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IRS signals increased enforcement for retirement plans

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The IRS Tax Exempt & Government Entities division (TE/GE) has published its annual program letter for the October 2021–September 2022 fiscal year (FY 2022). The program letter describes TE/GE's FY 2022 priorities in broad strokes, while quarterly updates of the division's compliance programs and priorities webpage detail specific plans and compliance initiatives. Retirement plan sponsors could see increased enforcement activity starting with the 2022 plan year, particularly in the areas of nondiscrimination testing and preapproved plan documentation.

Uptick in enforcement likely

The program letter says that TE/GE will significantly increase its staff in the upcoming year, with most new hires assigned to enforcement duties. Although the letter doesn't specifically mention heightened enforcement activity for retirement plans, IRS has already signaled that employers should expect that to happen. The recently proposed update to the Form 5500 series — which would take effect for 2022 plan-year filings — includes new IRS compliance questions to help the agency better identify noncompliant plans for examination. Employers would need to report if they relied on the permissive aggregation rules to pass minimum coverage and nondiscrimination testing. In addition, 401(k) plan sponsors would need to identify the method used to pass the actual deferral percentage (ADP) and actual contribution percentage (ACP) tests. Employers with preapproved plan documents would also have to report the serial number and date of their opinion letters.

The letter has little else to say about employee benefit plans, suggesting only that TE/GE will continue to pay close attention to employee stock ownership plans (ESOPs). The division also will support examinations of high-income taxpayers "with TE/GE issues," including retirement plans.

Compliance initiatives

The compliance webpage lists no new initiatives since the last quarterly update, but indicates that TE/GE will continue to focus on the following benefit and compensation issues in FY 2022:

- **Participant loans.** TE/GE will examine whether participant loans from employer retirement plans comply with the rules on maximum loan balances and repayment of early distributions before age 59-1/2. Audits will focus on retirement plans holding a high percentage of loans relative to total trust assets. This item prompted a recent IRS issue snapshot on deemed distributions arising from loan failures.
- **Required minimum distributions in large defined benefit plans.** TE/GE will audit large defined benefit plans to ensure they are beginning payments when required under Internal Revenue Code Section 401(a)(9) — generally age 70-1/2 for terminated participants born before June 30, 1949, and age 72 for participants born after that date (active participants may have a later date). Failure to begin benefits on time can subject the participant to a 50% tax on undistributed amounts and could lead to plan disqualification.
- **Section 4960 excise tax on excess compensation.** Section 4960 of the Internal Revenue Code (IRC) imposes a 21% excise tax if an applicable tax-exempt organization pays compensation exceeding $1 million to certain of its highest-paid employees. TE/GE will focus on organizations that appear to owe the tax but fail to report and pay it.
- **Worker classification.** TE/GE will check whether employers have improperly classified workers as independent contractors instead of employees. Misclassifying employees as independent contractors may lead to underpayment of Social Security, Medicare and federal income taxes. When TE/GE finds an employer has misclassified employees, a separate audit initiative will examine whether the employer’s retirement plans properly met IRC coverage requirements.
- **Wage misclassification.** TE/GE will examine federal, state, local and Indian tribal government employers that have issued a Form W-2 and a Form 1099-MISC to the same payee in the same calendar year. This review aims to determine whether any wages have been misclassified (distinguishing payments to employees as independent contractors from payments treated as wages).
- **Small sponsors of retirement plans.** TE/GE will examine whether small employers are correctly administering their retirement plan assets. Errors such as party-in-interest transactions or loan failures can lead to prohibited transactions, taxable income from deemed distributions or early distribution penalties under IRC Section 72(p).

Although the compliance page indicates that TE/GE will continue to pursue issues described in program letters from previous years, certain initiatives no longer appear on the page, which could indicate that the division believes these matters have been sufficiently addressed. Among those items are limited-scope compliance checks on partial plan termination and inflated assets reported on the Form 5500.

Related resources

Non-Mercer resources

- Tax Exempt & Government Entities FY 2022 program letter (IRS, Oct. 7, 2021)
- Tax Exempt & Government Entities — compliance program and priorities (IRS, Oct. 7, 2021)

Mercer Law & Policy resources

- New IRS snapshot tackles deemed distributions (Oct. 8, 2021)
- Form 5500 proposal reflects SECURE Act changes and more (Sept. 29, 2021)

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