Correcting Qualified Plan Errors under EPCRS

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This Note summarizes the Employee Plans Compliance Resolution System (EPCRS), a correction programs system established by the Internal Revenue Service (IRS) that plan sponsors of retirement plans can use to correct plan document and administrative errors and maintain the tax-qualified status of these plans.

ADVANTAGES OF MAINTAINING TAX-QUALIFIED RETIREMENT PLANS

Qualified retirement plans provide several tax advantages to both the plan sponsor and plan participants:

- Participants in a 401(k) plan can elect to defer their compensation on a pre-tax basis.
- Employer contributions to a qualified retirement plan on behalf of participants are not immediately included in participants' income.
- The plan sponsor gets an immediate deduction for employer contributions to a qualified retirement plan.
- Earnings on contributions to a qualified retirement plan grow tax-deferred.

However, to enjoy these tax advantages, plan sponsors must comply with plan document and operational legal requirements set out in the Internal Revenue Code (IRC) and accompanying regulations.

PLAN DOCUMENT COMPLIANCE

For plan document compliance, plan sponsors must keep their plan documents up to date by timely amending their plans for new legal requirements and any discretionary plan design changes that the plan sponsor may make. Typically, when a new legal requirement becomes effective, the Internal Revenue Service (IRS) requires plan sponsors to adopt interim amendments to incorporate the requirement by a deadline set out in IRS guidance. When implementing a discretionary plan design change, plan sponsors must amend their plans by the end of the plan year in which the change becomes effective.

OPERATIONAL COMPLIANCE

For operational compliance, plan sponsors must administer and operate their qualified plans under the plan terms and consistently with the technical requirements set out in the IRC and accompanying regulations. Many of these technical requirements must be satisfied each year, such as providing benefits to participants on a non-discriminatory basis and adhering to annual IRS limits on the amount of contributions that can be made for each plan participant.

VOLUNTARY COMPLIANCE UNDER EPCRS

The complexity of these compliance requirements leads, not surprisingly, to frequent errors. If left uncorrected, errors can jeopardize the tax-qualified status of a retirement plan. The IRS created the Employee Plans Compliance Resolution System (EPCRS) to help plan sponsors correct errors (or, as they are referred to in EPCRS, qualification failures). EPCRS, which was recently updated on December 31, 2012 in *Revenue Procedure 2013-12*, encourages voluntary compliance by allowing self-correction in certain situations and by providing plan sponsors an opportunity to voluntarily seek IRS approval of corrections at reduced costs and fees.

This Note:

- Describes the four categories of qualification failures identified by EPCRS.
- Summarizes the general correction principles set out in EPCRS.
- Discusses the three correction programs set out in EPCRS in detail, including the corresponding eligibility requirements, exceptions and applicable procedures.
- Summarizes the special correction rules for plan loan failures.

- Lists several common qualification failures for which EPCRS sets out "pre-approved" correction methods.
- Identifies some best practices when correcting a qualification failure.
- Provides examples of corrections, including pre-approved corrections.

While EPCRS can be used to correct certain qualification failures that occur with respect to 403(b) plans, simplified employee pension plans (SEPs) and SIMPLE IRA plans, this Note focuses on plans intended to be qualified under IRC *Section 401(a)*, such as defined contribution plans and defined benefit plans.

FOUR CATEGORIES OF FAILURES

Under EPCRS, any error that could adversely affect the qualification of a plan is called a qualification failure. EPCRS identifies four categories of qualification failures:

- **Operational failures.** Occur where the plan was not operated in accordance with the provisions of the plan document (or, practically speaking, IRC requirements, which are often incorporated into the plan document by reference). Operational failures can be classified as either insignificant or significant (see *Operational Failures: Insignificant Versus Significant*). A plan does not have an operational failure if the plan is permitted by the IRC to be amended retroactively to reflect the plan's operation.
- **Plan document failures.** Occur where a plan document does not comply with the IRC's requirements for provisions that must be included in the document. For example, the failure to timely or properly amend a plan within the plan's remedial amendment period under IRC *Section 401(b)* is considered a plan document failure.
- **Demographic failures.** Occur where the plan does not satisfy the IRC's minimum coverage, minimum participation or nondiscrimination requirements and which are not operational failures or employer eligibility failures.
- **Employer eligibility failures.** Occur where the plan sponsor is not eligible to establish the type of retirement plan it adopted. For example, the adoption of a plan that is intended to satisfy the requirements of IRC *Section 403(b)* by a plan sponsor that is not a tax-exempt organization is an employer eligibility failure.

GENERAL CORRECTION PRINCIPLES

EPCRS sets out several general principles to help guide plan sponsors in correcting qualification failures, including:

- Full correction (see *Full Correction*).
- Restoration of benefits (see *Restoration of Benefits*).
- Reasonable and appropriate corrections (see *Reasonable and Appropriate Correction*).
- Consistency (see *Consistency*).
- Adjusting for earnings (see *Adjust for Earnings*).
- Corrective allocations (see *Corrective Allocations*).
- Missed deferral opportunity corrections (see *Missed Deferral Opportunity Correction*).

Full Correction

Failures should be fully corrected for all affected participants and beneficiaries and for all affected years and should be based on the terms of the plan at the time of the failure. There are special exceptions to full correction in certain situations because it is unreasonable or not feasible.

Full correction does not have to be made in the following situations:

- **Reasonable estimates.** A reasonable estimate of the cost of correction, rather than the precise cost of correction, may be used if:
  - It is possible to make a precise calculation of the cost of correction but the probable difference between the approximate cost of correction and the precise cost is insignificant and the administrative cost of determining the precise correction significantly exceeds the probable difference.
  - It is not possible to make a precise calculation (for example, because plan data is not available).
- **Delivery of small benefits.** If the correction would require a distribution to a participant or beneficiary of $75 or less and the cost of processing and distributing the monies would exceed the amount of the distribution, the plan sponsor is not required to make the distribution. This does not apply to corrective contributions.
- **Recovery of small overpayments.** If the failure is an overpayment to a participant or beneficiary of $100 or less, the plan sponsor is *not* required to:
  - request return of the overpayment; or
  - notify the participant or beneficiary that the overpayment is not eligible for favorable tax treatment accorded to distributions from a qualified plan and is not eligible for tax-free rollover.
- **Locating lost participants.** The plan sponsor must take reasonable actions to find all current and former participants and beneficiaries to whom additional benefits are due, including:
  - A mailing to the individual's last known address using certified mail.
  - One or more additional search methods, such as the Social Security letter forwarding program, a commercial locator service, credit reporting agency or internet search tool.

  If reasonable actions are taken, a plan will not be considered to have failed to correct a failure because an individual cannot be found, as long as benefits are provided to the individual if later located. As of August 31, the IRS Letter Forwarding Program is no longer available as a mechanism to locate lost participants under EPCRS.

- **Small excess amounts.** If the total amount of an excess amount of a participant or beneficiary's benefit (for example, a contribution or allocation in excess of the amount permitted under plan terms or IRC limitations) is $100 or less, the plan sponsor is not required to distribute or forfeit the excess amount. However, if the excess amount exceeds a statutory limit, the plan must notify the individual that the excess amount, including earnings, is not eligible for favorable tax treatment under the IRC.

Restoration of Benefits

The correction should restore the plan to the same position it would have been had the failure not occurred, including restoring participants and beneficiaries with the benefits and rights they would have had if the failure had not occurred.

Reasonable and Appropriate Correction

The correction should be reasonable and appropriate for the failure. EPCRS provides certain pre-approved correction methods automatically deemed to be reasonable and appropriate (see *Pre-approved Corrections*). Depending on the facts and circumstances of a failure, there may be more than one reasonable and appropriate method of correction. Reasonable and appropriate corrections should also have the following characteristics, where possible:

- The correction method should resemble, to the extent possible, one already set forth in the IRC and regulations.
- Corrections should keep assets in the plan, except to the extent the IRC, regulations or other IRS guidance of general applicability provide for distributions to participants or the return of assets to the plan sponsor.
- Corrections relating to nondiscrimination failures should provide benefits to non-highly compensated employees.
- The correction method should not violate another specific requirement of the applicable section of the IRC governing the plan (for example, IRC *Section 401(a)* for qualified plans).
- If another government agency has authorized a correction within its interpretative authority and that correction relates to a failure to which EPCRS applies, the IRS may take that agency's correction procedure into account.

Consistency

Generally, if there is more than one reasonable and appropriate correction, the correction method chosen, including the method for determining earnings, should be applied consistently for all failures that occur within the same plan year.

Adjust for Earnings

Any corrective contributions, distributions, allocations and reallocations necessary as part of a correction should generally be adjusted for earnings (including losses) and forfeitures from the time of the failure through the date of correction. Certain corrective allocations are not required to be adjusted for losses (see *Corrective Allocations*).

There are many acceptable methods of calculating earnings under EPCRS, including determining actual investment results or, in limited circumstances, using the Department of Labor's *Voluntary Fiduciary Correction Program Online Calculator*.

Corrective Allocations

Allocations made to correct a failure should be based on the terms of the plan at the time of the failure and should come only from employer contributions, including forfeitures if the plan permits their use to reduce employer contributions.

Rev. Proc. 2013-12 adds correction procedures for operational failures under IRC Section 436(b), (c) or (e) which generally require the plan sponsor to make a corrective contribution to the plan equal to the amount required under IRC Section 436(b)(2), (c)(2), or (e)(2) (as applicable).

The procedure also provides that corrective distributions from a defined benefit plan subject to a benefit restriction under IRC Section 436 are not subject to the requirements of IRC Section 436 at the time of the correction. However, if that corrective distribution is made in the form of a prohibited payment under IRC Section 436 (such as a single-sum payment), the plan sponsor is required to make an additional corrective contribution to the plan in the amount of that corrective distribution.

Corrective allocations do *not* have to be adjusted for losses.

Missed Deferral Opportunity Corrections

If a qualified plan excludes an employee who should have been eligible to make a pre-tax elective deferral or an after-tax contribution, the employer should contribute to the plan on behalf of the employee an amount that makes up for the value of the lost opportunity to have a portion of the employee's income contributed to the plan and accumulated with earnings tax free in the future.

This is referred to as the missed deferral opportunity correction principle. EPCRS provides pre-approved correction methods to correct these types of failures (see *Pre-approved Corrections*). To correct, an employer is essentially required to make a qualified non-elective contribution (QNEC) to the plan equal to 50% of the employee's missed deferral if the employee is excluded from making a pre-tax elective deferral, or 40% if the employee is excluded from making an after-tax contribution. For an example of this correction, see *SCP Example: Exclusion of Eligible Employee from 401(k) Plan*.

Correcting Matching Contributions for Missed Deferral Opportunities

The updated EPCRS now provides that a plan sponsor may correct a failure to make a matching contribution to a participant due to the participant's improper exclusion from a non- safe harbor 401(k) plan by making a contribution to the plan equal to the matching contribution the participant would have received based on the participant's missed deferral. This corrective contribution can be in the form of an employer non-elective contribution (which is subject to the vesting schedule for matching contributions) rather than in the form of a QNEC (which are fully vested). QNECs must still be made to the plan to correct the participant's "missed deferral opportunity" to make elective deferrals to the plan.) (see *Missed Deferral Opportunity Corrections*).

EPCRS also provides additional methods for correcting the improper exclusion of employees:

- From safe harbor IRC Section 401(k) plans (see *Practice Note, Safe Harbor 401(k) Plans: Overview and Planning Opportunities (http://us.practicallaw.com/9-501-1089)*).
- From IRC Section 403(b) plans and SIMPLE IRA plans.

EPCRS CORRECTION PROGRAMS

EPCRS contains three programs under which plan sponsors can correct qualification failures:

- **Self-Correction Program (SCP).** This program allows an eligible plan sponsor to correct certain operational failures without any IRS involvement (see *SCP*).
- **Voluntary Correction with Service Approval Program (VCP)**. This program allows the plan sponsor to correct qualification failures. This program involves:
  - submitting a detailed application to the IRS that must contain several required elements;
  - paying a compliance fee; and
  - obtaining a compliance statement from the IRS that lists the qualification failures and the approved corrections of those failures (see *VCP*).
- **Audit Closing Agreement Program (Audit CAP).** This program allows the plan sponsor to correct qualification failures found during an IRS examination that have not been previously corrected under SCP or VCP (see *Audit Cap*).

SELF-CORRECTION PROGRAM (SCP)

Under EPCRS's Self-correction Program (SCP), eligible plan sponsors can self-correct certain operational failures without seeking IRS involvement or approval and without having to pay any fees.

Eligibility for SCP

To be eligible to use SCP, a plan sponsor must have established practices and procedures, whether formal or informal, which are reasonably designed to promote and facilitate overall compliance with the IRC's requirements. These practices and procedures must be routinely followed. The operational failures generally must occur as a result of an oversight or a mistake in applying the procedures. SCP also can be used in situations where the operational failure occurred because the reasonable procedures that were in place were not sufficient to prevent the occurrence of the failure.

Eligibility for SCP varies depending on:

- The type of plan involved (see *Plan Eligibility for SCP*).
- Whether the operational failure is considered insignificant or significant (see *Operational Failures: Insignificant Versus Significant*).

Plan Eligibility for SCP

Employee benefit plans qualified under IRC *Section 401(a)* and 403(b) plans are eligible for SCP to correct both significant and insignificant operational failures. However, there are additional requirements for significant operational failures (see *Effect of Determination of Significant Failure on SCP*).

SEPs and SIMPLE IRAs are eligible for SCP only for insignificant operational failures (see *Operational Failures: Significant Versus Insignificant*).

Operational Failures: Insignificant Versus Significant

To assess whether an operational failure is insignificant, EPCRS provides a non-exclusive list of seven factors to consider:

- Whether other failures occurred during the same period.
- The percentage of plan assets and contributions involved in the failure.
- The number of years the failure occurred.
- The number of participants who were affected relative to the total number of participants in the plan.
- The number of participants who were affected as a result of the failure relative to the number of participants who could have been affected by the failure.
- Whether correction was made within a reasonable time after discovery of the failure.
- The reason for the failure.

While assessing whether a failure is insignificant is a facts-and-circumstances analysis, **no single factor is determinative**.

Effect of Determination of Significant Failure on SCP: Two-Year Limit

Operational failures that are determined to be insignificant can be self-corrected at any time under SCP, even while the IRS is conducting an examination of the plan.

By contrast, correction of a significant operational failure under SCP must be completed by the end of the second plan year after the plan year in which the failure occurred. In addition, to correct significant operational failures under SCP, the plan sponsor must have a current IRS determination letter, which includes:

- An IRS advisory letter issued for a pre-approved volume submitter plan adopted by the plan sponsor.
- An IRS opinion letter issued regarding a pre-approved prototype plan adopted by the plan sponsor.

For more information on the IRS determination letter process, review *Practice Note, Applying for an IRS Determination Letter (http://us.practicallaw.com/9-501-4610).*

Correction Under SCP by Retroactive Plan Amendment

There are very limited circumstances where an operational failure can be self-corrected under SCP by a retroactive plan amendment to conform the terms of the plan to the plan's prior operations. These limited circumstances include:

- A failure under IRC *Section 401(a)(17)*.
- Where a plan has allowed hardship distributions or plan loans when the plan document did not allow for them.
- Where otherwise eligible employees were allowed to enter the plan before they met the plan's eligibility requirements (for example, age or service requirements).

These failures must be corrected according to the procedures set out in Appendix B to EPCRS. Correction by plan amendment may, in certain situations, require the plan sponsor to also file a determination letter application with the IRS (see *Applying for an IRS Determination Letter Checklist (http://us.practicallaw.com/3-501-4608)* and *Standard Document, Determination Letter Application Cover Letter (http://us.practicallaw.com/8-501-5337)*).

SCP Not Available for Egregious Errors

SCP is not available to correct failures that are egregious. For example, the IRS considers the following failures to be egregious:

- A plan has consistently and improperly covered only highly compensated employees (HCEs).
- A plan provides more favorable benefits for an owner of the employer based on a purported collective bargaining agreement where there has been no good faith bargaining between the employer and a union.
- A contribution is made to a defined contribution plan on behalf of an HCE that is several times greater than the dollar limit set in IRC *Section 415(c)*. The IRS adjusts this limit on an annual basis and publishes the *COLA Increases for Dollar Limitations on Benefits and Contributions*.
- The Voluntary Correction with Service Approval Program (VCP) and Audit Closing Agreement Program (Audit CAP) are both available to correct egregious errors (see *Voluntary Correction with Service Approval: VCP* and *Audit Closing Agreement Program: Audit Cap*).

Effect of SCP on Possible IRS Examination

Self-correction under SCP has no effect on a possible IRS examination or audit. Accordingly, the plan is not protected from a possible IRS examination of a failure in the event the IRS audits a plan before the plan has fully corrected a failure using the procedures authorized in SCP.

By contrast, a plan that is properly submitted under VCP is generally protected from an IRS examination while the submission is pending (see *Effect of VCP on Possible IRS Examination*).

VOLUNTARY CORRECTION WITH SERVICE APPROVAL PROGRAM: VCP

VCP allows a plan sponsor to correct any qualification failure by voluntarily seeking IRS approval and paying a limited compliance fee (see *Compliance Fee*). VCP also provides general procedures for the correction of participant loans that did not comply with the requirements of IRC *Section 72(p)(2)*.

Plan Eligibility for VCP

Qualified plans, 403(b) plans, SEPs and SIMPLE IRA Plans are eligible for VCP for all qualification failures, including operational, plan document, demographic and employer eligibility failures.

Compliance Fee

The compliance fee is generally based on the number of participants in the plan, as follows:

Number of Participants	Fee
20 or fewer	$750
21-50	$1,000
51-100	$2,500
101-500	$5,000
501-1,000	$8,000
1,001 – 5,000	$15,000
5,001-10,000	$20,000
Over 10,000	$25,000

The IRS may convert compliance fee checks into electronic fund transfers by using the account information on the check rather than processing the actual check. Plan sponsors should ensure that sufficient amounts exist in the account prior to sending the compliance fee check.

Reduced Compliance Fees for Certain Submissions

If the VCP submission involves only the failure to satisfy the minimum distribution requirements of IRC *Section 401(a)(9)* for 50 or fewer participants that would result in the imposition of an excise tax under IRC *Section 4974*, the compliance fee is $500.

If the VCP submission involves only the failure of participant loans to comply with the requirements of IRC *Section 72(p)(2)* for 25% or fewer of the plan participants in the plan year in which the failure occurs, the compliance fee is reduced by 50%.

If the VCP submission involves only non-amender failures that are submitted within a one year period following the expiration of the plan's remedial amendment period, the compliance fee is reduced by 50%. For VCP submissions that only include a failure to adopt timely interim amendments or amendments required to implement optional law changes, the compliance fee is $375. Under the updated EPCRS, the VCP compliance fee is $500 if the sole failure is the failure to adopt an amendment required under the terms of a favorable determination letter within the applicable remedial amendment period specified in the determination letter, provided that the amendment is adopted within three months of the end of that remedial amendment period. In addition, EPCRS provides reduced sanctions and otherwise updates the fee schedule for nonamender failures discovered during the determination letter application process (that are unrelated to failures submitted through VCP).

If multiple failures are included in one VCP submission and each failure is subject to a reduced fee, the plan sponsor is required to pay the lesser of the sum of the reduced fees or the applicable compliance fee based on the number of plan participants (see *Compliance Fee*).

The VCP compliance fee for a failure to adopt a written IRC Section 403(b) plan document is temporarily reduced by 50% if:

- the only failure included in the submission is the failure to adopt the plan; and
- the submission is made within one year of the date the updated EPCRS is published. (On January 2nd, 2013, the IRS provided Revenue Procedure 2013-12 in the Advance Federal Register.)

There are different rules for calculating compliance fees for group submissions (for example, for pre-approved plans) and for SEPs and SIMPLE IRA plans.

Submission Requirements for VCP

Generally, under VCP, the plan sponsor must submit an application to the IRS. The submission procedures for VCP applications changed substantially under Rev. Proc. 2013-12. Under the new EPCRS, all VCP submissions made on or after April 1, 2013 are required to include a completed Form 8950 (incorporating VCP application information) and Form 8951 (with VCP compliance fee information). These forms are currently available only in draft form and may not be used until the IRS issues the final forms (see *Draft Form 8950* and *Draft Form 8951*).

Much of the information requested for VCP submissions under the old EPCRS is now incorporated into Form 8950, including the following:

- A description of the qualification failures that the plan sponsor desires to address, including the years in which the failures occurred and the number of affected participants.
- An explanation of how the qualification failures arose and a description of the applicable administrative procedures that were in effect at the time.
- A description of the proposed method(s) of correcting the failures, including the costs of correction and the assumptions or calculations used to determine any corrective contributions.
- A description of the method used to calculate earnings on corrective contributions, distributions or allocations.
- Specific calculations for each affected employee (or a representative sample of employees), sufficient to demonstrate each aspect of the correction.
- A description of the method used to locate and notify former employees affected by the failures and the correction (or a statement that no such employees exist).
- A description of changes in administrative procedures that have been or are intended to be implemented to prevent a recurrence of the same failures.
- Relevant pages of the plan document related to any operational failures.
- Executed amendments or plan documents, in the case of plan document failures. The IRS clarified in Rev. Proc. 2013-12 that if a restated plan is submitted as evidence of a correction made pursuant to VCP, the plan sponsor must identify the page, section and the specific plan language that resolves each specified qualification failure in the VCP submission.
- A declaration or penalty of perjury statement. If a VCP submission is made anonymously, the individual submitting the VCP application must satisfy the power of attorney requirements of EPCRS Section 11.07.

Appendix C: Model VCP Submission Documents

The IRS revised the appendices to EPCRS to include Appendix C in place of the previous Appendix D and F. Appendix C is composed of two parts:

- a new model compliance statement providing a standardized framework that plan sponsors should (but are not required to) include in their VCP submission (see *Compliance Statement*); and
- schedules (formerly Appendix F schedules) that set out standardized descriptions of common qualification failures and streamlined correction methods. The IRS clarified that a schedule including a standardized correction method may only be used if its printed content applies **without modification** to the applicant's situation (see *Streamlined VCP Applications*).

Streamlined VCP Applications

For certain identified qualification failures, a plan sponsor can use a streamlined application process, which requires the submission of less information and documentation and usually a lower compliance fee. Streamlined VCP applications may be made using the fill-in Schedules to EPCRS, Appendix C noted below.

The qualification failures eligible for the streamlined application process include:

- Failure to timely adopt timely interim amendments and certain discretionary amendments (EPCRS, Appendix C, Part II, Schedule 1). For example, if the plan sponsor implemented any of the optional law changes under the *Economic Growth and Tax Relief Reconciliation Act of 2001* (EGTRRA) and failed to adopt good faith amendments timely to conform the plan to its operation.

- Failure to timely adopt amendments to comply with required law changes and Failure to timely adopt a 403(b) plan (EPCRS, Appendix C, Part II, Schedule 2). For example, if the plan was not amended to comply with the applicable provisions required by the cumulative list by the applicable deadlines.
- Failure to properly administer 401(k) plan loans that do not involve key employees or self-employed individuals (EPCRS, Appendix C, Part II, Schedule 5). Only certain loan failures listed in Appendix C, Schedule 5 may be corrected (see *Special Rules Governing Correction of Loan Failures*).
- Failure to satisfy the employer eligibility criteria to sponsor either a 403(b) or a 401(k) plan (EPCRS, Appendix C, Part II, Schedule 6).
- Failure to distribute elective deferrals in excess of the annual IRS limit on such deferrals (EPCRS, Appendix C, Part II, Schedule 7).
- Failure to make required minimum distributions under IRC Section 401(a)(9) (EPCRS, Appendix C, Part II, Schedule 8).
- Other specified failures relating to IRC Section 401(a)(17), hardship withdrawals, loans and early inclusion of otherwise eligible employees for which corrections are made by plan amendment (EPCRS, Appendix C, Part II, Schedule 9).

There are also streamlined submission procedures for certain failures relating to SEPs and SIMPLE IRAs.

Processing of VCP Submission

The IRS will review the VCP submission for accuracy and to ensure it satisfies the eligibility requirements. If it does not, the IRS reserves the right to return the submission and refund the compliance fee. Once the IRS determines that the submission is complete, the IRS will contact the plan sponsor (or its representative) to discuss the proposed correction.

If additional information is required, an IRS representative will contact the plan. The plan representative will have 21 calendar days to provide the requested information and if the information is not received within that time period:

- The matter will be closed.
- The compliance fee will not be returned.
- The case may be referred to the Employee Plans Examination unit of the IRS.

Any request for an extension of the 21-day period must be approved by the applicable IRS representative.

If the IRS determines that it cannot issue a compliance statement because the parties cannot agree on a correction, the plan will be offered a conference by the IRS, which can be held in person or by telephone. The conference must be held within 21 calendar days of the IRS' request for a conference and the plan will have 21 days after the conference to submit any additional information supporting the submission.

Determination Letter Applications No Longer Permitted with Certain VCP Submissions

The IRS provides in Rev. Proc. 2013-12 that determination letter applications are no longer required *or permitted* to be submitted with a plan sponsor's VCP submission for:

- Failures to adopt timely good faith, interim or optional law change amendments which are corrected by the plan sponsor by adopting corrective amendments before the plan's first on-cycle year following the date by which the amendment should have otherwise been adopted. (The updated EPCRS also provides definitions for good faith, interim and optional law change amendments.)
- Operational failures corrected through a plan amendment under VCP during an off-cycle year.
- Failures to adopt amendments required under the terms of a favorable determination letter within the applicable remedial amendment period specified in the determination letter.

Discovery of Additional Failures after VCP Submission

If the plan sponsor discovers additional failures after the initial VCP submission, these failures may generally be added to the submission. However, the IRS retains the discretion to reject the inclusion of additional failures in the VCP submission.

If the IRS discovers additional failures after the initial VCP submission, the failure will generally be added to the VCP submission. However, the IRS retains the right to determine that the failure is outside the scope of the VCP submission because the plan sponsor did not voluntarily bring it forward. If this is the case and the failure is significant, **all aspects of the plan** may be examined by the IRS and the submission may automatically be converted to Audit CAP (see *Audit Closing Agreement Program: Audit Cap*).

Compliance Statement

After reaching a successful resolution under VCP, the IRS sends to the plan sponsor a compliance statement, which essentially represents approval by the IRS of the specific corrections. If the plan sponsor included the Appendix C Part I Model VCP Submission Compliance Statement with its VCP submission, the IRS will sign and send that compliance statement specifying the corrective action required. In particular, the compliance statement contains the:

- Failures identified by the plan sponsor.
- Terms of the correction, including any revision of administrative procedure.
- Time period (generally 150 days) within which proposed corrections must be implemented, including any changes in administrative procedures.

The compliance statement also provides that the IRS will not treat the plan as failing to satisfy the applicable IRC qualification requirements on account of the failures described in the compliance statement, if the conditions of the compliance statement are satisfied.

Effect of VCP Application on Possible IRS Examination

A plan that has been properly submitted under VCP will not be examined by the IRS while the VCP submission is pending, unless:

- It is determined that either the plan or the plan sponsor was or may have been a party to an abusive tax avoidance transaction.
- The VCP application is submitted anonymously. In this case, until and unless the plan and plan sponsor are identified to the IRS, an anonymous VCP submission does not protect the plan from a possible examination.

Consideration of failures by the IRS under EPCRS does not stop the possibility of an IRS examination or audit of the plan for the taxable years involved regarding matters outside of the compliance statement. The reliance provided by a compliance statement is limited to the specific failures and years specified and does not provide reliance for any other failure or year.

Special Rules for Loans

EPCRS contains special rules on correcting failures relating to loans from qualified plans.

Rules Governing Qualified Plan Loans

Generally qualified plans may provide for loans to participants. If a qualified plan permits loans, the plan may limit the amount that can be taken as a loan. Under IRC *Section 72(p)(2)(A),* the maximum amount that the plan can permit as a loan is the lesser of:

- The greater of $10,000 or 50% of the participant's vested account balance.
- $50,000.

A plan that provides for loans must specify the procedures for applying for a loan and the repayment terms for the loan. IRC Section 72(p)(2)(B) provides that repayment of a loan must occur within five years for non-residence loans, and IRC Section 72(p)(2)(C) provides that loan repayments must be made in substantially equal payments that include principal and interest and that are paid at least quarterly. A loan that is taken for the purpose of purchasing the participant's principal residence may be paid back over a period of more than five years.

If a loan is not repaid according to its terms, it is in default. A loan in default is generally treated as a taxable distribution from the plan of the entire balance of the loan. This is known as a "deemed distribution" and is treated as an actual distribution for purposes of determining the tax on the distribution, including any early distribution tax. A plan may provide a grace period for purposes of determining when a deemed distribution occurs. However, the grace period may not extend beyond the calendar quarter following the quarter in which the repayment was missed.

Special Rules Governing Correction of Loan Failures

EPCRS provides special rules for the correction of loan failures, provided that:

- The corrections are made through VCP. These loan failures **cannot** be fixed under SCP.
- The special correction rules for loan failures are not available after the expiration of the maximum permissible repayment period under IRC *Section 72(p)(B)*.

EPCRS also provides that the following loan failures should be corrected using the streamlined VCP application in Appendix C, Part II, Schedule 5 (see *Streamlined VCP Applications*):

- Loans in excess of the maximum dollar limit under IRC Section 72(p)(2)(A) (see *Loans in Excess of the Maximum Dollar Limit*).
- Loans with repayment schedules that do not meet the maximum permissible repayment period under IRC Section 72(p)(2)(B) or the requirement to have substantially equal repayments under IRC *Section 72(b)(2)(C)* (see *Loans that Exceed the Maximum Loan Period*).
- Loans that are in default (see *Defaulted Loans*).
- There is a reduced VCP compliance fee for loan failures that involve a limited number of participants (see *Compliance Fee*).

Loans in Excess of the Maximum Dollar Limit

If a loan is issued in excess of the maximum permissible amount, EPCRS generally requires the participant to repay the excess loan amount to the plan, plus interest. The remaining balance of the loan is paid over the remaining period of the original loan (not beyond the maximum permissible repayment period permitted under IRC *Section 72(p)(2)(B)*, determined from the original date of the loan) in a manner that complies with the frequency and equal repayment requirements of IRC Section 72(p)(2)(C). The excess loan amount that is repaid by the participant is determined based on how previously made loan repayments have been applied to the loan. If previously made loan repayments were:

- Made within an amortization schedule that complied with the requirements of IRC Section 72(p)(2)(B) relating to the maximum permissible repayment period of the loan and IRC Section 72(p)(2)(C) relating to frequency and level loan payments, the previously made loan repayments may be applied:
  - to reduce the portion of the loan that did not exceed the maximum loan amount under IRC Section 72(p)(2)(A) so that the corrective repayment would equal the excess loan amount plus interest;
  - to reduce the excess loan amount to the extent of the interest on the excess, with the remainder of the prior loan repayments applied to reduce the portion of the loan that did not exceed the maximum loan amount under IRC Section 72(p)(2)(A), so that the corrective repayment equals the excess loan amount; or

- pro rata against the excess loan amount and the maximum loan amount under IRC *Section 72(b)(2)(A)*, so that the corrective repayment would equal the outstanding balance remaining on the excess loan amount on the date that the corrective repayment is made.

- Not made under an amortization schedule that complied with the requirements of IRC Section 72(p)(2)(B) or (C), and after corrective repayment is made:
  - the remaining loan balance may be repaid according to the original amortization schedule (this is only available if the original amortization schedule results in the loan being paid within the maximum permissible repayment period permitted under IRC Section 72(p)(2)(B) determined from the original date of the loan); or
  - the loan may be reformed to amortize the remaining principal balance as of the date of the corrective repayment over the remaining period of the original loan, provided that the recalculated payments over the remaining period comply with the maximum permissible repayment period requirements of IRC Section 72(p)(2)(B), determined from the original date of the loan.

Loans that Exceed the Maximum Loan Period

For loans that do not meet the maximum permissible repayment period requirements of IRC *Section 72(p)(2)(B)* or repayment schedules that do not meet the frequency and equal loan repayment requirements of IRC Section 72(p)(2)(C), the failure may be corrected by re-amortizing the loan balance under the level amortization requirements over a remaining period that does not extend beyond the original permissible repayment period.

Defaulted Loans

EPCRS also permits a correction if the loan terms satisfy the requirements of IRC *Sections 72(p)(2)(A)*, (B) and (C) and the loan is in default (after the passage of any "cure period"). In this case, EPCRS permits one of the following two corrections or a combination of both:

- A lump sum repayment equal to the amount of missed loan repayments, plus interest.
- Re-amortization of the outstanding balance of the loan, including accrued interest, over the remaining repayment schedule of the original term of the loan or the remaining period if the loan had originally been amortized over the maximum permissible repayment period.

Failure Where Plan Does Not Permit Loans but Provides Loans

If a plan that by its terms does not allow participant loans processes a loan, EPCRS allows for this to be corrected by retroactively amending the plan to provide for participant loans. This option is permitted only if the amendment satisfies IRC *Section 401(a)* and the loan requirements under IRC *Section 72(p)* were satisfied at the time the loan was issued.

Unless the loan corrections are made as required under EPCRS:

- A deemed distribution under IRC Section 72(p)(1) for a failure relating to a loan to a participant must be reported on Form 1099-R for the affected participant in the year of the failure.
- Any applicable income tax withholding amount that was required to be paid for the failure must be paid by the employer.

Special VCP Rules for Multiemployer Plans and Multiple Employer Plans

The plan administrator of a multiemployer plan or multiple employer plan, and **not** the contributing or adopting employer, must submit the VCP submission to the IRS.

If the VCP submission has failures that apply to fewer than all of the employers under the plan, the plan administrator may choose to have the compliance fee calculated separately for each employer rather than being attributable to the assets of the entire plan.

AUDIT CLOSING AGREEMENT PROGRAM: AUDIT CAP

Audit CAP is used by plan sponsors to correct operational failures, plan document failures and demographic failures, other than any failure corrected through SCP or VCP, discovered during a plan audit or a review of a determination letter application, and employer eligibility failures. Audit CAP permits plan sponsors to enter into a closing agreement regarding these failures with the IRS instead of facing plan disqualification.

Negotiating the Audit Cap Sanction

The plan sponsor may correct the qualification failure and pay a sanction based on a negotiated percentage of the maximum payment amount, which is an amount approximately equal to the sum of the following taxes that would be paid if the plan were disqualified for all open taxable years:

- Tax on the trust that holds the plan's assets (plus interest and penalties).
- Income tax resulting from the loss of employer deductions for plan contributions (plus interest and penalties).
- Income tax resulting from income inclusion for plan participants (plus any interest and penalties).
- Any other tax that results from a qualification failure that would apply but for the correction under EPCRS.

Negotiations in Audit CAP generally start at about 40% of the maximum payment amount. The sanction imposed typically bears a reasonable relationship to the nature, extent and severity of the failure, taking into account the extent to which the correction occurred before the audit. The factors the IRS will consider in determining the appropriate sanction include:

- The steps taken by the plan sponsor to prevent qualification failures.
- The steps taken to identify failures that may have occurred.

- The extent to which corrections had progressed before the audit was initiated.
- The number and type of employees affected by the failure.
- The number of non-highly compensated employees who would be adversely affected if the plan were not treated as qualified.
- Whether the failure is a failure to satisfy IRC *Sections 401(a)(4)*, *401(a)(26)* or *410(b)*.
- Whether the failure is solely an employer eligibility failure.
- The period of time over which the failure occurred (for example, for a plan document failure, the amount of time that has passed since the end of the applicable remedial amendment period).
- Whether the plan is the subject of a favorable determination letter.
- Whether the failure was discovered during the determination letter process.

PRE-APPROVED CORRECTIONS

EPCRS contains several pre-approved methods for correcting the following common operational failures, both under SCP and VCP:

- Failure to provide the minimum top-heavy benefit under IRC *Section 416* to non-key employees.
- Failure to satisfy the annual non-discrimination tests, the ADP test and ACP test, applicable to 401(k) plans.
- Failure to distribute elective deferral contributions that exceed the annual IRS limit.
- Exclusion of eligible employees from plan participation.
- Failure to timely implement a participant's elective deferral election.
- Failure to timely pay required minimum distributions under IRC *Section 401(a)(9)*.
- Failure to obtain participant or spousal consent for distributions subject to the IRC's qualified joint and survivor annuity rules.
- Failure to satisfy the annual limit on all contributions made on behalf of a participant to a defined contribution plan set forth in IRC *Section 415*.

EPCRS also sets out rules on how to correct several other qualification failures, including:

- Plan loan failures involving loans:
  - in an amount greater than the maximum permissible amount under IRC *Section 72(p)(2)(A)*:
  - with a repayment schedule longer than the maximum permissible duration under IRC Section 72(p)(2)(B) (generally five years);
  - with a repayment schedule that does not provide for level amortization with repayments at least quarterly; and
  - that are in default.

  (See *Special Rules for Loans*.)
- Employer eligibility failures.
- Excess allocations, which are contributions or allocations that exceed the maximum amount permitted to be contributed or allocated under the terms of the plan or an IRC limit and for which there is no correction method specified in the IRC or regulations. Excess allocations include, for example, elective deferral contributions or employer contributions made toward a participant's compensation in excess of the limit on the amount of compensation that can be taken into account under IRC Section 401(a)(17).
- Overpayments, which are payments to a participant which exceed the amount payable under the terms of the plan or an IRC limit.

BEST PRACTICES

When faced with correcting a qualification failure, a written copy should be kept of both the plan sponsor's analysis and the decision process used in determining which correction program to use and the method to correct the failure. This is particularly important when the failure is an operational failure, because the appropriate correction program to use, either SCP or VCP, can depend on whether the operational failure is insignificant or significant. In this instance, the plan sponsor's analysis should, at a minimum, consider the seven factors used to determine if an operational error is insignificant (see *Operational Failures: Insignificant Versus Significant*).

In addition, there is often more than one reasonable and appropriate correction method. One correction method may be a pre-approved correction (see *Pre-approved Corrections*), while other correction methods may vary in the steps taken but have the same general effect. As such, the analysis should consider whether each correction method satisfies the general correction principles (see *General Correction Principles*) and the pros and cons of using each correction method.

A primary reason to keep a written record of the plan sponsor's analysis and the decision process is to provide support that the correction was proper if the IRS ever audits the plan, especially if SCP was used to correct the failure. Because SCP does not require IRS involvement, the IRS will be addressing the qualification failure for the first time. The written record of the analysis should help the IRS understand the correction and the decisions made during the course of the process. Without these supporting documents, the IRS may not have all of the relevant facts and may determine that the correction was not appropriate and require additional corrective action, which would likely occur under an Audit Cap with its higher compliance fees (see *Negotiating the Audit Cap Sanction*).

SCP EXAMPLE: EXCLUSION OF ELIGIBLE EMPLOYEE FROM 401(K) PLAN

Facts

Company A has 100 employees and sponsors a 401(k) plan. The 401(k) plan provides for matching contributions equal to 100% of a participant's elective deferrals that do not exceed 3% of a participant's compensation. A new non-highly compensated employee, Employee A, satisfies the 401(k) plan's eligibility requirements and under the terms of the 401(k) plan, may begin participating on January 1, 2011. However, Employee A is inadvertently excluded from participating in the 401(k) plan for the 2011 plan year. Because Employee A was improperly excluded from making elective deferral contributions to the 401(k) plan, Employee A does not receive matching contributions on those deferrals for 2011. Employee A's salary in 2011 is $50,000 and the actual deferral percentage (ADP) for the 2011 plan year for the non-highly compensated employees group is 5%.

Pre-approved Correction

For this type of qualification failure, EPCRS provides that the employer must make a qualified nonelective contribution (QNEC), which is essentially a fully vested employer contribution, equal to 50% of the employee's "missed deferral." The employee's missed deferral is calculated by multiplying (i) the ADP of the group to which the employee belongs (for example, either non-highly compensated or highly compensated) for the year of the exclusion by (ii) the employee's compensation for the period of exclusion. The corrective QNEC is reduced as necessary so that it does not cause the employee to exceed plan limits, including the annual IRS limit on elective deferral contributions.

Company A must make a QNEC to the 401(k) plan on behalf of Employee A equal to 50% of Employee A's missed deferral. The missed deferral for Employee A is determined by multiplying the 2011 ADP for non-highly compensated employees (5%) by Employee A's 2011 compensation ($50,000), or $2,500. The QNEC, therefore, equals $1,250 (that is, 50% x $2,500).

For matching contributions, the employer must make a corrective matching contribution on behalf of the affected employee. This contribution is equal to the matching contribution the employee would have received had the employee made a deferral equal to 100% of the missed deferral, as described in the preceding paragraph. All corrective matching contributions must be adjusted for earnings to the date the contribution is made on behalf of the employee.

Company A must make a corrective matching contribution to the plan on behalf of Employee A equal to the matching contribution Employee A would have received had Employee A made elective deferral contributions equal to the missed deferral. Because the missed deferral for Employee A equals $2,500 (or 5% of Employee A's $50,000 compensation), Employee A is entitled to a matching contribution equal to 100% of 3% of Employee A's compensation ($50,000) or $1,500.

The total required corrective contributions (including QNECs and corrective matching contributions) on behalf of Employee A is $2,750 ($1,250 for the missed elective deferrals plus $1,500 for the missed matching contribution). The required corrective contribution is adjusted for earnings.

VCP Example: Compensation Definition Used Does Not Match Plan's Definition

Facts

Company B maintains a 401(k) plan by adopting a prototype plan. The 401(k) plan provides for elective deferral contributions, matching contributions and profit-sharing contributions. When the 401(k) plan was originally established, compensation for purposes of all of these contributions was defined as compensation as reported on Form W-2. Beginning in the 2009 plan year, Company B restated the 401(k) plan. In the restated adoption agreement, Company B amended the definition of compensation used for matching contributions and profit-sharing contributions to be base salary plus overtime, with the intent of removing annual bonuses (as well as other smaller forms of compensation) from the compensation definition.

However, Company B fails to update its systems for the new compensation definition and continues to administer the 401(k) plan by using Form W-2 compensation when calculating matching contributions and profit-sharing contributions. For the next three plan years, all plan participants receive more matching contributions and profit-sharing contributions than they are entitled to under the terms of the 401(k) plan.

Proposed Correction

Once discovered, Company B determines that this is a significant operational failure. Because of the time that has passed, Company B cannot use SCP but must instead use VCP. In its VCP application, Company B proposes to correct the failure by adopting a retroactive plan amendment that changes the definition of compensation for purposes of matching contributions and profit-sharing contributions to Form W-2 compensation. This retroactive amendment becomes effective as of the effective date of the restatement, so that the terms of the plan document match the actual operation of the 401(k) plan. In addition, the proposed correction method keeps assets in the 401(k) plan and is the most beneficial to all participants because the "excess" matching and profit-sharing contributions are not deducted from each participant's account.

Continued over...

Streamlined VCP Example: 401(k) Plan Loan Failure Using Appendix C, Part II, Schedule 5

Facts

Company C maintains a 401(k) plan that allows participants to borrow from the 401(k) plan (take loans). On June 1, 2011, Employee C borrows $10,000 from her 401(k) plan account with an interest rate of 5% for a five-year period. Loan repayments are scheduled to be made by payroll withholding. The 401(k) plan does not provide for a "cure period" for missed repayments. Employee C's loan information inadvertently is not entered into Company's C payroll system and, as a result, no loan repayments are withheld in 2011. The problem is discovered on December 15, 2011 and the date of the first missed payment is July 1, 2011. Under the terms of the 401(k) plan, Employee C's outstanding loan balance plus accrued interest is treated as a deemed distribution. Therefore, the balance of the loan plus accrued interest is treated as a taxable deemed distribution that, which must be reported on Employee C's 2011 tax return.

Proposed Correction

A loan's outstanding balance is a deemed distribution if the plan does not receive a required loan payment on its due date. Under the rules on correcting plan loan failures under EPCRS, Company C may request and obtain relief for the defaulted loan under VCP. To obtain relief, the failure to make repayments must be corrected by Employee C by using one of these methods:

- Make a lump sum payment equal to the amount due for any missed loan repayments (adjusted for interest at the plan loan interest rate) and continue making all loan repayments for the remaining period of the loan.
- Re-amortize the outstanding balance of the loan, resulting in increased loan repayments for the remainder of the loan period.
- Make a partial lump-sum payment and re-amortize the outstanding balance of the loan, resulting in a monthly payment that is greater than the first alternative above but less than the second alternative above.

EPCRS also provides that Company C may request relief through VCP from reporting the loan to Employee C as a deemed distribution. This type of failure has a streamlined application process involving a shorter "template" application form (see *Streamlined VCP Applications*). In addition, the compliance fee is half the amount required for a regular VCP application (see *Reduced Compliance Fees for Certain Submissions*).

This situation can also be prevented from occurring again by prospectively amending the plan to permit a cure period. For example, the plan could be amended prospectively to provide that a loan does not become a deemed distribution until the end of the calendar quarter following the quarter in which the repayment was missed (under applicable law). This gives the plan administrator time to take corrective action without negative consequences. For example, if the plan administrator followed such a procedure with respect to Employee C, then upon discovery on December 15, 2011, the plan administrator would have had the opportunity to secure the missed repayments from Employee C and prevent the loan from being treated as a deemed distribution (since the first missed payment was due on July 1, 2011, it could have been secured by December 31, 2011).

For more information on this topic, search for the following resources on our website.

Practice Notes:

- *Applying for an IRS Determination Letter Applying for an IRS Determination Letter (http://us.practicallaw.com/9-501-4610)*
- *Qualified Retirement Plan Loans (http://us.practicallaw.com/0-507-2685)*
- *Qualified Retirement Plans in Mergers and Acquisitions (http://us.practicallaw.com/1-521-1780)*
- *Requirements for Qualified Retirement Plans (http://us.practicallaw.com/3-506-6895)*

For the links to the documents referenced in this note, please visit our online version at http://us.practicallaw.com/7-513-5477.