COMPLIANCE

CORRECTING PLAN ERRORS: A STEP-BY-STEP GUIDE

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Whether it's a call from a participant wondering why the deferral election he made nine months ago wasn't implemented or an email from the record-keeper asking for an amendment that was never signed, the specter of the Internal Revenue Service (IRS) looms large whenever a retirement plan sponsor discovers an error.

Fortunately, the IRS has established a program intended to encourage sponsors to voluntarily correct plan failures. The Employee Plans Compliance Resolution System (EPCRS) [Rev. Proc. 2008-50] provides guidance on how certain errors should be corrected, but it's complicated and not comprehensive. The steps outlined below for correcting plan failures, along with examples from the authors' experiences, will assist sponsors in efficiently and fully correcting plan document and operational errors that occur in the administration of retirement plans.

STEP 1: GATHER FACTS AND DETERMINE FAILURES

When a sponsor discovers an error, the sponsor should contact the record-keeper and any other relevant parties to confirm exactly what occurred and whether there are any other related errors. Legal counsel should also be consulted. The full extent of the errors should be identified at the beginning of the correction

process for two main reasons.

First, time and money spent on corrections can be minimized with careful fact finding and planning from the start. Additional failures discovered later, while a sponsor is finalizing a correction plan or implementing a correction, will require additional fact finding and reexamination of correction strategies, which inevitably results in more time spent on corrections and additional expense.

Second, a sponsor can include an unlimited number of failures in an application under the Voluntary Correction Program (VCP) of EPCRS for a single user fee when it submits the application to the IRS. After submitting the VCP application, the IRS will generally allow a sponsor to supplement the VCP application while it's still pending. Once the IRS issues a VCP Compliance Statement, however, newly discovered failures generally require an additional user fee, which can be significant depending on the size of the employer (see below). [Rev. Proc. 2008-50, Section 10.07(5)].

For example, during a transition to a new record-keeper, a sponsor discovered a failure to timely amend its plan for good faith compliance with new final regulations under Code sections 401(k) and 401(m). The sponsor, with assistance from counsel, submitted a VCP application to correct the plan document failure. As the transition continued, the record-keeper found several additional qualification issues—including allowing early participation for some employees, delaying participation for other employees, mistakes in Form 5500s for several years, and failing to provide notice of safe harbor matching contributions.

Each of these new qualification or compliance issues required reexamination of plan provisions, census data, and contribution data and a reevaluation of the entire correction strategy. A supplement to the initial VCP application, several amended Form 5500s, and two years later, the sponsor completed the correction process and received a VCP Compliance Statement. If the sponsor had carefully examined plan administration and identified all applicable failures from the beginning, the correction process would have taken less time and the cost would have been reduced.

In a similar situation, another sponsor also discovered several significant errors while transitioning to a new record-keeper. A previous amendment to the sponsor's defined benefit plan provided an incorrect minimum benefit formula (which caused a benefit cutback), applied incorrect reduction factors to certain early retirement benefits, and included an incorrect table of factors used to calculate a supplemental pension benefit. The sponsor had also failed to provide required suspension-of-benefits notices to employees who worked past their normal retirement age. The sponsor filed a VCP application proposing corrections for each of the errors.

After the transition to the new record-keeper was well underway, the sponsor discovered an additional operational failure: Several employees had been allowed to participate in the plan even though they weren't eligible for participation on the date the plan was frozen to new participation. Although it generally takes several months for the IRS to review a complicated VCP application, in this case the sponsor received a VCP Compliance Statement less than four months after the VCP application was submitted and didn't have time to supplement the VCP application to include the early-participation error. In order to correct the early-participation error, the sponsor was required to prepare and file a new VCP application and pay an additional VCP user fee.

After a sponsor identifies what errors occurred, it must determine how to correct the errors.

STEP 2: DETERMINE APPROPRIATE CORRECTION

EPCRS provides specific correction methods for the most common plan failures. The IRS has also developed the 401(k) Plan Fix-It Guide which provides instructions for correcting

the most common failures in 401(k) plans. (Available at http://www.irs.gov/pub/irs-tege/401k_mistakes.pdf. EPCRS also provides guidelines for determining the appropriate correction method when the IRS hasn't specified a correction for a particular failure. [See Rev. Proc. 2008-50, Section 6.]

Sponsors should keep the following guidelines in mind when determining appropriate corrections:

Participants must be made whole. The main focus of the IRS in determining whether a correction is appropriate is whether participants are in the same position after the correction that they would have been if the failure hadn't occurred. [Rev. Proc. 2008-50, Section 6.02.] If participants aren't made whole, the IRS will consider the failure corrected only in very limited circumstances (*e.g.*, corrective distributions of less than $75 aren't required if processing costs exceed the amount of the distribution and a sponsor isn't required to seek repayment of overpayments of less than $100). [Rev. Proc. 2008-50, Section 6.02(5)] For example, an employer who fails to make a contribution cannot correct the failure by making a partial contribution. The failure won't be considered corrected unless the employer makes the full contribution along with earnings.

The IRS doesn't recognize scrivener's errors. All too often, a document drafter makes mistakes when a plan is restated or amended (scrivener's errors). After the restatement or amendment, the plan is administered in accordance with the intended provisions instead of the actual, incorrect plan terms, and the scrivener's error is discovered later.

The IRS has consistently indicated that it won't approve correction of scrivener's errors. However, under VCP the IRS does permit a plan to be amended retroactively to reflect the actual administration of the plan, as long as the retroactive amendment doesn't reduce accrued benefits. [Rev. Proc. 2008-50, Section 4.05(1)]

In practice, scrivener's errors shouldn't be mentioned in a VCP application. Instead, the correction should be referred to as a "retroactive amendment" to bring the terms of the plan into compliance with the actual administration of the plan. Even if the document with the scrivener's error provides for higher benefits than the sponsor intended, in our experience the IRS will allow a retroactive amendment if the intended plan design is consistent with participants' expectations. The challenge for the sponsor can be demonstrating participants' expectations during the applicable time period.

The IRS has established a program intended to encourage sponsors to voluntarily correct plan failures. The Employee Plans Compliance Resolution System (EPCRS) [Rev. Proc. 2008-50] provides guidance on how certain errors should be corrected, but it's complicated and not comprehensive.

For example, an employer had sponsored a plan for several years with a tiered profit-sharing contribution. The prior plan document specified three groups of employees, and the employer had discretion to provide a profit-sharing contribution to each group of employees in a different percentage of compensation. However, when the plan document was restated in conjunction with a transfer to a new record-keeper, the restatement provided for profit-sharing contributions in the same percentage of compensation for all employees, even though the sponsor intended the restated plan document to provide the same tiered profit-sharing contribution. In practice, the employer continued to provide the tiered profit-sharing contribution and the error wasn't discovered until several years later when the plan was restated to comply with the next round of required updates (*i.e.*, the Economic Growth and Tax Relief Reconciliation Act of 2001).

Although this is a prime example of a scrivener's error, special care was taken to not describe it as such in the VCP application. Instead, the sponsor asked the IRS to allow a "retroactive amendment" to reflect the actual administration of the plan.

The IRS was somewhat concerned by the proposed correction because it could technically be construed as reducing participants' benefits. In fact, under the tiered profit share some highly compensated employees received a higher percentage of compensation than some non-highly compensated employees. Whereas, under the incorrect formula in the restatement, all employees would have received the same percentage of compensation. However, the IRS approved the proposed correction based on participant communications that were provided as a supplement to the VCP application. The participant communications, which had been provided to participants at the time of the restatement, explained the tiered profit-sharing contribution. It should be noted, however, that even if the IRS permits correction of a scrivener's error, it's not binding on participants and they may still bring a suit under ERISA to enforce the terms of the erroneously drafted plan.

Earnings and losses. When a proposed correction involves additional allocations to a participant's account or corrective distributions or forfeitures from a participant's account, the allocation, distribution, or forfeiture should be adjusted for earnings or losses. For the purpose of corrective allocations, however, losses may be disregarded. [Rev. Proc. 2008-50, Section 6.02(4)]

Generally, earnings or losses should be determined based on the actual earnings or losses that would have applied to a corrective allocation if it had been made timely. If most of the employees involved are non-highly compensated employees, earnings for corrective allocations may be calculated based on the investment fund under the plan with the highest earnings rate. If a participant hasn't made an investment election, earnings may be calculated based on the weighted average earnings rate for the plan for the period of the failure. [Rev. Proc. 2008-50, Appendix B, Section 3.01] If it's not feasible to make a reasonable estimate of actual earnings, a reasonable interest rate may be used. [Rev. Proc. 2008-50, Section 6.02(5)(a)]

Alternative corrections. In some circumstances, the correction for a failure specified in Revenue Procedure 2008-50 is very burdensome for an employer and an alternative correction will also make participants whole. In this circumstance, the sponsor may consider filing a VCP application requesting that the IRS approve an alternative correction. As long as the alternative correction is reasonable and places participants in a similar position to the one they would have been in but for the failure, the IRS will often allow the alternative correction. [Rev. Proc. 2008-50, Section 6.02(2)]

For example, a sponsor recently obtained IRS approval of an alternate correction method. The sponsor had retained all forfeitures in a suspense account for nearly 10 years. The sponsor had sufficient records to calculate the forfeiture allocations that should have occurred but it didn't have sufficient records to determine the earnings and losses that would have accrued if the forfeiture allocations had been made timely.

A VCP application was submitted, explaining the proposed method for allocating forfeitures and requesting that the IRS allow earnings on the forfeiture allocations to be calculated based on the plan's average earnings rate for the applicable period, instead of actual earnings. (As noted above, EPCRS allows earnings to be calculated based on the plan's average earnings rate only when a participant hasn't made an investment election.) The IRS approved the proposed

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The ASPPA Annual Business Meeting will be held during the 2012 ASPPA Annual Conference at the Gaylord National in National Harbor, MD, on Sunday, October 28, at 3:00 p.m.

The Annual Business Meeting will include an address by ASPPA's 2011-2012 President, Robert M. Richter, APM, and a look toward the future by ASPPA's incoming President, Barry Max Levy, QKA.

All ASPPA members are strongly encouraged to attend this important meeting.

correction, demonstrating that in some circumstances reasonable estimates will be allowed when actual amounts aren't available or would be expensive to obtain.

DOL corrections. Although the IRS has jurisdiction over many of the most common plan errors, it's important to note that some issues fall within the jurisdiction of the Department of Labor (DOL). Specifically, the DOL has jurisdiction over issues relating to the handling of plan assets, compliance with fiduciary duties, prohibited transactions, and Form 5500 filings. The DOL's Delinquent Filer Voluntary Compliance Program provides procedures for filing late Form 5500s. [PWBA Notice, 3/28/2002]

In addition, the DOL's Voluntary Fiduciary Correction Program provides corrections for several types of failures (*e.g.*, late contributions of employee deferrals to a plan's trust). [EBSA Notice, 4/19/2006] Corrections under these programs may be made at the same time as corrections under EPCRS. However, the IRS and DOL determine the sufficiency of corrections independently.

STEP 3: FILE FOR IRS APPROVAL, IF NEEDED

After the appropriate correction for a failure is determined, a sponsor must also comply with the correction procedures outlined in EPCRS. EPCRS provides two programs for correcting plan errors outside of an IRS audit: the Self-Correction Program (SCP) and VCP.

SCP. SCP is generally preferable if it's available because a formal application to the IRS for approval of a correction isn't required, saving the sponsor the VCP fee and, possibly, additional legal and record-keeping fees. [Rev. Proc. 2008-50, Part IV] SCP is generally available for failures that are corrected before the end of the second plan year, after the year in which the failure occurs. [Rev. Proc. 2008-50, Section 9]

SCP is also available for insignificant failures. The sponsor must determine whether a failure is insignificant based on the following factors: what other failures occurred at the same time, the percentage of plan assets involved, the number of years involved, the number of participants affected (relative to the total number of participants and relative to the number of participants that could have been affected), whether the failure was corrected within a reasonable time after discovery, and the reason for the failure. [Rev. Proc. 2008-50, Section 8]

VCP. If SCP isn't available, the failure must be corrected under VCP. VCP requires a sponsor to submit an application to the IRS along with a user fee based on the number of participants in the plan. Fees range from $750 for a plan with 20 or fewer participants to $25,000 for a plan with more than 10,000 participants. [Rev. Proc. 2008-50, Section 12.02(1)] The VCP application must include an explanation of the details of the error, the proposed correction, and the procedures in place to prevent reoccurrence of the error.

If the IRS discovers failures during an audit, VCP and SCP aren't available (except that SCP does remain available for insignificant failures). If significant failures are discovered during an audit, the IRS will require correction and impose penalties significantly higher than the VCP fee that would have applied. This creates a significant economic incentive to correct under SCP or VCP. [Rev. Proc. 2008-50, Section 10]

IRS Review. After a VCP application is submitted, an IRS agent will be assigned to review the proposed correction method. If the IRS agent disagrees with a proposed correction or has any questions, he or she will contact the sponsor. The sponsor may supplement the VCP application with additional information and documents to support its proposed correction or it may negotiate with the IRS agent for an agreeable, alternative correction.

In our experience, the IRS generally approves reasonable corrections and, when there is a concern about a proposed correction, the agent will negotiate in good faith for a correction that isn't unduly burdensome to the sponsor. However, if the IRS and the sponsor can't agree on a correction, the IRS could potentially audit the plan and impose penalties. Before a VCP application is submitted, the sponsor should consider possible alternative corrections that the IRS may require and confirm that it's willing and able to comply with such an alternative correction if required by the IRS.

If the appropriate correction for a failure is unclear or the correction is potentially expensive, the sponsor may consider filing an anonymous VCP application. [Rev. Proc. 2008-50, Section 10.10] With an anonymous application, the identity of the plan and sponsor aren't disclosed until the IRS agrees to the correction. However, if the IRS initiates an audit before the identity of the plan is disclosed, the IRS will treat the failure as if a VCP application hadn't been filed.

STEP 4: MAKE THE CORRECTION

After an appropriate correction method is determined and the sponsor either confirms that the failure may be corrected under SCP or obtains a compliance statement under VCP, the sponsor should implement the correction. As a sponsor implements a correction method, it should be especially careful to (a) make corrections timely and (b) document corrective actions. The deadline for completing a correction depends on whether SCP or VCP applies.

Timing of the SCP correction. Under SCP, the sponsor doesn't qualify for corrective relief for a significant failure unless the correction is either completed or substantially completed before the end of the second plan year

following the plan year of the correction or, if earlier, the date the sponsor receives notice of an IRS audit (the "SCP deadline"). Generally, a failure is treated as substantially completed if the failure has been corrected for at least 65 percent of the participants involved. If a sponsor substantially completes a correction under SCP before the SCP deadline, the failure will be treated as corrected before the SCP deadline as long as it's actually fully corrected within 120 days of the SCP deadline. [Rev. Proc. 2008-50, Section 9]

Timing of the VCP correction. Once a sponsor receives a compliance statement, the sponsor generally has 150 days to fully complete the correction agreed upon and described in the compliance statement. If needed, the sponsor may obtain an extension by contacting the IRS auditor who reviewed the VCP application before the expiration of the 150-day period. [Rev. Proc. 2008-50, Section 10.07(9)]

If the correction is not completed within the 150-day period, or within an extension granted by the IRS, the failure won't be treated as corrected. The sponsor will have to ask the IRS to approve the late correction. It's entirely within the discretion of the IRS to approve a late correction and, in some cases, the IRS may impose an additional penalty.

Documenting corrections. Regardless of whether a sponsor corrects a failure under SCP or VCP, the sponsor should carefully document each step in the correction process. The sponsor should keep an internal file with an explanation of why a specific corrective action was taken, any administrative changes implemented to prevent reoccurrence of the failure (if applicable), a copy of the VCP application itself, along with any correspondence with the IRS during the review of the VCP application, and a copy of the VCP Compliance Statement. The sponsor's file should also contain written verification that each step in the correction process was timely completed. After completing the correction, the sponsor should review the file to confirm that if the plan were audited by the IRS in the future, the auditor would be convinced from the documentation in the file that the sponsor fully corrected the failure in accordance with EPCRS.

CONCLUSION

Dealing with plan errors will always be a stressful experience, but stress can be minimized if a sponsor carefully (a) gathers facts and determines the extent of the errors, (b) determines appropriate corrections, (c) complies with SCP or VCP procedures (or DOL procedure), as applicable, and (d) implements the correction timely.

The law in this area is always subject to change and, in fact, the IRS has indicated that we should expect a revised EPCRS "soon." Regardless of changes in the technical correction rules, however, the steps outlined above will continue to be a valuable guide for navigating the correction process. PC

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