**Internal Revenue**
# bulletin

**Bulletin No. 2002–29**
**July 22, 2002**

## HIGHLIGHTS OF THIS ISSUE

**These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.**

## INCOME TAX

**Rev. Rul. 2002–47, page 119.**
**LIFO; price indexes; department stores.** The May 2002 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, May 31, 2002.

**T.D. 9002, page 120.**
Final regulations under section 1502 of the Code revise rules concerning the common parent as agent for a consolidated group, including the term and scope of the common parent's authority as agent, the designation of a substitute agent by a terminating common parent, the existence of a default substitute agent under certain conditions, the designation of a substitute agent by the Commissioner under certain circumstances, and the filing of a tentative carryback adjustment with respect to a loss from a separate return year.

**Notice 2002–51, page 131.**
This notice solicits public comments on the application of section 142(a)(6) of the Code, which permits tax-exempt bonds to be issued to finance solid waste disposal facilities.

**Rev. Proc. 2002–50, page 173.**
This procedure states that if an individual exercises a statutory or nonstatutory stock option and sells the stock on the same day as the exercise, the sale constitutes an "excepted sale" for Form 1099–B reporting under section 1.6045–1(c)(3)(ii) of the regulations, provided certain conditions are satisfied.

**Rev. Proc. 2002–51, page 175.**
Specifications are set forth for the private printing of paper substitutes for the December 2001 revisions of Form W–2c, *Corrected Wage and Tax Statement*, and Form W–3c, *Transmittal of Corrected Wage and Tax Statements*. Rev. Proc. 95–18 superseded.

## EMPLOYEE PLANS

**Rev. Rul. 2002–45, page 116.**
**Restorative payments; nondiscrimination; deductions; qualified defined contribution plan**. This ruling describes two situations in which certain payments, which are termed "restorative payments" in the ruling, to a qualified defined contribution plan are not treated as contributions for purposes of various sections of the Code.

**Rev. Rul. 2002–46, page 117.**
**Deductibility; timing**. Contributions made during a grace period to a section 401(k) plan or as matching contributions to a qualified defined contribution plan are not deductible by the employer for a taxable year if the contributions are attributable to compensation earned by plan participants after the end of that taxable year. Rev. Proc. 2002–9 modified and amplified.

**Notice 2002–48, page 130.**
**Deductibility of contributions; timing**. This notice provides that the Service will not challenge the deductibility of certain contributions actually made during the taxable year in anticipation of section 401(k) deferrals and section 401(m) matching contributions.

**(Continued on the next page)**

**Finding Lists begin on page ii.**

Department of the Treasury
**Internal Revenue Service**

**Notice 2002–49, page 130.**
**Weighted average interest rate update.** The weighted average interest rate for July 2002 and the resulting permissible range of interest rates used to calculate current liability for purposes of the full funding limitation of section 412(c)(7) of the Code are set forth.

**Rev. Proc. 2002–47, page 133.**
**Administrative programs; closing agreements**. This procedure updates and expands upon the Service's correction programs for retirement plans within the jurisdiction of the Commissioner, Tax Exempt and Government Entities Division. Rev. Proc. 2001–17 modified and superseded.

## EXEMPT ORGANIZATIONS

**Announcement 2002–66, page 183.**
A list is provided of organizations now classified as private foundations.

## EMPLOYMENT TAX

**Rev. Proc. 2002–51, page 175.**
Specifications are set forth for the private printing of paper substitutes for the December 2001 revisions of Form W–2c, *Corrected Wage and Tax Statement*, and Form W–3c, *Transmittal of Corrected Wage and Tax Statements*. Rev. Proc. 95–18 superseded.

## EXCISE TAX

**Announcement 2002–65, page 182.**
This document contains corrections to proposed regulations (REG–209114–90, 2002–9 I.R.B. 576) under section 280G of the Code that provide guidance about the denial of the deduction to a corporation for any excess golden parachute payment to certain individuals.

## ADMINISTRATIVE

**T.D. 9001, page 128.**
Final regulations under section 6103 of the Code permit IRS to disclose an additional item of return information to the Department of Agriculture for its use in structuring, preparing, and conducting the Census of Agriculture. The additional item consists of the taxpayer's telephone number provided on Form 1040 (Schedule F).

**Rev. Proc. 2002–49, page 172.**
**Stranded costs**. This procedure provides that investor-owned utilities will not realize gross income upon the securitization and transfer of a statutorily created intangible property right to collect charges from their customers to cover stranded costs caused by restructuring of the electrical utility industry.

# The IRS Mission

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

# Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents are consolidated semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

### Part I.—1986 Code.

This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

### Part II.—Treaties and Tax Legislation.

This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

### Part III.—Administrative, Procedural, and Miscellaneous.

To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

### Part IV.—Items of General Interest.

This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The first Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the first Bulletin of the succeeding semiannual period, respectively.

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DRAFTING INFORMATION

The principal authors of this notice are Michael Brewer and Rebecca Harrigal of the Office of the Assistant Chief Counsel (CC:TEGE:EOEG). For further information regarding this notice, contact Mr. Brewer at (202) 622–3980 (not a toll-free call).

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*26 CFR 601.202: Closing agreements.*

## Rev. Proc. 2002–47

TABLE OF CONTENTS


PART I. INTRODUCTION TO EMPLOYEE PLANS COMPLIANCE RESOLUTION SYSTEM

SECTION 1. PURPOSE AND OVERVIEW
.01 *Purpose* ....p. 136
.02 *General principles underlying EPCRS* ....p. 136
.03 *Overview.* ....p. 136

SECTION 2. EFFECT OF THIS REVENUE PROCEDURE ON PROGRAMS
.01 *Effect on programs* ....p. 137
.02 *Future enhancements* ....p. 137

PART II. PROGRAM EFFECT AND ELIGIBILITY

SECTION 3. EFFECT OF EPCRS; RELIANCE
.01 *Effect of EPCRS on Qualified Plans.* ....p. 137
.02 *Effect of EPCRS on 403(b) Plans.* ....p. 137
.03 *Effect of EPCRS on SEPs.* ....p. 137
.04 *Compliance Statement* ....p. 138
.05 *Other taxes and penalties* ....p. 138
.06 *Reliance* ....p. 138

SECTION 4. PROGRAM ELIGIBILITY
.01 *Programs for Qualified Plans and 403(b) Plans* ....p. 138
.02 *Eligibility for other arrangements* ....p. 138
.03 *Effect of examination* ....p. 138
.04 *Favorable Letter requirement* ....p. 138
.05 *Established practices and procedures* ....p. 138
.06 *Correction by plan amendment* ....p. 138
.07 *Submission for a determination letter* ....p. 138
.08 *Availability of correction of Employer Eligibility Failure.* ....p. 138
.09 *Egregious failures* ....p. 139
.10 *Diversion or misuse of plan assets* ....p. 139

PART III. DEFINITIONS, CORRECTION PRINCIPLES, AND RULES OF GENERAL APPLICABILITY

SECTION 5. DEFINITIONS
.01 *Definitions for Qualified Plans.* ....p. 139
.02 *Definitions for 403(b) Plans* ....p. 140
.03 *Under Examination* ....p. 141
.04 *SEP* ....p. 141

SECTION 6. CORRECTION PRINCIPLES AND RULES OF GENERAL APPLICABILITY
.01 *Correction principles; rules of general applicability* ....p. 141
.02 *Correction principles* ....p. 141
.03 *Correction of an Employer Eligibility Failure (only available under VCP general procedures, VCT, and VCSEP)* ....p. 143
.04 *Correction by plan amendment* ....p. 143

.05 *Special rules relating to Excess Amounts* ....p. 143
.06 *Correction under statute or regulations*.... p. 143
.07 *Matters subject to excise taxes* ....p. 143
.08 *Correction for SEPs* ....p. 144
.09 *Confidentiality and disclosure* ....p. 144
.10 *No effect on other law* .... p. 144

PART IV. SELF-CORRECTION (SCP)

SECTION 7. IN GENERAL

SECTION 8. SELF-CORRECTION OF INSIGNIFICANT OPERATIONAL FAILURES
.01 *Requirements* ....p. 144
.02 *Factors*....p. 144
.03 *Multiple failures* .... p. 145
.04 *Examples*....p. 145

SECTION 9. SELF-CORRECTION OF SIGNIFICANT OPERATIONAL FAILURES
.01 *Requirements* .... p. 145
.02 *Correction period.*.... p. 145
.03 *Correction by plan amendment.* .... p. 145
.04 *Substantial completion of correction.*....p. 145
.05 *Examples*....p. 146

PART V. VOLUNTARY CORRECTION WITH SERVICE APPROVAL (VCP)

SECTION 10. VCP GENERAL PROCEDURES
.01 *VCP requirements.* .... p. 146
.02 *Identification of failures*.... p. 146
.03 *Availability of correction of a terminated plan.*....p. 146
.04 *Effect of VCP submission on examination.* ....p. 146
.05 *No concurrent examination activity.* .... p. 146
.06 *Submission of determination letter application for plan amendments.* .... p. 146
.07 *Processing of submission.*.... p. 146
.08 *Compliance statement.*.... p. 147
.09 *Effect of compliance statement on examination*....p. 148
.10 *Processing of determination letter applications not submitted under VCP*....p. 148
.11 *Special rules relating to VCO.*....p. 148
.12 *Special rules relating to VCS.* ....p. 148
.13 *Special rules relating to Anonymous (John Doe) Submission Procedure*....p. 148
.14 *Special rules relating to VCT.* ....p. 148
.15 *Special rules relating to VCGroup.* ....p. 148
.16 *Special rules relating to VCSEP*....p. 149
.17 *Multiemployer and multiple employer plans.*....p. 149

SECTION 11. APPLICATION PROCEDURES FOR VCP
.01 *General rules.*....p. 149
.02 *Submission requirements.*....p. 149
.03 *Submission requirements under special procedures*....p. 150
.04 *Required documents.* ....p. 150
.05 *Date VCP fee due generally.* ....p. 150
.06 *Fee due earlier for VCO, VCS, Anonymous Submission, VCGroup, and VCSEP.* ....p. 151
.07 *Signed submission.* ....p. 151
.08 *Power of attorney requirements*....p. 151
.09 *Penalty of perjury statement.*....p. 151
.10 *Checklist.* ....p. 151
.11 *Designation.*....p. 151
.12 *VCP mailing address*....p. 151
.13 *Maintenance of copies of submissions.* ....p. 151

SECTION 12. VCP FEES

.01 *VCP general procedure compliance fee.* ....p. 151
.02 *VCO fee.* ....p. 152
.03 *VCS fee.* ....p. 152
.04 *Fee for Anonymous Submission.* ....p. 152
.05 *VCT fee.* ....p. 152
.06 *VCGroup fees.* ....p. 153
.07 *VCSEP fees.* ....p. 153
.08 *Establishing amount of assets and number of plan participants.* ....p. 153

PART VI. CORRECTION ON AUDIT (AUDIT CAP)

SECTION 13. DESCRIPTION OF AUDIT CAP
.01 *Audit CAP requirements.* ....p. 153
.02 *Payment of sanction.* ....p. 153
.03 *Additional requirements.* ....p. 153
.04 *Failure to reach resolution.* ....p. 153
.05 *Effect of closing agreement.* ....p. 153
.06 *Other procedural rules.* ....p. 153

Section 14. AUDIT CAP SANCTION
.01 *Determination of sanction.* ....p. 153
.02 *Factors considered.* ....p. 153
.03 *Transferred Assets.* ....p. 154

PART VII. EFFECT ON OTHER DOCUMENTS; EFFECTIVE DATE; PAPERWORK REDUCTION ACT

SECTION 15. EFFECT ON OTHER DOCUMENTS
.01 *Revenue procedure modified and superseded* ....p. 154

SECTION 16. EFFECTIVE DATE

SECTION 17. PAPERWORK REDUCTION ACT

DRAFTING INFORMATION

APPENDIX A: OPERATIONAL FAILURES AND CORRECTIONS UNDER VCS
.01 *General rule.* ....p. 154
.02 *Failure to properly provide the minimum top-heavy benefit under § 416 of the Code to non-key employees.* ....p. 154
.03 *Failure to satisfy the ADP test set forth in § 401(k)(3), the ACP test set forth in § 401(m)(2), or the multiple use test of § 401(m)(9).* ....p. 154
.04 *Failure to distribute elective deferrals in excess of the § 402(g) limit (in contravention of § 401(a)(30)).* ....p. 155
.05 *Exclusion of an eligible employee from all contributions or accruals under the plan for one or more plan years.* ....p. 155
.06 *Failure to timely pay the minimum distribution required under § 401(a)(9).* ....p. 155
.07 *Failure to obtain participant and/or spousal consent for a distribution subject to the participant and spousal consent rules under §§ 401(a)(11), 411(a)(11), and 417.* ....p. 155
.08 *Failure to satisfy the § 415 limits in a defined contribution plan.* ....p. 155

APPENDIX B: CORRECTION METHODS AND EXAMPLES; EARNINGS ADJUSTMENT METHODS AND EXAMPLES

SECTION 1. PURPOSE, ASSUMPTIONS FOR EXAMPLES AND SECTION REFERENCES
.01 *Purpose.* ....p. 156
.02 *Assumptions for Examples.* ....p. 156
.03 *Section References.* ....p. 156

SECTION 2. CORRECTION METHODS AND EXAMPLES
.01 *ADP/ACP Failures.* ....p. 156
.02 *Exclusion of Eligible Employees.* ....p. 157
.03 *Vesting Failures.* ....p. 161
.04 *§ 415 Failures.* ....p. 161
.05 *Correction of Other Overpayment Failures.* ....p. 164
.06 *§ 401(a)(17) Failures.* ....p. 164
.07 *Correction by Amendment Under VCP and SCP* ....p. 164

SECTION 3. EARNINGS ADJUSTMENT METHODS AND EXAMPLES
.01 *Earnings Adjustment Methods.* ....p. 165
.02 *Examples.* ....p. 167

APPENDIX C: VCP CHECKLIST ....p. 170

## PART I. INTRODUCTION TO EMPLOYEE PLANS COMPLIANCE RESOLUTION SYSTEM

### SECTION 1. PURPOSE AND OVERVIEW

.01 *Purpose*. This revenue procedure updates the comprehensive system of correction programs for sponsors of retirement plans that are intended to satisfy the requirements of § 401(a), § 403(a), § 403(b), or § 408(k) of the Internal Revenue Code (the "Code"), but that have not met these requirements for a period of time. This system, the Employee Plans Compliance Resolution System ("EPCRS"), permits plan sponsors to correct these failures and thereby continue to provide their employees with retirement benefits on a tax-favored basis. The components of EPCRS are the Self-Correction Program ("SCP"), the Voluntary Correction Program ("VCP"), and the Audit Closing Agreement Program ("Audit CAP").

.02 *General principles underlying EPCRS*. EPCRS is based on the following general principles:

- Sponsors and other administrators of eligible plans should be encouraged to establish administrative practices and procedures that ensure that these plans are operated properly in accordance with the applicable requirements of the Code.
- Sponsors and other administrators of eligible plans should satisfy the applicable plan document requirements of the Code.
- Plan sponsors and other administrators should make voluntary and timely correction of any plan failures, whether involving discrimination in favor of highly compensated employees, plan operations, the terms of the plan document, or adoption of a plan by an ineligible employer. Timely and efficient correction protects participating employees by providing them with their expected retirement benefits, including favorable tax treatment.
- Voluntary compliance is promoted by providing for limited fees for voluntary corrections approved by the Service, thereby reducing employers' uncertainty regarding their potential tax liability and participants' potential tax liability.
- Fees and sanctions should be graduated in a series of steps so that there is always an incentive to correct promptly.
- Sanctions for plan failures identified on audit should be reasonable in light of the nature, extent, and severity of the violation.
- Administration of EPCRS should be consistent and uniform.
- Plan Sponsors should be able to rely on the availability of EPCRS in taking corrective actions to maintain the tax-favored status of their plans.

.03 *Overview*. EPCRS includes the following basic elements:

- *Self-correction (SCP)*. A plan sponsor that has established compliance practices and procedures may, at any time, correct insignificant Operational Failures without paying any fee or sanction. In addition, in the case of a Qualified Plan that is the subject of a favorable determination letter from the Service or in the case of a 403(b) Plan, the plan sponsor generally may correct even significant Operational Failures without payment of any fee or sanction.
- *Voluntary correction with Service approval (VCP)*. A plan sponsor, at any time before audit, may pay a limited fee and receive the Service's approval for correction. Under VCP, there are special procedures for certain submissions involving only Operational Failures (Voluntary Correction of Operational Failures ("VCO")), and for certain submissions in which limited Operational Failures are being corrected using standardized corrections (Voluntary Correction of Operational Failures Standardized ("VCS")). VCP also includes a special procedure that applies to 403(b) Plans (Voluntary Correction of Tax-sheltered Annuity Failures ("VCT")), a special procedure for anonymous submissions ("Anonymous Submission Procedure"), a special procedure for group submissions (Voluntary Correction of Group Failures ("VCGroup")), and a special procedure that applies to SEPs (Voluntary Correction of SEP Failures ("VCSEPs")).
- *Correction on audit (Audit CAP)*. If a failure (other than a failure corrected through SCP or VCP) is identified on audit, the plan sponsor may correct the failure and pay a sanction. The sanction imposed will bear a reasonable relationship to the nature, extent and severity of the failure, taking into account the extent to which correction occurred before audit.

SECTION 2. EFFECT OF THIS REVENUE PROCEDURE ON PROGRAMS

.01 *Effect on programs*. This revenue procedure modifies and supersedes Rev. Proc. 2001–17, 2001–1 C.B. 589, which was the prior consolidated statement of the correction programs under EPCRS. The modifications to Rev. Proc. 2001–17 that are reflected in this revenue procedure include:

- extending the duration of the self-correction period under SCP for significant operational compliance failures where the Plan Sponsor assumes a plan in connection with a corporate merger, acquisition, or other transaction. (section 9.02(2))
- extending the Anonymous Submission Procedure indefinitely. (section 10.13(3))
- expanding the Anonymous Submission Procedure to permit the submission of failures listed in Appendix A and Appendix B. (section 10.13(1))
- expanding the Anonymous Submission Procedure to VCGroup and VCSEP submissions. (section 10.13(1))
- expanding the definition of Employer Eligibility Failure to include the adoption of a 401(k) plan by any ineligible employer. (section 5.01(2)(d))
- broadening the VCGroup procedures to permit eligible organizations to submit operational and plan document failures in a single submission. (section 10.15(1))
- increasing the *de minimis* amount relating to corrective distributions. (section 6.02(5)(b))
- providing a *de minimis* rule for correcting certain Overpayments. (section 6.02(5)(c))
- clarifying the date by which correction of a failure related to Transferred Assets must be completed. (section 12.08)
- clarifying that the correction of failures in a terminated plan may be made under VCP. (section 10.03)
- clarifying what items may be excluded from the initial submission under the Anonymous Submission Procedure. (section 10.13(1))
- updating the definition of Favorable Letter. (section 5.01(4))
- modifying the correction procedure relating to Excess Amounts under VCT and overcontributions under VCSEP. (sections 12.05(3) and 12.07(2))
- clarifying the factors considered under Audit CAP for determining a sanction amount. (section 14.02)
- revising the checklist in Appendix C to include questions relating to Transferred Assets and the waiver of the excise tax under § 4974. (Appendix C items 10 and 18)

In addition, the following sections have been modified for purposes of clarification: sections 4.05, 5.01(8), 5.02(3), 6.02(3), 6.02(5)(d), 6.05(1), 6.05(2)(a) and (b), 9.05 Example 1, 10.06, 10.09, 10.13(2), 10.15(2), 10.15(3)(b), 11.01, 11.02(11), 11.03(4), 11.04(3), 11.04(4), 11.05, 11.12, 12.01(1), 12.01(3)(a), 12.02, 12.08, 13.02, 14.03, 15, 16, 17, Appendix A .05, Appendix B 2.01(b)(i) and 2.07(3), and Appendix C checklist item 26.

.02 *Future enhancements*. (1) It is expected that the EPCRS revenue procedure will continue to be updated on a periodic basis, including, as noted above, further improvements to EPCRS based on comments previously received. In addition, the Service and Treasury continue to invite further comments on how to improve EPCRS. Comments should be sent to:

Internal Revenue Service
Attention: T:EP:RA:VC
1111 Constitution Avenue, NW
Washington, D.C. 20224

(2) The Service and Treasury are considering expanding the procedures under EPCRS and are interested in receiving comments regarding, among other things, appropriate correction procedures for failures arising under SIMPLE IRAs (under § 408(p)) and § 457(b) plans. Submissions related to SIMPLE IRAs are currently being accepted by the Service on a provisional basis outside of EPCRS. Submissions relating to § 457(b) eligible governmental plans will be accepted by the Service on a provisional basis outside of EPCRS. Submissions relating to other § 457(b) eligible plans may be accepted outside EPCRS as Employee Plans develops experience in the § 457 area.

PART II. PROGRAM EFFECT AND ELIGIBILITY

SECTION 3. EFFECT OF EPCRS; RELIANCE

.01 *Effect of EPCRS on Qualified Plans*. For a Qualified Plan, if the eligibility requirements of section 4 are satisfied and the Plan Sponsor corrects a Qualification Failure in accordance with the applicable requirements of SCP in section 7, VCP in sections 10 and 11, or Audit CAP in section 13, the Service will not treat the Qualified Plan as failing to meet § 401(a). Thus, for example, if the Plan Sponsor corrects the failures in accordance with the requirements of this revenue procedure, the plan will be treated as a qualified plan for purposes of applying § 3121(a)(5) (FICA taxes) and § 3306(b)(5) (FUTA taxes).

.02 *Effect of EPCRS on 403(b) Plans*. (1) *Income taxes*. For a 403(b) Plan, if the applicable eligibility requirements of section 4 are satisfied and the Plan Sponsor corrects a failure in accordance with the applicable requirements of SCP in section 7, VCP in sections 10 and 11, or Audit CAP in section 13, the Service will not pursue income inclusion for affected participants, or liability for income tax withholding, on account of the failure. However, the correction of a failure may result in income tax consequences to participants and beneficiaries (for example, participants may be required to include in gross income distributions of Excess Amounts in the year of distribution).

(2) *Excise and employment taxes*. Excise taxes, FICA taxes, and FUTA taxes (and corresponding withholding obligations), if applicable, that result from a failure are not waived merely because the failure has been corrected.

.03 *Effect of EPCRS on SEPs*. For a SEP, if the eligibility requirements of section 4 are satisfied and the Plan Sponsor corrects a failure to satisfy the requirements of § 408(k) in accordance with the applicable requirements of SCP in section 7 (but only if the corresponding Qualification Failure is an insignificant Operational Failure), VCP in sections 10 and 11, or Audit CAP in section 13, the Service will not treat the SEP as failing to

meet § 408(k). Thus, for example, if the Plan Sponsor corrects the failures in accordance with the requirements of this revenue procedure, the SEP will be treated as satisfying § 408(k) for purposes of applying § 3121(a)(5) (FICA taxes) and § 3306(b)(5) (FUTA taxes).

.04 *Compliance Statement*. If a Plan Sponsor or Eligible Organization receives a compliance statement under VCP, the compliance statement is binding upon the Service and the Plan Sponsor or Eligible Organization as provided in section 10.08.

.05 *Other taxes and penalties*. See section 6.07 for rules relating to other taxes and penalties.

.06 *Reliance*. Taxpayers may rely on this revenue procedure, including the relief described in sections 3.01, 3.02, and 3.03.

SECTION 4. PROGRAM ELIGIBILITY

.01 *Programs for Qualified Plans and 403(b) Plans*. (1) *SCP*. Qualified Plans and 403(b) Plans are eligible for SCP. SCP is available only for Operational Failures.

(2) *VCP*. Qualified Plans and 403(b) Plans are eligible for VCP. VCP provides general procedures for correction of all Qualification Failures: Operational, Plan Document, Demographic, and Employer Eligibility.

(3) *Audit CAP*. Audit CAP is available for correction of all failures found on examination that have not been corrected in accordance with SCP or VCP.

.02 *Eligibility for other arrangements*. (1) A SEP that is maintained under a Plan Document is eligible for SCP with respect to insignificant failures and is eligible for VCP (under the special VCSEP procedure). A SEP is also eligible for Audit CAP. For purposes of EPCRS, a failure to satisfy § 408(k) is treated like the corresponding Qualification Failure. A failure to satisfy § 408(k) includes a failure to satisfy the 50%-eligible-employees election requirement of § 408(k)(6)(A)(ii) and a failure to satisfy the 25-employee limit of § 408(k)(6)(B).

(2) The Service may extend EPCRS to other arrangements.

.03 *Effect of examination*. If the plan or Plan Sponsor is Under Examination, VCP is not available. However, while the plan or Plan Sponsor is Under Examination, insignificant Operational Failures can be corrected under SCP and, if correction has been substantially completed before the plan or Plan Sponsor is Under Examination, significant Operational Failures can be corrected under SCP.

.04 *Favorable Letter requirement*. VCO and the provisions of SCP relating to significant Operational Failures (see section 9) are available for a Qualified Plan only if the plan is the subject of a Favorable Letter.

.05 *Established practices and procedures*. In order to be eligible for SCP, the Plan Sponsor or administrator of a plan must have established practices and procedures (formal or informal) reasonably designed to promote and facilitate overall compliance with applicable Code requirements. For example, the plan administrator of a Qualified Plan that may be top-heavy under § 416 may include in its plan operating manual a specific annual step to determine whether the plan is top-heavy and, if so, to ensure that the minimum contribution requirements of the top-heavy rules are satisfied. A plan document alone does not constitute evidence of established procedures. In order for a Plan Sponsor or administrator to use SCP, these established procedures must have been in place and routinely followed, and an Operational Failure must have occurred through an oversight or mistake in applying them or because of an inadequacy in the procedures. In the case of a failure that relates to Transferred Assets or to a plan assumed in connection with a corporate merger, acquisition, or other similar employer transaction between the Plan Sponsor and sponsor of the transferor plan or the prior plan sponsor of an assumed plan, the plan is considered to have established practices and procedures if such practices and procedures are in effect by the end of the first plan year that begins after the corporate merger, acquisition, or other similar transaction.

.06 *Correction by plan amendment*. (1) *Availability of correction by plan amendment in VCP general procedures*. A Plan Sponsor may use VCP for a Qualified Plan to correct an Operational Failure by a plan amendment to conform the terms of the plan to the plan's prior operations, provided that the amendment complies with the requirements of § 401(a), including the requirements of §§ 401(a)(4), 410(b), and 411(d)(6).

(2) *Certain correction by plan amendment permitted in SCP and VCO*. A Plan Sponsor may use SCP or VCO for a Qualified Plan to correct an Operational Failure by a plan amendment to conform the terms of the plan to the plan's prior operations only to correct Operational Failures listed in section 2.07 of Appendix B. These failures must be corrected in accordance with the correction methods set forth in section 2.07 of Appendix B. The amendment must comply with the requirements of § 401(a), including the requirements of §§ 401(a)(4), 410(b), and 411(d)(6). SCP and VCO are not otherwise available for a Plan Sponsor to correct an Operational Failure by a plan amendment. Thus, if loans were made to participants, but the plan document did not permit loans to be made to participants, the failure cannot be corrected under SCP or VCO by retroactively amending the plan to provide for the loans. However, if a Plan Sponsor corrects an Operational Failure in accordance with SCP or VCO, it may amend the plan to the extent necessary to reflect the corrective action. For example, if the plan failed to satisfy the average deferral percentage ("ADP") test required under § 401(k)(3) and the Plan Sponsor must make qualified nonelective contributions not already provided for under the plan, the plan may be amended to provide for qualified nonelective contributions. The issuance of a compliance statement does not constitute a determination as to the effect of any plan amendment on the qualification of the plan.

.07 *Submission for a determination letter*. In a case in which correction of a Qualification Failure includes correction of a Plan Document Failure or correction of an Operational Failure by plan amendment, as permitted under section 4.06, other than adoption of an amendment designated by the Service as a model amendment or standardized prototype plan, the amendment must be submitted to the Service for approval using the appropriate application form (*i.e.*, the Form 5300 series or, if permitted, Form 6406) to ensure that the amendment satisfies applicable qualification requirements.

.08 *Availability of correction of Employer Eligibility Failure*. A Plan

Sponsor may use VCP general procedures, VCT, or VCSEP to correct an Employer Eligibility Failure. However, under sections 4.01, 4.02, and 10, SCP, VCO, and VCGroup are not available for a Plan Sponsor to correct an Employer Eligibility Failure.

.09 *Egregious failures*. SCP, VCO, VCGroup, and VCSEP are not available to correct Operational Failures that are egregious. For example, if an employer has consistently and improperly covered only highly compensated employees or if a contribution to a defined contribution plan for a highly compensated individual is several times greater than the dollar limit set forth in § 415, the failure would be considered egregious. VCP is available to correct egregious failures; however, these failures are subject to the fees described in sections 12.01(4) and 12.05(6).

.10 *Diversion or misuse of plan assets*. SCP, VCP, and Audit CAP are not available to correct failures relating to the diversion or misuse of plan assets.

## PART III. DEFINITIONS, CORRECTION PRINCIPLES, AND RULES OF GENERAL APPLICABILITY

### SECTION 5. DEFINITIONS

The following definitions apply for purposes of this revenue procedure:

.01 *Definitions for Qualified Plans*. The definitions in this section 5.01 apply to Qualified Plans.

(1) *Qualified Plan*. The term "Qualified Plan" means a plan intended to satisfy the requirements of § 401(a) or § 403(a).

(2) *Qualification Failure*. The term "Qualification Failure" means any failure that adversely affects the qualification of a plan. There are four types of Qualification Failures: (a) Plan Document Failures, (b) Operational Failures, (c) Demographic Failures, and (d) Employer Eligibility Failures.

(a) *Plan Document Failure*. The term "Plan Document Failure" means a plan provision (or the absence of a plan provision) that, on its face, violates the requirements of § 401(a) or § 403(a). Thus, for example, the failure of a plan to be amended to reflect a new qualification requirement within the plan's applicable remedial amendment period under § 401(b) is a Plan Document Failure. For purposes of this revenue procedure, a Plan Document Failure includes any Qualification Failure that is a violation of the requirements of § 401(a) or § 403(a) and that is not an Operational Failure, Demographic Failure, or Employer Eligibility Failure.

(b) *Operational Failure*. The term "Operational Failure" means a Qualification Failure (other than an Employer Eligibility Failure) that arises solely from the failure to follow plan provisions. A failure to follow the terms of the plan providing for the satisfaction of the requirements of § 401(k) and § 401(m) is considered to be an Operational Failure. A plan does not have an Operational Failure to the extent the plan is permitted to be amended retroactively pursuant to § 401(b) or another statutory provision to reflect the plan's operations. However, if within an applicable remedial amendment period under § 401(b), a plan has been properly amended for statutory or regulatory changes and, on or after the later of the date the amendment is effective or is adopted, the amended provisions are not followed, then the plan is considered to have an Operational Failure.

(c) *Demographic Failure*. The term "Demographic Failure" means a failure to satisfy the requirements of § 401(a)(4), § 401(a)(26), or § 410(b) that is not an Operational Failure or an Employer Eligibility Failure. The correction of a Demographic Failure generally requires a corrective amendment to the plan adding more benefits or increasing existing benefits (cf., § 1.401(a)(4)–11(g)).

(d) *Employer Eligibility Failure*. The term "Employer Eligibility Failure" means the adoption of a plan intended to satisfy the requirements of § 401(a) or § 408(k) by an employer that fails to meet the employer eligibility requirements to establish a § 401(k) or § 408(k) plan. An Employer Eligibility Failure is not a Plan Document, Operational, or Demographic Failure.

(3) *Excess Amount*. The term "Excess Amount" means (a) an Overpayment, (b) an elective deferral or employee after-tax contribution returned to satisfy § 415, (c) an elective deferral in excess of the limitation of § 402(g) that is distributed, (d) an excess contribution or excess aggregate contribution that is distributed to satisfy § 401(k) or § 401(m), (e) an amount contributed on behalf of an employee that is in excess of the employee's benefit provided under a SEP, (f) an excess contribution that is distributed to satisfy § 408(k)(6)(A)(iii), (g) an elective deferral that is distributed to satisfy the limitation of § 401(a)(17), or (h) any similar amount that is required to be distributed in order to maintain plan qualification.

(4) *Favorable Letter*. The term "Favorable Letter" means, in the case of a Qualified Plan, a current favorable determination letter for an individually designed plan (including a volume submitter plan that is not identical to an approved volume submitter plan), a current favorable opinion letter for a Plan Sponsor that has adopted a master or prototype plan, (standardized or nonstandardized), or a current favorable advisory letter and certification that the Plan Sponsor has adopted a plan that is identical to an approved volume submitter plan. A plan has a current favorable determination letter, opinion letter, or advisory letter if (a), (b), (c), (d), (e), (f), (g), or (h) below is satisfied:

(a) The plan has a favorable determination letter, opinion letter, or advisory letter/certification that considers GUST (GUST is an acronym for the Uruguay Round Agreements Act (GATT), the Uniformed Services Employment and Reemployment Rights Act of 1994 (USERRA), the Small Business Job Protection Act of 1996 (SBJPA), the Taxpayer Relief Act of 1997 (TRA '97), the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA '98), and the Community Renewal Tax Relief Act of 2000 (CRA).)

(b) The plan (i) either has a favorable determination letter, opinion letter, or notification letter for a regional prototype plan that considers the Tax Reform Act of 1986 ("TRA '86") or was initially adopted or effective after December 7, 1994, and, (ii) the Plan Sponsor has by the later of February 28, 2002, or the last day of the first plan year beginning on or after January 1, 2001, either submitted an application for a determination letter on GUST, or has adopted or certified that it intends to adopt a master and prototype

plan (includes former regional prototype plans) or volume submitter plan, that has been submitted for a GUST opinion letter or advisory letter by December 31, 2000.

(c) The plan has a favorable determination letter that considers the Tax Reform Act of 1986 ("TRA '86") or was initially adopted or effective after December 7, 1994, and the plan is a plan directly affected by the September 11, 2001, terrorist attack on the United States, (see Rev. Proc. 2001–55, 2001–49 I.R.B. 552) and the Plan Sponsor has by June 30, 2002, submitted an application for a determination letter request for GUST.

(d) The plan was timely amended for TRA '86, the Unemployment Compensation Act of 1992 ("UCA"), and the Omnibus Budget and Reconciliation Act of 1993 ("OBRA '93") and the Plan Sponsor has submitted an application for a determination letter on GUST by September 3, 2002, in accordance with the procedures set forth in Rev. Proc. 2002–35, 2002–24 I.R.B. 1187.

(e) The plan is initially adopted or effective after February 28, 2002, and the Plan Sponsor timely submits an application for a determination letter within the plan's remedial amendment period under § 401(b).

(f) The plan is a governmental plan or non-electing church plan described in Rev. Proc. 99–23, 1999–1 C.B. 920, and has a favorable determination, opinion, or notification letter that considers the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), the Deficit Reduction Act of 1984 ("DEFRA"), and the Retirement Equity Act of 1984 ("REA"), and the § 401(b) remedial amendment period for TRA '86 has not yet expired.

(g) The plan is terminated prior to the expiration of the applicable GUST remedial amendment period under § 401(b) and the plan was amended to reflect the provisions of GUST.

(h) In the case of a SEP, the term "Favorable Letter" means (i) a valid Model Form 5305–SEP or 5305A-SEP adopted by an employer in accordance with the instructions on the applicable Form, (ii) a current favorable opinion letter for a Plan Sponsor that has adopted a prototype SEP which has been amended in accordance with procedures set forth in Rev. Proc. 94–13, 1994–1 C.B. 566, to take into account any applicable changes in the law since the issuance of the opinion letter, or (iii) in the case of an individually designed SEP, a private letter ruling that has been issued for the SEP.

(5) *Maximum Payment Amount*. The term "Maximum Payment Amount" means a monetary amount that is approximately equal to the tax the Service could collect upon plan disqualification and is the sum for the open taxable years of the:

(a) tax on the trust (Form 1041),

(b) additional income tax resulting from the loss of employer deductions for plan contributions (and any interest or penalties applicable to the Plan Sponsor's return), and

(c) additional income tax resulting from income inclusion for participants in the plan (Form 1040).

(6) *Overpayment*. The term "Overpayment" means a distribution to an employee or beneficiary that exceeds the employee's or beneficiary's benefit under the terms of the plan because of a failure to comply with plan terms that implement § 401(a)(17), § 401(m) (but only with respect to the forfeiture of nonvested matching contributions that are excess aggregate contributions), § 411(a)(3)(G), or § 415. An Overpayment does not include a distribution of any Excess Amount described in section 5.01(3)(b) through (h).

(7) *Plan Sponsor*. The term "Plan Sponsor" means the employer that establishes or maintains a qualified retirement plan for its employees.

(8) *Transferred Assets*. The term "Transferred Assets" means plan assets that were received, in connection with a corporate merger, acquisition or other similar employer transaction, by the plan in a transfer (including a merger or consolidation of plan assets) under § 414(l) from a plan sponsored by an employer that was not a member of the same controlled group as the Plan Sponsor prior to the corporate merger, acquisition, or other similar employer transaction. If a transfer of plan assets related to the same employer transaction is accomplished through several transfers, then the date of the transfer is the date of the first transfer.

.02 *Definitions for 403(b) Plans*. The definitions in this section 5.02 apply to 403(b) Plans.

(1) *403(b) Plan*. The term "403(b) Plan" means a plan or program intended to satisfy the requirements of § 403(b).

(2) *403(b) Failure*. A 403(b) Failure is any Operational, Demographic, or Employer Eligibility Failure as defined below.

(a) *Operational Failure*. The term "Operational Failure" means any of the following:

(i) A failure to satisfy the requirements of § 403(b)(12)(A)(ii) (relating to the availability of salary reduction contributions);

(ii) A failure to satisfy the requirements of § 401(m) (as applied to 403(b) Plans pursuant to § 403(b)(12)(A)(i));

(iii) A failure to satisfy the requirements of § 401(a)(17) (as applied to 403(b) Plans pursuant to § 403(b)(12)(A)(i));

(iv) A failure to satisfy the distribution restrictions of § 403(b)(7) or § 403(b)(11);

(v) A failure to satisfy the incidental death benefit rules of § 403(b)(10);

(vi) A failure to pay minimum required distributions under § 403(b)(10);

(vii) A failure to give employees the right to elect a direct rollover under § 403(b)(10), including the failure to give meaningful notice of such right;

(viii) A failure of the annuity contract or custodial agreement to provide participants with a right to elect a direct rollover under §§ 403(b)(10) and 401(a)(31);

(ix) A failure to satisfy the limit on elective deferrals under § 403(b)(1)(E);

(x) A failure of the annuity contract or custodial agreement to provide the limit on elective deferrals under §§ 403(b)(1)(E) and 401(a)(30);

(xi) A failure involving contributions or allocations of Excess Amounts; or

(xii) Any other failure to satisfy applicable requirements under § 403(b) that (A) results in the loss of § 403(b) status for the plan or the loss of § 403(b) status for one or more custodial account(s) or annuity contract(s) under the plan and (B) is not a Demographic Failure, an Employer Eligibility Failure, or a failure related to the purchase of

annuity contracts, or contributions to custodial accounts, on behalf of individuals who are not employees of the employer.

(b) *Demographic Failure*. The term "Demographic Failure" means a failure to satisfy the requirements of § 401(a)(4), § 401(a)(26), or § 410(b) (as applied to 403(b) Plans pursuant to § 403(b)(12)(A)(i)).

(c) *Employer Eligibility Failure*. The term "Employer Eligibility Failure" means any of the following:

(i) The adoption of a plan intended to satisfy the requirements of § 403(b) by an employer that is not a tax-exempt organization described in § 501(c)(3) or a public educational organization described in § 170(b)(1)(A)(ii);

(ii) A failure to satisfy the non-transferability requirement of § 401(g);

(iii) A failure to initially establish or maintain a custodial account as required by § 403(b)(7); or

(iv) A failure to purchase (initially or subsequently) either an annuity contract from an insurance company (unless grandfathered under Rev. Rul. 82–102, 1982–1 C.B. 62) or a custodial account from a regulated investment company utilizing a bank or an approved non-bank trustee/custodian.

(3) *Excess Amount*. The term "Excess Amount" means any contributions or allocations that are in excess of the limits under § 415 for the year (and for years prior to 1/1/02, the § 403(b)(2) exclusion allowance limit for the year).

(4) *Plan Sponsor*. The term "Plan Sponsor" means the employer that offers a 403(b) Plan to its employees.

(5) *Total Sanction Amount*. The term "Total Sanction Amount" means a monetary amount that is approximately equal to the income tax the Service could collect as a result of the failure.

.03 *Under Examination*. (1) The term "Under Examination" means: (a) a plan that is under an Employee Plans examination (that is, an examination of a Form 5500 series or other Employee Plans examination), or (b) a Plan Sponsor that is under an Exempt Organizations examination (that is, an examination of a Form 990 series or other Exempt Organizations examination).

(2) A plan that is under an Employee Plans examination includes any plan for which the Plan Sponsor, or a representative, has received verbal or written notification from Employee Plans of an impending Employee Plans examination, or of an impending referral for an Employee Plans examination, and also includes any plan that has been under an Employee Plans examination and is now in Appeals or in litigation for issues raised in an Employee Plans examination. A plan is considered to be Under Examination if it is aggregated for purposes of satisfying the nondiscrimination requirements of § 401(a)(4), the minimum participation requirements of § 401(a)(26), the minimum coverage requirements of § 410(b), or the requirements of § 403(b)(12), with a plan(s) that is Under Examination. In addition, a plan is considered to be Under Examination with respect to a failure of a qualification requirement (other than those described in the preceding sentence) if the plan is aggregated with another plan for purposes of satisfying that qualification requirement (for example, § 402(g), § 415, or § 416) and that other plan is Under Examination. For example, assume Plan A has a § 415 failure, Plan A is aggregated with Plan B only for purposes of § 415, and Plan B is Under Examination. In this case, Plan A is considered to be Under Examination with respect to the § 415 failure. However, if Plan A has a failure relating to the spousal consent rules under § 417 or the vesting rules of § 411, Plan A is not considered to be Under Examination with respect to the § 417 or § 411 failure. For purposes of this revenue procedure, the term aggregation does not include consideration of benefits provided by various plans for purposes of the average benefits test set forth in § 410(b)(2).

(3) An Employee Plans examination also includes a case in which a Plan Sponsor has submitted a Form 5310 and the Employee Plans agent notifies the Plan Sponsor, or a representative, of possible Qualification Failures, whether or not the Plan Sponsor is officially notified of an "examination." This would include a case where, for example, a Plan Sponsor has applied for a determination letter on plan termination, and an Employee Plans agent notifies the Plan Sponsor that there are partial termination concerns.

(4) A Plan Sponsor that is under an Exempt Organizations examination includes any Plan Sponsor that has received (or whose representative has received) verbal or written notification from Exempt Organizations of an impending Exempt Organizations examination or of an impending referral for an Exempt Organizations examination and also includes any Plan Sponsor that has been under an Exempt Organizations examination and is now in Appeals or in litigation for issues raised in an Exempt Organizations examination.

.04 *SEP*. The term "SEP" means a plan intended to satisfy the requirements of § 408(k). For purposes of this revenue procedure, the term SEP also includes a salary reduction SEP ("SARSEP") described in § 408(k)(6), when applicable.

## SECTION 6. CORRECTION PRINCIPLES AND RULES OF GENERAL APPLICABILITY

.01 *Correction principles; rules of general applicability*. The general correction principles in section 6.02 and rules of general applicability in sections 6.03 through 6.10 apply for purposes of this revenue procedure.

.02 *Correction principles*. Generally, a failure is not corrected unless full correction is made with respect to all participants and beneficiaries, and for all taxable years (whether or not the taxable year is closed). Even if correction is made for a closed taxable year, the tax liability associated with that year will not be redetermined because of the correction. In the case of a Qualified Plan with an Operational Failure, correction is determined taking into account the terms of the plan at the time of the failure. Correction should be accomplished taking into account the following principles:

(1) *Restoration of benefits*. The correction method should restore the plan to the position it would have been in had the failure not occurred, including restoration of current and former participants and beneficiaries to the benefits and rights they would have had if the failure had not occurred.

(2) *Reasonable and appropriate correction*. The correction should be reasonable and appropriate for the failure. Depending on the nature of the failure, there may be more than one reasonable and appropriate correction for the failure.

For Qualified Plans, any correction method permitted under Appendix A or Appendix B is deemed to be a reasonable and appropriate method of correcting the related Qualification Failure. Any correction method permitted under Appendix A applicable to a 403(b) Plan is deemed to be a reasonable and appropriate method of correcting the related 403(b) Failure. Whether any other particular correction method is reasonable and appropriate is determined taking into account the applicable facts and circumstances and the following principles:

(a) The correction method should, to the extent possible, resemble one already provided for in the Code, regulations thereunder, or other guidance of general applicability. For example, for Qualified Plans, the defined contribution plan correction methods set forth in § 1.415–6(b)(6) would be the typical means of correcting a failure under § 415. Likewise, the correction method set forth in § 1.402(g)–1(e)(2) would be the typical means of correcting a failure under § 402(g).

(b) The correction method for failures relating to nondiscrimination should provide benefits for nonhighly compensated employees. For example, for Qualified Plans, the correction method set forth in § 1.401(a)(4)–11(g) (rather than methods making use of the special testing provisions set forth in § 1.401(a)(4)–8 or § 1.401(a)(4)–9) would be the typical means of correcting a failure to satisfy nondiscrimination requirements. Similarly, the correction of a failure to satisfy the requirements of § 401(k)(3), § 401(m)(2), or § 401(m)(9) (relating to nondiscrimination), solely by distributing excess amounts to highly compensated employees would not be the typical means of correcting such a failure.

(c) The correction method should keep plan assets in the plan, except to the extent the Code, regulations, or other guidance of general applicability provide for correction by distribution to participants or beneficiaries or return of assets to the employer or Plan Sponsor. For example, if an excess allocation (not in excess of the § 415 limits) made under a Qualified Plan was made for a participant under a plan (other than a cash or deferred arrangement), the excess should be reallocated to other participants or, depending on the facts and circumstances, used to reduce future employer contributions.

(d) The correction method should not violate another applicable specific requirement of § 401(a) or § 403(b) (for example, § 401(a)(4), § 411(d)(6), or § 403(b)(12), as applicable), or § 408(k) for SEPs. If an additional failure is created as a result of the use of a correction method in this revenue procedure, then that failure also must be corrected in conjunction with the use of that correction method and in accordance with the requirements of this revenue procedure.

(3) *Consistency Requirement*. Generally, where more than one correction method is available to correct a type of Operational Failure for a plan year (or where there are alternative ways to apply a correction method), the correction method (or one of the alternative ways to apply the correction method) should be applied consistently in correcting all Operational Failures of that type for that plan year. Similarly, earnings adjustment methods generally should be applied consistently with respect to corrective contributions or allocations for a particular type of Operational Failure for a plan year. In the case of a VCGroup submission, the consistency requirement applies on a plan by plan basis.

(4) *Principles regarding corrective allocations and corrective distributions*. The following principles apply where an appropriate correction method includes the use of corrective allocations or corrective distributions:

(a) Corrective allocations under a defined contribution plan should be based upon the terms of the plan and other applicable information at the time of the failure (including the compensation that would have been used under the plan for the period with respect to which a corrective allocation is being made) and should be adjusted for earnings (including losses) and forfeitures that would have been allocated to the participant's account if the failure had not occurred. The corrective allocation need not be adjusted for losses. See section 3 of Appendix B for additional information on calculation of earnings for corrective allocations.

(b) A corrective allocation to a participant's account because of a failure to make a required allocation in a prior limitation year will not be considered an annual addition with respect to the participant for the limitation year in which the correction is made, but will be considered an annual addition for the limitation year to which the corrective allocation relates. However, the normal rules of § 404, regarding deductions, apply.

(c) Corrective allocations should come only from employer contributions (including forfeitures if the plan permits their use to reduce employer contributions).

(d) In the case of a defined benefit plan, a corrective distribution for an individual should be increased to take into account the delayed payment, consistent with the plan's actuarial adjustments.

(5) *Special exceptions to full correction*. In general, a failure must be fully corrected. Although the mere fact that correction is inconvenient or burdensome is not enough to relieve a Plan Sponsor of the need to make full correction, full correction may not be required in certain situations because it is unreasonable or not feasible. Even in these situations, the correction method adopted must be one that does not have significant adverse effects on participants and beneficiaries or the plan, and that does not discriminate significantly in favor of highly compensated employees. The exceptions described below specify those situations in which full correction is not required.

(a) *Reasonable estimates*. If it is not possible to make a precise calculation, or the probable difference between the approximate and the precise restoration of a participant's benefits is insignificant and the administrative cost of determining precise restoration would significantly exceed the probable difference, reasonable estimates may be used in calculating appropriate correction.

(b) *Delivery of small benefits*. If the total corrective distribution due a participant or beneficiary is $50 or less, the Plan Sponsor is not required to make the corrective distribution if the reasonable direct costs of processing and delivering the distribution to the participant or beneficiary would exceed the amount of the distribution.

(c) *Recovery of small Overpayments*. Generally, for a submission under VCP, if the total amount of an Overpayment made to a participant or beneficiary

is $100 or less, the Plan Sponsor is not required to seek the return of the Overpayment from the participant or beneficiary.

(d) *Locating lost participants*. Reasonable actions must be taken to find all current and former participants and beneficiaries to whom additional benefits are due, but who have not been located after a mailing to the last known address. In general, such actions include use of the Internal Revenue Service Letter Forwarding Program (see Rev. Proc. 94–22, 1994–1 C.B. 608) or the Social Security Administration Employer Reporting Service. A plan will not be considered to have failed to correct a failure due to the inability to locate an individual if either of these programs is used; provided that, if the individual is later located, the additional benefits must be provided to the individual at that time.

(6) *Reporting*. Any distributions from the plan should be properly reported.

.03 *Correction of an Employer Eligibility Failure (only available under VCP general procedures, VCT, and VCSEP)*. (1) The permitted correction of an Employer Eligibility Failure is the cessation of all contributions (including salary reduction and after-tax contributions) beginning no later than the date the application under VCP is filed. Pursuant to VCP correction, the assets in such a plan are to remain in the trust, annuity contract, or custodial account and are to be distributed no earlier than the occurrence of one of the applicable distribution events, *e.g.*, for 403(b) Plans, the events described in § 403(b)(7) (to the extent the assets are held in custodial accounts) or § 403(b)(11) (for those assets invested in annuity contracts that would be subject to § 403(b)(11) restrictions if the employer were eligible). A Plan that is corrected through VCP will be treated as subject to all of the requirements and provisions of § 401(a) for a Qualified Plan, § 403(b) for a 403(b) Plan, and § 408(k) for a SEP (including Code provisions relating to rollovers).

(2) Cessation of contributions is not required if continuation of contributions would not be an Employer Eligibility Failure (for example, a tax-exempt employer may maintain a § 401(k) plan after 1996).

(3) Because a plan with an Employer Eligibility Failure will be treated as subject to all of the applicable Code qualification requirements, the Plan Sponsor must also correct all other failures in accordance with this revenue procedure.

.04 *Correction by plan amendment*. In any case in which correction of a Qualified Plan failure includes correction of a Plan Document Failure or correction of an Operational Failure by plan amendment as permitted under section 4.06, other than adoption of a model amendment or a standardized prototype plan, the amendment must be submitted to the Service for approval under the appropriate application form (*i.e.*, Form 5300 series or Form 6406) to ensure that the amendment satisfies applicable qualification requirements.

.05 *Special rules relating to Excess Amounts*. (1) *Treatment of Excess Amounts under Qualified Plans*. A distribution of an Excess Amount is not eligible for the favorable tax treatment accorded to distributions from Qualified Plans (such as eligibility for rollover under § 402(c)). To the extent that a current or prior distribution was a distribution of an Excess Amount, distribution of that Excess Amount is not an eligible rollover distribution. Thus, for example, if such a distribution was contributed to an individual retirement arrangement ("IRA"), the contribution is not a valid rollover contribution for purposes of determining the amount of excess contributions (within the meaning of § 4973) to the individual's IRA. A distribution of an Excess Amount is generally treated in the manner described in section 3 of Rev. Proc. 92–93, 1992–2 C.B. 505, relating to the corrective disbursement of elective deferrals. The distribution must be reported on Forms 1099–R for the year of distribution with respect to each participant or beneficiary receiving such a distribution. Where an Excess Amount has been or is being distributed, the Plan Sponsor must notify the recipient that (a) an Excess Amount has been or will be distributed and (b) an Excess Amount is not eligible for favorable tax treatment accorded to distributions from Qualified Plans (and, specifically, is not eligible for tax-free rollover).

(2) *Treatment of Excess Amounts under 403(b) Plans*. (a) *Distribution of Excess Amounts*. Excess Amounts for a year, adjusted for earnings through the date of distribution, must be distributed to affected participants and beneficiaries and are includible in their gross income in the year of distribution. The distribution of Excess Amounts is not an eligible rollover distribution within the meaning of § 403(b)(8). A distribution of Excess Amounts is generally treated in the manner described in section 3 of Rev. Proc. 92–93 relating to the corrective disbursement of elective deferrals. The distribution must be reported on Forms 1099–R for the year of distribution with respect to each participant or beneficiary receiving such a distribution. In addition, the Plan Sponsor must inform affected participants and beneficiaries that the distribution of Excess Amounts is not eligible for rollover.

(b) *Retention of Excess Amounts*. Under VCT and Audit CAP, Excess Amounts will be treated as corrected (even though the Excess Amounts are retained in the 403(b) Plan) if the following requirements are satisfied. Excess Amounts arising from a § 415 failure, adjusted for earnings through the date of correction, must reduce affected participants' applicable § 415 limit for the year following the year of correction (or for the year of correction if the Plan Sponsor so chooses), and subsequent years, until the excess is eliminated.

.06 *Correction under statute or regulations*. Generally, none of the correction programs are available to correct failures that can be corrected under the Code and related regulations. For example, as a general rule, a Plan Document Failure that is a disqualifying provision for which the remedial amendment period under § 401(b) has not expired can be corrected by operation of the Code through retroactive remedial amendment.

.07 *Matters subject to excise taxes*. (1) Except as provided in paragraph (3) of this subsection, excise taxes and additional taxes, to the extent applicable, are not waived merely because the underlying failure has been corrected or because the taxes result from the correction. Thus, for example, the excise tax on certain excess contributions under § 4979 is not waived under these correction programs.

(2) Except as provided in paragraph (3) of this section, the correction programs are not available for events for which the Code provides tax consequences other than plan disqualification (such as the imposition of an excise tax or additional income tax). For example, funding deficiencies (failures to make the required contributions to a plan subject to § 412), prohibited transactions, and failures to file the Form 5500 cannot be corrected under the correction programs. However, if the event is also an Operational Failure (for example, if the terms of the plan document relating to plan loans to participants were not followed and loans made under the plan did not satisfy § 72(p)(2)), the correction programs will be available to correct the Operational Failure, even though the excise or income taxes generally still will apply.

(3) As part of VCP, if the failure involves the failure to satisfy the minimum required distribution requirements of § 401(a)(9), in appropriate cases, the Service will waive the excise tax under § 4974 applicable to plan participants. The waiver will be included in the compliance statement. The Plan Sponsor, as part of the submission, must request the waiver and in cases where the participant subject to the excise tax is an owner-employee, as defined in § 401(c)(3), or a 10 percent owner of a corporation, the Plan Sponsor must also provide an explanation supporting the request.

.08 *Correction for SEPs*. (1) *Correction for SEPs generally*. Generally, the correction for a SEP is expected to be similar to the correction required for a Qualified Plan with a similar Qualification Failure.

(2) *Special correction for SEPs*. Under VCSEP, in any case in which correction under section 6.08(1) is not feasible for a SEP or in any other case determined by the Service in its discretion (including failures relating to §§ 402(g), 415, and 401(a)(17), failures relating to deferral percentages, discontinuance of contributions to a SARSEP, and retention of overcontributions for cases in which there has been no violation of a statutory limitation), the Service may provide for a different correction. See section 12.07 for a special fee that may apply in such a case.

(3) *Correction of failure to satisfy deferral percentage test*. If the failure involves a violation of the deferral percentage test under § 408(k)(6)(A)(iii) applicable to a SARSEP, there are several methods to correct the failure, similar to the methods used in VCS and VCO. This failure may be corrected in one of the following ways:

(a) The Plan Sponsor may make contributions that are 100% vested to all eligible nonhighly compensated employees (to the extent permitted by § 415) necessary to raise the deferral percentage needed to pass the test. This amount may be calculated as either the same percentage of compensation or the same flat dollar amount (regardless of the terms of the SEP).

(b) The Plan Sponsor may effect distribution of excess contributions, adjusted for earnings through the date of correction, to highly compensated employees to correct the failure. The Plan Sponsor must also contribute to the SEP an amount equal to the total amount distributed. This amount must be allocated to (i) current employees who were nonhighly compensated employees in the year of the failure, (ii) current nonhighly compensated employees who were nonhighly compensated employees in the year of the failure, or (iii) employees (both current and former) who were nonhighly compensated employees in the year of the failure.

(4) *Treatment of undercontributions to a SEP*. (a) *Make-up contributions; earnings*. The Plan Sponsor should correct undercontributions to a SEP by contributing make-up amounts that are fully vested, adjusted for earnings credited from the date of the failure to the date of correction.

(b) *Earnings adjustment methods*. (i) The earnings rate generally is based on the investment results that would have applied to the corrective contribution if the failure had not occurred.

(ii) Insofar as SEP assets are held in IRAs, there is no earnings rate under the SEP as a whole. If the Plan Sponsor is unable to determine what the actual investment results would have been, a reasonable interest rate may be used.

.09 *Confidentiality and disclosure*. Because each correction program relates directly to the enforcement of the Code qualification requirements, the information received or generated by the Service under the program is subject to the confidentiality requirements of § 6103 and is not a written determination within the meaning of § 6110.

.10 *No effect on other law*. Correction under these programs has no effect on the rights of any party under any other law, including Title I of the Employee Retirement Income Security Act of 1974 ("ERISA").

## PART IV. SELF-CORRECTION (SCP)

### SECTION 7. IN GENERAL

The requirements of this section 7 are satisfied with respect to an Operational Failure if the Plan Sponsor of a Qualified Plan, a 403(b) Plan, or a SEP satisfies the requirements of section 8 (relating to insignificant Operational Failures) or, in the case of a Qualified Plan or a 403(b) Plan, section 9 (relating to significant Operational Failures).

### SECTION 8. SELF-CORRECTION OF INSIGNIFICANT OPERATIONAL FAILURES

.01 *Requirements*. The requirements of this section 8 are satisfied with respect to an Operational Failure if the Operational Failure is corrected and, given all the facts and circumstances, the Operational Failure is insignificant. This section 8 is available for correcting an insignificant Operational Failure even if the plan or Plan Sponsor is Under Examination and even if the Operational Failure is discovered by an agent on examination.

.02 *Factors*. The factors to be considered in determining whether or not an Operational Failure under a plan is insignificant include, but are not limited to: (1) whether other failures occurred during the period being examined (for this purpose, a failure is not considered to have occurred more than once merely because more than one participant is affected by the failure); (2) the percentage of plan assets and contributions involved in the failure; (3) the number of years the failure occurred; (4) the number of participants affected relative to the total number of participants in the plan; (5) the number of

participants affected as a result of the failure relative to the number of participants who could have been affected by the failure; (6) whether correction was made within a reasonable time after discovery of the failure; and (7) the reason for the failure (for example, data errors such as errors in the transcription of data, the transposition of numbers, or minor arithmetic errors). No single factor is determinative. Additionally, factors (2), (4), and (5) should not be interpreted to exclude small businesses.

.03 *Multiple failures*. In the case of a plan with more than one Operational Failure in a single year, or Operational Failures that occur in more than one year, the Operational Failures are eligible for correction under this section 8 only if all of the Operational Failures are insignificant in the aggregate. Operational Failures that have been corrected under SCP in section 9 and VCP in sections 10 and 11 are not taken into account for purposes of determining if Operational Failures are insignificant in the aggregate.

.04 *Examples*. The following examples illustrate the application of this section 8. It is assumed, in each example, that the eligibility requirements of section 4 relating to SCP have been satisfied and that no Operational Failures occurred other than the Operational Failures identified below.

*Example 1*: In 1984, Employer X established Plan A, a profit-sharing plan that satisfies the requirements of § 401(a) in form. In 1999, the benefits of 50 of the 250 participants in Plan A were limited by § 415(c). However, when the Service examined Plan A in 2002, it discovered that, during the 1999 limitation year, the annual additions allocated to the accounts of 3 of these employees exceeded the maximum limitations under § 415(c). Employer X contributed $3,500,000 to the plan for the plan year. The amount of the excesses totaled $4,550. Under these facts, because the number of participants affected by the failure relative to the total number of participants who could have been affected by the failure, and the monetary amount of the failure relative to the total employer contribution to the plan for the 1999 plan year, are insignificant, the § 415(c) failure in Plan A that occurred in 1999 would be eligible for correction under this section 8.

*Example 2*: The facts are the same as in *Example 1*, except that the failure to satisfy § 415 occurred during each of the 1998, 1999, and 2000 limitation years. In addition, the three participants affected by the § 415 failure were not identical each year. The fact that the § 415 failures occurred during more than one limitation year did not cause the failures to be significant; accordingly, the failures are still eligible for correction under this section 8.

*Example 3*: The facts are the same as in *Example 1*, except that the annual additions of 18 of the 50 employees whose benefits were limited by § 415(c) nevertheless exceeded the maximum limitations under § 415(c) during the 1999 limitation year, and the amount of the excesses ranged from $1,000 to $9,000, and totaled $150,000. Under these facts, taking into account the number of participants affected by the failure relative to the total number of participants who could have been affected by the failure for the 1999 limitation year (and the monetary amount of the failure relative to the total employer contribution), the failure is significant. Accordingly, the § 415(c) failure in Plan A that occurred in 1999 is ineligible for correction under this section 8 as an insignificant failure.

*Example 4*: Employer J maintains Plan C, a money purchase pension plan established in 1992. The plan document satisfies the requirements of § 401(a) of the Code. The formula under the plan provides for an employer contribution equal to 10% of compensation, as defined in the plan. During its examination of the plan for the 1999 plan year, the Service discovered that the employee responsible for entering data into the employer's computer made minor arithmetic errors in transcribing the compensation data with respect to 6 of the plan's 40 participants, resulting in excess allocations to those 6 participants' accounts. Under these facts, the number of participants affected by the failure relative to the number of participants that could have been affected is insignificant, and the failure is due to minor data errors. Thus, the failure occurring in 1999 would be insignificant and therefore eligible for correction under this section 8.

*Example 5*: Public School maintains for its 200 employees a salary reduction 403(b) Plan (the "Plan") that satisfies the requirements of § 403(b). The business manager has primary responsibility for administering the Plan, in addition to other administrative functions within Public School. During the 1998 plan year, a former employee should have received an additional minimum required distribution of $278 under § 403(b)(10). Another participant received an impermissible hardship withdrawal of $2,500. Another participant made elective deferrals of $11,000, $1,000 of which was in excess of the § 402(g) limit. Under these facts, even though multiple failures occurred in a single plan year, the failures will be eligible for correction under this section 8 because in the aggregate the failures are insignificant.

## SECTION 9. SELF-CORRECTION OF SIGNIFICANT OPERATIONAL FAILURES

.01 *Requirements*. The requirements of this section 9 are satisfied with respect to an Operational Failure (even if significant) if the Operational Failure is corrected and the correction is either completed or substantially completed (in accordance with section 9.04) by the last day of the correction period described in section 9.02.

.02 *Correction period*. (1) *End of correction period*. The last day of the correction period for an Operational Failure is the last day of the second plan year following the plan year for which the failure occurred. However, in the case of a failure to satisfy the requirements of § 401(k)(3), 401(m)(2), or 401(m)(9), the correction period does not end until the last day of the second plan year following the plan year that includes the last day of the additional period for correction permitted under § 401(k)(8) or 401(m)(6). If a 403(b) Plan does not have a plan year, the plan year is deemed to be the calendar year for purposes of this subsection.

(2) *Extension of correction period for Transferred Assets*. In the case of an Operational Failure that relates only to Transferred Assets, or to a plan assumed in connection with a corporate merger, acquisition or other similar employer transaction, the correction period does not end until the last day of the first plan year that begins after the corporate merger, acquisition, or other similar employer transaction between the Plan Sponsor and the sponsor of the transferor plan or the prior sponsor of an assumed plan.

(3) *Effect of examination*. The correction period for an Operational Failure that occurs for any plan year ends, in any event, on the first date the plan or Plan Sponsor is Under Examination for that plan year (determined without regard to the second sentence of section 9.02). (But see section 9.04 for special rules permitting completion of correction after the end of the correction period.)

.03 *Correction by plan amendment*. In order to complete correction by plan amendment (as permitted under section 4.06) during the correction period, the appropriate application (*i.e.*, the Form 5300 series or Form 6406) must be submitted before the end of the correction period.

.04 *Substantial completion of correction*. Correction of an Operational Failure is substantially completed by the last day of the correction period only if the requirements of either paragraph (1) or (2) are satisfied.

(1) The requirements of this paragraph (1) are satisfied if:

(a) during the correction period, the Plan Sponsor is reasonably prompt in identifying the Operational Failure, formulating a correction method, and initiating correction in a manner that demonstrates a commitment to completing

correction of the Operational Failure as expeditiously as practicable, and

(b) within 90 days after the last day of the correction period, the Plan Sponsor completes correction of the Operational Failure.

(2) The requirements of this paragraph (2) are satisfied if:

(a) during the correction period, correction is completed with respect to 85 percent of all participants affected by the Operational Failure, and

(b) thereafter, the Plan Sponsor completes correction of the Operational Failure with respect to the remaining affected participants in a diligent manner.

.05 *Examples*. The following examples illustrate the application of this section 9. Assume that the eligibility requirements of section 4 relating to SCP have been met.

*Example 1*: Employer Z established a qualified defined contribution plan in 1986 and received a favorable determination letter for TRA '86. During 1999, while doing a self-audit of the operation of the plan for the 1998 plan year, the plan administrator discovered that, despite the practices and procedures established by Employer Z with respect to the plan, several employees eligible to participate in the plan were excluded from participation. The administrator also found that for 1998 Operational Failures occurred because the elective deferrals of additional employees exceeded the § 402(g) limit and Employer Z failed to make the required top-heavy minimum contribution. During the 1999 plan year, the Plan Sponsor made corrective contributions on behalf of the excluded employees, distributed the excess deferrals to the affected participants, and made a top-heavy minimum contribution to all participants entitled to that contribution for the 1998 plan year. Each corrective contribution and distribution was credited with earnings at a rate appropriate for the plan from the date the corrective contribution or distribution should have been made to the date of correction. Under these facts, the Plan Sponsor has corrected the Operational Failures for the 1998 plan year within the correction period and thus satisfied the requirements of this section 9.

*Example 2*: Employer A established a qualified defined contribution plan, Plan A, in 1990 and received a favorable determination letter for TRA '86. In April 2002, Employer A purchased all of the stock of Employer B, a wholly-owned subsidiary of Employer C. Employees of Employer B participated in a qualified defined contribution plan sponsored by Employer C, Plan C. Following Employer A's review of Plan C, Employer A and Employer C agreed that Plan A would accept a transfer of plan assets attributable to the account balances of the employees of Employer B who had participated in Plan C. As part of this agreement, Employer C represented to Employer A that Plan C is tax qualified. Employers A and C also agreed that such transfer would be in accordance with § 414(l) and § 1.414(l)–1 and addressed issues related to costs associated with the transfer. Following the transaction, the employees of Employer B began participation in Plan A. Effective July 1, 2002, Plan A accepted the transfer of plan assets from Plan C. After the transfer, Employer A determined that all the participants in one division of Employer B had been incorrectly excluded from allocation of the profit sharing contributions for the 1998 and 1999 plan years. During 2003, Employer A made corrective contributions on behalf of the affected participants. The corrective contributions were credited with earnings at a rate appropriate for the plan from the date the corrective contribution should have been made to the date of correction and Employer A otherwise complied with the requirements of SCP. Under these facts, Employer A has, within the correction period, corrected the Operational Failures for the 1998 and 1999 plan years with respect to the assets transferred to Plan A, and thus satisfied the requirements of this section 9.

## PART V. VOLUNTARY CORRECTION PROGRAM WITH SERVICE APPROVAL (VCP)

### SECTION 10. VCP GENERAL PROCEDURES

.01 *VCP requirements*. The requirements of this section 10 are satisfied with respect to failures submitted in accordance with the requirements of this section 10 if the Plan Sponsor pays the compliance fee required under section 12 and implements the corrective actions and satisfies any other conditions in the compliance statement described in section 10.07.

.02 *Identification of failures*. VCP is not based upon an examination of the plan by the Service. Only the failures raised by the Plan Sponsor or failures identified by the Service in processing the application will be addressed under the program, and only those failures will be covered by the program. The Service will not make any investigation or finding under VCP concerning whether there are failures.

.03 *Availability of correction of a terminated plan*. Correction of Qualification Failures in a terminated plan may be made under VCP.

.04 *Effect of VCP submission on examination*. Because VCP does not arise out of an examination, consideration under VCP does not preclude or impede (under § 7605(b) or any administrative provisions adopted by the Service) a subsequent examination of the Plan Sponsor or the plan by the Service with respect to the taxable year (or years) involved with respect to matters that are outside the compliance statement. However, a Plan Sponsor's statements describing failures are made only for purposes of VCP and will not be regarded by the Service as an admission of a failure for purposes of any subsequent examination.

.05 *No concurrent examination activity*. Except in unusual circumstances, a plan that has been properly submitted under VCP will not be examined while the submission is pending. This practice regarding concurrent examinations does not extend to other plans of the Plan Sponsor. Thus, any plan of the Plan Sponsor that is not pending under VCP could be subject to examination.

.06 *Submission of determination letter application for plan amendments*. In any case in which correction of a Qualified Plan failure includes correction of a Plan Document Failure or correction of an Operational Failure by plan amendment as permitted under section 4.06, other than adoption of an amendment designated by the Service as a model amendment or a standardized prototype plan, the Plan Sponsor should submit a copy of the amendment, the appropriate application form (*i.e.*, Form 5300 series or Form 6406), and the appropriate user fee concurrently and to the same address as the VCP submission. The user fee for the determination letter application and the fee for a VCP submission which requires an up-front fee, for example, a VCO or VCS submission, must be submitted on separate certified or cashier's checks made payable to the U.S. Treasury.

.07 *Processing of submission*. (1) *Screening of submission*. Upon receipt of a submission under VCP, the Service will review whether the eligibility requirements of section 4 and the submission requirements of section 11 are satisfied. If the Service determines that a VCP submission is seriously deficient, the Service reserves the right to return the submission, including any compliance fee, without contacting the Plan Sponsor.

(2) *Review of submission*. Once the Service determines that the submission is complete under VCP, the Service will consult with the Plan Sponsor or the Plan Sponsor's representative to discuss the proposed corrections and the plan's administrative procedures.

(3) *Additional information required*. If additional information is required, a

Service representative will generally contact the Plan Sponsor or the Plan Sponsor's representative and explain what is needed to complete the submission. The Plan Sponsor will have 21 calendar days from the date of this contact to provide the requested information. If the information is not received within 21 days, the matter will be closed, the compliance fee will not be returned, and the case may be referred to Employee Plans Examinations. Any request for an extension of the 21-day time period must be made in writing within the 21-day time period and must be approved by the Service (by the applicable group manager).

(4) *Additional failures discovered after initial submission*. (a) A Plan Sponsor that discovers additional, unrelated Qualification or 403(b) Failures after its initial submission may request that such failures be added to its submission. However, the Service retains the discretion to reject the inclusion of such failures if the request is not timely, for example, if the Plan Sponsor makes its request when processing of the submission is substantially complete.

(b) If the Service discovers an unrelated Qualification or 403(b) Failure while the request is pending, the failure generally will be added to the failures under consideration. However, the Service retains the discretion to determine that a failure is outside the scope of the voluntary request for consideration because it was not voluntarily brought forward by the Plan Sponsor. In this case, if the additional failure is significant, all aspects of the plan may be examined and the rules pertaining to Audit CAP will apply. (See sections 13 and 14.)

(5) *Conference right*. If the Service initially determines that it cannot issue a compliance statement because the parties cannot agree upon correction or a change in administrative procedures, the Plan Sponsor (generally through the Plan Sponsor's representative) will be contacted by the Service representative and offered a conference with the Service. The conference can be held either in person or by telephone and must be held within 21 calendar days of the date of contact. The Plan Sponsor will have 21 calendar days after the date of the conference to submit additional information in support of the submission. Any request for an extension of the 21-day time period must be made in writing within the 21-day time period and must be approved by the Service (by the applicable group manager). Additional conferences may be held at the discretion of the Service.

(6) *Failure to reach resolution*. If the Service and the Plan Sponsor cannot reach agreement with respect to the submission, all aspects of the plan may be examined, and the Service may refer the submission to Employee Plans Examinations.

(7) *Issuance of compliance statement*. If agreement is reached, the Service will send to the Plan Sponsor an unsigned compliance statement specifying the corrective action required. Within 30 calendar days of the date the compliance statement is sent, a Plan Sponsor must sign the compliance statement and return it and any compliance fee required to be paid at the time that the compliance statement is signed (see sections 11.05 and 11.06 regarding timing of payment of compliance fee). The Service will then issue a signed copy of the compliance statement to the Plan Sponsor. If the Plan Sponsor does not send the Service the signed compliance statement (with the compliance fee) within 30 calendar days, the plan may be referred to Employee Plans Examinations for examination consideration.

(8) *Timing of correction*. The Plan Sponsor must implement the specific corrections and administrative changes set forth in the compliance statement within 150 days of the date of the compliance statement. Any request for an extension of this time period must be made in advance and in writing and must be approved by the Service.

(9) *Modification of compliance statement*. Once the compliance statement has been issued (based on the information provided), the Plan Sponsor cannot request a modification of the compliance terms except by a new request for a compliance statement. However, if the requested modification is minor and is postmarked no later than 30 days after the compliance statement is issued, the compliance fee for the modification will be the lesser of the original compliance fee or $1,250.

(10) *Verification*. Once the compliance statement has been issued, the Service may require verification that the corrections have been made and that any plan administrative procedures required by the statement have been implemented. This verification does not constitute an examination of the books and records of the employer or the plan (within the meaning of § 7605(b)). If the Service determines that the Plan Sponsor did not implement the corrections and procedures within the stated time period, the plan may be referred to Employee Plans Examinations for examination consideration.

.08 *Compliance statement*. (1) *General description of compliance statement*. The compliance statement issued for a VCP submission addresses the failures identified, the terms of correction, including any revision of administrative procedures, and the time period within which proposed corrections must be implemented, including any changes in administrative procedures. The compliance statement also provides that the Service will not treat the plan as failing to satisfy the applicable requirements of the Code on account of the failures described in the compliance statement if the conditions of the compliance statement are satisfied. Where current procedures are inadequate for operating the plan in conformance with the applicable requirements of the Code, the compliance statement will be conditioned upon the implementation of stated administrative procedures. The Service may prescribe appropriate administrative procedures in the compliance statement.

(2) *Compliance statement conditioned upon timely correction*. The compliance statement is conditioned on (i) there being no misstatement or omission of material facts in connection with the submission and (ii) the implementation of the specific corrections and satisfaction of any other conditions in the compliance statement.

(3) *Authority delegated*. Compliance statements (including any waiver of the excise tax under § 4974) are authorized to be signed by Area Managers reporting to the Director, Employee Plans Examinations, and managers within Employee Plans Rulings and Agreements, under the Tax Exempt and Government Entities Operating Division of the Service.

.09 *Effect of compliance statement on examination*. The compliance statement is binding upon both the Service and the Plan Sponsor or Eligible Organization (as defined in section 10.15(2)) with respect to the specific tax matters identified therein for the periods specified, but does not preclude or impede an examination of the plan by the Service relating to matters outside the compliance statement, even with respect to the same taxable year or years to which the compliance statement relates.

.10 *Processing of determination letter applications not submitted under VCP*. (1) The Service may process a determination letter application submitted under the determination letter program (including an application requested on Form 5310) concurrently with a VCP submission for the same plan. However, issuance of the determination letter in response to an application made on a Form 5310 will be suspended pending the closure of the VCP submission.

(2) A submission of a plan under the determination letter program does not constitute a submission under VCP. Thus, a Plan Sponsor that discovers a Qualification Failure in its plan must make a separate application under VCP. If the failure is discovered by the Service in connection with a determination letter application, the agent may issue a closing agreement with respect to the failures identified or, if appropriate, refer the case to Employee Plans Examinations. In either case, the fee structure in section 12, applicable to VCP, will not apply. Instead, the fee structure in section 14 relating to Audit CAP will apply. (See sections 13 and 14.)

.11 *Special rules relating to VCO*. (1) Under VCP, Operational Failures in a Qualified Plan may be corrected under the VCO rules in this subsection. VCO is available only if the plan's identified failures are all Operational Failures and only if the plan has a Favorable Letter.

(2) If the plan is not the subject of a Favorable Letter, or if the submission either includes a failure other than an Operational Failure or includes an egregious failure described in section 4.09, the submission will be converted from a submission under VCO to a submission under the VCP general procedures. The compliance fee will be retained and will be applied to the compliance fee required under the VCP general procedures. The Service retains the discretion to determine whether a submission is outside the scope of the special VCO rules even if the identified failures are Operational Failures and the plan has a Favorable Letter. The discretion will be applied only in rare and unusual circumstances.

.12 *Special rules relating to VCS*. (1) Under VCO, certain Operational Failures in a Qualified Plan may be corrected under the VCS rules in this subsection. VCS is available only if the plan's only identified Operational Failures are failures addressed in Appendix A or Appendix B of this revenue procedure and the failures are corrected in accordance with an applicable correction method set forth in Appendix A or Appendix B. Appropriate correction must be made for any Qualification Failure that results from the application of a VCS correction.

(2) The correction methods set forth in Appendix A and Appendix B are strictly construed and are the only acceptable correction methods for failures corrected under VCS. If the Plan Sponsor wishes to modify a correction method provided in Appendix A or Appendix B or to propose another method, the Plan Sponsor may not use VCS, but may request a compliance statement under the VCO procedure.

(3) VCS is not available if the Plan Sponsor has identified more than two failures in a single VCS request. If there are one or two failures that can be corrected under VCS and there are other failures that cannot be corrected under VCS, VCS is not available. The Service reserves the right to shift requests for consideration under VCS into VCO if the Plan Sponsor submits a second VCS request with respect to the same plan while the first VCS request is being considered or during the 12 months after the first VCS compliance statement is issued. Both VCS requests may be shifted into VCO if the first VCS request is still being considered.

(4) The Service will review a VCS request within 120 days of the date the submission is received and determined to be complete. If the Service determines that the request is acceptable, the Service will issue a compliance statement on the Plan Sponsor's proposed correction.

.13 *Special rules relating to Anonymous (John Doe) Submission Procedure*. (1) The Anonymous Submission Procedure permits submission of a Qualified or 403(b) Plan under VCP without initially identifying the applicable plan(s), the Plan Sponsor(s), or the Eligible Organization. The requirements of this revenue procedure relating to VCP, including sections 10, 11, and 12, apply to these submissions. However, information identifying the plan or the Plan Sponsor may be redacted (and the power of attorney statement and the penalty of perjury statement need not be included with the initial submission). For purposes of processing the submission, the State of the Plan Sponsor must be identified in the initial submission. Once the Service and the plan representative reach agreement with respect to the submission, the Service will contact the plan representative in writing indicating the terms of the agreement. The Plan Sponsor will have 21 calendar days from the date of the letter of agreement to identify the plan and Plan Sponsor. If the Plan Sponsor does not submit the identifying material (including the power of attorney statement and the penalty of perjury statement) within 21 calendar days of the letter of agreement, the matter will be closed and the compliance fee will not be returned.

(2) Notwithstanding section 10.05, until the plan(s) and Plan Sponsor(s) are identified to the Service, a submission under this subsection does not preclude or impede an examination of the Plan Sponsor or its plan(s). Thus, a plan submitted under the Anonymous Submission Procedure that comes Under Examination prior to the date the plan(s) and Plan Sponsor(s) identifying materials are received by the Service will no longer be eligible for either the Anonymous Submission Procedure or VCP.

(3) The Anonymous Submission Procedure is extended indefinitely.

.14 *Special rules relating to VCT*. A VCP submission for a 403(b) Plan is required to be made under the VCT procedure. A VCT submission is subject to the procedures of sections 10 and 11. A 403(b) Plan is not eligible for VCO or VCS.

.15 *Special rules relating to VCGroup*. (1) *General rules*. An Eligible Organization may submit a VCP request for a

Qualified Plan or a 403(b) Plan under the VCGroup procedure for Operational and Plan Document Failures under this subsection and may not submit an application under VCO, VCS, or VCT.

(2) *Eligible Organizations*. For purposes of VCGroup, the term "Eligible Organization" means either (a) a Sponsor (as that term is defined in section 4.09 of Rev. Proc. 2000–20, 2000–1 C.B. 553) of a master or prototype plan, (b) an insurance company or other entity that has issued annuity contracts or provides services with respect to assets for 403(b) Plans, or (c) an entity that provides its clients with administrative services with respect to Qualified Plans or 403(b) Plans. An Eligible Organization is not eligible for VCGroup unless the submission includes a failure resulting from a systemic error involving the Eligible Organization that affects at least 20 plans and that results in at least 20 plans implementing correction. If, at any time before the Service provides an unsigned compliance statement, the number of plans falls below 20, the Eligible Organization must notify the Service that it is no longer eligible for VCGroup (and the compliance fee will be retained).

(3) *Special VCGroup procedures*. (a) A VCGroup submission is subject to the same procedures as any VCP submission in accordance with sections 10 and 11, except that the Eligible Organization is responsible for performing the procedural obligations imposed on the Plan Sponsor under sections 10 and 11.

(b) When an Eligible Organization under VCGroup receives an unsigned compliance statement on the proposed correction and agrees to the terms of the compliance statement, the Eligible Organization must return to the Service within 120 calendar days not only the signed compliance statement and any additional compliance fee under section 12.06, but also a list containing (i) the employers' tax identification numbers for the Plan Sponsors of the plans to whom the compliance statement may be applicable and (ii) the plans by name, plan number, type of plan, number of plan participants, and trust's tax identification numbers, if applicable, along with (iii) a power of attorney (which may be a limited power of attorney) from each of the Plan Sponsors authorizing the Eligible Organization or its representative to act on the Plan Sponsor's behalf with respect to the items in the compliance statement and (iv) a certification that each Plan Sponsor timely filed the Form 5500 return for each plan. Only those plans for which correction is actually made within 240 calendar days of the date of the signed compliance statement (or within such longer period as may be agreed to by the Service at the request of the Eligible Organization) will be covered by that statement.

(c) Notwithstanding section 10.04, until the Eligible Organization provides the Service with the information of section 10.14(3)(b)(i) through (iv) with respect to a Plan Sponsor and its plan(s), a VCGroup submission does not preclude or impede an examination of the Plan Sponsor or its plan(s).

(4) *VCGroup implementation*. The VCGroup procedure is being implemented on a provisional basis, and the Service and Treasury invite comments on the operation of the VCGroup procedure.

.16 *Special rules relating to VCSEP*. A VCP submission for a SEP is required to be made under the VCSEP procedure. A VCSEP submission is subject to the procedures of sections 10 and 11. A SEP Plan is not eligible for VCO or VCS.

.17 *Multiemployer and multiple employer plans*. (1) In the case of a multiemployer or multiple employer plan, the plan administrator (rather than any contributing or adopting employer) must request consideration of the plan under the programs. The request must be with respect to the plan, rather than a portion of the plan affecting any particular employer.

(2) If a VCP submission for a multiemployer or multiple employer plan has failures that apply to fewer than all of the employers under the plan, the plan administrator may choose to have the compliance fee (in section 12) or sanction (in section 14) calculated separately for each employer based on the assets attributable to that employer, rather than being attributable to the assets of the entire plan. Thus, the plan administrator may choose to apply the provisions of this paragraph where the failure is attributable in whole or in part to data, information, actions, or inactions that are within the control of the employers rather than the multiemployer or multiple employer plan (such as attribution in whole or in part to the failure of an employer to provide the plan administrator with full and complete information).

## SECTION 11. APPLICATION PROCEDURES FOR VCP

.01 *General rules*. The requirements of this section 11 are satisfied if the request for a compliance statement from the Service under VCP satisfies the informational and other requirements of this section 11. In general, a request under VCP consists of a letter from the Plan Sponsor (which may be a letter from the Plan Sponsor's representative) or Eligible Organization (or representative) to the Service that contains a description of the failures, a description of the proposed methods of correction, and other procedural items, and includes supporting information and documentation as described below.

.02 *Submission requirements*. The letter from the Plan Sponsor or the Plan Sponsor's representative must contain the following:

(1) A complete description of the failures and the years in which the failures occurred, including closed years (that is, years for which the statutory period has expired).

(2) A description of the administrative procedures in effect at the time the failures occurred.

(3) An explanation of how and why the failures arose.

(4) A detailed description of the method for correcting the failures that the Plan Sponsor has implemented or proposes to implement. Each step of the correction method must be described in narrative form. The description must include the specific information needed to support the suggested correction method. This information includes, for example, the number of employees affected and the expected cost of correction (both of which may be approximated if the exact number cannot be determined at the time of the request), the years involved, and calculations or assumptions the Plan Sponsor used to determine the amounts needed for correction. See section 10.11 for special procedures regarding VCS.

(5) A description of the methodology that will be used to calculate earnings

or actuarial adjustments on any corrective contributions or distributions (indicating the computation periods and the basis for determining earnings or actuarial adjustments, in accordance with section 6.02(4)).

(6) Specific calculations for each affected employee or a representative sample of affected employees. The sample calculations must be sufficient to demonstrate each aspect of the correction method proposed. For example, if a Plan Sponsor requests a compliance statement with respect to a failure to satisfy the contribution limits of § 415(c) and proposes a correction method that involves elective contributions (whether matched or unmatched) and matching contributions, the Plan Sponsor must submit calculations illustrating the correction method proposed with respect to each type of contribution. As another example, with respect to a failure to satisfy the ADP test in § 401(k)(3), the Plan Sponsor must submit the ADP test results both before the correction and after the correction.

(7) The method that will be used to locate and notify former employees and beneficiaries, or an affirmative statement that no former employees or beneficiaries were affected by the failures or will be affected by the correction.

(8) A description of the measures that have been or will be implemented to ensure that the same failures will not recur.

(9) A statement that, to the best of the Plan Sponsor's knowledge, neither the plan nor the Plan Sponsor is Under Examination.

(10) If a submission includes a failure that refers to Transferred Assets and occurred prior to the transfer, a description of the transaction (including the dates of the employer change and the plan transfer).

(11) A statement (if applicable) that the plan is currently being considered in a determination letter application. If the request for a determination letter is made while a request for consideration under VCP is pending, the Plan Sponsor must update the VCP request to add this information.

.03 *Submission requirements under special procedures*. The letter from the Plan Sponsor or the Plan Sponsor's representative must also contain the following:

(1) *VCS*. In the case of a VCS submission, a statement that it is a VCS request, a description of the applicable correction in accordance with Appendix A or Appendix B, and a statement that the Plan Sponsor proposes to implement (or has implemented) the correction(s).

(2) *VCT*. In the case of a VCT submission, a statement that the Plan Sponsor has contacted all other entities involved with the plan and has been assured of cooperation in implementing the applicable correction, to the extent necessary. For example, if the plan's failure is the failure to satisfy the requirements of § 403(b)(1)(E) on elective deferrals, the Plan Sponsor must, prior to making the VCT application, contact the insurance company or custodian with control over the plan's assets to assure cooperation in effecting a distribution of the excess deferrals and the earnings thereon. An application under VCT must also contain a statement as to the type of employer (*e.g.*, a tax-exempt organization described in § 501(c)(3)) submitting the VCT application.

(3) *VCGroup*. A VCGroup submission must be signed by the Eligible Organization or the Eligible Organization's authorized representative and accompanied by a copy of the relevant portions of the plan document(s).

(4) *VCSEP*. In the case of a VCSEP submission, a statement that it is a VCSEP request.

.04 *Required documents*. A VCP submission must be accompanied by the following documents:

(1) *Form 5500 or similar information*. (a) *VCP*. In the case of the general procedures under VCP, a copy of the most recently filed Form 5500 series return.

(b) *VCO and VCS*. In the case of a VCO or VCS submission, a copy of the first page and a copy of the page containing employee census information (currently, line 7f of the 1999 Form 5500) and a copy of the page containing the total amount of plan assets (currently, line 31f of the 1999 Form 5500) or the most recently filed Form 5500 series return.

(c) *Anonymous submission*. In the case of a submission under the Anonymous Submission Procedure, the employee census and plan asset information may be redacted and replaced by numbers that are rounded up.

(d) *VCT*. In the case of a VCT submission, if Form 5500 is inapplicable, the information generally included on the first two pages of Form 5500, including the name and number of the plan, and the employer's Employer Identification Number.

(e) *VCSEP*. In the case of a VCSEP submission, if Form 5500 is inapplicable, the information generally included on the first two pages of Form 5500, including the name and number of the plan, and the employer's Employer Identification Number.

(2) *Plan document*. A copy of the relevant portions of the plan document. For example, in a case involving improper exclusion of eligible employees from a profit-sharing plan with a cash or deferred arrangement, relevant portions of the plan document include the eligibility, allocation, and cash or deferred arrangement provisions of the basic plan document (and the adoption agreement, if applicable), along with applicable definitions in the plan. If the plan is a 403(b) Plan and a plan document is not available, written descriptions of the plan, and sample salary reduction agreements if relevant. In the case of a SEP, submit the entire plan document.

(3) *Determination letter application*. In any case in which correction of a Qualified Plan failure includes correction of a Plan Document Failure or correction of an Operational Failure by plan amendment as permitted under section 4.06, other than adoption of an amendment designated by the Service as a model amendment or a standardized or prototype plan, the Plan Sponsor must submit the amendment, the appropriate application form (*i.e.*, Form 5300 series or Form 6406), and the appropriate user fee. The user fee for the determination letter application and the fee for a VCP submission which requires an up-front fee, for example, a VCO or VCS submission, must be submitted on separate certified or cashier's checks made payable to the U.S. Treasury.

(4) *Copy of Favorable Letter for VCO, VCS, or VCSEP*. In the case of VCO, VCS, or VCSEP, a copy of a Favorable Letter.

.05 *Date VCP fee due generally*. Except as provided in section 11.06, the VCP fee under section 12 is due at the

time the compliance statement is signed by the Plan Sponsor and returned to the Service. All fees must be submitted by certified or cashier's check made payable to the U.S. Treasury.

.06 *Fee due earlier for VCO, VCS, Anonymous Submission, VCGroup, and VCSEP*. In the case of a VCO or VCS submission, the appropriate fee described in section 12.02 or 12.03 must be included with the submission. In the case of a submission made under the Anonymous Submission Procedure, VCGroup, or VCSEP, the initial fee described in section 12.04(1), 12.06, or 12.07(1), respectively, must be included with the submission (and any additional fee is due at the time provided in section 11.05).

.07 *Signed submission*. The submission must be signed by the Plan Sponsor or the sponsor's authorized representative.

.08 *Power of attorney requirements*. To sign the submission or to appear before the Service in connection with the submission, the Plan Sponsor's representative must comply with the requirements of section 9.02(11) and (12) of Rev. Proc. 2002–4, 2002–1 I.R.B. 127.

.09 *Penalty of perjury statement*. The following declaration must accompany a request and any factual information or change in the submission at a later time: **"Under penalties of perjury, I declare that I have examined this submission, including accompanying documents, and, to the best of my knowledge and belief, the facts presented in support of this submission are true, correct, and complete."** The declaration must be signed by the Plan Sponsor, not the Plan Sponsor's representative.

.10 *Checklist*. The Service will be able to respond more quickly to a VCP request if the request is carefully prepared and complete. The checklist in Appendix C is designed to assist Plan Sponsors and their representatives in preparing a submission that contains the information and documents required under this revenue procedure. The checklist in Appendix C must be completed, signed, and dated by the Plan Sponsor or the Plan Sponsor's representative, and should be placed on top of the submission. A photocopy of this checklist may be used.

.11 *Designation*. The letter to the Service should be designated "VCP", "VCO", "VCS", "VCT", "VCSEP", or "VCGroup", as appropriate, in the upper right hand corner of the letter. In addition, if the submission is an Anonymous Submission, the letter should also be designated "Anonymous Submission Procedure".

.12 *VCP mailing address*. All VCP submissions should be mailed to:

Internal Revenue Service
Attention: T:EP:RA:VC
P.O. Box 27063
McPherson Station
Washington, D.C. 20038

.13 *Maintenance of copies of submissions*. Plan Sponsors and their representatives should maintain copies of all correspondence submitted to the Service with respect to their VCP requests.

SECTION 12. VCP FEES

.01 *VCP general procedure compliance fee*. (1) *Compliance fee chart*. Except as otherwise provided in this section 12, the compliance fee for an application under VCP is determined in accordance with the chart below. All fees must be submitted by certified or cashier's check made payable to the U.S. Treasury. The chart contains a graduated range of fees based on the size of the plan and the number of participants. Each range includes a minimum amount, a maximum amount, and a presumptive amount. In each case, the minimum amount is the applicable VCO fee in section 12.02. It is expected that in most instances the compliance fee imposed will be at or near the presumptive amount in each range; however, the fee may be a higher or lower amount within the range, depending on the factors in paragraph (2) below.

| VCP GENERAL PROCEDURES COMPLIANCE FEES | | |
|---|---|---|
| # of participants | Fee range | Presumptive Amount |
| 10 or fewer | VCO fee* to $4,000 | $2,000 |
| 11 to 50 | VCO fee* to $8,000 | $4,000 |
| 51 to 100 | VCO fee* to $12,000 | $6,000 |
| 101 to 300 | VCO fee* to $16,000 | $8,000 |
| 301 to 1,000 | VCO fee* to $30,000 | $15,000 |
| Over 1,000 | VCO fee* to $70,000 | $35,000 |

* Items marked by asterisk refer to the VCO compliance fee that would apply under section 12.02 if the plan had been submitted under VCO.

(2) *Factors considered*. Except as provided in section 12.01(3) with respect to nonamenders and section 12.01(4) relating to egregious failures, consideration of whether the compliance fee should be equal to, greater than, or less than the presumptive amount will depend on factors relating to the nature, extent, and severity of the failure. These factors include: (a) whether the failure is a failure to satisfy the requirements of § 401(a)(4), § 401(a)(26), or § 410(b), (b) whether the plan has both Operational and Plan Document Failures, (c) the period over which the violation occurred (for example, the time that has elapsed since the end of the applicable remedial amendment period under § 401(b) for a Plan Document Failure), (d) the extent to which the plan has accepted Transferred Assets, and the extent to which the failures relate to the Transferred Assets and occurred before the transfer, and (e) whether the plan has a Favorable Letter.

(3) *VCP fee for nonamenders*. The VCP compliance fee for a submission that includes only a Plan Document Failure that is solely a failure to amend the plan timely to comply with required tax law changes is determined in accordance with section 12.01(1), as follows:

(a) GUST (for plans filed after September 3, 2002), UCA or OBRA '93 model amendments only — the fee is the halfway point between the minimum amount and the presumptive amount of the applicable fee range.

(b) TRA '86 — the fee is the presumptive amount of the applicable fee range, and clause (a) does not apply.

(c) TEFRA, DEFRA, or REA — the fee is the halfway point between the presumptive amount and the maximum amount of the applicable fee range, and clauses (a) and (b) do not apply.

(d) ERISA — the fee is the maximum amount of the applicable fee range, and clauses (a), (b), and (c) do not apply.

(4) *Egregious failures*. In cases involving failures that are egregious (as described in section 4.09), (a) the maximum compliance fee applicable to the plan under the chart in 12.01(1) is increased to 40 percent of the Maximum Payment Amount and (b) no presumptive amount applies.

.02 *VCO fee*. Unless VCS is applicable, the VCO compliance fee depends on the assets of the plan and the number of plan participants.

(1) The fee for a plan with assets of less than $500,000 and no more than 1,000 plan participants is $500.

(2) The fee for a plan with assets of at least $500,000 and no more than 1,000 plan participants is $1,250.

(3) The fee for a plan with more than 1,000 plan participants but fewer than 10,000 plan participants is $5,000.

(4) The fee for a plan with 10,000 or more plan participants is $10,000.

.03 *VCS fee*. The VCS compliance fee is $350.

.04 *Fee for Anonymous Submission*. The compliance fee for the Anonymous Submission Procedure is the fee applicable under other provisions of this section 12 (*i.e.*, the fee under section 12.01 for VCP general procedures, the fee under section 12.02 for VCO, or the fee under section 12.05 for VCT).

(1) The initial portion of the fee is the amount determined under section 12.02 (for the VCP general procedures or VCO) or 12.05(2) (for VCT).

(2) The additional fee, if any, is the fee determined under section 12.01 or 12.05, if applicable, reduced by the fee in section 12.04(1).

.05 *VCT Fee*. (1) *VCT compliance fee*. The applicable VCT compliance fee depends on the type of failure and, generally, the number of employees of the employer.

(2) *Fee for Operational Failures*. Subject to section 12.05(3), the compliance fee for submissions that include only Operational Failures is as follows:

(a) The fee for an employer with fewer than 25 employees is $500.

(b) The fee for an employer with at least 25 and no more than 1,000 employees is $1,250.

(c) The fee for an employer with more than 1,000 employees but less than 10,000 is $5,000.

(d) The fee for an employer with 10,000 or more employees is $10,000.

(3) *Fee for certain Excess Amounts*. Subject to section 12.05(6), the compliance fee for Excess Amounts that are corrected pursuant to section 6.05(2)(b) is equal to the sum of (a) the applicable fee described in section 12.05(2), plus (b) ten percent of the Excess Amounts, adjusted for earnings through the date of the VCT application, contributed or allocated in the calendar year of the VCT application and in the three calendar years prior thereto. If there is a failure to satisfy both the § 403(b)(2) and § 415 limits with respect to a single employee for a year, the fee will take into account only the larger Excess Amount.

(4) *Fee for Demographic and Eligibility Failures*. (a) Subject to section 12.05(6), the compliance fee for a 403(b) Plan with failures that include any Demographic or Employer Eligibility Failure is determined in accordance with the VCP fee table in section 12.01(1), except that (i) the reference to VCO fees is changed to refer to the VCT compliance fee for Operational Failures in section 12.05(2) above and (ii) the fee is determined with reference to the number of employees rather than participants.

(b) In addition to the types of factors listed in section 12.01(2), factors considered in determining the compliance fee for failures that include any Demographic or Employer Eligibility Failure under VCT include: (i) whether the failures include a Demographic Failure, (ii) whether the 403(b) Plan has a combination of two or more types of failures (Operational, Demographic, and Employer Eligibility); and (iii) the period of time over which the failure occurred.

(5) *Fee for multiple failures*. If correction is requested for multiple failures, the compliance fee is determined in accordance with the table below.

| | |
|---|---|
| Multiple Operational Failures | Fee described in section 12.05(2) |
| Multiple Demographic or Eligibility Failures | Fee described in section 12.05(4) |
| Combination of Operational and Demographic or Eligibility Failures | Fee described in section 12.05(4) |
| Operational Failure(s) with section 6.05(2)(b) correction of Excess Amounts | Fee described in section 12.05(3) |
| Demographic or Eligibility Failures and Operational Failures including section 6.05(2)(b) correction of Excess Amounts | Fee described in section 12.05(3), substituting section 12.05(4) fee for section 12.05(2) fee |

(6) *Fee for egregious failures*. In cases involving failures that are egregious, the maximum VCT compliance fee applicable to the plan is increased to 40 percent of the Total Sanction Amount and no presumptive amount applies.

.06 *VCGroup fees*. The compliance fee for a VCGroup submission is based on the number of plans to which the compliance statement is applicable. The initial fee is $10,000. In the case of a submission with only corrections under Appendix A or B, an additional fee is due equal to the product of the number of plans in excess of 20 times $125, up to a maximum of $40,000; in any other case, the additional fee is equal to the product of the number of plans in excess of 20 times $250, up to a maximum of $90,000.

.07 *VCSEP fees*. The applicable VCSEP compliance fee is the same as the fee for VCP in section 12.01, subject to the following:

(1) In the case of a SEP with Operational Failures only, the compliance fee is determined in accordance with the VCO fee schedule in section 12.02, except that the fee is determined solely on the basis of the number of plan participants.

(2) In any case in which a SEP correction is not similar to a correction for a similar Qualification Failure (as provided under section 6.08(1)), the Service may impose an additional fee. If the failure involves an overcontribution to a SEP that is not the result of a failure to satisfy a statutory limit on contributions to a SEP and the Plan Sponsor retains the overcontribution in the SEP, a fee equal to at least ten percent of the overcontribution excluding earnings will be imposed. This is in addition to the VCSEP compliance fee.

.08 *Establishing amount of assets and number of plan participants*. Compliance fees under this section 12 are calculated by the Plan Sponsor using the numbers from the most recently filed Form 5500 series to establish the fee. Thus, with respect to the 1999 Form 5500, the Plan Sponsor would use the number shown on line 7(f) (or the equivalent line on the Form 5500 C/R or EZ) to establish the number of plan participants and would use line 31(f) (or the equivalent line on the Form 5500 C/R or EZ) to establish the amount of plan assets. If the submission involves a plan with Transferred Assets and no new incidents of the failure occurred after the end of the second plan year that begins after the corporate merger, acquisition, or other similar employer transaction, the Plan Sponsor may calculate the amount of plan assets and number of plan participants based on the Form 5500 information that would have been filed by the Plan Sponsor for the plan year that includes the employer transaction if the Transferred Assets were maintained as a separate plan. In the case of a SEP not required to file a Form 5500, the Plan Sponsor may use other reasonable information to determine the amount of plan assets and the number of participants.

## PART VI. CORRECTION ON AUDIT (AUDIT CAP)

### SECTION 13. DESCRIPTION OF AUDIT CAP

.01 *Audit CAP requirements*. If the Service identifies a Qualification or 403(b) Failure (other than a failure that has been corrected in accordance with SCP or VCP) upon an Employee Plans or Exempt Organizations examination of a Qualified Plan, 403(b) Plan, or SEP, the requirements of this section 13 are satisfied with respect to the failure if the Plan Sponsor corrects the failure, pays a sanction in accordance with section 14, satisfies any additional requirements of section 13.03, and enters into a closing agreement with the Service.

.02 *Payment of sanction*. Payment of the sanction under section 14 generally is required at the time the closing agreement is signed. All sanction amounts should be submitted by certified or cashier's check made payable to the U.S. Treasury.

.03 *Additional requirements*. Depending on the nature of the failure, the Service will discuss the appropriateness of the plan's existing administrative procedures with the Plan Sponsor. If existing administrative procedures are inadequate for operating the plan in conformance with the applicable requirements of the Code, the closing agreement may be conditioned upon the implementation of stated procedures. In addition, for Qualified Plans, the Plan Sponsor may be required to obtain a Favorable Letter before the closing agreement is signed unless the Service determines that it is unnecessary based on the facts and circumstances (for example, because the plan already has a Favorable Letter and no significant amendments are adopted). If a Favorable Letter is required, the Plan Sponsor is required to pay the applicable user fee for obtaining the letter.

.04 *Failure to reach resolution*. If the Service and the Plan Sponsor cannot reach an agreement with respect to the correction of the failure(s) or the amount of the sanction, the plan will be disqualified or, in the case of a 403(b) Plan or SEP, will not have reliance on this revenue procedure.

.05 *Effect of closing agreement*. A closing agreement constitutes an agreement between the Service and the Plan Sponsor that is binding with respect to the tax matters identified therein for the periods specified.

.06 *Other procedural rules*. The procedural rules for Audit CAP are set forth in Internal Revenue Manual ("IRM") 7.2.2, EPCRS.

### SECTION 14. AUDIT CAP SANCTION

.01 *Determination of sanction*. The sanction under Audit CAP is a negotiated percentage of the Maximum Payment Amount. For 403(b) Plans and SEPs, the sanction is a negotiated percentage of the Total Sanction Amount. Sanctions will not be excessive and will bear a reasonable relationship to the nature, extent, and severity of the failures, based on the factors below.

.02 *Factors considered*. Factors include: (1) the steps taken by the Plan Sponsor to ensure that the plan had no failures, (2) the steps taken to identify failures that may have occurred, (3) the extent to which correction had progressed before the examination was initiated, including full correction, (4) the amount of the fee the Plan Sponsor would have paid under section 12 for correcting the failures, (5) the number and type of employees affected by the failure, (6) the number of nonhighly compensated employees who would be adversely affected if the plan were not treated as qualified or as satisfying the requirements of § 403(b) or § 408(k), (7) whether the failure is a failure to satisfy the requirements of § 401(a)(4), § 401(a)(26), or § 410(b), either directly or through § 403(b)(12), (8) the period over which

the failure occurred (for example, the time that has elapsed since the end of the applicable remedial amendment period under § 401(b) for a Plan Document Failure), and (9) the reason for the failure (for example, data errors such as errors in transcription of data, the transposition of numbers, or minor arithmetic errors). Factors relating only to Qualified Plans also include: (1) whether the plan is the subject of a Favorable Letter, (2) whether the plan has both Operational and other failures, and (3) the extent to which the plan has accepted Transferred Assets, and the extent to which failures relate to Transferred Assets and occurred before the transfer. Additional factors relating only to 403(b) Plans include: (1) whether the plan has a combination of Operational, Demographic, or Employer Eligibility Failures, (2) the extent to which the failure relates to Excess Amounts, and (3) whether the failure is solely an Employer Eligibility Failure.

.03 *Transferred Assets*. If the examination involves a plan with Transferred Assets and the Service determines that no new incidents of the failures that relate to the Transferred Assets occur after the end of the second plan year that begins after the corporate merger, acquisition, or other similar employer transaction, the sanction under Audit CAP will not exceed the sanction that would apply if the Transferred Assets were maintained as a separate plan.

## PART VII. EFFECT ON OTHER DOCUMENTS; EFFECTIVE DATE; PAPERWORK REDUCTION ACT

### SECTION 15. EFFECT ON OTHER DOCUMENTS

.01 *Revenue procedure 2001–17 modified and superseded*. Rev. Proc. 2001–17 is modified and superseded by this revenue procedure.

### SECTION 16. EFFECTIVE DATE

This revenue procedure is effective July 22, 2002.

### SECTION 17. PAPERWORK REDUCTION ACT

The collection of information contained in this revenue procedure has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1673.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

The collection of information in this revenue procedure is in sections 4.06, 6.02(5)(c), 6.05, 10.01, 10.02, 10.05–10.07, 11.02–11.04, 11.07–11.13, 13.01, section 2.01–2.07 of Appendix B, and Appendix C. This information is required to enable the Commissioner, Tax Exempt and Government Entities Division of the Internal Revenue Service to make determinations regarding the issuance of various types of closing agreements and compliance statements. This information will be used to issue closing agreements and compliance statements to allow individual plans to continue to maintain their tax qualified and tax-deferred status. As a result, favorable tax treatment of the benefits of the eligible employees is retained. The likely respondents are individuals, state or local governments, business or other for-profit institutions, nonprofit institutions, and small businesses or organizations.

The estimated total annual reporting and/or recordkeeping burden is 56,272 hours.

The estimated annual burden per respondent/recordkeeper varies from .5 to 42.5 hours, depending on individual circumstances, with an estimated average of 13.11 hours. The estimated number of respondents and/or recordkeepers is 4,292.

The estimated frequency of responses is occasional.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally tax returns and tax return information are confidential, as required by 26 U.S.C. § 6103.

### DRAFTING INFORMATION

The principal authors of this revenue procedure are Maxine Terry and Carlton Watkins of the Tax Exempt and Government Entities Division. For further information concerning this revenue procedure, please contact the Employee Plans' taxpayer assistance telephone service at 1–877–829–5500 between 8:30 a.m. and 6:30 p.m., Eastern Time, Monday through Friday (a toll-free number). Ms. Terry and Mr. Watkins may be reached at (202) 283–9888 (not a toll-free number).

## APPENDIX A

## OPERATIONAL FAILURES AND CORRECTIONS UNDER VCS

.01 *General rule*. This appendix sets forth Operational Failures relating to Qualified Plans and corrections under VCS in accordance with section 10.11. In each case, the method described corrects the Operational Failure identified in the headings below. Corrective allocations and distributions should reflect earnings and actuarial adjustments in accordance with section 6.02(4). The correction methods in this appendix are acceptable under SCP and VCP (including VCS). Additionally, the correction methods and the earnings adjustment methods in Appendix B are acceptable under SCP and VCP (including VCS but not VCT).

.02 *Failure to properly provide the minimum top-heavy benefit under § 416 of the Code to non-key employees*. In a defined contribution plan, the permitted correction method is to properly contribute and allocate the required top-heavy minimums to the plan in the manner provided for in the plan on behalf of the non-key employees (and any other employees required to receive top-heavy allocations under the plan). In a defined benefit plan, the minimum required benefit must be accrued in the manner provided in the plan.

.03 *Failure to satisfy the ADP test set forth in § 401(k)(3), the ACP test set forth in § 401(m)(2), or the multiple use test of § 401(m)(9)*. The permitted correction method is to make qualified nonelective contributions (QNCs) (as defined in § 1.401(k)–1(g)(13)(ii)) on behalf of the nonhighly compensated employees to the extent necessary to raise the actual deferral percentage or actual contribution percentage of the nonhighly compensated employees to the percentage needed to pass the test or tests. The contributions must be made on behalf of all eligible nonhighly compensated employees (to the

extent permitted under § 415) and must either be the same flat dollar amount or the same percentage of compensation. QNCs contributed to satisfy the ADP test need not be matched. Employees who would have been eligible for a matching contribution had they made elective contributions must be counted as eligible employees for the ACP test, and the plan must satisfy the ACP test. Under this VCS correction method, a plan may not be treated as two separate plans, one covering otherwise excludable employees and the other covering all other employees (as permitted in § 1.410(b)–6(b)(3)) in order to reduce the number of employees eligible to receive QNCs. Likewise, under this VCS correction method, the plan may not be restructured into component plans (as permitted in § 1.401(k)–1(h)(3)(iii) for plan years before January 1, 1992) in order to reduce the number of employees eligible to receive QNCs.

.04 *Failure to distribute elective deferrals in excess of the § 402(g) limit (in contravention of § 401(a)(30))*. The permitted correction method is to distribute the excess deferral to the employee and to report the amount as taxable in the year of deferral and in the year distributed. In accordance with § 1.402(g)–1(e)(1)(ii), a distribution to a highly compensated employee is included in the ADP test; a distribution to a nonhighly compensated employee is not included in the ADP test.

.05 *Exclusion of an eligible employee from all contributions or accruals under the plan for one or more plan years*. The permitted correction method is to make a contribution to the plan on behalf of the employees excluded from a defined contribution plan or to provide benefit accruals for the employees excluded from a defined benefit plan. If the employee should have been eligible to make an elective contribution under a cash or deferred arrangement, the employer must make a QNC (as defined in § 1.401(k)–1(g)(13)(ii)) to the plan on behalf of the employee that is equal to the actual deferral percentage for the employee's group (either highly compensated or nonhighly compensated). If the employee should have been eligible to make employee contributions or for matching contributions (on either elective contributions or employee contributions), the employer must make a QNC to the plan on behalf of the employee that is equal to the actual contribution percentage for the employee's group (either highly compensated or nonhighly compensated). Contributing the actual deferral or contribution percentage for such employees eliminates the need to rerun the ADP or ACP test to account for the previously excluded employees. Under this VCS correction method, a plan may not be treated as two separate plans, one covering otherwise excludable employees and the other covering all other employees (as permitted in § 1.410(b)–6(b)(3)) in order to reduce the amount of QNCs. Likewise, restructuring the plan into component plans under § 1.401(k)–1(h)(3)(iii) is not permitted in order to reduce the amount of QNCs.

.06 *Failure to timely pay the minimum distribution required under § 401(a)(9)*. In a defined contribution plan, the permitted correction method is to distribute the required minimum distributions. The amount to be distributed for each year in which the failure occurred should be determined by dividing the adjusted account balance on the applicable valuation date by the applicable distribution period. For this purpose, adjusted account balance means the actual account balance, determined in accordance with § 1.401(a)(9)–5 Q&A F–3 of the regulations, reduced by the amount of the total missed minimum distributions for prior years. In a defined benefit plan, the permitted correction method is to distribute the required minimum distributions, plus an interest payment representing the loss of use of such amounts.

.07 *Failure to obtain participant and/or spousal consent for a distribution subject to the participant and spousal consent rules under §§ 401(a)(11), 411(a)(11) and 417*. The permitted correction method is to give each affected participant a choice between providing informed consent for the distribution actually made or receiving a qualified joint and survivor annuity. In order to use this VCS correction method, the Plan Sponsor must have contacted each affected participant and spouse (to whom the participant was married at the annuity starting date) and received responses from each such individual before requesting consideration under VCS. In the event that participant and/or spousal consent is required but cannot be obtained, the participant must receive a qualified joint and survivor annuity based on the monthly amount that would have been provided under the plan at his or her retirement date. This annuity may be actuarially reduced to take into account distributions already received by the participant. However, the portion of the qualified joint and survivor annuity payable to the spouse upon the death of the participant may not be actuarially reduced to take into account prior distributions to the participant. Thus, for example, if in accordance with the automatic qualified joint and survivor annuity option under a plan, a married participant who retired would have received a qualified joint and survivor annuity of $600 per month payable for life with $300 per month payable to the spouse upon the participant's death but instead received a single-sum distribution equal to the actuarial present value of the participant's accrued benefit under the plan, then the $600 monthly annuity payable during the participant's lifetime may be actuarially reduced to take the single-sum distribution into account. However, the spouse must be entitled to receive an annuity of $300 per month payable for life beginning at the participant's death.

.08 *Failure to satisfy the § 415 limits in a defined contribution plan*. The permitted correction for failure to limit annual additions (other than elective deferrals and employee contributions) allocated to participants in a defined contribution plan as required in § 415 (even if the excess did not result from the allocation of forfeitures or from a reasonable error in estimating compensation) is to place the excess annual additions into an unallocated account, similar to the suspense account described in § 1.415–6(b)(6)(iii), to be used as an employer contribution in the succeeding year(s). While such amounts remain in the unallocated account, the employer is not permitted to make additional contributions to the plan. The permitted VCS correction for failure to limit annual additions that are elective deferrals or employee contributions (even if the excess did not result from a reasonable error in determining the amount of elective deferrals or employee contributions that could be made with respect to an individual under the § 415 limits) is to distribute the elective deferrals or employee contributions

using a method similar to that described under § 1.415–6(b)(6)(iv). Elective deferrals and employee contributions that are matched may be returned, provided that the matching contributions relating to such contributions are forfeited (which will also reduce excess annual additions for the affected individuals). The forfeited matching contributions are to be placed into an unallocated account to be used as an employer contribution in succeeding periods.

## APPENDIX B

## CORRECTION METHODS AND EXAMPLES; EARNINGS ADJUSTMENT METHODS AND EXAMPLES

### SECTION 1. PURPOSE, ASSUMPTIONS FOR EXAMPLES AND SECTION REFERENCES

.01 *Purpose*. (1) This appendix sets forth correction methods relating to Operational Failures under Qualified Plans. This appendix also sets forth earnings adjustment methods. The correction methods and earnings adjustment methods described in this appendix are acceptable under SCP and VCP (including VCS, but not VCT).

(2) This appendix does not apply to 403(b) Plans or SEPs. Accordingly, sponsors of 403(b) Plans or SEPs cannot rely on the correction methods and the earnings adjustment methods under this appendix.

.02 *Assumptions for Examples*. Unless otherwise specified, for ease of presentation, the examples assume that:

(1) the plan year and the § 415 limitation year are the calendar year;

(2) the employer maintains a single plan intended to satisfy § 401(a) and has never maintained any other plan;

(3) in a defined contribution plan, the plan provides that forfeitures are used to reduce future employer contributions;

(4) the Qualification Failures are Operational Failures and the eligibility and other requirements for SCP, VCP or Audit CAP, whichever applies, are satisfied; and

(5) there are no Qualification Failures other than the described Operational Failures, and if a corrective action would result in any additional Qualification Failure, appropriate corrective action is taken for that additional Qualification Failure in accordance with EPCRS.

.03 *Section References*. References to section 2 and section 3 are references to the section 2 and 3 in this appendix.

### SECTION 2. CORRECTION METHODS AND EXAMPLES

.01 *ADP/ACP Failures*.

(1) *Correction Methods*. (a) VCS Correction Method. Appendix A, section .03 sets forth the VCS correction method for a failure to satisfy the actual deferral percentage ("ADP"), actual contribution percentage ("ACP"), or multiple use test set forth in §§ 401(k)(3), 401(m)(2), and 401(m)(9), respectively.

(b) One-to-One Correction Method. (i) General. In addition to the VCS correction method, a failure to satisfy the ADP, ACP, or multiple use test may be corrected using the one-to-one correction method set forth in this section 2.01(1)(b). Under the one-to-one correction method, an excess contribution amount is determined and assigned to highly compensated employees as provided in paragraph (1)(b)(ii) below. That excess contribution amount (adjusted for earnings) is either distributed to the highly compensated employees or forfeited from the highly compensated employees' accounts as provided in paragraph (1)(b)(iii) below. That same dollar amount (*i.e.*, the excess contribution amount, adjusted for earnings) is contributed to the plan and allocated to nonhighly compensated employees as provided in paragraph (1)(b)(iv) below. Under this correction method, a plan may not be treated as two separate plans, one covering otherwise excludable employees and the other covering all other employees (as permitted in § 1.410(b)–6(b)(3)). Likewise, restructuring the plan into component plans under § 1.401(k)–1(h)(3)(iii) is not permitted.

(ii) Determination of the Excess Contribution Amount. The excess contribution amount for the year is equal to the excess of (A) the sum of the excess contributions (as defined in § 401(k)(8)(B)), the excess aggregate contributions (as defined in § 401(m)(6)(B)), and the amount treated as excess contributions or excess aggregate contributions under the multiple use test pursuant to § 401(m)(9) and § 1.401(m)–2(c) for the year, as assigned to each highly compensated employee in accordance with § 401(k)(8)(C) and (m)(6)(C), over (B) previous corrections that complied with § 401(k)(8), (m)(6), and (m)(9). See Notice 97–2, 1997–1 C.B. 348.

(iii) Distributions and Forfeitures of the Excess Contribution Amount. (A) The portion of the excess contribution amount assigned to a particular highly compensated employee under paragraph (1)(b)(ii) is adjusted for earnings through the date of correction. The amount assigned to a particular highly compensated employee, as adjusted, is distributed or, to the extent the amount was forfeitable as of the close of the plan year of the failure, is forfeited. If the amount is forfeited, it is used in accordance with the plan provisions relating to forfeitures that were in effect for the year of the failure. If the amount so assigned to a particular highly compensated employee has been previously distributed; the amount is an Excess Amount within the meaning of section 5.01(3) of this revenue procedure. Thus, pursuant to section 6.05 of this revenue procedure, the employer must notify the employee that the Excess Amount was not eligible for favorable tax treatment accorded to distributions from qualified plans (and, specifically, was not eligible for tax-free rollover).

(B) If any matching contributions (adjusted for earnings) are forfeited in accordance with § 411(a)(3)(G), the forfeited amount is used in accordance with the plan provisions relating to forfeitures that were in effect for the year of the failure.

(C) If a payment was made to an employee and that payment is a forfeitable match described in either paragraph (1)(b)(iii)(A) or (B), then it is an Overpayment defined in section 5.01(6) of this revenue procedure that must be corrected (see sections 2.04 and 2.05 below).

(iv) Contribution and Allocation of Equivalent Amount. (A) The employer makes a contribution to the plan that is equal to the aggregate amounts distributed and forfeited under paragraph (1)(b)(iii)(A) (*i.e.*, the excess contribution amount adjusted for earnings, as provided in paragraph (1)(b)(iii)(A), which does not include any matching contributions forfeited in accordance with § 411(a)

(3)(G) as provided in paragraph (1)(b)(iii)(B)). The contribution must satisfy the vesting requirements and distribution limitations of § 401(k)(2)(B) and (C).

(B)(*1*) This paragraph (1)(b)(iv)(B)(*1*) applies to a plan that uses the current year testing method described in Notice 98–1, 1998–1 C.B. 327. The contribution made under paragraph (1)(b)(iv)(A) is allocated to the account balances of those individuals who were either (I) the eligible employees for the year of the failure who were not highly compensated employees for that year or (II) the eligible employees for the year of the failure who were not highly compensated employees for that year and who also are not highly compensated employees for the year of correction. Alternatively, the contribution is allocated to account balances of eligible employees described in (I) or (II) of the preceding sentence, except that the allocation is made only to the account balances of those employees who are employees on a date during the year of the correction that is no later than the date of correction. Regardless of which of these four options (described in the two preceding sentences) the employer selects, the contribution is allocated to each such employee either as the same percentage of the employee's compensation for the year of the failure or as the same dollar amount for each employee. (See Examples 1, 2 and 3.) Under the one-to-one correction method, the amount allocated to the account balance of an employee (*i.e*, the employee's share of the total amount contributed under paragraph (1)(b)(iv)(A)) is not further adjusted for earnings and is treated as an annual addition under § 415 for the year of the failure for the employee for whom it is allocated.

(*2*) This paragraph (1)(b)(iv)(B)(*2*) applies to a plan that uses the prior year testing method described in Notice 98–1. Paragraph (1)(b)(iv)(B)(*1*) is applied by substituting "the year prior to the year of the failure" for "the year of the failure".

(2) *Examples*.

*Example 1*:

Employer A maintains a profit-sharing plan with a cash or deferred arrangement that is intended to satisfy § 401(k) ("401(k) plan") using the current year testing method described in Notice 98–1. The plan does not provide for matching contributions or employee after-tax contributions. In 1999, it was discovered that the ADP test for 1997 was not performed correctly. When the ADP test was performed correctly, the test was not satisfied for 1997. For 1997, the ADP for highly compensated employees was 9% and the ADP for nonhighly compensated employees was 4%. Accordingly, the ADP for highly compensated employees exceeded the ADP for nonhighly compensated employees by more than two percentage points (in violation of § 401(k)(3)). (The ADP for nonhighly compensated employees for 1996 also was 4%, so the ADP test for 1997 would not have been satisfied even if the plan had used the prior year testing method described in Notice 98–1.) There were two highly compensated employees eligible under the 401(k) plan during 1997, Employee P and Employee Q. Employee P made elective deferrals of $8,000, which is equal to 10% of Employee P's compensation of $80,000 for 1997. Employee Q made elective deferrals of $9,500, which is equal to 8% of Employee Q's compensation of $118,750 for 1997.

*Correction*:

On June 30, 1999, Employer A uses the one-to-one correction method to correct the failure to satisfy the ADP test for 1997. Accordingly, Employer A calculates the dollar amount of the excess contributions for the two highly compensated employees in the manner described in § 401(k)(8)(B). The amount of the excess contribution for Employee P is $3,200 (4% of $80,000) and the amount of the excess contribution for Employee Q is $2,375 (2% of $118,750), or a total of $5,575. In accordance with § 401(k)(8)(C), $5,575, the excess contribution amount, is assigned $2,037.50 to Employee P and $3,537.50 to Employee Q. It is determined that the earnings on the assigned amounts through June 30, 1999, are $407 and $707 for Employees P and Q, respectively. The assigned amounts and the earnings are distributed to Employees P and Q. Therefore, Employee P receives $2,444.50 ($2,037.50 + $407) and Employee Q receives $4,244.50 ($3,537.50 + $707). In addition, on the same date, a corrective contribution is made to the 401(k) plan equal to $6,689 (the sum of the $2,444.50 distributed to Employee P and the $4,244.50 distributed to Employee Q). The corrective contribution is allocated to the account balances of eligible nonhighly compensated employees for 1997, *pro rata* based on their compensation for 1997 (subject to § 415 for 1997).

*Example 2*:

The facts are the same as in Example 1.

*Correction*:

The correction is the same as in Example 1, except that the corrective contribution of $6,689 is allocated in an equal dollar amount to the account balances of eligible nonhighly compensated employees for 1997 who are employees on June 30, 1999, and who are nonhighly compensated employees for 1999 (subject to § 415 for 1997).

*Example 3*:

The facts are the same as in Example 1, except that for 1997 the plan also provides (1) for employee after-tax contributions and (2) for matching contributions equal to 50% of the sum of an employee's elective deferrals and employee after-tax contributions that do not exceed 10% of the employee's compensation. The plan provides that matching contributions are subject to the plan's 5-year graded vesting schedule and that matching contributions are forfeited and used to reduce employer contributions if associated elective deferrals or employee after-tax contributions are distributed to correct an ADP, ACP or multiple use test failure. For 1997, nonhighly compensated employees made employee after-tax contributions and no highly compensated employee made any employee after-tax contributions. Employee P received a matching contribution of $4,000 (50% of $8,000) and Employee Q received a matching contribution of $4,750 (50% of $9,500). Employees P and Q were 100% vested in 1997. It is determined that, for 1997, the ACP for highly compensated employees was not more than 125% of the ACP for nonhighly compensated employees, so that the ACP and multiple use tests would have been satisfied for 1997 without any corrective action.

*Correction*:

The same corrective actions are taken as in Example 1. In addition, in accordance with the plan's terms, corrective action is taken to forfeit Employee P's and Employee Q's matching contributions associated with their distributed excess contributions. Employee P's distributed excess contributions and associated matching contributions are $2,037.50 and $1,018.75, respectively. Employee Q's distributed excess contributions and associated matching contributions are $3,537.50 and $1,768.75, respectively. Thus, $1,018.75 is forfeited from Employee P's account and $1,768.75 is forfeited from Employee Q's account. In addition, the earnings on the forfeited amounts are also forfeited. It is determined that the respective earnings on the forfeited amount for Employee P is $150 and for Employee Q is $204. The total amount of the forfeitures of $3,141.50 (Employee P's $1,018.75 + $150 and Employee Q's $1,768.75 + $204) is used to reduce contributions for 1999 and subsequent years.

.02 *Exclusion of Eligible Employees*.

(1) Exclusion of Eligible Employees in a 401(k) or (m) Plan. (a) Correction Method. (i) VCS Correction Method for Full Year Exclusion. Appendix A, section .05 sets forth the VCS correction method for the exclusion of an eligible employee from all contributions under a 401(k) or (m) plan for one or more full plan years. (See Example 4.) In section 2.02(1)(a)(ii)

below, the VCS correction method for the exclusion of an eligible employee from all contributions under a 401(k) or (m) plan for a full year is expanded to include correction for the exclusion of an eligible employee from all contributions under a 401(k) or (m) plan for a partial plan year. This correction for a partial year exclusion may be used in conjunction with the correction for a full year exclusion.

(ii) Expansion of VCS Correction Method to Partial Year Exclusion. (A) In General. The correction method in Appendix A, section .05 is expanded to cover an employee who was improperly excluded from making elective deferrals or employee after-tax contributions for a portion of a plan year or from receiving matching contributions (on either elective deferrals or employee after-tax contributions) for a portion of a plan year. In such case, a permitted correction method for the failure is for the employer to satisfy this section 2.02(1)(a)(ii). The employer makes a corrective contribution on behalf of the excluded employee that satisfies the vesting requirements and distribution limitations of § 401(k)(2)(B) and (C).

(B) Elective Deferral Failures. The appropriate corrective contribution for the failure to allow employees to make elective deferrals for a portion of the plan year is equal to the ADP of the employee's group (either highly or nonhighly compensated), determined prior to correction under this section 2.02(1)(a)(ii), multiplied by the employee's plan compensation for the portion of the year during which the employee was improperly excluded. The corrective contribution for the portion of the plan year during which the employee was improperly excluded from being eligible to make elective deferrals is reduced to the extent that (*1*) the sum of that contribution and any elective deferrals actually made by the employee for that year would exceed (*2*) the maximum elective deferrals permitted under the plan for the employee for that plan year (including the § 402(g) limit). The corrective contribution is adjusted for earnings. (See Examples 5 and 6.)

(C) Employee After-tax and Matching Contribution Failures. The appropriate corrective contribution for the failure to allow employees to make employee after-tax contributions or to receive matching contributions because the employee was precluded from making employee after-tax contributions or elective deferrals for a portion of the plan year is equal to the ACP of the employee's group (either highly or nonhighly compensated), determined prior to correction under this section 2.02(1)(a)(ii), multiplied by the employee's plan compensation for the portion of the year during which the employee was improperly excluded. The corrective contribution is reduced to the extent that (*1*) the sum of that contribution and the actual total employee after-tax and matching contributions made by and for the employee for the plan year would exceed (*2*) the sum of the maximum employee after-tax contributions permitted under the plan for the employee for the plan year and the matching contributions that would have been made if the employee had made the maximum matchable contributions permitted under the plan for the employee for that plan year. The corrective contribution is adjusted for earnings.

(D) Use of Prorated Compensation. For purposes of this paragraph (1)(a)(ii), for administrative convenience, in lieu of using the employee's actual plan compensation for the portion of the year during which the employee was improperly excluded, a *pro rata* portion of the employee's plan compensation that would have been taken into account for the plan year, if the employee had not been improperly excluded, may be used.

(E) Special Rule for Brief Exclusion from Elective Deferrals. An employer is not required to make a corrective contribution with respect to elective deferrals, as provided in section 2.02(1)(a)(ii)(B), (but is required to make a corrective contribution with respect to any employee after-tax and matching contributions, as provided in section 2.02(1)(a)(ii)(C)) for an employee for a plan year if the employee has been provided the opportunity to make elective deferrals under the plan for a period of at least the last 9 months in that plan year and during that period the employee had the opportunity to make elective deferrals in an amount not less than the maximum amount that would have been permitted if no failure had occurred. (See Example 7.)

(b) Examples.

*Example 4*:

Employer B maintains a 401(k) plan. The plan provides for matching contributions for eligible employees equal to 100% of elective deferrals that do not exceed 3% of an employee's compensation. The plan provides that employees who complete one year of service are eligible to participate in the plan on the next January 1 or July 1 entry date. Twelve employees (8 nonhighly compensated employees and 4 highly compensated employees) who had met the one year eligibility requirement after July 1, 1995, and before January 1, 1996, were inadvertently excluded from participating in the plan beginning on January 1, 1996. These employees were offered the opportunity to begin participating in the plan on January 1, 1997. For 1996, the ADP for the highly compensated employees was 8% and the ADP for the nonhighly compensated employees was 6% . In addition, for 1996, the ACP for the highly compensated employees was 2.5% and the ACP for the nonhighly compensated employees was 2% . The failure to include the 12 employees was discovered during 1998.

*Correction*:

Employer B uses the VCS correction method for full year exclusions to correct the failure to include the 12 eligible employees in the plan for the full plan year beginning January 1, 1996. Thus, Employer B makes a corrective contribution (that satisfies the vesting requirements and distribution limitations of § 401(k)(2)(B) and (C)) for each of the excluded employees. The contribution for each of the improperly excluded highly compensated employees is 10.5% (the highly compensated employees' ADP of 8% plus ACP of 2.5% ) of the employee's plan compensation for the 1996 plan year (adjusted for earnings). The contribution for each of the improperly excluded nonhighly compensated employees is 8% (the nonhighly compensated employees' ADP of 6% plus ACP of 2% ) of the employee's plan compensation for the 1996 plan year (adjusted for earnings).

*Example 5*:

Employer C maintains a 401(k) plan. The plan provides for matching contributions for each payroll period that are equal to 100% of an employee's elective deferrals that do not exceed 2% of the eligible employee's plan compensation during the payroll period. The plan does not provide for employee after-tax contributions. The plan provides that employees who complete one year of service are eligible to participate in the plan on the next January 1 or July 1 entry date. A nonhighly compensated employee who met the eligibility requirements and should have entered the plan on January 1, 1996, was not offered the opportunity to participate in the plan. In August of 1996, the error was discovered and Employer C offered the employee an election opportunity as of September 1, 1996. The employee made elective deferrals equal to 4% of the employee's plan compensation for each payroll period from September 1, 1996, through

December 31, 1996 (resulting in elective deferrals of $500). The employee's plan compensation for 1996 was $36,000 ($23,500 for the first eight months and $12,500 for the last four months). Employer C made matching contributions equal to $250 for the excluded employee, which is 2% of the employee's plan compensation for each payroll period from September 1, 1996, through December 31, 1996 ($12,500). The ADP for nonhighly compensated employees for 1996 was 3% and the ACP for nonhighly compensated employees for 1996 was 1.8% .

*Correction*:

Employer C uses the VCS correction method for partial year exclusions to correct the failure to include the eligible employee in the plan. Thus, Employer C makes a corrective contribution (that satisfies the vesting requirements and distribution limitations of § 401(k)(2)(B) and (C)) for the excluded employee. In determining the amount of corrective contributions (both for the elective deferral and for the matching contribution), for administrative convenience, in lieu of using actual plan compensation of $23,500 for the period the employee was excluded, the employee's annual plan compensation is pro rated for the eight-month period that the employee was excluded from participating in the plan. The failure to provide the excluded employee the right to make elective deferrals is corrected by the employer making a corrective contribution on behalf of the employee that is equal to $720 (the 3% ADP percentage for nonhighly compensated employees multiplied by $24,000, which is 8/12ths of the employee's 1996 plan compensation of $36,000), adjusted for earnings. In addition, to correct for the failure to receive the plan's matching contribution, a corrective contribution is made on behalf of the employee that is equal to $432 (the 1.8% ACP for the nonhighly compensated group multiplied by $24,000, which is 8/12ths of the employee's 1996 plan compensation of $36,000), adjusted for earnings. Employer C determines that $682, the sum of the actual matching contribution received by the employee for the plan year ($250) and the corrective contribution to correct the matching contribution failure ($432), does not exceed $720, the maximum matching contribution available to the employee under the plan (2% of $36,000) determined as if the employee had made the maximum matchable contributions. In addition to correcting the failure to include the eligible employee in the plan, Employer C reruns the ADP and ACP tests for 1996 (taking into account the corrective contribution and plan compensation for 1996 for the excluded employee) and determines that the tests were satisfied.

*Example 6*:

The facts are the same as in Example 5, except that the plan provides for matching contributions that are equal to 100% of an eligible employee's elective deferrals that do not exceed 2% of the employee's plan compensation for the plan year. Accordingly, the actual matching contribution made by Employer C for the excluded employee for the last four months of 1996 is $500 (which is equal to 100% of the $500 of elective deferrals made by the employee for the last four months of 1996).

*Correction*:

The correction is the same as in Example 5, except that the corrective contribution made for the first 8 months of 1996 to correct the failure to make matching contributions is equal to $220 (adjusted for earnings), instead of the $432 (adjusted for earnings) in Example 5, because the corrective contribution is limited to the maximum matching contributions available under the plan for the employee for the plan year, $720 (2% of $36,000), reduced by the actual matching contributions made for the employee for the plan year, $500.

*Example 7*:

The facts are the same as in Example 5, except that the error is discovered in March of 1996 and the employee was given the opportunity to make elective deferrals beginning on April 1, 1996. The amount of elective deferrals that the employee was given the opportunity to make during 1996 was not less than the maximum elective deferrals that the employee could have made if the employee had been given the opportunity to make elective deferrals beginning on January 1, 1996. The employee made elective deferrals equal to 4% of the employee's plan compensation for each payroll period from April 1, 1996, through December 31, 1996, of $28,000 (resulting in elective deferrals of $1,120). Employer C made a matching contribution equal to $560, which is 2% of the employee's plan compensation for each payroll period from April 1, 1996, through December 31, 1996 ($28,000). The employee's plan compensation for 1996 was $36,000 ($8,000 for the first three months and $28,000 for the last nine months).

*Correction*:

Employer C uses the VCS correction method for partial year exclusions to correct the failure to include an eligible employee in the plan. Because the employee was given an opportunity to make elective deferrals to the plan for at least the last 9 months of the plan year (and the amount of the elective deferrals that the employee had the opportunity to make was not less than the maximum elective deferrals that the employee could have made if the employee had been given the opportunity to make elective deferrals beginning on January 1, 1996), under the special rule set forth in section 2.02(1)(a)(ii)(E), Employer C is not required to make a corrective contribution for the failure to allow the employee to make elective deferrals. In determining the amount of corrective contribution with respect to the failure to allow the employee to receive matching contributions, in lieu of using actual plan compensation of $8,000 for the period the employee was excluded, the employee's annual plan compensation is pro rated for the three-month period that the employee was excluded from participating in the plan. Accordingly, a corrective contribution is made on behalf of the employee that is equal to $160, which is the lesser of (i) $162 (a matching contribution of 1.8% of $9,000, which is 3/12ths of the employee's 1996 plan compensation of $36,000), and (ii) $160 (the excess of the maximum matching contribution for the entire plan year, which is equal to 2% of $36,000, or $720, over the matching contributions made after March 31, 1996, $560). The contribution is adjusted for earnings.

(2) Exclusion of Eligible Employees In a Profit-Sharing Plan.

(a) Correction Methods. (i) VCS Correction Method. Appendix A, section .05 sets forth the VCS correction method for correcting the exclusion of an eligible employee. In the case of a defined contribution plan, the VCS correction method is to make a contribution on behalf of the excluded employee. Section 2.02(2)(a)(ii) below clarifies the VCS correction method in the case of a profit-sharing or stock bonus plan that provides for nonelective contributions (within the meaning of § 1.401(k)–1(g)(10)).

(ii) Clarification of VCS Correction Method for Profit-Sharing Plans. To correct for the exclusion of an eligible employee from nonelective contributions in a profit-sharing or stock bonus plan under the VCS correction method, an allocation amount is determined for each excluded employee on the same basis as the allocation amounts were determined for the other employees under the plan's allocation formula (*e.g.*, the same ratio of allocation to compensation), taking into account all of the employee's relevant factors (*e.g.*, compensation) under that formula for that year. The employer makes a corrective contribution on behalf of the excluded employee that is equal to the allocation amount for the excluded employee. The corrective contribution is adjusted for earnings. If, as a result of excluding an employee, an amount was improperly allocated to the account balance of an eligible employee who shared in the original allocation of the nonelective contribution, no reduction is made to the account balance of the employee who shared in the original allocation on account of the improper allocation. (See Example 8.)

(iii) Reallocation Correction Method. (A) In General. Subject to the limitations set forth in section 2.02(2)(a)(iii)(F) below, in addition to the VCS correction method, the exclusion of an eligible employee for a plan year from

a profit-sharing or stock bonus plan that provides for nonelective contributions may be corrected using the reallocation correction method set forth in this section 2.02(2)(a)(iii). Under the reallocation correction method, the account balance of the excluded employee is increased as provided in paragraph (2)(a)(iii)(B) below, the account balances of other employees are reduced as provided in paragraph (2)(a)(iii)(C) below, and the increases and reductions are reconciled, as necessary, as provided in paragraph (2)(a)(iii)(D) below. (See Examples 9 and 10.)

(B) Increase in Account Balance of Excluded Employee. The account balance of the excluded employee is increased by an amount that is equal to the allocation the employee would have received had the employee shared in the allocation of the nonelective contribution. The amount is adjusted for earnings.

(C) Reduction in Account Balances of Other Employees. (*1*) The account balance of each employee who was an eligible employee who shared in the original allocation of the nonelective contribution is reduced by the excess, if any, of (I) the employee's allocation of that contribution over (II) the amount that would have been allocated to that employee had the failure not occurred. This amount is adjusted for earnings taking into account the rules set forth in section 2.02(2)(a)(iii)(C)(*2*) and (*3*) below. The amount after adjustment for earnings is limited in accordance with section 2.02(2)(a)(iii)(C)(*4*) below.

(*2*) This paragraph (2)(a)(iii)(C)(*2*) applies if most of the employees with account balances that are being reduced are nonhighly compensated employees. If there has been an overall gain for the period from the date of the original allocation of the contribution through the date of correction, no adjustment for earnings is required to the amount determined under section 2.02(2)(a)(iii)(C)(*1*) for the employee. If the amount for the employee is being adjusted for earnings and the plan permits investment of account balances in more than one investment fund, for administrative convenience, the reduction to the employee's account balance may be adjusted by the lowest earnings rate of any fund for the period from the date of the original allocation of the contribution through the date of correction.

(*3*) If an employee's account balance is reduced and the original allocation was made to more than one investment fund or there was a subsequent distribution or transfer from the fund receiving the original allocation, then reasonable, consistent assumptions are used to determine the earnings adjustment.

(*4*) The amount determined in section 2.02(2)(a)(iii)(C)(*1*) for an employee after the application of section 2.02(2)(a)(iii)(C)(*2*) and (*3*) may not exceed the account balance of the employee on the date of correction, and the employee is permitted to retain any distribution made prior to the date of correction.

(D) Reconciliation of Increases and Reductions. If the aggregate amount of the increases under section 2.02(2)(a)(iii)(B) exceeds the aggregate amount of the reductions under section 2.02(2)(a)(iii)(C), the employer makes a corrective contribution to the plan for the amount of the excess. If the aggregate amount of the reductions under section 2.02(2)(a)(iii)(C) exceeds the aggregate amount of the increases under section 2.02(2)(a)(iii)(B), then the amount by which each employee's account balance is reduced under section 2.02(2)(a)(iii)(C) is decreased on a *pro rata* basis.

(E) Reductions Among Multiple Investment Funds. If an employee's account balance is reduced and the employee's account balance is invested in more than one investment fund, then the reduction may be made from the investment funds selected in any reasonable manner.

(F) Limitations on Use of Reallocation Correction Method. If any employee would be permitted to retain any distribution pursuant to section 2.02(2)(a)(iii)(C)(*4*), then the reallocation correction method may not be used unless most of the employees who would be permitted to retain a distribution are nonhighly compensated employees.

(b) Examples.

*Example 8*:

Employer D maintains a profit-sharing plan that provides for discretionary nonelective employer contributions. The plan provides that the employer's contributions are allocated to account balances in the ratio that each eligible employee's compensation for the plan year bears to the compensation of all eligible employees for the plan year and, therefore, the only relevant factor for determining an allocation is the employee's compensation. The plan provides for self-directed investments among four investment funds and daily valuations of account balances. For the 1997 plan year, Employer D made a contribution to the plan of a fixed dollar amount. However, five employees who met the eligibility requirements were inadvertently excluded from participating in the plan. The contribution resulted in an allocation on behalf of each of the eligible employees, other than the excluded employees, equal to 10% of compensation. Most of the employees who received allocations under the plan for the year of the failure were nonhighly compensated employees. No distributions have been made from the plan since 1997. If the five excluded employees had shared in the original allocation, the allocation made on behalf of each employee would have equaled 9% of compensation. The excluded employees began participating in the plan in the 1998 plan year.

*Correction*:

Employer D uses the VCS correction method to correct the failure to include the five eligible employees. Thus, Employer D makes a corrective contribution to the plan. The amount of the corrective contribution on behalf of the five excluded employees for the 1997 plan year is equal to 10% of compensation of each excluded employee, the same allocation that was made for other eligible employees, adjusted for earnings. The excluded employees receive an allocation equal to 10% of compensation (adjusted for earnings) even though, had the excluded employees originally shared in the allocation for the 1997 contribution, their account balances, as well as those of the other eligible employees, would have received an allocation equal to only 9% of compensation.

*Example 9*:

The facts are the same as in Example 8.

*Correction*:

Employer D uses the reallocation correction method to correct the failure to include the five eligible employees. Thus, the account balances are adjusted to reflect what would have resulted from the correct allocation of the employer contribution for the 1997 plan year among all eligible employees, including the five excluded employees. The inclusion of the excluded employees in the allocation of that contribution would have resulted in each eligible employee, including each excluded employee, receiving an allocation equal to 9% of compensation. Accordingly, the account balance of each excluded employee is increased by 9% of the employee's 1997 compensation, adjusted for earnings. The account balance of each of the eligible employees other than the excluded employees is reduced by 1% of the employee's 1997 compensation, adjusted for earnings. Employer D determines the adjustment for earnings using the earnings rate of each eligible employee's excess

allocation (using reasonable, consistent assumptions). Accordingly, for an employee who shared in the original allocation and directed the investment of the allocation into more than one investment fund or who subsequently transferred a portion of a fund that had been credited with a portion of the 1997 allocation to another fund, reasonable, consistent assumptions are followed to determine the adjustment for earnings. It is determined that the total of the initially determined reductions in account balances exceeds the total of the required increases in account balances. Accordingly, these initially determined reductions are decreased *pro rata* so that the total of the actual reductions in account balances equals the total of the increases in the account balances, and Employer D does not make any corrective contribution. The reductions from the account balances are made on a *pro rata* basis among all of the funds in which each employee's account balance is invested.

*Example 10*:

The facts are the same as in Example 8.

*Correction*:

The correction is the same as in Example 9, except that, because most of the employees whose account balances are being reduced are nonhighly compensated employees, for administrative convenience, Employer D uses the earnings rate of the fund with the lowest earnings rate for the period of the failure to adjust the reduction to each account balance. It is determined that the aggregate amount (adjusted for earnings) by which the account balances of the excluded employees is increased exceeds the aggregate amount (adjusted for earnings) by which the other employees' account balances are reduced. Accordingly, Employer D makes a contribution to the plan in an amount equal to the excess. The reduction from account balances is made on a *pro rata* basis among all of the funds in which each employee's account balance is invested.

.03 *Vesting Failures*.

(1) Correction Methods. (a) Contribution Correction Method. A failure in a defined contribution plan to apply the proper vesting percentage to an employee's account balance that results in forfeiture of too large a portion of the employee's account balance may be corrected using the contribution correction method set forth in this paragraph. The employer makes a corrective contribution on behalf of the employee whose account balance was improperly forfeited in an amount equal to the improper forfeiture. The corrective contribution is adjusted for earnings. If, as a result of the improper forfeiture, an amount was improperly allocated to the account balance of another employee, no reduction is made to the account balance of that employee. (See Example 11.)

(b) Reallocation Correction Method. In addition to the contribution correction method, in a defined contribution plan under which forfeitures of account balances are reallocated among the account balances of the other eligible employees in the plan, a failure to apply the proper vesting percentage to an employee's account balance which results in forfeiture of too large a portion of the employee's account balance may be corrected under the reallocation correction method set forth in this paragraph. A corrective reallocation is made in accordance with the reallocation correction method set forth in section 2.02(2)(a)(iii), subject to the limitations set forth in section 2.02(2)(a)(iii)(F). In applying section 2.02(2)(a)(iii)(B), the account balance of the employee who incurred the improper forfeiture is increased by an amount equal to the amount of the improper forfeiture and the amount is adjusted for earnings. In applying section 2.02(2)(a)(iii)(C)(*1*), the account balance of each employee who shared in the allocation of the improper forfeiture is reduced by the amount of the improper forfeiture that was allocated to that employee's account. The earnings adjustments for the account balances that are being reduced are determined in accordance with sections 2.02(2)(a)(iii)(C)(*2*) and (*3*) and the reductions after adjustments for earnings are limited in accordance with section 2.02(2)(a)(iii)(C)(*4*). In accordance with section 2.02(2)(a)(iii)(D), if the aggregate amount of the increases exceeds the aggregate amount of the reductions, the employer makes a corrective contribution to the plan for the amount of the excess. In accordance with section 2.02(2)(a)(iii)(D), if the aggregate amount of the reductions exceeds the aggregate amount of the increases, then the amount by which each employee's account balance is reduced is decreased on a *pro rata* basis. (See Example 12.)

(2) Examples.

*Example 11*:

Employer E maintains a profit-sharing plan that provides for nonelective contributions. The plan provides for self-directed investments among four investment funds and daily valuation of account balances. The plan provides that forfeitures of account balances are reallocated among the account balances of other eligible employees on the basis of compensation. During the 1997 plan year, Employee R terminated employment with Employer E and elected and received a single-sum distribution of the vested portion of his account balance. No other distributions have been made since 1997. However, an incorrect determination of Employee R's vested percentage was made resulting in Employee R receiving a distribution of less than the amount to which he was entitled under the plan. The remaining portion of Employee R's account balance was forfeited and reallocated (and these reallocations were not affected by the limitations of § 415). Most of the employees who received allocations of the improper forfeiture were nonhighly compensated employees.

*Correction*:

Employer E uses the contribution correction method to correct the improper forfeiture. Thus, Employer E makes a contribution on behalf of Employee R equal to the incorrectly forfeited amount (adjusted for earnings) and Employee R's account balance is increased accordingly. No reduction is made from the account balances of the employees who received an allocation of the improper forfeiture.

*Example 12*:

The facts are the same as in Example 11.

*Correction*:

Employer E uses the reallocation correction method to correct the improper forfeiture. Thus, Employee R's account balance is increased by the amount that was improperly forfeited (adjusted for earnings). The account of each employee who shared in the allocation of the improper forfeiture is reduced by the amount of the improper forfeiture that was allocated to that employee's account (adjusted for earnings). Because most of the employees whose account balances are being reduced are nonhighly compensated employees, for administrative convenience, Employer E uses the earnings rate of the fund with the lowest earnings rate for the period of the failure to adjust the reduction to each account balance. It is determined that the amount (adjusted for earnings) by which the account balance of Employee R is increased exceeds the aggregate amount (adjusted for earnings) by which the other employees' account balances are reduced. Accordingly, Employer E makes a contribution to the plan in an amount equal to the excess. The reduction from the account balances is made on a *pro rata* basis among all of the funds in which each employee's account balance is invested.

.04 *§ 415 Failures*.

(1) Failures Relating to a § 415(b) Excess.

(a) Correction Methods. (i) Return of Overpayment Correction Method. Overpayments as a result of amounts being paid in excess of the limits of

§ 415(b) may be corrected using the return of Overpayment correction method set forth in this paragraph (1)(a)(i). The employer takes reasonable steps to have the Overpayment (with appropriate interest) returned by the recipient to the plan and reduces future benefit payments (if any) due to the employee to reflect § 415(b). To the extent the amount returned by the recipient is less than the Overpayment, adjusted for earnings at the plan's earnings rate, then the employer or another person contributes the difference to the plan. In addition, in accordance with section 6.05 of this revenue procedure, the employer must notify the recipient that the Overpayment was not eligible for favorable tax treatment accorded to distributions from qualified plans (and, specifically, was not eligible for tax-free rollover). (See Examples 15 and 16.)

(ii) Adjustment of Future Payments Correction Method. (A) In General. In addition to the return of overpayment correction method, in the case of plan benefits that are being distributed in the form of periodic payments, Overpayments as a result of amounts being paid in excess of the limits in § 415(b) may be corrected by using the adjustment of future payments correction method set forth in this paragraph (1)(a)(ii). Future payments to the recipient are reduced so that they do not exceed the § 415(b) maximum limit and an additional reduction is made to recoup the Overpayment (over a period not longer than the remaining payment period) so that the actuarial present value of the additional reduction is equal to the Overpayment plus interest at the interest rate used by the plan to determine actuarial equivalence. (See Examples 13 and 14.)

(B) Joint and Survivor Annuity Payments. If the employee is receiving payments in the form of a joint and survivor annuity, with the employee's spouse to receive a life annuity upon the employee's death equal to a percentage (*e.g.*, 75% ) of the amount being paid to the employee, the reduction of future annuity payments to reflect § 415(b) reduces the amount of benefits payable during the lives of both the employee and spouse, but any reduction to recoup Overpayments made to the employee does not reduce the amount of the spouse's survivor benefit. Thus, the spouse's benefit will be based on the previous specified percentage (*e.g.*, 75% ) of the maximum permitted under § 415(b), instead of the reduced annual periodic amount payable to the employee.

(C) Overpayment Not Treated as an Excess Amount. An Overpayment corrected under this adjustment of future payment correction method is not treated as an Excess Amount as defined in section 5.01(3) of this revenue procedure.

(b) Examples.

*Example 13*:

Employer F maintains a defined benefit plan funded solely through employer contributions. The plan provides that the benefits of employees are limited to the maximum amount permitted under § 415(b), disregarding cost-of-living adjustments under § 415(d) after benefit payments have commenced. At the beginning of the 1998 plan year, Employee S retired and started receiving an annual straight life annuity of $140,000 from the plan. Due to an administrative error, the annual amount received by Employee S for 1998 included an Overpayment of $10,000 (because the § 415(b)(1)(A) limit for 1998 was $130,000). This error was discovered at the beginning of 1999.

*Correction*:

Employer F uses the adjustment of future payments correction method to correct the failure to satisfy the limit in § 415(b). Future annuity benefit payments to Employee S are reduced so that they do not exceed the § 415(b) maximum limit, and, in addition, Employee S's future benefit payments from the plan are actuarially reduced to recoup the Overpayment. Accordingly, Employee S's future benefit payments from the plan are reduced to $130,000 and further reduced by $1,000 annually for life, beginning in 1999. The annual benefit amount is reduced by $1,000 annually for life because, for Employee S, the actuarial present value of a benefit of $1,000 annually for life commencing in 1999 is equal to the sum of $10,000 and interest at the rate used by the plan to determine actuarial equivalence beginning with the date of the first Overpayment and ending with the date the reduced annuity payment begins. Thus, Employee S's remaining benefit payments are reduced so that Employee S receives $129,000 for 1999, and for each year thereafter.

*Example 14*:

The facts are the same as in Example 13.

*Correction*:

Employer F uses the adjustments of future payments correction method to correct the § 415(b) failure, by recouping the entire excess payment made in 1998 from Employee S's remaining benefit payments for 1999. Thus, Employee S's annual annuity benefit for 1999 is reduced to $119,400 to reflect the excess benefit amounts (increased by interest) that were paid from the plan to Employee S during the 1998 plan year. Beginning in 2000, Employee S begins to receive annual benefit payments of $130,000.

*Example 15*:

The facts are the same as in Example 13, except that the benefit was paid to Employee S in the form of a single-sum distribution in 1998, which exceeded the maximum § 415(b) limits by $110,000.

*Correction*:

Employer F uses the return of overpayment correction method to correct the § 415(b) failure. Thus, Employer F notifies Employee S of the $110,000 Overpayment and that the Overpayment was not eligible for favorable tax treatment accorded to distributions from qualified plans (and, specifically, was not eligible for tax-free rollover). The notice also informs Employee S that the Overpayment (with interest at the rate used by the plan to calculate the single-sum payment) is owed to the plan. Employer F takes reasonable steps to have the Overpayment (with interest at the rate used by the plan to calculate the single-sum payment) paid to the plan. Employee S pays the $110,000 (plus the requested interest) to the plan. It is determined that the plan's earnings rate for the relevant period was 2 percentage points more than the rate used by the plan to calculate the single-sum payment. Accordingly, Employer F contributes the difference to the plan.

Example 16:

The facts are the same as in Example 15.

*Correction*:

Employer F uses the return of overpayment correction method to correct the § 415(b) failure. Thus, Employer F notifies Employee S of the $110,000 Overpayment and that the Overpayment was not eligible for favorable tax treatment accorded to distributions from qualified plans (and, specifically, was not eligible for tax-free rollover). The notice also informs Employee S that the Overpayment (with interest at the rate used by the plan to calculate the single-sum payment) is owed to the plan. Employer F takes reasonable steps to have the Overpayment (with interest at the rate used by the plan to calculate the single-sum payment) paid to the plan. As a result of Employer F's recovery efforts, some, but not all, of the Overpayment (with interest) is recovered from Employee S. It is determined that the amount returned by Employee S to the plan is less than the Overpayment adjusted for earnings at the plan's earnings rate. Accordingly, Employer F contributes the difference to the plan.

(2) Failures Relating to a § 415(c) Excess.

(a) Correction Methods. (i) VCS Correction Method. Appendix A, section .08 sets forth the VCS correction method for correcting the failure to satisfy the § 415(c) limits on annual additions.

(ii) Forfeiture Correction Method. In addition to the VCS correction method, the failure to satisfy § 415(c) with respect to a nonhighly compensated employee (A) who in the limitation year of the failure had annual additions consisting of both (I) either elective deferrals or employee after-tax contributions or both and (II) either matching or nonelective contributions or both, (B) for whom the matching and nonelective contributions equal or exceed the portion of the employee's annual addition that exceeds the limits under § 415(c) ("§ 415(c) excess") for the limitation year, and (C) who has terminated with no vested interest in the matching and nonelective contributions (and has not been reemployed at the time of the correction), may be corrected by using the forfeiture correction method set forth in this paragraph. The § 415(c) excess is deemed to consist solely of the matching and nonelective contributions. If the employee's § 415(c) excess (adjusted for earnings) has previously been forfeited, the § 415(c) failure is deemed to be corrected. If the § 415(c) excess (adjusted for earnings) has not been forfeited, that amount is placed in an unallocated account, similar to the suspense account described in § 1.415–6(b)(6)(iii), to be used to reduce employer contributions in succeeding year(s) (or if the amount would have been allocated to other employees who were in the plan for the year of the failure if the failure had not occurred, then that amount is reallocated to the other employees in accordance with the plan's allocation formula). Note that while this correction method will permit more favorable tax treatment of elective deferrals for the employee than the VCS correction method, this correction method could be less favorable to the employee in certain cases, for example, if the employee is subsequently reemployed and becomes vested. (See Examples 17 and 18.)

(iii) Return of Overpayment Correction Method. A failure to satisfy § 415(c) that includes a distribution of the § 415(c) excess attributable to nonelective contributions and matching contributions may be corrected using the return of overpayment correction method set forth in this paragraph. The employer takes reasonable steps to have the Overpayment (*i.e.*, the distribution of the § 415(c) excess adjusted for earnings to the date of the distribution), plus appropriate interest from the date of the distribution to the date of the repayment, returned by the employee to the plan. To the extent the amount returned by the employee is less than the Overpayment adjusted for earnings at the plan's earnings rate, then the employer or another person contributes the difference to the plan. The Overpayment, adjusted for earnings at the plan's earnings rate to the date of the repayment, is to be placed in an unallocated account, similar to the suspense account described in § 1.415–6(b)(6)(iii), to be used to reduce employer contributions in succeeding year(s) (or if the amount would have been allocated to other eligible employees who were in the plan for the year of the failure if the failure had not occurred, then that amount is reallocated to the other eligible employees in accordance with the plan's allocation formula). In addition, the employer must notify the employee that the Overpayment was not eligible for favorable tax treatment accorded to distributions from qualified plans (and, specifically, was not eligible for tax-free rollover).

(b) Examples.

*Example 17*:

Employer G maintains a 401(k) plan. The plan provides for nonelective employer contributions, elective deferrals, and employee after-tax contributions. The plan provides that the nonelective contributions vest under a 5-year cliff vesting schedule. The plan provides that when an employee terminates employment, the employee's nonvested account balance is forfeited five years after a distribution of the employee's vested account balance and that forfeitures are used to reduce employer contributions. For the 1998 limitation year, the annual additions made on behalf of two nonhighly compensated employees in the plan, Employees T and U, exceeded the limit in § 415(c). For the 1998 limitation year, Employee T had § 415 compensation of $60,000, and, accordingly, a § 415(c)(1)(B) limit of $15,000. Employee T made elective deferrals and employee after-tax contributions. For the 1998 limitation year, Employee U had § 415 compensation of $40,000, and, accordingly, a § 415(c)(1)(B) limit of $10,000. Employee U made elective deferrals. Also, on January 1, 1999, Employee U, who had three years of service with Employer G, terminated his employment and received his entire vested account balance (which consisted of his elective deferrals). The annual additions for Employees T and U consisted of:

| | T | U |
|---|---|---|
| Nonelective Contributions | $7,500 | $4,500 |
| Elective Deferrals | 10,000 | 5,800 |
| After-tax Contributions | 500 | 0 |
| Total Contributions | $18,000 | $10,300 |
| § 415(c) Limit | $15,000 | $10,000 |
| § 415(c) Excess | $3,000 | $300 |

*Correction*:

Employer G uses the VCS correction method to correct the § 415(c) excess with respect to Employee T (*i.e.*, $3,000). Thus, a distribution of plan assets (and corresponding reduction of the account balance) consisting of $500 (adjusted for earnings) of employee after-tax contributions and $2,500 (adjusted for earnings) of elective deferrals is made to Employee T. Employer G uses the forfeiture correction method to correct the § 415(c) excess with

respect to Employee U. Thus, the § 415(c) excess is deemed to consist solely of the nonelective contributions. Accordingly, Employee U's nonvested account balance is reduced by $300 (adjusted for earnings) which is placed in an unallocated account, similar to the suspense account described in § 1.415–6(b)(6)(iii), to be used to reduce employer contributions in succeeding year(s). After correction, it is determined that the ADP and ACP tests for 1998 were satisfied.

*Example 18:*

Employer H maintains a 401(k) plan. The plan provides for nonelective employer contributions, matching contributions and elective deferrals. The plan provides for matching contributions that are equal to 100% of an employee's elective deferrals that do not exceed 8% of the employee's plan compensation for the plan year. For the 1998 limitation year, Employee V had § 415 compensation of $50,000, and, accordingly, a § 415(c)(1)(B) limit of $12,500. During that limitation year, the annual additions for Employee V totaled $15,000, consisting of $5,000 in elective deferrals, a $4,000 matching contribution (8% of $50,000), and a $6,000 nonelective employer contribution. Thus, the annual additions for Employee V exceeded the § 415(c) limit by $2,500.

*Correction*:

Employer H uses the VCS correction method to correct the § 415(c) excess with respect to Employee V (*i.e.*, $2,500). Accordingly, $1,000 of the unmatched elective deferrals (adjusted for earnings) are distributed to Employee V. The remaining $1,500 excess is apportioned equally between the elective deferrals and the associated matching employer contributions, so Employee V's account balance is further reduced by distributing to Employee V $750 (adjusted for earnings) of the elective deferrals and forfeiting $750 (adjusted for earnings) of the associated employer matching contributions. The forfeited matching contributions are placed in an unallocated account; similar to the suspense account described in § 1.415–6(b)(6)(iii), to be used to reduce employer contributions in succeeding year(s). After correction, it is determined that the ADP and ACP tests for 1998 were satisfied.

.05 *Correction of Other Overpayment Failures.*

An Overpayment, other than one described in section 2.04(1) (relating to a § 415(b) excess) or section 2.04(2) (relating to a § 415(c) excess), may be corrected in accordance with this section 2.05. An Overpayment from a defined benefit plan is corrected in accordance with the rules in section 2.04(1). An Overpayment from a defined contribution plan is corrected in accordance with the rules in section 2.04(2)(a)(iii).

.06 *§ 401(a)(17) Failures*.

(1) Reduction of Account Balance Correction Method. The allocation of contributions or forfeitures under a defined contribution plan for a plan year on the basis of compensation in excess of the limit under § 401(a)(17) for the plan year may be corrected using the reduction of account balance correction method set forth in this paragraph. The account balance of an employee who received an allocation on the basis of compensation in excess of the § 401(a)(17) limit is reduced by this improperly allocated amount (adjusted for earnings). If the improperly allocated amount would have been allocated to other employees in the year of the failure if the failure had not occurred, then that amount (adjusted for earnings) is reallocated to those employees in accordance with the plan's allocation formula. If the improperly allocated amount would not have been allocated to other employees absent the failure, that amount (adjusted for earnings) is placed in an unallocated account, similar to the suspense account described in § 1.415–6(b)(6)(iii), to be used to reduce employer contributions in succeeding year(s). For example, if a plan provides for a fixed level of employer contributions for each eligible employee, and the plan provides that forfeitures are used to reduce future employer contributions, the improperly allocated amount (adjusted for earnings) would be used to reduce future employer contributions. (See Example 19.) If a payment was made to an employee and that payment was attributable to an improperly allocated amount, then it is an Overpayment defined in section 5.01(6) of this revenue procedure that must be corrected (see sections 2.04 and 2.05).

(2) Example.

*Example 19*:

Employer J maintains a money purchase pension plan. Under the plan, an eligible employee is entitled to an employer contribution of 8% of the employee's compensation up to the § 401(a)(17) limit ($160,000 for 1998). During the 1998 plan year, an eligible employee, Employee W, inadvertently was credited with a contribution based on compensation above the § 401(a)(17) limit. Employee W's compensation for 1998 was $220,000. Employee W received a contribution of $17,600 for 1998 (8% of $220,000), rather than the contribution of $12,800 (8% of $160,000) provided by the plan for that year, resulting in an improper allocation of $4,800.

*Correction*:

The § 401(a)(17) failure is corrected using the reduction of account balance method by reducing Employee W's account balance by $4,800 (adjusted for earnings) and crediting that amount to an unallocated account, similar to the suspense account described in § 1.415–6(b)(6)(iii), to be used to reduce employer contributions in succeeding year(s).

.07 *Correction by Amendment Under VCP and SCP*.

(1) § 401(a)(17) Failures. (a) Contribution Correction Method. In addition to the reduction of account balance correction method under section 2.06 of this Appendix B, an employer may correct a § 401(a)(17) failure for a plan year under a defined contribution plan under VCP and SCP (in accordance with the requirements of sections 8, 10, and 11) by using the contribution correction method set forth in this paragraph. The employer contributes an additional amount on behalf of each of the other employees (excluding each employee for whom there was a § 401(a)(17) failure) who received an allocation for the year of the failure, amending the plan (as necessary) to provide for the additional allocation. The amount contributed for an employee is equal to the employee's plan compensation for the year of the failure multiplied by a fraction, the numerator of which is the improperly allocated amount made on behalf of the employee with the largest improperly allocated amount, and the denominator of which is the limit under § 401(a)(17) applicable to the year of the failure. The resulting additional amount for each of the other employees is adjusted for earnings. (See Example 20.)

(b) Examples.

*Example 20*:

The facts are the same as in Example 19.

*Correction*:

Employer J corrects the failure under VCP using the contribution correction method by (1) amending the plan to increase the contribution percentage for all eligible employees (other than Employee W) for the 1998 plan year and (2) contributing an additional amount (adjusted for earnings) for those employees for that plan year. To determine the increase in the plan's contribution percentage (and the additional amount contributed on behalf of each eligible employee), the improperly allocated amount ($4,800) is divided by the § 401(a)(17) limit for 1998 ($160,000). Accordingly, the plan is amended to increase the contribution percentage by 3 percentage points ($4,800/$160,000) from 8% to

11% . In addition, each eligible employee for the 1998 plan year (other than Employee W) receives an additional contribution of 3% multiplied by that employee's plan compensation for 1998. This additional contribution is adjusted for earnings.

(2) Hardship Distribution Failures. (a) Plan Amendment Correction Method. The Operational Failure of making hardship distributions to employees under a plan that does not provide for hardship distributions may be corrected under VCP and SCP using the plan amendment correction method set forth in this paragraph. The plan is amended retroactively to provide for the hardship distributions that were made available. This paragraph does not apply unless (i) the amendment satisfies § 401(a), and (ii) the plan as amended would have satisfied the qualification requirements of § 401(a) (including the requirements applicable to hardship distributions under § 401(k), if applicable) had the amendment been adopted when hardship distributions were first made available. (See Example 21.)

(b) Example.

*Example 21*:

Employer K, a for-profit corporation, maintains a 401(k) plan. Although plan provisions in 1998 did not provide for hardship distributions, beginning in 1998 hardship distributions of amounts allowed to be distributed under § 401(k) were made currently and effectively available to all employees (within the meaning of § l.401(a)(4)–4). The standard used to determine hardship satisfied the deemed hardship distribution standards in § 1.401(k)–1(d)(2). Hardship distributions were made to a number of employees during the 1998 and 1999 plan years, creating an Operational Failure. The failure was discovered in 2000.

*Correction*:

Employer K corrects the failure under VCP by adopting a plan amendment, effective January 1, 1998, to provide a hardship distribution option that satisfies the rules applicable to hardship distributions in § 1.401(k)–1(d)(2). The amendment provides that the hardship distribution option is available to all employees. Thus, the amendment satisfies § 401(a), and the plan as amended in 2000 would have satisfied § 401(a) (including § 1.401(a)(4)–4 and the requirements applicable to hardship distributions under § 401(k)) if the amendment had been adopted in 1998.

(3) Inclusion of Ineligible Employee Failure. (a) Plan Amendment Correction Method. The Operational Failure of including an ineligible employee in the plan who has not completed the plan's minimum age or service requirements may be corrected under VCP and SCP by using the plan amendment correction method set forth in this paragraph. The plan is amended retroactively to change the eligibility provisions to provide for the inclusion of the ineligible employee to reflect the plan's actual operations. The amendment may change the eligibility provisions with respect to only those ineligible employees that were wrongly included, and only to those ineligible employees, provided (i) the amendment satisfies § 401(a) at the time it is adopted, (ii) the amendment would have satisfied § 401(a) had the amendment been adopted at the earlier time when it is effective, and (iii) the employees affected by the amendment are predominantly nonhighly compensated employees.

(b) Example

*Example 22*:

Employer L maintains a 401(k) plan applicable to all of its employees who have at least six months of service. The plan is a calendar year plan. The plan provides that Employer L will make matching contributions based upon an employee's salary reduction contributions. In 2001, it is discovered that all four employees who were hired by Employer L in 2000 were permitted to make salary reduction contributions to the plan effective with the first weekly paycheck after they were employed. Three of the four employees are nonhighly compensated. Employer L matched these employees' salary reduction contributions in accordance with the plan's matching contribution formula. Employer L calculates the ADP and ACP tests for 2000 (taking into account the salary reduction and matching contributions that were made for these employees) and determines that the tests were satisfied.

*Correction*:

Employer L corrects the failure under SCP by adopting a plan amendment, effective for employees hired on or after January 1, 2000, to provide that there is no service eligibility requirement under the plan and submitting the amendment to the Service for a determination letter.

## SECTION 3. EARNINGS ADJUSTMENT METHODS AND EXAMPLES

.01 *Earnings Adjustment Methods*. (1) In general. (a) Under section 6.02(4)(a) of this revenue procedure, whenever the appropriate correction method for an Operational Failure in a defined contribution plan includes a corrective contribution or allocation that increases one or more employees' account balances (now or in the future), the contribution or allocation is adjusted for earnings and forfeitures. This section 3 provides earnings adjustment methods (but not forfeiture adjustment methods) that may be used by an employer to adjust a corrective contribution or allocation for earnings in a defined contribution plan. Consequently, these earnings adjustment methods may be used to determine the earnings adjustments for corrective contributions or allocations made under the correction methods in section 2 and under the VCS correction methods in Appendix A. If an earnings adjustment method in this section 3 is used to adjust a corrective contribution or allocation, that adjustment is treated as satisfying the earnings adjustment requirement of section 6.02(4)(a) of this revenue procedure. Other earnings adjustment methods, different from those illustrated in this section 3, may also be appropriate for adjusting corrective contributions or allocations to reflect earnings.

(b) Under the earnings adjustment methods of this section 3, a corrective contribution or allocation that increases an employee's account balance is adjusted to reflect an "earnings amount" that is based on the earnings rate(s) (determined under section 3.01(3)) for the period of the failure (determined under section 3.01(2)). The earnings amount is allocated in accordance with section 3.01(4).

(c) The rule in section 6.02(5)(a) of this revenue procedure permitting reasonable estimates in certain circumstances applies for purposes of this section 3. For this purpose, a determination of earnings made in accordance with the rules of administrative convenience set forth in this section 3 is treated as a precise determination of earnings. Thus, if the probable difference between an approximate determination of earnings and a determination of earnings under this section 3 is insignificant and the administrative cost of a precise determination would significantly exceed the probable difference, reasonable estimates may be used in calculating the appropriate earnings.

(d) This section 3 does not apply to corrective distributions or corrective reductions in account balances. Thus, for example, while this section 3 applies in

increasing the account balance of an improperly excluded employee to correct the exclusion of the employee under the reallocation correction method described in section 2.02(2)(a)(iii)(B), this section 3 does not apply in reducing the account balances of other employees under the reallocation correction method. (See section 2.02(2)(a)(iii)(C) for rules that apply to the earnings adjustments for such reductions.) In addition, this section 3 does not apply in determining earnings adjustments under the one-to-one correction method described in section 2.01(1)(b)(iii).

(2) Period of the Failure. (a) General Rule. For purposes of this section 3, the "period of the failure" is the period from the date that the failure began through the date of correction. For example, in the case of an improper forfeiture of an employee's account balance, the beginning of the period of the failure is the date as of which the account balance was improperly reduced.

(b) Rules for Beginning Date for Exclusion of Eligible Employees from Plan. (i) General Rule. In the case of an exclusion of an eligible employee from a plan contribution, the beginning of the period of the failure is the date on which contributions of the same type (*e.g.*, elective deferrals, matching contributions, or discretionary nonelective employer contributions) were made for other employees for the year of the failure. In the case of an exclusion of an eligible employee from an allocation of a forfeiture, the beginning of the period of the failure is the date on which forfeitures were allocated to other employees for the year of the failure.

(ii) Exclusion from a 401(k) or (m) Plan. For administrative convenience, for purposes of calculating the earnings rate for corrective contributions for a plan year (or the portion of the plan year) during which an employee was improperly excluded from making periodic elective deferrals or employee after-tax contributions, or from receiving periodic matching contributions, the employer may treat the date on which the contributions would have been made as the midpoint of the plan year (or the midpoint of the portion of the plan year) for which the failure occurred. Alternatively, in this case, the employer may treat the date on which the contributions would have been made as the first date of the plan year (or the portion of the plan year) during which an employee was excluded, provided that the earnings rate used is one half of the earnings rate applicable under section 3.01(3) for the plan year (or the portion of the plan year) for which the failure occurred.

(3) Earnings Rate. (a) General Rule. For purposes of this section 3, the earnings rate generally is based on the investment results that would have applied to the corrective contribution or allocation if the failure had not occurred.

(b) Multiple Investment Funds. If a plan permits employees to direct the investment of account balances into more than one investment fund, the earnings rate is based on the rate applicable to the employee's investment choices for the period of the failure. For administrative convenience, if most of the employees for whom the corrective contribution or allocation is made are nonhighly compensated employees, the rate of return of the fund with the highest earnings rate under the plan for the period of the failure may be used to determine the earnings rate for all corrective contributions or allocations. If the employee had not made any applicable investment choices, the earnings rate may be based on the earnings rate under the plan as a whole (*i.e.*, the average of the rates earned by all of the funds in the valuation periods during the period of the failure weighted by the portion of the plan assets invested in the various funds during the period of the failure).

(c) Other Simplifying Assumptions. For administrative convenience, the earnings rate applicable to the corrective contribution or allocation for a valuation period with respect to any investment fund may be assumed to be the actual earnings rate for the plan's investments in that fund during that valuation period. For example, the earnings rate may be determined without regard to any special investment provisions that vary according to the size of the fund. Further, the earnings rate applicable to the corrective contribution or allocation for a portion of a valuation period may be a *pro rata* portion of the earnings rate for the entire valuation period, unless the application of this rule would result in either a significant understatement or overstatement of the actual earnings during that portion of the valuation period.

(4) Allocation Methods. (a) In General. For purposes of this section 3, the earnings amount generally may be allocated in accordance with any of the methods set forth in this paragraph (4). The methods under paragraph (4)(c), (d), and (e) are intended to be particularly helpful where corrective contributions are made at dates between the plan's valuation dates.

(b) Plan Allocation Method. Under the plan allocation method, the earnings amount is allocated to account balances under the plan in accordance with the plan's method for allocating earnings as if the failure had not occurred. (See Example 23.)

(c) Specific Employee Allocation Method. Under the specific employee allocation method, the entire earnings amount is allocated solely to the account balance of the employee on whose behalf the corrective contribution or allocation is made (regardless of whether the plan's allocation method would have allocated the earnings solely to that employee). In determining the allocation of plan earnings for the valuation period during which the corrective contribution or allocation is made, the corrective contribution or allocation (including the earnings amount) is treated in the same manner as any other contribution under the plan on behalf of the employee during that valuation period. Alternatively, where the plan's allocation method does not allocate plan earnings for a valuation period to a contribution made during that valuation period, plan earnings for the valuation period during which the corrective contribution or allocation is made may be allocated as if that employee's account balance had been increased as of the last day of the prior valuation period by the corrective contribution or allocation, including only that portion of the earnings amount attributable to earnings through the last day of the prior valuation period. The employee's account balance is then further increased as of the last day of the valuation period during which the corrective contribution or allocation is made by that portion of the earnings amount attributable to earnings after the last day of the prior valuation period. (See Example 24.)

(d) Bifurcated Allocation Method. Under the bifurcated allocation method, the entire earnings amount for the valuation periods ending before the date the corrective contribution or allocation is made is allocated solely to the account balance of the employee on whose behalf the corrective contribution or allocation is made. The earnings amount for the valuation period during which the corrective contribution or allocation is made is allocated in accordance with the plan's method for allocating other earnings for that valuation period in accordance with section 3.01(4)(b). (See Example 25.)

(e) Current Period Allocation Method. Under the current period allocation method, the portion of the earnings amount attributable to the valuation period during which the period of the failure begins ("first partial valuation period") is allocated in the same manner as earnings for the valuation period during which the corrective contribution or allocation is made in accordance section 3.01(4)(b). The earnings for the subsequent full valuation periods ending before the beginning of the valuation period during which the corrective contribution or allocation is made are allocated solely to the employee for whom the required contribution should have been made. The earnings amount for the valuation period during which the corrective contribution or allocation is made ("second partial valuation period") is allocated in accordance with the plan's method for allocating other earnings for that valuation period in accordance with section 3.01(4)(b). (See Example 26.)

.02 Examples.

*Example 23*:

Employer L maintains a profit-sharing plan that provides only for nonelective contributions. The plan has a single investment fund. Under the plan, assets are valued annually (the last day of the plan year) and earnings for the year are allocated in proportion to account balances as of the last day of the prior year, after reduction for distributions during the current year but without regard to contributions received during the current year (the "prior year account balance"). Plan contributions for 1997 were made on March 31, 1998. On April 20, 2000, Employer L determines that an operational failure occurred for 1997 because Employee X was improperly excluded from the plan. Employer L decides to correct the failure by using the VCS correction method for the exclusion of an eligible employee from nonelective contributions in a profit-sharing plan. Under this method, Employer L determines that this failure is corrected by making a contribution on behalf of Employee X of $5,000 (adjusted for earnings). The earnings rate under the plan for 1998 was +20% . The earnings rate under the plan for 1999 was +10% . On May 15, 2000, when Employer L determines that a contribution to correct for the failure will be made on June 1, 2000, a reasonable estimate of the earnings rate under the plan from January 1, 2000, to June 1, 2000 is +12%.

*Earnings Adjustment on the Corrective Contribution*:

The $5,000 corrective contribution on behalf of Employee X is adjusted to reflect an earnings amount based on the earnings rates for the period of the failure (March 31, 1998, through June 1, 2000) and the earnings amount is allocated using the plan allocation method. Employer L determines that a *pro rata* simplifying assumption may be used to determine the earnings rate for the period from March 31, 1998, to December 31, 1998, because that rate does not significantly understate or overstate the actual earnings for that period. Accordingly, Employer L determines that the earnings rate for that period is 15% (9/12 of the plan's 20% earnings rate for the year). Thus, applicable earnings rates under the plan during the period of the failure are:

| Time Periods | Earnings Rate |
|---|---|
| 3/31/98 — 12/31/98 (First Partial Valuation Period) | +15% |
| 1/1/99 — 12/31/99 | +10% |
| 1/1/00 — 6/1/00 (Second Partial Valuation Period) | +12% |

If the $5,000 corrective contribution had been contributed for Employee X on March 31, 1998, (1) earnings for 1998 would have been increased by the amount of the earnings on the additional $5,000 contribution from March 31, 1998, through December 31, 1998, and would have been allocated as 1998 earnings in proportion to the prior year (December 31, 1997) account balances, (2) Employee X's account balance as of December 31, 1998, would have been increased by the additional $5,000 contribution, (3) earnings for 1999 would have been increased by the 1999 earnings on the additional $5,000 contribution (including 1998 earnings thereon) allocated in proportion to the prior year (December 31, 1998) account balances along with other 1999 earnings, and (4) earnings for 2000 would have been increased by the earnings on the additional $5,000 (including 1998 and 1999 earnings thereon) from January 1 to June 1, 2000, and would be allocated in proportion to the prior year (December 31, 1999) account balances along with other 2000 earnings. Accordingly, the $5,000 corrective contribution is adjusted to reflect an earnings amount of $2,084 ($5,000[(1.15)(1.10)(1.12)–1]) and the earnings amount is allocated to the account balances under the plan allocation method as follows:

(a) Each account balance that shared in the allocation of earnings for 1998 is increased, as of December 31, 1998, by its appropriate share of the earnings amount for 1998, $750 ($5,000(.15)).

(b) Employee X's account balance is increased, as of December 31, 1998, by $5,000.

(c) The resulting December 31, 1998, account balances will share in the 1999 earnings, including the $575 for 1999 earnings included in the corrective contribution ($5,750(.10)), to determine the account balances as of December 31, 1999. However, each account balance other than Employee X's account balance has already shared in the 1999 earnings, excluding the $575. Accordingly, Employee X's account balance as of December 31, 1999, will include $500 of the 1999 portion of the earnings amount based on the $5,000 corrective contribution allocated to Employee X's account balance as of December 31, 1998 ($5,000(.10)). Then each account balance that originally shared in the allocation of earnings for 1999 (*i.e.*, excluding the $5,500 additions to Employee X's account balance) is increased by its appropriate share of the remaining 1999 portion of the earnings amount, $75.

(d) The resulting December 31, 1999, account balances (including the $5,500 additions to Employee X's account balance) will share in the 2000 portion of the earnings amount based on the estimated

January 1, 2000, to June 1, 2000, earnings included in the corrective contribution equal to $759 ($6,325 (.12)). (See Table 1.)

TABLE 1
CALCULATION AND ALLOCATION OF THE
CORRECTIVE AMOUNT ADJUSTED FOR EARNINGS

| | Earnings Rate | Amount | Allocated to: |
|---|---|---|---|
| Corrective Contribution | | $5,000 | Employee X |
| First Partial Valuation Period Earnings | 15% | 750[1] | All 12/31/1997, Account Balances[4] |
| 1999 Earnings | 10% | 575[2] | Employee X ($500)/ All 12/31/1998, Account Balances ($75)[4] |
| Second Partial Valuation Period Earnings | 12% | 759[3] | All 12/31/1999, Account Balances (including Employee X's $5,500)[4] |
| Total Amount Contributed | | $7,084 | |

[1] $5,000 x 15%
[2] $5,750 ($5,000 +750) x 10%
[3] $6,325 ($5,000 +750 +575) x 12%
[4] After reduction for distributions during the year for which earning are being determined but without regard to contributions received during the year for which earnings are being determined.

*Example 24*:

The facts are the same as in Example 23.

*Earnings Adjustment on the Corrective Contribution*:

The earnings amount on the corrective contribution is the same as in Example 23, but the earnings amount is allocated using the specific employee allocation method. Thus, the entire earnings amount for all periods through June 1, 2000 (*i.e.*, $750 for March 31, 1998, to December 31, 1998, $575 for 1999, and $759 for January 1, 2000, to June 1, 2000) is allocated to Employee X. Accordingly, Employer L makes a contribution on June 1, 2000, to the plan of $7,084 ($5,000(1.15)(1.10)(1.12)). Employee X's account balance as of December 31, 2000, is increased by $7,084. Alternatively, Employee X's account balance as of December 31, 1999, is increased by $6,325 ($5,000(1.15)(1.10)), which shares in the allocation of earnings for 2000, and Employee X's account balance as of December 31, 2000, is increased by the remaining $759. (See Table 2.)

TABLE 2
CALCULATION AND ALLOCATION OF THE
CORRECTIVE AMOUNT ADJUSTED FOR EARNINGS

| | Earnings Rate | Amount | Allocated to: |
|---|---|---|---|
| Corrective Contribution | | $5,000 | Employee X |
| First Partial Valuation Period Earnings | 15% | 750[1] | Employee X |
| 1999 Earnings | 10% | 575[2] | Employee X |
| Second Partial Valuation Period Earnings | 12% | 759[3] | Employee X |
| Total Amount Contributed | | $7,084 | |

[1] $5,000 x 15%
[2] $5,750 ($5,000 +750) x 10%
[3] $6,325 ($5,000 +750 +575) x 12%

*Example 25*:

The facts are the same as in Example 23.

*Earnings Adjustment on the Corrective Contribution*:

The earnings amount on the corrective contribution is the same as in Example 23, but the earnings amount is allocated using the bifurcated allocation method. Thus, the earnings for the first partial valuation period (March 31, 1998, to December 31, 1998) and the earnings for 1999 are allocated to Employee X. Accordingly, Employer L makes a contribution on June 1, 2000, to the plan of $7,084 ($5,000(1.15)(1.10)(1.12)). Employee X's account balance as of December 31, 1999, is increased by $6,325 ($5,000(1.15)(1.10)); and the December 31, 1999, account balances of employees (including Employee X's increased account balance) will share in estimated January 1, 2000, to June 1, 2000, earnings on the corrective contribution equal to $759 ($6,325(.12)). (See Table 3.)

TABLE 3
CALCULATION AND ALLOCATION OF THE
CORRECTIVE AMOUNT ADJUSTED FOR EARNINGS

| | Earnings Rate | Amount | Allocated to: |
|---|---|---|---|
| Corrective Contribution | | $5,000 | Employee X |
| First Partial Valuation Period Earnings | 15% | 750[1] | Employee X |
| 1999 Earnings | 10% | 575[2] | Employee X |
| Second Partial Valuation Period Earnings | 12% | 759[3] | 12/31/99, Account Balances (including Employee X's $6,325)[4] |
| Total Amount Contributed | | $7,084 | |

[1] $5,000 x 15%
[2] $5,750 ($5,000 +750) x 10%
[3] $6,325 ($5,000 +750 +575) x 12%
[4] After reduction for distributions during the 2000 year but without regard to contributions received during the 2000 year.

*Example 26*:

The facts are the same as in Example 23.

*Earnings Adjustment on the Corrective Contribution*:

The earnings amount on the corrective contribution is the same as in Example 23, but the earnings amount is allocated using the current period allocation method. Thus, the earnings for the first partial valuation period (March 31, 1998, to December 31, 1998) are allocated as 2000 earnings. Accordingly, Employer L makes a contribution on June 1, 2000, to the plan of $7,084 ($5,000 (1.15)(1.10)(1.12)). Employee X's account balance as of December 31, 1999, is increased by the sum of $5,500 ($5,000(1.10)) and the remaining 1999 earnings on the corrective contribution equal to $75 ($5,000(.15)(.10)). Further, both (1) the estimated March 31, 1998, to December 31, 1998, earnings on the corrective contribution equal to $750 ($5,000(.15)) and (2) the estimated January 1, 2000, to June 1, 2000, earnings on the corrective contribution equal to $759 ($6,325(.12)) are treated in the same manner as 2000 earnings by allocating these amounts to the December 31, 2000, account balances of employees in proportion to account balances as of December 31, 1999 (including Employee X's increased account balance). (See Table 4.) Thus, Employee X is allocated the earnings for the full valuation period during the period of the failure.

TABLE 4
CALCULATION AND ALLOCATION OF THE
CORRECTIVE AMOUNT ADJUSTED FOR EARNINGS

| | Earnings Rate | Amount | Allocated to: |
|---|---|---|---|
| Corrective Contribution | | $5,000 | Employee X |
| First Partial Valuation Period Earnings | 15% | 750[1] | 12/31/99, Account Balances (including Employee X's $5,575)[4] |
| 1999 Earnings | 10% | 575[2] | Employee X |
| Second Partial Valuation Period Earnings | 12% | 759[3] | 12/31/99, Account Balances (including Employee X's $5,575)[4] |
| Total Amount Contributed | | $7,084 | |

[1] $5,000 x 15%
[2] $5,750 ($5,000 +750) x 10%
[3] $6,325 ($5,000 +750 +575) x 12%
[4] After reduction for distributions during the year for which earnings are being determined but without regard to contributions received during the year for which earnings are being determined.

APPENDIX C

VCP CHECKLIST
IS YOUR SUBMISSION COMPLETE?

*INSTRUCTIONS*

The Service will be able to respond more quickly to your VCP request if it is carefully prepared and complete. To ensure that your request is in order, use this checklist. Answer each question in the checklist by inserting yes, no, or N/A, as appropriate, in the blank next to the item. *Sign and date the checklist* (*as taxpayer or authorized representative) and place it on top of your request*.

You must submit a completed copy of this checklist with your request. If a completed checklist is not submitted with your request, substantive consideration of your submission will be deferred until a completed checklist is received.

TAXPAYER'S NAME_____

TAXPAYER'S I.D. NO._____

PLAN NAME & NO._____

ATTORNEY/P.O.A._____

The following items relate to all submissions:

_____ 1. Have you included a complete description of the failure(s) and the years in which the failure(s) occurred (including the years for which the statutory period has expired)? (See section 11.02(1) of Rev. Proc. 2002–47.) (Hereafter, all section references are to Rev. Proc. 2002–47.)

_____ 2. Have you included an explanation of how and why the failure(s) arose, including a description of the administrative procedures for the plan in effect at the time the failure(s) occurred? (See section 11.02(2) and (3).)

_____ 3. Have you included a detailed description of the method for correcting the failure(s) identified in your submission? This description must include, for example, the number of employees affected and the expected cost of correction (both of which may be approximated if the exact number cannot be determined at the time of the request), the years involved, and calculations or assumptions the Plan Sponsor used to determine the amounts needed for correction. In lieu of providing correction calculations with respect to each employee affected by a failure, you may submit calculations with respect to a representative sample of affected employees. However, the representative sample calculations must be sufficient to demonstrate each aspect of the correction method proposed. Note that each step of the correction method must be described in narrative form. (See section 11.02(4).)

_____ 4. Have you described the earnings or interest methodology (indicating computation period and basis for determining earnings or interest rates) that will be used to calculate earnings or interest on any corrective contributions or distributions? (As a general rule, the interest rate (or rates) earned by the plan during the applicable period(s) should be used in determining the earnings for corrective contributions or distributions.) (See section 11.02(5).)

If you inserted "N/A" for item 4, enter explanation:

_____

_____

_____

_____ 5. Have you submitted specific calculations for each affected employee or a representative sample of affected employees? (See section 11.02(6).)

_____ 6. Have you described the method that will be used to locate and notify former employees or, if there are no former employees affected by the failure(s) or the correction(s), provided an affirmative statement to that effect? (See section 11.02(7).)

_____ 7. Have you provided a description of the administrative measures that have been or will be implemented to ensure that the same failure(s) do not recur? (See section 11.02(8).)

_____ 8. Have you included a statement that, to the best of the Plan Sponsor's knowledge, the plan is not currently under an Employee Plans examination? (See section 11.02(9).)

_____ 9. Have you included a statement that, to the best of the Plan Sponsor's knowledge, the Plan Sponsor is not under an Exempt Organizations examination? (See section 11.02(9).)

_____ 10. If the submission includes a failure related to Transferred Assets, have you included a description of the related employer transaction, including the date of the employer transaction and the date the assets were transferred to the plan?

_____ 11. Have you included a copy of the portions of the plan document (and adoption agreement, if applicable) relevant to the failure(s) and method(s) of correction? (See section 11.04(2).)

_____ 12. Have you included a copy of the plan's most recent Favorable Letter and/or the required applicable document(s)? (See section 11.04(4).)

_____ 13. Have you included the appropriate voluntary compliance fee due with the submission? (See section 11.06.)

_____ 14. Have you included the original signature of the sponsor or the sponsor's authorized representative? (See section 11.07.)

_____ 15. Have you included a Power of Attorney (Form 2848)? Note: representation under VCP is limited to attorneys, certified public accountants, enrolled agents, and enrolled actuaries; unenrolled return preparers are not eligible to act as representatives under VCP. (See section 11.08.)

_____ 16. Have you included a Penalty of Perjury Statement signed (original signature only) and dated by the Plan Sponsor? (See section 11.09.)

_____ 17. Have you designated your submission as a VCP, VCO, VCS, VCT, VCSEP, VCGroup, or Anonymous Submission Procedure, as appropriate? (See section 11.11.)

_____ 18. If you are requesting a waiver of the excise tax under § 4974 of the Code, have you included the request, and, if applicable, an explanation supporting the request for any affected owner-employee or 10 percent owner? (See section 6.07(3).)

_____ 19. Have you submitted an application for a determination letter? (See section 10.06.)

_____ 20. If the plan is currently being considered in a determination letter application, have you included a statement to that effect? (See section 11.03(1).)

The following items relate only to submissions under VCO (including VCS):

_____ 21. Have you included a copy of the first page, the page containing employee census information (currently line 7f of the 1998 Form 5500), and the information relating to plan assets (currently line 31f of the 1998 Form 5500) of the most recently filed Form 5500 series return? Note: If a Form 5500 is not applicable, insert N/A and furnish the name of the plan, and the census information required of Form 5500 series filers. (See section 11.04(1)(b).)

_____ 22. Have you proposed a time period of correction that is limited to 150 days (240 days for VCGroup) from the date the compliance statement is issued? (See sections 10.06(8) and 10.14(3)(b).)

The following items relate only to submissions under VCS:

_____ 23. Are each of the failures you have identified eligible for correction under VCS? (See Appendix A and Appendix B.)

_____ 24. Have you identified no more than two VCS failures? (If more than two failures were identified, VCS is not available, but you may make a submission under VCO.) (See section 10.11(3).)

_____ 25. Have you proposed to correct the failure(s) identified in your request using the permitted correction method(s) set forth in Appendix A or Appendix B? (See Appendix A and Appendix B.)

The following item relates only to submissions under VCGroup:

_____ 26. Have you submitted a certified or cashier's check for the initial fee of ten thousand dollars ($10,000) made payable to the U.S. Treasury?

The following item relates only to submissions under the general procedures of VCP:

_____ 27. Have you included a copy of the most recently filed Form 5500? (See section 11.04(1)(b).)

_____ _____

Signature Date

_____

Title or Authority

_____

Typed or printed name of person signing checklist

_____

*26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability.*
*(Also Part I, §§ 61, 451, 1001)*

## Rev. Proc. 2002–49

SECTION 1. PURPOSE

This revenue procedure sets forth a manner in which an electric utility company may treat a transaction in which the utility is issued a financing order by a State agency authorizing the recovery of certain costs incurred by the utility.

SECTION 2. BACKGROUND

In general, State public utility commissions set rates for public utility companies that are calculated to allow for the recovery of prudently incurred costs. In the case of capital expenditures, rates are set to allow recovery of costs over an extended period of time. With the advent of restructuring and a competitive marketplace, these rates are no longer guaranteed. Thus, the recovery of previously incurred costs associated with generation facilities that have market values below their book value, as well as costs associated with contracts to purchase electricity at above-market prices, have become uncertain. Some States have enacted legislation to allow the recovery of these costs through a non-bypassable surcharge to customers upon their consumption of electricity within the utility's historic service area. These statutes, which also authorize securitization of the surcharge, are unique to the regulated utility industry. Accordingly, the law and analysis applied to these transactions is peculiar to this situation.

SECTION 3. SCOPE

This revenue procedure applies to investor-owned public utility companies that, pursuant to transition legislation, receive an irrevocable financing order from an appropriate State agency determining the amount of transition costs the utility will be permitted to recover through qualifying securitization of an intangible property right created under the transition legislation.

SECTION 4. DEFINITIONS

.01 PUBLIC UTILITY COMPANY

For purposes of this revenue procedure, the terms "public utility" or "utility" refer to a utility company that is subject to the regulatory authority of the State public utility commission or other appropriate State agency.

.02 TRANSITION LEGISLATION

For purposes of this revenue procedure, transition legislation is legislation that:

(1) is enacted by a State to facilitate the conversion from a wholly regulated public utility regime to a competitive environment caused by restructuring of the public utility industry within the State;

(2) authorizes the utility to apply for, and authorizes the public utility commission or other appropriate State agency to issue, a financing order determining the amount of transition costs the utility will be allowed to recover;

(3) provides that pursuant to the financing order, the utility acquires an intangible property right to charge, collect, and receive charges in a fixed amount necessary to provide for the full recovery of the transition costs determined to be recoverable, and assures that the charges are non-bypassable and will be paid by customers within the utility's traditional service territory who receive electricity through the utility's transmission and distribution system, even if those customers elect to purchase electricity from a third-party generator;

(4) guarantees that neither the State nor any agency thereof has the authority to rescind or amend the financing order, to revise the amount of transition costs, or in any way to reduce or impair the value of the intangible property right, except as may be contemplated by periodic adjustments authorized by the transition legislation;

(5) provides procedures assuring that the sale, assignment or other transfer of the intangible property right from the utility to a financing entity will be perfected under State law as an absolute transfer of the utility's right, title and interest in the property; and

(6) authorizes the securitization of the intangible property right to recover