
**CORRECTING PLAN DEFECTS --
RECENT GUIDELINES**

**Marcia S. Wagner, Esq.
Marcia S. Wagner, Esq. & Associates, P.C.
One Union Street, Fourth Floor
Boston, Massachusetts 02108
Tel: (617) 725-8811
Fax: (617) 725-1830
E-mail: mwagner@cybercom.net
www.erisa-lawyers.com**

A. Introduction

In December 1990, the IRS introduced its first qualified plan compliance program on a temporary basis, the Closing Agreement Program (“CAP”). Under this program, a plan sponsor facing disqualification could enter into an agreement with the IRS to correct an operational or form plan defect, pay a fee and avoid plan disqualification. Subsequently, the IRS made this program permanent and added other programs under which plan sponsors could voluntarily correct plan defects in order to avoid plan disqualification (e.g., Administrative Policy Regarding Sanctions (“APRS”), and the Voluntary Compliance Resolution (“VCR”) program).

Over the years, these programs were expanded, modified and honed into such variations as Walk-in CAP and Administrative Policy Regarding Self Correction (“APRSC”). A program was also introduced for correction of defects under Section 403(b) plans, the Tax Sheltered Annuity Voluntary Correction (“TVC”) program. Many of the modifications were inspired by recommendations from private sector groups, in which Marcia Wagner is heavily involved.

The IRS has now consolidated all of these programs (except TVC) into one program, the Employee Plans Compliance Resolution System (“EPCRS”). In Revenue Procedure 98-22, the IRS introduces this consolidated system and explains the changes made to the various correction programs under the system.

B. EPCRS

The purpose of EPCRS is to encourage plan sponsors to maintain their plan practices and procedures in accordance with the terms of their plans and IRS rules, and when defects are discovered, to encourage voluntary and timely correction. EPCRS allows sponsors to correct defects without fear of onerous sanctions or excessive fees being imposed. EPCRS outlines a consistent, consolidated scheme for correction of plan defects on which plan sponsors can rely.

One of the key objectives of EPCRS is to promote the establishment of administrative procedures that will assure ongoing compliance by plan sponsors. The IRS will generally require as part of the closing agreement proof that ongoing administrative procedures have been established.

The various IRS programs under EPCRS, as discussed below, allow for correction of form, operational and demographic defects. A “form defect” is one relating to the plan document, such as a plan document not timely amended to be in compliance with tax law changes. An “operational defect” results when the terms of the plan have not been followed. A “demographic failure” occurs when a change in the employee population results in a plan failing to meet IRS rules (e.g., nondiscrimination). In some cases, EPCRS allows for correction of egregious defects.

The EPCRS incorporates the following IRS correction programs:

- Administrative Policy Regarding Self-Correction (“APRSC”), which allows a plan sponsor of a qualified or Section 403(b) plan to self-correct an insignificant operational failure without fee, sanction or IRS involvement.
- Voluntary Compliance Resolution (“VCR”) program, which allows a plan sponsor to voluntarily correct an operational plan defect before IRS audit with payment of a fixed fee and IRS approval.
- Standardized VCR Procedure (“SVP”), which allows correction of seven specified operational defects in a prescribed manner with payment of a minimal compliance fee.
- Walk-In Closing Agreement Program (“Walk-In CAP”), which allows a plan sponsor to disclose and correct form, operational or demographic failures voluntarily before an IRS audit and pay a compliance correction fee.
- Audit Closing Agreement Program (“Audit CAP”), which allows correction of form, operational or demographic defects after an IRS audit has commenced, with payment of a negotiated sanction.

Revenue Procedure 98-22 does not incorporate or modify the Tax Sheltered Annuity Voluntary Correction (“TVC”) program, although it notes that TVC could be incorporated in the future. However, the revenue procedure does specify that certain Section 403(b) operational violations (other than those that would cause income inclusion for some employees) are eligible for correction under APRSC.

The EPCRS provides an element of consistency for all its component programs by including a list of uniform definitions. It also illustrates the interrelationship of the various programs. For example, for plans under current IRS examination, EPCRS provides that the VCR program and Walk-In CAP cannot be used. However, for plans under current IRS examination, under APRSC, insignificant violations may be corrected and even significant violations may be corrected if certain conditions are met (as discussed below). It should be noted that no program is available to correct problems relating to diversion or misuse of plan assets.

EPCRS revises the sanction and fee structure of the various programs, as noted below. It also reduces uncertainty by promising plan sponsors that if they meet the eligibility requirements under EPCRS, then they may rely on the availability of EPCRS in making corrections with respect to their plans.

C. General Correction Rules Under All Programs

The correction method should restore the plan to the position in which it would have been had the qualification failure not occurred. Although there may be more than

one reasonable and appropriate correction method, the correction method should resemble, to the extent possible, methods already provided in the Internal Revenue Code, regulations, or other IRS guidance of general applicability. The correction method should keep assets in the plan, either by reallocating excess assets to other participants or by reducing future employer contributions. Thus, for example, nondiscrimination rule violations should be corrected by providing additional benefits for nonhighly compensated employees. The IRS has added a provision that allows special exceptions to full correction in certain situations, although the correction method must not have a significant adverse impact on participants and must not discriminate significantly in favor of highly compensated employees. These special exceptions: (i) allow reasonable estimates when precise calculations are not possible; (ii) eliminate the requirement of corrective distributions of \$20 or less if the reasonable distribution costs would exceed the amount of the distribution; and (iii) excuse the failure to locate lost participants after use of the IRS or Social Security program for locating missing individuals.

D. Modifications of Current Programs

Revenue Procedure 98-22 makes the following modifications to the programs incorporated in the EPCRS:

1. APRSC

Under the APRSC, a plan sponsor can correct insignificant operational failures without fee or sanction at any time. A plan sponsor can correct significant operational failures without payment of fee or sanction if the plan has a favorable determination letter and the correction is substantially completed by the end of the second plan year after the plan year of the failure.

Whether an operational failure is significant is determined under all the facts and circumstances, including: (i) the number of the operational failures; (ii) the percentage of plan assets and contributions involved; (iii) the number of years and participants involved; (iv) the timeliness of the correction; and (v) the reason for the failure.

In addition, the revenue procedure provides the opportunity under APRSC to complete the correction of a significant operational failure after the end of the correction period if the correction was substantially completed by the end of the correction period.

The revenue procedure reiterates that egregious failures may not be corrected under APRSC.

2. VCR

The VCR program, which involves the correction of operational failures raised by the plan sponsor in its submission to the IRS national office, has not been significantly modified. However, the revenue procedure makes the VCR program more user-friendly by reducing the specificity required in the calculations supporting a plan sponsor's

proposed correction method and extending the time period for correcting defects to 150 days after IRS approval of the compliance method. Also, it modifies the circumstances under which closing agreements may be entered into with respect to excise taxes for failure to meet minimum distribution requirements under Internal Revenue Code Section 401(a)(9). Further, the revenue procedure provides a checklist for use by plan sponsors in preparing VCR requests.

3. SVP

The revenue procedure modifies the correction methods under the Standardized VCR Procedure. It also provides a checklist for making SVP requests.

4. Walk-In CAP

The revenue procedure makes the Walk-In CAP more palatable for plan sponsors by restructuring the sanction amounts. Importantly, the use of 40 percent of the maximum payment amount (tax due on plan disqualification) as a negotiation starting point is no longer required, other than for egregious failures. The revenue procedure provides fee charts for this program with six ranges of fees based on the size of the plan. The minimum fees are the VCR fees (which range from \$500 to \$10,000) and the maximum fees are specified dollar amounts (which range from \$4,000 to \$70,000). The expected amount of the fee (the presumptive amount) is one-half of the maximum.

The revenue procedure also provides a checklist for plan sponsors preparing Walk-In CAP requests.

5. Audit CAP

The revenue procedure restructures the sanctions under the Audit CAP to be commensurate with the type and extent of the violation. It also states that any corrections made before audit will be an important factor in reducing the potential sanction under Audit CAP. As noted above, insignificant violations, as well as certain significant violations, may still be corrected under APRSC after audit.

E. Effective Dates

Revenue Procedure 98-22 is generally effective for VCR, SVP and Walk-in CAP applications submitted on or after September 1, 1998. For Audit CAP, it is effective with respect to examinations commencing on or after September 1, 1998. Under APRSC, it is effective for failures that have not been fully corrected before January 1, 1999.

Comment: The EPCRS shows the IRS' willingness to listen to the employee benefits community and Congress and make its plan qualification programs more reasonable and user-friendly. It is also important to note that the IRS plans to further modify the system based on the experience and input of plan sponsors.

Under EPCRS, the IRS has modified its qualified plan compliance programs and made them more usable. Plan sponsors should review their qualified plans for past and future compliance with IRS rules, and, if appropriate, consider one of the IRS correction mechanisms. We would be pleased to assist in this review and if defects are found, to help employers choose an appropriate option for correction under the EPCRS.