Employee Plans Compliance Resolution System: A Guide for the Novice

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The Employee Plans Compliance Resolution System (EPCRS) L encourages voluntary correction of tax-qualified retirement plans through a system of known, graduated, and limited correction fees. These correction fees are a fraction of the penalties that the Internal Revenue Service (IRS) could impose upon disqualifying a plan. The IRS achieves the graduated compliance fee objective by creating essentially three programs within EPCRS: Self-Correction Program (SCP), Voluntary Correction Program (VCP), and Audit Closing Agreement Program (Audit CAP). SCP is a viable alternative for clearly insignificant operational failures corrected by the end of the second plan year following the plan year in which the failure occurred. For other qualification failures, VCP is a better alternative. Audit CAP is really not an alternative; it is the consequence of not taking advantage of SCP or VCP. This article presents the EPCRS highlights with tables, bulleted lists, and references to enable practitioners to access the key provisions.

Before the Employee Plans Compliance Resolution System (EPCRS),¹ draconian disqualification penalties applied to tax-qualified retirement plans that failed to comply with the qualification rules. The disqualification penalties included additional income taxes on the:

- Employer for the loss of its tax deductions for plan contributions;
- Plan participants for the vested portion of employer contributions under defined contribution plans and for the increase in their vested accrued benefits under defined benefit plans; and
- Plan's trust for its investment income as if it were a taxable trust.²

The sum of these disqualification penalties for open taxable years is the basis for determining the "maximum payment amount" in

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EPCRS.³ In an effort to create more reasonable sanctions for qualification failures, the IRS has created certain programs within EPCRS to encourage voluntary correction through a system of known, graduated, and limited correction fees that are a fraction of the maximum payment amount.

For its fiscal year ending in 2006, the IRS issued 2,935 voluntary compliance agreements under EPCRS.⁴ Congress recently clarified that the IRS has the full authority to implement EPCRS, including the authority to waive income, excise, or other taxes. Congress also recently directed the IRS to continue improving EPCRS.⁵

The current unabridged version of EPCRS consumes 56 pages in the Internal Revenue Bulletin. After providing an overview of EPCRS, this relatively short article presents the highlights with tables, bulleted lists, and references to enable practitioners to access the key EPCRS provisions.

OVERVIEW

The IRS achieves the graduated compliance fee objective by creating essentially three programs within EPCRS:

- 1. Self-Correction Program (SCP);
- 2. Voluntary Correction Program (VCP); and
- 3. Audit Closing Agreement Program (Audit CAP).

Under SCP, disqualifying operational failures can be corrected with no compliance fee. Under VCP, the compliance fee is capped at 40 percent of the maximum payment amount,⁶ although for most failures it is significantly less.⁷ In Audit CAP, the IRS's starting point for negotiations is 100 percent of the maximum payment amount.⁸ Because there is no fee schedule published in Audit CAP, the IRS also has considerably more discretion in demanding typically much higher compliance fees in Audit CAP than in VCP. The rationale for no compliance fees in SCP and significantly reduced and relatively fixed compliance fees in VCP, as opposed to Audit Cap, is that the compliance failures are voluntarily corrected and/or disclosed before the IRS detects the failures on audit.

In evaluating whether to use SCP or VCP, a practitioner needs to consider how the statute of limitations applies to qualification failures. Generally, the statute of limitations starts when a plan's Form 5500 is filed. However, a qualification failure is considered to be a continuing failure until it is corrected. Thus, a plan that has experienced a qualification failure does not gain any protection from the statute of limitations until the qualification failure is corrected. If an employer is going to correct a failure to take advantage of the statute

of limitations, the employer should also consider the advantages and disadvantages of correcting the failure in SCP or VCP.

FAILURES ELIGIBLE FOR CORRECTION IN EPCRS

Figure 1 identifies the types of failures that are eligible to be corrected in EPCRS and defines those failures.

FAILURES INELIGIBLE FOR CORRECTION IN EPCRS

Figure 2 describes the types of failures that are ineligible to be corrected in EPCRS and defines those failures.

Figure 1. Failures Eligible for Correction in EPCRS

Type of Failure	Definition	Rev. Proc. 2006-27
Qualification failure	Any failure that that adversely affects the qualification of a plan, including: • Employer eligibility failure; • Operational failure; • Demographic failure; and • Plan document failure.	§ 5.01(2)
Employer eligibility failure	Adoption of a 401(k) plan by a tax-exempt employer that was not eligible to sponsor a 401(k) plan between 1987 and 1996.	§ 5.01(2)(d)
Operational failure	A failure to follow the terms of the plan.	§ 5.01(2)(b)
Insignificant operational failure	There is no definition. The IRS simply lists factors to be considered in determining whether or not an operational failure is insignificant.	§ 8.02
Significant operational failure	An operational failure that is not insignificant.	_
Demographic failure	A failure of Section 401(a)(4) or 410(b) nondiscrimination rules or Section 401(a)(26) minimum participation standards that is not an operational failure and generally requires a plan amendment to correct.	§ 5.01(2)(c)
Plan document failure	A plan provision (or absence of a plan provision) that violates IRC § 401(a) or any other failure that does not fit into another category.	§ 5.01(2)(a)
Egregious failure	 Examples: Consistently and improperly covering only highly compensated employees. DC plan allocations for highly compensated employees several times greater than the Section 415 dollar limit. Providing more favorable benefits for an owner of the employer based on a purported collective bargaining agreement. 	\$ 4.11

Figure 2. Failures Ineligible for EPCRS

Type of Failure	Definition	Rev. Proc. 2006-27
Failure not penalized by disqualification	Examples: Delinquent Form 5500; Prohibited transactions; and Minimum funding failures.	§ 6.09(1)
Misusing plan assets	Failures relating to the diversion or misuse of plan assets	§ 4.12
Abusive tax transactions	Plan or plan sponsor is a party to an abusive transaction described on the "EP Abusive Tax Transactions" Web site at www.irs.gov/retirement/article/0,,id=156240,00.html	§ 4.13

SCP VS. VCP VS. AUDIT CAP

In addition to the compliance fees or sanctions, there are several other important differences and similarities between SCP, VCP, and Audit CAP as shown in Figure 3.

SCP: Insignificant Versus Significant Operational Failures

In Figure 3, note that SCP is divided into two components: (1) insignificant operational failures; and (2) significant operational failures. An important difference between the two SCP components is when the operational failure can be corrected. Insignificant failures may generally be corrected at any time, without the IRS supervision or the payment of a compliance fee. Indeed, insignificant failures can be corrected after the IRS has initiated an audit. On the other hand, significant failures must be corrected by the end of the second plan year following the plan year in which the failure occurred. Within this two-year deadline, these significant failures may be corrected without IRS supervision or the payment of a compliance fee.

In assessing the significance of an operational failure, the following factors should be considered:

- The number of participants affected relative to the total number of participants;
- The number of participants affected relative to the number of participants who could have been affected by the operational failure;
- The percentage of plan assets involved in the failure;
- The number of years during which the failure occurred;

Figure 3. EPCRS Programs

	SCP	SCP	VCP	Audit CAP
Eligible failures	Insignificant operational	Significant operational (but not egregious)	Significant and insignificant operational	Significant and insignificant operational
٠	Rev. Proc. 2006-07 §§ 1.03,	Rev. Proc. 2006-07 §§ 1.03,	Demographic	Demographic
	4.01(1)	4.01(1), 4.11	Employer eligibility	Employer eligibility
			Egregious Rev. Proc. 2006-07 § 4.01(2)	Egregious Rev. Proc. 2006-07 § 4.01(3)
Current determination letter	No	Yes	No	No
required		Rev. Proc. 2006-07 § 4.03		
Deadline for correction	None	Before the IRS audit	Before the IRS audit	As required by the IRS auditor
	Rev. Proc. 2006-07 § 1.03	Substantially completed within two plan years after	Rev. Proc. 2006-07 §§ 1.03, 10.02	Rev. Proc. 2006-07 § 1.05
		the fallure		
		Special rules for M&A and excess 401(k) or after-tax		
	a a	contributions Rev Proc. 2006-07 § 9.02		
	XX. Lead only Con	Vec hut only for	Yes but the IRS must approve.	Yes, but the IRS must approve
Operational failures	realisable amplement failure	tos, our our) tox:	usually with a determination letter	Rev. Proc. 2006-07 § 4.05(1)
COTTECTABLE DY ALLCHALLELLE	Compensation limit failure	Compensation limit failure	or compliance statement	
	Plan loan and hardship	Plan loan and hardship	Rev. Proc. 2006-07 § 4.05(1)	
	distributions	distributions Rev Proc 2006-07 (4.05(2)		
THE STREET		No	Yes	Yes
correction	Rev. Proc. 2006-07 § 1.03	Rev. Proc. 2006-07 § 1.03	Rev. Proc. 2006-07 § 1.03	Rev. Proc. 2006-07 § 1.03
Compliance fee or	None	None	Fecs generally vary from \$750 to	Negotiations start at 100% of
sanction	Rev. Proc. 2006-07 § 1.03	Rev. Proc. 2006-07 § 1.03	\$25,000 based on number of plan participants; capped at 40% of	Rev. Proc. 2006-07 § 14.01
			maximum payment amount	
			Rev. Proc. 2006-07 §§ 12.01-12.02	
If no agreement with the IRS, then.	Not applicable	Not applicable	The IRS may audit plan Rev. Proc. 2006-07 § 10.07(7)	The IRS disqualifies plan Rev. Proc. 2006-07 § 13.04

- Whether other failures occurred during the period being examined;¹²
- Whether correction was made within a reasonable time after discovery of the failure; and
- The reason for the failure. 13

Figure 4 is based on three examples¹⁴ the IRS uses to illustrate several factors. The examples involve defined contribution plans that fail to comply with the limit on allocations under IRC Section 415.

SCP Risks

Based on these factors and examples, reasonable people could disagree over whether particular operational failures are insignificant. However, assuming that operational failures are insignificant is risky when they are more than two years old. If the IRS discovers them on audit and concludes that the failures are significant, a plan could be negotiating discretionary sanctions in Audit CAP that would be significantly greater than the relatively fixed compliance fees available in VCP. Another SCP risk is that the IRS may find the self-corrections unacceptable during a subsequent determination letter request¹⁵ or audit if they do not comply with the EPCRS correction examples discussed below.

Audit CAP

While Figure 3 would suggest that VCP should be discussed before Audit CAP, it is important to understand that Audit CAP is really not an alternative but simply the consequence of not taking advantage of SCP or VCP. For that reason, this article will quickly review Audit CAP before taking up VCP.

Figure 4. IRS Examples

Factors	Insignificant	Insignificant	Significant
Years during which failure occurred	1	3	3
Participants affected relative to the total number of participants	50 out of 250	50 out of 250	50 out of 250
Participants affected relative to those who could have been affected	3 out of 50	3 out of 50*	18 out of 50
Percentage of plan assets involved Excess allocations worth Total contributions worth	\$4,500 \$3.5 million	\$4,500 \$3.5 million	\$150,000 \$3.5 million

^{*}In this example, the IRS makes the point that the failures are insignificant even if the three out of 50 affected each year are not identical.

As indicated in the overview, the IRS's starting point for negotiations in Audit CAP is 100 percent of the maximum payment amount. In negotiating compliance fees in Audit CAP, the IRS considers the following factors:

- Whether the plan has a favorable determination letter;
- Number and type of employees affected by the failure;
- Number of nonhighly compensated employees affected if the plan were disqualified;
- Whether the failure is based on discrimination in favor of the highly compensated;
- · Reason for the failures;
- Period over which the failures occurred;
- Fee that would have been paid under VCP; and
- Steps taken to prevent, identify, or correct failures before the audit.¹⁶

The sanctions in Audit CAP are not supposed to be excessive and should bear a reasonable relationship to the nature, extent, and severity of the failures.¹⁷ In practice, the negotiated sanctions typically depend upon the facts of the case, the discretion of the IRS official, and the advocacy skills of the practitioner.

Corporate Mergers and Acquisitions

Audit CAP has a special rule for plans receiving assets transferred as a result of corporate mergers or acquisitions. ¹⁸ If no failures relating to the transferred plan assets occur after the end of the second plan year following the corporate merger or acquisition, then transferred plan assets are treated as a separate plan for sanction purposes.

Nonamenders

As indicated above, Audit CAP sanctions are usually negotiated. The notable exception is for plans that were not timely amended to comply with changes in the qualification requirements imposed by legislative or regulatory developments. These plans are called "non-amenders" in EPCRS.¹⁹ As shown in Figure 5, fixed sanctions apply to nonamenders in Audit Cap based on (1) the number of participants; and (2) the legislation or regulations that changed the qualification requirements that caused the plan document failure.

Figure 5. Fixed Audit Cap Sanction for Nonamenders

Number of Participants	EGTRRA ¹ and Subsequent Legislation	GUST ² and 401(a)(9) Regulations	UCA ³ and OBRA '93 ⁴	TRA '86 ⁵	TEFRA ⁶ DEFRA ⁷ and REA ⁸	ERISA9
Fewer than 21	\$2,500	\$3,000	\$3,500	\$4,000	\$4,500	\$5,000
21-50	5,000	6,000	7,000	8,000	9,000	10,000
51-100	7,500	9,000	10,500	12,000	13,500	15,000
101-500	12,500	15,000	17,500	20,000	22,500	25,000
501-1,000	17,500	21,000	24,500	28,000	31,500	35,000
1,001-5,000	25,000	30,000	35,000	40,000	45,000	50,000
5,001-10,000	32,500	39,000	45,500	52,000	58,500	65,000
10,001 or greater	40,000	48,000	56,000	64,000	72,000	80,000

Notes

VCP

VCP requires an employer to submit an application to the IRS that describes in detail the qualification failures and proposed corrections (including calculations showing the correction methodology), the reasons why they occurred, and the steps that have been taken to avoid a recurrence of the failures. As discussed more fully below, the corrections must restore the plan (or the plan participants) to the position it (or they) would have been in had the failures not occurred. If the IRS agrees with the proposed corrections, it issues a compliance statement indicating that it has examined the failures, approved the corrections, and will not take further action because of the failures.²⁰

VCP Fees

In contrast to the high negotiated or fixed sanctions in Audit Cap, VCP offers lower fixed compliance fees based on the number of participants²¹ as shown in Figure 6. For example, a plan with 501 participants would pay \$17,500 in Audit CAP to correct failing to amend to

¹Economic Growth and Tax Relief Reconciliation Act of 2001.

²GUST is an acronym for GATT (General Agreement on Tariffs and Trade that was amended by the Uruguay Round Agreements Act of 1994); the Uniformed Services Employment and Reemployment Rights Act of 1994; the Small Business Job Protection Act of 1996; the Taxpayer Relief Act of 1997; the Internal Revenue Service Restructuring and Reform Act of 1998; and the Community Renewal Tax Relief Act of 2000.

³Unemployment Compensation Act of 1992.

⁴Omnibus Budget and Reconciliation Act of 1993.

⁵Tax Reform Act of 1986.

⁶Tax Equity and Fiscal Responsibility Act of 1982.

⁷Deficit Reduction Act of 1984.

⁸Retirement Equity Act of 1984.

⁹Employee Retirement Income Security Act of 1974.

comply with the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). In VCP, the compliance fee for this nonamender would be only \$8,000. The compliance fee also could be reduced further to \$4,000 or \$375 under the special rules for nonamenders described below.

Nonamenders

The compliance fee is reduced²² by 50 percent of the applicable amount in Figure 6 if a nonamender is submitted within a one-year period following the end of the applicable remedial amendment period for the change in the qualification requirement.²³ In addition, the compliance fee is further reduced to only \$375 for nonamenders with respect to:

- EGTRRA good-faith plan amendments;
- Section 401(a)(9) final and temporary regulations; and
- Other interim amendments described in Revenue Procedure 2005-66.²⁴

Egregious Failures

For plans with egregious failures, the compliance fee is a negotiated fee up to 40 percent of the maximum payment amount, unless the compliance fee in Figure 6 is higher.²⁵

VCP Procedures

While a VCP submission is pending, the IRS generally will not audit the plan. However, the IRS reserves the right to audit the plan if it has engaged in an abusive tax avoidance transaction.²⁶

Figure 6. VCP Compliance Fees*

Number of Participants	Fee
Fewer than 21	\$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
10,101 or greater	25,000

*Rev. Proc. 2006-27 § 12.02(1).

The VCP application determines the scope of the compliance statement's protection in the event the plan is subsequently audited.²⁷ If the employer discovers additional qualification failures during the correction process, the VCP application should be updated to include those failures before the IRS issues the compliance statement.

After reviewing the VCP application, the IRS will contact the practitioner to discuss the proposed corrections. The IRS and practitioners use the correction principles described later in this article in negotiating corrections that are not specifically covered by the examples provided in Revenue Procedure 2006-27. Using VCP, as opposed to SCP, enables a practitioner to fashion correction methods that are not explicitly described in the EPCRS guidance. VCP also provides a forum to discuss and negotiate alternative corrections. If the IRS and the practitioner agree on the corrections, the IRS will issue a compliance statement.

If the practitioner and the IRS cannot agree on the corrections during the negotiation process, the IRS will close the case but not return the compliance fee. Alternatively, before an impasse is reached, the practitioner may choose to withdraw the VCP application. In either case, if an agreement is not reached, the IRS also may refer the case to Employee Plan Examinations for an audit.

Determination Letter Request Concurrent with VCP Application

Two different sets of instructions apply to determination letter requests as part of VCP applications, depending upon whether the failure involves:

- 1. Nonamenders (*i.e.*, a failure to amend the plan to comply with a change in a qualification requirement within the applicable remedial amendment period for that change); and
- 2. Other situations (e.g., plan amendments to correct an operational or plan document failures).

Nonamenders

A nonamender generally must submit a determination letter request with the VCP application.²⁸ However, the IRS will not process a determination letter for a corrective amendment relating to a qualification change for which the remedial amendment period is still open.²⁹ Rather than issue a determination letter, the compliance statement will treat the corrective amendment as if it were a timely adopted interim amendment. This timely adopted treatment will preserve the employer's ability to adopt a final amendment during the remedial

amendment period to retroactively correct any mistakes in the corrective amendment.

Other Situations

Although determination letters are generally required for nonamenders, the IRS generally will not issue determination letters for plan amendments correcting other failures. However, if the employer submits a determination letter request with the VCP application, the IRS will issue a determination letter for corrective retroactive amendments during:

- The year the plan is terminated; or
- The last year of the plan's five-year remedial amendment period.³⁰

The IRS also reserves the right in VCP to require the submission of a determination letter request for any amendment to correct any qualification failure.³¹ Even if the IRS does not issue a determination letter on the qualification of the plan as a whole, the compliance statement will still constitute a determination as to the effect of the corrective plan amendment on the plan's qualification.

Anonymous VCP

To accommodate employers who may be concerned about the corrections that the IRS may demand for its plan's qualification failures, EPCRS allows employers to submit VCP applications on an anonymous basis.³² A completed VCP application must be submitted except for:

- Information identifying the plan or the employer sponsoring the plan;³³
- · Penalty of perjury statement; and
- Power of attorney statement.

If the IRS and the practitioner representing the plan cannot reach agreement on the correction method, the IRS will close the case and refund 50 percent of the VCP compliance fee.³⁴ If an agreement is reached, the employer sponsoring the plan has 21 calendar days from the date of the IRS letter describing the agreement to submit the identifying information (and penalty of perjury statement and power of attorney statement). If the employer does not meet the 21-day deadline, the IRS will also close the case but will not return the compliance fee.

The principal drawback with anonymous VCP is that, until the identifying information is submitted, the IRS is not precluded from auditing the plan and, thus, from eliminating the plan's eligibility for VCP.³⁵ If an audit does occur, then the Audit CAP rules would apply.

Corrections

EPCRS takes essentially two approaches to providing guidance on corrections to cure qualification failures:

- · Publishing statements of general correction principles; and
- Furnishing very detailed examples of corrections for common operational failures.

The IRS and practitioners use the general principles in negotiating corrections not specifically covered by the examples included in EPCRS.

Correction Principles

The correction principles section of Revenue Procedure 2007-27 can be subdivided into three sections:

- 1. General principles;
- 2. Full correction exceptions; and
- 3. Detailed guidance for certain failures.

General Principles

The following principles³⁶ can fairly be called general principles:

- Plan must be restored to the position it would have been in but for the failure. [6.02]
- Corrections must be made for all participants for all plan years, including closed plan years. [6.02]
- More than one reasonable and appropriate correction method may be available. [6.02(2)]
- Corrections methods should be consistently applied to the same type of failure for the plan year. [6.02(3)]
- Correction methods described in Appendix A of Revenue Procedure 2007-27 or Appendix B of Revenue Procedure 2007-27 are deemed reasonable and appropriate. [6.02(2)]

- Correction should not create another qualification failure.
 [6.02(2)(d)] For example, a correction should not:
 - Discriminate in favor of highly compensated employees;
 or
 - Reduce benefits in violation of the anti-cutback rule.
- Nondiscrimination corrections should increase benefits for highly compensated employees rather than reduce benefits for nonhighly compensated employees. [6.02(2)(b)]
- Corrections should keep the plan assets in the plan. [6.02(2)(c)] For example, excess allocations for some participants should be:
 - Reallocated to other participants; or
 - Used to reduce future employer contributions.
- Defined benefit plan corrective distributions should be adjusted for delayed payments. [6.02(4)(d)]
- Correction methods should resemble those that already exist. [6.02(2)(a)] For example, corrections for excess elective deferrals should be corrected using the method described in 26 C.F.R. Section 1.402(g)-1(e)(2).
- Corrective allocations under defined contribution plans should be based on conditions (e.g., salary) at the time of the failure. [6.02(4)(a)]
- Corrective contributions and allocations should be adjusted for *earnings* and forfeitures. However, corrective allocations need not be adjusted for losses. [6.02(4)(a)]
- Corrective allocations are recognized for the year corrected—not the year made—for Section 415 purposes.
 However, corrective allocations are recognized in the year made for deduction purposes. [6.02(4)(b)]
- Corrective contributions should come from employer contributions, including forfeitures if they are normally used to reduce contributions. [6.02(4)(c)]

Full Correction Exceptions

Although a qualification failure generally must be fully corrected, the IRS will not insist on full correction if it is unreasonable or not feasible. Instead, reasonable estimates may be used. [6.02(5)(a)]

Corrective distributions of \$50 or less need not be made if the cost of distribution would exceed the amount of distribution. [6.02(5)(b)]

Overpayments of \$100 or less need not be collected from the overpaid plan participants and those participants need not be informed that the overpayment does not qualify for favorable tax treatment. [6.02(5)(c)]

"Excess amounts" (described below) of \$100 or less allocated to a participant's account need not be distributed or forfeited. [6.02(5)(e)] If the excess amount exceeds a statutory limit (e.g., \$15,500 elective deferral limit for 2007), however, then the plan participant must be informed that the excess amount and investment earnings are not entitled to favorable tax treatment.

Only reasonable effort needs to be exerted to find missing participants using the IRS Letter Forwarding Program, or Social Security Administration Reporting Service. [6.02(5)(d)] Of course, any corrective benefit or distribution must be provided if the missing participant is found.

Detailed Guidance

Although included in the correction principles section, detailed guidance is provided for correcting the following failures:

- Loan failures [6.02(6) and 6.07];
- Excluding employees from making elective contributions or after-tax employee contributions [6.02(7)];
- Allowing ineligible employers to sponsor the plan [6.03];
 and
- Failing to obtain spousal consent [6.04].

Treatment of "Excess Amounts"

The correction principles section also provides guidance on the treatment of "excess amounts" that are distributed as part of a correction [6.06]. In particular, the employer must tell the affected participants that they are receiving excess amounts and that the excess amounts are not eligible for tax-free rollover or other favorable tax treatment. The excess amounts include:

- · Overpayments;
- Elective deferrals or employee after-tax contributions returned to satisfy Section 415 limits;
- Elective deferrals in excess of the elective deferral limit under IRC Section 402(g);

- Excess contributions distributed to satisfy IRC Section 401(k) or excess aggregate contributions distributed to satisfy IRC Section 401(m);
- Elective deferrals distributed to satisfy the compensation limit under IRC Section 401(a)(17); or
- Similar amount that is required to be distributed in order to maintain plan qualification [5.01(3)].

Correction Examples

The bulk of Revenue Procedure 2006-27 is devoted to providing examples of correction methods for common operational failures in Appendix A or Appendix B. Figure 7 below identifies the operational failures covered by the examples and briefly describes the applicable correction methodology.³⁷ Some operational failures are covered in both Appendix A of Revenue Procedure 2006-27 and Appendix B of Revenue Procedure 2006-27. Others are covered in one or the other but not both.

The examples in Appendix A are more favorable to nonhighly compensated employees than the examples in Appendix B. For example, Appendix A says the correction for failing to satisfy the ADP test for 401(k) plans is to make nonelective contributions for nonhighly compensated employees. On the other hand, Appendix B says the correction is to distribute or forfeit the excess contributions for the highly compensated employees.

Before the IRS simplified EPCRS, the distinction between Appendix A and Appendix B had more significance.³⁸ Now, practitioners can choose examples from either appendix in negotiating with the IRS. Employers correcting operational failures in SCP, however, should consider using the examples in Appendix A instead of those in Appendix B to better withstand a review of the correction methodology later by the IRS in a determination letter request or an audit.³⁹

CONCLUSION

EPCRS provides incentives to identify and correct qualification failures sooner rather than later. SCP is a viable alternative for clearly insignificant operational failures corrected by the end of the second plan year following the plan year in which the failure occurred. For other failures, VCP is a better alternative. Employers concerned about the cost of correction can submit the VCP application anonymously.

Audit CAP is not an alternative; it is the consequence of not taking advantage of SCP or VCP.

Relying on the statute of limitations to protect an employer from Audit CAP also is not an alterative, unless the employer corrects the

Figure 7. Correction Examples

Appendix A		Appendix B		
Operational Failure	Correction	Operational Failure	Correction	
Exclusion of eligible employee for full DC or DB plan years	Make contribution or provide accrual Appendix A § .05	Exclusion of eligible employee for partial 401(k) or profit sharing plan year	Make contributions Appendix B § 2.02(ii)	
ADP or ACP tests	Make qualified nonelective contributions Appendix A § .03	ADP or ACP tests	Excess contribution distributed or forfeited Appendix B § 2.01(1)(b)(i)	
DC plan 415 limit	Place excess annual addition in suspense account Appendix A § .08	DB and DC 415 limits	Return DB overpayment Forfeit DC excess allocation or recover excess distribution Appendix B § 2.04	
Distributions of excess elective deferrals	Make distributions and report Appendix A § .04	_		
Minimum top- heavy benefits	Make proper allocation or accrual Appendix A § .02		_	
Minimum distributions	Distribute minimum required distribution Appendix A § .06	_	_	
Consent for distributions	Give informed choice to each affected participant Appendix A § .07	_, .	_	
		Overpayment failures	Return DB overpayment Forfeit DC excess allocation or return DC excess distribution Appendix B § 2.05	
· <u> </u>	_	Vesting	Apply proper vesting percentage Appendix B § 2.03	
	_	Compensation limit	Reduce account balance Appendix B § 2.06 Retroactively amend to allow additional contribution for others Appendix B § 2.07(1)	
- 12	_	Plan loans and hardship distributions	Retroactively amend to allow plan loans or hardship distributions Appendix B § 2.07(2)	
	_	Covering an employee excluded by plan's minimum age or service requirement	Retroactively amend to eliminate age or service requirement Appendix B § 2.07(3)	

qualification failure to start the statute of limitations. If the employer is going to correct the failure, it should take advantage of VCP in most cases. Otherwise, the employer takes the risk that the IRS will not approve its self-correction during a subsequent determination letter request or audit. By paying a relatively modest compliance fee, the employer can negotiate a correction with the IRS that will withstand a subsequent IRS audit on those failures. With flexibility provided under current EPCRS guidance, practitioners can advise plan sponsors with certainty about the costs and methodologies involved in correcting otherwise disqualifying plan failures.

NOTES

- 1. EPCRS is currently published in Rev. Proc. 2006-27 [2006-22 I.R.B. 945 (5/30/2006)]. The IRS has posted Rev. Proc. 2006-27, Ten Reasons to Identify and Correct Mistakes in Your Retirement Plan Operations, Top Ten Failures Found in Voluntary Correction Program, Frequently Asked Questions, and related materials on its Web site at http://www.irs.gov/retirement/article/0, https://www.irs.gov/retirement/article/0, https://www.irs.gov/retirement/article/0, https://www.irs.gov/retirement/article/0, https://www.irs.gov/retirement/article/0, https://www.irs.gov/retirement/article/0, https://www.irs.gov/retirement/articl
- 2. See Wagner and Bianchi, "EPCRS—Plan Correction and Disqualification," BNA Tax Management Portfolio No. 375 at A-2.
- 3. The term "maximum payment amount" is defined in Rev. Proc. 2006-27 § 5.01.
- 4. Internal Revenue Service Data Book, 2006, Table 22 on p. 53 [IR-2007-63 (3/16/2007)].
- 5. Pension Protection Act of 2006 § 1101 [H.R.4; Public Law 109-280 (8/17/2006)].
- 6. Rev. Proc. 2006-27 § 12.06.
- 7. Rev. Proc. 2006-27 \$12.02(1).
- 8. Rev. Proc. 2006-27 § 14.
- 9. Prior to Amendment 2007-63 [2007-30 I.R.B. 236 (7/23/07)], the IRS required the filing of Schedule P, Annual Return of Fiduciary of Employee Benefit Trust, to start the statute of limitations. Ann. 2007-63 eliminates Schedule P, beginning with the 2005 plan year for Form 5500-EZ filers and beginning with the 2006 plan year for all other Form 5500 series filers.
- 10. Martin Fireproofing Profit Sharing Plan and Trust, 92 TC 1173, 10 EBC 2686 (5/31/1989).
- 11. Rev. Proc. 2006-27 \S 5.01(8) and 9.02(2), could extend the two-year deadline for a plan receiving assets transferred from another plan as a result of a corporate merger or acquisition.
- 12. Rev. Proc. 2007-27 § 8.03 says that operational failures in same or different years must be considered in the aggregate to determine whether they are insignificant as a group. However, operational failures that have already been corrected in SCP or VCP are not taken into consideration.
- 13. Rev. Proc. 2006-27 § 8.02.
- 14. Rev. Proc. 2006-27 § 8.04.

- 15. Rev. Proc. 2006-27 § 4.06(2) says that, if an operational failure is corrected through a plan amendment in SCP, the employer must submit a determination letter request before the end of the plan's five-year remedial amendment cycle. The cover letter for submission must identify the SCP corrective plan amendment.
- 16. Rev. Proc. 2006-27 § 14.02.
- 17. Rev. Proc. 2006-27 § 14.01.
- 18. Rev. Proc. 2006-27 § 14.03.
- 19. Rev. Proc. 2006-27 § 4.06.
- 20. Rev. Proc. 2006-27 § 10.07(8).
- 21. Rev. Proc. 2006-27 § 5.01(8) and 12.07 provide a special rule for counting participants in a plan receiving assets transferred from another plan as a result of a corporate merger or acquisition.
- 22. Rev. Proc. 2006-27 § 12.03.
- 23. In response to changes in the qualification requirements, a plan usually needs to be amended twice. First, an interim amendment must be adopted by the end of the plan year in which the qualification change is effective, although more time may be available based on the employer's income tax return filing deadline. Also, the IRS frequently extends the interim amendment deadline. Second, a final amendment must be adopted by the end of the so-called remedial amendment period to retroactively correct any mistakes in the interim amendment without paying any compliance fees or sanctions. For individually designed plans, the end of the remedial amendment period depends upon the employer's tax identification number and the schedule published in Rev. Proc. 2006-27.
- 24. The IRS updated Rev. Proc. 2005-66 with Rev. Proc. 2006-27. In Section 12.03(c), Rev. Proc. 2006-27 describes the interim amendments described in Rev. Proc. 2005-66.
- 25. Rev. Proc. 2006-27 § 12.06.
- 26. Rev. Proc. 2006-27 § 10.04.
- 27. Rev. Proc. 2006-27 §§ 10.03 and 10.09.
- 28. Rev. Proc. 2006-27 § 4.06(1).
- 29. Rev. Proc. 2006-27 §§ 4.06(1) and 10.08(1). The current examples of corrective amendments for which the IRS will not issue a determination letter in VCP include EGTRRA good faith plan amendments, interim amendments to comply with Section 401(a)(9) final and temporary regulations, and other interim amendments described in Rev. Proc. 2005-66.
- 30. Q&A 7 of EPCRS Overview posted on the IRS Web site at http://www.irs.gov/pub/irs-tege/epcrs_overview.pdf.
- 31. Rev. Proc. 2006-27 § 4.06(1).
- 32. Rev. Proc. 2006-27 § 10.10(1).
- 33. The employer's state must be identified in an anonymous VCP application to enable the IRS to process the submission.
- 34. Rev. Proc. 2006-27 § 10.07(7).

- 35. Rev. Proc. 2006-27 § 10.10(2).
- 36. Rev. Proc. 2006-27 \S 6. References to relevant subsections are included in brackets at the end of each listed correction principle.
- 37. It should be noted that Section 3 of Appendix B 3 provides extensive guidance and examples on how to adjust corrective contributions and distributions for lost investment earnings, although it is not included in Figure 7.
- 38. The first version of EPCRS was significantly more complex than the current version. See Rev. Proc. 2001-17, 2001-1 CB 589.
- 39. Before EPCRS was simplified in Rev. Proc. 2003-44, 2003-1 CB 1051, certain EPCRS programs could use only the then-called "standardized corrections" in Appendix A.