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# TAX CONSEQUENCES OF RETIREMENT PLAN DISQUALIFICATION

When the IRS audits a plan purporting to be qualified under the Internal Revenue Code, the audit sometimes discloses one or more failures that the IRS deems significant enough to warrant plan disqualification. As a practical matter, the IRS goes out of their way to help an employer avoid the actual disqualification of a retirement plan. If the defects or failures will result in plan disqualification, absent additional IRS intervention, the IRS invites the employer to participate in the Audit Closing Agreement Program ("Audit CAP"). Audit CAP involves the employer paying a negotiated financial sanction to the government in return for the government overlooking the discovered plan failures that were detected upon audit as long as they are promptly corrected by the employer.

The first step in the Audit CAP process is to determine the financial impact if the plan was disqualified. Plan disqualification has a negative impact on the employer, the employer's employees who receive plan benefits, and the trust fund holding the plan's money. Typically, the IRS calculates taxes that would be due for tax years still open to IRS audit.

**Consequence 1: General Rule – Employees Include Plan Contributions in Gross Income.**

In a non-qualified retirement plan, participants must include as taxable income employer plan contributions in which the employee has a vested interest. There are exceptions to this rule. For example, if the only reason the plan is disqualified is because it failed prescribed minimum coverage or participation rules, only Highly Compensated Employees must include vested employer contributions as taxable income. Likewise, if the plan failed qualification simply because it discriminated in favor of Highly Compensated Employees, only Highly Compensated Employees include vested contributions as current taxable income.

**Consequence 2: Employer Deductions are Limited**

In a qualified plan, employer contributions are immediately deductible by the employer up to prescribed limits, without regard for whether the benefits are vested. Upon plan disqualification, however, employer contributions are currently deductible only to the extent the contribution is includible in the employee's taxable income. If the employer's tax year is different from the employee's tax year, the employer cannot take a deduction until its first taxable year that ends after the employee's taxable year ends. For example, an employer with a June 30 tax year employs employees with calendar tax years and makes contributions to a disqualified retirement plan. The contribution is made on March 24, 2012 and is immediately vested. The contribution would not be deductible on the employer's June 30, 2012 tax return because the employee's applicable tax year does not end until December 31, 2012. The employer, in this example, deducts the contribution for its June 30, 2013 tax year. Employer contributions to disqualified plans such as defined benefit plans (that have no separate accounts for participants) are not deductible.

**Consequence 3: Plan Trust Owes Tax on Trust Earnings**

Trusts established to fund tax qualified retirement plans are exempt from trust income tax rules. However, if the plan is disqualified, the trust's earnings must be reported on Form 1041 and appropriate income taxes must be paid by the trust.

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**Consequence 4: Rollovers are not allowed**

Any distributions from a disqualified retirement plan are not subject to rollover, either to an IRA or to another qualified plan. This means distributions are immediately taxable in the year distributed.

Finally, the IRS calculates the total taxes associated with a given plan becoming disqualified and then offers a fraction of that amount, representing what it will accept to close the audit. Following a successful negotiation process, the employer pays the agreed upon sanction, corrects the plan failures, and the IRS issues a Closing Agreement settling the matter.

## MISSED THE DEFINED BENEFIT RESTATEMENT DEADLINE? GOVERNMENT OFFERS "HALF PRICE SALE" FOR PROMPT FIXES

As we have discussed in more than one issue of this newsletter, April 30, 2012 was the last day for an employer using a pre-approved defined benefit plan document to restate and update the document. Dubbed "EGTRRA Restatements" by many in our business, the restatements are essential in order for a retirement plan to retain the various tax benefits Congress has bestowed upon them. Failure to timely amend can be cured, but only by submitting the matter to the IRS under their Voluntary Correction Program ("VCP" for short). As you might expect, filing under VCP involves a non-deductible fee payable to the U.S. Treasury. This charge depends upon the number of plan participants and normally ranges from a low of $750 for plans with 20 or fewer participants up to as much as $25,000 for a plan covering 10,000 or more.

In cases of slow restatements to keep tax qualified retirement plans up to date, the VCP program features a built in fee reduction for employers who act promptly to fix tardy restatements. The fee remains graded, depending upon the number of participants, but the employer pays only half of the normal submission fee provided the submission occurs no later than one year after the document was supposed to be restated. For example, a plan covering 25 participants that would normally pay a $1,000 submission fee need only pay $500. However, if the submission is after April 30, 2013 (one year after the original due date), the fix is still available; but the fee in our example goes back to the normal $1,000.

If there are employers who missed the April 30, 2010 deadline for adopting the EGTRRA Restatement for defined contribution plans, VCP is available for them as well; but only with regular submission fees.

To the best of our knowledge, no NRS client was late in adopting the necessary restatements. However, if you are a client who thinks you may have missed the deadline, you should contact your Account Manager for assistance.

## REMINDERS FOR JUNE 2012

**<u>All Plan Types:</u>**

**June 15 - Form 5500/8955-SSA** - Forms due for Plan Year Ending ("PYE") 8/31/2011 that are on extension

**June 30 - Form 5500/8955-SSA** - Forms due for PYE 11/30/2011

**<u>401(k) Plans Only:</u>**

**June 30 -** Deadline for corrective distributions for failed non-discrimination test without 10% Penalty for Plans with an Eligible Automatic Contribution Arrangement ("EACA")

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