Common Plan Failures and Correcting Plan Errors with IRS and/or DOL Correction Programs

27th Annual GWSCPA Nonprofit Finance & Accounting Symposium
December 3, 2015

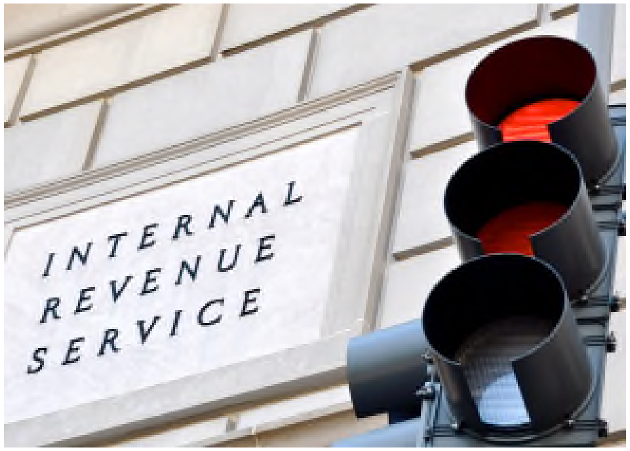
By Lisa A. Tavares
Partner, Venable LLP

IRS Employee Plans Examination Program

- Internal Controls must exist in order to mitigate sanctions on audit.
  - Requires self-audit internal control procedures to qualify for IRS self-correction program under Employee Plans Compliance Resolution System (ECPRS) and mitigate the amount of IRS monetary sanctions.
  - Get credit for starting correction process prior to audit.

IRS Employee Plans Examination Program

- IRS imposes monetary sanctions on employer plan sponsors for:
  - **Failure** to operate 401(k)/403(b) plans in accordance with Internal Revenue Service Code requirements.
  - **Failure** to follow the terms of the plan documents even if plan operation is within compliance with Internal Revenue Code requirements.



Common Plan Drafting and Operational Errors

- Automatic Enrollment/Automatic Increase
- Compensation – incorrect use of definition
- Eligibility of Employees
- Employee Exclusions
- Vesting
- Safe Harbor Contributions
- Forfeitures
- Required Minimum Distributions
- In-Service Distributions
- True up

Employee Plans Compliance Resolution System (EPCRS), Revenue Procedures 2013-12, 2015-27 and 2015-28

- EPCRS provides a voluntary system for plan sponsors of retirement plans that experience a plan document or operational failure by allowing plan sponsors to correct failures and retain tax-qualified status.
  - Provides income tax relief under Sections 72(p) and 72(t) of the Internal Revenue Code (the "Code").
  - Provides excise tax relief under Sections 4972, 4974, and 4979 of the Code.

EPCRS Correction Principles

- Full correction necessary for all taxable years, regardless of whether tax year is closed or not.
- Correction should be reasonable and appropriate.
- Restore plan and participants to position they would have occupied.

EPCRS Correction Principles (cont.)

- A corrective contribution or distribution must be adjusted for earnings from the date of the failure.
- Full correction should be made unless it is unreasonable or not feasible. Reasonable estimates are permitted where it is impractical or unfeasible to make a precise calculation and the probable difference between the precise calculation and the estimate are insignificant.
- Small benefits - if the total corrective distribution is $75 or less then the plan sponsor is not required to make the corrective distribution if the cost of making the distribution exceeds the amount.
- The plan sponsor is not required to seek the return of an overpayment of $100 or less.

Types of Qualification Failures

- Plan Document Failure:
  - Plan provision that on its face violates the requirements of Sections 401(a), 403(a), or 403(b) of the Code or the absence of such plan provision.
  - Includes the failure to timely or properly amend the plan document by the end of the remedial amendment period or interim amendment deadline.
  - Also includes failures that impact the plan’s qualified status or status under Section 403(b) that are operational, demographic, or employer eligibility failures.
- Operational Failure:
  - Failure to operate plan in accordance with plan provisions.
  - An operational failure does not occur to the extent that the plan is corrected by retroactive amendment to reflect the plan’s operations.

Types of Qualification Failures (cont.)

- Demographic Failure:
  - Failure to satisfy the requirements of minimum coverage and minimum participation that is not an operational failure or employer eligibility failure.

Types of Correction Programs

- Self-Correction Program (SCP)
- Voluntary Correction Program (VCP)
- Audit Closing Agreement Program (Audit CAP)

Self Correction Program (SCP)

- Insignificant operational error/non-egregious.
- Time frame for SCP:
  - Before end of second plan year after the error occurred if correction is completed.
  - Failures related to plan acquisitions, until last day of the plan year after a business transaction, even if error was more than two years ago.

Self Correction Program (SCP), cont.

- SCP Requirements:
  - ADP/ACP correction period starts after close of 12-month correction period of 401(k) and (m) regulations.
  - Available to plan sponsors that have established compliance procedures and practices.
  - No sanction or fee.
  - Consider creating self-correction memo in event of future IRS audit.
  - SCP not available for employer eligibility failure.

Voluntary Correction Program (VCP)

- Significant errors.
- More than two years after error occurred.
- Significant error impacting participants.
  - Retroactive amendments to conform the terms of the plan to the plan's prior operations if the amendment complies with the requirements of the Code only under VCP.

VCP Fees

- Based upon number of participants on the most recent Form 5500:

Number of Participants	Fee
20 or fewer	$ 750
21-50	$1,000
51-100	$2,500
101-500	$5,000
501-1,000	$8,000
1,001-5,000	$15,000
5,001-10,000	$20,000
More than 10,000	$25,000

Audit CAP

- Audit Closing Agreement Program (Audit CAP).
  - Errors identified during audit or determination letter review.
  - Correction based upon EPCRS principles.
  - Pay sanction negotiated with IRS.

Audit CAP

- Non-Amender Sanction Chart- plan document failures:
  - Non-amender failures are the failure to timely adopt EGTRRA good faith, interim and/or optional amendment failures.
  - Sanction is reduced by 40% if failure to adopt good faith amendment, interim amendment, or amendments required to reflect changes in operation of plan related to an optional law change by the applicable deadline but before the expiration of the plan's extended remedial amendment period.

Number of Participants	Employer's 2nd 5 or 6 year	Employer's 1st 5 or 6 year	GUST/401(a)(9) Regs	UCA/OBRA '93	TRA	T/D/R	ERISA
20 or fewer	$2,500	$3,000	$3,500	$4,000	$4,500	$5,000	$5,500
21-50	$5,000	$6,000	$7,000	$8,000	$9,000	$10,000	$11,000
51-100	$7,500	$9,000	$10,500	$12,000	$13,500	$15,000	$16,500
101-500	$12,500	$15,000	$17,500	$20,000	$22,500	$25,000	$27,500
501-1,000	$17,500	$21,000	$24,500	$28,000	$31,500	$35,000	$38,500
1,001-5,000	$25,000	$30,000	$35,000	$40,000	$45,000	$50,000	$55,000
5,001-10,000	$32,500	$39,000	$45,500	$52,000	$58,500	$65,000	$71,500
Over 10,000	$40,000	$48,000	$56,000	$64,000	$72,000	$80,000	$88,000

403(b) Plans

- Corrections for failures that adversely affect the exclusion from income provided by Section 403(b). (Rev. Proc. 2013-12, Section 5.02.)
- Corrections principles for 403(b) plans are substantially the same as those for qualified plans. (Rev. Proc. 2013-12, Section 2.03.)

403(b) Plans (cont.)

- Plan Document Failures:
  - Substantial changes were made to the prior versions of EPCRS by Rev. Proc. 2013-12 to provide for correction of a plan document failure for 403(b) plans for the first time beginning on or after January 1, 2009.
    - Previously, 403(b) correction failures were limited to operational, demographic, or employer eligibility failures.
  - Plan document failures that can be corrected are the failure to have a written form, in accordance with 403(b) regulations and notice 2009-3 requiring all 403(b) plans to adopt a written plan by the end of the 2009 plan year (12/31/09 for calendar year plans).

403(b) Plans (cont.)

- Plan Document Failures, cont.:
  - Correction under VCP
    - Plans submitted will be treated as if timely adopted within the remedial amendment period set forth under Announcement 2009-89.
    - The VCP compliance statement is not a determination that the written plan meets the requirements of Section 403(b) or the regulation but merely memorializes the correction of the failure to have a plan document in place by the end of the 2009 plan year.
    - Review VCP Submission Kit on IRS website for instructions and copy of a sample application.
  - Correction also available in Audit CAP.

403(b) Plans (cont.)

- Operational Failures:
  - EPCRS is not available for correction of the failure to follow the terms of a 403(b) plan document that occurred before January 1, 2009 because 403(b) plans were not required to have a written document prior to 2009.
  - Rev. Proc. 2013-12 expanded EPCRS to:
    - A 403(b) failure (other than an employer eligibility failure) that arises solely from the failure to follow plan provisions.
    - A failure to follow the terms of the plan providing for the satisfaction of the requirements of Sections 403(b)(12)(ii)(relating to the availability of elective deferral contributions) and 401(m) (as applied to 403(b) plans pursuant to Section 403(b)(12)(A)(i)) is an operational failure.
    - The failure cannot be corrected by a retroactive amendment.
    - Operational errors occurring in a 403(b) plan prior to 2009 may be corrected only if it is one of the operational failures that was outlined in 2008-50.

403(b) Plans (cont.)

- Demographic Failure:
  - A failure to satisfy the requirements of Sections 401(a)(4) or 410(b) (as applied to 403(b) plans pursuant to Section 403(b)(12)(A)(i)) that is not an operational failure or an employer eligibility failure.
  - A plan amendment is used to add more benefits or increase existing benefits.
- Employer Eligibility Failure:
  - Adoption of a plan that is intended to be a 403(b) plan by a plan sponsor that is not a tax-exempt organization described in Section 501(c)(3) or a public educational organization described in Section 170(b)(1)(A)(ii).
    - Under VCP, employees can retain contributions but no new employee or employer contributions are permitted in the future but the assets may remain in the plan.
    - Alternative correction is to treat contributions as not being excluded under Section 403(b) and the contribution can be treated as contributions to a 403(c) annuity contract.

Common 403(b) Errors

- Excluded Employee- Universal Availability:
  - The failure results because employees are not given the opportunity to participate in the 403(b) plan and make salary deferrals. The failure is often the result of excluding a class of employees, such as part-time employees or employees that work over 20 hours per week.
    - A 403(b) plan may only exclude the following employees for eligibility to make elective deferrals: (1) employees eligible to defer under another employer plan (*i.e.*, a 457(b) or 401(k) of the employer); (2) non-resident aliens; (3) students performing services as described in Section 3121(b)(1) of the Code (*i.e.*, medical residents); and (4) employees who normally work fewer than 20 hours per week.
    - If employees are improperly excluded then the plan sponsor must make corrective contributions to the participants.

Common 403(b) Errors (cont.)

- Hardship Distributions.
- Special 15 years of service catch-up.
- Mandatory contributions that are mischaracterized as elective deferrals are technically non-elective employer contributions subject to nondiscrimination testing under Section 401(a)(4) of the Code (no universal availability) or the 402(g) limit.

Recent Changes to EPCRS

- Rev. Proc. 2015-27: EPCRS Update:
  - Clarifies requirements for recoupment of overpayments.
  - Modifies IRC Section 415(c) excess contribution failure correction.
  - Reduces VCP fees for RMDs of 300 or fewer participants and participant loans that do not comply with 72(p).

Recent Changes to EPCRS

- Rev. Proc. 2015-28: EPCRS Update:
  - New safe harbor EPCRS correction for automatic contribution features (failure to implement a salary reduction election or failure to implement an automatic contribution feature):
    - Relief if error corrected in first 9 ½ months after the end of plan year. Affected participant(s) must be notified within 45 days of beginning of the correction of deferrals.
    - Corrective matching contributions must be made within SCP two-year window and adjusted for earnings (based upon default investment alternative for earnings, if no affirmative investment election).
    - Currently only available for failures on or before 12/31/20.

Recent EPCRS Changes

- Rev. Proc. 2015-28: EPCRS Update:
  - New safe harbor for elective deferral failures corrected quickly:
    - Relief if elective deferral failure corrected within first 3 months of failure.
    - After 3 months, but before two-year SCP period expires, plan sponsor may make corrective contribution of 25% of missed deferrals (QNEC) instead of highest deferral rate.
      - Affected participant(s) must be notified within 45 days of beginning of the correct deferrals.
      - Corrective matching contributions must be made within SCP two-year window (based upon default investment alternative for earnings, if no affirmative investment election).
      - Includes auto escalation features.

Top Ten Errors

ERROR

1. **Automatic enrollment/Automatic Increase**
   - **What went wrong (error):**
     - Eligible employees are not enrolled automatically based on plan provisions.
   - **Internal controls to avoid errors:**
     - Effective date is critical when testing employee deferrals.
     - Review for proper inclusion of employees, designated salary deferral has been withheld, auto-escalation of deferral percentages has been applied, and review the “opt-out” participants to determine if money needs to be returned.
     - A qualified automatic contribution arrangement (QACA) has additional requirements.

Top Ten Errors

2. Compensation

– **What went wrong (error):**
  - Compensation being used for calculating employee and employer contributions, compliance tests, etc. is inconsistent with the plan document.
  - Compensation factors: base pay, bonuses, overtime, severance, etc.

– **Internal controls to avoid errors:**
  - Review definition of eligible compensation.
  - Verify all calculations and compliance tests are using the proper compensation amount.

Top Ten Errors

ERROR

3. **Eligibility of employees**
   - **What went wrong (error):**
     - Lack of understanding for various eligibility requirements (individuals, hours, service, full/part-time, seasonal, etc).
     - Lack of tracking mechanism for ineligible employees.
   - **Internal controls to avoid errors:**
     - Reconcile service provider's enrollment report to plan sponsor's enrollment report.
     - Determine if monies need to be returned to participant, or participant needs to be made whole.

Top Ten Errors

ERROR

4. Employee Exclusions

- **What went wrong (error):**
  - Failure to review or understand the employees that are excluded in the plan document.
  - Failure to ensure that employees are not improperly excluded once eligible.
  - Failure to provide opportunity to make deferral election.
- **Internal controls to avoid errors:**
  - Monitor census information to confirm that employees are not excluded (at least quarterly).
  - Maintain system to flag when deferral opportunity begins (or start day one).

Top Ten Errors

5. **Vesting**
   - **What went wrong (error):**
     - Lack of understanding of how vesting provisions need to be calculated.
     - Errors in recordkeeping system
   - **Internal controls to avoid errors:**
     - Review records for rehired employees for prior service credits.
     - Review sample of employees to determine whether years of service and vesting are properly calculated.

Top Ten Errors

ERROR

6. **Safe harbor contributions**
   - **What went wrong (error):**
     - Failure to provide timely safe harbor notice explaining contribution.
     - Failure to make matching or nonelective contributions to eligible employees.
   - **Internal controls to avoid errors:**
     - Maintain a calendar for due dates.
     - Review plan's procedures for issuing and distributing notices.

Top Ten Errors

7. Forfeitures

– **What went wrong (error):**
  - Failure to use forfeitures (account needs to go to $0 once per year).
  - Inappropriate forfeiture of vested participant account.

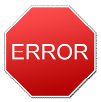
– **Internal controls to avoid errors:**
  - Reduce by end of plan year or allocate.
  - Use in accordance with plan document (for employer contributions or reasonable administrative expenses – and in the correct order).
  - Look for SSN 999-99-9999 or XXX on service provider reports.

Top Ten Errors

ERROR

8. **In-Service Distributions**
   - **What went wrong (error):**
     - Hardship withdrawals made prior to loans (violating plan document).
   - **Internal controls to avoid errors:**
     - Participant loan (if available) must be taken prior to hardship withdrawal.
     - Generally suspension of salary deferrals (usually 6 months) following the date of the hardship distribution.

Top Ten Errors



9. Distributions

- **What went wrong (error):**
  - Allowed impermissible distribution form.
  - Illiquid assets.
- **Internal controls to avoid errors:**
  - Ensure recordkeeping system has accurate distribution options.
  - Maintain list of protected benefits.
  - Look for illiquid assets and flag for manual override at distribution.

Top Ten Errors

10. True-up

- **What went wrong (error):**
  - Incorrect contribution calculated at year-end (*i.e*. if plan has matching formula).
- **What could you do (correction):**
  - Review plan provisions, including necessary true-up contributions, to determine if additional deposit is required to ensure contribution is full for the given year. Plan document must refer to time up requirement.

QUESTIONS?

Lisa A. Tavares
Partner, Venable LLP
LATavares@Venable.com
202.344.4075