

IT ISN'T THAT BAD: USING SELF-CORRECTION METHODS APPROPRIATELY

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Learning Objectives

1. Learn when you can use Self-Correction and when you cannot
2. Learn when even if Self-Correction is available, it may not be the best option
3. Apply the overriding principles to determine an appropriate correction method

When Can You Use Self-Correction

Qualified Plan or 403(b)

1. Failure is Operational, and
2. Plan has “Practices and Procedures” that would normally lead to compliance but were either insufficient or not followed and either:

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When Can You Use Self-Correction

Qualified Plan or 403(b)

- a. Failures are Insignificant, or
- b. Failures are Significant but timely corrected and plan has “Favorable Letter.”

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When Can You Use Self-Correction

SEP or SIMPLE if:

1. Failures are Operational
2. Failures are Insignificant
3. Plan has “Practices and Procedures” and
4. Plan is IRS Model or valid prototype with current favorable opinion

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Correction Principals

- Should generally ensure full correction for: (i) the plan, (ii) participants and (iii) for all years whether or not closed
- Should generally keep assets in the plan
- Should look like other approved correction methods

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Correction Principles

- Should restore the plan and participants to the position they would have been in absent the failure, and
- Should be reasonable, consistent and appropriate

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SCP—Distribution Issues

EX: 401(k) with Safe Harbor Hardship

- 401(k) Plan uses the 6 safe harbor hardship standards
- Lee applies for and is granted a casualty hardship withdrawal
- Later, the Plan determines that the event did not qualify as a hardship withdrawal

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SCP—Distribution Issues

EX: 401(k) with Safe Harbor Hardship

How should the Plan correct?

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SCP—Distribution Issues

EX: 401(k) with Safe Harbor Hardship

Correction

- Plan would likely need to require repayment plus interest

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SCP—Distribution Issues

EX: 401(k) with Safe Harbor Hardship
Correction—Why repayment?

1. Adheres to the correction principle of keeping assets in the plan
2. Is similar to other approved correction methods for overpayments

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SCP—Distribution Issues

EX: 401(k) with Safe Harbor Hardship

- What will likely NOT be accepted on audit is attempting to use reformation by retroactively amending to include an additional hardship category that would include the reason for the participant's request

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SCP—Distribution Issues

EX: 401(k) with Safe Harbor Hardship

- Remember reformation under SCP limited to:
 1. 401(a)(17) failures
 2. Allowing loans or hardships w/o plan provision, or
 3. Early inclusion of ineligible predominantly NHCEs

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SCP—Distribution Issues

EX: 401(k) with Safe Harbor Hardship

- Specifically, making hardship distributions to EEs under a Plan that does not provide for hardship distributions

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SCP—Distribution Issues

EX: 401(k) with Safe Harbor Hardship

- Why such an extension (i.e., of reformation) will likely not be acceptable

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SCP—Distribution Issues

EX: 401(k) with Safe Harbor Hardship

1. IRS applies SCP fairly stringently
2. Retroactively amending does not place the participant and the Plan in the position they would have been in absent the failure

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SCP—Distribution Issues

EX: 401(k) with Safe Harbor Hardship

- Can proposed correction actually be done?
- Concern is, of course, the likelihood that the EE, having already experienced a financial set back of some sort, will be unable to repay

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SCP—Distribution Issues

EX: 401(k) with Safe Harbor Hardship

- Could the Plan apply the new “overpayment” correction options of Rev. Proc. 2015-27?

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SCP—Distribution Issues

EX: 401(k) with Safe Harbor Hardship

- Correcting Overpayments
 - Previously required attempt to obtain repayment
 - Not all ERs were comfortable attempting repayment
 - While generally associated with DBs applies equally to DC Plans

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SCP—Distribution Issues

EX: 401(k) with Safe Harbor Hardship

- Overpayment Means
 - Payment that exceeds the amount payable under the terms of the Plan, or
 - Exceeds a limitation
 - Includes both payments from a DB and DC Plans, including when not permitted under the Code

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SCP—Distribution Issues

- EX: 401(k) with Safe Harbor Hardship
- IRS will now allow some flexibility--other acceptable options may include
 1. ER or someone else repaying, or
 2. Reformation-subject to satisfaction of all 401(a), 401(a)(4) requirements

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SCP—Distribution Issues

- EX: 401(k) with Safe Harbor Hardship
- Remember to Self Correct, must have “Practices and Procedures”
 1. If there are wholesale hardship failures, may mean no “Practices and Procedures”
 2. If only HCEs received, may not satisfy §4.05, i.e., 401(a), 401(a)(4)

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SCP—Distribution Issues

EX: 401(k) with Safe Harbor Hardship

- Is the event something that could be classified as a hardship in a non-safe harbor hardship plan?
- If so, could VCP be used to retroactively amend to reclassify?

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SCP—Hardship Suspension Issues

Ex: 401(k) with 6-Month Suspension

- 401(k) Plan provides for 6 month suspension of elective deferrals following hardship
- Plan fails to suspend in operation
- Elective deferrals continued for 2 payrolls during first month following distribution

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SCP—Hardship Suspension Issues

Ex: 401(k) with 6-Month Suspension

How should the Plan Self Correct?

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SCP—Hardship Suspension Issues

Ex: 401(k) with 6-Month Suspension

Correction

- IRS preferred correction is to retroactively implement 6 month suspension
- Means, refund elective deferrals made during suspension period

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SCP—Hardship Suspension Issues

Ex: 401(k) with 6-Month Suspension

- Why refunding elective deferrals works
 1. It places the participant and the Plan in the position each would have been in absent the error
 2. Similar to correction for excess deferrals

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SCP—Hardship Suspension Issues

Ex: 401(k) with 6-Month Suspension

- What the IRS does not like as a SCP method is implementing the 6 month suspension prospectively
- There is no certainty that the participant will be placed in the exact same position he/she would have been in absent the failure

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SCP—Hardship Suspension Issues

Ex: 401(k) with 6-Month Suspension

- IRS is concerned that prospective 6-month suspension could mean things like rate of match may be different

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SCP—Hardship Suspension Issues

Ex: 401(k) with 6-Month Suspension

- To correct by prospective 6-month suspension, Plan could instead apply to correct under VCP

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SCP--Late Notice

EX: Safe Harbor 401(k) Plan

- PY is calendar year
- Safe Harbor Notice for 2015 issued 12/10/2014
- Plan looks but no change in any participant's contribution level
- Is correction required?

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SCP--Late Notice

EX: Safe Harbor 401(k) Plan

- Plan might argue no failure
 - While not distributed at least 30 days prior to PY
 - Notice still distributed within a "reasonable period of time" prior to PY
 - 90 to 30 day period is deemed safe harbor but not mandated period

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SCP--Late Notice

- Analyzing Correction when Safe Harbor Notice is late
 1. Appropriate correction depends upon the impact on individual participants;
 2. If EE otherwise informed of Plan features and how to make contributions, a make-up QNEC may not be required;
 3. EEs not otherwise informed may require make-up QNEC

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SCP--Late Notice

- Looking for clues as to impact:
 1. Was EE otherwise informed—has ER always contributed same safe harbor contribution over several years; does SPD suggest same contribution unless notices says otherwise?
 2. Did on-going participants contribute the same as when Notice was timely?

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SCP--Late Notice

- Looking for clues as to impact:
 3. Were newly eligible EEs advised as to the Plan's features and how to make contributions for example by HR?

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SCP--Late Notice

- Analyzing Correction when Safe Harbor Notice is late
 1. If, no discernable reduction from on-going participants and/or EEs otherwise aware of plan features, and
 2. Newly-eligible EEs, if any, contribute, then QNECs may NOT be required

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SCP--Late Notice

EX: Safe Harbor 401(k) Plan

- Safe Harbor Notice Given 21 Days Prior
- Plan concludes no failure

90 to 30 day period is deemed compliance but Notice still provided within reasonable period prior to beginning of PY and no change in any participant's contribution level

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SCP--Late Notice

EX: Safe Harbor 401(k) Plan

- Same facts except Notice provided 36 days after beginning of PY
- Assume also
 - Plan has been in effect for 5 years
 - Each year, ER contributes 3% match
 - No unusual reduction in participation among on-going participants

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SCP--Late Notice

EX: Safe Harbor 401(k) Plan

- Is any correction required?
- Is the failure eligible for Self Correction?

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SCP--Late Notice

EX: Safe Harbor 401(k) Plan

- It is a failure and therefore correction is required
- This is the case even if correction does not require the contribution of QNECs
- Plan must still document correction by adopting administrative changes

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SCP—Late Notice

- One reason to document the adoption of an administrative correction even where no QNEC is required is to demonstrate that full correction has been made and when
- Depending upon how aggressive the IRS agent wants to be on audit, the failure could be viewed as Significant

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SCP--Late Notice

- If viewed as Insignificant, it could be corrected at any time even on audit.
- If Significant, must be corrected by the last day of the 2nd PY following the PY of the failure

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SCP--Missed Deferrals

EX: 401(k) Plan

- Chris becomes eligible to participate in the ABC 401(k) Plan and elects 4% elective deferrals starting January 1, 2016.
- Chris' election is overlooked but the error is caught in February, 2016.
- How should the error be corrected?

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SCP--Missed Deferrals

EX: 401(k) Plan

- The Plan actually has two options:
 1. The new 3 month missed deferral correction method of Rev. Proc. 2015-28, or
 2. The old 9 months still remaining option under Rev. Proc. 2013-12

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SCP---Missed Deferrals

EX: 401(k) Plan

- New 3 Month Rule means
 - If failure not beyond three months, then
 - No QNEC for missed Elective Deferral provided that:

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Missed Deferrals—3 Month

1. Correct deferrals begin no later than earlier of first paycheck:
 - a. on or after 3 month period that begins when failure first occurred or
 - b. on or after end of the month after the month the EE notifies ER of failure.

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Missed Deferrals-3 Month Rule

2. Notice of failure to EE not later than 45 days after the date on which correct deferrals begin, and
3. EE receives the full applicable match not later than the time for self-correcting Significant failures (i.e, by the last day of the 2nd PY following PY of failure) plus earnings.

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Missed Deferral-3 Month Rule

- Special Earnings Rule
 - Earnings may be calculated using Plan's default investment if no affirmative election by EE, and
 - Any cumulative losses may not reduce match

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Missed Deferral-Brief Exclusion Rule

- The Brief Exclusion Special rule remains available if:
 1. EE provided opportunity to make contributions for at least 9 months of that PY, and
 2. Had the opportunity to contribute maximum amount for the PY

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Missed Deferral-Brief Exclusion Rule

- If so, then:
 1. No QNEC required for missed deferrals;
 2. Full match must be made,
 3. No Notice required

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SCP--Missed Deferral

EX: Safe Harbor 401(k)

- ABC 401(k) operates as a QACA
- Chris, a new hire, should have entered in July, 2016 but is overlooked
- The Plan discovers the omission in February, 2017

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SCP--Missed Deferral

EX: Safe Harbor 401(k)

- Plan applies 9 ½ month correction for automatic contribution failures under Rev. Proc. 2015-28

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SCP--Missed Deferral

- 9 ½ month correction rule allows
 - Correction of Automatic Contribution and Escalation Failures
 - Allows 403(b)s and 401(k)s to avoid contributing QNECs for missed or incorrect deferrals if:

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SCP--Missed Deferral

1. Correct deferrals begin by the first paycheck made on or after the earlier of:
 - 9 ½ months after end of PY in which failure first occurred, or
 - last day of the month after the month EE first notified ER of failure, and

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SCP--Missed Deferral

2. ER issues written notice complying with the Rev. Proc. to affected EE not later than 45 days after correct deferrals begin,
3. Makes the full match, adjusted for earnings, by SCP timing for significant failures, and
4. Failure occurred on or before 12/31/20

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SCP--Missed Deferral

9 ½ month Correction rule

- Special Earnings Rule
 - Earnings may be calculated using Plan's default investment if no affirmative election by EE, and
 - Any cumulative losses may not reduce match

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SCP or VCP?

EX: Small SIMPLE (IRAs) Plan

- SIMPLE established in 1998—no Notices ever issued
- ER made 3% match from 1998-2008
- Stops matches from 2009-2014 and verbally advises

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SCP or VCP?

EX: Small SIMPLE (IRAs) Plan

- ER verbally confirms that missed matches will be made up when fortunes improve
- EEs only gradually stop all elective contributions
- Investment returns post 2010 are significant
- Largest contributions would be for the owner

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SCP or VCP?

EX: Small SIMPLE (IRAs) Plan

- What ER Wants:
 1. Stop incurring any more costs for match
 2. Make EEs whole but limit its cost particularly given the significant rates of investment returns post 2010
- Company still not economically healthy

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SCP or VCP?

EX: Small SIMPLE (IRAs) Plan

- Its Now 2014 and ER wants to correct
- What if ER Self Corrects?
 - Are all failures eligible for SCP?
 - Can ER goals be achieved?
- Before IRS correction is made DOL contacts

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SCP or VCP?

EX: Small SIMPLE (IRAs) Plan

- Analyzing options:
- A SIMPLE can only use Self Correction if:
 1. Failures are Operational and
 2. In the aggregate, Insignificant

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SCP or VCP?

Factors weighed in determining whether Insignificant:

1. Existence of other failure
2. % of assets and contributions involved
3. # of years involved;
4. # of affected participants relative to total #;
5. # of affected participants relative to # that could have been affected

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SCP or VCP?

Factors weighed in determining whether Insignificant:

6. How long to correction after discovery, and
7. Reason for the failure (for example, data errors or minor math errors)

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SCP or VCP?

EX: Small SIMPLE (IRAs) Plan

- Failure to issue Notices likely problematic to correct under SCP

- SCP will not allow any flexibility in attempting to limit cost to ER

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SCP or VCP?

EX: Small SIMPLE (IRAs) Plan

- Given concerns, submit to VCP
- Questions to ask:
 1. What if IRS requires correction client cannot or will not fulfill?
 2. What if IRS will not accept proposal designed to reduce ultimate cost to ER?

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SCP or VCP?

- When unsure whether the correction you propose under VCP will be accepted and you have concerns as to whether your client can and/or will accept a likely proposed correction suggested by IRS, consider benefits and risk of “John Doe”

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SCP or VCP?

EX: Small SIMPLE (IRAs) Plan

- Greatest risk of an Anonymous submission is the risk that the plan will be pulled for audit before final resolution.
- If audited, plan will be unable to continue under Voluntary Correction.

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SCP or VCP?

EX: Small SIMPLE (IRAs) Plan

- So all failures submitted John Doe VCP
- Proposed Correction:
 1. Terminate before submission to cut off cost;
 2. Make matching contributions, + earnings for all unmatched Elective Contributions other than for the owner (largest cost)

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SCP or VCP?

EX: Small SIMPLE (IRAs) Plan

3. Argued that Notice failure should be treated as administratively corrected by termination given:

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SCP or VCP?

EX: Small SIMPLE (IRAs) Plan

- Participants were advised numerous times orally over the 15 period of the plan as to its existence and features;
- 3% match had remained the level of contribution for that entire 15 year period.

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SCP or VCP?

EX: Small SIMPLE (IRAs) Plan

- After providing financial statements for the company, all proposed methods of correction were accepted by the IRS including no match for the owner

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SCP or VCP?

EX: Small SIMPLE (IRAs) Plan

- If correction had been made instead under SCP
 - Perhaps could not correct failed Notices;
 - Could not have avoided contributions for owner

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SCP--Omitting Eligible EE

EX: Profit Sharing Plan

- PSP has failed to timely include part-time EEs who satisfied the plan's eligibility requirements
- Correction by new contributions would be too costly for the ER

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SCP--Omitting Eligible EE

EX: Profit Sharing Plan

- What other option might be available for correction if new contributions is too costly?

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SCP--Omitting Eligible EE

EX: Profit Sharing Plan

- Correction might instead be made by reallocating contributions and earnings from accounts of HCEs

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SCP--Ineligible Deferrals

EX: 401(k)

- Ex: Former CFO retires and enters into 6 month consulting agreement with prior ER
- Payroll incorrectly continues deferral election with ER match

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SCP--Ineligible Deferrals

EX: 401(k)

Correction

- Correct by refunding deferrals with earnings
- Forfeit match and apply to future matches

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SCP--Ineligible Deferrals

- Why refunding contributions works:
 1. It places the Plan and EE in the position they would have each been in absent the error
 2. It is the same correction the IRS generally requires for similar events where money goes in when it should not

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Significant or Insignificant

- If failures are all Insignificant, failures can be Self-Corrected at any time even if failures discovered by agent on audit
- If failures are Significant, must be corrected (or substantially completed) by the last day of the second PY following PY of the failure

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Significant or Insignificant

- If failures under SIMPLE IRA or SEPs are Significant, failures can never be Self-Corrected
- If failure to satisfy 401(k)(3), 401(m)(2) or 401(m)(9), 2 year window for correcting Significant failures begins after close of Code-provided correction period

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Significant or Insignificant

Factors weighed in determining whether Insignificant:

1. Existence of other failure
2. % of assets and contributions involved
3. # of years involved;
4. # of affected participants relative to total #;
5. # of affected participants relative to # that could have been affected

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Significant or Insignificant

Factors weighed in determining whether Insignificant:

6. How long to correction after discovery, and
7. Reason for the failure

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Examples of Significant v. Insignificant

From Presentation of IRS Mid-Atlantic Area Manager and Area Coordinator:

- **ADP Failures**
 - Insignificant—1 year failure due to miscalculation of an HCE
 - Significant—4 year failure of the same miscalculation not identified until IRS agent identifies on audit.

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Examples of Significant v. Insignificant

From Presentation of IRS Mid-Atlantic Area Manager and Area Coordinator:

- **Vesting Failures**
 - Insignificant—Incorrect vesting for 1 terminated EE
 - Significant—Same failure for a number of years even if only 1 terminated EE if vesting over a number of years was incorrect.

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Examples of Significant v. Insignificant

From Presentation of IRS Mid-Atlantic Area Manager and Area Coordinator:

- Excluded EE Failures
 - Insignificant-1 EE excluded
 - Significant—Multiple EEs excluded particularly of a certain class, like part time EEs