

Pension Protection Act of 2006 Impacts Retirement Plan Corrections

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For over a decade, the Internal Revenue Service has permitted plan sponsors to correct errors and failures that would cause retirement plans to lose their tax-favored status. In a 1998 Revenue Procedure, the IRS consolidated its correction procedures and created a uniform set of correction principles called the Employee Plans Compliance Resolution System ("EPCRS").

The IRS created EPCRS and the related correction principles without specific direction from Congress. The recently passed Pension Protection Act (the "Act") specifically directs the Treasury Department (which includes the IRS) to establish and maintain the EPCRS program. The Act gives the Treasury Department the authority to waive income, excise or other taxes to ensure penalties are reasonable and to encourage plan sponsors to correct their compliance failures. Thus, the Act solidifies the role of voluntary correction in the administration of the private retirement plan system.

Overview of the EPCRS Program

Over the years, EPCRS has evolved to permit sponsors of qualified plans, 403(a) and 403(b) plans, SEPs, and SIMPLE IRAs to correct many types of plan "failures." Types of failures that can be corrected include:

- When an employer sponsors a plan that it is not permitted to sponsor. This can happen, for example, when a taxable entity sponsors a 403(b) plan, which is reserved to nontaxable and government employers.
- If the plan is not in compliance with the Internal Revenue Code (the "Code"). This type of error most commonly happens when a plan is not amended to reflect a change in the law by the amendment deadline.
- If a plan does not operate in compliance with its terms. For example, a plan may require unvested amounts to be forfeited after a participant has had a one-year break in service, but the recordkeeper waits until a five-year break in service to forfeit the unvested amounts.

EPCRS, allows a plan sponsor to self correct certain failures and, in other cases, submit corrections to the IRS for approval. IRS audits of retirement plans are also included under EPCRS, under a process known as “Audit Cap.” Audit Cap, unlike the other EPCRS correction alternatives, is not voluntary and begins when the IRS notifies the plan sponsor that the IRS intends to audit the plan and comes into plan when an error is found on audit.

The EPCRS Program

Revenue Procedure 2006-27 (the “Procedure”) contains the most recent EPCRS program. The Procedure replaced Revenue Procedure 2003-44 by clarifying EPCRS, adding model corrections, and creating a new fee schedule. Additionally, the Procedure revises EPCRS to take into account the new determination letter program filing deadlines that are based on the last digit of the plan sponsor's Federal Employer Identification Number (“FEIN”). Because most plan sponsors are familiar with previous versions of the EPCRS program, this advisory is a summary of some of the more significant changes to EPCRS contained in the Procedure.

1. Favorable Determination Letter Requests. Under the prior EPCRS program, all failures that were corrected with a plan amendment needed to include a determination letter request application. The one exception to this filing requirement was if the required plan amendment was accomplished by adopting an IRS model amendment. In addition, submitters that did not correct with a plan amendment could submit a determination letter with the filing if, for example, the plan had never received a letter.

The Procedure significantly changes the EPCRS determination letter filing requirements. Under the new rules, even if a plan sponsor corrects a failure to timely amend, it can file for a determination letter only if (a) the applicable remedial amendment is closed, (b) the EPCRS correction coincides with the Economic Growth Tax Relief and Reconciliation Act (“EGTRRA”) determination letter filing cycle (i.e., the EPCRS filing is made during the applicable filing period for the plan's EGTRRA determination letter filing) or (c) the plan is terminating.

Under this rule, if a plan sponsor files an EPCRS submission because it failed to timely adopt its EGTRRA amendments, only terminating plans and those sponsors that have an FEIN that ends in 1 or 9 may currently (until January 31, 2007) include a determination letter request with the EPCRS filing. All other plan sponsors would submit the EPCRS filing, including the amendment to the IRS, but would wait until their EGTRRA filing cycle to request a favorable determination letter. These plan sponsors will need to note on their favorable determination letter requests that they had submitted the plan and related EGTRRA amendment to the IRS for approval.

2. Failure to Permit Eligible Employees to Participate. One of the most significant changes to EPCRS relates to the model correction for the improper exclusion of an employee who was eligible to participate in the plan. Under the prior program, the employer would need to make a corrective contribution for missed contributions (both employer and employee). The contribution for missed salary deferrals equaled the annual deferral percentage ("ADP") for that group of employees (highly compensated or non-highly compensated) multiplied by the affected employee's compensation. The correction for missed after-tax contributions, meanwhile, equaled the actual deferral percentage ("ACP") for that group of employees multiplied by the employee's compensation. This model correction results in a windfall for the excluded employee because the employee received the compensation and missed the deferral and/or contribution.

The Procedure revises the model correction to reduce this windfall by reducing the prior procedure's correction for missed salary deferrals by 50 percent and missed after-tax contributions by 60 percent. Any employer contributions must be made without taking into account the reduction in missed employee contributions, and the Procedure includes special rules for safe harbor plans.

3. Plan Loans. Whether plan mistakes involving loans could be corrected through EPCRS had been questionable. The issue is that loan failures generally cause a participant to be taxed; they do not cause the retirement plan to lose its tax-favored benefits. Mistakes on loans, however, are common and, to help plan sponsors and participants, the Procedure includes some model corrections for loan mistakes. The first of these applies when a loan has been made in excess of the Code's maximum amount. The second applies when loan terms do not satisfy the maximum permitted term of the loan. (The correction that cannot be made is for loans that have been outstanding longer than the maximum term, which is five years for nonresidential loans.) The benefit of correcting through EPCRS is that the Form 1099-R would report a deemed distribution in the year of the correction; the Form 1099-R would not be retroactive to the year the deemed distribution actually occurred. As an alternative to the current-year Form 1099-R, the correction would exclude loan repayments from the participant's basis in the plan and the deemed distribution
would not be reported on a Form 1099-R.

4. Orphan Plans. EPCRS now gives some much needed guidance on plans that no longer have a plan sponsor or "orphan plans." The Procedure states that the IRS has discretion to determine whether a full correction of an orphan plan is required in order to terminate it or whether a partial correction would be acceptable, and the IRS may waive the submission fee.

5. Spousal Consent. The Procedure contains a new correction for a plan that is subject to the qualified joint and survivor annuity provisions, but does not obtain the required spousal consent. Generally, the spouse can provide the needed consent or the participant may repay the distribution. If

the participant will not repay and if the spouse will not consent, the plan is required to pay the spouse a benefit equal to the death benefit that would have been payable to the spouse if the qualified joint and survivor form of distribution had been elected.

6. Taxes and Penalties. The Procedure adds that a 403(b) plan failure that is corrected through EPCRS will not cause the plan to lose its 403(b) plan status for purposes of FICA and FUTA taxes. Other types of retirement plans, such as qualified plans and government plans, were afforded similar FICA and FUTA exemptions under previous EPCRS programs. The Procedure adds corrections of 403(b) plans to this list.

Also, the Procedure includes waivers of excise taxes if a plan sponsor voluntarily submits certain corrections to the IRS through EPCRS. If an EPCRS correction requires a plan sponsor to make a nondeductible contribution, the IRS will not assess Code § 4972 excise taxes. If a VCP correction involves correction of an ADP test or actual contribution percentage test failure, the IRS will not assess Code § 4979 excise taxes if the tests were timely performed, but the data was inaccurate. Finally, if the required minimum distributions have not been made, the IRS will waive the excise tax under Code § 4974, which would otherwise be applicable to plan participants.

7. Tax Avoidance Disclosure and Procedure. The Procedure contains new tax avoidance disclosures and procedures. Generally, the Procedure provides that a plan sponsor who is a party to an abusive tax avoidance transaction cannot self correct if the failure is directly or indirectly related to the abusive transaction. (An abusive tax avoidance transaction is any listed transaction under Treasury Regulation § 1.6011-4(b)(2) and any other transaction listed on the IRS's website under “EP Abusive Tax Transactions.”) Also, if the agent reviewing the EPCRS submission believes a submission involves a listed transaction, the agent will refer the submission to the Tax Shelter Coordinator, and the submission could ultimately be referred to examination.

In addition, submissions to the IRS under EPCRS need to include a statement that the plan sponsor was not involved in an abusive transaction. Further, a compliance statement cannot be relied upon as a conclusion that the sponsor was not subject to an abusive transaction.

8. EPCRS Fees. The Procedure reduces certain IRS submission fees. The last EPCRS revision (Revenue Procedure 2003-44) significantly reduced fees for all types of failures. The Procedure, however, provides a reduced fee schedule for only certain types of failures: (a) the failure to satisfy the required minimum distribution requirements if the plan has 50 or fewer participants, (b) the failure to timely amend a plan, and (c) applications for SEPs and SIMPLE IRAs.

The Procedure is effective September 1, 2006, but sponsors could start using it on or after May 30, 2006. Those plan sponsors that have outstanding submissions that involve the exclusion of eligible

participants should consider supplementing the submission to take advantage of the reduced corrective contributions.

Changes to the EPCRS Program Required by the Act

In addition to specifically allowing the Treasury Department to create and maintain the EPCRS program, the Act directs the Treasury Department to further enhance the current program by:

1. Extending the time period by which significant operational failures may be self corrected. Currently, a significant error (determined under a facts and circumstances test using seven criteria) must be corrected by the last day of the second plan year following the plan year in which the error occurred. All other significant operational failures need to be corrected through a submission to the IRS and must receive IRS approval.
2. Permitting plan sponsors to self-correct insignificant errors while the plan is under audit. Currently, self correction is not possible if a plan is being audited. This enhancement will encourage correction of small problems while avoiding potentially large audit sanctions.
3. Assuring that any penalties and sanctions imposed under the EPCRS program are not excessive and bear a relationship to the extent and severity of the failure.
4. Educating small employers as to the availability and use of EPCRS.
5. Addressing the concerns small employers have with using the EPCRS program.

Based on the Congressional support of the EPCRS program and the direction Congress gave to the Treasury Department, we expect to see further enhancements to the EPCRS program. Likewise, more plan sponsors can be expected to correct plan failures once discovered.

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