Plan Errors: Correction and Prevention

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Agenda

- Overview of EPCRS
- Anatomy of a correction
- Examples/ Stories
  - IRS
  - Mine
  - Yours
Oops, there's a problem
Disqualification Consequences

- Taxation
  - Employer Deductions
  - Trust is taxable
  - Employees taxed on contributions/account balance (if vested)
- From year of disqualification—3 years back
- Penalties
  - Interest and penalty on unpaid taxes
Four Types of Qualification Failures

Plan Document Failures
- Terms of plan not qualified
- Failure to timely adopt interim amendment/restatement

Demographic Failures
- Fail to satisfy Sec. 410(b) or Sec. 401(a)(26)

Employer Eligibility Failure
- Wrong type of plan—403(b); government 401(k)

Operational Failures
- Not following terms of the plan or ERISA
Correction Principle

• Generally, a failure is not corrected unless full correction is made with respect to all participants and beneficiaries, and for all tax years (whether or not the taxable year is closed).

• Key items
  • Restoration of benefits
  • Reasonable and appropriate correction
  • Consistent
Exceptions to Full Corrections

- Unreasonable or not feasible
- Reasonable estimates are necessary (earnings)
- Distribution of small amounts ($75 or less)
- Recovery of small overpayments ($100 or less)
- Lost participants
- Small excess allocations ($100 or less)
Structure

Self-Correction—Operational Errors ONLY

Voluntary Correction Program

Audit Closing Agreement Program

8B-8
Self-Correction

**Pros**
- No fee
- No approval process
- IRS regulations have examples of many common errors and approved corrections

**Cons**
- Not for all errors
- Must meet set requirements
Operational Error

**Insignificant**
- Small percentage of plan assets
- Small number of participants affected
- Recently discovered error
- Other failures?

**Significant**
- Not insignificant
- Must "substantially" correct during the "correction period"
  - End of 2nd plan year following year of error
  - ADP/ACP: End of 3rd plan year following year of testing failure
VCP

**Pros**
- IRS approves the correction
- Can handle more complex situations
- Can suggest a novel correction
- Protected from audit on the error
- No restriction on type of error

**Cons**
- Costly
  - IRS Fees
  - Attorney & service providers
- Lengthy process
- Cannot be under “audit” by IRS or DOL
- No correction until approved
- Proposed correction can be rejected
## VCP Fees

<table>
<thead>
<tr>
<th>Range</th>
<th>Fee</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0 to 500,000</td>
<td>$1,500</td>
</tr>
<tr>
<td>$500,000 to $10,000,000</td>
<td>$3,000</td>
</tr>
<tr>
<td>Over $10,000,000</td>
<td>$3,500</td>
</tr>
</tbody>
</table>

Based on Plan Assets

Plus attorney and service provider fees

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Submit formal description of

- Error
- Why it happened
- Participants affected
- Proposed correction
- Proposed process changes to prevent future errors
VCP—IRS Response

- Approved, proceed with correction
- Need more information
- Proposed changes to correction process
- Reject correction, return fee
VCP Correction

- Wait until have IRS approval
- Complete approved correction items within set timeframe following IRS approval, generally 150 days

Delays have dangerous ends
Shakespeare
King Henry III, Part I
Anonymous VCP Filing

- No audit protection during process
- But IRS doesn’t know who is the plan sponsor
- Useful for complex, questionable corrections
- If proposed correction is rejected, fee is not returned
Audit CAP

Pros
• None

Cons
• IRS in control
• Potential financial sanctions
• Lengthy process
• All aspects of the plan is under scrutiny
Maximum Sanction

- Plan Disqualification Penalty—starting point for negotiations
- IRS procedure says penalty should
  - Not be excessive
  - Bear reasonable relationship to nature, extent, severity of the failure
- IRS decides what is
  - Excessive
  - Reasonable
Correction Process

Problem Solving Flowchart

DOES IT WORK?

DON'T MESS WITH IT!

YES

NO

DID YOU MESS WITH IT?

YES

NO

DOES ANYONE KNOW?

YOU'RE TOAST!

DID YOU BLAME SOMEONE ELSE?

NO

YES

HIDE IT!

CAN YOU BLAME SOMEONE ELSE?

NO

YES

FORGET ABOUT IT!

NO PROBLEM

WILL YOU GET BLAMED ANYWAY?

NO

YES

YOU/IDST!

NO

YES

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Initial Process

- Clearly identify the error and participants involved
- Timeframe
- Why did it happen?
- Does it fit within the Self-Correction or is it VCP?
- Work with attorney and service providers
  - From the start
  - But start with attorney
    - Attorney-client privilege issues
Self-Correction File

- Determination as to why this error fits in the Self-Correction requirements
  - Timing
  - Significant vs insignificant
- Nature of error
- Process elected to correct
- Sample of participant communication re: error
- Date the error was identified
- Date of correction
- Data on the error
- Details on correction process
- Action taken to avoid error in the future
Are there any other errors that should be included? No reason not to include in filing No extra fee

If not following any of the safe-harbor correction procedures, clearly identify the reason why you prefer a different method.

Don’t delay—don’t have audit protection while getting things together.

Process might take many months, what impact will that have on the participants?

Implement process improvements immediately.
Examples

- IRS
- Mine
- Yours
Employee excluded from deferral opportunity for two years

- Determine average deferral rate each year for NHCEs if NHCE/HCE average deferral rate if HCE

Employee receives

- 50% of Average deferral
- Plus matching contribution on full average deferral
- Plus earnings
Excluded Employees in Profit Sharing Plan

**Allocation was 10%**
- Give excluded employees 10%
- Plus Earnings
- No change in other participants accounts

**Allocation would have been 9%**
- Give excluded employees 9%
- Plus earnings
- Reduce other participants’ account to 9% contribution
- Adjust for earnings
Loans

VCP only way to correct!

- Exceeds dollar amount
  - Corrective repayment of excess
  - Apply prior payments to proper loan amount

- Exceeds maximum time period
  - Re-amortize to fit the time limit

- In default
  - Participant pays the additional interest accrued. Re-amortize loan
The Helpful IRS

List of various common errors and how to correct them

"Scrivener error"—immediate eligibility for deferral; 1 year wait for match

No plan documents

Definition of Compensation—bonuses
Your Opps! or Questions?