

*Plan Corrections: The  
Employee Plans Compliance  
Resolution System ("EPCRS")*

**Avaneesh Bhagat and Stephanie Bennett**  
Employee Plans Voluntary Compliance  
Internal Revenue Service

# Agenda

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- EPCRS Overview and Update
- Correction Principles
- Common Failures (Find, Fix, Avoid)

# EPCRS Revenue Procedure

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- Current Revenue Procedure: Rev. Proc. 2008-50 (generally effective in January 1, 2009)
- Expected update TBD
- Primary Purpose: Update to reflect the written plan requirement under the final 403(b) regulations

# 403(b) Plans—Failures Eligible for Correction

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- Ineligible submissions include cases where:
  - the plan's written program did not satisfy the legal requirements under Code §403(b) and the 403(b) final regulations, or the plan failed to adopt a written plan program before December 31, 2009; or
  - the plan failed to operate according to its written program's terms.
- Those VCP submissions will be returned along with the submission fee.
- An employer sponsoring a 403(b) plan may currently use VCP to correct employer eligibility and demographic failures, and the operational failures listed in Revenue Procedure 2008-50 §5.02(2)(a)

# Rev. Proc. 2008-50

## Comments Requested

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- 401(k) automatic enrollment
- Failure to provide safe harbor notice
- Designated Roth contributions

# EPCRS correction programs

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- EPCRS consists of three correction programs
  - Self-Correction Program (SCP)
  - Voluntary Correction Program (VCP)
  - Audit Closing Agreement Program (Audit CAP)
- Goal:
  - Preserve tax deferred benefits for participants under §§ 401(a) (qualified plans), 403(b) (tax-sheltered annuities), 408(k) (SEPs and SARSEPs), 408(p) (SIMPLE IRAs)
  - Income/excise tax relief: §§ 72(p) (loans), 72(t) (early distributions), 4974 (min. distributions), 4972/4973 (excess contributions), 4979 (ADP/ACP test)

# Correction Principles

*ref: §6 of Rev. Proc. 2008-50*

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- Full correction includes all taxable years, whether or not the taxable year is closed.
- The correction method should restore the Plan and its participants to the position they would have been in had the failure not occurred.
- The correction should be reasonable and appropriate for the failure.
  - Appendix A/B - correction deemed to be reasonable
  - Other: Consistency with the IRC; provide benefits to NHCEs; keep assets in plan

# Categories of Failures

*ref: §5.01 of Rev. Proc. 2008-50*

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- Plan document failure. “Form”
- Operational Failure: Failure to comply with plan’s terms
- Demographic Failure: Failure to satisfy coverage, discrimination rules even after following plan’s terms
- Employer Eligibility Failure.

**Note: EPCRS not available for ATAT/diversion/misuse of plan assets**



# Self Correction Program (SCP)

*ref: §4 , 7, 8 and 9 of Rev. Proc. 2008-50*

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- Operational Failures (that are not egregious) only
- Practices and procedures
- 2 year limit if failure is significant
- Insignificant failures can be corrected at any time
- Limited use of correction by plan amendment.
- Egregious failure examples:
  - Plan only covers HCEs
  - Plan provides favorable benefits to owners via CBA not negotiated in good faith (see Notice 2003-24 for welfare funds)
  - Plan provides HCEs benefits that are several times 415 lim.

# SCP- Practices and Procedures

*ref: §4.04 of Rev. Proc. 2008-50*

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- Self-correction available only if plan has practices and procedures reasonably designed to promote compliance
- Plan document not enough
- Doesn't have to be formal
- Generally should be in place before failure
- Operational failure should have occurred because of oversight or mistake in applying procedures

# SCP: Failure significant or insignificant? *ref: §8 of Rev. Proc. 2008-50*

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- Did other failures occur during same period?
- What % of assets and contributions involved?
- How many years did failure occur?
- How many participants affected (relative to total)?
- How many affected relative to how many who could have been affected?
- Was correction made in reasonable time after failure discovered?
- Why did failure occur?

# SCP: Significant failures

*ref: §4.03, 9 of Rev. Proc. 2008-50*

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- Must have Favorable Letter (determination letter or opinion letter)
- Deadline to correct
  - Generally, by the end of the 2<sup>nd</sup> plan year following the plan year in which failure occurred
- If plan comes under IRS examination, correction period ends
  - Unless correction substantially completed

## Advantages of SCP

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- No IRS involvement. Can focus on correction; and avoid the cost/processing time associated with a VCP submission.
- Deemed IRS reliance if corrections using App. A/B of Rev. Proc. 2008-50.

# Disadvantages of SCP

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## Uncertainties?

- Eligibility: Operational failures, Practices and Procedures, Significance
- Corrections (outside of App. A/B) and uncertainty with respect to the application of correction principles
- Scope? E.g. SCP can only fix operational failures; No income or excise tax relief

# Voluntary Correction Program (VCP): Key Elements

*ref: §4 ,10, 11 and 12 of Rev. Proc. 2008-50*

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- Employer submits application with a compliance fee. (Generally fixed under RP 2008-50 and payable up front along with the submission).
- Employer identifies qualification failures to the Service.
- Employer outlines methods used to correct the qualification failures to the Service.
- Employer outlines changes in administrative procedures to the Service that would ensure that failures do not reoccur.
- Employer and IRS agree to the methods of correction and the proposed revision of administrative procedures.
- IRS agrees not to pursue the sanction of Plan disqualification with respect to the qualification failures provided that all corrective actions and changes to the administrative procedures are completed within 150 days of the execution of the “compliance statement”.

## VCP: Eligibility and Fees

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- If the Plan or Plan sponsor is Under Examination, VCP is not available.
- VCP can be used to correct all categories of qualification failures: plan document, operational, demographic, employer eligibility.
- Fee is generally based on the number of participants in the plan.



# VCP Fees

*ref: §12 of Rev. Proc. 2008-50*

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<u>Number of Participants</u>	<u>Fee</u>
20 or fewer	\$ 750
21 to 50	\$1,000
51 to 100	\$ 2,500
101 to 500	\$ 5,000
501 to 1,000	\$ 8,000
1001 to 5,000	\$ 15,000
5,001 to 10,000	\$ 20,000
Over 10,000	\$ 25,000

Special situations: RMD (<51 ppants): \$500; Interim amendments (before expiration of extended RAP): \$375; Loans (25% ppants or less); nonamenders (< 1yr)- 50% off; Egregious- higher than schedule

# Streamlined VCP Application Procedures

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- Appendix F:
  - Schedule 1- Interim amendments or discretionary amendments relating to the implementation of optional law changes
  - Schedule 2- Other nonamender failures
  - Schedule 3- SEPs/SARSEPs
  - Schedule 4- SIMPLE IRAs
  - Schedule 5- Loan failures for nonkey employees
  - Schedule 6- Ineligible employer failure: 403(b) or 401(k) plan
  - Schedule 7- Elective deferrals in excess of § 402(g)
  - Schedule 8- Failure to make required minimum distributions under §401(a)(9)
  - Schedule 9- Failures corrected by plan amendments allowable under SCP
- Appendix D:
  - Sample format for submissions not covered by Appendix F

# VCP Submissions- Common Errors

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- Failure to submit fees- VCP; determination letter
- Failure to submit with correct signatures- e.g. penalty of perjury statement must be signed by the plan sponsor. Power of Attorney cannot sign
- Incomplete submission (all required items not submitted); Incomplete/inaccurate POA forms.
- Submissions where the failure is not presented as a failure and the applicant is asking us to determine if it is a failure
- “Scrivener’s Error”
- See article on common mistakes in VCP submissions:  
<http://www.irs.gov/retirement/article/0,,id=156238,00.html>
- Please review application pkg. before sending it in.

# Audit CAP *ref: §4 , 13, and 14 of Rev. Proc.* *2008-50*

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- IRS discovers failure (usually upon IRS audit; sometimes in DL application review) and offers resolution by closing agreement.
- Conditions for closing agreement:
  - Correction of failures
  - Payment of sanction
- Consequence: Plan's qualified status preserved.

# Audit CAP sanctions

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- Negotiated percentage of the maximum payment amount i.e. tax liability if plan was disqualified. (Nature, extent and severity of failures considered)
- Fee schedule for nonamender failures found in determination letter process based on # participants and earliest legislation for which the plan was not timely amended.
  - \$2,500 to \$80,000
  - Check documentation before filing a determination letter application; VCP is cheaper

# Common 401(k) plan failures

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For common failures in 401(k) plans please see:

[http://www.irs.gov/pub/irs-tege/401k\\_mistakes.pdf](http://www.irs.gov/pub/irs-tege/401k_mistakes.pdf)

Common mistakes have been identified. Ideas presented on steps that can be taken to:

- Find errors, fix them and avoid them going forward.

(FIND, FIX, AVOID)

# 401(k) plan failures contd..

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1. Failure to timely update plan documents
2. Failure to operate the plan in accordance with plan terms
  - Compensation
  - Matching contributions
  - ADP/ACP test
  - Eligible employees
  - 402(g) limit
  - Top Heavy contributions
  - Hardship distributions
  - Loans (incl. compliance with § 72(p))

# Finding plan document mistakes

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- Review of records including:
  - Original plan document
  - Subsequent amendments or restatements
  - Adoption Agreements
  - Opinion Letter or Advisory Letter issued by the IRS
  - Determination Letter issued by the IRS
  - Board of Directors' resolutions/minutes
  - Summary Plan Description



# Correcting plan document mistakes

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- Adoption of corrective amendments
- VCP submission
  - Appendix F Sch. 1 available for interim amendments (and extended RAP has not expired);
  - Appendix F Sch. 2 available for non-amenders (i.e. extended RAP for law changes has expired). DL application required if correction is made using individually designed plan.

# Avoiding plan document mistakes

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- Maintenance of plan document records
- Frequent interaction between employer and service provider
- Maintenance of a calendar that would provide deadlines by which certain amendments need to be adopted
- Consistency between plan and SPD

# Identifying/avoiding mistakes arising from plan operation

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- Familiarity with the terms of the plan
  - Employer, Employees, Service providers
  - Communications between parties (e.g. Human Resources may need to communicate the definition of compensation used for determining elective deferrals to Payroll)
- Periodic review of plan operations and plan terms (review should also include review of systems, e.g. implementation of automatic enrollment, auto-escalation)
- Checklists
  - IRS checklist  
<http://www.irs.gov/pub/irs-tege/pub4531.pdf>

## Correcting mistakes arising from failure to operate plan in accordance with terms of plan document

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- See correction principles; App. A/B
- SCP may be available

# Selected correction issues

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- Compensation (plan document less and/or more inclusive than plan operation)
- Exclusion of eligible employees (and impact of auto-enrollment feature)
- Failed ADP/ACP test (use of forfeitures for corrective QNEC)
- Safe Harbor 401(k) plans (Failure to provide safe harbor notice)
- Hardship Distributions (Failure to suspend elective deferrals)
- Loans (72(p) relief; loan start date; owners)

# Compensation

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- Wages and salaries
- Commissions
- Bonuses
- Etc.
- Typical problem:
  - Improper inclusion or exclusion of one or more categories of compensation for employer contributions, elective deferrals

## Example 1 (adapted from 401k fix it guide)

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- Plan definition of comp. excludes bonuses for purposes of employer contributions and elective deferrals.
- Jane receives a \$30,000 bonus and contrary to plan terms:
  - receives additional 5% profit sharing contribution (\$1,500)
  - makes 6% elective deferral (\$1,800)

## Correction

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- Forfeit profit sharing allocations of \$1,500 plus earnings, place in an unallocated account to be used for profit sharing allocations
- Distribute improper elective deferral of \$1,800 plus earnings



## Example 2 (adapted from Fall 2007 Retirement News for Employers)

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- Plan definition of comp. includes bonuses for purposes of employer contributions, elective deferrals.
- In operation, contrary to plan terms, bonuses were excluded. Bob elected to defer 5% of compensation. The profit sharing contribution for the year was 3% of compensation. Bob's bonus for the year was \$10,000.

# Correction

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- Deferrals: Bob was not provided with the opportunity to make deferrals from “bonus” compensation. If Bob’s election was properly implemented, an additional \$500 ( $5\% \times \$10,000$ ) would have been withheld for deferral. The missed deferral opportunity is  $50\% \times \$500$  or \$250. The employer should make a corrective QNEC of \$250 (adjusted for earnings) on behalf of Bob.
- Employer P/S contribution: By not counting bonuses, Bob’s profit sharing contribution was understated by \$300 ( $3\% \times \$10,000$ ). The employer should make a corrective contribution of \$300 (adjusted for earnings) on behalf of Bob.

# Exclusion of eligible employees (general rules for correction)

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## General Rule:

- Elective deferrals: Employer makes a corrective contribution to replace the missed deferral opportunity for the period of exclusion. Missed deferral opportunity = 50% of the employee's missed deferral (estimated using ADP for the employee's category during year of exclusion).
- Matching contributions: Employer makes a corrective contribution equal to contributions employee would have received had the missed deferral been made.

# Exclusion of eligible employees (variations)

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- Failure to implement employee elections *App. A .05(5) Rev. Proc. 2008-50; Ex. 12 App. B*
  - Use employee's elected deferral percentage instead of ADP
- Failure to implement an employee's election for all categories of compensation (e.g. bonuses)
  - May be able to calculate missed deferral using the employee's election in file.
- Failure to provide safe harbor notice in a safe harbor 401(k) plan
  - Could it result in an "excluded employee" problem?

# Excluded employees and automatic enrollment

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Is the failure to implement a plan's automatic enrollment provision-

- (a) a failure to implement an employee's negative election? (e.g. failure occurred because employee took no affirmative action upon receiving election forms, but payroll did not withhold in accordance with the participant's "negative election")
- (b) an erroneous exclusion of an eligible employee? (e.g. failure occurred because employee did not receive enrollment materials and was not provided with the opportunity to make elective deferrals to the plan )

See Summer 2009 issue of Retirement News for Employers

<http://www.irs.gov/retirement/article/0,,id=212043,00.html>

# Correction of failed ADP/ACP tests

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- Correction can be made within 12 months after the end of the plan year [IRC 401(k)(8), 401(m)(6)]
- If 12 months have elapsed since close of the plan year: EPCRS is available
- EPCRS corrections:
  - Uniform QNEC (App. A .03 of RP 2008-50)
  - 1 to 1 correction (App. B 2.01 of RP 2008-50)

# Use of forfeitures to make corrective QNECs

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- Can a plan use forfeitures to make QNECs for correcting a failed ADP test?
- No. See QNEC definition in IT Reg. 1.401(k)-6. It requires that the QNEC come from nonelective contributions that satisfy vesting (100%) and distribution requirements under 401(k) when contributed to the plan. Forfeitures are derived from contributions that were not fully vested when made.
- Will the Service permit the use of forfeitures to provide for the employer contribution in the case of:
  - Employees improperly excluded from making elective deferrals to the 401(k) plan? Yes, if employee is fully vested and the 401(k) distribution restrictions apply when the contribution is allocated.

# Safe harbor 401(k) plan- Failure to provide notice

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- Correction depends on the impact on individual participants.
  - If failure to provide notice results in an employee not being able to make elective deferrals to the plan, then the failure to provide notice would result in the erroneous exclusion of an eligible employee. Corrective contributions on behalf of the employee would be required.
  - If employee otherwise informed and able to make elective deferrals, then correction may involve revising practices and procedures going forward.
  - See article in Fall 2008 edition of Retirement News for Employers (pg 6).  
[http://www.irs.gov/pub/irs-tege/rne\\_fall08.pdf](http://www.irs.gov/pub/irs-tege/rne_fall08.pdf)



## Failure to suspend deferrals

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- 401(k) plan provides that upon receiving a hardship distribution, the participant is prohibited from making elective deferrals for 6 months. In operation, plan fails to suspend deferrals. Correction?

# Failure to suspend deferrals contd..

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- Option 1- Can plan return the improper elective deferrals (adjusted for earnings) to employee? **Yes.** This would put the participant in the same position he or she would have been in had failure not occurred.
- Option 2- Can plan suspend elective deferrals for a six month period going forward? **Possibly.** However, this may not put the participant in the same position.
  - Matching contribution levels for the six month period going forward could be different than what they were during suspension period.
  - Participant may quit employment before expiration of 6 month period.

## Failure to suspend deferrals contd..

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- Option 3- Take no action. Revise administrative procedures going forward?
- No. The failure will not have been corrected.

# Participant Loans: 72(p) relief for owner participants?

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- Appendix F schedule 5 is not available for VCP applications in cases where the affected participant is also the owner of the business. Does this mean 72(p) relief is not available for an owner?
- No. But more facts are needed before a decision can be made. These could include answers to questions such as: Was the loan itself a bonafide loan? Or is it a withdrawal that is being recharacterized as a loan? Were there reasonable attempts to make payments on the loan? How long did the problem occur before attempts at correcting the missed payments were made? Why did the problem occur and what steps are being taken to ensure that the problem does not occur again?
- These details can be addressed in a VCP application using the format under Appendix D in Rev. Proc. 2008-50.

# Defaulted Loan- Employer payment

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- Section 6.02(6) of Rev. Proc. 2008-50 states that if a loan is being corrected under EPCRS, the employer should pay the portion of the correction payment equal to the interest that accumulates as a result of the failure. When is employer payment required?

## Defaulted Loan- Employer payment contd..

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- Participant's responsibility to make payments on the loan- both principal and interest. However, employer payments could be required under certain circumstances
  - Failure occurred because of employer actions
  - Rate of return on plan investments exceeded plan loan rate.

# Defaulted Loan.. Reamortization correction

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- If a defaulted loan is being corrected under EPCRS through reamortization, is it permissible to use an interest rate that is different from the interest rate used at the time the loan was made?
- Assuming the interest rate on the loan complied with plan terms at the time the loan was made, it is expected that the correction would be made using the interest rate on the loan.