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BENEFITS BRIEF

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IRS Updates Plan Correction Program and Modifies Criteria for Monetary Penalties in Plan Audits

Background

The IRS recently issued the anticipated update to the most recent version of its qualified plan correction guidance, the Employee Plans Compliance Resolution System ("EPCRS") (Revenue Procedure 2016-51 (Sept. 29, 2016) modifying and superseding Rev. Proc. 2013-12). EPCRS may be used to correct plan qualification issues affecting certain types of retirement plans, such as 401(k) and profit sharing plans, pension plans, 403(a) plans, 403(b) annuities, SEPs, and SIMPLE plans. It permits the correction of errors either (i) by "self-correction," whereby a plan sponsor or other entity takes reasonable steps to correct an issue, or (ii) under the auspices of the IRS via its "voluntary compliance program", whereby a plan sponsor or other entity submits a proposed correction to the IRS for review, along with a user fee, and ultimately receives a compliance statement from the IRS "blessing" the correction. In addition, EPCRS includes a program whereby an error identified by the IRS during an audit may be corrected ("Audit CAP"), as discussed in more detail below.

Generally, this updated EPCRS revenue procedure does not introduce new concepts, but (i) incorporates "correction" guidance previously issued by the IRS in 2015 (Rev. Procs. 2015-27 (addressing, among other items, the correction of overpayments) and 2015-28 (addressing the correction of auto-enrollment and other elective deferral failures)) and (ii) modifies EPCRS to take into account the major changes to the determination letter program for individually designed plans, reflected in Rev. Proc. 2016-37. For example, in light of the elimination of the staggered 5-year determination letter cycles for individually-designed plans, the new EPCRS provides that an individually-designed plan need not have a current determination letter in order to qualify for the self-correction of a significant error. In addition, the new guidance deletes the "user fees" section previously in the EPCRS revenue procedure (and lowered the fee for a late amendment upon which a favorable letter was conditioned that is adopted within 3 months from $1,000 to $750) – the user fees will now be included in the annual "user fee" revenue procedure (currently, Rev. Proc. 2016-8).

The new EPCRS is effective January 1, 2017. The IRS invites further comments on how to further improve EPCRS.

Impact of Updated EPCRS on Audit CAP

Perhaps the most significant change in the updated guidance is the manner in which the Audit CAP sanction will be determined. Audit CAP is available for correction of all failures found on examination that have not been otherwise corrected (e.g., via self-correction or VCP). It is also available to correct participant loan errors that do not comply with the requirements of Code section 72(p)(2).

Under Audit CAP, if the IRS identifies a qualification failure, in order to preserve the tax-qualified status of the plan, the plan sponsor generally must correct the failure, pay a sanction, and enter into a closing agreement with the IRS. Historically, the sanction was a negotiated percentage of the "maximum payment amount," which is the maximum tax that the IRS could collect if the plan were disqualified for all open tax years, and includes:

- the tax on the previously tax-exempt trust, including interest and penalties that would be due on the trust return (Form 1041);
- the tax due resulting from the loss of the employer's deduction for contributions made to the trust, including interest and penalties that would be due on the employer's tax return (e.g., Form 1120);
- the tax due resulting from income inclusion of participants' account balances, including the tax that would be due on plan distributions previously rolled to an eligible retirement plan, along with interest and penalties that would be due on the participants' individual tax returns (e.g., Form 1040); and
- any other tax that would occur if the plan were disqualified (e.g., employment taxes).

The maximum payment amount can be very large, and the Audit CAP sanction large as well.

Under this new version of EPCRS, the sanction is a negotiated amount based on the relevant facts and circumstances, and the maximum payment amount is simply one such factor. The other factors are the same factors listed in the prior EPCRS as relevant to determining the negotiated percentage of the maximum payment amount: (1) the steps taken by the plan sponsor to ensure that the plan had no failures; (2) the steps taken by the plan sponsor to identify failures that may have occurred; (3) the extent to which correction had progressed before the examination was initiated, including full correction; (4) the number and type of employees affected by the failure; (5) the number of non-HCEs who could be adversely affected if the plan were disqualified; (6) whether the failure is a failure to satisfy nondiscrimination requirements; (7) whether the failure is solely an employer eligibility failure; (8) the period over which the failure occurred; and (9) the reason for the failure.

Additional factors are considered for a "nonamender" failure (generally, the failure to timely adopt required amendments), including whether the plan sponsor has sufficient internal controls to ensure the timely adoption of amendments. With the more limited determination letter program, this latter factor may take on added importance with well-advised plan sponsors adopting systematic document control and review procedures. Generally, the Audit CAP sanction will not be less than the VCP user fee applicable to the plan. Hopefully, the Audit CAP sanctions determined under the new EPCRS will be more reasonable than they were under the prior system. The possible reduction in the sanction amount could be helpful in the new era where determination letters are no longer generally available to protect plans from qualification concerns raised by IRS auditors.

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The current version of EPCRS includes a chart showing the sanction that would apply to various nonamender failures that were discovered as part of the determination letter program, with the sanction amount based on the number of participants in the plan and the law that was the subject of the failure (e.g., GUST, EGTRRA, etc.). The new EPCRS establishes a different fee structure whereby the sanction is based on a percentage of the VCP fee that would otherwise apply (either 150% or 250%), depending on when the amendment should have been adopted. The changes apply to both individually-designed and pre-approved plans. Given the restriction on determination letter reviews for plans, this portion of the new guidance may have limited impact, though it may be helpful for determination letters on plan termination. Under certain scenarios, the IRS may reduce or increase (if the failure is "egregious") the sanction determined in this manner.

Additional Changes/Clarifications

In addition to the changes noted above, the updated guidance includes the following provisions:

- **Anonymous Applications** – If a VCP application is filed on an anonymous basis, and the applicant and IRS fail to agree on a correction methodology, no portion of the user fee will be refunded to the applicant. Previously, the IRS typically refunded 50% of the fee.

- **Correction of Interim Amendment and Nonamender Failures** – The new EPCRS clarifies that such failures must be corrected by adopting the required amendment *before* a VCP application is submitted to the IRS. In contrast, an amendment required as part of the correction now must be adopted no later than 150 days after the date of the compliance statement.

- **Effect of Compliance Statement** – The new EPCRS clarifies that a compliance statement blessing a correction via a plan amendment only covers the correction of the error, and is not evidence that the amendment or plan meets the qualification requirements.

- **Failure to Timely Adopt Discretionary Amendment** – The new EPCRS clarifies that the failure to timely adopt a discretionary amendment does not result in a plan document failure. Presumably, it results in an operational failure.

Observations

Time will tell whether IRS agents are more reasonable in seeking monetary sanctions under Audit CAP as a result of these changes. In our experience, it was quite rare that agents would seek anything close to the maximum payment amount – nevertheless, they often seek monetary sanctions disproportionate to the errors in question, and it can be difficult to obtain major reductions.

The new Revenue Procedure expressly states that the IRS is considering comments on the correction of overpayments submitted under Rev. Proc. 2015-27. Hopefully, future changes in this area will ease the expected actions by plan sponsors and participants in this problem area that regularly arises.

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