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# Session 33IF
# Living and Working with Voluntary Compliance Resolution (VCR)/Closing Agreement Program (CAP)/Compliance Audits

**Track:** Pension
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*Summary: The CAP and VCR programs have passed from their birth and infancy into young adulthood. Experience has begun to develop. This session will focus on how these programs actually operate, including what cases are likely to be best served through each program.*

**Ms. Karen Field:** The Internal Revenue Service (IRS) is likely to collect some amount of the taxes they collect from the employer rather than collecting taxes from everyone. There are now compliance programs in all the qualified plans. There is also a compliance program for 403(b) tax-sheltered annuity plans. There's a third program which we'll talk about later that is more general and slightly less formal. If you have something that doesn't really fit anywhere else, you can use this general program.

**Ms. Rhonda L. Davis:** How many of you either have a client or believe yourself that, in spite of what Karen's telling you, there's just no chance in the world that the IRS would decide to disqualify a big plan like the plan sponsored by GM, Ford

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Motor Company, or Xerox Corporation? I don't know about you, but I've worked with clients who say, “That's just not going to happen. That may be the sanction which is available to the IRS, but it just won't happen.” I think that was absolutely true until about four years ago. Before that, I don't think there was any chance that the IRS would have taken on a big corporation. It looks at plans sponsored by “mom and pop” operations. That's easy. Mom and pop plans are a giveaway because mom and pop are really nice people, but the only people in their pension plan are mom and pop. The six other workers don't get to participate in the plan.

Small plans like this aren't complicated to disqualify. However, you start getting into complicated issues in big corporations when you're dealing with a lot of workers and many voters. All voters have the opportunity to write to their congressional representatives and complain about the IRS, everybody's favorite target, and “how terrible the IRS is,” “look what they're doing to us,” and “I can't continue my plan if they're going to behave like this.” I think people believe that large plans will not be disqualified.

**Ms. Field:** It was true.

**Ms. Davis:** Right, but not any more. Well, it's still true that the IRS is not going to disqualify a plan, but the reason the IRS won't disqualify a plan isn't because it's afraid to do so. It's because your clients won't let it happen. Your clients can't afford to have all of their employees get tax bills from the IRS because the clients didn't do something, as plan administrators, they were required to do on a timely basis, or an accurate basis, and the result is that employees get tax bills (which can go back to the three open years).

**Ms. Field:** If you decide to let the IRS disqualify your plan, it will only be the last three years, but it's the last three years both for the employer and for all of the employees. Before you confidently say you don't mind getting that tax bill, a client we know of, in a 403(b) tax-sheltered annuity plan situation, not a 401(a) qualified plan, did, in fact, decide the IRS was not serious recently and basically said—”Sure, we don't believe you. We're not going to the bargaining table.” The IRS sent out a few thousand deficiency notices to all of the participants in the plan. The benefits office had the unpleasant task of telling all those employees what was going on. It's not fun.

**From The Floor:** The issue was only for the last three years?

**Ms. Field:** It was only the last three years—but it's the last three years, plus interest, plus penalties, and so forth.

**Ms. Davis:** When we say last three years, Karen, if I'd been a participant in the plan for 12 years and I'm fully vested, and I have an account balance now that over the last three years has grown at the rate of $10,000 a year, but my total account balance is $120,000, are we talking about only the $30,000 or are we talking about the vested account balance?

**Ms. Field:** Generally, you're only talking about the contributions and interest for the last three years. There's an exception, and the IRS has always threatened that exception—the exception is, if the defect has to do with 401(a)(26) (mini-mum participation) or 410(b) (minimum coverage), the IRS can go after all the highly compensated employees and go after their entire vested account balance. They have never done that, but they could.

**From the Floor:** There are not additional adverse consequences, though. Those other years don't suddenly escape taxation?

**Ms. Field:** You will be taxed on those.

**From the Floor:** Is there a cheap way out?

**Ms. Field:** No, there's no cheap way out. You can't say—well, everything should have been taxed, and so I'm taking the position that it was taxed. There's something called a duty of consistency. In fact, there was a case very recently on a Keogh plan, but the courts made it clear that they believed in the duty of consistency, saying that you can't go back and say, "IRS, you should have caught me back then. You should have gotten my taxes back then and you didn't, so I don't have to pay them again." The court said, "No, it doesn't work that way. So you still will pay taxes on those amounts."

**Ms. Davis:** That's not common nor expected. The unexpected part is when it's 1996, and you're going to be taxed on contributions and earnings from 1994, 1995, and 1996, and because you're still active, you can't get a distribution from the plan. Ordinarily, when you have to pay tax on your distribution from a pension plan or a 401(k), you have the cash in hand. If the plan is disqualified, you have employees with tax bills and no cash distribution to pay the tax.

**Ms. Field:** It tends to be hard on morale.

**From the Floor:** You're saying there was no immediate tax bill in the example we gave, but eventually you would get taxed on the first nine years of your employment.

**Ms. Field:** Sure, just like any distribution from any plan.

**From the Floor:** The principle of mitigation, is that part of the principle of consistency?

**Ms. Field:** Yes, it's the same thing. What's out there? Assuming that you do not want the IRS going after all of your participants and collecting back taxes, you don't really want to mess with the year for which you took the deductions. You don't want to have the trust pay income taxes on the interest which was earned, which are the three elements on which the IRS can collect. What happens? You become a lot more interested in compliance, which is what the IRS wants in the first place.

The IRS has put together different levels of programs and the first of those is Administrative Policy Regarding Sanctions (APRS). It's not a full-blown program the way the others are, but it's actually very useful in certain small situations, and the IRS has promised over the years to expand this program. It hasn't happened yet. I'm no longer betting on it this year, but the IRS is fond of the program and it is likely to make the program broader in the future.

Here is an example of how APRS works. You have a defect that only happened in one year and it was fairly di minimus. It might be your basic computer glitch. Somebody got into the plan early. Only one person, somebody messed up and you find it, that year or a couple of years later, and it hasn't happened since then. You can use APRS. What you do is document your file. "We think it's di minimus compared to the total amount in the plan, compared to the total number of employees in the plan and because of that we're simply going to fix it." That's the whole point of this program—you simply fix it. You don't go to the IRS. You don't get permission to do the fix. You just make a fix that's reasonable, and you document in the file that you think this is within APRS. You can also do this during an IRS examination.

You argue on examination, there's a problem. You say, "There is a problem. It may even look worse because the plan allowed a highly compensated employee to begin participating early, but it only happened once. Just call it APRS, we're not going to pay a sanction." The IRS is willing to do that.

**Ms. Davis:** We had a similar situation. APRS is equivalent to what the IRS used to do. In the "old days," the IRS used to come in on audit, find that you made a mistake in the administration of the plan, and say to you, "Karen, you shouldn't have done that. Now, go back and straighten it out and don't do that again." That was it. The IRS walked away. Now, once again, we're not talking about a truckload of violations. We're talking about, for example, you missed the 415 limit, or you didn't start age 70.5 distributions on time. You had some little problems, but they were falling-through-the-crack problems as opposed to systemic problems. The IRS said, "You made a mistake, clean it up and let's move on."

When they invented CAP, suddenly if you made a mistake, you could have a big problem. APRS is simply the Internal Revenue Manual "codification" of the old IRS rule, but they've told you it only applies if you have a problem for one year. You could have a problem if you let a highly paid—or even a nonhighly paid—into the plan early in both 1994 and 1995—one person in each year, that still sounds tiny, doesn't it? That doesn't sound awful, at least to me, but as APRS is currently written, you couldn't use APRS, could you?

**Ms. Field:** Under current APRS, on paper, it does not work. Certain districts are more willing to let you go to two years even though they know it's not really permitted under APRS. Other districts go by the letter of the manual. This is in the Internal Revenue Manual. It says one year. You have something that's in one year, the IRS will let you use APRS. Anything else, the IRS is going to collect a sanction. Now if the violation is that close to APRS, the sanction may be very low, but it still will be a sanction.

But remember, APRS can be used. This is the perfect fix, when you get the call from a client saying they did one stupid little thing, and asking whether they should go into VCR, or should they do something about this? The answer is—No. 1, yes, always fix it. But No. 2, if it really was the one stupid little problem, fix it and document in your file that it was APRS, that you think it was just di minimus.

**From the Floor:** Are you prevented from using APRS if the plan is under audit?

**Ms. Field:** No, the nice thing is, you can argue it under audit. We've all argued it under audit. That's really the purpose for which it was originally intended. Since then, it has been broadened—the IRS has said, "If you find the problem before we do, just fix it."

**Ms. Davis:** Isn't this unlike other IRS programs, where you can't be under audit to get into the program? For APRS you can be under audit.

**Ms. Field:** Also, remember, if you have enough different problems over the course of a year, there's no way you can argue APRS. You just can't do it. If the IRS finds systemic problems, APRS is never arguable. Sometimes if it's a problem here, a problem there, APRS will work. It depends on the district.

**Ms. Davis:** In regards to the issue which you raised about a problem with fund transfers, if the transfers didn't move on exactly the right date, so the earnings weren't exactly right, but the difference is so tiny that no one will notice or truly care, it would seem that we're not even talking about APRS.

**Ms. Field:** Yes, and it's not really an IRS issue for the most part.

**From the Floor:** I would distinguish between things that have to do with fund transfers and the rest of it, from things that are IRS issues which the IRS cares about like, starting age 70.5 distributions on time and 415 issues and the rest of it. If your only problems were some glitches with earnings, especially if you're converting from one recordkeeper to another recordkeeper and you have blackout periods, I wouldn't worry about that as an IRS issue. I also do not believe it is a Department of Labor (DOL) issue. The DOL's issue is with plan assets, but it's about the correct use of plan assets and what the fiduciaries are doing with them. I don't believe the DOL is going to get too excited about the fact that these things didn't mesh exactly as they should because, in my experience, they can't if it is off by only a small amount.

**From the Floor:** You say documented APRS, you mean you don't report it, but keep track of it.

**Ms. Field:** That's right. What it shows is intent to comply or an attempt to comply. The only problem with the APRS program is, because you can't report it, you can't go in to the IRS. You can certainly pick up the phone and try to get through to an IRS agent and say, "What do you think about this type of correction?" Usually it's not worth that—most corrections you can just figure out. Ask yourself, "What makes sense? What makes this person whole or this situation whole?" You can do that. We usually say document it in the file. The requirement is to fix it. There are two sides to that.

**Ms. Davis:** The side about fixing it is when the IRS comes in two and a half years from now, the benefits administrator who was there when it was fixed, has now moved to another company and nobody remembers who this happened to. If you documented it, there would be some record. The downside of documenting it is that we can all see it. As soon as you write it down, you've just created a paper trail for the IRS, and do you really want to say to the IRS, "By the way, you didn't find it, so let me show you the three things I know I did wrong?" How many of you do this—pass a state trooper on the highway and then you pull over and say, "By the way, I was doing 60 and it was a 55 mile an hour zone?" None of us, of course not. And what do you do on your 1040? "By the way, some of these charitable contributions aren't really right." You don't do it. The problem is that people are really torn between wanting to document it so that they remember how they fixed it because you ought to be consistent, especially if the first fix was for a highly compensated employee. You don't want to do some nice fix for a highly paid employee and come along two years later and find similar problems within a nonhigh paid employee and do something which is not as favorable. That doesn't look good, it doesn't feel good.

**Ms. Field:** Let's go on to the first of the real programs. Actually, CAP is the real program. It's the one that everybody worries about. IRS comes out and audits your plan, finds a problem with your plan that goes back many years. You have found a problem that you're fairly certain you can win in court. You have section 415 issues, you have top heavy issues, you have distribution issues, take your pick. They're not little issues or the IRS probably wouldn't have stumbled across them, although sometimes they do.

Now what? First, you sit down with the IRS and make sure it has its issues right. I think we've all been through situations with the IRS. We say, “No, IRS. You think there is an issue here, but there isn't and here's why. Take a look at this regulation.” There are plenty of agents out there, and I say this having just left the IRS a year ago, who don't know the technicalities all that well, and you have to educate them. That's the first step. Fight back. The next step is, you caught us, let's negotiate. First you negotiate correction. How do we correct this problem? How do we correct this problem in a way that's fair to the company, fair to the participants, and fair to the IRS, and balances off those issues? Once the correction is in place or maybe as part of the same discussion, that's very often part of the same discussion, what sanction are we going to pay? What are we going to have to pay to the IRS, the Treasury, to get the IRS to finish up the audit and leave? The sanction in this program is at the IRS’s discretion, and that's been upheld in court. This is the IRS’s call.

The IRS is trying to get consistent, and if you get something that really seems out of whack, you want to talk to the CAP coordinator, the closing coordinator, for that area, which is the key district office for that area. Sometimes the coordinator knows what the IRS has done elsewhere and knows that this case is out of whack. If that doesn't work, sometimes it's worth calling the national office and talking to the national office CAP coordinator because he or she would be interested in keeping these things on a level playing field throughout the country. That doesn't mean that he or she will intervene directly in your case. But at the next video conference, which they have often, he or she can say, “You know, with this type of defect, unless there are really strange facts, you probably want to handle it this way. Around the country, most of our percentages are around these numbers, and if you have sanctions that are way over that, you might want to reconsider.” So the key district and national office coordinators are not intervening directly, but they give direction. I think you've dealt with some of these, haven't you?

**Ms. Davis:** Yes. This is an important point to make—don't be afraid of the IRS. It's the most important thing to remember here. Have a healthy respect for what they can do to you, but if you're not happy with the agent, the employee plans specialist, because you think the person is being unreasonable, go to the group manager. If you have to, go to the head of employee plans, or up to the district director. You move it up. That doesn't mean that the first time they tell you that they have a problem with what you did, it's time for you to push it up the line. I'm simply saying the same thing Karen is saying. For example, if you're working with an employee plans specialist who is totally unreasonable and takes the position that the six 415(b) violations you have should result in a 100% CAP penalty, that's unreasonable, if everything else in your plan is OK. That would be the time to walk it up, one step at a time, to a higher level at the IRS.

You can negotiate with the IRS. Remember that as much as you don't believe this, there are real human beings at the IRS. They're real people, so if you treat them like real people, in general they will treat you like real people, and they will try to be accommodating. Some district offices and key districts are better than others for being accommodating. Some people are more reasonable than others. It's worth trying. It's worth having a negotiation. You listen to what they say. You go back and do what Karen suggested, which is research what they're telling you, because they may not know the law.

**Ms. Field:** Another tip for negotiating with the IRS—some agents focus on a percentage. I'm going to go for 40%. I'm going to go for some percentage of everything I could collect from everyone, and they're stuck with that number. If someone is stuck with that number and won't negotiate down further, sometimes you can attack it a different way. You can say, fine, I agree with you, 40%. But let's think about what that total is. Would you really collect from all of the nonhighly compensated? If not, maybe we could drop them out of the picture so they're not part of the total. You can nibble away at the total number instead of at the percentage, because sometimes going against the percentage isn't going to work. Go for the total instead.

There are a number of things you can negotiate on. Really, the best one to go after is to eliminate the nonhighly compensated employees from the total. There are some other things. But, this is really important—argue good faith, that is, all the things you've been doing over the years to make this plan run right. If you've done a compliance review, tell them you've done a compliance review, because they see that as evidence of good faith. If you have done that, then you obviously care about this plan. If you have had various groups brought in to administer this plan from the outside, that looks better. Tell them everything that you can, again, to reduce those numbers. With any luck you also reduce the percentages.

**From the Floor:** Does the agent's compensation vary depending upon the amount of the sanction?

**Ms. Field:** Absolutely not.

**Ms. Davis:** It did years ago, in about 1945. Currently the agents make no more or no less, depending on whether they find no changes or they bring home a million dollars. There is no commission at the IRS.

**Ms. Field:** In fact, there aren't even any bonuses on it. Not that long ago, well, quite a few years ago, when I first got in the IRS, there were occasionally bonuses which had nothing to do with dollar amounts of adjustments, but were for people who were very productive. But now it's really not pegged to the same things any more. The IRS is very sensitive to this whole issue.

When the CAP program first started, a lot of people called their congressional representatives and called the CAP program extortion. They said, “The IRS has no right to do this.” I was on the receiving end of the congressional staffer who had to deal with this problem. A congressional committee had told him to find out what the IRS was up to, and I had to take that call. He said, “We've been told that you guys are extorting money. You've been holding these plans hostage so that you can get more money.” The answer to the committee was fairly simple. The answer was, “The law says we're supposed to disqualify this plan if there are violations. We can do that for you if you want. We can go back to every one of those people that we assessed a CAP penalty against, and instead of taking the money, we can disqualify the plan. We can collect taxes from everybody. But that's not going to do anything good for their retirement. Or, Congress, you can give us some other rule. You can give us intermediate sanctions like you're talking about doing with exempt organizations.” The IRS has never gotten another call from the committee on this. Because, when presented with the choice of disqualifying the plan and harming a whole lot of voters, or using CAP, most employers, and certainly Congress, is much more interested in keeping the plans alive.

Remember if you're going to make arguments to the IRS, make good policy arguments. Tell them they don't want to disqualify the plan. Don't ever make litigation hazard arguments. In other words, you could say, “I could win this in court.” The IRS’s proper response is, “Fine, do so.” Because it's not the IRS’s function, particularly not the part of the IRS agent examining your plan, to decide whether or not there are litigation hazards here. That's done after the plan is disqualified. That's done at the appeals office. You have the right to go to appeals. But if you go to appeals, you don't get to go back to CAP. I think there are some people who have found that out the hard way recently. They didn't go to the negotiation table with the IRS. They went up to appeals and appeals said, "These are issues we know the IRS can win in court, so all we can do is disqualify the plan. We can't send you back to employee plans because you've already cut off that avenue." You make your arguments, but you negotiate with the IRS agent.

Let's discuss voluntary programs. Very soon after the examination CAP program got going, some people said, "You know, we've always wanted to correct some of these issues." There are some consultants out there who used to call us on a regular basis who said, "What do we do about this? There's nothing we can do. We know we have a problem. How do we fix it?" Very soon after the CAP program got going, people started calling us saying, "Can we come in? Can we come in voluntarily? Can we fix it?" Nobody had ever volunteered to come in for an exam before, and those of us in the National Office didn't really know what to do about it. But what we did about it was to set up the VCR program.

The VCR program is the voluntary compliance resolution program. In the voluntary compliance program you find a defect on your own, and you know it's a defect that if the IRS came in and found the problem, would cost your client a great deal of money. You can walk into the national office of the IRS and pay a fixed fee (generally $1,250) and correct it. The correction may actually cost much more than the fixed fix. There's some cost involved in having a representative take you into the VCR program. There is no sanction.

The VCR program is only for operational defects. If you have something wrong with the form of your plan, that cannot be fixed in the VCR program. But the day-to-day operational programs that you were worrying about, you have many age 70.5 violations and several hardship violations and all these different things, employers add those all together and say, "If even half of these got caught, I'm in serious trouble. I may end up paying a CAP sanction. I don't want that." You walk into the VCR program and you're going to pay $1,250 and you're clean. You walk out with a letter from the IRS saying, "We think you're great. For all of the things that you listed and corrected, you're done. We will never consider your plan disqualified for those things."

**Ms. Davis:** Just one clarification. The $1,250 which you're talking about is on a sliding scale. For a very large plan, it could be as much as $10,000, but for those of you who are familiar with some of the things that have been out there in the trade press with regard to the CAP sanctions, like the $10 million sanctions, $10,000 doesn't look like such a big number compared to $10 million. VCR is your opportunity to turn yourself in to the IRS. That's a very hard thing for people to do. How popular is this program?

**Ms. Field:** We spent a year wondering if it was going to survive. Once we opened the program, we sat around waiting for the first case. Then the first case came in, and we waited months for the next two cases. It took a long time for people to believe that the IRS was serious. What people really worried about was that, as soon as they received their VCR letter, the IRS was going to examine their plan. But there's an opposite argument to that and most IRS agents will give it to you and they believe it. Why should they audit a plan that's just been through VCR and spend valuable time, which they barely have, for a company who has already looked at its own plan? The IRS is going to go after a company that hasn't bothered to look at its plan in the last five years. There the IRS has a chance of finding something wrong. It's a lot more productive than going after somebody who has been through VCR.

A couple of other things are important to know. While you are in the VCR program, that plan cannot be examined. It has a shield around it, if you make it in the door ahead of the examiner. That is, you haven't been told yet that this plan is under exam, then the plan cannot be examined while you're in the VCR program. Now the VCR program is taking quite a long time. In some cases it's taking over a year. One of our clients is very happy about that. He's saying, “Let it stay in there three years. I have three years where I know the plan is not going to be examined, and meanwhile I'm getting every system back into order and I know everything is all right. My plan is safe.” So they're taking their time. They're not stalling; they're just not very worried about the IRS taking its time. Most VCR applications don't take that long. Most of them take nine months, a year, or something like that.

There's another part of the program called the standardized voluntary compliance program (SVP). There you only pay $350. If you have one of the seven or eight standardized defects—these are the common ones, the ones that the IRS deals with the most often—and you are willing to accept the correction that the IRS has mandated for these defects, then instead of paying something higher, you pay $350. The IRS works on those cases first because there's not much to negotiate. There's no correction to negotiate, and there's no sanction to negotiate. The only thing the IRS discusses is how you determined the interest rates. If you have to put money into the plan, the IRS will be discussing with you how you figured out the interest rate and things like that.

An example would be the most common standardized VCR defect which is the section 415 defect. As often as not it's a 401(k) plan because of the way the 401(k) plans' rules work. I can go into almost any 401(k) plan in the country and find 415 defects. I do it on a regular basis, in fact. The same is true, by the way, for the few of you who do work with 403(b) plans. I don't know if anybody in here does, but the same thing is true. It has the exact same fact pattern. You have 415(c) defects. You walk into the IRS; you say oops; and you either kick the money out or you suspend it and reallocate in the next year, depending on what the money is. There's a standardized defect: 415, and a standardized correction: money out or suspended. That's the whole of the program. You spend $350 and you get a letter.

**From the Floor:** What is to prevent an employer from listing the 80 minor operational violations and entering into VCR and essentially having insurance against the loss?

**Ms. Field:** There are certainly people who have said that from day one, that this looks like a type of insurance. Remember, there is a cost of having your benefits professionals go through all of this. It tends to be a cynical approach. There are some employers who may be taking that approach. There are now thousands of employers in the VCR program, so who knows—maybe some have selected this approach. Mostly it's people who have gone through their plans to find what they really have. They're more worried about being caught on examination. I think long-term that worry is becoming more real. I don't know how much you all keep up with the IRS, but the IRS is in the process of consolidating right now. They're moving all of their determination letter work. All the determination letters they do, reading plans, and making sure that the language is proper, that's all going to be done in one place. All of the agents around the rest of the country will have only one focus: examining plans. You're going to free up a lot of people who now turn paper to go do examinations. In fact, they're all thoroughly excited about it, and they're hoping the examination percentages will go up considerably.

**Ms. Davis:** There is one thing to be careful of, I think, with VCR. Everything that Karen said is absolutely true, but one thing you want to watch out for is what the correction is. You know that the penalty here is some sliding scale from $350 for SVP, up to $10,000 if you're a large plan. But that's just what you're paying to the IRS. In addition, you're paying your attorney, your accountant, your benefits consultant, or your actuary to determine what the error is and how to fix it. The correction has to be something the IRS agrees to. You would not want to determine what you think the correction is, and go into the IRS without having discussed the correction with the IRS on a no-names basis.

The reason is that the correction you thought was reasonable and was cheap may not be acceptable to the IRS. Instead the IRS may want a more expensive correction. One of the considerations you must have before you file the VCR application is that you have to be willing to do whatever it is the two of you agree on. Because if you don't agree on a correction, you automatically become an audit candidate. In the VCR filing you will have laid out a road map for the IRS of all the things that are wrong. By not reaching an agreement, you've just taken yourself from a voluntary maximum $10,000 sanction program into CAP with potentially 40% of the expected tax liability if they disqualified your plan. That's a major shift. So, you don't want to ever end up in that situation. This is why, if it's a standardized defect, you know what the correction is.

If you don't like what they tell you to do to correct in the SVP revenue procedure, don't go into SVP, go into regular VCR. It's all outlined in the same revenue procedure. Before you even go in there, you want to have a conversation with somebody at the IRS on the VCR hotline. You want to have a conversation with them about what your problem is and how you want to fix it. In case you've ever called the hotline, it comes with a major caveat that says, “Anything we tell you has absolutely no weight, no bearing, and you cannot depend on it.” Having said that, what you're going to do is talk to people at the IRS who have done 100 of these, and they will tell you that the way you want to fix it is generally acceptable or not.

**Ms. Field:** I absolutely agree.

**From the Floor:** If you have an operational defect that's addressed under SVP, but you don't really like the SVP solution, do you have any hope under VCR of getting something different?

**Ms. Field:** Actually you do, depending on the type of defect and the type of problem involved. There are plenty of times where the SVP is just the easiest. It's not necessarily the only right answer. There are certain things like top heavy where there's not going to be a debate. It doesn't matter whether you go into SVP or regular CAP, there is only one correction. Give the nonkey employees what the statute says to give them. But for other defects, like distributions, you can argue a range. Check to make sure what that range is, because what you think is the right answer may not be the right answer.

Let me give the classic example. You have a 401(k) plan and you have money that you should have distributed to some highly compensated employees to correct the 401(k) test, the average deferred percentage (ADP) test, but you didn't. Now you go into the IRS and say, “Well, why don't you just let me distribute the money to them?” The IRS’s standard response in almost all cases is, “No. You had your year to kick it out. Now to correct it, you're going to put additional contributions in for the nonhighly compensated employees, give them extra money.” That can cost a great deal more. Now it may not cost as much more as you think it will, but it still costs a great deal more, and anyone who goes into the IRS counting on the IRS to let you distribute may be in for a big shock.

**From the Floor:** What if we have a fact pattern where that solution would bankrupt the company?

**Ms. Field:** If you can show financial hardship, and I mean show, the IRS has accepted that on a number of occasions. It has also said repeatedly that if there is a huge disparity between kicking money out and putting money in, the IRS will permit you to kick money out to the highly compensated, but that's only happened in very few circumstances. But if you can show financial hardship, the IRS can accept that. It is not interested in bankrupting the company. That doesn't help the plan or the participants.

The standardized correction is to give the same percentage to everybody. In the regular VCR program you can say, "Look, I have this bunch of janitors over here. They all work for the company, but they all make about $10,000. I'll give them the 415 limit. We'll have this problem solved immediately." Yes, you can do that. The IRS will accept it. The one thing the IRS won't accept on that usually is, you can't go in and say, "I have these people who terminated in the third and fourth week of the year, so their compensation is $300 or $400, I'll just give them the maximum and that will correct the problem." They usually want it to be a band of employees.

**Ms. Davis:** We had just that situation where the ADP test had not ever been run. The client came and said, "We heard about this test. We haven't done it for the last three years. Now we have to do something." The amount to kick out was something on the order of $80,000 and the amount that you were going to have to put in, if you did across-the-board to bring the nonhighly compensated employees' percentage up, was $260,000. That's outrageous. As Karen suggested, you might expect the IRS to say, "You had a year to kick out the $80,000 now put in $260,000." No, the IRS said, "You don't have to do that. We're not trying to ruin you financially." What they really hate, as Karen said, is kicking money out to the highly-paids. They said, "We want you to help the nonhighly paids and the way you're going to do this is to start with your lowest salary participant and work up." In our situation we started with the lowest paid participant and we made a contribution for him or her until we hit the 415 limit, and then we moved up to the next lowest paid, and so on until we solved the problem. The fix was $10,000. That's still a lot of money, but compared to $260,000, that's small.

Would it have been much better if the client paid a fee to somebody to do the ADP test in the first place? Of course. That's exactly what Karen and I want you to walk away with—the thought that you should encourage your clients or yourself, if you happen to be an in-house actuary, to take a look at plan administration. You don't want to learn about any of the things that Karen has just talked about from first-hand knowledge. You don't want to learn about CAP on audit. VCR is not a bad thing to learn about, but to get into VCR you have to identify the problems yourself. We're going to talk about this some more, but that's something that you really want to do is take a look at the problems, identify them yourself, go in to the IRS before the IRS comes to you.

**From the Floor:** In the example you just gave, you're saying that they could have kicked $80,000 out to the highly compensated and instead they accepted the employer putting in an additional $10,000—why didn't they kick the $80,000 out instead of paying more money?

**Ms. Davis:** Because the $80,000 was going to be kicked to the highly compensated employees to bring down the highly compensated employees' ADP percentage. But because the IRS likes to keep the corpus of the plan intact, it doesn't like money going out. It wants you to keep the money in the plan, so the issue becomes how much do you have to give the nonhighly paids to bring their ADP percentage up?

**From the Floor:** Why are they so against the highly compensated?

**Ms. Field:** Remember, Congress is against the highly compensated employees. All of this is thoroughly embedded in the statutes. The statutes say you can't discriminate in favor of the highly compensated employees. That's done because, in the past, there were plenty of cases where people did discriminate in favor of the highly compensated employees. Congress made it very clear to the IRS that anything that benefits the highly compensated is suspect. But there is something higher on the list, as Rhonda mentioned, and that is keep these plans intact. Keep retirement money in the retirement plan. Why? Because everybody is worried about Social Security. Everybody is worried about money being there for retirement. Yes, there is a natural band against the highly compensated because Congress wants it there.

**From the Floor:** I never thought the IRS was here to protect our money.

**Ms. Field:** Oh, yes. The employee plans portion of the IRS is literally charged with two different things. One is to collect tax, but the other is that they are absolutely charged with protecting the retirement system. Which is the reason for all of this. It's the reason behind their whole focus on compliance and voluntary compliance. They're stuck with the same rules that you're stuck with. Congress wrote these rules. Yes, they have some regulations. You'll notice many of the regulations, although they make things more complicated, as often as not, give away more than the statute does. You're right. They want plans to be in compliance and they want money there for the future.

**From the Floor:** You go into VCR and you say you have a defect and you'll fix it. What does the IRS say? Does the IRS ask what you've done in prior years?

**Ms. Field:** Under the VCR program, unless something is glaringly obvious on its face, the IRS is not examining your plan. The IRS doesn't have the resources, the time, or the will to examine your plan, when you've already done so. What they do say in the VCR program and all of these voluntary compliance programs is, it is really not just the open years that have to be corrected. If you know something happened for five years, you really ought to come in for the five years—not just the three open years.

They take what you come in with, and they're not going to look at other things, unless the information you give them tells them something else. The case I remember best is, somebody who brought in whatever defect it was, section 415, for example, something that considered a percentage of compensation, and it was obvious from the face of the documents that they were considering compensation well in excess of the 401(a)(17) limit. Somebody made $300,000, and they made contributions on the basis of $300,000. Something that obvious, the IRS will raise in the VCR process. Does that mean you immediately go to another program, that you're out of the VCR program? No. What they used to do is call you up and say, “This one is a little too obvious. You want to fix it, too? We'll just put it in the program.”

**From the Floor:** In my office, I've had experiences with regular VCR. In every case I found the IRS to be very reasonable. I know that's not a widely known experience. We had success.

**Ms. Field:** I think that's been true more and more over the last few years as the agents and the employers get more familiar with these programs. I think the first year or so, people were fumbling. They didn't know what to do. For the agents it was a whole new world. They didn't know what to negotiate for, and for awhile everybody hovered about 90%. Then the sanction levels were in the 70% range. They've since crept down to much lower ranges, because people have gotten more comfortable with the theory and have learned how to negotiate.

With regards to additional voluntary compliance programs, this is another case of the IRS responding to people calling in. The VCR program was in place, but there are plenty of defects that cannot be fixed in the VCR program. If you don't have a determination letter, you can't come into the VCR program. If you have a form defect, instead of an operation defect, you can't come into the VCR program. The program hadn't been in effect more than about a year before calls started coming in saying, “I don't have one of those defects. I have a form defect or I have some other defect that's not eligible, but I want to correct it voluntarily, too. What do I do?”

So we designed the voluntary closing agreement program where you walk into the local field office which would normally examine this plan and you say, “I'm coming in voluntarily, help me fix it.” Again, just like with VCR. You don't do this without calling them first on an anonymous basis. But you can go in. We've had success with that just in the year that I've been with KPMG. We've taken a few employers in and said, "They just forgot to amend, but it was just a small defect. Work with us." The IRS worked with the employer to fix the defect.

Like all of these programs, the IRS wants to make sure that your procedures are in place, so this won't happen again in the future. Maybe it means that you go to a regional prototype plan or some other type of plan where someone else will watch the plan and the plan document. You pay a sanction. There is good news on the sanction—and again, you'll see the same pattern developing all over the place.

The IRS, if it caught you on examination could start you at 100% and negotiate down from 100%. You get a 60% discount for walking in voluntarily, so instead of starting at 100%, you start at 40% and again, you negotiate down. Use the same negotiation technique. Bring up the same issues you would bring up in regular CAP. Tell them how wonderful the employer is. Tell them how hard they've tried to comply and what they're going to do in the future. Really focus on the equities. You can talk about all the good things this company does for its participants. All of those reduce the sanction. It will put the IRS in a better frame of mind. They didn't catch you; you walked in voluntarily, so you're in a better negotiating position.

This is a newer program, and more than being a newer program, it's not used that often because most people are worried about going in blind. Yes, it's 40%, but 40% still is a lot of money and a lot of employers don't want to do this. But it has picked up steam as people realize the IRS is out there doing examinations. There have been reports of very large sanctions on exam. More employers are weighing the risks and saying, “I'm going to take my chances and go into the voluntary closing agreement program. Maybe I won't get 40%. Maybe I'll get 20%, maybe I'll get 10%.” I've seen voluntary CAPS as low as 9%. I've seen more that are in the 15% to 20%. Rhonda, what have you seen?

**Ms. Davis:** It's all over the place, but you're right. My experience is that it is less than 40%. As Karen said, start doing the multiplication. Forty percent of a big number is still a big number. That's the reason that you get to the place where you don't have to walk in. You do want to look at your plan and find out what's going on with it. Voluntary CAP is different from VCR, as Karen said, because voluntary CAP addresses things that can't be addressed in VCR, such as nonamenders. You really don't want to get involved in anything that has the word "CAP" in it. Whether it's audit CAP, you were caught, or it's voluntary CAP, you walked yourself in. Because the sanctions can be so much larger than under VCR. Even if it's in the 15% range, it's probably going to be more than $10,000, which is the maximum sanction under VCR. You want to be in a place where you either fix it and forget it and hope you don't get caught in audit lottery. Or, you walk yourself into VCR. You don't want the IRS walking into you, and you don't want to walk into voluntary CAP, if you can avoid it. If you're in a nonamender situation, you can also play audit lottery, but the risks are pretty high now.

**From the Floor:** You mentioned audit roulette strategy, and I've always been reluctant to put that in writing.

**Ms. Davis:** No, we won't put audit roulette in writing, but it is, in fact, one of the choices. You have to decide what it is you're going to do. Employers have to make an informed decision about what they're going to do. If you're not going to do something, don't. If you're not willing to change what you're doing, don't spend the time to look at the plan and find out what's going on. For what? Even if you're only going to change prospectively, it's worth taking a look at your plan to figure out what you're doing wrong. But if your choice is to do nothing, then don't spend the time to look at your plan.

**From the Floor:** As enrolled actuaries, do you think we could be disenrolled for recommending willful noncompliance?

**Ms. Field:** Yes, and I'm not suggesting willful noncompliance. If you know about it, you have an obligation to try to do something about it. But this is a decision your clients have to make. I'm suggesting that, even if the employer found that there was a 415 problem, the employer may not do anything about it, either retroactively or proactively. The employer may not clean it up. Instead, the employer may decide to start doing it correctly tomorrow as opposed to correcting retroactively. I would not suggest willful noncompliance, but instead, one of—”I don't care.” There are millions of plans in America and an employer may say, “I don't care if they move all of the determination letters to Cincinnati. There aren't enough agents in my lifetime to audit all of my plans”—and that's absolutely true. All the plans in America will not be audited. It can't happen. So some employers say—it's not going to happen to me. I think that's a silly, head-in-the-sand attitude in 1996. In 1986 I think that was probably not a bad strategy. In 1996, I think that's really foolish. With the 401(k) study, with what you might remember a few years ago, with the small plans and the IRS's excitement about mortality and interest rates. There's always something that excites the IRS, and you don't want them to be excited. You want them to be bored to death, so they go away and leave you alone.

**From the Floor:** When you talk about not enough auditors, what are the chances of just getting audited? Is it possible to know something like that?

**Ms. Field:** It has changed so much over time. Years ago it was well below 1%, because about 80% of all the IRS's resources were put into the determination letter program. Two or three years ago, 55% of their resources went to examination. It has gone up quite a bit. They're now hoping to have close to 100% in most areas. Their aim, when this was discussed years ago, was to push for 5% a year. Five percent adding up over a few years increases your chances quite a bit of being audited.

**From the Floor:** Five percent of what? Employers? What size plans?

**Ms. Field:** Five percent of plans. The number I've always heard is, that the IRS would love to be able to audit 5% of the plans. I doubt that's even realistic. There are many plans out there. In any given year, they may decide—this year we're going to look at Keogh plans. How they're going to find Keoghs, I don't know. Actually I do know, but whatever they decide to go after, they could go after a lot of. Now your numbers are all skewed. Yes, we're going to go after 15% or 20% of the Keoghs or the small defined-benefit plans, whatever it is.

**Ms. Davis:** The problem with that is, even if you figure you're safe because the IRS is looking in 1996 at (and I'm making this part up) only large 401(k) plans, and you happen to work with medium or small plans or only defined-benefit plans, so you think you're safe. The problem is that two years from now, in 1998, when they decide that they're going to target either small 401(k)s or defined-benefit plans, they'll be looking at 1995 5500s and there you go. In 1998 they look at 1995—why? Because 1995 5500s are filed in 1996, and there is a three-year statute of limitations. So you can't really afford, I think, to try and segment the market by thinking they're never going to look at this kind of plan or that kind of plan. This year they're focusing on 401(k)s, but next year there will be another focus.

**From the Floor:** I have to deal with these programs by managing the risk. I can see the reasons why I'd want to know the risk levels about possibly wanting to correct the past. In my mind, I want to correct the future, but it's just a function of using what you know to manage the risk level.

**Ms. Davis:** That's precisely what it is. It is risk management. It's risk tolerance. If you have two defects and you know two defects could throw you into CAP, but you think the cost to fix it retroactively under VCR is too great, you may run for luck.

**From the Floor:** I can assess the risk levels and I can assess the penalty levels, but to me it's up to the client to determine what their risk management level is and what they're willing to take on as a business risk.

**Ms. Field:** That's right. In fact, that's what we usually do. Nobody is ever going to force a client into one of these programs. You'd be crazy to, because you don't know what's going to come out of it. What you do is, you give them the options. Here's what is going to happen. Here's what happens if they happen to catch you on examination. Here's what happens if you just walk in. Here's what happens if you use the VCR program. Here are your choices. I think informing the clients is really what this is all about and encouraging the clients to worry about compliance and to know that the world is not the same as it was five or ten years ago. There are many employers who think, “I never had to do this before. My plan was examined back in 1985. I didn't have to pay anything, what's the big deal?” The big deal now is if you're caught, there's a cost. It may be a big cost. Some of the CAP numbers have been very big. Employers need to know that as part of their business decision. It is a business decision, but they need to know the whole array.

Let's touch on a couple of other issues. For those of you who do work with tax-exempt organizations, you probably know that, many people have spent 30 years ignoring 403(b) plans. The 403(b) plans are defined-contribution plans for tax-exempt organizations, particularly 501(c)(3) organizations. Unfortunately, we're seeing a few other tax exempts that have 403(b)s, and they're not supposed to. We're actually having to get our own actuaries involved in these plans because many people didn't realize that, if you have a 403(b) plan and you have an defined-benefit plan, there are calculations which need to be done every year to take into account the defined-benefit contributions for that given employee, and that amount is counted against what they can put into the 403(b) plan. People have not known that until recently—it's not in the statute but it's been in the regulation since 1966.

It is difficult to argue with the IRS when it does come out and ask, where are your calculations? Did you consider the defined-benefit plan? The clients usually answer, “Huh?” They usually turn to the insurance companies and say, “Well, did you take into account our defined-benefit plan?” As often as not, the agent's response is also, “Huh?” Everybody gets their actuaries involved. We try to figure out what's going on. It's coming up more often. If you haven't heard about it, if you do work with tax exempts, it might be time to ask questions. Make sure that somebody is minding the store because the IRS is definitely out there looking at this, and it's definitely one of the things the IRS is looking for.

If you also happen to be in the unfortunate situation of having a client who is not a 501(c)(3), for example, is a trade association or something else—a 501(c),(4), (5), (6), (7), or other tax exempts which are not charities or not state universities, a lot of them were sold 403(b) plans, especially by insurance companies, but also by a bunch of excited mutual funds three years ago. They're not allowed to have 403(b) plans. If they have 403(b) plans or they think they have 403(b) plans, they don't. They have taxable plans. The IRS is in the process of figuring out what to do with those. Meanwhile, if one of your clients is involved in that, you can drag your client into the IRS and try to work with the IRS to fix it. The IRS has been trying to fix it. The IRS has also been promising a program in the future to fix it, but it's worth asking. Even if you have nothing to do with that plan, doesn't it look better, doesn't it protect your client better, than to have the IRS walk in the door, as we're seeing happen once in a while.

I don't know if you've worked with tax-exempt organization voluntary correction (TVC) program. We've gotten into it by mistake because we do have many tax exempts, and the IRS has been out there examining them. They're paying serious money because nobody is looking at the 403(b) plan. The clients all think, “It's not my plan. The insurance company takes care of it.” Insurance company says, “I'm one of 15 different vendors that sells 403(b) products to this client. I can't take care of them.” No one is looking. The IRS is finding problems. I'm not going to go into 403(b) rules, but if you have got a tax-exempt client, ask the client whether they have one of these.

**From the Floor:** Are there 415 issues?

**Ms. Field:** You better believe it. They are the same problems you find in 401(k) plans. They go through the 415 limits all the time. There's a special rule for them that gives them a little bit of extra play, a little bit more money than you can put into a 401(k), for example, but they still go through all those limits.

The last kind of program, nobody has ever heard of, because it doesn't really have a name. It isn't a program as such. It's what if something comes up and you don't know how to fix it and it's not a qualified plan issue for this client. Say you're doing outsourcing. You're doing plan administration for 40 different plans for different employers, and now you find out that your computer system was wrong. Something is fouled up, you have no idea, but you do know that it happened to 40 different employers. One thing you could do is bury your head in the sand, but somebody is going to call you on it. You could also have each of those employers go into the IRS on VCR.  The IRS figures out patterns very well.  The IRS has seen this a number of times and doesn't like it very much.

A third option is to use informal CAP.  Walk in to the IRS National Office and say, “We've got something which crosses a bunch of different employers.  We can flood you with 40 cases or 1,000 cases, or we can work with you right now.”  This has happened two or three times that I know of.  A large company has come in which does plan administration or does fund work, has Keogh plans, IRAs, defined-benefit plans, and the same systemic program has affected all of these plans.  They go into the IRS under informal CAP, and they say, “We goofed.  We don't really want to tell all of our clients about this problem.  We'd rather fix it and get on with life and we'll pay something.”  The IRS has worked with them and allowed them to fix these problems, because they are usually inadvertent—they're never deliberate.  It's usually computer problems or one person somewhere thought they had the right answer and gave that answer to a lot of different people.  Very fixable, but remember—if it saved the IRS its resources, you have a good argument for going into the IRS and just saying, “Let's fix it.”  You just know it's available if something comes up if you ever deal with large problems that affect more than one employer.

All of these programs have one thing in common which is compliance.  The IRS, with the examination programs, with the voluntary program, what the IRS really wants is for employers to run their plan correctly.  It wants their advisors out there helping employers run their plans correctly.

You come to seminars like this and you go to all of the different subjects you can go and you learn everything you can, but you say, all right, now is the time.  IRS is getting out there much more.  There's a great deal more activity.  Maybe it's time to figure out what is going on with this plan.  There are some plans that are run very well, but many of us have seen plans that aren't run all that well.  At some point it's worth drawing the line and saying, “Let's find out everything that's wrong with this plan.  If we do find some problems that look scary, let's take it into the VCR while we still have a chance.”  We're doing a lot of diagnostic reviews.  Hewitt is doing tons of diagnostic reviews.  Every company that's out there is doing diagnostic reviews.  We're not necessarily saying, “Hire us.”  But somebody needs to do it.

**Ms. Davis:** What you want to do is to figure out what's really going on in the plan. What has happened in the past is that the IRS issued determination letters, telling you the language in the plan was fine.  Nowadays they're doing operational audits. They want to find out if you're operating the plan correctly, which means what your client needs to do is to do an operational audit of the way the plan is administered. What goes on in most administration will scare you because all of you work with your clients to keep them on the straight and narrow.  You know the rules and you explain the rules to them and they nod and smile and you go home, and then they do what they've always done, not what you told them to do. It's not because they don't think that you're trustworthy, it's because they don't remember what you told them.

The biggest problem in plan administration that we've ever seen is that nobody writes anything down. For those of you who ever played that game as a child called, “Telephone,” I whisper a secret to Karen who whispers it and it goes all the way around and when it comes back to me, it sounds nothing like the secret I whispered to Karen. That's how most plan administration is done today. “I know how to handle joint and survivor annuities. I know how to calculate them. I know when to send out the forms. I know the right timing. I know this thing about spousal consent. Well, there is some rule about spousal consent. Somebody explained it to me once.” That's how plan administration gets done. “Even if I do know all the answers, I take a month vacation and while I'm gone, somebody has to process distributions and in comes my assistant who can't remember what it was that she or he thinks I said.” That's plan administration. Who remembers what it is if you don't write it down? Get your clients to write it down. Then you review it for them. Find out if what they wrote down is correct, but write it down. It doesn't matter if it's on a yellow sticky note. Keep it some place you can find it, because if you don't write it down, I guarantee you it won't get done correctly.

If you've been involved in anything, diagnostic reviews, compliance reviews, operational reviews, like Karen and I have, then you know there are no qualified plans in America. Well, there it is. You thought it, I thought it. Not because people don't care, but because the code is this thick and administrators can't keep up with it all. Talk to the administrative people. Even if they write it down, talk to them and ask them how it is that they do something. Even if they've heard the rules, they may not apply them correctly.

It isn't enough to have a procedure. You have to talk to the people and then you have to look at the files. One employer told us that age 70.5 distributions were easy. They said, “We go to our recordkeeper, our recordkeeper gives us a list every year of anybody who is going to turn 70.5 that year, so we know who needs a distribution.” I thought—this administrator is great. I checked the files and found they never made any distributions. They knew exactly what to do, but there was no follow-through. I promise, I don't look at the only bad plans in America. They're all like this. They're not all going to get caught by IRS and they're not going to get caught on all the issues. But this is one of those areas where you can really add value to your clients.

You can look smart because you can point out ways that they can help themselves. Even if they decide they're not going to clean up anything retroactively, but starting tomorrow they want to be right. We strongly encourage you to discuss this with your client, even if your client doesn't want to go VCR, to give serious thought to writing things down or having somebody write things down for them.

What you want to write down is how the plan is supposed to be administered, and I'm talking about all the details, because that's how you make sure it's done correctly. Then take a look at what actually has been done. What do the files have? What do the people say they do? Here's a novel concept for some plan administrators—what does the plan document say? How many of you have clients who you know have never cracked a spine on the plan document? They haven't even read the summary plan description, and they administer the plan because they remember what so-and-so told them about how it was supposed to work. That was great. That was before Tax Reform Act (TRA) 86. They're excluding people over 65. All kinds of things can go wrong.

You need to talk with them about it. Annually is our suggestion. Get the attorney, if it's a defined-benefit plan. If it's a defined-contribution plan, maybe you also bring in the recordkeeper. Get everybody in a room, and talk about what's new. How are you doing this? Tell me how you're doing loans. What goes on with disability retirement? Which factors are you using? How many of you have had problems because your client was cashing people out using the wrong Pension Benefit Guarantee Corporation interest rate? They've been cashing out people thinking they had a benefit with a present value of $3,400 when the present value was $3,600, and now you have a VCR issue. If your client says, “I don't have the money for a meeting like this,” or, “I can't spare the time.” You can explain to them that after everything Karen's told you, as much as it costs to put all those folks in a room for a day, you have so much more to lose if it isn't done correctly. The IRS is out there, so we strongly encourage you to know what the rules are, and you do, and to explain to your clients how important it is to follow them.