ASPEN PUBLISHERS VOL. 32, NO. 2 AUTUMN 2006

Employee Relations
LAW JOURNAL

Employee Benefits

Fixing the Problem: Correcting Errors in Qualified Plans

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The Internal Revenue Service (IRS) has long had an informal policy of allowing qualified plans to correct operational and other errors with varying levels of sanctions. In order to publicize the need to correct plan errors, and to encourage consistent practices among parties that establish qualified plans, and the IRS agents who audit plans, the IRS developed specific procedures that plan sponsors can use to correct their plan defects. These procedures, called the Employee Plans Compliance Resolution System (EPCRS), were recently updated. This column answers basic questions about EPCRS and how plan sponsors can use the program.

Why Is the Correction System Necessary?

Despite their best efforts, sponsors or administrators of qualified pension and 401(k) plans will make errors, such as underpayments and overpayments, improper exclusion of employees, failure to follow the plan's documented procedures, incorrect administration of loans or withdrawals, or plan documents with faulty language or that are not timely amended. The IRS takes the position that any errors in the operation of a plan or the form of plan documentation, no matter how inconsequential or unintentional, can disqualify a plan, and when challenged (which is infrequent), the courts have held that this position was not an abuse of the IRS's discretion.[1] The IRS has also consistently refused to recognize a "scrivener's error" defense for plan language that does not reflect actual operations.

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Most plans with errors discovered on audit are not disqualified, but they face heavy penalties, and the threat of disqualification and the loss of prior and future tax benefits is a major bargaining tool for the IRS. In order to encourage self-correction and provide consistency in enforcement, the IRS developed standardized procdures.[2] The most recent procedure is set forth in Revenue Procedure 2006-27 (Rev. Proc. 20006-27).[3]

What Are the Three Basic Correction Programs?

The EPCRS consists of three basic correction programs: the Self-Correction Program (SCP—or self-correction), the Voluntary Correction Program (VCP—correction with IRS approval), and the Correction on Audit Program (Audit CAP—correction when "caught"). The appropriate correction method and program will be determined by the type of employer, plan, and failure. The IRS categorizes failures as "operational" (*e.g.*, incorrect administration or failure to follow the plan document), "plan document" (*e.g.*, failure to amend timely or properly); "demographic" (failing a nondiscrimination test) or "employer eligibility" (an employer not eligible to adopt the plan it is using). These basic programs are summarized below and then discussed in more detail.

SCP

A plan sponsor that has established compliance practices and procedures may self-correct insignificant operational failures without applying to the IRS or paying any fee or sanction. Similarly, a qualified plan with a favorable determination letter from the IRS or a Section 403(b) plan may self-correct even significant operational failures as long as the correction is "timely." As discussed below, a "timely" correction is generally a two-year period after the error occurs and before the error is discovered by the IRS.

VCP

At any time before audit, the plan sponsor can suggest a correction, pay a stated fee, and seek the IRS's approval of the correction. VCP can be used for operational, demographic, plan document, or employer eligibility failures for qualified plans and section 403(b) plans. The VCP also contains special procedures for anonymous and group submissions, simplified employee pension (SEP) plans and savings incentive match plans for employees (SIMPLE) IRAs. So called "orphan" plans and terminated plans can also be corrected under VCP or Audit CAP, discussed below.

Audit CAP

If a failure (other than a failure corrected through the SCP or VCP) is identified on audit, the plan sponsor may correct the failure and pay a penalty. The penalty 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. It will likely be higher than the self-correction fees.

How Is the IRS Guidance Structured?

Rev. Proc. 2006-27 first explains what types of plans are eligible to use the various programs and then recites a number of correction "principles" which should be followed when crafting a correction. Appendices A and B provide examples of permitted corrections that cover many of the typical plan errors. Note, however, that because Rev. Proc. 2006-27 was based on earlier IRS Revenue Procedures, examples and rules for the same errors are sometimes contained in both appendices (usually alternative correction methods) as well as in the body of the Revenue Procedure, making the procedure confusing and hard to follow for the first-time reader. This column briefly discusses the correction principles and procedures first and then describes some of the common plan errors and their method of correction.

Can All Errors Be Corrected Under EPCRS?

Certain errors are not covered by EPCRS and certain plans cannot use EPCRS in all circumstances. For example, plans under IRS examination generally cannot use SCP for significant errors or use VCP. However, if a plan is not eligible to use the formal EPCRS program, in most cases the IRS will work with a plan to correct errors related to Internal Revenue Code (Code) violations. Also, excise taxes are generally not waived (except for certain minimum distribution violations).

An error that involves the diversion or misuse of plan assets cannot be corrected under EPCRS. Prohibited transactions, a failure to file Form 5500, or a funding deficiency, may not be corrected under EPCRS. Some of those errors may be corrected under the Voluntary Fiduciary Correction Program of the Department of Labor (DOL) or the DOL's Delinquent Filer Voluntary Compliance Program. These programs, which are beyond the scope of this column, are discussed at the Department of Labor's Web site.[4] Special rules apply to plans and plan sponsors with abusive tax avoidance transactions, discussed below.

What Special Rules Apply to Plans or Plan Sponsors with Abusive Tax Avoidance Transactions?

IRS Rev. Proc. 2006-27 contains special rules for plans or plan sponsors that have been a party to "abusive tax avoidance transactions, " or "ATATs." These transactions are specific tax avoidance transactions that are "listed transactions" that require special disclosure, or transactions identified on the IRS website entitled "EP Abusive Tax Transactions."[5] Many of the listed transactions do not directly involve qualified plans, but some involve executive compensation and welfare plans. Examples of listed transactions that could affect qualified plans and plan sponsors are certain contributions from corporations to Roth IRAs, improper use of voluntary employee beneficiary associations (VEBAs), or the use of allegedly improper funding mechanisms under a Section 412(i) insurance funded plan. The list of ATATs is updated regularly and should be checked before using EPCRS, since additional disclosure of the ATAT may be required.

The revenue procedure states that SCP is not available for a plan or plan sponsor that has been a party to an abusive tax avoidance transaction if the operational failure is directly or indirectly related to the transaction. VCP applications must affirmatively state that the plan or plan sponsor is not involved in any ATAT, or, if it is, provide a description of that ATAT. If there is an ATAT, or if in an audit situation the Service determines that a plan sponsor may have been a party to an ATAT, the matter will be referred to the IRS Employee Plans Tax Shelter Coordinator, who will determine whether the proposed correction is related to the ATAT. It appears that the IRS does intend to process errors unrelated to an ATAT under VCP, but the IRS specifically reserves the right to refer the ATAT for examination. This may make VCP less attractive to plan sponsors with an ATAT even if the ATAT is unrelated to the plan error.

What General Principles Apply to the EPCRS Program?

The IRS correction principles can be used to craft a correction that may not be specifically mentioned in Rev. Proc. 2006-27. Plan sponsors can also use these principles to consider whether to attempt any deviation from the common correction methods used by the IRS.

These principles state that 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). The correction method should restore the plan to the position in which it would have been had the failure not occurred.

The correction should be reasonable and appropriate for the failure and applied consistently. The correction should keep assets in the plan and not violate any other qualification requirement under the Code. The IRS says that any correction method permitted under Appendix A or Appendix B to Revenue Procedure 2006-27 is deemed to be an appropriate correction method. If a plan is not using the methods under Appendix A or B, the proposed correction should, if possible, resemble an analogous correction provided for by the Code, regulations, or other guidance. The correction should add benefits for nonhighly compensated employees (NHCEs) rather than distribute to highly compensated employees (HCEs)—if the qualification error is a “demographic” one that relates to nondiscrimination.

The IRS has also stated that corrective allocations should only come from employer contributions (which can include forfeitures if the plan so permits). A corrective distribution under a defined benefit plan for an individual should be increased to take into account the delayed payment, consistent with the plan’s actuarial adjustments.

The correction should be based upon the terms of the plan and adjusted for earnings and forfeitures that would have been allocated to the participant’s account if the failure had not occurred. However, a corrective allocation to a participant's account will not be treated as an annual addition with respect to the year of correction, but will apply to the year to which the allocation relates. The normal rules of Code Section 404 governing deductions apply.[6]

What Are the Exceptions to the Full Correction Requirement? When Can "Best Estimates" Be Used?

As noted above, generally corrections must be made for all years the error occurred, including closed years. There are several exceptions, however. For example, if it is not possible to make a precise calculation, or if the cost of making a precise estimate would significantly exceed the probable difference between a precise and approximate correction, a reasonable estimate may be used in calculating the appropriate correction. Estimates of lost or overpaid earnings can also be made, as discussed below.

There are also important de minimis rules. 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. This relief does not specifically apply to excess contributions.

For a submission under the VCP or Audit CAP, 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 or to notify such individuals that the overpayment is not eligible for favorable tax treatment. Also, if under VCP or Audit CAP, the error is an "excess amount"—payment in excess of certain Code limits described in Rev. Proc. 2006-27—the excess need not be distributed from the plan if it is $100 or less, but the affected individuals must be notified that these excess amounts are not eligible for favorable tax treatment (e.g., rollovers). Note that these last two exemptions to not apply to SCP under Rev. Proc. 2006-27.[7]

How Can a Plan Sponsor Self-Correct Without Contracting the IRS?

Most employers would prefer self-correction to prolonged discussions with the IRS. A plan sponsor can self-correct *insignificant* operational failures at any time, even if the plan is under audit or the failure is discovered by an IRS agent during examination.[8] Plan sponsors can even self-correct *significant* operational errors during the two-year period following the plan year in which the defects occurred (the "correction period") unless an IRS audit occurs before the correction is complete.[9] But a plan must have a favorable determination letter, opinion letter, or notification letter from the IRS to self- correct significant operational failures. Egregious errors may not be self-corrected under SCP. An example of an egregious error is a plan that has consistently covered only HCEs.

A plan sponsor that self-corrects must have in place established practices and procedures (either formal or informal) that are reasonably designed to promote and facilitate compliance. Most practitioners recommend that any SCP correction be documented internally including a list of the facts supporting eligibility to self-correct.

The IRS lists various factors that are considered in determining whether an operational failure under a plan is insignificant, although no single factor is determinative. These factors include, but are not limited to:

1. Whether other failures occurred during the period being examined (a single failure that affects multiple parties is only considered a single failure);

2. Percentage of plan assets and contributions involved in the failure;

3. Number of years the failure occurred;

4. Number of participants affected relative to the total number of participants in the plan;

5. 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. Reason for the failure (*e.g.*, errors in the transcription of data, the transposition of numbers, or minor arithmetic errors).

The IRS recognizes that if all of these factors were applied, some entities might be excluded based on their structure (*e.g.*, a failure with respect to one participant in a plan of a small company with only three eligible employee-participants arguably involves a significant percentage of participants). Rev. Proc. 2006-27 states that depending on the circumstances, the factors listed as (2), (4), and (5) should not be interpreted to exclude small businesses from self-correction.[10]

Self-corrections must be substantially completed during the correction period. Correction of an operational failure is substantially completed by the last day of the correction period if (1) during the correction period, the plan sponsor is reasonably prompt in identifying the operational failure, formulating a correction method, and initiating correction, and within 90 days after the last day of the correction period, the plan sponsor completes correction of the operational failure; or (2) during the correction period, correction is completed with respect to 85 percent of all participants affected by the operational failure, and thereafter, the plan sponsor completes correction of the operational failure for the remaining affected participants in a diligent manner.

A special rule applies to corrections involving "transferred assets." In that case, 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 transaction between the plan sponsor and the sponsor of the transferor plan. Transferred assets means assets that are received by a plan in connection with a corporate merger, acquisition, or other similar employer transaction in a transfer from a plan sponsored by an employer that is not a member of the same controlled group as the plan sponsor.[11]

Most plan sponsors will try to fit into a self-correction procedure if they can. But even if eligible for self-correction, a plan sponsor might want to seek approval of the IRS if it wants the certainty of IRS review and a compliance statement, or if it wants to correct the error in a manner that is not identical or substantially similar to one of the suggested correction methods. Certain de minimis rules, allowing overpayments to be ignored or excess amounts to stay in the plan, do not technically apply to self-correction. Moreover, there are many cases in which a plan is not eligible for self-correction, requiring correction with IRS approval.

What Is the VCP Program for Obtaining IRS Approval of a Correction and How Does One Participate?

The VCP program initially involves steps similar to self-correction—the plan sponsor identifies an error and decides on a correction. However, the IRS must then be informed of the error and correction by the filing of an application that describes the error, how it occurred, and the proposed correction. As discussed in more detail below, the application must be accompanied by a fee based on the size of the affected plan and other factors. In some cases, the application is accompanied by a draft compliance statement to be signed by the IRS. Because VCP does not occur in connection with an IRS examination, use of VCP will not preclude a later IRS review of the plan sponsor or the plan of matters that are outside the compliance statement.

VCP is available for egregious errors, but a higher fee will apply. Once a plan is "under examination"[12] VCP may not be used; that is, once "caught" the more stringent penalties under Audit Cap apply. SCP can be used for insignificant errors when a plan is under audit, but generally a plan is under Audit Cap program for any significant errors that have not been corrected before the plan comes under examination.

Can Only Qualified Plans Use VCP?

EPCRS allows Section 403(b) plans as well as qualified plans to correct an operational failure, demographic failure, or employer eligibility failure. EPCRS can also be used by simplified employee plans (SEPs) and SIMPLE IRAs. Although not discussed in detail in this column, principles and procedures used for those programs are similar to those used for qualified plans. Although correction of Section 457(b) plans is not formally permitted under VCP, the IRS has stated in Rev. Proc. 2006-27 that taxpayers with errors under a 457(b) plan may submit them to the IRS for approval on a trial basis.

Are There Other Special Procedures Under VCP?

The IRS correction program allows "group submissions" by eligible organizations under a procedure called "VCGroup." VCGroup can be used if (1) the failures are all operational failures and the applicant is an "eligible organization;" or (2) the failures are plan document failures and the eligible organization is a sponsor.[13] For purposes of VCGroup, the term *eligible organization* generally includes sponsoring organizations of a master and prototype plan, an insurance company that issues annuity contracts, or a third-party administrator. Some employers may find themselves part of a group submission if their service providers discover systemic errors that need to be fixed.

A submission under VCGroup must affect at least 20 plans. An initial fee of $10,000 (for the first 20 plans) is paid up front, with an additional fee of $250 per plan in excess of 20 capped at $50,000. The submission procedures vary slightly from VCP, but the correction principles and methods are similar. Note that all employers whose plans are included will be identified to the IRS. Eligible organizations may find VCGroup a useful way to correct plan errors without unduly burdening their participating employers. Fees per plan are generally lower under VCGroup if a large number of plans are involved. Participating employers will have to be told about the correction and given the opportunity to "opt out" of the Group Submission.

What Are the Application Procedures Under VCP?

A plan sponsor or its representative must submit an application to the IRS that meets the specific requirements of Rev. Proc. 2006-27, which should be consulted before preparing the submission.

Essentially, the submission describes the type of plan affected, the failures that occurred, and the period of failure and how the failures occurred. The submission must describe the administrative procedures in effect at the time the failures occurred. It must explain how the failure will be corrected, and describe the methodology used to calculate earnings or actuarial adjustments on contributions or distributions. Calculations for each affected employee or a representative sample of affected employees must be provided. The submission must explain how the applicant will locate and notify former employees and beneficiaries or contain an affirmative statement that no former employees or beneficiaries were affected by the failures. It must describe measures that have been or will be implemented to ensure that the same failures will not recur. The plan sponsor will also have to sign a statement that, to the best of the plan sponsor's knowledge, neither the plan nor the plan sponsor is under examination and a statement that neither the plan sponsor nor the plan has been a party to an abusive tax avoidance transaction (or provide a brief statement describing the transaction). Other requirements apply depending on the nature of the plan and the errors involved.

The application should also include a copy of the most recently filed Form 5500, if applicable; copies of the relevant portions of the plan document; and a copy of a favorable IRS determination letter, if applicable. Generally the correction fee is required with the submission. The submission must be signed by the plan sponsor or the sponsor's authorized representative (*e.g.*, under a power of attorney—IRS Form 2848). A declaration under penalty of perjury as to the correctness and completeness of the submission must be signed by the plan sponsor (not the representative). The applicant also must attach a completed and signed VCP Checklist.[14]

What Is the VCP Process Like?

Due to personnel shortages and other factors, it has oftern been over six months before the IRS contacts a taxpayer who files under the VCP portion of EPCRS. (The check with the submission fee, however, will be cashed more quickly.) The new procedures require that the taxpayer prepare an acknowledgment letter to be signed by the IRS, which will likely facilitate earlier confirmation that the IRS has received the request.

Once a submission is made, the IRS reviews it for completeness and then contacts the plan sponsor or representative to discuss the proposed corrections. Only those failures voluntarily raised by the plan sponsor or failures identified by the IRS in processing the application are addressed under the program, and only those failures are covered by the program. It has generally been this author's experience that the IRS does not explore matters unrelated to the submission.

If agreement is reached, the plan sponsor will sign a compliance statement setting forth the correction. The compliance statement is binding on both the IRS and the plan sponsor (or eligible organization) with respect to the specific tax matters identified therein for the periods specified, but it does not preclude examination of the plan by the IRS relating to matters outside the compliance statement, even involving the same taxable year or years to which the compliance statement relates. 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 (this can sometimes be extended). If the IRS and the plan sponsor cannot reach an agreement, the IRS may refer the submission to Employee Plans Examinations.[15] There is no refund of the application fee except for an anonymous submission, where 50 percent of the application fee is refunded.

Once the compliance statement is issued, it generally cannot be modified. However, if the modification is minor and postmarked no later than 30 days after the statement is issued, the compliance statement can be modified for the lesser of the original compliance fee or $3,000.

When Can Plan Amendments Be Used to Correct Errors?

Plan amendments may be used under VCP or Audit CAP to correct plan document, demographic and operational errors. For example, the plan sponsor can adopt an amendment to conform the operation of the plan to its terms, as long as the amendment complies with all requirements of the Code. Plan amendments can also be added to permit a correction (*e.g.*, loans or distributions made due to hardship) that is otherwise not authorized in the plan. A plan sponsor may also use VCP or Audit CAP to correct for missed amendments that should have been made to the plan, or for amendments that are late.

The sponsor can submit plan amendments that were not timely made. Appendix F of Rev. Proc. 2006-27 sets forth a streamlined application/compliance statement that can be used for amendment failures (or failure to amend) related to relatively recent (generally post-2001) required amendments, if that is the sole error. Presumably this will provide a quicker VCP application process than the regular VCP.

Plan amendments generally cannot be used to correct under SCP, except as listed at section 2.07 of Appendix B. Section 2.07 permits amendments to (1) increase the allowable contribution percentage for all participants so as to allow the amount improperly contributed under section 401(a)(17) to comply; (2) correct loans and hardship distributions that were not authorized by the plan by amending the plan to make these distributions available; and (3) amend the plan to allow earlier inclusion for all employees to correct for an operational error that permitted an employee to begin before the allowable entry date.

In What Circumstances Are Determination Letter Applications Required Under the EPCRS Program?

This issue has become more complicated now that plan sponsors are scheduled to submit determination letters during individual cycles, so that the end of the required "remedial amendment periods" will differ for sponsors with similar plans. Under VCP and Audit Cap, a determination letter will be issued for a nonamender failure, but it will only cover the applicable laws with respect to which the remedial amendment period has expired, and it will not be issued for "out of cycle" plans for certain of the post-2001 amendments that the IRS is requiring to be submitted in cycles, unless the plan is terminating or submitting a letter on an "on cycle year." For example, if a failure to make a GUST amendment is being corrected, only a GUST determination letter will be issued. The plan sponsor will have to obtain separately (on its proper cycle) a determination letter on post-GUST amendments. Special rules explain the circumstances under which the compliance statement will protect the plan's qualification in the absence of a determination letter.

Suppose I Am Reluctant to Disclosure My Errors to the IRS Without Knowing the Consequences?

The IRS has established a system known as the "John Doe" or "Anonymous" submission procedure to allow plans[16] to approach the IRS with a proposed correction without initially identifying the plan or the plan sponsor. The VCP application procedures still generally apply, but the plan sponsor can redact any identifying information and need not include a power of attorney statement or penalty of perjury statement with the initial submission. However, the state of the plan sponsor must be identified in the initial submission. Once the IRS and the plan representative reach an agreement with respect to the submission, the plan sponsor and plan must be identified.

A problem may occur under this procedure if the plan comes under examination. Until the plan and plan sponsor are identified, an anonymous submission does not preclude an examination of the plan sponsor or its plans. However, one would assume any audit would take into account any prior tentative agreements with the IRS regarding correction (if the parties are at a negotiation stage) as well as take into account the fact that a voluntary submission was in process.

What Are the Relevant Compliance Fees?

The compliance fee for an application under VCP is based on the number of plan participants and the error involved. For most operational errors (except egregious ones), the fees are set forth in the following table. [17]

Compliance Fees Under VCP (Nonamenders Who Are Caught)

Compliance Fees Under VCP (General Rules)

Number of Participants	Fee
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
1,001 to 5,000	$15,000
5,001 to 10,000	$20,000
More than 10,000	$25,000

If a VCP submission involves only a failure to meet the minimum distribution requirements of Section 401(a)(9) for 50 or fewer participants and would result in an excise tax, the compliance fee is $500. The IRS may choose to waive compliance fees for terminated and “orphan” plans (plans with no identified sponsor), if requested in the submission.

In general, the fee for nonamenders is the same as the fee for operational compliance. The fee is reduced by one half if it is submitted within one year of the required remedial amendment period. Moreover, the fee for a submission that contains only a failure to amend for (a) “good faith” EGTRRA amendments, including changes listed in Notice 2005-5, (b) plan amendments for Section 401(a)(9) final and temporary regulations, and (c) interim amendments as described in Section 5 of Rev. Proc. 2005-66, is $375.

A separate VCP fee schedule for nonamenders discovered during the determination letter process is set forth below. The fee depends on the number of participants and the type of amendment that is missed. The earlier in time the amendment was required, the higher the fee. Fees for the latest set of amendments are set forth below. Higher fees apply for failure to amend for ERISA and other pre-1993 law changes.

Number of Participants	EGTRRA Failure	GUST/401(a)(9) Failure	UCA/OBRA 93 Failure
20 or fewer	$2,500	$3,000	$3,500
21 to 50	$5,000	$6,000	$7,000
51 to 100	$7,500	$9,000	$10,500
101 to 500	$12,500	$15,000	$17,500
501 to 1,000	$17,500	$21,000	$25,500
1,001 to 5,000	$25,000	$30,000	$35,000
5,001 to 10,000	$32,500	$39,000	$45,500
More than 10,000	$40,000	$48,000	$56,000

Special fees apply for SEPs and SIMPLE IRA plans, and the VCP fee for egregious failures is negotiated with the IRS. It will be greater than the fees in the fee schedule.

What Is Audit CAP?

If the IRS audits a plan and identifies a failure (other than a failure that has been corrected in accordance with EPCRS), Audit CAP allows a plan to avoid disqualification if the plan sponsor corrects the failure, pays a penalty, satisfies any additional requirements imposed by the IRS, and enters into a closing agreement with the IRS.

There is no formal submission in Audit CAP. Depending on the nature of the failure, the IRS may require changes to the plan's existing administrative procedures, and the plan sponsor may be required to obtain a favorable determination letter. The penalty under Audit CAP is an amount negotiated with the IRS, generally based on a negotiated percentage of the total income tax the IRS could collect as a result of the failure.[18] Rev. Proc. 2006-27 states that penalties should not be excessive and should bear a reasonable relationship to the nature, extent, and severity of the failures.

If the IRS and the plan sponsor cannot agree with respect to the correction of the failure(s) or the amount of the penalty, the plan will be disqualified or, in the case of a Section 403(b) plan or SEP plan, result in adverse tax consequences to participants.

What Kinds of Corrections Can I Suggest to the IRS?

The best way to understand the type of corrections that make sense and pass muster with the IRS is to review Appendices A and B in Rev. Proc. 2006-27. These appendices describe IRS-approved correction methods and procedures. Some of the more typical errors this author has seen and the corrections suggested by the IRS are discussed below. Remember that variations of these corrections may be accepted by the IRS, although most practitioners caution entities that want to self-correct without IRS review to adhere as closely as they can to the IRS-suggested correction.

Top-Heavy Failures

Top heavy plans generally must make a contribution or accrue a minimum benefit for non-key employees. The standard correction for failure to do so is for the plan sponsor to make the top-heavy minimum contributions.

Failure to Satisfy ADP or ACP Tests for 401(k) Plans

Section 401(k) plans must pass objective nondiscrimination tests that compare the average deferral percentage for pre-tax deferrals of the HCE and the NHCE participants—the actual deferral percentage (ADP) test. Under that test, the percentage for HCEs cannot exceed the percentage for NHCEs by more than a specified amount. A similar test is performed for matching and after-tax contributions—the actual contribution percentage (ACP) test. Plans often fail these tests if HCEs contribute more to the plan than NHCEs.

IRS regulations allow the plan to correct so as to pass the tests in a variety of ways, but the correction must be complete before the close of the following plan year and it must be authorized in the plan document. Under the regulations, one way to correct for failure to pass the ADP test is to recharacterize the excess contribution as an after-tax contribution, if the plan allows for after-tax contributions. In addition, the employee would have to include the distribution in income and the plan sponsor must advise affected HCEs that they must file an amended return if a return has already been filed for that earlier year. Alternatively, the plan can provide that the excess contribution (and any income allocable to that excess contribution) is distributed to the HCEs without recharacterization (with the same income tax consequences to the HCEs as described above). Another alternative which doesn't affect HCEs, but which could be expensive, is for the plan sponsor to make a contribution of a uniform amount to the NHCEs.[19]

Sometimes 401(k) plans cannot use these regulatory methods because the plans cannot accommodate these corrections or because the error is discovered too late. In that case, EPCRS can be used.

One "approved" EPCRS correction is making contributions in a uniform dollar amount or percentage to all eligible NHCEs to the extent necessary to raise the NHCE ADP or ACP to pass the applicable test. This is similar to the regulatory correction discussed above.

Another method is for the plan to determine the excess contribution amount (adjusted for earnings) for the affected HCEs (based on the ADP/ACP test) and either distribute the excess to the HCEs or forfeit those amounts from their accounts. The plan sponsor then makes a contribution to the plan in an amount equal to the aggregate amount of the distributions/forfeitures, and the contribution is allocated to the accounts of NHCEs. As under the regulations, if an excess amount so assigned to a particular HCE has been previously distributed, the plan sponsor must notify the employee that the excess amount was not eligible for favorable tax treatment. There are examples in Appendix B that illustrate how this correction works.

Exclusion of Eligible Employees

Sometimes plans inadvertently exclude otherwise eligible employees—by incorrect service counting or classification, or by a gap in payroll. If the affected employee could have made salary deferrals under the plan, the plan sponsor must make a contribution equal to one half the ADP for that excluded employee's group (highly paid or not highly paid). The IRS initially required a contribution of 100 percent of the ADP. Rev. Proc. 2006-27 reduced the percentage to 50 percent because the excluded employee did not lose the salary deferral contribution entirely, but received it as *taxable* salary. Thus, the reduced amount represents the lost opportunity to make a qualified plan contribution (a "missed deferred opportunity"). If the employee also lost the opportunity to make after-tax contributions (other than Roth contributions), the plan sponsor must make a contribution equal to 40 percent of the relevant average contribution percentage. If matching or employer nonelective contributions were lost, they must be replaced as well. If a safe-harbor plan is involved, however, the full safe-harbor contribution must be made.

If an eligible employee had the opportunity to make contributions under a 401(k) plan for a partial plan year, the failure may be corrected by making a contribution based only on the employee's compensation for the portion of the plan year such employee was excluded from participating in the plan.

The amount of any corrective contribution is reduced if the sum of that contribution and any contributions actually made by or on behalf of the employee for that year would exceed the maximum limits permitted under the plan for the employee for that plan year. Moreover, a plan sponsor need not make a corrective contribution with respect to elective deferrals for an employee for a plan year if the employee had been provided the opportunity to make elective deferrals (of up to the maximum amount permitted) under the plan for a period of at least the last nine months in that plan year.

Exclusion of Employees from Nonelective Contributions in a Profit Sharing Plan

If an eligible employee did not receive nonelective contributions in a profit sharing or stock bonus plan, the plan sponsor must make a corrective contribution on behalf of the excluded employee using the allocation formula under the plan. Alternatively, if certain conditions are met, the account balance of all participants could be redetermined as if the excluded employees shared in the allocation of the nonelective contribution (adjusted for earnings). The account balance of each eligible employee who shared in the original allocation of the nonelective contribution is reduced by the excess, if any, of (1) the employee's allocation of that contribution over (2) the amount that would have been allocated to that employee had the failure not occurred (adjusted for earnings). The excluded employees receive an allocation. This last alternative is generally not used. Special rules allow the plan sponsor to ignore earnings (or use the plan's lowest earnings ratio) when determining reallocations if most of the participants who are losing allocated amounts under the correction are NHCEs.

Loan Failures

Generally, under the IRS loan regulations, deemed distributions for failed plan loans must be reported on a Form 1099-R and the plan sponsor is responsible for paying income tax withholding amounts. As part of VCP, a deemed distribution may be reported on a 1099-R for the year of correction (rather than the year of failure).

Rev. Proc. 2006-27 provides procedures for correcting plan loan failures.[20] Generally, if the loan has not been defaulted, the procedures allow new repayment schedules instead of a deemed distribution. In certain cases, the loan failures corrected as described in (1) and (2) below may not be required to be reported on a Form 1099-R.

1. *Loans Exceeding Allowable Dollar Limit.* The participant may repay the amount exceeding the allowable loan limit and reamortize the remaining loan balance.

2. *Loans Not Repaid in Accordance with Schedule.* The remaining term of the loan may be shortened to reamortize and repay the loan within five years of the loan's origination date (longer if loan is for purchase of residence).

3. *Defaulted Loans Still in Grace Period.* If the loan is in the grace period, the participant may be given the opportunity to repay the overdue amount in a lump sum, or have the loan reamortized, or use a combination of the two approaches.

Failure to Obtain Spousal Consent

If spousal consent was required but not obtained, the standard correction 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 (QJSA) based on the monthly amount that would have been provided under the plan at his or her retirement date, actuarially reduced to take into account distributions already received by the participant. However, the portion of the annuity payable to the spouse upon the participant's death may not be reduced to take into account the prior distributions to the participant. An alternative is to give the affected participant a choice between providing informed consent, receiving the annuity type payment described above, or receiving a single sum payment equal to the present value of the survivor annuity. The IRS requires that letters be sent to affected participants that explain the QJSA or qualified preretirement survivor annuity (QPSA) option.

Rev. Proc. 2006-27 provides alternatives if spousal consent is not obtained because the spouse chooses not to consent or does not respond. In that case, the spouse will be entitled to a benefit equal to the portion of the qualified joint and survivor annuity that would have been payable to the spouse upon the death of the participant had a qualified joint and survivor annuity been provided. This benefit must be provided if a claim is made by the spouse.

Additionally, if the spousal consent is not obtained, the plan may offer the spouse a choice between the survivor annuity benefit and a single sum payment equal to the actuarial present value of that survivor annuity benefit. [21]

Hardship Distribution Failures

Under the plan amendment correction method, the plan can be amended retroactively to provide for the hardship distributions that were made available. This method does not apply unless (1) the amendment satisfies Code Section 401(a), and (2) the plan as amended would have satisfied the qualification requirements of Code Section 401(a) (including the requirements applicable to hardship distributions under Section 401(k), if applicable) had the amendment been adopted when hardship distributions were first made available. This amendment must be noted when the next determination letter for the plan is submitted.

Failure to Pay Minimum Distributions

The standard correction method is to distribute the required minimum distributions (RMDs) for all prior years. The amount to be distributed is determined by dividing the adjusted account balance on the valuation date by the applicable distribution period. In a defined benefit plan, the distributions must include an interest payment representing the loss of use of such amounts.

Vesting Failures

If an improper forfeiture occurs in a defined contribution plan due to a vesting mistake, the error may be corrected if the plan sponsor makes a corrective contribution (adjusted for earnings) on behalf of the affected employee. 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.

Alternatively, in a defined contribution plan where forfeitures of account balances are reallocated among the account balances of the other eligible employees, and if the forfeitures are not used to pay a specified percentage of compensation to each employee, such failure may be corrected by reducing the accounts of the employees who shared in the allocation of any improper forfeiture by the forfeiture amount (adjusted for earnings), and reallocating these aggregate amounts are to the account balance of the employee who incurred the improper forfeiture.

Code Section 415(b) Excess Payments from a Defined Benefit Plan

If a participant has been paid an amount from a defined benefit plan that was greater than allowed under Section 415(b), the plan sponsor must take reasonable steps to have any Code Section 415 overpayment (with appropriate interest) returned by the recipient to the plan and/or to reduce future benefit payments (if any) due the employee to reflect the limits of Section 415(b). The plan sponsor must contribute to the plan the difference, if any, between the overpayment and the amount actually returned. The plan sponsor 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).

If payments are being distributed in the form of periodic payments, the plan sponsor may make reduced future payments over time to recoup the excess amounts. Future payments should be limited to ensure that the actuarial present value of the reductions equals the overpayment plus applicable interest. If the employee is receiving payments in the form of a joint and survivor annuity, the reduction of future annuity payments to reflect Code Section 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.

Code Section 415 Excess Allocations in a Defined Contribution Plan

The standard correction for excess annual additions that are attributable to employer contributions is to place the excess annual additions in an unallocated suspense account that is used to offset future employer contributions. Until such amounts are exhausted, the plan sponsor may not make additional contributions to the plan. The IRS has indicated that it is reviewing this correction method and has requested comments on its continued use.

If the annual additions are attributable to elective deferrals or employee contributions, they should be reallocated to other participants in the plan until the limits of Code Section 415 are again exceeded, in which case a suspense account is created.

Elective deferrals and employee contributions that are matched may be returned, provided that the matching contributions relating to such contributions are forfeited (and placed into an unallocated account to be used as an employer contribution in succeeding periods).

Code Section 415(c) Excess Payments from a Defined Contribution Plan

The return-of-overpayment method, similar to the method used for Code Section 415(b) excesses, may be used if the Section 415(c) excess was previously distributed to the employee.

A plan sponsor may also treat a Section 415(c) excess payment as forfeited if (1) it was an NHCE that had the excess; (2) the matching and nonelective contributions equal or exceed the portion of the employee's excess annual addition for the limitation year; and (3) the NHCE terminated with no vested interest in the matching and nonelective contributions. Thus, the Section 415(c) excess is deemed to consist solely of matching and nonelective contributions that are forfeited. If that amount has not been forfeited, it is placed in an unallocated account to be used to reduce employer contributions in the future, or if appropriate, is reallocated to the other employees in accordance with the plan's allocation formula.

Code Section 401(a)(17) Excesses

The account balance of an employee who received an allocation based on compensation greater than the Section 401(a)(17) limit may be reduced by this improperly allocated amount (adjusted for earnings). If that 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, to be used to reduce employer contributions in later years.

Alternatively, if the plan sponsor can adopt an amendment to the plan increasing the maximum percentage of compensation so as to correct the Section 401(a)(17) excess, it may do so. In that case, it must contribute an additional amount on behalf of each of the other employees (excluding each employee for whom there was a Section 401(a)(17) failure) who received an allocation for the year of the failure.

Inclusion of Ineligible Employees

Under the plan amendment method, the plan can be amended retroactively to change the eligibility provisions to provide for the inclusion of ineligible employees to reflect the plan's actual operations. This method does not apply unless (1) the amendment satisfies Code Section 401(a) at the time it is adopted, (2) the amendment would have satisfied Code Section 401(a) had the amendment been adopted at the earlier time when it is effective, and (3) the employees affected by the amendment are predominantly NHCEs. This amendment must be noted when the next determination letter for the plan is submitted.

How Must Earnings Be Determined?

Under EPCRS, any corrective contribution or allocation must be adjusted for earnings and forfeitures. These adjustments are based on the period of the failure and the earnings rate. The period of the failure is generally the period from the date that the failure began through the date of correction. 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.

If participants direct the investment of account balances, the preferred earnings rate is based on the rate applicable to the affected participants' investment choices for the period of the failure. If participants do not make 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). For administrative convenience, alternative methods may be used. For example, if only NHCEs are receiving a correction, the plan may use the highest earnings rate of any investment fund used by the plan. (This is usually not attractive to employers.) In this author's experience, the IRS is usually amenable to other alternative earnings measurements as long as they are reasonable.

Generally, earnings amounts are allocated in accordance with the plan's method for allocating earnings as if the failure had not occurred. Alternative allocation methods are used in certain circumstances.

Should I Use EPCRS?

The EPCRS program is a useful tool for plan sponsors. However, it also sets a standard for plan administration that assumes plan sponsors will review their programs frequently and make corrections using the principles and methods set forth therein. As EPCRS is more widely used, the IRS may be less sympathetic to errors caught on audit and more inclined to insist on standard corrections for the sake of consistency. Nonetheless, plan sponsors should not try to hide their errors, but consider correcting their mistakes using this program's principles. They should keep in mind that the EPCRS program continually changes, and if necessary, they should approach the IRS informally about corrections that may not fit precisely into the IRS standard method. Finally, because each plan's situation is different, it is imperative for plan sponsors and administrators to consult with an attorney or advisor before using EPCRS.

Notes

1. *See* Basch Eng'g, Inc. v. Commissioner, T.C. Memo 1990-212; Martin Fireproofing Profit Sharing Plan & Trust v. Commissioner, 92 T.C. 1173 (1989); Tionesta Sand & Gravel, Inc. v. Commissioner, 73 T.C. 758, 764 (1980), *aff'd without published opinion*, 642 F.2d 444 (3d Cir. 1981).

2. *See* Revenue Procedure 98-22, 1998-1 C.B. 723.

3. Rev. Proc. 2006-27, 2006 I.R.B. 871.

4. *See http://www.dol.gov.ebsa*.

5. *See http://www.irs.gov*.

6. Rev. Proc. 2006-27, Part III, § 6.02.

7. Rev. Proc. 2006-27, Part III, § 6.02(5).

8. Rev. Proc. 2006-27, Part IV.

9. Some additional time may apply for failure to follow 401(k) and 401(m) correction regulations; see Rev. Proc. 2006-27 at Part IV, § 9.02.

10. Rev. Proc. 2006-27, Part IV, § 8.02.

11. Rev. Proc. 2006-27, Part III, § 5.01(8).

12. The definition of *under examination* is complex, but in essence the term means that the plan has received verbal or written notification from Employee Plans of an impending examination or referral for an examination (including if still in the appeals process) or notification from an Employee Plans agent of possible qualification failures in conjunction with filing a determination letter application. Rev. Proc. 2006-27, Part III, § 5.03.

13. Rev. Proc. 2006-27, Part V, § 10.11.

14. Rev. Proc. 2006-27, Part V, § 11.

15. Rev. Proc. 2006-27, Part V, §§ 10.07 (7).

16. Rev. Proc. 2006-27, Part V, § 10.10.

17. Rev. Proc. 2006-27, Part V, § 12.

18. The *maximum payment amount* is defined as the tax that the IRS could expect to collect on all open years if the plan were disqualified. This includes (1) the tax on the trust income, (2) additional income tax by virtue of the employer's loss of deductions for plan contributions, and (3) additional income tax resulting from income inclusion of the benefits of the HCEs covered by the plan.

19. *See* Treas. Reg. § 1.401(k)-2(b).

20. Rev. Proc. 2006-27, Part II, § 6.07.

21. Rev. Proc. 2006-27, Part III, § 6.04, and Appendix A.07.