

TAX MANAGEMENT COMPENSATION PLANNING JOURNAL

Reproduced with permission from Tax Management Compensation Planning Journal, Vol. 34, No. 8, 08/04/2006. Copyright © 2006 by The Bureau of National Affairs, Inc. (800-372-1033) <http://www.bna.com>

EPCRS' 2006 Makeover: Are the Changes More than Cosmetic?

by Kathryn J. Kennedy*

Summary:

On May 5, 2006, the Internal Revenue Service issued Rev. Proc. 2006-27, its long-awaited update of the Employee Plans Compliance Resolution System (EPCRS). The EPCRS allows plan sponsors and plan administrators to correct disqualifying defects so as to avoid plan disqualification. The article discusses the changes that were made to EPCRS and concludes that, although the update was issued later than expected, it affirms the IRS's wel-

* Professor of Law and Director of the Center for Tax Law and Employee Benefits, The John Marshall Law School; B.S. 1974 Drake University; J.D. 1980 Northwestern University School of Law. The author would like to thank Larry Grudzien, an employee benefits lawyer practicing in the Chicago area, for his assistance in the preparation of this article. Portions of this article originally appeared in 31 *Tax Mgmt. Compensation Plan. J.* 411 (11/7/03). This article has been updated to include the changes made by Rev. Proc. 2006-27, 2006-22 I.R.B. 945.

come goal to make plan qualification corrections more available and more cost-effective.

INTRODUCTION

To the casual observer, a retirement or profit sharing plan should be able to become qualified under the Internal Revenue Code ("the Code") upon its adoption and remain qualified during its existence until it is ultimately terminated. However, due to the Code's complexity and continuous legislative changes, establishing and maintaining a qualified plan has become a definite challenge for plan sponsors and plan administrators. To assist plan sponsors, the Internal Revenue Service ("the Service") has developed a correction program to assure continued and ongoing qualification for plans. This program is called the Employee Plans Compliance Resolution System (EPCRS), which is administered by the Service through its revenue procedures. Rev. Proc. 2003-44¹ made comprehensive and wide-spread changes to EPCRS. The Service had indicated its intent to make annual changes to EPCRS, but the absence of any EPCRS guidance during 2004 or 2005 left practitioners wondering whether meaningful changes would really be made and how often future changes would be forthcoming.

¹ 2003-25 I.R.B. 1051.

TAX MANAGEMENT INC.
WASHINGTON, D.C.

ing. The long-awaited Rev. Proc. 2006-27, updating Rev. Proc. 2003-44, was released on May 5, 2006. It is cumulative in nature — reflecting the changes under Rev. Proc. 2003-44 and the 2006 changes.² To assist practitioners, the Service has published a chart comparing the changes between the two revenue procedures.³ It has also published a topical index to the 2006 revenue procedure⁴ and a PowerPoint presentation highlighting the new changes.⁵ The updated EPCRS program embodied in Rev. Proc. 2006-27 sets forth 24 significant changes to account for changes that the IRS has made to its determination letter program reflected in Rev. Proc. 2005-66.⁶

This article is intended for those practitioners unfamiliar with EPCRS. It summarizes the recent changes as well as the cumulative effect of the changes made to EPCRS. Practitioners should also be aware that the IRS's correction program is independent of the Department of Labor's (DOL) Voluntary Fiduciary Correction Program (VFCP) and DOL's Delinquent Filer Voluntary Compliance (DFVC) Program.⁷ Compliance under the IRS program does not necessarily result in compliance with the DOL's programs.

OVERVIEW

The Service's correction program is best understood as part of a twofold comprehensive system designed to keep retirement and profit-sharing plans qualified. The determination letter process (with extensions provided through the remedial amendment provisions)⁸ assures plan *document* compliance. The correction program assures plan *operational* compli-

² See <http://www.irs.gov/retirement/article/0,,id=156617,00.html> for a summary of the changes, a topical index and a presentation highlighting the changes.

³ The chart can be found at http://www.irs.gov/pub/irs-tege/rp0627_summary.pdf. There is also a summary of the changes at <http://www.irs.gov/retirement/article/0,,id=96907,00.html>.

⁴ The topical index can be found at http://www.irs.gov/pub/irs-tege/rp0627_index.pdf.

⁵ The PowerPoint presentation can be found at http://www.irs.gov/pub/irs-tege/epcrs_presentation.pdf.

⁶ 2005-37 I.R.B. 509.

⁷ The finalized version of the DOL's VFCP is available at http://www.dol.gov/ebsa/compliance_assistance.html#section8, effective May 19, 2006. The DOL's DFVC Program is summarized by the DOL at http://www.dol.gov/ebsa/faqs/faq_dfvc.html.

⁸ Determination letters are written statements issued by the IRS in response to written requests from plan sponsors. The filing of such requests has become centralized, with Cincinnati, Ohio being the IRS office that issues determination letters. A favorable determination letter issued by the Service indicates its opinion that the terms of the plan document meet the standards of §401(a). If it is determined that operational problems could develop even though there are no disqualifying plan document features, the letter will be conditional with such caveats. See Rev. Proc. 2006-6, 2006-1 I.R.B. 204, for the current rules applicable to requesting a

ance and permits nonamenders⁹ to make certain retroactive plan amendments to attain plan document compliance.¹⁰ Generally, those plan sponsors that have utilized the Service's determination letter process in a timely fashion will be concerned only with ongoing operational failures, whereas plan sponsors that have not taken advantage of the Service's determination letter program will be concerned with both plan document *and* operational failures.

As a professor, I am always trying to analogize the law of employee benefits to the everyday experiences of my students. Reflecting on the Service's determination letter and correction programs, it occurred to me that the purchase of a new car and the establishment and maintenance of a qualified plan may have a lot in common. When I purchase a new car, I certainly expect that it will work in accordance with the owner's manual. The manual is designed to explain to me how to maintain and care for the car so that mechanical difficulties will be minimized; no one believes that difficulties won't *ever* occur. If I was lucky to secure a manufacturer's warranty on the car, it promises to cover the costs of unexpected mechanical failures, either at no charge or for a modest fee. Certain ongoing maintenance items may not be covered by the warranty: oil changes, tire rotations, windshield wipers, etc. Nevertheless, it is in my best interest to perform these routine maintenance items, even at my own expense, in order to avoid later and more expensive charges that may or may not be covered under the manufacturer's warranty. As significant problems unfold (e.g., transmission leakage), it may still be more effective for me to correct the defect, whether or not covered under the warranty. The alternative of waiting too long may result in the car's self-destruction after years of non-maintenance.

Likewise, every qualified plan needs an instruction manual, referred to as its plan document. Certainly, many small and medium-size employers utilize a standardized master or prototype plan or a volume sub-

determination letter from the Service. Code §7476 permits an applicant that has not been given a favorable determination letter to petition the Tax Court for a declaratory judgment, provided all administrative remedies have been pursued. All section references herein are to the Internal Revenue Code of 1986, as amended, and the regulations thereunder, unless otherwise specified.

⁹ Plan sponsors that do not make necessary corrective retroactive plan amendments within the applicable remedial amendment period (or cycle) are referred to as "nonamenders."

¹⁰ Retroactive plan amendments may be used to correct plan document failures that would otherwise cause the plan to lose its qualified status, provided such amendments are made within the remedial amendment period as described in §401(b) and Regs. §1.401(b)-1. The remedial amendment period refers to the applicable time period during which the plan amendment must be made and retroactively effective such that the plan attains or retains qualified status.

mitter plan, which has a plan document pre-approved by the Service. Other employers desiring an individually-designed plan generally draft the plan and then have the Service *later* affirm its qualified status through the determination letter process. As long as the plan document terms are followed, the Service's determination letter assures the plan sponsor that the plan document is qualified. Likewise, as legislative changes occur requiring plan amendments, re-submission of a determination letter assures the sponsor that the plan will continue to be qualified as long as the plan amendments are made retroactively in accordance with the applicable remedial amendment period. The Service has discretion under the Code's remedial amendment period to extend the time frame for retroactive plan amendments, which it does for those sponsors seeking a determination letter.¹¹ Thus, the determination letter program is designed to review and perfect the plan document within an appropriate time frame so that most but not all plan document qualification failures may be avoided.

Because operational errors can occur with the administration of the plan and certain plan features are not covered by the Service's determination letter program, the Service has initiated a second program — EPCRS — by which plan sponsors and plan administrators may correct disqualifying defects so as to avoid plan disqualification. This program is designed for use by plans qualified under §§401(a) and 403(b) and for SEPs and SIMPLE IRAs. Section 457(b) governmental and tax-exempt entity eligible deferred compensation plans may apply to the IRS for corrective closing agreements; they are outside of EPCRS, but use similar standards.

The Service's Overall System to Assure Qualification

To understand the Service's correction program, it is important to step back and review the Service's overall structure to assure qualification for existing plans. To ensure that the terms of the plan document are valid, the Service's determination letter program is available on a voluntary basis for every plan.¹² Because the plan administrator is required to administer the plan as written,¹³ it makes no sense to start out with a defective plan document, especially when the

Service has a voluntary program to review the plan's terms. Unfortunately, the Service does not review the terms of most plan documents in advance of its actual establishment and during the plan's ongoing administration. For most plans, a determination letter is sought within the first years of the plan's establishment. For subsequent plan amendments required because of legislative or regulatory changes, plan sponsors may need to request subsequent determination letters. Also, when a plan terminates, it must request a determination letter to assure that the distributions are qualified plan distributions and eligible for roll-over treatment.

Due to the flurry of legislative activity in the late 1990s, the Service temporarily closed its determination letter program in order to provide guidance under the new rules.¹⁴ It utilized its discretion under the §401(b) remedial amendment provisions and postponed the adoption of the retroactive GUST plan amendments for all plans.¹⁵ This afforded practitioners sufficient time to amend plan documents so that they retroactively reflected the Code's new requirements. While this additional time allowed the plan document to become "picture perfect" as of the appropriate date, the plan sponsor and plan administrator were still required to operate the plan in compliance with the applicable law beginning on and after the effective date of the changes.¹⁶ Such a disconnect between the timing of the plan amendments and the effective dates of the legislative changes exposed the plan sponsor and plan administrator to the potential for *operational* failures. EPCRS was designed to permit corrections to be made for those errors.

Over the past five years, the IRS has been revising and simplifying this correction program *and* its deter-

¹⁴ See Rev. Proc. 99-23, 1999-16 I.R.B. 5, §3.01.

¹⁵ See Rev. Proc. 2000-27, 2000-1 C.B. 1272 (extending remedial amendment period for disqualifying provisions for nongovernmental plans until the later of (1) the last day of the first plan year beginning on or after Jan. 1, 2001, or (2) the last day of the first plan year beginning after the "2000 legislative date"). Announcement 2001-12, 2001-6 I.R.B. 526, provides a different extension for certain employers that utilize master and prototype plans or volume submitter plans. GUST is an acronym for the Uruguay Round Agreements Act (GATT), P.L. 103-465; the Uniformed Services Employment and Reemployment Rights Act of 1994 (USERRA), P.L. 103-465; the Small Business Job Protection Act of 1996, P.L. 104-188; the Taxpayer Relief Act of 1997 (TRA '97), P.L. 105-34; the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA '98), P.L. 105-206; and the Community Renewal Tax Relief Act of 2000 (CRA), P.L. 106-554. The Service later issued Rev. Proc. 2002-35, 2002-24 I.R.B. 1187, which permitted plan sponsors that failed to timely amend their plans by the end of the GUST remedial amendment period to apply for determination letters provided they paid an enhanced user fee on or before Sept. 3, 2002.

¹⁶ Thus, the correction methods under Rev. Proc. 2006-27 are not needed to correct disqualifying defects that are cured within the remedial amendment period.

¹¹ See Regs. §1.401(b)-1(e).

¹² See IRS Pub. 794. During the early 2000s, the Service reexamined the future of the Employee Plans Determination Letter Program. See Announcement 2003-32, 2003-20 I.R.B. 933. The determination letter process eventually was bifurcated with individually-designed plans operating on a different 5-year cycle than pre-approved plans.

¹³ See Regs. §1.401-1(a)(2).

mination letter program. *By now, the EPCRS program is so simplified and streamlined that practitioners should educate and advise plan sponsors and administrators that use of such correction procedures is simply “best practices” for the ongoing maintenance of a qualified plan.* The costs of implementing proper practices and procedures to take advantage of this program must no longer be dismissed as unnecessary costs. Just as we have taken for granted the submission of a determination letter for approval of the plan document’s compliance, even though there is a related user fee, use of the IRS’s correction program now simply makes economic sense for keeping the plan in compliance during operation. The days of playing the “audit roulette wheel” are over — such costs now far surpass the costs of ongoing compliance.¹⁷ This is now of particular importance as the Employee Plans (EP) Examination Program has increased its examination coverage, an initiative that will increase with the addition of newly-hired EP examination agents.

Even if a plan sponsor secures a favorable determination letter, not all aspects of the plan document are protected under the Service’s determination letter.¹⁸ Certain terms of the plan document are operational in nature, e.g., the minimum participation and coverage rules under §§410(b) and 401(a)(26) and the nondiscrimination rules under §401(a)(4).¹⁹ Thus, the Service cannot always pre-approve their application in operation. Failures to satisfy these requirements on an ongoing basis are referred to as “demographic failures,” because such failures are the result of a shift in the demographics of the sponsor’s workforce.²⁰ Obviously, such failures can only be cured through the EPCRS program. Such corrections can be differentiated from other types of operational failures as these may require corrective plan amendments to provide

for *greater* benefits in order to assure compliance. Other types of operational failures (e.g., failures under §401(k) or (m)) may simply necessitate the use of a correction method but not a retroactive plan amendment.

Other operational failures can occur for a multitude of reasons, for example, if an inadvertent error is made; if the terms of the plan are not followed; or if, as legislative changes were made, the plan’s administration was not in compliance, even though the plan document was later properly retroactively amended. Most of the time, correction of an operational failure involves following the terms of the plan and restoring the participants and beneficiaries to the position they should have been in had the failure not occurred. However, correction of an operational failure may require a retroactive plan amendment so that the plan’s terms actually match the operation of the plan. For example, if hardship distributions or participant loans were made from the plan but not authorized by the terms of the plan, correction requires a retroactive plan amendment authorizing such distributions or loans. If such a retroactive amendment is made during the remedial amendment period, EPCRS is not needed. If such an amendment must be made after the expiration of the remedial amendment period, such defect must be cured under EPCRS.

Finally, the adoption of a certain type of qualified plan by an employer that is not eligible to establish that type of plan is also a qualification failure, referred to as an “employer eligibility failure,” and can only be corrected through EPCRS. For example, employer eligibility would occur if a tax-exempt employer had established a §401(k) plan between 1987 and 1996, or if an employer implemented a SARSEP but has more employees than permitted under the limits of §408(k).²¹

In summary, the Service’s EPCRS program permits correction of the following qualification failures:

- **plan document failures** (a plan provision or absence of a plan provision that violates §401(a)) that cannot be corrected through the determination letter program either because the plan sponsor did not seek a determination letter (“nonamender”) or the required retroactive plan amendment was not made within the remedial amendment period (“late-amender”);
- **operational failures** that occur because the terms of the plan were not followed (correction may be accomplished either through a

¹⁷ According to the General Accounting Office’s (GAO) findings, “Pension Plans: IRS Programs for Resolving Deviations from Tax-Exemption Requirements,” plans eligible to use the Service’s voluntary program could have avoided sanctions that were approximately 30% higher than the audit cap fees. The GAO’s findings supported the IRS’s assertions that voluntary reporting and correction of plan qualification defects are far preferable to the plan sponsor than correcting such defects as a part of an IRS audit. For more information on the GAO report, see <http://benefitslink.com/articles/audits001102.shtml> (May 28, 2003).

¹⁸ See *Ludden v. Comr.*, 68 T.C. 826 (1977), *aff’d*, 620 F.2d 700 (9th Cir. 1980).

¹⁹ Coverage rules under §410(b), the minimum participation requirements of §401(a)(26) for defined benefit plans, and the nondiscrimination rules of §401(a)(4) may require testing on an annual basis to assure compliance.

²⁰ Note that as part of the determination letter process, a higher user fee may be paid in order for the Service to review the plan sponsor’s method of testing for participation and nondiscrimination rules. See Rev. Proc. 2006-8, 2006-1 I.R.B. 245, for the applicable user fee for Employee Plans Determination Letter Requests.

²¹ See Rev. Proc. 2006-27, §5.01(2)(d) (and §4.07, noting that the Self-Correction Program (SCP) is not available to correct an employer eligibility failure).

retroactive plan amendment or a certain type of correction method, depending on which is appropriate);

- **demographic failures** in which the coverage/participation rules or the nondiscrimination testing rules are not satisfied; and
- **employer eligibility failures** caused by the employer's inability to establish the type of qualified plan that was adopted.

Historical Background of EPCRS

The evolution of EPCRS began in 1990 with the Service's original Closing Agreement Program (CAP), utilized to avoid disqualifying a plan.²² It was restrictive regarding the issues that could be corrected and resulted in a sanction equal to a negotiated percentage of the "maximum payment amount" (i.e., the amount that approximated the taxes owed by the plan sponsor if the plan were actually disqualified). By 1991, the Service began an administrative policy, known as APRS (Administrative Policy Regarding Sanctions) or the Nonenforcement Policy, throughout the key district offices to correct minor operational defects without any sanctions.²³ The Voluntary Compliance Resolution Program (VCR) was announced in 1992²⁴ and made permanent in 1994.²⁵ Employers utilizing VCR had to have a favorable determination letter, disclose the defect and make the correction, and pay a fixed fee to the IRS as a sanction.

For plans not eligible for VCR, the Service devised a Walk-In Closing Agreement Program (Walk-In CAP) in 1994.²⁶ This program did not require a favorable determination letter and provided relief for plans with plan document and demographic failures. By 1998, the programs were then consolidated under EPCRS, with the Service stating that ongoing revenue procedures would be implemented to further perfect

the program.²⁷ By 2000, the correction program was extended to qualified plans under §403(b).²⁸ In 2001, the Service made major revisions to its correction program, consolidating it into three separate programs, which still exist today.²⁹ The Service made further refinements in Rev. Proc. 2002-47.³⁰ Rev. Proc. 2003-44 greatly simplified the submission of a plan for voluntary compliance and drastically reduced the fee for such submissions. Finally, apparently three years late in publication, Rev. Proc. 2006-27 reflects the Service's continued intention to make ongoing compliance of the Code's qualification rules straightforward and without threat of an impending audit. Although the 2006 changes are not as extensive as the 2003 changes, they are nevertheless welcome additions to EPCRS.

EPCRS is administered by the Employee Plans segment of the Tax-Exempt and Government Entities (TE/GE) Division of the Service, through the Program Manager, the four Program Coordinators, the four Voluntary Compliance (VC) Group Managers, the respective group VC Coordinators, and the six Audit CAP Coordinators, depending on whether VCP, SCP or Audit CAP is being utilized.³¹ In his opening remarks at the May 2006 Great Lakes Area IRS/ASPPA Benefits Conference, Joseph Grant, Director of EP Rulings and Agreements, noted that EPCRS had an inventory of 2,700 cases, generally closing within 14 months. He noted that last year, 1,500 cases were closed over a 420-day cycle. With the improvements under the 2006 revenue procedure and electronic changes in processing cases, Mr. Grant is confident that implementation of initiatives, such as the addition of technical employees from the Determination Program and Technical in Washington, D.C., and the adoption of efficiencies, such as streamlined compliance statements, will expedite the processing of cases.

To appreciate the relevance of the EPCRS program, it is important to understand the Service's position on disqualifying plan document and operational failures.

²⁷ See Rev. Proc. 98-22, 1998-1 C.B. 723, §16, for a chronology of the IRS's prior programs.

²⁸ See Rev. Proc. 2000-16, 2000-1 C.B. 518 (extending the EPCRS programs for plans covered under §403(b) through a separate program known as the Tax-Sheltered Annuity Voluntary Correction Program (TVC)).

²⁹ See Rev. Proc. 2001-17, 2001-1 C.B. 589.

³⁰ 2002-29 I.R.B. 133 (expanding the John Doe submissions procedure; introducing the concept of group submissions for eligible organizations (i.e., sponsors of a master or prototype or volume submitter plan and organizations providing administrative services) to correct the same defect in at least 20 plans; and introducing a special rule in determining the correction period in the case of an operational defect relating solely to transferred assets).

³¹ See Appendix 1 of this article, which sets forth the names, addresses and phone numbers of these individuals.

²² IRS Memo dated Dec. 21, 1990.

²³ In a memorandum from John E. Burke, Assistant Commissioner (Employee Plans and Exempt Organizations), to Assistant Regional Commissioners (Examination) and District Directors: Brooklyn, Chicago and Cincinnati ("APRS Memo"), the Service's Administrative Policy Regarding Sanctions was implemented on Mar. 26, 1991. The APRS Memo was the transmittal for inclusion in the Employee Plans Examination Guidelines Handbook in the Internal Revenue Manual, located at IRM 7(10)54.660 (July 19, 1992), reprinted in CCH Pension Plan Guide, Extra Edition, No. 843 (Apr. 17, 1991).

²⁴ See Rev. Proc. 92-89, 1992-2 C.B. 498.

²⁵ See Rev. Proc. 94-62, 1994-2 C.B. 778.

²⁶ See Rev. Proc. 94-16, 1994-1 C.B. 576.

Beginning in 1989, the Service became vocal in its position that *any* disqualifying defect, no matter how insignificant, could disqualify the plan — an insurmountable hurdle for any plan! The Tax Court affirmed the Service’s literal position, regardless of the significance of the defect, the innocence of the violation, or the unreasonableness of disqualification in light of the violation committed.³² The Service’s position was further exacerbated by its position that once a disqualifying defect occurs, the plan remains disqualified until correction, thereby subverting the statute of limitations.³³

Given the Service’s rigid position, plan sponsors have been grateful that audits of qualified plans have been relatively limited in both number and scope.³⁴ But, the Service’s literal focus on disqualification and the potential cost to the plan sponsor in sanctions if disqualification is pursued should heighten plan sponsors’ concerns to address emerging plan disqualification failures in a prompt fashion. The Service’s EPCRS program is a welcome response for plan sponsors and plan administrators, particularly with the Service’s assurances that use of such programs will not heighten the threat of a plan audit. During informal discussions with the Service, the issue was raised whether a plan sponsor that was in the midst of self-correction or voluntary correction and discovered itself under audit could continue to resolve known defects under the voluntary programs. The Service indicated its willingness to allow plan sponsors to finalize the voluntary program’s correction methods before resolution under the audit correction method, affirming its intent to promote EPCRS in lieu of audit.

During the GUST restatement period, the Service’s resources were diverted towards the determination letter and compliance programs instead of examinations. During the past two years, the Service has expanded its examination program to include not only wide-

spread audits of qualified plans but also targeted audits on specific qualification requirements. The top five items that trigger an audit include:

- large number of separated participants with less than 100% vesting;
- large percentage of plan assets classified as “other assets”;
- large distributions on income statement;
- top-heavy §401(k) plans; and
- top-heavy plans covering self-employed individuals.³⁵

The Service has a recently formed the Employee Plans Compliance Unit (EPCU) that conducts targeted audits based on focused issues.³⁶ It also is aggressively targeting abusive tax avoidance transactions (“ATATs”) that may involve a qualified plan or the plan sponsor.³⁷

Goals and Structure of EPCRS

The Service has listed the following items as goals for the EPCRS program.³⁸

- to encourage plan sponsors to establish administrative practices and procedures;
- to have plans satisfy the applicable plan document requirements of the Code;
- to have plan sponsors make voluntary and timely correction of plan failures;
- to impose sanctions that are reasonable in light of the nature, extent and severity of the violation;

³² See, e.g., *Buzetta Constr. Corp. v. Comr.*, 92 T.C. 641 (1989); *Martin Fireproofing Profit-Sharing Plan and Trust v. Comr.*, 92 T.C. 1173 (1989); *Basch Engineering, Inc. v. Comr.*, 59 T.C.M. 482 (1990).

³³ The IRS’s tainted asset theory is that if a plan is disqualified for more than five years and the money remains in the plan, it can perpetually disqualify the plan and, thus, must be corrected, even for years barred by the statute of limitations. See Rev. Rul. 73-79, 1973-1 C.B. 194. See also *Martin Fireproofing Profit-Sharing Plan and Trust v. Comr.*, 92 T.C. 1173, 1188 (1989).

³⁴ According to Carol Gold, Director of Employee Plans, there were 20,000 audits from 2001 to 2003, with another 10,000 in process, in comparison with the 1,000,000 filers of Form 5500. She also noted that the Employee Plans Team Audit’s focus was on larger employers, e.g., those over 2,500 employees, because these govern 60% of the covered employees. See Remarks of Carol Gold, “Washington Legislative and Regulatory Update,” the 2003 Great Lakes IRS/ASPA Benefits Conference (May 1, 2003).

³⁵ See Remarks of Monika Templeman, EP Area Manager, Great Lakes, “Preparing for an IRS Audit,” the 2006 Great Lakes Area IRS/ASPPA Benefits Conference (May 2-3, 2006).

³⁶ See Remarks of Craig Chomyok, EPCU Group Manager, “What Is the EPCU?” the 2006 Great Lakes Area TE/GE Council Meeting (Apr. 21, 2006) (noting that the current projects focus on funding deficiencies, funding waivers, Form 5330 audits, voluntary compliance follow-up, fraud, §401(k) excess deferrals, party-in-interest transactions, and compliance with the universal availability requirement under §403(b)).

³⁷ See Regs. §1.6011-4(b)(2) (concerning listed transactions that are regarded as tax avoidance transactions; these include in the employee benefits context: §401(k) accelerated deductions, prohibited allocations of ESOP securities in a S corporation, collectively-bargained welfare benefit funds for sham unions, certain trust arrangement seeking to qualify for exemption under §419, abusive Roth IRA transactions, S corporation ESOP abuses and §409 violations, deductions for excess life insurance in a §412(i) plan, and channeling S corporation pass-through income to government retirement plans).

³⁸ See Rev. Proc. 2006-27, §1.02, stating the general principles underlying EPCRS. In an effort to update and improve the EPCRS program, comments are welcomed at the IRS.

- to administer the program in a consistent and uniform way; and
- to provide reliance to plan sponsors in taking correction actions.

These goals are certainly important considerations in applying the features of EPCRS, especially those that are dependent upon individual facts and circumstances.

The easiest way to envision EPCRS is to view it as providing three “doors” of correction. Two of the doors are voluntary — the Self-Correction Program (SCP) and the Voluntary Correction Program (VCP) — that are accessible only if the plan is not “under examination.”³⁹ The third door for correction, Audit CAP, is actually a “trap door” which may be opened by the Service for unsuspecting plan sponsors during the EP examination process. The audit fee structure under Audit CAP obviously penalizes those plan sponsors that wait for an examination, whereas the voluntary programs encourage self-correction and offer minimal costs. Unfortunately, not all violations may be corrected through EPCRS; failures relating to diversion or misuse of plan assets cannot be corrected through any of these three programs.⁴⁰ Rev. Proc. 2006-27 made it clear that ATATs also cannot be corrected through EPCRS.⁴¹ It may also not be available to resolve certain excise tax liabilities, income tax li-

³⁹ See *id.* at §4.02. Also see *id.* at §5.03, which defines “under examination” as either an Employee Plans examination with respect to the Form 5500 series (or other Employee Plans examination) or an Exempt Organizations examination (if the Plan Sponsor is an Exempt Organization) in which the plan sponsor or its representative has received verbal or written notice of an impending exam or referral for an exam. Rev. Proc. 2006-27 expanded this definition to include investigations by the Criminal Investigation Division of the IRS. It also clarified that submission of a determination letter request and later discovery by the agent of possible qualification failures and withdrawal of a determination letter request after discovery by the agent of possible qualification failures constitutes “under examination.” See *id.* at §5.03(1)(c) and 5.03(3). Once such period begins, it is not clear how long the plan remains under examination for purposes of EPCRS.

⁴⁰ See *id.* at §§4.11 and 4.12. Note that the Department of Labor has a Voluntary Fiduciary Correction Program (VFCP) to allow the avoidance of civil actions initiated by the Department and the assessment of civil penalties under ERISA §502(l) for certain fiduciary violations. See 67 Fed. Reg. 15062 (Mar. 28, 2002).

⁴¹ See Rev. Proc. 2006-27, at §4.13. The revenue procedure states that the SCP is not available to correct any operational failures related to ATATs, and if an ATAT is raised upon VCP, the issue will be referred to an IRS EP Tax Shelter Coordinator. Unrelated failures can continue to be processed under VCP, but any compliance statement will not apply to any ATAT failures. ATAT failures may be referred to examination. With respect to Audit CAP and SCP (for plans under examination), if the Service determines that the plan or plan sponsor was or may have been a party to an ATAT, the matter may be referred to the Service’s EP Tax

abilities that are not directly related to plan disqualification, additions to tax (e.g., the §72(t) penalty), and employment tax liabilities.⁴²

Rev. Proc. 2006-27 expanded the use of VCP and Audit CAP to “orphan plans” (also known as “abandoned plans”).⁴³ Under EPCRS, an “eligible party” may demonstrate that the plan sponsor no longer exists, cannot be located, is unable to maintain the plan, or is deemed to have abandoned the plan under DOL regulations. An “eligible party” includes a court-appointed representative, a person determined by the DOL as having responsibility to distribute the plan’s assets and terminate the plan, or a surviving spouse who is the sole beneficiary of the plan, provided it was never covered under ERISA Title I because the owner was the sole participant.⁴⁴ This inclusion permits orphan plans to have distributions and closure with respect to benefit payments. The Service may permit orphan plans to make less than full correction and reserves the right to waive the usual VCP compliance fee if a formal request is made.⁴⁵

The focus of the IRS correction program is on the common defects that are routinely seen in the ongoing administration of qualified plans. In ascertaining how a given defect is going to be corrected, Rev. Proc. 2006-27 envisions correction either through a retroactive plan amendment or through a correction method that will restore the plan to its qualified status. Rev. Proc. 2003-44 endorsed only three situations in which such retroactive plan amendment may be automatically made; other situations will require approval from the Service. Rev. Proc. 2006-27 permits a fourth retroactive plan amendment if the plan is making plan loans without the necessary plan language.⁴⁶ This was added to reduce the number of Forms 1099 that would otherwise have to be distributed to participants for distributions in lieu of plan loans.

In contrast, operational defects cured by a correction method that does not involve a plan amendment are regarded as more prevalent, and thus, Rev. Proc. 2006-27 affords multiple correction methods for a variety of operational failures. If the defect is one not contemplated by the revenue procedure, or if an alternative correction method is sought for a given defect, dialogue with the Service must commence to ascertain

Shelter Coordinator.

⁴² See Beth Levine, Stanley Pustulka and Marianne Davis, “A Guide to the Self-Correction and Audit Closing Agreement Programs,” *2003 IRS Employee Plans Continuing Professional Education Program, Coursebook*, Catalog No. 89089V, Chapter 11, p. 45.

⁴³ See Rev. Proc. 2006-27, §5.06(1).

⁴⁴ See *id.* at §5.06(2).

⁴⁵ See *id.* at §12.02(3).

⁴⁶ See *id.*, Appendix B, §2.07.

a correction method, consistent with the model correction principles.⁴⁷

Model Correction Principles

Under all three correction programs, there are underlying principles that the Service utilizes in designing its model correction methods/retroactive plan amendments and in accepting alternative proposals. Practitioners must be aware of these principles in order to fashion correction methods/amendments that best suit the plan sponsor's needs. Many times, the *model* correction method may not be the most cost-efficient correction method. Thus, the practitioner must work with the Service to fashion a correction method that satisfies the qualification rules consistent with the plan sponsor's desire to minimize costs and administration concerns. The Service's general correction principles⁴⁸ are as follows:

- The correction method must make full correction to all affected participants (former and active) and authorized beneficiaries for all tax years, not simply those open under the statute of limitations.⁴⁹
- The correction method should be restitutionary in nature, restoring the participants/beneficiaries to the position they would have been in had the failure not occurred.⁵⁰
- In correcting operational failures, the correction method must take into account the terms of the plan at the time of the failure.⁵¹
- The correction method should be reasonable and appropriate for the failure;⁵² correction methods permitted under the appendices of the revenue procedure are deemed to be reasonable and appropriate for correcting the related qualification failure.⁵³
- The correction method, if feasible, should resemble one otherwise provided under the

⁴⁷ See Appendix 2 of the article for a summary of the four permissible retroactive plan amendments and the model correction methods for a variety of different operational failures. See Appendix 3 of this article for the most common failures seen under VCP, as compiled by Gary Mitchell, VCP Area Manager for the Great Lakes Area.

⁴⁸ See Rev. Proc. 2006-27, §6.

⁴⁹ See *id.* at §6.02. However, if correction is made for a closed tax year, the Service will not redetermine the tax liability because of the correction.

⁵⁰ See *id.* at §6.02(1).

⁵¹ See *id.* at §6.02(4)(a).

⁵² See *id.* at §6.02(2) (noting that the determination of whether a correction method is reasonable and appropriate is a facts-and-circumstances determination).

⁵³ See *id.*

Code, the regulations or other authoritative guidance.⁵⁴

- The correction method should be applied consistently in correcting failures of the same type in the same plan year.⁵⁵
- Discriminatory defects must be resolved in favor of the non-highly compensated employees (NHCEs).⁵⁶
- The correction method must keep assets in the plan.⁵⁷
- The correction method should not violate another applicable provision of §§401(a), 403(b), 408(k) or 408(p).⁵⁸
- The correction method must include a procedure to locate former participants/beneficiaries.⁵⁹

Exceptions to Model Correction Principles

There are several noted exceptions to these model correction principles which may serve as welcome relief for plan sponsors:

- Reasonable estimates may be used in making a correction if it is impossible to make precise calculations or if the administrative costs of exact calculations outweigh the difference between the proposed correction method and the precise corrective amount.⁶⁰
- Corrective distribution of small benefits (\$50 or less/participant) need not be made if the administrative costs of making the correction exceed the amount of the distribution.⁶¹

⁵⁴ See *id.* at §6.02(2)(a).

⁵⁵ See *id.* at §6.02(3) (including the method used for adjusting for earnings).

⁵⁶ See *id.* at §6.02(2)(b).

⁵⁷ See *id.* at §6.02(2)(c) (noting an exception provided for under the Code, regulations or other IRS guidance for correction by participants or beneficiaries, or return of plan assets to the plan sponsor).

⁵⁸ See *id.* at §6.02(2)(d).

⁵⁹ See *id.* at §11.02(8) (requiring the plan sponsor or its representative to identify the method used to locate or notify former employees or beneficiaries or to state that no such individuals were affected by the correction).

⁶⁰ See *id.* at §6.02(5)(a). Although the Service generally requires full correction, it acknowledges this need not occur if it is unreasonable or not feasible; however, the mere fact that the correction is inconvenient or burdensome alone is not sufficient.

⁶¹ See *id.* at §6.02(5)(b).

- Recovery of small overpayments (\$100 or less) do not have to be sought if the plan sponsor so decides.⁶²
- Corrective distributions to former participants/beneficiaries whose location is unknown do not have to be made.⁶³

SELF-CORRECTION PROGRAM (SCP)

The EPCRS program provides a “revolving door” for the plan sponsor because it can simply self-correct as operational failures unfold with no IRS involvement.⁶⁴ In addition, no IRS compliance fees are assessed.⁶⁵ The cost of correction is simply the cost of applying the corrective method to the affected participants/beneficiaries. Obviously, the sooner the defect is caught, the cheaper it is to correct the defect. SCP is not available to cure plan document failures for nonamenders⁶⁶ or to correct *egregious* operational failures.⁶⁷ The determination of an egregious failure is a facts-and-circumstances determination, but several examples are provided in Rev. Proc. 2006-27.⁶⁸

Prerequisites to SCP

Although SCP is voluntary on the part of the plan sponsor, there are several prerequisites to utilizing this program:

- Generally, any operational failure may be corrected under SCP; however, operational failures that require retroactive *plan amendments* to conform the terms of the plan to the prior operations are permitted *only* with respect to the failures noted in §2.07 of Appendix B of the revenue procedure.⁶⁹
- *Significant* operational failures must be cured within a two-year window period under SCP, whereas *insignificant* operational failures may be cured at any time.⁷⁰
- The plan sponsor must have received a favorable determination letter⁷¹ in order to correct significant operational failures under SCP.⁷²

⁶⁹ See *id.* at §4.05(2) and App. B, §2.07, providing three situations in which retroactive plan amendments are provided as the corrective method: (1) amending the plan to permit hardship distributions and/or plan loans if the plan has been providing such distributions and/or loans; (2) amending the plan to reflect that the plan has admitted employees at an earlier entry date than specified in the plan document (provided the only employees affected by the amendment are predominately NHCEs); and (3) for §401(a)(17) failures, amending the plan to increase the allocations for employees below the §401(a)(17) limit so that the allocation becomes the same percentage of compensation as contributed for the employee having the §401(a)(17) failure. The Service will consider other corrections through retroactive amendments even though they do not fit within one of the three model amendments.

⁷⁰ *Id.* at §9.02 requires that the correction be completed or “substantially completed” by the last day of the second plan year following the plan year for which the failure occurred. However, for violations of the actual deferral percentage (ADP) and actual contribution percentage (ACP) applicable to §401(k) plans, employers actually have up to three years to correct the failure. See Regs. §§1.401(k)-2(b)(5)(ii) and 1.401(m)-2(b)(4)(ii). The correction is “substantially completed” if at least 85% of all affected participants have been corrected and the plan sponsor is diligent in completing the remaining 15% of affected participants. Also, the correction period for correcting failures relating only to “transferred assets” or plans assumed in connection with a corporate merger or acquisition has been extended to the last day of the first plan year that begins after the merger or acquisition.

⁷¹ Note that in the context of a prototype plan, an advisory letter from the plan sponsor certifying that the plan as adopted is identical to the plan approved under the determination letter is sufficient to qualify for SCP submission. Rev. Proc. 2006-27, §5.01(4), clarified that this requirement will be satisfied if (1) plan has a favorable determination letter, opinion letter, or advisory letter that considers GUST; (2) the plan is initially adopted or effective after Dec. 31, 2001, and the sponsor submits a timely application for a determination letter or it adopts an approved master/prototype plan or volume submitter plan within the plan’s remedial amendment period; (3) the plan is terminated prior to the GUST remedial amendment period and amended to reflect GUST changes; or (4) the plan is terminated prior to the expiration of the EGTRRA remedial amendment period and the plan was amended to reflect EGTRRA.

⁷² See *id.* at §4.03. Special conditions may apply to SEPs and SIMPLE IRA plans with respect to insignificant operational fail-

⁶² See *id.* at §6.02(5)(c).

⁶³ See *id.* at §6.02(5)(d) (noting that the method for locating a former participant or beneficiary includes use of the IRS Letter Forwarding Program (see Rev. Proc. 94-22, 1994-1 C.B. 608) or the Social Security Administration Employer Reporting Service).

⁶⁴ Rev. Proc. 2006-27, §4.01(1) (SEP and SIMPLE IRA plans may only utilize SCP for insignificant operational failures). SCP is also available if the plan is under examination, but only for failures that are either insignificant and/or correctable under SCP. *Id.* at §4.02.

⁶⁵ See *id.* at §1.03.

⁶⁶ See *id.* at §4.05(2).

⁶⁷ See *id.* at §4.11.

⁶⁸ *Id.*, citing the following as examples of egregious failures: (1) the plan has consistently and improperly covered only highly compensated employees; (2) the plan provides more favorable benefits for an owner of the employer based on a purported collective bargaining agreement where there has in fact been no good faith bargaining between bona fide employee representatives and the employer; or (3) there are contributions to a defined contribution plan for a highly compensated employee several times greater than the maximum dollar limitations set forth in §415. In informal discussions with the Gary Mitchell, VCP Area Manager for the Great Lakes Area, no other examples of egregious failures have been presented to the Service during the past few years of operation. Thus, plan sponsors should feel comfortable in utilizing SCP for routine operational failures. In addition, SCP is not available to the plan or the plan sponsor to correct operational failures that are directly or indirectly related to an ATAT. See *id.* at §4.13(1)(a).

- The plan sponsor must have in place “practices and procedures” designed to promote and facilitate overall compliance with the Code.⁷³

Limitations of SCP

Since SCP is “self-corrective” on the part of the plan sponsor, the Service is reluctant to provide blanket permission for retroactive plan amendments to cure operational failures due to a concern that such amendments could result in a cut-back of benefits in violation of §411(d)(6). Thus, self-correction of an operational failure by means of a retroactive plan amendment is available *only if* the operational failure relates to the types of failures noted in §2.07 of Appendix B of Rev. Proc. 2006-27: §401(a)(17) failures, hardship distribution failures, inclusion of ineligible employees and lack of plan loan language.⁷⁴ The Service also requires that such plan amendments be submitted for a determination letter review (under either the Form 5300 series or Form 6406) with the applicable user fee.⁷⁵ Retroactive plan amendments to cure *other* types of operational failures must be corrected under VCP.⁷⁶

For correction of other operational defects, use of any of the model correction methods described in Appendices A or B of the revenue procedure is deemed to be appropriate and reasonable.⁷⁷ However, the Service acknowledges that there may be more than one reasonable and appropriate correction for a given failure. Hence, if the plan sponsor wants assurance that the use of an alternative correction method is reasonable and appropriate, VCP, not SCP, must be utilized.

ures.

⁷³ See *id.* at §4.04, noting that the plan sponsor or administrator must have established practices and procedures (formal or informal) reasonably designed to promote and facilitate overall compliance with applicable Code requirements. Although the Service does not elaborate on the types of practices and procedures that would suffice, it does note that the plan document alone is insufficient. It is also not clear whether such practices and procedures can be developed on an ongoing basis as problems are detected and corrected.

⁷⁴ Each of these defects has a retroactive plan amendment provided to cure such defect. However, such permitted correction amendment must also comply with the requirements of §401(a), including §§401(a)(4), 410(b) and 411(d)(6).

⁷⁵ See Rev. Proc. 2006-27, §§4.06(2) and 9.03 (requiring the application for a determination letter before the end of the plan’s applicable remedial amendment period as described in Rev. Proc. 2005-66).

⁷⁶ See Rev. Proc. 2006-27, §4.05(1) (noting that VCP is available to correct operational failures by a plan amendment to conform the terms of the plan to its prior operations, provided such amendment complies with the requirements of §§401(a)(4), 410(b) and 411(d)(6)).

⁷⁷ See *id.* at §6.02(2).

Although this alternative involves a fee under VCP, the alternative correction method approved by the Service may be less expensive for the plan sponsor than the model correction method.⁷⁸

Significant Versus Insignificant Defects

SCP makes a distinction between significant and insignificant operational defects, as the former must be cured within the two-year window.⁷⁹ Rev. Proc. 2006-27 provides the following list of factors to be used in determining “significance” (but no one factor is outcome determinative, nor is the list exhaustive):⁸⁰

- whether other failures occurred during the period of examination;
- percentage of assets/contributions involved;
- number of years involved in the failure;
- percentage of participants who were affected and could be affected;
- whether correction occurred within a reasonable period; and
- the reason for the failure.⁸¹

In applying these factors, the Service has indicated that *all* failures during an applicable correction period must be aggregated before applying these factors. Thus, plans with multiple defects will have a more difficult time justifying that the cumulative failures amount to an insignificant failure.

Two-Year Window for Significant Failures

The two-year window available for SCP generally begins on the date of the operational failure (not the

⁷⁸ The Service has indicated its willingness to dialogue with plan sponsors as to the viability of alternative correction methods, even under SCP.

⁷⁹ See Rev. Proc. 2006-27, §9.02(1).

⁸⁰ See *id.* at §8.02. Also note that the Service does not construe factors such as the percentage of assets/contributions involved in the failure, number of affected participants relative to the total number of participants, and number of affected participants relative to the total number of participants who could have been affected by the failure to exclude small businesses sponsoring plans from using SCP.

⁸¹ See *id.* at §8.04, Exs. 1-5. In informal contacts with the Service, it has expressed willingness to dialogue with the plan sponsor’s representative as to whether a given set of facts-and-circumstances would qualify as an insignificant or significant error. Such discussion should ameliorate concerns for plan sponsors as to whether SCP would be sufficient compliance under a given set of facts.

date the plan sponsor discovers the error) and ends on the last day of the second plan year following the plan year in which the failure occurred.⁸² For example, if a plan sponsor with a calendar plan year discovers that certain eligible employees were excluded from participation as of the plan's entry date of July 1, 2003, the date of the operational failure is the applicable entry date (July 1, 2003, when employees were excluded from participation) and the two-year ending date is December 31, 2004 (the second plan year following the date of the initial plan failure). A few exceptions exist.

- If the plan comes under examination, the correction period ends on the date notice of examination is provided (however, §5.03 of Rev. Proc. 2006-27 recognizes that if correction has been substantially completed before that time, the plan sponsor will be permitted to complete correction).⁸³
- If the operational failure is due to failing the special discrimination tests of §§401(k)(3) or 401(m)(2), the correction period is extended by the additional period of time permitted under those applicable Code sections.⁸⁴
- For §403(b) plans that do not have a plan year, the calendar year will be presumed to be used.⁸⁵
- Special rules and an extended period exist for transferred assets.⁸⁶

Administrative Practices and Procedures

To utilize SCP, the Service requires that the plan sponsor have in place administrative practices and

⁸² See *id.* at §9.02. Because Regs. §1.401(m)-2(b)(4)(ii) permits correction of ADP failures by the return of excess contributions to the HCEs within 12 months after the plan year in which the test failed or by contribution of nonqualifying elective contributions (QNECs) for NHCEs within 12 months after the plan year in which the test was failed, such defect (if significant) has 36 months in which it may be corrected.

⁸³ See *id.* Rev. Proc. 2006-27, §9.04 (noting that "substantial completion of correction" occurs (1) if the plan sponsor was reasonably prompt in identifying the failure, formulating a correction, and initiating the correction during the applicable period and within 90 days after that period completes the correction; or (2) if the plan sponsor completes the correction with respect to 85% of the affected participants during the applicable period and diligently completes the correction for the remaining affected participants thereafter).

⁸⁴ This creates a three-year window, as §401(k) plans that fail to satisfy the ADP or ACP tests have an additional 12 months after the close of the plan year of failure to make a valid correction.

⁸⁵ See Rev. Proc. 2006-27, §9.02(1).

⁸⁶ See *id.* at §9.02(2).

procedures designed to ensure compliance with the Code's qualification rules. Thus, the operational failure must have occurred as a result of an oversight or mistake in application or because of the inadequacy of the procedures.⁸⁷ Although the Service does not offer much guidance as to what must be in place to satisfy the practices and procedures requirement, it notes that the plan document alone is not sufficient.⁸⁸ Specifically what type of operations manual must be in place to spot disqualifying failures is not clear from the revenue procedures. Also, it is not clear whether a plan sponsor can formulate these procedures on an ongoing basis as errors are uncovered and methods are adopted to correct such errors.⁸⁹

This requirement of pre-existing practices and procedures to facilitate ongoing compliance is consistent with the Service's distinction in treatment between significant and insignificant operational defects. Such ongoing practices and procedures assume that routine and insignificant defects will be uncovered and corrected on an ongoing basis (i.e., within a two-year window for *significant* operational failures). To the extent a *significant* operational failure occurs but is not corrected within this two-year window, SCP is unavailable, and thus, the plan sponsor must pursue VCP, which requires the Service's involvement and payment of a compliance fee in order to bring the plan back into compliance. Such an approach is certainly consistent with the philosophy that the plan's "best practices" should have ongoing practices and procedures to identify any defects as they occur, with assumed methods of correction (from the IRS's EPCRS revenue procedure) which keep the plan in compliance and the Service at bay.

Because SCP is self-corrective on the part of the plan sponsor, certain verification information should be recorded by the plan sponsor in the event that the plan later finds itself "under examination." In reviewing such verification, the Service will look for the following documentation:

⁸⁷ See *id.* at §4.04. In the context of a failure relating to "transferred assets," the plan will be considered to have had established practices and procedures if they are in effect by the end of the first plan year that begins after the acquisition, merger or similar transaction.

⁸⁸ *Id.* APRS, the predecessor to SCP, required established practices and procedures regarding the area in which the violation occurred. Therefore, some concern exists if the plan sponsor's general checklist or procedural guidelines do not cover a specific qualification failure; whether broad categories of qualification covered by the checklist or procedure are sufficient is not yet known. See Rev. Proc. 92-89.

⁸⁹ If a plan sponsor retains an external or third-party recordkeeper, such recordkeeper's procedures should suffice for purposes of satisfying the "administrative practices and procedures," but as is the case in any fiduciary delegation, the plan sponsor must exercise due diligence in selecting and maintaining a given recordkeeper.

- that corrective contributions/distributions were adjusted for earnings;
- that significant operational failures were corrected within the applicable two-year window;
- if the correction method used was not one of the ones specifically described in the appendices of the revenue procedure, the correction method nevertheless complied with the Service's correction principles, especially those outlined in §6.02(2) of the revenue procedure regarding reasonableness and appropriateness; and
- steps were taken to verify that self-correction actually occurred.⁹⁰

VOLUNTARY CORRECTION PROGRAM (VCP)

VCP has evolved the most over the past decade. This door of opportunity must be opened by the plan sponsor and does involve the Service. The variety of programs offered under Rev. Proc. 2002-47 — VCO, VCS, VCT⁹¹ — has now been consolidated into a single VCP program to simplify the submission process. For plan sponsors with very minor defects, the prior VCO provided a flat \$350 fee, which was preferable to the new VCP fee schedule.⁹² In all other respects, the simplification and reduced fee schedule make the new VCP a more-welcomed program.⁹³

Types of Failures

VCP is available to cure a wide variety of qualifying defects, including:

- plan document failures because the plan was not timely amended within the remedial amendment period afforded to plans requesting determination letters (e.g., non-amenders or late-amenders) or because the plan was not administered in accordance with its terms but operated in accordance with the qualification rules;
- operational failures that are egregious in nature;
- demographic and employer eligibility failures; and

- significant operational defects not cured within the two-year correction period available under SCP.⁹⁴

See Appendix 3 of the article for a list of the most common operational failures as seen by the VC Area Managers.

Applicable Fee Schedule

Under Rev. Proc. 2006-27, for a given modest fee, the Service is willing to affirm acceptable correction methods in order for plans to rely on continued qualification, without the risk of plan disqualification. Interestingly, plan document failures were relatively rare during the past decade of compliance submission. During the past few years, the Service has indicated that plan document failures amount to a significant percentage of VCP requests. The fee schedule under Rev. Proc. 2003-44 ranged from \$750 for plans with fewer than 20 participants to \$25,000 for plans with more than 10,000 participants, a decrease of at least 50% for the appropriate brackets under the prior fee schedule. This fee schedule remains intact under Rev. Proc. 2006-27 and is as follows:⁹⁵

# of Participants under the Plan	Fee
Less than 20	\$750
20 – 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
Over 10,000	\$25,000

Rev. Proc. 2006-27 reduced the VCP fee to \$500 for a disqualifying failure related to the §401(a)(9) requirements if the violation affects 50 or fewer participants, the failure is the only failure of the submission, and the failure would result in the imposition of the

⁹⁴ See Rev. Proc. 2006-27, §4.01(2). If under VCP, the Service determines that the plan or the plan sponsor was or may have been a party to an ATAT, the matter will be referred to the IRS's Employee Plans' Tax Shelter Coordinator. If the failure in the VCP submission is related to the ATAT, the case will be referred to EP Examinations. See *id.* at §4.13(1)(b).

⁹⁵ See *id.* at §12.02. Although the reduction in fees under Rev. Proc. 2003-44 and Rev. Proc. 2006-27 gives relief to employers, it still provides perverse incentives at the break-points. For example, a plan sponsor with 50 participants pays a fee of \$1,000, while a plan sponsor with 51 participants pays an additional \$1,500 in fees. Perhaps the Service should consider making the schedule incrementally graduated, similar to the income tax table.

⁹⁰ See *Levine, et al.*, fn. 42, above, at Ch. 11, p. 13.

⁹¹ See Rev. Proc. 2002-47, §1.03, for the definition of VCO, VCS and VCT.

⁹² See Rev. Proc. 2006-27, at §12.02.

⁹³ Compare the fee schedule in §12.02(2) of Rev. Proc. 2002-47, to the fee schedule in §12.02 of Rev. Proc. 2003-44.

excise tax under §4974.⁹⁶ The VCP compliance fee for SEP/SIMPLE IRA plans was reduced from \$500 to \$250.⁹⁷ Possible relief from the 10% excise tax penalties under §§4972 (for employer contributions that are nondeductible due to the limits of §404) and 4979 (excess elective deferrals or matching contributions made to highly compensated employees due to ADP or ACP testing failures) may also be provided.⁹⁸ The waiver will be discretionary and will generally be available in inadvertent situations (e.g., ADP testing was done on a timely basis but the data was faulty). Also, the failures to make good faith EGTRRA amendments, §401(a)(9) amendments and interim amendments are now subject to a flat \$375 fee.⁹⁹ Ap-

pendix F of Rev. Proc. 2006-27 provides a sample cover letter and a sample VCP submission for these types of nonamenders.

Rev. Proc. 2006-27 adds a separate fee schedule for nonamenders discovered during the determination letter process (plans that were not amended for legislative changes but applied for a determination letter).¹⁰⁰ This is not a VCP submission, and the schedule applies if the only failure is a nonamender failure. This is a welcome addition to EPCRS, as it encourages sponsors to seek a determination letter even if defects are later discovered during the application process. Like the VCP fee schedule, this nonamender fee schedule is based on the number of plan participants; however, it also varies by the earliest statute for which the plan was not amended:

⁹⁶ Rev. Proc. 2006-27, at §12.02(2).

⁹⁷ See *id.* at §12.05.

⁹⁸ See *id.* at §§6.09(3)-(4).

⁹⁹ See *id.* at §12.03. According to IRS officials, the \$375 fee is

applicable to each failure, not for each year of failure.

¹⁰⁰ See *id.* at §14.04.

Number of Participants	EGTRRA/ subsequent legislation	GUST/ 401(a)(9) Regs.	UCA/OBRA '93	TRA '86	TEFRA/ DEFRA/ REA	ERISA
20 or less	\$ 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
Over 10,000	\$40,000	\$48,000	\$56,000	\$64,000	\$72,000	\$80,000

This fee schedule is not cumulative (e.g., if there are 20 or fewer participants and the plan failed to timely amend for ERISA and forward, the fee is only \$5,000). Note that the fees for nonamender failures discovered during an IRS audit are even higher than those noted above.¹⁰¹

Correction Methods and Retroactive Plan Amendments

The two voluntary doors (SCP and VCP) permit different correction methods, but SCP assumes that defects listed in Appendix A of Rev. Proc. 2006-27 will be corrected according to the model correction methods provided in the Appendices. If a retroactive plan amendment is necessary, Appendix B of the revenue procedure contemplates four different scenarios. Use of the VCP permits *alternate* correction methods

and *alternate* plan amendments, provided they meet with the Service's approval. The Service has indicated its willingness to engage in dialogue with the plan sponsor's representative regarding possible correction methods, realizing that one correction method may not fit all fact situations. Although EPCRS is primarily focused on operational plan defects, the Service realizes that not all plan sponsors have taken advantage of the determination letter process and the various extended remedial amendment periods.

Application Process and Compliance Statement

VCP begins with the submission by the plan sponsor's representative of a given or proposed correction method for a disclosed failure. Under Rev. Proc. 2006-27, the IRS will acknowledge receipt of a submission if the identifying information is submitted on the Acknowledgement Letter (contained in Appendix E of the revenue procedure) and included in the sub-

¹⁰¹ See *id.* at §14.02.

mission.¹⁰² The fee levied for VCP must be paid in advance with submission to the IRS's Washington, D.C. office. Previously, it was not always clear how much detail had to be presented in the initial submission. Thankfully, Rev. Proc. 2006-27, provides an inclusive format for the VCP submission, designed to expedite the process. The application should include:

- a complete description of the failures and the years in which the failures occurred;
- number of participants affected by the failures;
- a description of the administrative procedures in effect at the time the failures occurred;
- an explanation of how and why the failures occurred;
- a detailed narrative description of the correction method;
- the methodology that will be used to compute earnings on any corrective contributions;
- specific calculations for affected participants or a representative sample of affected participants;
- the method that will be used to locate and notify former employees/beneficiaries;
- a description of the administrative practices and procedures that will be or have been taken to prevent future failures; and
- a statement that the plan and plan sponsor are not under examination.¹⁰³

Although the Service would prefer the submission to be as detailed as possible, it realizes that the written application is only the beginning of the process in which the plan sponsor's representative and the VC agent will dialogue in fashioning a suitable correction method and a final compliance statement.

One concern for practitioners is whether additional qualification defects may be added after the initial VCP submission has been made. Although Rev. Proc. 2006-27 states that the IRS retains discretion in allowing or rejecting new failures,¹⁰⁴ the Service has indicated informally that it wishes to be extremely flexible in this regard, as its goal is to resolve all known qualification failures.

¹⁰² The plan sponsor prepares its own Acknowledgement Letter using the sample in App. E. The IRS will then stamp the date of receipt of the letter and assign a control number. This should expedite the processing time.

¹⁰³ See *id.* at App. D.

¹⁰⁴ See *id.* at §10.07(5).

VCP should end with a compliance statement issued by the IRS, assuring the plan sponsor that the Service will not seek to disqualify the plan based on the information submitted in the VCP.¹⁰⁵ The compliance statement does not have to be signed by the plan sponsor unless material changes have been made to the application and the plan sponsor has not submitted a penalty of perjury statement with respect to such subsequent modifications. This change is intended to expedite the processing time for submission. In the unlikely event that the parties are unable to agree upon resolutions, the plan sponsor may withdraw its submission. The Service has indicated that this rarely ever happens.

John Doe Submissions

EPCRS began offering anonymous or "John Doe" submissions to VCP in 2001.¹⁰⁶ Originally, such submissions could only address compliance failures not otherwise addressed in the appendices of the applicable revenue procedure. Today, any type of failure permitted under EPCRS may be submitted under a "John Doe" basis. A "John Doe" submission contains the same information that is required to be submitted under the VCP, except that identifying information is redacted. It is important to note that a submission under the "John Doe" procedures does not preclude or impede an examination of the plan sponsor or its plan(s). Once an agreement is reached between the Service and the plan sponsor's representative, there is a 21-day window in which the plan sponsor must be identified in order to move forward under VCP.¹⁰⁷

As practitioners continue to receive assurances from the Service that EPCRS is not "EPCRS with referral for examination," there is actually no reason for the plan sponsor to pursue a "John Doe" submission under VCP. If the plan sponsor cannot reach an agreement under VCP with the Service, experience has proven that a plan audit is not imminent, let alone automatic. In these circumstances, pursuing a "John Doe" submission simply forestalls the VCP process and subjects the plan to a greater time period in which it could be selected for audit.

Group Submissions

Group submissions under EPCRS were introduced in 2001 by adding a separate submission process for

¹⁰⁵ Because ATATs cannot be corrected through EPCRS, any compliance statement issued by the Service through VCP may not be relied on for purposes of concluding that the plan or the plan sponsor was not a party to an ATAT. See *id.* at §4.13(1)(b).

¹⁰⁶ See Rev. Proc. 2001-17, §10.12.

¹⁰⁷ See Rev. Proc. 2006-27, §10.10.

“Eligible Organizations” (i.e., a sponsor or administrator of an eligible master or prototype plan) to correct plan document and operational failures.¹⁰⁸ According to the Service, very few Eligible Organizations have taken advantage of this program. A VC Group submission may be made only for failures “resulting from a systematic error involving the Eligible Organization that affects at least 20 plans. . . .”¹⁰⁹ The Eligible Organization makes the submission, as opposed to the plan sponsors (which do not have to be identified until the compliance stage). Once agreement is reached between the Eligible Organization and the Service, Rev. Proc. 2006-27 provides a 120-day window period in which the plan sponsor’s identifying information must be revealed and a 240-day window period to make the agreed-upon corrections.¹¹⁰ The fee schedule for VC Group submissions is now a flat \$10,000, with a fee of \$250 for each additional plan, with an overall maximum of \$50,000.¹¹¹ The group VCP submission protects all the adopting employers’ plans against examination but only with respect to the failures identified in the submission.¹¹²

Specific Correction Methods Under Rev. Proc. 2006-27

There are specified correction methods in Appendix A of Rev. Proc. 2006-27 to correct certain operational failures.¹¹³ Appendix B of the revenue procedure expands the model correction methods for additional op-

¹⁰⁸ See Rev. Proc. 2001-17, §10.14(2) (defining an Eligible Organization: as (1) a sponsor of a master or prototype plan that receives an opinion letter that considers the provisions of GUST or has received an opinion letter than considers the Tax Reform Act of 1986 (TRA ’86), P.L. 99-514, and was submitted for a GUST opinion letter by Dec. 31, 2000; (2) an insurance company or other entity that has issued annuity contracts or provided services with respect to assets for §403(b) plans; or (3) an entity that provides its clients with administrative services with respect to qualified plans, §403(b) plans, SEPs or SIMPLE IRA plans).

¹⁰⁹ See Rev. Proc. 2006-27, §10.11(2).

¹¹⁰ See *id.* at §10.11(3)(c). Note that the power of attorney for each affected plan sponsor is no longer required. The sponsor of the master or prototype plan, the insurance company or the third-party administrator must notify all affected plan sponsors of the group submission.

¹¹¹ See *id.* at §12.04. If a sponsor of a master or prototype plan submits failures with respect to more than one master or prototype plan, each plan will be treated as a separate submission and a separate fee must be submitted for each prototype plan. Similarly, if a Volume Submitter practitioner submits failures with respect to more than one volume submitter plan, each plan will be treated as a separate submission and a separate fee must be submitted for each specimen plan.

¹¹² See *id.* at §10.04.

¹¹³ See *id.* at App. A (providing the original seven operational errors and correction methods approved under the original SVP program that was part of VCR).

erational failures and provides model retroactive plan amendments that may be used to correct the plan document. Corrective allocations and distributions prescribed under a given model correction must reflect investment earnings and actuarial adjustments, if necessary. An explanation of the model correction methods is provided in Appendix 2 of this article. The following discusses the changes made by Rev. Proc. 2006-27.

Excluded Eligible Employees

Rev. Proc. 2006-27 revised the correction method for eligible employees who have been excluded from §401(k) participation. Such guidance provides alternative corrective methods for non-safe harbor §401(k) plans versus statutory safe harbor §401(k) plans.

For *non-safe harbor* §401(k) plans, the employer’s correction involves a nonelective employer contribution (QNEC) equal to 50% (as opposed to the prior correction method of 100%) of the ADP percentage rate relating to the employee’s group (NHCE or HCE) applied to the employee’s compensation. For example, if NHCE ADP was 4% and a NHCE participant with \$30,000 in salary was erroneously excluded from participation, the employer would be required to make a QNEC equal to 50% of [4% × \$30,000], or \$600.¹¹⁴

Employers regarded the prior correction method of 100% as resulting in a windfall to the employee, as he/she never had to give up any take-home pay for the deferral. For after-tax employee contributions that should have been made but were not, the correction method permits a QNEC of 40% of the average rate of such contributions. Such contributions are referred to as missed deferral opportunity or missed opportunity for making after-tax employee contributions.

For *safe harbor* §401(k) plans, the correction for eligible employees who were excluded from elective deferrals is slightly different. For plans that use the 3% non-elective contribution, the missed deferral is deemed to be 3% of compensation. Thus, the QNEC for the missed opportunity cost is 50% of 3% of compensation. In addition, if the 3% safe harbor contribution was not made on behalf of the employee, an additional QNEC of 3% must also be made. For example, if a NHCE participant with \$30,000 in salary was erroneously excluded from participation, the employer would be required to make a QNEC equal to 50% of [3% × \$30,000], or \$450. If applicable, a QNEC for the 3% safe harbor contribution of \$900 may also have to be made [3% × \$30,000].¹¹⁵

For plans that use a matching contribution of 100% of the first 3% of compensation plus 50% of the next

¹¹⁴ See slide 30 in the IRS’s PowerPoint presentation, available at http://www.irs.gov/pub/irs-tege/epcrs_presentation.pdf.

¹¹⁵ See *id.*, slide 31.

2% of compensation, the missed deferral is deemed to be the greater of: (1) 3% of compensation, or (2) the maximum deferral percentage for which the employer provided a matching contribution rate that is at least as favorable as 100% of the elective deferrals made by the employee.¹¹⁶ In addition, if the employer matching contribution was not made, a QNEC equal to the matching contribution that would have been received if the employee had made the deemed §401(k) deferral must be made.

For example, if a NHCE participant with \$30,000 in salary was erroneously excluded from participation and the plan provides a match equal to 100% of the first 3% of compensation and 50% of the next 2% of compensation, the employer would be required to make a QNEC equal to 50% of [3% × \$30,000], or \$450. If applicable, a QNEC for the matching contribution of \$900, or [3% × \$30,000] may also have to be made.¹¹⁷ If a NHCE participant with \$30,000 in salary was erroneously excluded from participation and the plan provides a match equal to 100% of the first 4% of compensation, the employer would be required to make a QNEC equal to 50% of [4% × \$30,000], or \$600. If applicable, a QNEC for the matching contribution of \$1,200, or [4% × \$30,000] may also have to be made.¹¹⁸

The above correction method is not necessarily applicable for correction of qualification failures relating to failures to permit eligible employees to make Roth §401(k) contributions or to any other failure (e.g., improper exclusion from salary reduction contributions under a §403(b) plan or ADP/ACP testing failures). For example, if the employee made an election to defer 10% of compensation but only 8% of compensation was deferred, restoring the participant to the position he/she should have been in may require the correct elective deferral (10%) to be honored, requiring a QNEC for the additional 2% of compensation. However, the IRS certainly offers the ability to present alternative corrective methods under EPCRS.

Failure to Obtain Required Spousal Consent

Rev. Proc. 2006-27 also sets forth an additional correction method for failure to obtain the required spousal consent under §§401(a)(11), 411(a)(11) and 417. If a distribution was made without the necessary spousal consent, EPCRS recognizes that consent may be given retroactively. However, as it is unlikely that the spouse will provide such consent, the plan is still required to provide the survivor portion of the QJSA after the participant's death. Under the 2003 revenue procedure, the plan could commence payment of the

QJSA upon the participant's death (with the participant's portion of the QJSA offset by payments already made).¹¹⁹ The 2006 revenue procedure provides the plan with the alternative of providing the spouse with a lump sum equivalent to the actuarial value of the survivor benefit.¹²⁰ This avoids the problem of waiting and seeing whether the spouse later claims a spousal benefit. It also eliminates the plan's liability for the survivor annuity benefit.

Retroactive Plan Amendments for Plan Loans

Rev. Proc. 2006-27 also provides that retroactive plan amendments may be made if plan loans are made but not authorized under the terms of the plan. Such loans must comply with the Code requirements in order to retain the plan's qualification status. For example, if a plan loan is made for \$10,000 over a six-year repayment schedule and the defect is discovered in year two, the loan may be reamortized and repaid over the next three-year period (consistent with the §72(p)(2)(B) five-year required repayment schedule) and comply with the qualification rules.

Correction of Failures of the ADP, ACP and/or Multiple Use Tests

Rev. Proc. 2003-44 provided two correction methods for §401(k) plans that failed §401(k)(3) (ADP test), §401(m)(2) (ACP test), and for plan years beginning before December 31, 2001, §401(m)(9) (multiple use test) (i.e., the special nondiscrimination tests applicable under §401(k) and (m)). Under the 2003 revenue procedure, both methods permitted QNEC contributions to be made on behalf of NHCEs, allocated *either* on a pro rata basis (based on compensation) or per capita basis (equal amount for each eligible NHCE).¹²¹ In December 2004, the §401(k) final regulations eliminated the use of disproportionate QNECs to correct ADP failures¹²² or ACP failures.¹²³ Thus, Rev. Proc. 2006-27 updated EPCRS to eliminate the per capita method of allocation under both of these correction methods.¹²⁴

AUDIT CAP

The third door by which a plan sponsor may correct disqualifying defects is actually a "trap door" in which the plan sponsor finds itself once the plan is "under examination." The Service provides a closing

¹¹⁶ See Rev. Proc. 2006-27, at App. A, §.05(2)(c).

¹¹⁷ See slide 35 in the IRS's PowerPoint presentation.

¹¹⁸ See *id.*, slide 36.

¹¹⁹ See Rev. Proc. 2003-44, §6.04, and App. A, §.07.

¹²⁰ See Rev. Proc. 2006-27, at App. A, §.07.

¹²¹ See Rev. Proc. 2003-44, at App. B, §2.01(1)(b).

¹²² See Regs. §1.401(k)-2(a)(6)(iv).

¹²³ See Regs. §1.401(m)-2(a)(6)(v).

¹²⁴ See Rev. Proc. 2006-27, at App. A, §.03, and App. B, §2.01(1)(b).

agreement program (Audit CAP) for plans under examination to correct uncovered failures or risk plan disqualification. All types of qualification failures may be corrected under this program: plan document failures, operational failures, demographic failures and employer eligibility failures. Defects relating to the misuse or diversion of plan assets and ATATs may not be corrected through this program. Unfortunately, plan sponsors that refuse to accept correction under Audit CAP are faced with the penalties of plan disqualification.

Under Audit CAP, because the plan sponsor did not take advantage of VCP, the fixed fee schedule of VCP is no longer available. Instead, the Service negotiates a sanction as a percentage of the maximum payment amount (MPA) that could be assessed if the plan were disqualified.¹²⁵ The MPA equals the tax the Service would collect upon disqualification due to the following:

- sum of the tax on realized trust earnings for all open years;
- income tax on the employer's disallowed deductions for the non-vested allocation of employer contributions;
- income tax on the vested allocations to participants' accounts under the plan; and
- any other tax resulting from a qualification failure that would apply if not for the EPCRS correction.¹²⁶

In fashioning the actual sanction, the percentage applied to this MPA is dependent upon a variety of different factors:

- whether the plan sponsor had steps in place to ensure that the plan had no failures;
- whether the plan sponsor's steps identified failures that may have occurred;
- the extent to which correction had progressed prior to the audit;
- the amount of fees that the plan sponsor would have paid under VCP;
- the number and type of employees affected by the failure;
- the number of NHCEs that would be affected if the plan were disqualified;

¹²⁵ See *id.* at §14.01.

¹²⁶ See *id.* at §5.01(5). In the context of failures attributable to transferred assets identified within the correction period, the maximum payment amount is determined solely upon the taxes that would have resulted had the portion of the plan with the transferred assets had been disqualified. See *id.* at §14.03.

- whether the failure is of the type under §§401(a)(4), 410(a)(26) or 410(b) (or 403(b)(12) for §403(b) plans);
- the period of time over which the failure occurred; and
- the reason for the failure.¹²⁷

Under Rev. Proc. 2001-17, the sanction fee was to bear a reasonable relationship to the nature, extent and severity of the qualification defect.¹²⁸ This requirement has now been eliminated, signaling a shift towards a sanction more in line with the VCP correction fee amount. Practitioners negotiating for a given correction method during Audit CAP should be cognizant of negotiating a less restrictive fee for their client. Depending on the types of failures uncovered during an audit, the plan sponsor may be required to obtain a favorable determination letter and/or establish administrative practices and procedures.¹²⁹

Audit CAP should result in a closing agreement after full correction and the payment of the sanction fee has been made.¹³⁰ Such an agreement binds the plan sponsor and the Service regarding the tax matters identified in the agreement.¹³¹

THE NEW DETERMINATION LETTER PROGRAM

As the Service updated its determination letter program in 2005, EPCRS was redesigned to dovetail with it. The determination letter program was reconfigured to smooth out the peaks and valleys for submission of determination letter applications for qualified plans.¹³² Unlike the prior model, the new determination letter model is designed to have sponsors make necessary plan amendments according to the legislative or regulatory effective date in a more timely fashion, even if such amendments (i.e., referred to as "interim plan amendments") would not be reviewed for determination letter status until a later date. For EPCRS purposes, the necessity of more timely amendments should reduce the number of operational failures, provided the amendments are actually made. Under the new determination letter program, a determination letter obtained during the appropriate cycle will cover all plan amendments made since the last cycle.

¹²⁷ See *id.* at §14.02.

¹²⁸ See Rev. Proc. 2001-17, §14.01.

¹²⁹ See Rev. Proc. 2006-27, §13.03.

¹³⁰ See *id.* at §13.02.

¹³¹ See *id.* at §13.05.

¹³² See Announcement 2001-83, 2001-2 C.B. 205, and Announcement 2003-32, 2003-1 C.B. 933.

Under the new determination program, each plan has its own remedial amendment cycle (RAC) (i.e., timeline for submission of initial and subsequent determination letters). The new system establishes a variety of staggered remedial amendment cycles for qualified plans, as follows:¹³³

- A five-year cycle (Cycle A–E) for individually-designed plans, in which the determination letter application is submitted based on the last digit of the plan sponsor’s Employer’s Identification Number (EIN), and
- A six-year cycle for pre-approved plans (such as master and prototypes and volume submitter plans). Pre-approved defined contribution plans will have a different six-year RAC than pre-approved defined benefit plans.

For individually-designed plans, a plan’s initial EGTRRA and subsequent remedial amendment periods (RAPs) vary according to the last digit of the plan sponsor’s EIN, and the determination letter filing period is the last twelve months of the cycle, running from February 1 to January 31:¹³⁴

Last digit of EIN	Cycle	Initial RAP ends	Next RAP ends
1 or 6	A	1/31/07	1/31/12
2 or 7	B	1/31/08	1/31/13
3 or 8	C	1/30/99	1/31/14
4 or 9	D	1/29/10	1/30/15
5 or 0	E	1/31/11	1/29/16

For example, for a Cycle A plan, January 31, 2007, is the last day of the EGTRRA remedial amendment period. The plan sponsor of this Cycle A plan will file for a determination letter between February 1, 2006, and January 31, 2007. The Service will review the Cycle A plan based on the 2005 Cumulative List of Changes in Plan Qualification Requirements.¹³⁵

During “off-cycles,” employers may file their plans for a determination letter, but such applications will

not be reviewed until all submitted “on-cycle” applications are complete. When processed, the Service will only consider changes on the last Cumulative List published before the filing in its “off-cycle” review.¹³⁶ To guarantee that all cumulative changes applicable to a plan’s next cycle are considered, the employer may have to resubmit for another determination letter as of its next “on-cycle” deadline.¹³⁷

For pre-approved plans, a six-year cycle applies. If an employer is a prior adopter, new adopter, intended adopter or an adopter of a replacement prototype or volume submitter plan and the sponsor/practitioner timely submits an opinion or advisory letter, it has a six-year cycle.¹³⁸ The initial cycle for pre-approved plans was February 16, 2005, for defined contribution plans and January 31, 2007, for defined benefit plans.¹³⁹ Cycles then vary for new adopters, intended adopters or adopters of replacement plans.

Under the new determination letter program, there is a distinction between the time in which disqualifying versus discretionary plan provisions must be made. Disqualifying provisions include a provision of a new plan or absence of a provision in a new plan or an amendment to an existing plan that causes the plan to fail the qualification requirements. For this purpose, such provisions include those which, in the IRS’s discretion, are deemed integral to the qualification requirements of the Code.¹⁴⁰ Disqualifying plan amendments must be made by the end of the plan’s applicable remedial amendment period,¹⁴¹ otherwise, there is a nonamender or late-amender failure. In contrast, discretionary plan amendments must be adopted by the end of the plan year in which the amendment is effective. EPCRS has also been extended to correct qualified plans that have failed to make timely good faith EGTRRA amendments, amendments relating to the final and temporary §401(a)(9) regulations, and interim amendments as provided in §5 of Rev. Proc. 2005-66.¹⁴²

Under Rev. Proc. 2003-44, sponsors making plan amendments to correct qualifying defects or to conform the plan’s operation to the qualification require-

in Notice 2005-101, 2005-52 I.R.B. 1219.

¹³⁶ Rev. Proc. 2005-66, §3.04.

¹³⁷ *Id.*

¹³⁸ *See id.* at §§17.01 – 17.05.

¹³⁹ *See id.* at §17.02.

¹⁴⁰ *See id.* at §2.02.

¹⁴¹ The remedial amendment period is the period during which a plan may be amended retroactively to comply with the Code’s qualification requirements. *See* Regs. §1.401(b)-1 for the disqualifying provisions that may be amended retroactively and the remedial amendment period during which retroactive amendments may be adopted.

¹⁴² *See* Rev. Proc. 2006-27, §4.06.

¹³³ *See generally* Rev. Proc. 2005-66, §6.01.

¹³⁴ *See id.* at §9.03.

¹³⁵ *See id.* at §3.04. Cumulative Lists are expected to be published annually, usually around mid-November. They are intended to identify all changes in the qualification requirements resulting from statutory, regulatory or other changes in guidance published in the Internal Revenue Bulletin that are required to be taken into account in the written plan document for an upcoming cycle. *See* Employee Plans Determination Quality Assurance Bulletin, FY-2006 No. 2 (Jan. 23, 2006). The 2005 Cumulative List appeared

ments were permitted to submit such amendments for an updated determination letter.¹⁴³ If this process were to continue, it would permit sponsors to accelerate attainment of a determination letter by simply using EPCRS, instead of relying on the new five-year or six-year cycles. To discourage this “off-cycle” filing, Rev. Proc. 2006-27 revised the contexts in which a determination letter would be issued in connection with a correction.

Under the SCP, a plan sponsor that corrects an operational failure through a plan amendment must request a determination letter with respect to such plan amendment.¹⁴⁴ If this determination letter request is “off-cycle,” the plan sponsor will simply have to wait until the “on-cycle” applications have been processed. Other corrective amendments may be submitted during the employer’s next remedial amendment cycle.¹⁴⁵ VCP and Audit CAP closing agreements will result in a determination letter *only* in the following situations: (1) the defect includes a document failure for which the remedial amendment period has expired;¹⁴⁶ (2) the year of the VCP submission is one in which an “on-cycle” determination application may be submitted;¹⁴⁷ (3) the plan is terminating (and therefore is deemed to be “on-cycle”); or (4) the IRS decides that the plan should obtain a determination let-

¹⁴³ See Rev. Proc. 2003-44, §10.06. If a determination letter was not required, the compliance statement did not constitute a determination that the plan amendment satisfied the requirement of §401(a) (even though the IRS approved the amendment as part of the correction).

¹⁴⁴ See Rev. Proc. 2006-27, §4.06(2). The determination letter application must be submitted before the end of the plan’s applicable remedial amendment period and the amendment should be identified as such in the cover letter.

¹⁴⁵ See Rev. Proc. 2005-66, §6.

¹⁴⁶ See Rev. Proc. 2006-27, §4.06 (this does *not* include failure to make good faith timely amendments for EGTRRA, for the final and temporary regulations under §401(a)(9), and interim amendments as provided under §5 of Rev. Proc. 2005-66).

¹⁴⁷ The IRS has informally stated that a determination letter for a VCP submission of an “on-cycle” plan will consider all amendments made to the plan since the last cycle, as opposed to requiring the plan sponsor to submit a separate determination letter request.

ter immediately.¹⁴⁸ Otherwise, the sponsor should submit plan amendments during its appropriate remedial amendment cycle. If no determination letter is issued in connection with the VCP submission, the compliance statement will state that the plan sponsor may rely on the corrective amendment.¹⁴⁹

EFFECTIVE DATE AND CONCLUSION

The effective date of Rev. Proc. 2006-27 is September 1, 2006. However, plan sponsors are permitted to apply certain provisions of Rev. Proc. 2006-27 on or after May 30, 2006,¹⁵⁰ but other provisions of the revenue procedure are available only after the effective date.¹⁵¹

Due to the cumulative changes reflected in Rev. Proc. 2006-27, EPCRS’ 2006 makeover continues to be a welcome breath of fresh air for qualified plans.¹⁵² Although the 2006 revenue procedure was late in delivery, it certainly affirmed the IRS’s welcome goal to make plan qualification corrections more available and more cost-effective. Practitioners should encourage plan sponsors and plan administrators to conduct internal audits, not only to self-correct ongoing failures, but also to eliminate the potential for future failures. *This is simply “best practices” for the ongoing maintenance of a qualified plan.* Just as we take for granted the submission of a determination letter for approval of the plan document, use of the IRS’s correction program simply makes sense to keep the plan in compliance during operation.

¹⁴⁸ See Rev. Proc. 2006-27, §4.06.

¹⁴⁹ *Id.*

¹⁵⁰ Plan sponsors utilizing the changes in Rev. Proc. 2006-27 before the Sept. 1, 2006 effective date are required to sign a penalty of perjury statement that they have not engaged in any ATATs.

¹⁵¹ See *id.* at §16. Specifically, only §§11.11 (acknowledgement letter), 11.14 (assembling the submission), and 14.04 (fees for nonamenders discovered during the determination letter process) are effective May 30, 2006. *Id.*

¹⁵² The Service has requested comments on how to correct the following types of failures under EPCRS: §414(v) catch-up contributions; designated Roth contributions in §§401(k) and 403(b) plans; and applicable correction methods for excess annual additions now in Regs. §1.415-6(b)(6). See *id.* at §2.02(2).

APPENDIX 1

For VCP, the Voluntary Compliance Staff members are as follows:

<u>Name/Title</u>	<u>Phone/Fax</u>	<u>Location</u>
Joyce Kahn Program Manager	614.208.8737 614.280.8614 (fax)	Columbus, Ohio
Beverly Thomas VC Tax Law Specialist	202.283.9601 202.283.9598 (fax)	Washington, D.C.
Maxine Terry Program Coordinator	202.283.9644 202.283.9598 (fax)	Washington, D.C.
Louis Leslie Program Coordinator	202.283.9612 202.283.9598 (fax)	Washington, D.C.
Keith Ruprecht Program Coordinator	214.413.5526 214.413.5507 (fax)	Dallas, TX
Avaneesh Bhagat Program Coordinator	949.389.4420 949.389.5017 (fax)	24000 Avila Rd., MS 3000 Laguna Niguel, CA
Wanda Wims Program Assistant	202.283.9707 202.283.9598 (fax)	Washington, D.C.

The various VC Group Managers are as follows:

<u>Name/Title</u>	<u>Phone/Fax</u>	<u>Location</u>	<u>Area</u>
Janet Mak	718.488.2383 718.488.2405 (fax)	VC 7551 10 Metrotech Center 625 Fulton Station Brooklyn, NY	Northeast & Mid-Atlantic Areas ¹
Gary Mitchell	312.566.4478* 312.566.3941 (fax) 812.471.6603 812.471.6617 (fax) *Gary's primary office is in the Evansville, IN, Post- of-Duty	VC 7552 230 S. Dearborn Rm. 1720 (Evansville, IN) Chicago, IL 60604	Great Lakes ²
Bill Bond	214.413.5526 214.413.5507 (fax)	VC 7553 1100 Commerce St. Dallas, TX	Gulf Coast ³

¹ These areas include Pennsylvania, New Jersey, Delaware, Maryland, Virginia, North Carolina, South Carolina, New York, Vermont, New Hampshire, Massachusetts, Connecticut, Rhode Island and Maine.

² This area includes Wisconsin, Illinois, Michigan, Indiana, Kentucky, Ohio and West Virginia.

³ This area includes Oklahoma, Texas, Arkansas, Louisiana, Tennessee, Mississippi, Alabama, Georgia and Florida.

John Sechini	623.312.3628 (ext.5080) 626.312.5061 (fax)	VC 7554 9350 E. Flair Dr. El Monte, CA 91731	Pacific Coast & Central Mts. ⁴
--------------	--	--	--

The various VC Coordinators are as follows:

Scott Feldman	718.488.2255 718.488.2405 (fax)	VC 7551 10 Metrotech Center 625 Fulton St. Brooklyn, NY 11201	Northeast & Mid-Atlantic
Al Dorevitch	312.566.3833 312.566.3941 (fax)	VC 7552 230 S. Dearborn St. Rm. 1720 Chicago, IL 60604	Great Lakes
William Kerr	214.413.5508 214.413.5507 (fax)	VC 7553 1100 Commerce St. Dallas, TX 75242	Gulf Coast
Paul Hogan	206.220.6085 206.220.6071 (fax)	VC 7554 915 Second Ave. Seattle, WA 98174	Pacific Coast & Central Mts.

For SCP and Audit CAP, the various Area Coordinators are as follows:

Beth Levine	954.423.7466 954.423.7477	EP 7646 SW 6th Court, Room 306 Plantation, FL 33324	Gulf Coast
Stanley Pustulka	716.961.4322 716.961.5375	EP 7601 111 W. Huron St. Room 1434 Buffalo, NY 14201	Northeast
George Brim	215.656.7700 (ext. 537) 215.861.1038	1606 Market St. Philadelphia, PA 19103	Mid Atlantic
Carron Newby	312.566.3826 312.566.3951	230 S. Dearborn MC 4913CHI Chicago, IL 60604	Great Lakes
Theresa Parsons	636.940.6309	1122 Town & Country Commons Chesterfield, MO 63017-8293	Central Mts.
Kevin Masushige	626.312.2933 (ext. 5088) 626.312.2928 (fax)	9350 E. Flair Dr. El Monte, CA 91731	Pacific Coast
Frederick Parker	513.263.3410 513.263.3413	550 Main St. Cincinnati, OH 45201	EP Determinations

⁴ These areas include Alaska, Hawaii, Washington, Oregon, California, Idaho, Nevada, Montana, Wyoming, Utah, Arizona, Colorado, New Mexico, North Dakota, South Dakota, Nebraska, Kansas, Minnesota, Iowa, and Missouri.

APPENDIX 2

Appendix A of Rev. Proc. 2006-27 covers most correction defects, prescribing model correction methods for such defects. Appendix B expands the list of defects and correction methods. Such failures and correction methods are as follows:

1. Failure to make the minimum top-heavy allocation/benefit: The employer must contribute and allocate the make-up top-heavy contribution (for defined contribution plans) or the make-up top-heavy benefit (for defined benefit plans) for non-key employees (and any other employees required under the plan) to receive the top-heavy allocation.¹
2. Failure to pass the §401(k)(3) (ADP test), the §401(m)(2) (ACP test),² or the §401(m)(9) (multiple use test)³ required for passing the special nondiscrimination rules applicable under §401(k) and (m) and to correct within the prescribed 12-month correction period:

- a. QNEC correction method: Under the correction method specified in Appendix A, the employer must contribute QNECs (qualified nonelective contributions) for *all* eligible NHCEs (in accordance with §415) to raise the ADP or ACP of the NHCEs so as to satisfy the tests.⁴ This allocation is not done in accordance with the terms of the plan but, instead, in conformity with the terms of the revenue procedure. QNECs must be given to all eligible NHCEs and must now be a flat percentage of compensation amount for eligible NHCEs. Rev. Proc. 2003-44 permitted QNECs to be determined as a flat dollar amount (i.e., per capita allocation) for NHCEs (usually cheaper than a flat percentage of compensation

allocation).⁵ The QNEC is considered an annual addition for §415 purposes in the year it was contributed, not the year the test was failed. Such QNECs need not be matched.

Example: ADP test is failed. Based on the applicable percentages used in the testing, \$25,000 in QNECs must be contributed and allocated to NHCEs in order to pass the ADP test. [*Note:* correction of the ADP test could also been made by distribution of the excess contributions, such as \$10,000, to the HCEs within 12 months after the close of the plan year of failure.⁶]

- b. One-to-one correction method: Under the alternative correction method specified in Appendix B, the Service permits a one-to-one correction method to satisfy this failure. Such method may be cheaper for the employer and thus worth considering. Under this method, the excess ADP amount and vested excess ACP amount for each HCE is distributed (including earnings), and the plan forfeits any nonvested excess ACP amounts and related match contributions.⁷ The employer then contributes as a QNEC (including earnings) in the *same amount* (excluding the amount of the forfeited match) to a smaller group of eligible NHCEs. So, in the above example, if \$10,000 in corrective distributions is made to HCEs, QNECs in the amount of \$10,000 may be made under the one-to-one correction method. In this example, correction of \$10,000 is preferable to the \$25,000 amount necessary under the method proposed in Appendix A. Rev. Proc. 2006-27 eliminated the option of a per capita allocation of contributions, which is consistent with the 2004 final §401(k) regulations which state that disproportionate contributions may not be taken into account for purposes of satisfying the ADP test or the ACP test.⁸

3. Failure to distribute timely elective deferrals in excess of the §402(g) limit (i.e., the

¹ See Rev. Proc. 2006-27, App. A, §.02.

² Regs. §1.401(m)-2(b)(4)(ii) allows the plan sponsor to contribute QNECs by the end of the 12-month period after the plan year in which the test is failed. Often, this additional 12-month period is not sufficient to correct the failed test(s) because of the amount of data needed to make the correction.

³ Note that §666(a) of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), P.L. 107-16, eliminated the multiple use test, effective for years beginning after Dec. 31, 2001.

⁴ See Rev. Proc. 2006-27, App. A, §.03.

⁵ See Rev. Proc. 2003-44, App. A, §.03.

⁶ See Regs. §1.401(m)-2(b)(4)(ii).

⁷ See Rev. Proc. 2006-27, App. B, §2.01(1)(b).

⁸ See Regs. §§1.401(k)-2(a)(6)(iv) and 1.401(m)-2(a)(6)(v).

annual dollar limit applicable to elective §401(k) deferrals): The employer must distribute the excess amount and report such amount as taxable income in the year of distribution (even though the excess deferral already was taxable in the year of contribution).⁹

4. Exclusion of an eligible employee from plan participation under the plan's eligibility requirements: The employer must contribute the appropriate employer allocation in the case of a defined contribution plan, and a QNEC if the plan denied eligibility under a §401(k) plan, as well as any required matching contribution.¹⁰ Such QNEC may be determined as the ADP for the employee's group (either HCE or NHCE).¹¹

Appendix B Rev. Proc. 2006-27 clarifies the correction methods in the context of a profit-sharing, stock bonus or §401(k) or (m) plan.

- (1) For §401(k) or (m) plans, Appendix B in states that the make-up contribution for the excluded employee is based on the ADP or ACP for the employee's applicable group (NHCE or HCE) multiplied by 50% of the employee's compensation during the excluded period.¹² (Use of the average rate of the applicable NHCE or HCE group negates the necessity of re-running the ADP and ACP tests.) Such amount may be reduced by the amount actually deferred or matched by the employee. In the case of a partial year exclusion, the employer may use prorated compensation (as opposed to actual compensation during the excluded period).¹³ Appendix B provides an exception if an employee was improperly excluded for three months or less during a plan year but was provided the opportunity during the remaining months of the plan year to defer the maximum amount;

in such case, a QNEC need not be made for the excluded months, but the employer must make up any ACP (matching and after-tax) amounts.¹⁴

Example: Employee A (a NHCE) was eligible for participation as of July 1, 2001, but not included until January 1, 2002. A QNEC based on 50% of the average rate of NHCE deferrals must be made for A, prorated for the time period that A was excluded, including any full match and earnings.

For employees excluded from making after-tax contributions, Appendix B in Rev. Proc. 2006-27 states that the make-up contribution for the excluded employee is based on the ACP for the employee's applicable group (NHCE or HCE) multiplied by 40% of the employee's compensation during the excluded.¹⁵ The IRS Power-Point presentation notes that the employer can separately determine the ACP attributable to after-tax contributions and use that percentage to determine the missed after-tax contributions.

- (2) For profit-sharing or stock bonus plans, Appendix B provides a "reallocation method" as an alternative correction method.¹⁶ This method assumes that the employer intended to make a given contribution to be allocated among all eligible employees, but the original allocation was incorrect because all eligible employees had not been considered. Thus, the proper amount may be redetermined for each eligible employee's account, realizing that this will increase the accounts of the excludible employees and decrease the accounts of the includible employees. The model correction requires that the make-up contribution be based on the allocations provided to all other employees under the plan formula, taking into account all relevant facts for the excluded employees, but the accounts of the other employees are not adjusted.

⁹ See Rev. Proc. 2006-27, App. A, §.04.

¹⁰ See *id.* at App. A, §.05.

¹¹ See *id.* By using the actual ADP rate for the applicable group (HCE or NHCE) as the basis of the corrective QNEC, the employer does not have to rerun the ADP or ACP test to account for previously excluded employees.

¹² See *id.* at App. B, §2.02(1)(a)(ii)(B).

¹³ See *id.* at App. B, §2.02(1)(a)(ii)(E).

¹⁴ See *id.* at App. B, §2.02(1)(a)(ii)(F).

¹⁵ See *id.* at App. B, §2.02(1)(a)(ii)(C).

¹⁶ See *id.* at App. B, §2.02(2)(iii).

Example: The employer contributes \$250,000, which resulted in an allocation of 10% for eligible employees. It was discovered that certain employees had been inadvertently excluded from participation. Once the \$250,000 is reallocated according to all eligible employees, 9.75% is allocated to each participant's account. Those employees that had 10% allocated will now reflect a 9.75% allocation; the excluded employees will now receive a 9.75% allocation.

5. Failure to make timely required minimum distribution under §401(a)(9): The employer is required to distribute the required minimum distribution amounts for all prior years.¹⁷
6. Failure to obtain participant and spousal consent as required under §§401(a)(11), 411(a)(11) and 417: If a non-QJSA distribution was made without the necessary spousal consent, EPCRS recognizes that consent may be given retroactively. However, that is unlikely, as the spouse has no incentive to provide such consent if the plan is required, in absence of the consent, to provide the survivor portion of the QJSA after the participant's death. Under the 2003 revenue procedure, the plan could commence payment of the QJSA (with the participant's portion of the QJSA offset by payments already made).¹⁸ If the spouse did not consent to the QJSA, the spousal portion would become payable to the spouse when he/she became entitled to the benefit. Rev. Proc. 2006-27 provides the plan with the alternative of providing the spouse with a lump sum equivalent to the actuarial value of the survivor benefit.¹⁹ This avoids the problem of waiting and seeing whether the spouse later claims a spousal benefit.
7. Failure to limit the annual additions (other than elective deferrals and employee contributions) allocated under a *defined contribution* plan in compliance with §415: The model correction method under Appendix A requires the employer to place such excess amounts in an unallocated suspense account; such account must be allocated to all plan participants as an employer contri-

bution in succeeding years.²⁰ If *elective* deferrals created the excess annual addition, the correction method is then to distribute such excess to the individual participant and to forfeit any match related to the excess portion. The excess portion is taxable to the participant in the year of distribution.

- a. Appendix B provides two alternative correction methods, applicable in different fact situations. If a §415 excess amount attributable to matching or nonelective contributions has been returned to the employee, Appendix B provides a "return of overpayment" method.²¹ This method requires the employer to take reasonable steps to return the amount of the overpayment (plus earnings), and if such amount is not returned, the employer must contribute the difference. The employer is required to notify the employees of the applicable tax treatment of the overpayment amount.
 - b. If a §415 failure occurs with respect to certain NHCEs who have terminated employment, Appendix B provides an alternate "forfeiture" correction method.²² If the NHCE has a §415 excess and made elective deferrals and received a match or nonelective contributions (but was 0% vested in the latter), the §415 excess may be considered to consist solely of the matching and nonelective contributions. The excess adjusted for earnings is forfeited and used to reduce future employer contributions is or reallocated according to the terms of the plan.
8. Failure to satisfy §415 for *defined benefit* plans: Appendix B provides two correction methods that may be used to correct an excess benefit payment.
 - a. The "return of overpayment" correction method directs the plan sponsor to have the employee return the overpayment (i.e., the portion in excess of the §415(b) limit), adjusted for earnings at the plan's earnings rate.²³ If the employee returns less than is required,

¹⁷ See *id.* at App. A, §.06.

¹⁸ See Rev. Proc. 2003-44, §6.04, and App. A, §.07.

¹⁹ See Rev. Proc. 2006-27, at App. A, §.07.

²⁰ See *id.* at App. A, §.08.

²¹ See *id.* at App. B, §2.04(2)(a)(iii).

²² See *id.* at App. B, §2.04(2)(a)(ii).

²³ See *id.* at App. B, §2.04(1)(a)(i).

the plan sponsor or “another person” must make up the difference. Also, the employee must be notified that the overpayment was not eligible for favorable tax treatment (e.g., tax-free rollover). This method must be used if the employee has no remaining plan benefits which could be used to offset the excess amount.²⁴

- b. Alternatively, there is an “adjustment to future payments” method that may be used if benefits are being distributed as periodic payments.²⁵ This method permits future payments to be reduced over the remaining payment period by the actuarial equivalence of the overpayment plus earnings. Such adjustment may not result in the reduction of any surviving spouse’s joint and survivor benefits; thus, it must be returned over the employee’s lifetime benefit.²⁶
9. Vesting failures: If an employee is not credited with the sufficient vesting percentage, the employer is permitted to use either the “contribution correction” method or the “reallocation” method for correction.²⁷ The contribution correction method requires the employer to contribute the improperly forfeited amount, but no adjustment is made to the other participants sharing in the original improper forfeiture.²⁸ The reallocation method adjusts a variety of accounts, increasing the accounts of those who suffered an improper forfeiture (plus earnings) and decreasing the accounts of other participants to the amount they would have received had the error not occurred.²⁹
10. Section 401(a)(17) failures: A defined contribution plan that allocated contributions or forfeitures on the basis of compensation that was in excess of the annual dollar limit under §401(a)(17) must be corrected under a “reduction of account balance” correction method.³⁰ The excess amount allocated to the affected employ-

ee’s account must be reduced (along with earnings). Where this excess portion goes depends on whether the plan has a fixed or discretionary employer contribution formula. If the employer contribution formula is fixed, the excess amount is placed in an unallocated suspense account to be used to reduce future employer contributions.³¹ If the employer contribution formula is discretionary, the excess amount is reallocated to other participants according to the plan’s allocation formula.³²

11. Correction by plan amendment: Appendix B provides retroactive plan amendments as correction methods for four specific failures: failures for allocation in violation of §401(a)(17); hardship distributions made without authorizing plan document language; inclusion of ineligible employees; and plan loans being made without authorizing plan document language.
- a. Section 401(a)(17) failures: Although Rev. Proc. 2006-27 envisions a “reduction of account balance” as a valid correction method, Appendix B provides an additional correction in which the plan sponsor may contribute an additional amount for all other participants. Such correction requires a retroactive plan amendment which is permitted under the revenue procedure.³³
- b. Hardship distribution failures: If hardship distributions have been made under a plan even though the plan document never envisioned such distributions, Appendix B permits a retroactive plan amendment to permit such hardship withdrawals.³⁴
- c. Inclusion of ineligible employee failures: If the plan administration disregarded the plan’s eligibility requirements and allowed premature eligibility for employees, Appendix B permits a retroactive plan amendment to change the eligibility or entry date provisions to reflect the plan’s actual operations.³⁵
- d. Plan loan failures: If plan loans to participants have been made under a plan

²⁴ See *id.*

²⁵ See *id.* at App. B, §2.04(1)(a)(ii)(A).

²⁶ See *id.* at App. B, §2.04(a)(a)(ii)(B).

²⁷ See *id.* at App. B, §2.03.

²⁸ See *id.* at App. B, §2.03(1)(a).

²⁹ See *id.* at App. B, §2.03(1)(b).

³⁰ See *id.* at App. B, §2.06(1).

³¹ See *id.*

³² See *id.*

³³ See *id.* at App. B, §2.07(1)(a).

³⁴ See *id.* at App. B, §2.07(2)(a).

³⁵ See *id.* at App. B, §2.07(3)(a).

even though the plan document never envisioned such loans, Appendix B permits a retroactive plan amendment to permit such plan loans in certain situations.³⁶ The IRS's PowerPoint presentation provides three examples of plan loan failures that can be corrected:

- *Example 1:* Participant borrows \$60,000 and the violation is discovered two years later. Correction requires the participant to repay the \$10,000 excess; the remaining loan balance is reamortized over the remaining life of the original loan; and the prior loan payments attributable to the \$10,000 excess can be applied to interest on the excess if the participant pays only the \$10,000 or can be applied to the remaining loan balance if the \$10,000 excess plus interest is repaid.³⁷
- *Example 2:* Participant borrows \$10,000 over six years instead of the required five-year period and the violation is discovered two years later. Correction requires

the loan to be reamortized over the remaining three-year period of the loan. *Note:* this correction is not available if the statutory term of the loan has expired (e.g., violation is discovered in year six).³⁸

- *Example 3:* Participant borrows \$10,000 over a five-year period but loan repayments never began and the violation is discovered two years later. The correction provides three options: (1) the participant can make a lump-sum payment (including interest) to bring the loan current and continue payments under the old payment schedule; (2) the loan may be reamortized over the remaining life of the original loan term; or (3) any combination of (1) or (2).³⁹

12. Earnings and forfeiture adjustments: As various of the above correction methods require adjustments for earnings and forfeitures, Appendix B affords approval of various earnings adjustment methods (but not forfeiture methods).⁴⁰

³⁶ See *id.* at App. B §2.07(2)(a).

³⁷ See slide 10 in the IRS's PowerPoint presentation.

³⁸ See slide 11, *id.*

³⁹ See slide 12, *id.*

⁴⁰ See Rev. Proc. 2006-27, at App. B, §3.01.

APPENDIX 3

Employee Plans Compliance Resolution System (EPCRS) Voluntary Compliance Program

Common Failures under Applicable Sections of the Internal Revenue Code and related Treasury Regulations

Basic Code Sections

- Exclusion of eligible employees — §§401(a)(3) & 410(a)
- Premature inclusion of eligible employees — §§401(a)(3) & 410(a)
- Participation/Coverage — §§401(a)(3) & 410(a)
- Inclusion of ineligible employees/individuals — §§401(a)(3) & 410(a)
- Vesting/benefit accrual — §§401(a)(7) & 411
- Required Distributions — §401(a)(9)
- Joint and Survivor Annuity — §§401(a)(11) & 417
- Timely QJSA notice to participants — §417
- QDRO requirements — §401(a)(13)(B)
- Commencement of Benefits — §401(a)(14)
- Contribution/benefit limitations — §§401(a)(16) & 415
- Compensation limits — §401(a)(17)
- Coverage — §401(a)(26)
- Eligible rollover distribution — §401(a)(31)
- §401(k) salary deferral limitation — §§401(a)(30) & 402(g)
- §401(k) hardship distributions — §401(k)(2) & Regs. §1.401(k)-1(d)(3)
- §401(k) ADP test — §§401(k)(3) & 401(a)(1) & Regs. §1.401-1(a)(2)
- §401(k) distribution requirements — §401(k)(10)
- §401(m) ACP test — §§401(m)(2) & 401(a)(1) & Regs. §1.401-1(a)(2)
- §401(m) multiple use test — §401(a)(1) & former §401(m)(9); Regs. §1.401-1(a)(2) & former Regs. §1.401(m)-2(b)
- Top-Heavy Plan Document Failure — §416

Related Specifically to Definite Written Plan

- Plan not operated in accordance with its written terms — §401(a)(1) & Regs. §1.401-1(a)(2)
- Error drafting plan document/amendment — §401(a)(1) & Regs. §1.401-1(a)(2)

Plan Document Failure other than a non/late-amender — §401(a)(1) & Regs. §1.401-1(a)(2)

No plan sponsor (orphaned plan) — §401(a)(1) & Regs. §1.401-1(a)(2)

Related to Non-Amenders/Late-Amenders — §401(a)

ERISA & subsequent legislation

TDR & subsequent legislation

TRA '86 & subsequent legislation

UCA & subsequent legislation

OBRA '93 & subsequent legislation

CRA & subsequent legislation

GUST I & subsequent legislation

GUST II & subsequent legislation

EGTRRA & subsequent legislation

Related to SEPs and SARSEPs

Participation requirements — §408(k)(2)

Prohibited participant withdrawals — §408(k)(4)

Written allocation formula — §408(k)(5)

Salary reduction arrangement — §408(k)

Related to §403(b) Plans

Employer Eligibility — §403(b)

Demographic failure — §403(b)

Excess amounts — §403(b)

Nontransferable annuity — §§403(b) & 401(g)

Annuity contract/custodial account — §§403(b)(1) & (7)

Salary deferral limitation — §§403(b)(1)(E) & 402(g)

Excess contributions — former §403(b)(2)

Distribution requirements — §403(b)(7) & (11)

Rollover requirements — §403(b)(8)

Distribution/incidental benefits — §§403(b)(10), 401(a)(9) & 401(a)(31)

Discrimination/participant compensation — §403(b)(12)(A)(i)

Universal availability — §403(b)(12)(A)(ii)

Related to ESOPs

Voting rights requirement — §§401(a)(22) & 409(e)

Put option/distribution — §§401(a)(23), 409(h) & 409(o)

Independent appraisal — §401(a)(28)(C)