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View From Groom: Updated IRS Correction Program Guidance—What's New and What Isn't

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On Dec. 31, 2012, the Internal Revenue Service published the long-awaited update to its 2008 version of qualified plan correction guidance, Rev. Proc. 2013-12 (Jan. 22 IRS Bulletin). The two most significant changes are: (1) the addition of explicit correction procedures for tax code Section 403(b) plans that take into account the final 403(b) regulations and Notice 2009-3; and (2) new filing procedures, including two new forms (Forms 8950 and 8951) that must be included in all applications. The new procedures are mandatory beginning April 1, 2013, but may be used earlier.

The new guidance does not address the correction of important auto-enrollment issues, such as the failure to provide the safe-harbor notice before the start of the plan year, or Roth account issues; like the prior guidance, IRS requests comments on the these topics, as well as on the failure to implement an auto-escalation provision. Nor does the new guidance expand relief for plan loans or provide any exceptions to the ban on retroactive plan amendments (including ones that are ''pro participant'').

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The most significant changes (and some disappointments) are described below.

General Nonprocedural Provisions

Earnings. Numerous plan corrections require makeup contributions to participants, which generally must reflect ''earnings'' for the relevant period. A new definition of earnings has been added to clarify that earnings may reflect losses, at the option of the plan sponsor.

457(b) Plans. The guidance still provides that applications for tax code Section 457(b) plans will be accepted on a provisional basis, outside of the normal Employee Plans Compliance Resolution System (EPCRS) process, but based on similar standards. The types of 457(b) plans that will be accepted are not entirely clear. The guidance states that, generally, plans sponsored by governmental entities will be considered and that plans covering ''top hat'' employees of a tax-exempt entity will not be considered. However, it also states that, under limited circumstances, it will consider such ''top hat'' plans, for example, where the plan was erroneously established to cover non-''top hat'' employees and was operated in a manner similar to a qualified plan.

De Minimis Amounts. The de minimis amounts for which no correction is required, provided the cost of processing the corrective amount would be greater than the corrective amount, were not changed. These amounts are $75 for a corrective distribution (e.g., no need to make a corrective distribution if the amount involved does not exceed $75 and the reasonable direct costs of processing and delivering the distribution would exceed the amount of the distribution), and $100 for an overpayment (no need to request that the participant repay an overpayment that does not exceed $100).

Missing Participants. In light of the fact that IRS has eliminated the IRS letter-forwarding program as a method for locating missing participants, IRS modified the steps that must be taken to locate such a participant. Generally, such action includes mailing a letter to the participant's last known address using certified mail and using an additional search method (or more than one, if circumstances warrant), which can include the Social Security letter-forwarding program, a commercial locator service, a credit reporting agency, or internet search tools. A special ''transition'' rule is included for plan sponsors that proposed using the IRS letter-forwarding program to locate missing participants and have either received a compliance statement or were self-correcting an error.

General Procedure Provisions

No significant changes have been made to the procedures regarding self-correction. However, there are several significant changes to the VCP procedures, described below.

Form 8950. The submission must include new Form 8950. This new form includes some of the general information that was included in Appendices D and F (i.e., the applicant's information, the type of submission and type of plan), as well as the employer statements, including the penalties of perjury statement, statements regarding whether the plan or plan sponsor have been parties to an abusive tax avoidance transaction, and whether the plan or plan sponsor is ''under examination.'' It also includes a checklist, similar to the checklist previously included in Appendix C.

Form 8951. The submission also must include new Form 8951, which is a user fee form for Voluntary Correction Program (VCP) applications. The check, as well as a copy of the check, must be attached to this new form. The guidance states that IRS may process the check as an electronic fund transfer.

New Appendix C. Appendices D and F have been combined into a new Appendix C, which has two parts. The first part includes much of the information previously included in Appendices D and F (i.e., the plan and applicant information, description of the failure and proposed correction, method of locating missing participants, description of revised administrative procedures, requests involving excise taxes, and the enforcement resolution to be signed by IRS). The second part includes Schedules 1 through 9 (i.e., schedules to be used to correct failures involving late amendments, salary reduction simplified employee pension plans (SAR/SARSEPs), SIMPLE IRAs, plan loans, eligibility, excess deferrals, and minimum required distributions, as well as correction by plan amendment), generally unchanged from the prior guidance, except that Schedule 1, used to correct the failure to timely adopt required or discretionary amendments, has been clarified to state that it may be used only for a corrective amendment adopted before the end of the plan's determination letter filing cycle. Under the prior guidance, it was unclear whether a nonamender failure should be reported on Schedule 1 or Schedule 2, which is also used to report nonamender failures. The guidance clarifies that the schedules may be used only without modification.

Acknowledgement Letter. This has been retained, but is now located in Appendix D.

Submission of Determination Letter Application. The rules regarding when a determination letter application should be included in the VCP application have not changed, although an attempt has been made to clarify them. For this purpose, IRS added new definitions for several types of amendments (''good faith amendment,'' ''interim amendment,'' and ''optional law change''), but the rules that apply to each are the same.

If a determination letter application is included, the new guidance provides that ''stand-alone'' VCP and determination letter submissions must be provided and that, where an item would be includable in both submissions, two copies of that item must be included. For example, if a copy of the plan document is required for both the VCP and determination letter submissions, then a copy of the plan document must be included in each part of the submission.

New Mailing Address. VCP submissions should now be sent to the Covington, Ky., address to which determination letter applications are sent. Previously, they were sent to IRS's national office in Washington.

Anonymous Filings. If an anonymous filing is made on behalf of a plan by the plan's attorney, the attorney must sign a new ''penalty of perjury statement'' to the effect that the applicant is the plan's authorized representative and will file a Form 2848 at the appropriate time.

Correction of Preapproved Plans. In a helpful clarification, an employer utilizing a preapproved plan document that must adopt a corrective amendment generally may continue to rely on the plan sponsor's advisory/opinion letter and remain within the six-year remedial amendment cycle, provided the corrective amendment.

Group VCP Submission. The guidance clarifies that the VCP compliance fee for a group submission is based on the number of basic plan documents included in the submission—not the number of associated adoption agreements. It also clarifies that a participating employer must certify it has timely filed a Form 5500 only for the most recent plan year. The 20-employer minimum and other rules for group submissions have not been changed.

Compliance Fee Changes

The general EPCRS fee structure has not changed. However, several special provisions have been added.

Reduced Fee for Failure to Timely Adopt Determination Letter. If the sole failure is to timely adopt an amendment on which a favorable determination letter was conditioned, the compliance fee is $500, but only if the amendment is adopted within three months of when it should have been adopted.

Multiple Failures. The guidance provides that if a VCP submission includes several failures, each of which is subject to a reduced fee, the fee will be the lesser of the sum of the reduced fees or the regular fee.

Multiemployer or Multiple Employer Plans. If a qualification failure applies to fewer than all participating employers, the fee can be calculated separately for each employer, based on the number of that employer's participants, rather than on the basis of the employer's plan assets.

Fee for Plans Not Required to File Form 5500. Usually, the compliance fee is based on the number of participants listed on the most recent Form 5500. For plans that are not required to file Form 5500 (e.g., governmental plans), the fee may be based on the number of participants as of the last day of the most recently completed plan year. However, if this information has not been compiled by the time the VCP submission is mailed, the number of participants for the plan year before the most recent plan year may be used, provided the submission is mailed to the Service no more than seven months after the close of the most recent plan year.

Reduced Fee for Failure to Timely Adopt a Written 403(b) Plan. If the sole failure is to timely adopt a written 403(b) plan in accordance with relevant guidance, the fee is reduced by 50 percent, provided the submission is filed with IRS no later than Dec. 31, 2013.

Fee for Certain Amendment Failures Discovered During Audit. Two new provisions describe the fee for untimely adopted amendments discovered during audit, including determination letter review: (1) If the sole failure is the plan sponsor's failure to timely adopt good-faith or interim amendments, or amendments reflecting optional law changes by their deadline, but before the expiration of the plan's extended remedial amendment period, the fee is 40 percent of the applicable fee on the chart included in the guidance; (2) If the sole failure is the plan sponsor's failure to timely adopt an amendment upon which a favorable determination letter was conditioned, the fee is $1,000, provided the required amendment has been adopted within three months of the time it should have been adopted.

Defined Contribution/Section 403(b) Plan Provisions

Section 403(b) Plan. Generally, the correction of 403(b) plan issues follows the correction methods for qualified plans under tax code Section 401(a) and is available for periods before 2009 (although there is no document requirement applicable for periods before 2009). In addition, a 403(b) failure may be corrected by treating a contract as a nonqualified annuity under Section 403(c). The guidance expressly provides that the failure to adopt any written 403(b) plan timely may be corrected under VCP or the Audit Closing Agreement Program.

Corrective 'Make-Whole' Contribution. There had been an ongoing issue as to whether a plan sponsor should make a corrective contribution to a defined contribution or 403(b) plan when a participant receiving an overpayment does not return the overpayment. The new guidance provides that such a ''make-whole'' payment is not required, but only if the distribution was made in the absence of a distributable event—for example, an impermissible in-service distribution—and provided the amount of the distribution was correctly determined. Accordingly, the exception is narrow, and a make-whole contribution will be required in other contexts, for example, if a participant receives an overpayment after terminating employment. The guidance also changes the earnings rate that applies to determine the amount due from the participant receiving the overpayment. The prior guidance stated that an ''appropriate'' earnings rate should be used; the new guidance states that the ''plan's earnings rate'' should be used. The latter calculation can be quite complex, e.g., for a DC plan with many investment funds.

Plan Loans. No significant changes were made to the correction procedures for plan loan failures, although they now allow correction in Audit CAP. Significantly, the correction procedures were not expanded to include any self-correction option that avoids the need to file corrected 1099-Rs for prior years.

Source of Corrective Contributions. The new guidance provides that corrective contributions addressing a plan's failure to meet the actual deferral percentage/actual contribution percentage (ADP/ACP) tests must be qualified nonelective contributions (QNECs) within the meaning of Treasury Regulation § 1.401(k)-6, indicating that they must be made from ''new'' employer contributions, not from a plan's forfeiture account. This is consistent with IRS's informal comments.

Correction of QACA Eligibility Failure. If an employee was not given the opportunity to make an affirmative election under a qualified automatic contribution arrangement (QACA), the ''missed deferral opportunity'' for the first year is 3 percent of the participant's compensation, with subsequent increases at the rate prescribed under tax code Section 401(k)(13)(C)(iii). Accordingly, the plan sponsor must make a contribution on behalf of the affected participant equal to 50 percent of the missed deferral opportunity, along with the missed matching or nonelective contribution, both adjusted for earnings. With regard to the nonelective contribution, the guidance states that the amount is deemed to be 3 percent of compensation for the period of the failure.

Corrective Matching Contributions. In the context of eligibility failures involving a 401(k) plan, if a participant is owed a corrective contribution to replace missed matching contributions, the contribution generally may be an ''employer nonelective contribution.'' A QNEC is required for safe harbor plans and will be subject to the vesting and distribution rules that apply to matching contributions.

403(b) Plan Failure to Meet the 'Universal Availability' Requirement. The guidance states that the correction provisions applicable to 401(k) plans that fail to timely enroll participants apply to 403(b) plans correcting a failure to meet the ''universal availability'' requirement. For this purpose, the plan may deem the missed deferral opportunity to be the greater of 3 percent of compensation or the maximum deferral percentage for which the plan provides a 100 percent matching contribution.

SIMPLE IRAs. The guidance states that the correction provisions applicable to 401(k) plans apply to SIMPLE IRAs in the context of the improper exclusion of eligible employees. For this purpose, the missed deferral opportunity may be deemed to be 3 percent of compensation.

403(b) Plan Failure—Absence of Information-Sharing Agreement. A permitted correction of a 403(b) failure resulting from a contract issued in an exchange not being part of a 403(b) plan due to the failure to have an ''information sharing agreement'' is for the assets to be transferred to another vendor to which contributions are being made under the plan.

Defined Benefit Plan Provisions

Adjustment of Corrective Distributions. The guidance states that corrective distributions from a defined benefit plan should be increased to reflect the delay in payment in accordance with the ''plan's provisions for actuarial equivalence in effect on the date the distribution should have been made.'' The guidance clarifies that the Section 417(e)(3) factors—the minimum interest rates for lump-sum and other nonannuity distributions—do not apply if the corrective distribution covers missed payments made in forms not subject to Section 417(e)(3). This is significant in a wide variety of common failures—such as payments that should have been made because a timely benefit suspension notice was not given. It appears that this is mandatory, which is a significant change because many plans have used the relatively low Section 417(e)(3) rates in this context.

Coordination With Section 436 Benefit Restrictions. There are two aspects to this issue. First, if a plan fails to follow the restrictions of Section 436 (e.g., it makes a lump-sum payout when it shouldn't), the correction is to make the employer contribution necessary so that the restriction no longer applies, adjusted for earnings. It may be problematic for affected plan sponsors to make this correction. Second, a corrective distribution or amendment is not, in and of itself, subject to the requirements of Section 436. However, if a plan is subject to the Section 436 restrictions at the time a correction (e.g., to correct a minimum required distribution (MRD) failure) is made, the plan sponsor generally must make a special contribution to the plan equal to the impermissible distributions if the distribution was a ''prohibited payment'' (e.g., a lump sum) or the increased funding target attributable to a corrective amendment. Any such contribution is treated as a ''section 436 contribution'' and will not count toward minimum funding requirements.

Minimum Required Distributions. The new guidance provides that, in correcting a failure to make minimum required distributions pursuant to tax code Section 401(a)(9), the plan must make the ''missed'' payments, adjusted for interest based on the plan's actuarial equivalence factors in effect on the date the distribution should have been made. Previously, the correction guidance did not explicitly state what the interest rate should be based on—many plans used the Section 417(e)(3) rates for this purpose. This will typically result in larger payments.

Closing Observations

IRS's voluntary correction program has come a long way in the more than 20 years since IRS first established a policy in this area. It has essentially reversed the mind-set of plan sponsors and administrators from simply correcting the problem going forward to correcting the problem for all periods and filing thousands of VCP applications annually.

Hopefully, the new procedures for VCP submissions will improve IRS response times and help reduce the backlog of applications. Unfortunately, the updated guidelines do not contain the types of changes that expand the ability of plan sponsors and administrators to self-correct more types of violations, though 403(b) plans will benefit from greater parity with qualified plans in the correction process.

In our experience, plan loan violations and retroactive amendments still are among the most common areas for which submissions are made. A key reason is that IRS guidance continues to generally force plans to go through VCP to avoid onerous 1099-R corrections/ penalties (in the case of plan loans) and Audit CAP risks (for ''retro'' amendments). Hopefully, IRS will see its way to give more leeway in these areas in future iterations of EPCRS.

