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LEGAL ALERT



Legal Alert: IRS Clarifies When Plan Amendments May be Used to Correct Operational Failures

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The Internal Revenue Service (IRS) recently explained when a plan amendment can be used to correct a failure to follow plan terms in the operation of a retirement plan. (See *Retirement News for Employers*, Winter 2008). The Employee Plans Compliance Resolution System (EPCRS) is a voluntary correction program that allows plan sponsors to correct plan mistakes that, if left uncorrected, could result in a retirement plan losing its favorable tax treatment. The EPCRS includes a Self-Correction Program (SCP), under which a correction can be made without paying a fee or contacting the IRS. However, SCP is only available to correct a failure to follow the terms of the plan in its operation (operational failure).

Generally, a failure to follow plan terms can be corrected by changing the administration of the plan to match the plan's terms. Alternatively, the employer may retroactively amend the plan so that the terms of the plan match the way the plan was operated. Usually, SCP is available only for corrections made by changing the plan's administration to match its terms.

However, the IRS has clarified that failure to follow plan terms may be corrected under the SCP by retroactively amending the plan, in three specific situations. These three situations are the following operational failures listed in Rev Proc 2006-27, 2006-22 IRB 945, Appendix B, Sec. 2.07:

- **Maximum compensation (Code Sec. 401(a)(17)) failures.** A defined contribution plan that allocates contributions or forfeitures based on a participant's compensation that exceeds the compensation limit under section 401(a)(17) of the Code may be corrected by amending the plan. The affected participant's allocation rate (after taking into account only compensation up to the Code section 401(a)(17) limit) must be recalculated, and extra amounts must also be contributed to the other employees.
- **Hardship distribution and plan loan failures.** Making hardship distributions or participant loans under a plan that does not allow them is an operational failure. The failure may be corrected by retroactively amending the plan to permit hardship distributions and/or plan loans; provided, however, that the plan loans or hardship distributions were mostly made to individuals who were not highly compensated employees, loans were made according to the limits in section 72(p) of the Code, and, in the case of a 401(k) plan, any hardship distributions complied with the applicable rules under section 401(k) of the Code and the final regulations.

- **Early inclusion of otherwise eligible employee failures.** An operational failure due to the early inclusion of an otherwise eligible employee may be corrected by retroactively amending the eligibility provisions of the plan. Generally, this would apply to an employee who either: (i) has not completed the plan's minimum age or service requirements, or (ii) has completed the plan's minimum age or service requirements, but became a participant in the plan earlier than the plan entry date. To be entitled to make this retroactive amendment, employees affected by the amendment should be mainly non-highly compensated employees.

A plan sponsor who amends a plan to correct a failure using SCP must submit a determination letter application on the corrective amendments, identifying the amendments separately in the application. The determination letter application must be submitted before the end of the plan's applicable remedial amendment period described in Revenue Procedure 2007-44.

Employers can help prevent operational failures by conducting periodic plan reviews to ensure that all parties are familiar with the terms of the plan. If you have any questions about this issue or other employment related benefits issue, please contact Elizabeth Ward, an attorney in our Chicago, Illinois office at eward@fordharrison.com or 312-332-0777 or any member of Ford & Harrison's Benefits Practice Group.