, most employers are committed to running their programs properly.

We should note that if you think that's running a plan properly, the fees for an initial diagnostic review to assess the level of compliance could be paid by plan assets. That can get an employer to do what's right, even though it can't offer the fees to pay for the review. However, when you get into corrective actions, you can't use the plan assets to fix the plan.

And, finally, the prospective actions. Even if you came out with an *A* on your report card, you can't assume that it's going to continue. What needs to be part of the business process running these plans to make sure that they're in compliance on an ongoing basis? Internal auditors can be involved with the whole review process. That's the best solution. It only works for employers that have an internal audit department, where they're doing audits on an annual basis. In particular, when there are multiple plans, you can establish internal audit processes. You can audit once every two or three years to make sure things are going properly from an internal audit perspective.

If you have multiple locations, rotate which location you're going to audit each year so that some auditing is going on every year. On the other hand, you're pulling things apart on an annual basis at every location. Those are all things that you need to do to make sure that the plan that's in compliance will stay in compliance.

The one other thing that I don't think we've mentioned is that the VCR program goes to the national office. The benefit of that is that you're not necessarily targeted for audit by going in for a VCR. Your district office does not know you're in for a VCR program, and you get limited relief.

You get to correct whatever you've told them is wrong, and unless they've noticed something else that's wrong through the process of doing that review, you get that relief.

The district office does not know about it, and therefore, you haven't opened up the door for more audits.

Many audits do seem to come through the tax audits and the payroll, audits that are going on in other areas of the company. A VCR application does not raise a red flag with your district office.