IRS Updates the EPCRS Program

by Kendall Daines

A. Introduction

The IRS has updated the Employee Plans Compliance Resolution System (EPCRS) in Rev. Proc. 2006-27 (May 30 IRS Bulletin). The updated guidance generally carries forward the prior guidance, found in Rev. Proc. 2003-44, with a number of helpful changes, described in Sections B-F below.

In addition to the revenue procedure, the IRS has posted several related items on its website, including, among other things, (a) a chart showing the changes made by the new revenue procedure, (b) Q&As, (c) a user-friendly version of the revenue procedure, (d) a topical index, (e) a list of the name, address, phone number, and e-mail address of the regional VCP Coordinators, and (f) guidance on abusive transactions that affect a plan's eligibility for EPCRS.

This new guidance is generally effective September 1, 2006. However, the provisions regarding the assembly of the VCP submission, as well as the fee for a nonamender failure discovered in connection with a determination letter request (both discussed below), are effective May 30, 2006. In addition, a plan sponsor may voluntarily apply this revenue procedure beginning May 30, 2006.

As with past guidance, the IRS requests comments on possible future enhancements of the Program. Specifically, it requests comments on the following:

- the appropriate method to correct a failure to provide an eligible employee with the opportunity to make catch-up or Roth contributions;
- in light of the fact that the new Code section 415 regulations will no longer include provisions addressing the correction of excess 415 amounts, the appropriate correction of excess 415 contributions, including whether the option of establishing a 415 suspense account should be retained; and
- whether additional correction methods are needed for plans to take advantage of the fiduciary safe harbor recently issued by the DOL for orphan plans, where the plan is subject to the spousal consent requirement.

We understand that the IRS is also exploring the possibility of (a) instituting a uniform sanction structure for Audit CAP, as well as (b) implementing a system to make sure that a plan sponsor is fulfilling the terms of a compliance statement. These topics might be addressed in future guidance, which we understand the IRS at some point hopes to issue on an annual basis under a uniform revenue procedure number.

B. Availability of Correction by Plan Amendment/Need For Separate Determination Letter Filing

A plan sponsor may correct a plan document or demographic failure, as well as an operational failure, by a retroactive plan amendment under both VCP and Audit CAP.

Correction by retroactive plan amendment is also available under SCP, but only to address one of the operational failures specifically listed in Appendix V:

- a failure to comply with the maximum annual compensation limit;
- a hardship distribution which is contrary to the terms of the plan;
- a plan loan which is contrary to the terms of the plan; and
- the provision of benefits to ineligible employees.

Appendix V also describes the required correction method for these failures.

Generally, if a VCP submission involves a corrective plan amendment, a separate determination letter application will not be required unless (a) the plan is submitted under VCP during its determination letter filing cycle, in which case, a representative of the IRS has stated informally that the VCP filing will serve as the plan's determination letter filing so that the plan sponsor will have to make only one filing (we understand that the IRS intends to issue clarification on this point); (b) the qualification failure is a "nonamender" failure (defined as the failure to timely adopt a required change in the qualification requirements); or (c) the amendment is made to a terminating plan. Where a determination letter application is not required, the compliance statement will constitute a determination as to the effect of the plan amendment on the plan's status as a qualified plan.

If a plan sponsor using SCP corrects a qualification failure by adopting a plan amendment, the plan sponsor must submit a determination letter application with the IRS during its normal filing cycle and identify the corrective amendment in its cover letter.

C. Operational Failures

The IRS has issued new guidance addressing a number of common operational failures.

Plan Loans – The new EPCRS includes more options for plan loan failures. Under the prior guidance, the advantage of correcting a plan loan problem under VCP was that any deemed distribution could be reported on Form 1099 for the current year, instead of the year in which the loan should have been defaulted. The new procedure includes this option, but also includes options that permit a plan loan failure to be corrected without the plan loan being defaulted, provided the maximum period for repayment, generally five years, has not expired. The new guidance applies only to plan loan failures where: (a) the loan amount exceeds the amount permissible under Code section 72(p)(2)(A), in which case the participant can repay the excess and reamortize the loan over the remaining repayment period (i.e., a new amortization period does not begin); (b) the amortization period exceeds the 5-year period or "level amortization" requirement, in which case the loan can be reamortized to meet these requirements; or (c) loan repayments fail to be timely made, in which case the participant can either make a lump sum payment equal to the missed payments, plus interest, and/or the loan may be reamortized over the remaining amortization period. The guidance provides that if the employer is partially responsible for failing to have the loan repayments timely made, for example, by failing to make proper payroll deductions, it would be responsible for the payment of interest.

Exclusion of Employees – In order to correct the improper exclusion of an employee from a 401(k) plan, the employer must make a QNEC to the plan. The new guidance changes the manner in which the amount of the QNEC is determined so that it reflects the value of the excluded participant's "lost opportunity" instead of the full value of the contribution. Generally, the QNEC to replace 401(k) contributions equals 50% – instead of 100% – of the appropriate ADP, multiplied by the excluded employee's compensation. In the case of after-tax contributions, the value of the lost opportunity is 40%, so that the QNEC to replace after-tax contributions equals 40% of the appropriate ACP, multiplied by the employee's compensation. In either case, the QNEC to cover the match is based on the full value of the 401(k) or after-tax contributions, not merely the value of the lost opportunity.

Spousal Consent – The new guidance includes an alternative method to correct a failure to obtain spousal consent. Under the prior guidance, if a spouse refuses to consent to a prior distribution, the proper correction was to provide the spouse with an annuity equal to the portion of the QJSA that he or she would have received. This method of correction is still available, but, in addition, the plan may distribute a lump sum payment to the spouse, equal to the present value of the annuity, based on the interest and mortality factors used to calculate lump sums.

D. Abusive Tax Avoidance Transactions

New provisions restrict the availability of EPCRS where a qualification failure is directly or indirectly related to an abusive tax avoidance transaction ("ATAT"). An ATAT is any transaction listed under Reg. section 1.6011-4(b)(2), as well as any other transaction identified as an ATAT on the IRS' website. If the plan is under examination, the definition of an ATAT is expanded to include any transaction that the IRS determines was designed to facilitate the impermissible avoidance of tax. Under the new VCP filing procedures, the plan sponsor must certify that it has not been a party to an ATAT or give a brief description of any ATAT.

Some examples of ATATs from the IRS' website include:

- a plan's purchase of insurance to provide death benefits that exceed the death benefits provided by the plan so that the employer can claim a large tax deduction (Rev. Rul. 2004-20, Situation 2);
- an abusive 412(i) plan that pays high premiums for life insurance and/or annuity contracts that, if continued, would (absent surrender charges) exceed the amount needed to provide the plan benefits (Rev. Rul. 2004-20, Situation 1); and
- springing cash value insurance contracts, whereby a plan transfers a life insurance contract to a participant where the cash surrender value of the policy is temporarily depressed so that the tax on the distribution is small (Rev. Rul. 2004-21 and Rev. Proc. 2005-25).

The following summarizes the key points relating to the new guidance on ATATs:

- SCP is not available to correct any qualification failure directly or indirectly related to the ATAT.

- If, upon review of a VCP application, the IRS determines that there may have been an ATAT, the submission will be referred to the Employee Plans' Tax Shelter Coordinator. If the Tax Shelter Coordinator determines that the failure is related to the ATAT, VCP will not be available to correct the failure, and the case will be referred to examination. If the Tax Shelter Coordinator determines that the failure is unrelated to the ATAT, the failure can be addressed through the VCP application, but the IRS reserves the right to refer the ATAT for examination.
- If, upon review of a plan during audit, the IRS discovers a qualification failure and also determines that there may have been an ATAT, the matter will be referred to the Tax Shelter Coordinator. If the Tax Shelter Coordinator determines that the failure relates to the ATAT, or that satisfactory corrective actions have not been taken with regard to the ATAT, the IRS reserves the right to conclude that EPCRS is not available for that failure. If the Tax Shelter Coordinator determines that the failure is unrelated to the ATAT, Audit CAP or SCP would be available.

E. Relief For Small Transactions and Excise Taxes

Several changes provide helpful relief in common problem areas.

- **Recovery of Small Overpayment** – A plan is no longer required to seek the return of an overpayment of $100 or less, or notify the affected participant that such overpayment is not eligible for rollover treatment.
- **Small Excess Amounts** – The plan is no longer required to distribute or forfeit an excess amount credited to the participant if the amount is $100 or less. However, if the excess amount exceeds a statutory limit (e.g., section 415), the participant must be notified that the excess amount, including earnings, is not eligible for favorable tax treatment and is not eligible for rollover.
- **Relief From Certain Excise Taxes** – The new guidance permits a plan sponsor to obtain relief from the excise tax (a) on nondeductible contributions, where the sponsor is required to make a contribution as part of a plan correction, and (b) on the distribution of amounts to meet the ADP or ACP test after 2½ months following the end of the year tested, where the testing was performed in a timely manner, but based on data later determined to be inaccurate. This relief is only available under VCP.

F. Other Changes

VCP Application Changes – The IRS made a number of changes to the format of the VCP application, including –

- **Submission Requirements** – The IRS has included an outline of the manner in which it would like the VCP submission to be organized.
- **Acknowledgement Letter** – A plan sponsor that would like the IRS to acknowledge receipt of a VCP application must now complete and include in the submission a copy of the Acknowledgement Form that is included in the guidance.

- **Streamlined Process for Interim Nonamender Failures** – A streamlined submission procedure has been added for certain interim nonamender failures, including the failure to adopt a good faith EGTRRA amendment, an interim amendment required under the Code 401(a)(9) rules, or an interim amendment required under Rev. Proc. 2005-66, Section 5. It is intended that a plan sponsor can complete this relatively simple form and the IRS will simply stamp it as accepted. The IRS intends that the form also will serve as the compliance statement. (No determination letter application is required because the IRS does not issue determination letters on interim amendments.)

Fees – The IRS has established reduced compliance fees in the following circumstances:

- **SEPS and SIMPLE IRAs** – The initial fee for SEPs and SIMPLE IRAs has been reduced from $500 to $250. However, the IRS retains discretion to charge a higher fee in appropriate circumstances;

- **MRD Failures** – A flat fee of $500 will apply if a plan's sole failure is the failure to make minimum required distributions, provided the failure affects no more than 50 employees;

- **Nonamender Schedule** – The IRS has reduced the filing fee for certain nonamender failures. For a nonamender submission involving the failure to adopt a good faith EGTRRA amendment, an amendment under the 401(a)(9) rules, or an interim amendment required under Rev. Proc. 2006-55, Section 5, the fee has been reduced to $375 for each year in which the nonamender failure existed. In some circumstances, the current fee structure (half of the normal fee if the submission is filed within one year following the expiration of the remedial amendment period, or otherwise the normal fee) may continue to apply.

- **Nonamender Failures Discovered By IRS** – A fee schedule has been added for nonamender failures discovered during a determination letter submission, as well as during a plan audit. For example, if a plan with 1,000 participants failed to amend the plan for EGTRRA or subsequent legislation, the fee would be $17,500 instead of the relatively low fees described above.

Orphan Plans – An orphan plan is a plan whose plan sponsor either (a) no longer exists, (b) cannot be located, (c) is unable to maintain a plan, or (d) has abandoned the plan pursuant to regulations issued by the DOL. The new guidance makes VCP and Audit CAP available to orphan plans, and lists the entities that may act on their behalf: (a) a court appointed representative with authority to terminate the plan, (b) if the plan is under investigation by the DOL, the party determined by the DOL to have accepted responsibility for terminating the plan, or (c) if Title I has never applied to the plan and the plan covered only one participant who was the sole owner of the plan sponsor, the participant's surviving spouse if he or she is the sole beneficiary of the plan. Significantly, the new guidance provides that the IRS may permit less than full correction and waive the submission fee for orphan plans. (It should be noted that a plan that has terminated pursuant to DOL regulations governing the termination of abandoned plans are not treated as orphan plans under EPCRS.)

Group Submissions – Several helpful changes have been made to the group submissions procedures:

- Sponsors of pre-approved plans (including volume submitter plans) may submit group submissions to cover plan document, operational, and employer eligibility failures.
- The new guidance makes it clear that a separate fee must be paid for each pre-approved plan document included in a group submission.
- The list of participating employers may be provided to the IRS during any stage of the submission process. The IRS encourages that the information be provided electronically.
- If a participating employer is notified of an impending Employee Plans audit after the Eligible Organization has filed the group submission, it's plan will remain part of the group submission.

Copyright © 2006
Groom Law Group, Chartered
All rights reserved.