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Evidence—How Much Is Enough?

Plan administrators may find that business owners inadvertently omit sharing critical information. To meet the TPA's contractual, legal, and ethical obligations—which may involve discovering and rectifying plan errors—it is important to proactively collect underlying information that can help to set the client on a successful compliance path.

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When doing new plan design or on-boarding work, and even annual administrative work, it can be difficult to identify whether information provided by a client or prospect is accurate and/or complete. In this column, we will use a scenario to explore a frequent question in third party administration (TPA) work: "How much evidence is enough?" To illustrate, we will present a situation that shows the benefit of not only asking a question, but also obtaining evidence to support the answer provided.

Often, even the most successful business owners do not fully understand their entity's tax and ownership

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structure. For example, the question posed to a physician-owner of how the practice entity is taxed may be met with confusion or frustration, and may solicit incorrect information from a busy doctor who "simply" wants to establish a plan quickly, without any trouble. While being sensitive to the seemingly endless task list of a business owner, correctly identifying the ownership and tax structure is a very important piece of the qualified plan puzzle for a variety of reasons. Understanding the correct structure is necessary to:

1. Identify the tax forms from which the data should be derived,
2. Calculate minimums and maximums,
3. Cover the required minimum number of employees,
4. Adjust for self-employment tax,
5. Adopt participating employer agreements,
6. Meet the deduction deposit deadline, and so forth.

Given the inherent risk to the client of reliance on poor or inaccurate information, how much should we depend on the representations made by the client or their advisors? How much evidence should we collect to support their representations?

Setting the Stage: A Sole Proprietor's Plan Issues

By way of example, let us explore what information can be learned by reviewing the evidence. Just before October 15, we had a call from an advisor regarding her client's one-participant plan. The advisor discovered the plan had exceeded the $250,000 filing threshold as of December 31, 2015, but had not yet completed the required Form 5500 filings for 2015, 2016, and 2017. In this case, we collected the year-end brokerage statements and mapped out the activity for each of the accounts (husband and wife) to identify the beginning and ending balances, contributions, and investment returns. We agreed with the advisor on the initial year of the required filing of the Form 5500. Knowing the scope of the engagement, we drafted an engagement agreement for the client and obtained the client's signature. Then, we requested evidence to support the deposits made to the plan. Based on the advisor's representation as to the type of entity sponsoring the plan, we requested the Schedule C to the personal Form 1040, Schedule SE, and the W-2 for the spouse.

What Did the Evidence Show?

First, we were able to confirm that the single-member limited liability company (LLC) was indeed a disregarded entity, such that the income and expenses for his business did flow through to his personal return's Schedule C. (The advisor had provided the 2017 extension for the personal return, which could have also been used to extend the 2017 Form 5500 due date to the extended filing due date. The evidence was supportive of doing so.) We were also able to see that the spouse was the only employee, as the W-2 wages did tie exactly to the "wages" expensed on the Schedule C. Finally, we were able to confirm the tax ID used by the LLC, which would be used on the Form 5500 filings as well.

What Additional Concerns Arose from the Evidence?

Unfortunately, it also became obvious there were issues beyond the failure to complete Forms 5500. The deposits to the spouse's plan account were at the 415-dollar limitation, yet the wages were merely $20,000, from which the maximum 401(k) salary deferral had been made. Additionally, the Schedule C listed an expense for pension contributions of just $5,000. There was quite a disparity between the amounts reported on the supporting documents and the deposits made to the plan accounts. Essentially, there were assets held in the plan that would ultimately be taxed on distribution, yet these amounts were deposited *post*-tax (i.e., never deducted, because the deduction was limited). The plan was put in place to save for retirement on a pre-tax basis, but, instead, our client was going to end up paying tax twice on the same hard-earned dollars.

Meeting Our Contractual Obligations

Per review of our engagement letter, we can assess TPA and client obligations. The engagement agreement indicates we will "perform annual administrative services" and, to do so, will "collect certain information." From information provided, we will complete the specific tasks outlined (one of which is to calculate the contribution obligations and opportunities). The engagement agreement states the TPA will "rely exclusively on information provided by you to us," will not be liable for any errors or omissions, and will not be liable for verifying the accuracy of the information provided. We are not attorneys, but our interpretation is that we have met the minimum requirements by asking the client to provide his and her compensation for each of the three years; therefore, by considering the accuracy of the information, we acknowledge we have gone beyond the minimum requirements

of the engagement letter, but that is not the only requirements we should consider.

Circular 230 Due Diligence Requirements

As tax practitioners, we are subject to the requirements of Circular 230. Specifically focusing on "Section 10.22 Diligence as to Accuracy" of Circular 230, it states:

(a) In general. A practitioner must exercise due diligence—
  (1) In preparing or assisting in the preparation of, approving, and filing tax returns, documents, affidavits, and other papers relating to Internal Revenue Service matters;
  (2) In determining the correctness of oral or written representations made by the practitioner to the Department of the Treasury; and
  (3) In determining the correctness of oral or written representations made by the practitioner to clients with reference to any matter administered by the Internal Revenue Service.

(b) Reliance on others. Except as modified by Sections 10.34 and 10.37, a practitioner will be presumed to have exercised due diligence for purposes of this section if the practitioner relies on the work product of another person and the practitioner used reasonable care in engaging, supervising, training and evaluating the person, taking proper account of the nature of the relationship between the practitioner and the person.

To break down this requirement, focusing on sections (a)(1) and (b), we note that we must exercise due diligence in preparing the Form 5500 and other papers relating to Internal Revenue Service (IRS) matters. Because our engagement letter obligates us to "perform annual administrative services," we could not simply complete the Form 5500 based on the brokerage account information. Part of annual administrative services includes determining the maximum permissible contribution amount; thus we needed to learn the compensation figure to determine the maximum permissible contribution amount. As a practitioner subject to Circular 230, one may or may not feel comfortable meeting the "due diligence" requirement by simply asking the sole proprietor client the amount of his or her compensation. In addition, based on item (b), one may question if one could rely on the contributions calculated by the accountant. Some may argue yes; others may say no. In this situation, both the client and accountant relationships were new to us. Based on our knowledge and past experience with one-participant plans, we know that often each of the three parties involved (i.e., the client, the accountant, and the financial advisor) does not have enough information individually to ascertain the deductions and the contributions tying out accurately. So, even if we could rely on the accountant's calculation and satisfy our Circular 230 obligations, we believed it was prudent for us to at least confirm with the accountant that the deposits were made correctly. However, the analysis doesn't end with the IRS requirements, either.

Meeting Our Own Ethical Obligations

Finally, we evaluate our own ethical obligations. Our client had established a plan several years earlier with an individual who was likely well versed in the investment world. This advisor did catch that the $250,000 limitation had been exceeded, but three years after the fact. There was also an issue with not being able to locate a Pension Protection Act (PPA) compliant document from the financial advisor, whose broker-dealer had sponsored the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) restatement. So, while the client has retained individuals well versed in each of their respective professions, if those professionals fail to collaborate with one another, and the client doesn't have any reason to suggest they should, something may be missed. Is it ethical for us to think the client can pull this all together properly without any of our guidance? One may argue that, as practitioners, we may encounter situations in which we have an ethical obligation to obtain evidence to support the information we are using to carry out our engagement, or at least to ask enough questions of the client to ensure we are satisfied the client understands the importance of accurate information and the risk of directing us to rely on representations without additional evidence.

What Was Accomplished

In addition to merely meeting our contractual, legal, and ethical obligations, tangible benefits were derived by diving in deeper and collecting the underlying information. Completing the corrective refund of the excess 415 contribution (and dealing with the lack of a PPA restatement) meant that the client would avoid duplicative taxation on over $90,000 *and* restore the qualified status of the plan. We also expanded the scope and revenue of our original engagement. As a result, we hope to have a long and rewarding relationship with a quality client, and we have positively

marketed our firm to the accountant and financial advisor, who may become strong referral sources and valued partners.

We suggest that collecting the underlying governmental forms from the accountant was easier on the client, much more reliable, and allowed the issues to be resolved more quickly. Surely the avoidance of duplicate taxation on the same dollars was the real benefit here, with the bonus that the plan will be restored to an audit-ready position. ■

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