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**Madison Pension Services, Inc.**  
Strong Designs That Work and Last

Summer/Fall 2009

**Newsletter Topics:**

- Prior years tax deductions
- Operational Failures
- Document Related Defects
- The Closing Agreement Program (CAP)
- The Voluntary Corrections Program (VCP)

**Deadlines:**

401(k) Safe Harbor Notice **12/1**

Summary Annual Report of Form 5500 **12/15**

Extended Deadline ADP/ACP failure **12/31**



**Is Your Retirement Plan In Jeopardy Of Losing Prior Years Tax Deductions?**

The word “prior” is not a typo. Prior years’ tax deductions can indeed be in jeopardy. In fact, given the amount of company contributions and employee deferrals that get deposited into companies’ retirement plans each year, you could argue that the danger of the retirement plan losing its special tax benefits represents one of the greatest threats facing your company. Why your company and not the plan? Because if issues arise surrounding the qualification of a retirement plan, it is the company and not the plan that will need to pay any additional income taxes, penalties and interest. Previous articles that I have written have focused on things that you and your professional advisors can do to avoid or reduce a liability precipitated by your qualified retirement plan that might exist out in the future. One of our articles discussed the Plan Sponsor’s personal or company liability that is tied to their fiduciary obligation to properly monitor the investment choices in a company’s

401(k) plan. Another talked about the need to remit all employee deferrals within 7 business days of separating that money from their employees’ paycheck and the penalties associated with not doing that. In all instances, we recommended policies and/or procedures that could be put into place that would protect your company and you personally on a going forward basis. That is excellent advice and I still stand by that advice.

But what about prior tax years? If those tax years are exposed, in a very real sense, they can represent a larger liability to your retirement plan than anything that might occur out in the future.

What exactly could ever occur to put these prior years in jeopardy and how many open years might there be? It is the qualified status of your retirement plan that could be at risk. Remember that it is the retirement plan’s qualified status that allows for all of the following special tax benefits:

1. Contributions from either the employer or the employee are tax deductible
2. Contributions to the retirement plan do not get included in the current income of either the employer or the employee
3. No current income tax is due on interest, dividends or any realized gains from any security transactions that the retirement plan engaged in

One of two things can cause a retirement plan to lose its qualified status. The plan can experience an operational failure or there may be a disqualifying defect in the plan document and/or amendments.

*(Operational Failures Pg. 2)*





### **Operational Failures**

Think that an operational failure needs to be pretty serious to cause the plan to lose its qualified status? Think again! One operational failure that will automatically disqualify the plan is failing to operate the plan in accordance with its terms. So let's say that at one time your company's 401(k) plan had a one year wait to enter the plan. At

some point, it was determined that you wanted to let folks in much sooner than that. So you switched the eligibility to let your employees enter the plan on the first day of the month following their date of hire. Simple right? Well, if the plan had not been amended to change the eligibility, and if that amendment was never signed and/or dated then

you are running the plan contrary to its terms.

If the way that you operate your plan is not supported by language in the plan document, then you have inadvertently disqualified the plan. So if making the plan more liberal puts you at risk, imagine how making the plan provisions stricter might be viewed?

### **Document Related Defects**

The second and by far the majority of plan disqualification defects that we see are deficiencies in the plan document. These defects almost always take the form of a failure to properly sign and date the original plan and trust, a failure to timely restate the plan for new tax laws or (and this is the one we see most often) a failure

to timely execute one of the many amendments that the IRS mandated be adopted as each year passed by. I would say that 75% - 80% of all of the retirement plans that we take over have some sort of document or amendment related defects. These defects cause the plan to lose its special tax treatment. Also, remember

that your company is the Plan Sponsor. It is your responsibility to have all of the properly dated documents and/or amendments available at all times. How many of you actually know where these documents live in your office and whether they are properly signed and dated?

### **The Closing Agreement Program (CAP)**

If an operational failure and/or a document related defect is discovered upon audit, the IRS will put you into something called the Closing Agreement Program (CAP) and they will:

1. Assess additional income tax resulting from the loss of employer deductions for possibly as many as 3 preceding tax years. Think about it. If you filed your retirement plan's Form

5500 for the 2006 plan year on October 15, 2007, then by simply counting back 3 years 2008, 2007 and 2006 are all open years!

2. The trust would owe income tax on any interest, dividends or realized gains that the plan may have received during the course of these open tax years.

Under CAP, the IRS will then calculate the "Maximum Payment Amount." The

Maximum Payment Amount is basically the additional taxable revenue that (1) and (2) above would generate. At that point, they will apply a discount of about 30% to that amount and request that the plan sponsor write a check to the IRS for the remaining 70%.

### The Closing Agreement Program (CAP): COMPANY 'A' EXAMPLE

**Example:** Company A's retirement plan has 25 participants, wins the IRS "audit lottery" and is examined for the 2006 plan year. The client failed to timely adopt the final 401(k)/ (m) amendment, which needed to have been executed no later than December 31, 2006. Let's further say that the company put \$100,000 per annum into the plan for 2006, 2007 and 2008. Also, while 2008 was not a good year for the market, 2007 and 2006 were. So let's also say that for those 3

years, the plan had, in the aggregate, interest, dividends and realized gains from the sale of securities of \$50,000. The Maximum Payment Amount would therefore constitute income tax on:

1.  $(\$100,000 \times 3) + \$50,000 = \$350,000$
2. Discount by 30%:  
 $\$350,000 \times 70\% = \$245,000$
3. Estimated income tax on  
 $\$245,000 = \$73,500^*$

\*assumes a melded corporate rate of 30%

Late payment penalties and/or interest would also apply.

Of course, you still need to correct any and all of the defects that have been identified by the IRS, which may include making additional contributions for employees that terminated years ago and/or adopting any amendments which cannot be located or were never adopted in the first place.



### What is The Voluntary Corrections Program (VCP) ?

VCP is an extremely valuable IRS program that is little known outside of the pension community. It was the result of a joint effort between various pension organizations and the IRS to find a way to have retirement plans that had inadvertently wandered "off the reservation" recapture their qualified status and retain their special tax benefits. Since the pension division of the IRS is primarily compliance driven, they welcomed the opportunity to find a solution that would allow plans to self-correct themselves. Thus was born VCP.

The first thing you need to know about VCP is that the operative word here is **voluntary**. The decision to avail yourself of VCP *must* come from the client or be given to the client as an option by one of their professional

advisors. Once the audit notice from the IRS shows up, your ability to use VCP is gone. The process of utilizing VCP is fairly simple. The defect is identified, corrective action is taken and the package with the proposed corrective action is submitted to the IRS, along with a check that corresponds to an IRS schedule based on the number of participants in the plan. Normally, failure to adopt an amendment for a 25 participant plan carries with it compliance/fee is \$1,000. However, because in this particular case the defect was caused by a failure to timely adopt an **interim** amendment, the IRS compliance/filing fee would only be \$375.

A fairly long amount of time may pass from when you make your submission to the IRS to the time you hear back from them that your

correction has been accepted. However, once you place the plan into VCP, you have now walled the plan off from CAP. If you were to receive an audit notice the day after your submission to VCP, the IRS auditor would need to back off, even though your correction had not yet been formally accepted.

Note that it is important to identify and correct *all* plan defects. VCP will only protect you for the defects that you identify and submit for. If the IRS finds another defect that you did not correct, they can still put you into CAP, where the financial sanctions are clearly much harder.

(continued page 4)

**" VCP is an extremely valuable IRS program that is little known outside of the pension community."**



**Let us help you build a safe road to retirement.**

Cost Of Living Adjustments to dollar Limits under Employee Benefit Plan are status-quo for 2010 (see chart below).

Item	2009	2010
Defined Contribution	\$49,000	\$49,000
Defined Benefit	195,000	195,000
Maximum Compensation	245,000	245,000
401(k) - SARSEP - 403(b) – 457: Deferrals/Catch-up contributions	16,500 / 5,500	16,500 / 5,500
Simple Deferrals/Catch-up Contributions	11,500 / 2,500	11,500 / 2,500
IRA Limit / catch-up	5,000 / 1,000	5,000 / 1,000
Highly Compensated Employee	110,000	110,000
Key Employee-Officer	160,000	160,000
Social Security Taxable Wage Base	106,800	106,800



**(Continued) The Voluntary Corrections Program (VCP)**

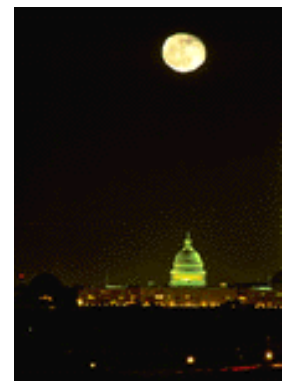
For 401(k) plans, the following is a list of the documents that need to have been adopted prior to the time of the current round of restatements:

- The Gust Restatement
- The EGTRRA Amendment (*not the restatement*)
- The 401(k) Amendment
- The Automatic Rollover Amendment
- The Final 401(k)/(m) Amendment
- The Final Regulations Amendment

By the way, fixing a missing or undated amendment is not as simple as “finding” and dating the amendment. Many of these amendments have different dates that they needed to have been executed by. Making a mistake and use the wrong date (and that has happened) or use a date after the language in the amendment would now be part of the overall language in the body of retirement plan (and that has also happened) and the “f” (fraud) starts to get used by the IRS. They take back dating very seriously. You never want to put yourself in that position.

If you would like to have your plan reviewed to ensure that you are not exposed, or if you would like to discuss these or any other issues that might concern you in confidence, please contact:

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