

*U.S. Update:*

# IRS Can Disqualify Plans

By: Carol Buckmann

There have been some well-known cases in which qualified plans were disqualified retroactively by the IRS for less than major violations of the rules. In one of the most well-known, *Tionesta Sand and Gravel* 73 T.C. 758 (1980), a plan was disqualified for failing to contain language requiring full vesting on any plan termination or complete discontinuance of contributions, even though no plan termination had occurred. However, as a result of the IRS' formal correction program for plan mistakes, plan disqualification has become a very rare event.

Retroactive plan disqualification can have the following serious tax consequences:

- Trust income becomes taxable
- Deductions for contributions to Defined Contribution plans are disallowed to the extent participants are not vested
- The plan sponsor is penalized for failing to withhold income tax and FICA relating to vested contributions
- Participants are taxed while in the plan, even if the plan denies them a distribution to satisfy the liability
- Plan distributions are not eligible for rollover to an IRA or other eligible plan

However, we were recently reminded that disqualification is not a thing of the past by not one, but two cases in which the Tax Court upheld the IRS' retroactive disqualification of plans. The first case, *Hollen*, involved a seeming abuse of the ESOP rules, but the second case involved an ordinary profit sharing plan that was neglected and had not been timely amended. Taken together, these cases set out some important rules about the IRS' ability to disqualify a plan, and lay out a blueprint of what not to do if you want to avoid any question about your qualified plan's tax benefits.

In the *Hollen* case, the court determined that adopting amendments with the wrong effective dates - a problem not unique to ESOPs - was alone a valid reason for disqualification.

In the *Christy & Swan* profit sharing case, the following defenses were rejected by the Tax Court:

- The plan automatically incorporated by reference any changes in the law, so specific amendments were not required
- The missing amendments were not required because the plan was simple. It didn't matter that qualified transportation benefits weren't included in the definition of compensation as required, because the employer didn't provide them
- The plan terminated before the amendment deadline. (Actually, the trust was not liquidated, so it was still an ongoing plan. However, IRS rules also require early adoption of required amendments when a plan terminates before the adoption deadline.)
- The IRS' ability to revoke qualified status is limited by the three-year statute of limitations for assessing taxes, so the plan could not be disqualified back to 2001

It is important to note that had these plan sponsors done regular compliance audits and paid a modest penalty, they could have adopted required amendments late without jeopardizing qualification under the IRS' voluntary correction program. They could also have tried to work out a settlement with the IRS preserving qualification under its closing agreement program (also known as 'CAP'), which is available even if the IRS catches the problem on audit or when reviewing a determination letter application.

Plan disqualification will probably remain a rare sanction applied primarily to very small plans, but the message sent by these cases applies equally to all plan sponsors:

- Review amendment requirements each year to ensure timely adoption
- Do regular compliance audits to check for problems

- Adopt required IRS boilerplate regardless of whether it is currently relevant
- If IRS reviewers or auditors still contend that your plan is not in compliance, try to take advantage of CAP, because the burden of proof to show the IRS abused its discretion in disqualifying a plan will be on you, and your chances of getting the Tax Court to overrule the IRS are not good ■

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