

To Err Is Human, To Forgive Is Up to the IRS

Understanding Qualified Plan Failures &
How to Fix Them

May 19, 2021

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Roadmap

- Impact of Qualified Plan Failures
- Understanding the IRS Correction Programs
- Identifying and Correcting Common Failures under EPCRS
 - Eligibility
 - Plan Document
 - Contributions
 - Distributions
 - Plan Loans
 - Timely Deposits
- Best Practices

Impact of Qualified Plan Failures

- Qualified retirement plans provide tax advantages to both plan sponsors and plan participants
- To receive these advantages, plan sponsors must meet certain documentation and operational requirements as set out in the Code
- Failures that go uncorrected can result in plan disqualification (*i.e.*, loss of tax-advantaged status)
- Remember that no plan is error-free

IRS Correction Programs

- Employee Plans Compliance Resolution System (“EPCRS”)
 - Most recently updated April 19, 2019 in Revenue Procedure 2019-19
 - Available to plans satisfying the requirements of 401(a), 403(a), 403(b), 408(k), or 408(p)
- EPCRS is intended to encourage plan sponsors to identify and correct failures
- The IRS will not treat a plan as failing to meet the qualification requirements of the Code if the plan sponsor corrects using EPCRS
- EPCRS permits three approaches to correction
 - Self-Correction Program (“SCP”)
 - Voluntary Correction Program (“VCP”)
 - Audit Closing Agreement Program (“Audit CAP”)
- IRS also provides for voluntary closing agreements for failures that do not fit within EPCRS

EPCRS - General Correction Principles

- Full Correction for all Tax Years
 - Correct all affected participants and all affected tax years (not just open years)
- Restoration of Benefits
 - Restore the plan and participants to the same position they would have been in but for the failure
- Reasonable and Appropriate Correction
 - EPCRS sets out several pre-approved correction methods that are deemed reasonable and appropriate
- Consistency
 - If choosing among several correction methods, select the one most consistent with past practice
- Corrective Allocations and Earnings
 - Allocations made to correct a failure should come from employer contributions only
 - Corrective contributions, distributions, and allocations should be adjusted for earnings

Self-Correction Program – General

- Eligible plan sponsors can correct failures under SCP without involving the IRS
- Eligibility for SCP:
 - Only plan sponsors with established compliance practices and procedures may use SCP
 - Plans qualified under 401(a) or 403(b) are eligible for SCP
 - SEPs and SIMPLE IRAs are eligible for SCP but only with respect to insignificant operational failures
- No fee for SCP but no audit protection during correction
- Timing of corrections under SCP
 - In general, significant operational failures must be corrected by the last day of the second plan year following the plan year of the failure
 - Previously, a plan needed to have a favorable determination letter to correct a significant error via SCP but no longer required for most corrections
 - Insignificant operational failures can be corrected at any time

Self-Correction Program – Significance

- Determining Whether the Failure is Significant or Insignificant
- Facts and Circumstances Determination
- Factors to Determine Significance
 - Other failures during the same period
 - Percentage of plan assets and contributions involved
 - Number of years of the failure
 - Number of participants affected
 - Number of participants affected relative to the number that could have been affected
 - Timeliness of correction
 - Reason for the failure
- If the plan has multiple failures, the failures are eligible for SCP only if all of the failures are insignificant in the aggregate
- Revenue Procedure 2019-19

Voluntary Correction Program – General

- VCP allows plan sponsors to correct failures by requesting IRS approval and paying a user fee
- Plan sponsors are generally protected from IRS examination while a VCP application is pending
 - No protection if the VCP application is submitted anonymously
- 401(a), 403(b), SEPs, and SIMPLE IRAs are eligible for VCP for a wide range of qualification failures
- A VCP application must describe the qualification failures and propose a method of correction
 - Model documents are posted to the IRS website
 - Beginning April 1, 2019, all VCP submissions must be submitted electronically (beware: size of files)

Voluntary Correction Program

- The user fee is based on the assets held in the plan

Net Plan Assets	Fee
\$500,000 or less	\$1,500
Over \$500,000 to \$10,000,000	\$3,000
Over \$10,000,000	\$3,500

Audit CAP

- Audit CAP is used to correct failures discovered during a plan audit or review of a determination letter application
- Plan sponsors may enter into a closing agreement with the IRS instead of facing plan disqualification
- Plan sponsor may correct the failure and pay a sanction based on a negotiated percentage of the maximum payment amount
 - “Maximum payment amount” is approximately equal to the sum of the taxes that would be paid if the plan were disqualified for all open taxable years
 - Audit CAP sanction generally will be more expensive than the VCP user fee

Voluntary Closing Agreements

- Plan sponsors may request a closing agreement with the IRS for failures that cannot be resolved through EPCRS
 - 457(f) plans are not eligible for closing agreements
- The IRS may determine that it is inappropriate to enter into a closing agreement if any party was involved in an abusive tax avoidance transaction
- If the correction involves a prohibited transaction, the prohibited transaction should be corrected with the Department of Labor first
- In preparing application, the applicant should attempt to show:
 - Closing agreement is in the best interest of both the IRS and the taxpayer;
 - The federal government will suffer no disadvantage from entering into the closing agreement; and
 - Any Code violation or tax deficiency was unintentional
- Closing Agreements may be initiated anonymously

Eligibility Failures – General Rule

- Must provide a QNEC equal to the “missed deferral opportunity,” which is 50% of the missed deferral
 - Missed deferral is ADP for employee’s group in the plan (HCE or NHCE)
 - Employer also must make allocation of missed matching contributions as if the employee had made a deferral equal to the missed deferral
 - All amounts must be adjusted for earnings
- Example: Johnny is a NHCE who was excluded from the plan and had \$20,000 of eligible compensation during the period in which he was excluded. The ADP for NHCE’s is 3%. The missed deferral opportunity is \$300 (50% of \$600). Assume the plan also matches 100% on the first 3% of compensation. Johnny would be entitled to a match of \$600 (3% of \$20,000). The entire \$900 must be adjusted for earnings.

Eligibility Failures – General Rule Failure to Implement Election

- Must provide a QNEC equal to the “missed deferral opportunity,” which is 50% of the missed deferral, plus QNEC for missed matching contribution
 - Missed deferral is of employee’s elected deferral percentage
- Example: Moira was excluded from the plan and had \$90,000 of eligible compensation during the period in which she was excluded. She elected a 10% elective deferral percentage. The missed deferral opportunity is \$4,500 (50% of \$9,000).

Eligibility Failures – Plan with Automatic Enrollment

- If the plan fails to implement an automatic contribution feature or an affirmative election and the failure does not extend beyond the end of the 9½ month period after the end of the plan year of the failure, no QNEC is required for the missed elective deferrals if the following requirements are met:
 - Correct deferrals begin no later than the earlier of (1) the first payment of compensation made on or after the last day of the 9½ month period after the end of the plan year or (2) if the employee notifies the plan sponsor of the failure, the first payment of compensation made on or after the end of the month after the month of notification;
 - Notice that meets certain requirements must be provided not later than 45 days after the correct deferrals begin; and
 - The employer makes a matching contribution, if applicable, equal to the matching contributions on the missed deferrals
- EPCRS provides that this correction sunsets as of December 31, 2020

Eligibility Failures – Plan with Automatic Enrollment (cont'd)

- David should have been automatically enrolled in the plan at a 3% elective deferral percentage in December 2020. The plan administrator discovered the error today. He had \$50,000 in eligible compensation during the period in which he was excluded. As long as David is automatically enrolled by October 15, 2021, no QNEC is required for the elective deferrals. The plan must make a QNEC for the missed matching contributions.

Eligibility Failures – Less than 3 months

- For plans that do not provide for automatic enrollment, a special rule applies if the failure occurs for a period of no more than 3 months
 - Correct deferrals begin no later than the earlier of (1) the first payment of compensation made on or after the last day of the 3-month period or (2) if the employee notifies the plan sponsor of the failure, the first payment of compensation made on or after the end of the month after the month of notification
 - Same notice requirement as for the automatic enrollment failure and same obligation to provide QNEC on matching contributions

Eligibility Failures – More than 3 months and less than SCP period

- QNEC is equal to 25% of missed deferrals
- Subject to contribution timing rules, notice requirement and matching contribution QNEC consistent with other failures
- EPCRS contains special rules for safe harbor plans, Roth contributions, catch-up contributions, 403(b) universal availability rules

Documentation Failures

- Failure to adopt a qualified plan cannot be corrected under SCP
- SCP may be used to correct:
 - Nonamender failures
 - Failure to adopt good faith amendments
 - Failure to adopt interim amendments
- SCP may not be used for discretionary amendments
- Plan document failures are considered significant, so plan document must be corrected by the end of the second plan year following the failure

Self-Correction Program – Rev. Proc. 2019-19

- Revenue Procedure 2019-19 expanded the use of retroactive amendments under SCP
- As of April 19, 2019, a retroactive amendment can be used to correct an operational failure if the following are met:
 - The plan amendment would result in an increase in benefits, rights, or features
 - The increase in benefits, rights, or features is available to all eligible employees
 - The increase in benefits, rights, or features is permitted under the Code
 - The increase in benefits, rights, or features complies with the correction principles of EPCRS
- How helpful is this new guidance?

Contribution Failures

- Disconnect between plan definition of “compensation” and payroll system definition of “compensation” is the most common
- Can use SCP to correct by retroactively amending plan if error is beneficial to participants and corrected by end of the plan year
- Retroactive amendment beyond end of plan year is unlikely due to IRS’ interpretation of “all eligible employees”
- May use SCP to correct by refunding excess contributions

Contribution Failures – Example

- Alexis, Stevie, and Roland all received bonus pay in 2020. Bonuses are ineligible compensation under the plan, but the employer took elective deferrals on the bonuses and also provided matching contributions on the bonuses.
- Plan may not be retroactively amended in SCP because failure did not affect all eligible employees

Distributions

- Improper Hardship Distributions
 - The plan does not permit hardships
 - The event does not qualify as a hardship under the terms of the plan
 - The event is not supported by documentation
 - The distribution is in excess of the permitted hardship amount
- Failure to Distribute Required Minimum Distributions
- Overpayment of Benefits to a Participant
- Correction

Plan Loan Corrections – SCP

- Failures include failures under Section 72(p), improper amortization, failure to apply the correct interest rate, failure to obtain spousal consent, and more
- Rev. Proc. 2019-19 permits several corrections of loan failures via SCP

Failure	Correction Under SCP
Loan does not meet the requirements of 72(p)(2) or is in default	Report deemed distribution in year of correction instead of year of failure
Defaulted loan	Participant makes a single lump sum payment that includes all missed payments and interest; and/or the outstanding balance of the loan and interest is re-amortized over the remaining period of the loan
Failure to obtain spousal consent for a plan loan if required by plan terms	Notify affected participant and the participant's spouse and obtain spousal consent to the loan
Number of loans to a participant exceeds the number of loans permitted by the plan	Adopt a retroactive plan amendment to conform the written plan document to operations

Timely Deposits

- Failure to Timely Forward Contributions to the Trust
 - Must deposit as soon as possible
 - Seven business day safe harbor for small plans
 - Fiduciary violation under ERISA
- Correction
 - Determine which deposits were late and calculate lost earnings
 - Deposit any missed elective deferrals and lost earnings into the trust
 - Review procedures and correct deficiencies that led to the late deposits
 - SCP is available – but note timing rules if “significant” failure
 - VFCP

Best Practices to Discover and Prevent Errors

- Regularly review plan documents and procedures to determine if you have qualification failures
- If you identify a failure, correct it as soon as possible
 - Use SCP, if available
 - Document the analysis of the correction and the correction methodology
- If filing VCP submission, correct all failures for one fee
- Regularly meet with payroll to discuss payroll codes included in “compensation” definition
- Review “administrative manual” provided by recordkeeper
- Communicate issues to legal counsel and auditors as they arise

Questions?

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