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IRS Issues New Retirement Plan Correction Program

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On December 31, 2012, the Internal Revenue Service ("IRS") rang in the New Year by issuing an updated version of its Employee Plans Compliance Resolution System ("EPCRS"), in Rev. Proc. 2013—12. This new version of EPCRS replaces Rev. Proc. 2008—50. Although the new procedure takes effect on April 1, 2013, it may be relied upon immediately.

Background

If a plan sponsor corrects an error in accordance with EPCRS, the IRS will not treat the plan as failing to meet the qualification requirements of the Internal Revenue Code ("Code"). EPCRS is comprised of three programs:

- Self Correction Program ("SCP")
- Voluntary Correction with Service Approval Program ("VCP")
- Correction on Audit Program ("Audit CAP")

In general, SCP may be used to correct minor operational errors, such as the failure to permit an employee to participate in a Code section 401(k) plan ("401(k) plan"), without the need to pay a fee or apply for IRS approval. SCP can also be used to correct a failure to satisfy the nondiscrimination, minimum participation or coverage requirements. VCP may be used to correct more significant operational errors or most plan document errors, i.e., plan provisions that violate a requirement of the Code or Treasury Regulations, such as a failure to adopt a plan amendment within the time prescribed by the Code. VCP requires the payment of a fee based on the size of the plan. Audit CAP may be used to correct errors found by the IRS during an audit. Audit CAP also requires the payment of a fee, which is much higher than the fee for correcting an error under VCP, and much lower than the taxes, penalties, etc. that could result from plan disqualification.

What’s New?

Code Section 403(b) Plans

Perhaps the most significant change to EPCRS is its expansion with respect to Code section 403(b) plans ("403(b) plan"). Sponsors of 403(b) plans, particularly those who failed to adopt a written plan before January 1, 2009, have been awaiting such an expansion since the regulations governing 403(b) plans were overhauled in 2007.

If a 403(b) plan sponsor failed to adopt a written plan by January 1, 2009, the error may be corrected under VCP. If the VCP submission is sent to the IRS on or before December 31, 2013, the VCP submission fee is reduced by 50%. Beginning in 2014, the normal VCP submission fee will apply.

In general, the procedures for correcting operational errors in a qualified plan can now be used to correct operational errors in a 403(b) plan. However, with respect to 403(b) plans, an operational error cannot be corrected under EPCRS if the error occurred before January 1, 2009, unless the error constituted a violation of Code section 403(b). For example, a 403(b) plan sponsor may correct a pre—2009 failure to observe the universal availability rule, but may not correct a pre—2009 failure to match elective deferrals in accordance with the terms of the 403(b) plan. Does that mean that 403(b) plan sponsors are prohibited from taking any action to correct pre—2009 operational errors? Of course not! Taking corrective action other than

that prescribed by EPCRS generally is better than not taking any corrective action at all. If the IRS discovers a pre—2009 operational error that has been corrected in a reasonable and nondiscriminatory manner (e.g., the manner prescribed by EPCRS for correcting post—2008 operational errors), any adverse action taken in response to the error will likely be less objectionable than it would have been had no corrective action been taken.

Premature Payments from Defined Contribution Plans

Under Rev. Proc. 2008—50, if a defined contribution plan participant received a payment to which he or she was not entitled, the payment was considered an overpayment even if it was merely a premature payment, that is, even if the participant would have been entitled to receive the same amount upon the occurrence of a distributable event, such as a termination of employment. The new version of EPCRS prescribes a different correction method for this type of overpayment. As with any overpayment, the plan sponsor must notify the participant that the overpayment is not eligible for rollover, and attempt to recover the overpayment, plus earnings. (Rev. Proc. 2013—12 clarifies that "earnings" includes both earnings and losses.) If the overpayment is recovered, the amount recovered is restored to the participant's account. Any unrecovered amount of a true overpayment must be contributed to the plan by the plan sponsor. In general, this contribution would be allocated to a suspense account and used to offset future employer contributions to the plan. However, to the extent the overpayment is merely a premature payment, the plan sponsor is not required to make such a contribution. For example, if a participant who is not eligible for a distribution and only 50% vested in his account balance receives a distribution of his entire account balance, 50% of the overpayment is a premature payment, and the other 50% (the non—vested portion) is a true overpayment. If none of the payment is recovered, the plan sponsor must contribute to the plan only the non—vested portion, plus earnings, and allocate that amount to the plan's forfeiture account.

Correction for Violation of Section 436 Funding—Based Benefit Restrictions

Code section 436 ("Section 436"), which was added by the Pension Protection Act of 2006, imposes restrictions on plan amendments to, benefit accruals under, and benefit distributions from a single—employer defined benefit plan that is less than 80% funded. If the plan is less than 60% funded, the restrictions are more severe. However, if a plan sponsor makes a sufficient contribution to the plan, Section 436 permits otherwise prohibited amendments, benefit accruals and benefit distributions to occur during the year of the contribution. Under Rev. Proc. 2012—13, if a plan sponsor permits an amendment, benefit accrual or distribution that is prohibited by Section 436, the plan sponsor can correct the error by contributing an amount equal to the contribution that would have been required during the year of the error (plus interest) to make permissible the amendment, benefit accrual or distribution. For example, if a prohibited lump sum distribution is paid and the plan sponsor could have contributed $200,000 to preserve the plan's ability to make that distribution, the plan sponsor can correct the error by contributing $200,000 (plus interest) to the plan.

If a plan is subject to the Section 436 restrictions for the year in which an error is corrected under EPCRS, the plan sponsor may be required to make a contribution to the plan. A contribution is necessary if an error is to be corrected by making a distribution or adopting a plan amendment that would violate Section 436. The contribution would equal the amount of the corrective distribution (or half that amount if the plan is between 60% and 80% funded), or the amount necessary to fund the plan amendment.

Arguably, an employer should only have to contribute the amount necessary to avoid a Section 436 violation. Thus, if a plan makes a corrective distribution of $6,000, and Section 436 permits the plan to distribute lump sums of up to $5,000, an employer should only have to contribute $1,000 to fund the corrective distribution. However, Rev. Proc. 2013—12 suggests that an employer must contribute the entire amount of a corrective distribution.

QNECs Cannot be Funded with Forfeitures

Some of the correction procedures prescribed by EPCRS require the plan sponsor to make a qualified nonelective contribution ("QNEC") to the plan. The IRS has taken the position for several years (although arguably not supported by the Code or Treasury Regulations) that such a contribution cannot be funded by a plan's forfeiture account. This could be problematic for a plan that has a large forfeiture account balance and, for one reason or another, does not provide for employer contributions. Rev. Proc. 2012—13 confirms that the IRS has not changed its position with respect to this issue. Thus, for

example, if a failed ADP or ACP test is corrected with a QNEC, the employer must contribute the entire amount of the QNEC even if the plan's forfeiture account balance is sufficient to fund the QNEC.

Exclusion of Eligible Employees and Correction of Missed Matching Contributions

From time to time, plan sponsors inadvertently exclude an eligible employee from participation in a 401(k) plan. To correct this error, the plan sponsor must contribute to the plan an amount equal to the employee's "missed deferral opportunity," which is equal to one—half of the elective deferral that would have (or likely would have in the case of an employee who did not make a deferral election) been contributed to the plan on the employee's behalf absent the error, plus earnings. Rev. Proc. 2008—50 did not explain how to calculate the "missed deferral opportunity" with respect to a qualified automatic contribution arrangement ("QACA"), perhaps because the QACA was a relatively new concept when EPCRS was last updated. Rev. Proc. 2013—12 provides that the "missed deferral opportunity" with respect to a QACA is equal to one—half of the amount that would have been contributed to the plan on the employee's behalf had the employee been automatically enrolled in the plan. For example, if a QACA's automatic enrollment percentage is 3%, increasing by 1% each year and an employee is excluded for two years, the missed deferral opportunity is 1.5% of compensation for the first year, and 2% of compensation for the second year.

If an employee is excluded from a plan that provides for matching contributions, an employer must also contribute an amount equal to the excluded employee's "missed matching opportunity," which is 100% of the matching contribution the employee would have received absent the error, plus earnings. Rev. Proc. 2013—12 permits such a corrective matching contribution to be subject to the same vesting schedule and distribution restrictions as other matching contributions. Previously, corrective matching contributions were treated as QNECs and, as a result, were required to be fully vested when made and were subject to the distribution restrictions applicable to QNECs, even if other participants' matching contributions were subject to a vesting schedule and different distribution restrictions.

Procedural Changes

Of the many procedural changes made by Rev. Proc. 2013—12, one of the more significant changes is the publication of two forms that must be included with any VCP submission sent to the IRS after April 1, 2013. Form 8950, Application for Voluntary Correction Program, combines Appendix C and much of Appendix D of Rev. Proc. 2008—50. Form 8951, Compliance Fee for Approval for Voluntary Correction Program Submission Under the Employee Plans Compliance Resolution System, is similar to Form 8717, which is used for determination letter applications. A check in the amount of the VCP submission fee must be attached to Form 8951 and a copy of the check must be included in the VCP submission.

Action Items

Sponsors of 403(b) plans who did not adopt a written plan by January 1, 2009 should file a VCP submission before December 31, 2013 to take advantage of the reduced VCP submission fee. All plan sponsors should, on a regular basis (at least annually), review plan procedures and documentation to identify and correct errors that could adversely affect a plan's status as a qualified plan or 403(b) plan. The IRS has posted on its website a number of **"fix-it"** guides that plan sponsors have found helpful in conducting periodic compliance reviews.

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