

**RE: The Employee Plans Compliance Resolution System:
An Overview for Governmental Retirement Plans**
FROM: Paul Zorn
DATE: December 2, 2008

This memorandum summarizes IRS guidance related to its programs for correcting retirement plan qualification errors. However, the memo is not intended to completely describe all related rules. Moreover, the author is not an attorney and the information provided is not legal advice or opinion. Plan administrators and other benefit professionals should consult with qualified legal counsel to ensure plan provisions comply with applicable laws and regulations.

On August 14, 2008, the IRS released Revenue Procedure 2008-50, providing guidance and revisions related to its programs for correcting retirement plan qualification errors under the Internal Revenue Code (Code).¹ These programs are collectively referred to as the Employee Plans Compliance Resolution System (EPCRS), which applies to plans (including governmental plans) qualified under Code §§ 401(a), 403(a), and 403(b), as well as simplified employee pensions (SEPs), and savings incentive match plans (SIMPLE IRAs).²

The EPCRS was created to encourage plans to establish administrative practices and procedures that ensure plan documents conform to Code requirements and the plans operate according. The EPCRS was also created to provide plans with a means of correcting qualification errors in a voluntary and timely manner. These corrections allow plans to come back into compliance with the qualification rules and continue providing plan members with tax-favored retirement benefits. The EPCRS consists of three programs:

- **Self-Correction Program (SCP)** – allowing plans with established compliance practices to correct minor operational errors without notifying the IRS or paying penalties;
- **Voluntary Correction Program (VCP)** – allowing plans that are not being audited by the IRS to submit plan corrections to the IRS for approval in exchange for a limited fee; and,
- **Audit Closing Agreement Program (Audit CAP)** – allowing plans being audited by the IRS to correct errors in exchange for a larger fee based on the nature and severity of the errors.

Section 1101 of the 2006 Pension Protection Act gives the Secretary of the Treasury full authority to establish and implement the EPCRS. It also instructs the Secretary to update the system, improve its accessibility for small employers, and expand self-correction for insignificant compliance errors. To meet these goals, Rev. Proc. 2008-50 modifies the earlier correction procedures provided in Rev. Proc. 2006-27, streamlines the EPCRS, adds new correction options, and reduces some penalty fees. These changes are effective as of January 1, 2009; however, plans may apply the provisions beginning September 2, 2008.

¹ Rev. Proc. 2008-50 modifies and supersedes Rev. Proc. 2006-27 (as modified by Rev. Proc. 2007-49). In many cases, the rules provided in Rev. Proc. 2008-50 are more liberal than the former correction rules.

² Corrections related to § 457(b) governmental plans will be accepted by the IRS on a provisional basis outside EPCRS through standards that are similar to EPCRS.

Types of Qualification Errors

Essentially there are four types of qualification errors:

Plan Document Errors. These occur when written plan provisions do not conform to the qualification requirements under Code § 401(a) and related regulations. To correct such errors, the plan document is amended to reflect the applicable Code requirements and plan participants are treated as subject to the requirements as of the requirements' effective date(s). Since the correction involves amendment to the plan document, it would also involve a request for a determination letter from the IRS in order to ensure compliance with the Code.³

When a change is enacted to the Code, plans must operate in accordance with the change as of the change's effective date. However, plans have until the end of the related "remedial amendment period" to make the necessary change to plan documents. If the plan document is not amended by the end of the remedial amendment period, it is out of compliance. Generally, interim plan amendments are also required during the remedial amendment period in order to implement a good faith interpretation of the change in the qualification rule.⁴ Due to the complexity of these rules, assistance from qualified legal counsel would be useful.

Comment: Beginning in 2006, the IRS changed the remedial amendment periods to better reflect the determination letter cycle. Under the IRS's new determination letter process, individually designed plans (including governmental plans) have a 5-year remedial amendment cycle. For private-sector plans, the cycle is based on the employer's tax identification number. Originally, all governmental plans were placed in Cycle C, which began February 1, 2008, and ends January 31, 2009, repeating every 5 years thereafter.⁵ However, in November 2008, the IRS announced it will offer governmental plans a one-time option to file in Cycle E, which begins February 1, 2010, and ends January 31, 2011.⁶ After 2011, all governmental plan sponsors will again be subject to Cycle C, with the next Cycle C ending January 31, 2014.

Operational Errors. These occur when the plan is operated in a manner inconsistent with the plan provisions. Provided the plan document is in compliance, operational errors include (but are not limited to);

- Paying less than the minimum distributions required under Code § 401(a)(9), and
- Paying benefits in excess of the limits under Code § 415(b).

Corrections for these errors are discussed at the end of this memorandum.

Demographic Errors. These occur when the plan operates in a way that discriminates in favor of highly compensated employees, or violates certain other participation rules.⁷ Governmental plans are generally not subject to these requirements.⁸

Employer Eligibility Errors. These occur when the employer sponsoring the plan is not eligible to provide the offered benefits. For example, this would occur when a plan that operates as a

³ Rev. Proc. 2008-50, Section 6.05.

⁴ Rev. Proc. 2007-44, Section 5.06.

⁵ To assist in identifying the necessary plan changes, the IRS issues an annual list of the statutory and regulatory changes that apply. For Cycle C, IRS Notice 2007-94 specifies the applicable changes.

⁶ This announcement was made in the November 2008 issue of *Employee Plans News*, published by the IRS. It is available on the web at: <http://www.irs.gov/pub/irs-tege/se1108.pdf>.

⁷ See Code § 401(a)(26) and § 410(b).

⁸ Rev. Proc. 2008-50, Section 5.01(2)(c).

401(k) plan fails to meet the employer eligibility requirements needed to establish a 401(k) plan.⁹ Such would be the case for a 401(k) plan adopted by a government after May 6, 1986, if the government had not already adopted a 401(k) plan before that date. However, for a government that adopted a 401(k) plan before May 6, 1986, any 401(k) plan adopted thereafter is treated as adopted before that date.¹⁰

Correction Principles

The rules related to the EPCRS are based on general correction principles developed by the IRS. A key principle is that an error is not corrected unless “full correction is made with respect to all participants and beneficiaries, and for all taxable years (whether or not the taxable year is closed.)”¹¹ The correction is determined taking into account the terms of the plan at the time of the error. Another correction principle is that the correction should restore the plan to the position it would have had if the error had not occurred, and restore any rights and benefits due members and beneficiaries. Still another principle is that the correction should be “reasonable and appropriate” given the facts and circumstances.¹² Rev. Proc. 2008-50 provides correction methods for a variety of compliance errors in its appendices.

In many cases, the correction involves either payments to members for benefits due or recovery from members for benefit overpayments. In both cases, the correction principles indicate the correction should take into account interest on the delayed payment, consistent with the plan’s provisions. In addition, full payments should be made (or received) to correct the errors. However, the correction principles also state the correction should not result in “significant adverse effects on participants and beneficiaries or the plan...”¹³ Moreover, where it is impossible to make a precise calculation of the correction amount, reasonable estimates may be used. Generally, plans are not required to make corrective distributions of \$75 or less, or recover overpayments of \$100 or less.¹⁴

The Self Correction Program (SCP)

The SCP is a correction program for resolving minor operational errors. To be eligible for the SCP, the plan must have “established practices and procedures (formal or informal) reasonably designed to promote and facilitate overall compliance with applicable Code requirements.”¹⁵ Corrections made under the SCP do not have to be reported to the IRS and do not involve fees. However, if the SCP is used, all steps taken to complete the process should be documented and retained with plan records. One potential disadvantage with using the SCP is that no feedback is received from the IRS regarding the acceptability of the correction method.

Insignificant Operational Errors. The SCP can be used to resolve “insignificant” (and certain “significant”) operational errors.¹⁶ Whether an operational error is significant or insignificant is based on the related facts and circumstances, using a range of factors, including (but not limited to):

- Whether other operational errors occurred during the period involved;
- The percent of plan assets and contributions involved in the error;

⁹ Rev. Proc. 2008-50, Section 5.01(2)(d).

¹⁰ Treas. Reg. § 1.401(k)-1(e)(4)(ii).

¹¹ Rev. Proc. 2008-50, Section 6.02.

¹² Rev. Proc. 2008-50, Section 6.02(2).

¹³ Rev. Proc. 2008-50, Section 6.02(5).

¹⁴ Rev. Proc. 2008-50, Section 6.02(5)(b) and (c).

¹⁵ Rev. Proc. 2008-50, Section 4.04.

¹⁶ Rev. Proc. 2008-50, Section 7.01.

- The number of years the error occurred;
- The percent of participants affected;
- Whether the correction was made within a reasonable period; and,
- The reason for the failure.¹⁷

While Rev. Proc. 2008-50 does not provide specific information about how the factors should be applied to determine whether an operational error is insignificant, it does provide several examples. To illustrate an insignificant operational error, it offers the example of a plan that failed to satisfy the § 415(c) limits for 3 out of 50 eligible participants over a three-year period from 2005 to 2007. Because the error involved a small percent of the participants and a small percent of plan contributions, the error was deemed insignificant even though it occurred over more than one limitation year. In contrast, failure to satisfy the § 415(c) limits for 18 out of 50 eligible participants in one year was deemed to be a significant error, since a large percent eligible participants were involved.¹⁸

Significant Operational Errors. The SCP may also be used to correct a significant operational error if the plan has a “current” favorable determination letter and the error is at least “substantially corrected” no more than two years after the year the error occurred.¹⁹ An error is considered substantially corrected if, during the correction period:

- The plan is reasonably prompt in identifying the error, formulating a correction method, and initiating the correction with the intent to complete it as expeditiously as possible (and it is completed not later than 120 days after the last day of the correction period); and,
- The correction is completed for at least 65% of all participants affected by the operational error, and will be completed for the remaining participants in a diligent manner.²⁰

If the operational error is significant and is not corrected in a timely manner, the Voluntary Correction Program (VCP) would be used to correct it. The SCP is also not available for “egregious” errors, including cases where the IRS concludes that the parties controlling the plan recognize the action taken would constitute a qualification failure and involve a substantial number of participants or participants who are predominantly highly compensated employees.²¹ Egregious errors are correctable under the VCP.

Plan Amendments under the SCP. Generally, a plan may not use the SCP to correct qualification errors in plan documents. However, a plan may use the SCP to correct certain operational errors by a plan amendment.²² For any correction of an operational error through plan amendment under the SCP, the plan would also apply for a determination letter and identify the relevant amendment in the cover letter. The determination letter would be submitted before the end of the plan’s applicable remedial amendment period as described in Rev. Proc. 2007-44.

¹⁷ Rev. Proc. 2008-50, Section 8.02.

¹⁸ Rev. Proc. 2008-50, Section 8.04. See Examples 3 and 4.

¹⁹ Rev. Proc. 2008-50, Section 9.02. Specifically, the last day of the correction period is the “last day of the second plan year following the plan year for which the failure occurred. If a plan does not have a designated plan year, the calendar year is used by default.

²⁰ Rev. Proc. 2008-50, Section 9.04.

²¹ Rev. Proc. 2008-50, Section 4.11.

²² Rev. Proc. 2008-50, Section 4.05(2). The specific operational failures for which plan amendments can be made under the SCP are listed in Rev. Proc. 2008-50, Appendix B, Section 2.07.

The Voluntary Correction Program (VCP)

The VCP is a voluntary program used to correct all qualification errors, including: plan document errors, operational errors, demographic errors, and employer eligibility errors. Under this program, the plan would bring the error to the IRS's attention along with the proposed correction, including proposed changes to administrative procedures designed to ensure the error would not happen again. In cases where plan documents are corrected, an application for a determination letter may also be required.²³

The plan sponsor would also pay a relatively limited compliance fee based on the number of plan participants.²⁴ Provided the error is not "egregious," VCP fees range from \$750 for a plan with 20 or fewer participants to \$25,000 for a plan with over 10,000 participants. For egregious errors, the fee is equal to the greater of: (1) the fee based on the number of participants or (2) not more than 40% of the taxes the IRS could collect if the plan were disqualified, including: (i) tax on the trust, (ii) additional income tax on employer deductions for plan contributions, and (iii) additional income tax for highly compensated employees.

Comment: For plan sponsors that filed in Cycle C and used the Voluntary Corrections Program (VCP), the IRS will reduce VCP collection fees by one-half.²⁵ Plan sponsors who have already paid the full fee may apply to have half refunded.

In return, the IRS would respond with a Compliance Statement detailing the qualification error(s) along with appropriate corrections.²⁶ Thereafter, the plan sponsor would have 150 days to make the necessary corrections. This program is available to plans that are not being audited by the IRS. Generally, while the VCP submission is pending, the plan will not be subject to IRS audit, except in unusual circumstances.

Anonymous Submissions. The VCP allows a plan representative to submit corrections under the VCP without identifying the plan or plan sponsor until after the IRS and plan representative reach agreement. This approach would not prevent the IRS from examining the plan sponsor while the submission was pending.

The Audit Closing Agreement Program (Audit CAP)

The Audit CAP is a correction program used by plan sponsors after significant problems have been identified by the IRS during an audit. Under this program, the plan sponsor corrects the problem for all years of errors, enters into a Closing Agreement with the IRS, and pays a substantial fee based on a negotiated percentage of the Maximum Payment Amount (MPA). The MPA is the estimated amount of all taxes the IRS could collect if the plan were disqualified, including: (1) taxes on the trust; (2) additional income taxes resulting from loss of employer deductions for plan contributions; (3) additional income taxes resulting from income inclusion for plan participants (including taxes on rollovers); and (4) other related taxes, interest, and penalties.

Revenue Procedure 2008-50 was published in IRB 2008-35, available at:
<http://www.irs.gov/pub/irs-irbs/irb08-35.pdf>

²³ Rev. Proc. 2008-50, Section 4.10. An even smaller fee could apply in circumstances where the plan correction is minor and is disclosed before the IRS becomes aware of it.

²⁴ Rev. Proc. 2008-50, Section 12.02.

²⁵ IRS, *Employee Plans News*, November 2008.

²⁶ Rev. Proc. 2008-50, Section 10.09. A Compliance Statement is binding on the IRS with respect to the specific errors and corrections covered by the statement. However, it does not constitute an IRS determination, and does not preclude future IRS examinations related to matters outside the items covered by the statement.

Examples of Errors and Corrections for Governmental DB Plans

The following provides a few examples of errors that might be made by a governmental plan and the steps for correcting the errors.

Paying Less than the Minimum Distribution Required under § 401(a)(9)

Generally, Code § 401(a)(9) requires defined benefit plans to begin paying minimum distributions as of April 1 of the year following the later of: (1) the year the member attains age 70 ½ or (2) the year the member retires. If the plan pays less than this minimum distribution, the plan should correct the problem by paying any minimum distributions due to the member plus an interest payment representing the loss of use of such amounts. If the plan document reflects the § 401(a)(9) provisions and the error is insignificant, this would be an operational error correctable under the SCP. If the plan document does not reflect the § 401(a)(9) provisions, or the error is not correctable under the SCP, the VCP would be used.

Paying Benefits in Excess of the Code § 415(b) Limits

Generally, Code § 415(b) requires benefits paid from a qualified defined benefit plan to be limited to certain dollar amounts, adjusted for age at retirement.²⁷ If a benefit is paid exceeding the § 415(b) limit, one of two correction methods may be used:

- (1) **Return of Overpayment.** Under this correction method, the employer takes reasonable steps to have the member repay the overpayment to the plan with appropriate interest, and future benefits are reduced to reflect the § 415(b) limit. To the extent the overpayment and appropriate interest are not repaid, the employer or another person (acting on behalf of the member) must make up the difference. In addition, the employer must notify the recipient that the overpayment was not subject to the favorable tax treatment provided to distributions from qualified plans, including that it was not eligible for a tax-free rollover.
- (2) **Adjustment of Future Payments.** Under this correction method, future payments to the participant are reduced so they do not exceed the applicable § 415(b) limit, and an additional reduction is made to recoup the overpayment over a period not longer than the remaining payment period. If the benefit is paid as a joint and survivor annuity, the reduction of future annuity payments to reflect the § 415(b) limit reduces the benefits payable during the lives of both the employee and spouse, but any reduction to recoup overpayments made to the employee does not reduce the amount of the spouse's survivor benefit.

Circular 230 Notice

Pursuant to IRS Circular 230, to the extent this communication concerns tax matters, it is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax-related penalties under the Internal Revenue Code or (ii) marketing or recommending to another party any tax-related matter addressed within. Each taxpayer should seek advice based on the individual's circumstances from an independent tax advisor.

²⁷ For a more detailed explanation, see the GRS Research Memorandum: "Final 415 Regulations Related to Governmental Defined Benefit Plans," available on the GRS web site (www.gabrielroeder.com).