



Electronic Dispatch

Employee Benefits Law Action Memo

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IRS ISSUES REVISED PLAN CORRECTION PROGRAM

As any administrator or sponsor of a retirement plan knows, the legal rules governing retirement plans are complex and ever-changing. As a result, errors in the operation of such plans are not uncommon, even for the most diligent and well-intentioned. The potential consequences of plan errors can be severe (i.e., the loss of the plan's tax-favored status or the payment of substantial penalties to avoid such a loss). In recognition of these facts, the Internal Revenue Service ("IRS") sponsors a number of programs pursuant to which a plan sponsor or administrator may voluntarily correct plan errors and avoid the loss of the plan's tax-favored status for a substantially (in general) reduced cost. These programs are collectively referred to as the Employee Plans Compliance Resolution System ("EPCRS").

The IRS recently issued a new revenue procedure (IRS Revenue Procedure 2006-27, 2006-22 I.R.B) in which EPCRS has been updated and expanded. The new guidance is generally effective September 1, 2006. However, plan sponsors are permitted, but are not required, to apply the new guidance beginning June 1, 2006.

What Types Of Retirement Plans May Take Advantage of EPCRS?

EPCRS is available to retirement plans intended to be qualified under Section 401(a) of the Internal Revenue Code ("Code") (e.g., defined benefit pension plans, 401(k) plans, and profit sharing plans), tax-deferred annuity plans under Section 403(b) of the Code, simplified employee pension plans ("SEPs") and SIMPLE Individual Retirement Account plans. EPCRS is not available to non-qualified deferred compensation arrangements, including Code Section 457(b) plans. However, the IRS will accept eligible governmental 457(b) plans outside of EPCRS through standards similar to EPCRS.

What Types of Errors May Be Corrected Through EPCRS?

The following four broad categories of errors may be corrected under EPCRS: (1) "plan document failure" – a plan provision, or an absence of a plan provision, that violates the applicable statutory requirements (e.g., a failure to amend the plan document for a required legal change within the applicable "remedial amendment period"); (2) "demographic failure" – a failure to satisfy a nondiscrimination, minimum participation or minimum coverage requirement (e.g., the failure to satisfy the nondiscrimination test applicable to elective deferrals under a Code Section 401(k) plan); (3) "operational failure" – a failure that arises out of a failure to follow the terms of the plan; and (4) "employer eligibility failure" – the failure to meet the employer eligibility requirements to establish a 401(k) or 403(b) plan.

What Correction Programs Are Available under EPCRS?

Self-Correction Program ("SCP") – Under SCP, a plan sponsor can "self-correct" operational failures without any IRS involvement or the payment of any fee. SCP is available for correction of insignificant operational failures at any time. However, significant operational failures must be self-corrected by the end of the second plan year following the year in which the failure occurred. The determination of whether an operational failure is significant or insignificant is made taking into consideration factors set forth in EPCRS. In order to take advantage of SCP, the plan sponsor must have established practices and procedures that are reasonably designed to promote and facilitate overall compliance with the applicable requirements. The principal advantages of SCP are the ability to self-correct operational failures without the involvement of the IRS and the absence of any penalty or fee. However, the lack of IRS involvement means that the sponsor has no assurance what the IRS will agree that the error was eligible for self-correction under SCP or that the error was corrected appropriately in the event that the error is discovered upon a subsequent IRS examination.



Voluntary Correction Program ("VCP") – Under VCP, a plan sponsor can correct all types of failures by submitting a detailed application to the IRS. The sponsor must identify the failures and propose the method by which they will be corrected. If the IRS agrees with the proposed correction, the sponsor will receive written assurance from the IRS that the plan will not lose its tax-favored status as a result of the failure. The plan sponsor must pay a compliance fee to the IRS. In general, the amount of the fee is based upon the number of participants in the plan, and ranges from \$750 for plans with 20 or fewer participants to \$25,000 for plans with more than 10,000 participants.

Audit Closing Agreement Program ("Audit CAP") – Failures that are discovered by the IRS during an examination may be corrected under Audit CAP as an alternative to plan disqualification. The plan sponsor must reach an agreement with the IRS regarding the correction and must enter into a closing agreement. Pursuant to the closing agreement, the disqualification of the plan is avoided by implementing the agreed upon corrective actions and the payment of a sanction. The sanction is a negotiated percentage of the maximum tax that the IRS could have assessed upon disqualification of the plan.

What are the General Correction Principles under EPCRS?

In general, a failure is not corrected unless full correction is made with respect to all participants and beneficiaries for all years. A correction should restore the plan and the affected individuals to the positions they would have been in had the failure not occurred. Correction methodologies for a number of specific failures are provided in the EPCRS. However, there may be more than one acceptable correction methodology for a failure.

What Are Some of the Significant Changes in the Revised EPCRS?

- The IRS has provided acceptable correction methodologies for failures involving plan loans to participants. However, these correction methods are available only through VCP.
- The IRS has revised the correction methodology for the failure to include an eligible employee in a Code Section 401(k) plan. Under the new methodology, the employer is required to make a replacement contribution on behalf of the excluded employee equal to 50% of the missed deferral (rather than 100% of the missed deferral, as under previous guidance). Other corrective contributions also may be required (e.g., matching contributions).
- The circumstances in which the IRS will waive otherwise applicable excise taxes in connection with the correction of certain failures have been expanded.
- A flat compliance fee of \$500 is provided for the correction of minimum required distribution failures affecting 50 or fewer individuals, regardless of the number of participants in the plan.
- Ordinarily, the correction of a failure to timely amend a plan document for a required legal change under VCP requires the payment of the standard compliance fee, which may be reduced by 50% if the failure is corrected within one year of the expiration of the applicable amendment deadline. The revised EPCRS provides for a reduced fee for the late adoption of certain "good faith amendments" equal to \$375 for each year that the amendment is late.
- In an effort to further encourage plan sponsors to voluntarily correct late plan amendments, the revised EPCRS also sets forth a schedule of fees that will be assessed by the IRS in the event that it discovers late amendments outside of EPCRS (e.g., during the review of a determination letter application not related to a VCP submission). The fee assessed will depend upon the number of participants in the plan and the legislation that required the amendment. The fees range from \$2,500 to \$80,000 (as compared to the \$750 to \$25,000 fee range that would generally apply if the late amendment was resolved under VCP). Furthermore, the IRS has provided that if a late amendment is discovered upon IRS examination, the sanction will be even greater.

EPCRS has been designed to give plan sponsors significant incentives to correct plan errors voluntarily. A plan sponsor that discovers that a failure in the operation of a retirement plan has occurred should give serious consideration to the utilization of SCP or VCP (as applicable) to correct the failure. The use of SCP and VCP can help the sponsor avoid the loss of the tax-favored status of the plan and the imposition of significant monetary penalties that could occur if the failure were to be discovered by the IRS in connection with an IRS examination.

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