

# Navigating The IRS Pre-Audit Retirement Plan Pilot Program

By **Gary Blachman, Tara Sciscoe and Austin Anderson** (July 8, 2022)

On June 3, the Internal Revenue Service Employee Plans function announced a new pilot program for retirement plans to promote compliance while reducing audit costs.

Under the Pre-Examination Compliance Pilot, which went into effect last month, the IRS notifies retirement plan sponsors 90 days in advance that their plan has been selected for an audit. The plan sponsor then has 90 days to review its plan documents and operations, and to correct any compliance issues that may be discovered.

## Program Features

The pilot program has three main features, outlined below.

### ***Advance Notice by an IRS Pre-Audit Letter***

The IRS gives 90 days' advance written notice, or a pre-audit letter, to plan sponsors that their retirement plans have been selected for an upcoming audit. The letter may identify a specific focus of the audit, such as compliance with the 415(c) limits or the required minimum distribution rules.

The pilot program indicates that if the plan sponsor does not respond adequately to the pre-audit letter within the 90-day window, the IRS will likely move forward with scheduling the audit. However, if the plan sponsor responds to the pre-audit letter, the IRS will determine whether to issue a closing letter based on the information supplied by the plan sponsor, or to conduct a limited or full scope audit.

At this point, the IRS has not provided guidelines describing the criteria that will be used to determine whether to proceed with an audit.

### ***Self-Correction During the 90-Day Review Period***

The IRS encourages plan sponsors to use the 90-day period to review their plan documents and operations to confirm they are up to date with current tax laws, and that operation accurately reflects the documents.

Any errors identified during this 90-day period may be self-corrected by the plan sponsor using the IRS Self-Correction Program, if eligible, or the IRS Voluntary Correction Program under the Employee Plans Compliance Resolution System, or EPCRS.

### ***Reduced Fees for Certain Errors***

The plan sponsor must submit to the IRS a description of the errors and documentation to support any correction action. If the plan sponsor discovers errors that may not be self-corrected, it may correct through the Audit Closing Agreement Program, or Audit CAP, and request a closing agreement with the IRS.



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In that process, the IRS will apply the lower Voluntary Correction Program, or VCP, fee structure to determine the sanction amount, rather than the Audit CAP fees that would otherwise apply to errors identified during a routine IRS examination.

The fees under the VCP program are based on plan assets and are currently capped at \$3,500 for plans with assets of more than \$10 million. The Audit CAP fees can be significantly higher than these VCP fees. For this reason, the pilot program provides an opportunity for plan sponsors to reduce the cost of corrections, especially for errors not eligible for self-correction.

The IRS indicates in its announcement of the pilot program that it will evaluate the effectiveness of the program to reduce overall audit costs and the time spent on examinations in order to determine whether it should be made a permanent part of the IRS' compliance strategy. The IRS did not specify how long the pilot program will be initially available to plan sponsors.

### **Open Questions**

The June 3 announcement outlines the basic structure of the pilot program while leaving many details unclear. Retirement plan sponsors and their advisers should stay tuned for more information about the following topics:

#### ***Pre-Audit Eligibility***

The IRS announcement does not indicate whether all retirement plans selected for an audit will be offered the pilot program. Additionally, it does not mention which types of retirement plans might receive the pre-audit letters.

At a minimum, it appears that the pilot program will be offered to both Internal Revenue Code Section 401(a) and 403(b) retirement plans. It is unclear whether the pilot program will be available to all plans typically eligible to use EPCRS — which includes plans under Sections 401(a), 403(a), and 403(b), in addition to Simplified Employee Pension plans and SIMPLE IRA plans — or to a subset of these plans.

Similarly, it is unclear whether the pilot program will be available to Section 457(b) plans, for which the IRS currently allows corrective submissions on a provisional basis outside EPCRS, using standards similar to those of the VCP, or to any other types of retirement plans.

#### ***Likelihood of Audit After Pre-Audit Letter***

At this point, the IRS has not provided guidelines to describe the criteria that will be used to determine whether to proceed with an audit after the IRS issues a pre-audit letter.

It is clear that if a plan sponsor receives a pre-audit letter and fails to respond within 90 days, the IRS will move forward with an audit of the sponsor's plan. It is less clear what circumstances will prompt the IRS to conduct an audit when it receives a timely response to a pre-audit letter from the plan sponsor, but the sponsor has not completed the identified self-corrections.

Similarly, plan sponsors cannot avoid an audit if their responses to the pre-audit letter are timely, but the responses are cursory or incomplete. It would appear that even if a plan

sponsor reviews its plan in response to the pre-audit letter and finds no compliance errors, it will need to substantiate its position in some way to avoid an audit.

It is also possible that even a complete correction with adequate documentation could result in an audit if the nature or extent of the problem suggests more systemic problems with the plan or its administration. Additional guidance is required to clarify these open questions.

### ***Frequency of IRS Pre-Audit Letters***

With the reduced time and cost of issuing these pre-audit letters, it is possible that this IRS program becomes permanent. In that case, plan sponsors may find that there is a higher likelihood of receiving a pre-audit letter than being selected under the current audit program.

As many sponsors have discovered over time, some errors can be quite onerous and time-consuming to correct. This scenario would make it even more important for sponsors to have a rapid response process upon receiving a pre-audit letter.

### ***Timeline of the Pilot Program***

At this time, it is too early to determine if the pilot program will become a permanent fixture of the EPCRS program. The IRS has not provided any details about how many months or years the pilot program will continue. Based on prior Employee Plans Compliance Unit programs, an initial pilot is likely to last at least 12 to 18 months so that the IRS has time to complete audits and assess data.

### ***Selection for Pre-Audit Letters***

The pilot program announcement does not indicate that every plan potentially eligible for the program will actually receive a pre-audit letter. It is certainly possible that some Section 401(a) or 403(b) plans will still be subject to a full audit without being permitted to use the pilot program.

### ***Next Steps***

There are two important steps for plan sponsors and administrators to take at this time.

#### ***Establish a Rapid Response Process Upon Receipt of Pre-Audit Letters***

In many cases, conducting a detailed review to identify errors and then fully correcting those errors could take longer than the 90-day period, particularly since plan sponsors will frequently have to rely on record-keepers and third-party administrators for assistance. This makes it important for plan sponsors to establish a response process in advance of receiving a pre-audit letter.

All essential parties should be involved in reviewing the plan documents and administration before the plan sponsor receives a pre-audit letter. For plan sponsors that are in the process of renewing their contracts with advisers and service providers, we would recommend specifically addressing the pilot program to ensure timely responses from all parties essential to responding to a pre-audit letter and/or correcting identified errors.

#### ***Conduct Proactive Self-Audits***

We strongly recommend that plan sponsors and administrators be proactive and periodically conduct self-audits of their retirement plan documents and operations rather than wait for an IRS pre-audit letter.

Conducting a self-audit with your advisers and record-keepers could help to significantly reduce both the burden of responding to a pre-audit letter and the likelihood of finding an error in response to one. Plan sponsors should also review internal administrative procedures on a regular basis to ensure they are consistent with plan documents and are being followed.

When compliance errors are discovered on self-audit, they can be corrected using the IRS self-correction procedures, if eligible, or voluntary correction procedures under EPCRS.

Of course, sponsors and administrators who receive a 90-day IRS pre-audit letter should work quickly and efficiently to conduct a self-audit to identify any compliance issues and to address them within the 90-day window.

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