

The Internal Revenue Service Correction Program For Tax-Qualified Retirement Plans



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Even the most diligent in-house attorney can make a mistake with respect to a retirement plan. That's why the Internal Revenue Service has developed the Employee Plans Compliance Resolution System (EPCRS).

PRIVATE RETIREMENT PLANS represent a major source of retirement income (second only to Social Security) for many Americans. Illustrative of their importance, these plans carry with them substantial tax benefits to employers and employees alike and an extensive regulatory system under the tax and labor laws has been enacted to protect employees' benefits.

To encourage employers to offer retirement plans and to induce employees to participate in elective plans, such as 401(k) plans, by contributing a portion of their compensation to the 401(k) plan, the Internal Revenue Code (the "Code") confers significant tax benefits to employers offering these plans and to employees who participate in them. These tax benefits include:

- Employer contributions to a plan are currently deductible;
- Employees do not include the value of employer provided retirement benefits in their income until the benefits are actually received;
- Employee contributions to a 401(k) plan and earnings on these contributions are not subject to tax until received by the employee as a distribution;

- Earnings on the assets of a plan held in trust are exempt from tax until distributed from the trust; and
- Distributions to employees may be eligible for special tax treatment, that is, the availability of tax-free rollover to an individual retirement plan or another tax-qualified plan further deferring taxation.

To reap these tax benefits, retirement plans must be maintained in accordance with a complex regime of tax laws in order to be considered a “tax-qualified” retirement plan under Code section 401(a). Any failure to meet these obligations can lead to plan disqualification, the severe effects of which are retroactive loss of tax deductions for employers, retroactive income inclusion for employees, taxation of earnings on the assets of the plan held in trust, and loss of the employees’ right to rollover distributions from the plan tax-free.

Over the last 20 years, the Internal Revenue Service (IRS) developed voluntary correction programs to improve enforcement, to encourage employers to establish administrative practices and procedures to ensure compliance, and to help plan sponsors and plan participants avoid the harsh tax penalties of plan disqualification. These voluntary correction programs have been consolidated into the Employee Plan Compliance Resolution System (EPCRS) most recently published as Revenue Procedure 2008-50. EPCRS provides, among other things, the opportunity for plan sponsors to self-correct qualification failures that could potentially result in the loss of tax-qualification for the plan. Depending on the nature of the failure, the plan sponsor may or may not be required to obtain IRS approval of the correction and pay a compliance fee to the IRS as part of the correction process.

This article highlights some of the key features of EPCRS and provides general guidance to sponsors of tax-qualified retirement plans on how to determine which EPCRS program should be used to correct a plan’s qualification failure(s). Although retirement plans maintained under Code section 403(b), SEPS and SARSEPS under Code section 408(k), and SIMPLE IRAs under Code section 408(p) are also eligible to self-correct under EPCRS, the focus of this article will be on the application of EPCRS to tax-qualified retirement plans that meet the requirements of Code section 401(a).

Employee Plans Compliance Resolution System (EPCRS)

EPCRS consists of three separate correction programs:

- The Self-Correction Program (SCP);
- The Voluntary Compliance Program (VCP); and
- The Audit Closing Agreement Program (Audit-CAP).

These three programs permit plan sponsors to self-correct the following categories of qualification failures:

- Plan document failures;
- Operational failures; and
- Demographic failures.

In order to proceed under EPCRS, the plan sponsor must first identify the type of qualification failure and then identify the appropriate correction program.

a. Identify the Type of Qualification Failure. There are three types of qualification failures that can be corrected under EPCRS. The first type of qualification failure is a plan document failure. In order for a plan to meet the tax-qualification requirements of the Code, it must be in writing and include certain legally required provisions. A plan document failure occurs when the plan document, on its face, violates the requirements of Code section 401(a). This type of failure can occur when the plan document includes a provision that is not permitted under Code section 401(a), or when the plan document fails to include a provision that is required to be included under Code section 401(a). A plan document failure can also occur if a plan has not been amended by the applicable amendment deadline.

Example of a plan document failure: The plan document fails to include provisions regarding the minimum distribution requirements under Code section 401(a)(9) or the statutory compensation limits under Code section 401(a)(17). In order for a plan to be considered tax-qualified, the plan document must include these provisions.

The second type of qualification failure is an operational failure. An operational failure occurs when the terms of the plan comply with Code section 401(a) but the plan has not been operated in accordance with its terms and the plan cannot be amended retroactively to reflect the plan's operations.

Example of an operational failure: A 401(k) plan that permits hardship distributions fails to suspend the ability of participants to make pre-tax contributions to the plan for six months following the date of receipt of a hardship distribution. Under the Code, if a participant receives a hardship distribution from a 401(k) plan, the participant is not permitted to make additional pre-tax contributions to the plan for six months.

An operational failure also occurs when a plan fails to comply with the nondiscrimination testing requirements of Code sections 401(k) and 401(m), commonly referred to as the ADP/ACP tests. When a plan fails either of these tests, affected highly compensated employees must receive refunds of a portion of their contributions. If these refunds are not made within the time period provided under the Code (generally, two and a half months after the end of the year of the test failure), an operational failure has occurred.

The last type of qualification failure is a demographic failure. A demographic failure occurs when the plan's terms were followed but, as a result of the plan's design, the plan:

- Fails to comply with Code section 401(a)(26) and cover a sufficient number of employees;
- Provides contributions or benefits that discriminate in favor of highly compensated employees in violation of Code section 401(a)(4); or
- Fails to cover a sufficient number of non-highly compensated employees in order to comply with the requirements of Code section 410(b).

Example of a demographic failure: A defined benefit pension plan includes a lump sum payment option available only to participants whose compensation in the year of termination or retirement exceeds \$150,000. Under the Code, a highly compensated employee is an employee who was

paid more than \$110,000 in the prior year (2010). Because the lump sum option is available only to highly compensated employees, the plan's design fails to comply with Code section 401(a)(4).

b. Identify the appropriate correction program. After the type of qualification failure has been identified, the second step in the process is to identify the appropriate correction program and correction method. As previously mentioned, EPCRS includes three separate correction programs: a self-correction program (SCP); a voluntary correction program (VCP); and an audit closing agreement program (Audit CAP).

Corrections under SCP can be done at no cost to the plan sponsor and IRS approval is not required. In contrast, corrections under VCP and Audit CAP require the plan sponsor to pay either a compliance fee or penalty and the IRS must approve the proposed correction.

1. Self-Correction Program (SCP). The only type of qualification failure eligible for correction under SCP is an operational failure. SCP is available to correct both "insignificant" and "significant" operational failures, provided the failure is not "egregious" and the plan sponsor had in place, at the time the failure(s) occurred, established practices and procedures (both formal and informal) that were "reasonably designed to promote and facilitate overall compliance with applicable Code requirements."

In EPCRS, the IRS describes an "egregious failure" as "[a] case in which the IRS concludes that the parties controlling the plan recognized that the action taken would constitute a Qualification Failure and the failure either involves a substantial number of participants or beneficiaries or involves participants who are predominantly highly compensated employees." An example of an egregious failure is a plan that has consistently and improperly covered only highly compensated employees.

In addition, the established procedures must have been in place and routinely followed, with the operational failure occurring as the result of an oversight or mistake. SCP can also be used if the procedures were in place, but not sufficient to prevent the occurrence of the error. Under EPCRS, a plan document alone is not acceptable evidence of established procedures.

Example: Employer sponsors a 401(k) profit sharing plan. Employee deferral elections are honored by the payroll department for the entire calendar year. The employer has no procedures in place to monitor whether employees exceed the maximum permissible pre-tax contribution amount; rather, in January of the following year, the employer reviews its payroll records for the prior year to identify employees who contributed more than the maximum pre-tax contribution amount for the year and then refunds the excess amount. For purposes of EPCRS, this plan does not have established practices and procedures in place because as a matter of course, the plan violates the annual pre-tax contribution limit for certain participants. Therefore, the plan sponsor is not eligible for SCP.

Special rules apply in the case of a plan that includes assets transferred from another plan or assumed in connection with a merger or other corporate action. In either of those situations, the plan will be treated as having established practices and procedures in place if the practices and

procedures apply to the transferred assets by the end of the plan year that follows the date of the corporate transaction.

Requirements for SCP. The requirements for correction under SCP vary according to whether the operational failure to be corrected is “insignificant” or “significant.” Under EPCRS, the factors to be considered in determining whether an operational failure is significant or insignificant, include, but are not limited to:

- Whether other failures occurred during the same time period;
- The percentage of plan assets and contributions involved in the failure;
- The number of years the failure occurred (single vs. multiple);
- The number of participants affected as a result of the failure compared to the number of participants who could have been affected by the failure;
- The number of participants affected as a result of the failure compared to the number of participants in the plan;
- The period of time between discovery of the failure and correction of the failure; and
- The reason for the failure.

Under EPCRS, no one factor is determinative and no factor should be given more weight than another factor. When determining whether other failures occurred during the same time period, a failure is considered to have occurred only once even if more than one participant is affected by the failure.

Example 1: Employer maintains a 401(k) plan. All participants in the plan are eligible to receive matching contributions and nonelective retirement contributions. In 2010, the benefits of 50 of the 250 participants were limited by Code section 415. In 2010, following an internal review, the employer discovers that in 2009, the amounts allocated to the accounts of three employees exceeded the maximum limitations under Code section 415. In 2009, the employer contributed \$3,500,000 to the plan for the plan year. The amount of the excesses attributable to the 3 employees totaled \$5,000. Based on these facts, the IRS would conclude that the failure would be insignificant.

Example 2: The same facts as Example 1, except that in 2009, 18 of the 50 employees whose benefits were limited by Code section 415 exceeded the maximum amount and the amount of the excesses attributable to the 18 employees totaled \$150,000. Based on these facts, the IRS would conclude that the failure would be significant.

If a plan has more than one operational failure in a single year, or operational failures that occur in multiple years, the failures can be treated as insignificant only if all of the operational failures are insignificant in the aggregate.

Example 3: The facts are the same as in Example 1 except that the failure to comply with Code section 415 occurred in 2008 and 2009 and the three participants affected each year

were not the identical. Based on these facts, the IRS would conclude that the failures are still insignificant.

It is important, when using SCP to correct an operational failure, to document the qualification failure(s), the plan sponsor's decision-making process for determining whether the operational failure was significant or insignificant, and the steps taken to correct the failure(s) and to keep the written documentation with the records of the plan until the statute of limitations for the plan year has expired, if not later. One method of documenting an operational failure and subsequent correction is to document it in a manner similar to information requested in a VCP submission (discussed below). If there is a subsequent audit of the plan, this information would have to be provided to the IRS to prove that the correction was completed. A sample correction file memo is available at Appendix A.

SCP for insignificant operational failures. If the operational failure is insignificant, it can be corrected under SCP at any time, even if the plan is currently under IRS examination. This is the only type of failure that can be corrected when a plan is being examined by the IRS. The correction is completed once the operational failure is corrected.

Example: Employer's 401(k) plan provides that each eligible employee is entitled to a matching contribution equal to three percent of compensation contributed to the plan each payroll period. In May, the plan administrator discovers that Participant A had only received a match equal to two percent of compensation for the last two payroll periods.

Correction: Employer provides Participant A with an additional matching contribution equal to one percent of compensation contributed to the plan during the two payroll periods in which the error occurred, adjusted for earnings as soon as administratively feasible. The correction is complete when the additional matching contribution is deposited in Participant A's account.

SCP for significant operational failures. If the operational failure is significant, in order to be eligible for SCP, the plan must have an up-to-date favorable determination letter (for an individually designed plan) or a favorable opinion letter (for a prototype or volume submitter plan) from the IRS. If the plan is "under examination," SCP is not available if the errors are significant. This underscores the importance of being able to determine that the errors identified are insignificant based on the list of factors previously discussed. Under EPCRS, a plan is "under examination" when a plan is under IRS audit, or the plan has received a verbal or written notification from the IRS that the plan will be audited or referred for an audit. A plan is also considered to be "under examination" if the plan has been notified by the IRS of any potential qualification failures discovered during the review of the plan's determination letter application. Further, for this purpose, "plan" is defined by reference to all plans maintained by an entity that has at least 80 percent common ownership with the plan sponsor.

Example: Employers A, B, and C are all wholly owned subsidiaries of Parent. Employers A, B, and C each maintain a separate 401(k) plan for the benefit of their employees. Employer

B's 401(k) plan is under examination by the IRS. Until the examination of Employer B's plan is completed, Employers A and C are unable to self-correct any significant operational failures under SCP.

Correction of any significant operational failure under SCP must be completed, or substantially completed, by the last day of the second plan year following the plan year in which the failure occurred. There is no exception for operational failures discovered after the expiration of this period. If the correction of the operational failure is not substantially completed within this time frame, SCP is no longer an option for correction and the plan sponsor will be required to proceed under VCP in order to correct the operational failures. There is an extended correction period for operational failures that relate only to assets transferred from another plan or a plan assumed in connection with a corporate merger, acquisition or other similar transaction. In that case, the correction period does not end until the last day of the plan year following the date of the corporate transaction, regardless of when the failure occurred.

Self-correction under SCP by retroactive plan amendment. Under EPCRS, the following four types of operational failures can be corrected under SCP by the adoption of a retroactive plan amendment that conforms the terms of the plan to the plan's prior operations:

- Failing to comply with the Code section 401(a)(17) annual compensation limit;
- Permitting hardship distributions when the plan does not provide for hardship distributions;
- Permitting participant loans when the plan does not provide for loans; and
- Permitting employees who have not satisfied the plan's eligibility requirements to participate in the plan.

The retroactive amendment cannot, however, result in a violation of any other provision of the Code. As a practical matter, this means that the failure must have occurred on a nondiscriminatory basis during the applicable period. For example, if the plan was impermissibly permitting hardship distributions, as long as the group of participants able to receive an impermissible hardship distribution was not discriminatory, the plan can be retroactively amended to permit hardship distributions under SCP.

SCP Checklist. When proceeding under SCP, plan sponsors should take the following steps:

- Identify the operational failure(s) that need to be corrected and the period of time during which the error(s) occurred;
- Determine whether the error(s) in the aggregate are insignificant or significant and confirm that the error(s) are not egregious;
- If the error(s) are significant, confirm that the maximum time period for correcting the error(s) has not expired;
- Confirm that the plan has established practices and procedures in place;
- Determine whether the operational failure is identified on Appendix A or B of Revenue Procedure 2008-50, 2008-2 C.B. 464 (discussed below), and if so, the appropriate correction method;

- If the operational failure is not identified on Appendix A or B, the plan sponsor should create a correction method that is likely to be deemed reasonable and appropriate by the IRS if the correction is reviewed by the IRS during an audit of the plan; and
- Document, in writing the steps taken by the plan sponsor as part of the correction process and maintain this information with the records of the plan.

If a plan sponsor is unable to correct the failure under SCP, the plan sponsor must proceed to VCP, as discussed in the next section.

2. Voluntary Correction Program (VCP). As discussed above, the only type of qualification failure that can be corrected under SCP is an operational failures. If the failure involves a plan document failure, a demographic failure or an operational failure that cannot be corrected using SCP (because the failure was significant and not corrected within the required two year time period or the failure is egregious), the plan sponsor must correct the qualification failure under VCP, provided the plan is not “under examination” by the IRS. In addition, VCP also provides general procedures for the correction of participant loans that do not comply with the requirements of the Code. In order to proceed under VCP, the plan sponsor is required to pay a compliance fee (which varies depending on the number of plan participants), obtain IRS approval for the proposed method of correction and then implement the proposed corrections.

Although proceeding under VCP requires the plan sponsor to pay a compliance fee, one reason a plan sponsor may choose VCP over SCP is that a number of operational failures carry with them additional taxes levied on either the participant or the plan sponsor. Qualification failures that can result in additional taxes being imposed on the participant include:

- Failure to timely distribute a required minimum distribution resulting in the imposition of a 50 percent excise tax on the amount of the late distribution;
- Overpayment from a plan creating an excess contribution to an individual retirement account resulting in the imposition of a six percent excise tax on the amount of the excess contribution; and
- Payment from the plan is made pursuant to an impermissible distribution event resulting in the imposition of a ten percent additional income tax on the amount of the distribution.

Similarly, qualification failures which can result in additional taxes being imposed on the plan sponsor include:

- Contributions of nondeductible amounts to a plan by the plan sponsor resulting in the imposition of a 10 percent excise tax on the amount of the nondeductible contribution for each year the amount is carried over; and
- Failure to refund excess contributions to affected participants in a timely manner following the plan’s failure to pass the ADP/ACP tests resulting in the imposition of a 10 percent excise tax on the amount that is not distributed timely.

Under VCP, the plan sponsor may request relief from these additional taxes. This relief is not available under SCP. However, in each case, the plan sponsor should weigh the amount of the

VCP compliance fee versus the amount of the income or excise taxes that may be assessed as a result of the failure because the income or excise taxes may be lower than the VCP compliance fee. In order to avoid placing an additional tax burden on plan participants, many plan sponsors will pay the excise tax and additional income taxes on behalf of the affected participant if they decide not to proceed under VCP.

General VCP principles. In general, while a VCP submission is pending, the plan will not be examined by the IRS unless the IRS determines that an abusive tax avoidance transaction is involved. In that situation, the IRS may authorize the examination of the plan. In addition, submission of a VCP application does not preclude the plan from being selected for examination by the IRS at a later date for one or more taxable years. In the event this was to occur, the examination would be limited to items outside the scope of the compliance statement for the year(s) under examination.

There is no limit on the number of errors that a plan sponsor may request relief from in a single VCP application. For example, a plan sponsor can request relief for a demographic failure and multiple operational failures in a single submission. Only the failures identified by the plan sponsor and any additional failures discovered by the IRS during the processing of the application will be covered by the compliance statement issued to the plan sponsor under VCP. If a plan sponsor discovers additional, unrelated qualification failures after its original submission, the plan sponsor may ask the IRS to include the newly discovered failures as part of its original submission. Whether or not the additional failures may be included as part of the VCP application is solely in the discretion of the IRS and the IRS may reject the inclusion of the additional failures in the current application if the request is not timely or the application of VCP to the additional failure would be inappropriate or impracticable. If the IRS discovers an unrelated qualification failure while reviewing the application, the IRS has the discretion to include it with the current application or it may determine that the failure is outside the scope of the pending VCP because the plan sponsor did not voluntarily bring it forward. In that case, if the failure is significant, the entire plan may be examined and the plan will be subject to the rules of Audit CAP instead of VCP.

Upon completion of its review of the VCP application, the IRS will issue a compliance statement, which addresses the failures identified and the proposed corrections, to the plan sponsor. In the compliance statement, the IRS agrees not to pursue disqualification of the plan in connection with the qualification failure(s) identified in the VCP application if the failures are corrected within 150 days. Requests to extend the 150-day period must be made in writing and approved by the IRS prior to the end of the original 150 days. A compliance statement is binding on the plan sponsor and the IRS with respect to the specific failures identified for the periods specified in the statement.

If a plan sponsor is uncertain about whether the IRS will approve its proposed method of correction for one or more qualification failures, the plan sponsor may submit a VCP application on an anonymous (John Doe) basis. The VCP application process, including the compliance fee and eligibility conditions remain the same, however, in the event the IRS and plan sponsor are unable to agree on a proposed method of correction, the plan sponsor can withdraw its VCP application without having identified itself to the IRS and the IRS will refund 50 percent of the com-

pliance fee. If the plan sponsor and IRS agree on a method of correction, the identity of the plan sponsor and plan are revealed to the IRS and a compliance statement is issued. However, because the submission is anonymous, in the event the plan is selected for examination by the IRS before the date the plan and plan sponsor are identified to the IRS, the plan will no longer be eligible for VCP.

Correction of plan loans under VCP. In addition to the correction of qualification failures, EPCRS can also be used by plan sponsors to correct plan loans that do not comply with one or more requirements of Section 72(p) of the Code. Normally, under applicable Treasury regulations, when a plan loan failure occurs, the plan sponsor is required to report the loan as a deemed distribution to the participant on a Form 1099-R for the year in which the loan failure occurred. When this happens, the participant is required to include in income the amount of the deemed distribution on his or her tax return. Often, the loan failure is not discovered until after the end of the tax year in which the failure occurred, which can result in an administrative headache for participants who have already filed their income tax returns for that year. If the plan sponsor corrects the loan in accordance with the procedures outlined in EPCRS, the plan sponsor has the option of reporting the deemed distribution in the year of correction (and not the year of failure) for Form 1099-R reporting purposes. If the deemed distribution is reported in the year of correction, the affected participant can avoid having to file an amended tax return for the year of the failure. The types of loan failures that may be corrected under EPCRS include:

- Loans that are in excess of the maximum permitted amount;
- Loans that have repayment terms that do not comply with the requirements of the Code; and
- Loans that are in default.

However, the correction methods provided in EPCRS are not permitted if the maximum period for repayment of the loan has expired (generally five years for non-mortgage based loans and 30 years for mortgage based loans). It is important to note that not all plan loan failures have to be corrected under EPCRS. Correction under EPCRS requires payment of a compliance fee that is generally the same regardless of the number of loans being corrected (the normal compliance fee is reduced 50 percent if the total number of participants affected doesn't exceed 25 percent). Because the compliance fee is based on the number of participants in the plan and not the number of participants with loans that need to be corrected, larger employers may be reluctant to proceed under VCP if the number of participants affected is small.

The VCP application. In order to proceed under VCP, the plan sponsor must submit an application to the IRS. The application consists of a letter from the plan sponsor (or the plan sponsor's representative) to the IRS that must include the information listed below to the extent applicable to the failure(s) at issue. If the application does not include one or more of these items, the application will be deemed incomplete and returned to the plan sponsor. Revenue Procedure 2008-50 includes a number of appendices to facilitate the proper completion of VCP applications. Appendix C is the "VCP Checklist" and Appendix D provides the format for the VCP application (the format should not be modified). A properly completed VCP application includes the following information:

- Information identifying the plan sponsor and the plan;
- Plan data, including the total number of plan participants and amount of plan assets as of the most recent Form 5500 filing;
- The type of VCP submission;
- A complete description of the plan failures, including the years in which the failure(s) occurred (including years for which the statute of limitations has expired) and the number of employees affected by each failure;
- An explanation of how and why the failures occurred;
- A proposed method of correction, including specific information needed to support the correction;
- A description of the methodology used to calculate earnings or actuarial adjustments on any corrective contributions or distributions (including the computation periods and the basis used for determining actuarial adjustments or earnings);
- Specific calculations for each affected employee or a representative sample of affected employees;
- The method that will be used to locate former employees or beneficiaries, or an affirmative statement that no former employees or beneficiaries were affected by the failures or will be affected by the correction;
- A description of the changes in the plan's administrative procedures that will be implemented to ensure that the same failures will not recur;
- If applicable, a request for excise tax relief under the applicable Code section(s);
- A request for tax reporting relief for loan failures, if applicable;
- A statement that to the best of the plan sponsor's knowledge, neither the plan nor the plan sponsor is under examination;
- A description of the transfer if the submission includes a failure that relates to transferred assets and the failure was discovered after the transfer;
- A statement that neither the plan nor the plan sponsor has been party to an abusive tax avoidance transaction or a brief identification of any abusive tax avoidance transaction to which the plan or plan sponsor was a party; and
- If applicable, a statement that the plan is currently being considered in a determination letter application that is not related to the VCP application. If a plan sponsor submits a determination letter application while a request for consideration under VCP is pending, a plan sponsor is required to notify the IRS and update the earlier VCP application with this information.

VCP compliance fees. To discourage plan sponsors from repeatedly using VCP to correct qualification failures, submission of an application under VCP requires payment of a compliance fee. The compliance fee is non-deductible to the plan sponsor and may not be paid from the plan's trust. The VCP compliance fee is based on the number of participants in the plan.

Number of Participants	VCP 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
5001 to 10,000	\$20,000
Over 10,000	\$25,000

For this purpose, the number of plan participants is generally established by referring to the number of participants reported on line 6(f) of the plan sponsor's most recent Form 5500. If the VCP submission involves failures relating to participant loans, the failure does not affect more than 25 percent of the plan's participants in any year(s) in which the loan failures occurred and there are no other failures included in the VCP application, the above VCP fee is reduced by 50 percent.

Streamlined VCP. Appendix F of Revenue Procedure 2008-50 includes a streamlined VCP application process that simplifies the VCP application for nine specific qualification failures. Each specific qualification failure is contained in a schedule with a pre-approved correction method. A streamlined VCP submission can include more than one Appendix F schedule. Each schedule is a fill-in form that requires the plan sponsor to provide requested information. The fill-in forms are available at www.irs.gov/retirement/article/0,,id=214894,00.html. The failures eligible for the Streamlined VCP Application procedure and the corresponding Appendix F schedules include:

- **Schedule 1.** The plan sponsor failed to timely adopt (i) certain interim amendments, or (ii) amendments required to reflect the plan's adoption of optional plan changes;
- **Schedule 2.** The plan sponsor failed to timely adopt amendments required to comply with required legislative or regulatory changes;
- **Schedule 3.** Applicable to plans that are SEPS or SARSEPS;
- **Schedule 4.** Applicable to plans that are SIMPLE IRAs;
- **Schedule 5.** The plan sponsor failed to administer loans in accordance with the requirements of the Code;
- **Schedule 6.** The plan sponsor failed to satisfy the criteria required to sponsor a 401(k) plan;
- **Schedule 7.** The plan failed to distribute elective deferrals in excess of the annual pre-tax contribution limit;
- **Schedule 8.** The plan failed to make required minimum distributions to participants who had reached the plan's mandatory distribution date;
- **Schedule 9:** The plan sponsor experienced one or more of the following failures: (i) inclusion of compensation over the statutory limit for the applicable plan year (\$245,000 in 2010); (ii) hardship

distribution failures; (iii) loans permitted in operation but not provided for under the terms of the plan; and (iv) early inclusion of otherwise excludible employees.

Unfortunately, only certain applications submitted under the streamlined procedure are eligible for a reduced VCP compliance fee. All applications submitted under the streamlined VCP application process must submit the standard fee (based on the number of plan participants) unless the sole failure addressed in the application is the plan's failure to:

- Make minimum required distributions for 50 or fewer participants (reduced fee of \$500);
- Administer loans in accordance with the requirements of Code Section 72(p) and the failures involve no more than 25 percent of the plan's participants for the years the failure occurred (50 percent of the standard VCP fee);
- Adopt a plan amendment, provided the amendment is adopted within one year of the expiration of the remedial amendment date (50 percent of the standard VCP fee); or
- Adopt interim amendments and discretionary amendments to implement optional law changes (reduced fee of \$375 per amendment).

The streamlined VCP process provided by EPCRS simplifies the application process for many common qualification failures and also reduces the cost for many of the most common errors.

Determination letter application. Under the current regulatory regime, tax-qualified plans are generally submitted to the IRS for a determination of the plan's tax-qualified status every five years (the actual filing date depends on the last digit of the plan sponsor's employer identification number). Generally, there are two circumstances in which a VCP application must also include a determination letter request:

- The qualification failure is being corrected, in whole or in part, by adoption of a plan amendment and the plan is otherwise due to be filed for a determination letter (based on the last digit of the employer identification number); or
- The qualification failure is a "nonamender" failure.

For this purpose, a "nonamender failure" refers to a document failure that has not been corrected within the time period permitted for retroactive amendments under the Code. This does not include the failure to timely adopt "interim" or "discretionary" amendments. "Interim amendments" are certain amendments made in response to changes in the law or regulations in between determination letter cycles and "discretionary amendments" are amendments made in response to changes in the law which are optional as opposed to mandatory (there is a list of interim and discretionary amendments included in Schedule 1 of the Streamlined VCP application).

When a qualification failure goes undetected or uncorrected and is discovered during an IRS audit, except in the case of an insignificant operational failure, the voluntary programs (SCP and VCP) are no longer available and the plan sponsor will need to negotiate an audit closing agreement with the IRS under Audit-CAP.

3. Audit CAP (Correction on Audit). Audit CAP is not a “voluntary correction program” in the sense that the plan sponsor identifies a failure and corrects it with or without IRS approval. When the IRS identifies a qualification failure upon an audit of a plan that cannot be corrected under SCP as an insignificant operational failure, as an alternative to plan disqualification, the plan sponsor and the IRS may negotiate a closing agreement with respect to the qualification failure(s) identified. The requirements of Audit CAP are as follows:

- The qualification failure must be corrected;
- The plan sponsor must pay the negotiated penalty (described below);
- The closing agreement may be conditioned upon the implementation of new administrative procedures; and
- The plan sponsor may be required to apply for and receive a favorable determination letter before the closing agreement is signed.

The sanction under Audit CAP is a negotiated percentage of the amount of tax liability that could be assessed on the plan’s trust if the plan were disqualified. The sanction has the potential to be very large for plans with significant assets. This sanction is not deductible by the plan sponsor. The IRS states that the sanctions are not intended to be excessive and will bear a reasonable relationship to the nature, extent, and severity of the failures, based on a number of factors including:

- The steps taken by the plan sponsor to ensure that the plan had no qualification failures;
- The steps taken to identify failures that may have occurred;
- The extent to which correction had progressed before the examination 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 disqualified;
- Whether the failure is a failure to satisfy the nondiscrimination requirements under the Code;
- The number of years over which the failure(s) occurred;
- The reason for the failure(s) (for example, data errors such as errors in transcription of data, the transposition of numbers, or minor arithmetic errors);
- Whether the plan is the subject of a determination letter; and
- Whether the failure(s) were discovered during the determination letter process.

If the IRS and the plan sponsor cannot reach an agreement with respect to the correction of the failure(s) or the amount of the sanction, the plan will be disqualified, but only as a last resort. While Audit CAP is an alternative to plan disqualification, the terms of the closing agreement, especially the amount of the sanction, can be extremely harsh.

Correction Principles And Procedures Applicable To SCP And VCP

Appendices A and B of Revenue Procedure 2008-50 include numerous examples of operational failures and correction methods applicable to tax-qualified plans that the IRS has deemed to be appropriate and reasonable methods of correction that can be used by plan sponsors to correct various operational failures

under SCP or VCP. Appendices A and B provide IRS-approved correction methods for the following operational failures:

- Failure to properly provide the minimum top-heavy benefit under Code section 416 to non-key employees;
- Failure to satisfy the annual nondiscrimination tests applicable to pre-tax, Roth 401(k), matching and/or after-tax contributions (ADP/ACP test failures);
- Failure to distribute pre-tax contributions in excess of the annual Code section 402(g) limit;
- Exclusion of an eligible employee from all contributions or accruals under the plan for one or more plan years;
- Failure to timely pay the minimum distribution required under Code section 401(a)(9);
- Failure to obtain participant or spousal consent for a distribution subject to the participant and spousal consent rules;
- Failure to satisfy the Code section 415 limits in a defined contribution plan;
- Failures relating to abandoned orphan plans, orphan contracts or abandoned plan assets; and
- Failure to comply with the annual compensation limit under Code section 401(a)(17).

Appendix B also provides examples of methods a plan sponsor can use to calculate earnings on amounts contributed to the plan in order to correct an operational failure.

If the correction method used by a plan sponsor to correct an operational failure is not included in Appendix A or Appendix B, the proposed correction method should be reasonable and appropriate taking into account the following criteria:

- Whether the correction is consistent with or resembles a method already provided for in the Code;
- Whether the correction of a failure relating to nondiscrimination testing provides additional benefits to non-highly compensated employees;
- Whether the correction method keeps plan assets in the plan, unless the Code, regulations, or other guidance requires a distribution to be made;
- Whether the correction restores the plan to the position it would have been in if the operational failure had not occurred;
- Whether the correction method violates another specific requirement of the Code; and
- Whether the correction method was authorized by another government agency.

Under EPCRS, subject to the five limited exceptions to full correction identified below, the IRS does not consider an operational failure to be fully corrected unless the operational error is corrected for all taxable years, even if the statute of limitations for the year is closed. However, if the tax year is closed, the plan sponsor will not have to re-determine its tax liability because of the correction. The IRS does not require full correction under EPCRS in the following five situations:

- The benefits to be provided are \$75 or less;
- The amount of the overpayment to be recovered is \$100 or less;
- The affected participants cannot be located and the plan administrator has made reasonable efforts to locate such participants;

- The excess amount (e.g., contributions/allocations in excess of maximum permitted) involved is \$100 or less; and
- The administrative cost of determining the precise amount of the correction would exceed the difference between the estimated and precise amount to be restored to the participant's account.

When proceeding under VCP, all aspects of the correction method proposed by the plan sponsor in its VCP application must be approved by the IRS. If the qualification failure is included on Appendix A or B, proposed methods of correction that do not follow the corrections outlined in those Appendices may be subject to greater scrutiny by the IRS. For qualification failures that are not included in Appendix A or B, the proposed method of correction should be as similar as possible to a method identified in Appendix A or B that also complies with the IRS's correction principles. If the IRS does not agree with the plan sponsor's proposed method of correction, the IRS will generally request modifications to the proposed correction as a condition of approval under VCP. If the plan sponsor and IRS cannot reach resolution on the appropriate method of correction, the application is closed, the fee is not returned and the case may be referred for examination. If the IRS approves the plan sponsor's proposed method of correction, the IRS will issue a compliance statement to the plan sponsor.

The same correction principles apply when proceeding under SCP. Even though IRS approval is not required at the time the correction is made, the correction may be subject to IRS review at a later date if the plan is audited. In the event the IRS disagrees with the method of correction used by the plan sponsor, the IRS can take the position that the qualification failure was not corrected and still exists. In this case, unless the qualification failure can be classified as insignificant, correction of the error would take place under Audit CAP.

Conclusion

Given the complexities of the tax laws and the severe penalties associated with plan disqualification, the availability of EPCRS is important, both for the role it plays in the government's ability to maintain and manage the private retirement system and the opportunity it provides plan sponsors to correct plan errors before an IRS plan audit. Plan sponsors should continually review the operation and administration of their retirement plans. If errors are identified, immediate steps should be taken to correct the error(s) in accordance with SCP or VCP and before the error(s) are discovered by the IRS. Otherwise, it will cost more for the plan sponsor to correct.

Additional information regarding correction of plan errors is available on the internet from the IRS at www.irs.gov/ep. From this Web page, click on "Correcting Plan Errors."

PRACTICE CHECKLIST FOR

The Internal Revenue Service Correction Program For Tax-Qualified Retirement Plans

The following is a guide to the Internal Revenue Service correction program for tax-qualified retirement plans.

- Programs:
 - ___ There are three programs — the Self-Correction Program (SCP), the Voluntary Correction Program (VCP) and the audit closing agreement program (Audit-CAP);
 - ___ Eligibility for each program depends on the type of qualification failure, the severity of the failure, and how the failure was discovered.

- Identify the type of qualification failure in order to determine which correction program is available:
 - ___ Plan document failure — document does not comply with the tax-qualification requirements of the Internal Revenue Code;
 - ___ Operational failure — otherwise tax-qualified plan is not operated in accordance with its terms;
 - ___ Demographic failure — otherwise tax-qualified plan discriminates in operation with respect to benefits provided to highly compensated employees.

- Most common failures corrected by EPCRS:
 - ___ Failure to amend the plan for tax law changes by the end of the required period;
 - ___ Failure to follow the plan’s definition of compensation for determining contributions;
 - ___ Failure to include eligible employees in the plan or the failure to exclude ineligible employees from the plan;
 - ___ Failure to satisfy plan loan provisions;
 - ___ Impermissible in-service withdrawals.
 - ___ Failure to satisfy the Internal Revenue Code’s minimum distribution rules;
 - ___ Failure to pass the ADP/ACP nondiscrimination tests;
 - ___ Failure to properly provide the minimum top-heavy benefit or contributions;
 - ___ Failure to satisfy the contribution limits of the Internal Revenue Code.

(All of the above failures are operational failures except the first, failure to timely amend a plan, which is a plan document failure.)

- How was the qualification failure discovered?
 - ___ If qualification failure was discovered by the plan sponsor and the plan isn’t “under examination” by the Internal Revenue Service, the failure may be corrected under SCP (does not require submission or payment of a fee to the IRS) or VCP (requires submission of application for compliance statement and payment of a fee to the IRS);
 - ___ If plan is “under examination” but the failure is an insignificant operational failure, it may still be corrected under SCP;
 - ___ If the qualification failure was discovered upon audit of the plan and is not an insignificant operational failure, the only program available is Audit CAP.

- SCP:
 - ___ SCP is only available for operational failures. (In order to be eligible, there must be established practices and procedures in place to facilitate compliance with the Code and the failure was the result of an oversight or mistake in applying the procedures);

___ Insignificant and significant operational failures may be corrected through SCP. (There is a time limit on the self-correction of significant operational failures);

___ If the error is not an operational failure or if it is an operational failure that is significant and it is being corrected beyond the time limit, the failure should be corrected under VCP. (The operational failure and correction should be documented in writing; see Appendix A.)

- VCP:

___ VCP is available to correct plan document failures, operational failures, and demographic failures;

___ VCP requires a formal submission with the IRS describing the failure and the correction proposed and payment of a fee based on the total number of participants in the plan;

___ The IRS may request adjustments to the correction proposal before issuing a compliance statement approving the correction;

___ Certain qualification failures require the employer or the employee to pay excise taxes. Relief from these excise taxes may be requested under VCP (not available under SCP);

___ The IRS provides “streamlined” VCP procedures for certain qualification failures; in some cases, with reduced fees.

- Audit CAP:

___ Qualification failure discovered during an IRS audit or during a determination letter application;

___ Avoid plan disqualification by correcting the qualification failure, paying the negotiated penalty, and entering into a closing agreement with the IRS;

___ The closing agreement may be conditioned upon the implementation of new administrative procedures;

___ The plan sponsor may be required to apply for and receive a favorable determination letter before the closing agreement is signed.

APPENDIX A

Self-Correction Program under Rev. Proc. 2008-50; Sample

Correction File Memo

I. BACKGROUND

This document is prepared in connection with Revenue Procedure 2008-50 (hereinafter referred to as “2008-50”). Specifically, this document addresses one or more “operational failures” with respect to the [Name of Plan] (“Plan”) to determine if operational failure(s) discussed in this memo are eligible for correction under the Self-Correction Program contained in 2008-50.

The operational failures satisfy one of the following criteria:

1) The operational failure is insignificant OR

2) Both of the following requirements are satisfied:

- The operational failure was completely corrected or was substantially corrected by the last day of the second plan year following the plan year in which the failure occurred; and
- The Plan was not “under examination” at the time the above criteria was satisfied.

Factors (not exhaustive) to consider in determining whether or not an operational failure under a plan is insignificant or significant. No single factor is determinative.

Factor	Plan Response
Have other failures occurred during the same period?	
Percentage of plan assets involved in the failure:	
Percentage of plan contributions involved in the failure:	
The number of years the failure occurred:	
The number of participants affected relative to the total number of participants:	
Was the correction made within a reasonable time after discovery of the failure?	
The reason for the failure (for example, data errors such as errors in the transcription of data, the transposition of numbers, or minor arithmetic errors):	

Conclusion: The operational failure was [] insignificant OR [] significant.

Plan may use SCP correction method only if all of the following are satisfied:	(✓)
The plan has a current IRS determination letter (this requirement is not necessary if the operational failure is insignificant).	
The plan sponsor or the plan administrator must have established practices and procedures in place which are reasonably designed to promote and facilitate overall compliance with applicable Code requirements.	
The operational failure is not an “egregious failure” and does not involve the diversion or misuse of plan assets.	

Neither the plan nor the plan sponsor has been a party to an abusive tax transaction (as defined in 2008-50) that is directly or indirectly related to the operational failure(s) described in this memo.	
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II. GENERAL INFORMATION

[Include plan identifying information: plan sponsor, plan name, address, and EIN numbers.]

III. DESCRIPTION OF OPERATIONAL FAILURE(S)

1. A complete description of the operational failure(s) and the year(s) in which it occurred. Each operational failure should be addressed separately.
2. A description of the administrative procedures in effect at the time the operational failure occurred.
3. An explanation of how and why the operational failure occurred.
4. A detailed description of the method for correcting the operational failure.
5. Specific calculations for each affected employee including the amount of any over or under contribution plus earnings.
6. A description of the procedures that have been or will be implemented to ensure that the same operational failure will not recur.
7. Copies of the sections of the plan document relevant to the failures and methods of correction.

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