EPCRS Corrections:
Strategies and Negotiation Tips When Dealing With the IRS

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EPCRS: The Tools to Correct Plan Errors

- Rev. Proc. 2013-12 was released 1/22/13
- Updates issued on 3/27/15 (Rev. Proc. 2015-27) and 4/2/15 (Rev. Proc. 2015-28)
- Updates did not replace Rev. Proc. 2013-12

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<u>Quick</u> Review of General EPCRS Principles and Terms

Four Types of Qualification Errors

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

- Demographic Failure
  - Failure to satisfy §410(b) or §401(a)(26)

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Four Types of Qualification Errors (continued)

- Employer Eligibility Failure
  - Not eligible to establish type of plan (e.g., governmental 401(k) or ineligible for 403(b))

- Operational Failure
  - Not following the terms of the plan (i.e., usually everything else you encounter)
    - Other than prohibited transactions; exclusive benefit violations

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Consequences of Disqualification

- Taxation (IRS refers to this in EPCRS as Maximum Payment Amount)
  - Employer deductions lost if no inclusion in employee income
  - Trust is taxable (earnings may be taxable)
  - Employees taxed on amounts not subject to risk of forfeiture
- Exception: if sole failure is §410(b) coverage or §401(a)(26) participation failure, then only HCEs taxable

How Do You Correct?

- <u>Goal</u>: Make sure that your correction method will be acceptable to the IRS
  - If not, you could be creating another problem in the plan!
- First option: EPCRS itself contains correction methods for several errors that are preapproved
  - Following these methods is safe
  - You do not <u>have to</u> follow these methods, but they are preferred
  - Note: it is very hard to get the IRS to agree to a different method for ADP/ACP failure correction
- Second option: find reasonable, appropriate method
  - Use Code, regulations, and EPCRS as a guide
  - Correct discrimination failures by giving to NHCEs
- Note: the farther you get from pre-approved methods, the more beneficial it is to ask for IRS approval

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Follow EPCRS Correction Principles

- Must correct all taxable years (even if closed)
- Restore plan and participants to position they would have been in had the failure not occurred
- Should be reasonable and appropriate
  - Appendix A/B deemed reasonable
- Consistent with IRC (don't create another violation)
- Provide benefits to NHCEs
- Keep assets in plan
- Consideration of other agencies (e.g., DOL on abandoned plans)

Exceptions to Full Correction

- Unreasonable or not feasible (tough one to apply)
- Reasonable estimates are necessary (e.g., earnings)
- Distribution of small amounts ($75 or less)
- Recovery of small overpayments ($100 or less)
- Lost participants
- Small excess allocations ($100 or less)

Lost Earnings

- Corrective contributions, allocations or distributions must be adjusted for earnings
  - Don't have to adjust for losses, but can
  - Assume that the date on which the earnings begin:
    - Date on which contribution/forfeiture would have been allocated to the participant's account
    - For salary deferrals and after-tax contributions, assume mid-point of plan year (or period of exclusion)

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Lost Earnings

- Methods for determining earnings:
  - Generally use actual earnings based on EE's investment choices
  - Reasonable estimates of investment returns
    - Multiple investment options – option with highest rate of return (if most EEs are NHCEs)
    - If EE has no investment selections – average of all investment options
  - Can the DOL's online VFCP calculator be used?

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EPCRS Structure

- Three correction procedures:
  – Self-correction procedure (“SCP”)
    - Insignificant errors: anytime
    - Significant errors: time limited
  – Voluntary submissions to IRS (“VCP”)
    - Forms 8950 and 8951
    - Cannot be “under examination”
  – Audit Closing Agreement Program (“CAP”)

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Self-Correction Procedure: Insignificant Failures

CORRECTION MAY BE MADE AT ANY TIME

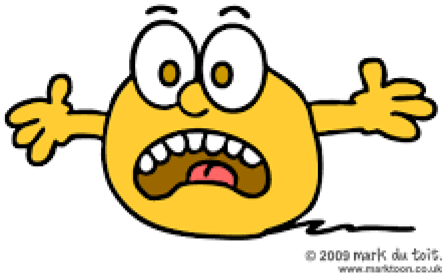
(even if the plan is under audit by the IRS)

Self-Correction Procedure: Insignificant Failures

- What is “insignificant?” Balancing of factors:
  - Have other failures occurred?
  - % of plan assets and contributions involved
  - Number of years affected
  - Number of participants affected (as % of total in plan and as % of those who could have been affected)
  - Was correction made within a reasonable time after discovery?
  - Why did the failure happen?
  - **Note: you will never know for sure whether something is insignificant in the IRS’s view**

Self-Correction Procedure: Significant Failures

- Defined: anything that is not insignificant
- Rule: must be "substantially" corrected during the "correction period"
  - Correction Period:
    - General rule: last day of second plan year following year of occurrence
    - ADP/ACP: last day of third plan year following year for which testing is failed



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VCP

- Plan sponsor submits a plan to the IRS for coordinated correction process
  - Fee payable
  - Plan must be eligible for the program
  - No correction applies until after approval granted under VCP program (correction letter)

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VCP

- General procedure
  - File with the IRS
  - Pay user fee
  - Negotiate with IRS as to correction method
  - Sign compliance statement with agreed-upon correction
  - Complete correction within 150 days

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Audit CAP

- IRS discovers problem on audit
- IRS and plan sponsor enter into a contract called a "Closing Agreement" to correct the problem
- Sponsor pays a sanction to the IRS

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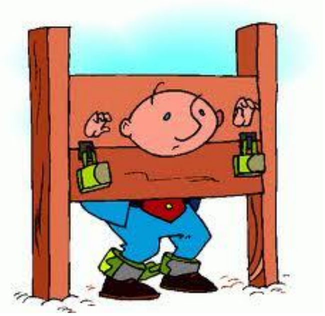
Audit CAP Sanction

- Starting place for negotiations: taxes that would be due if the plan were disqualified ("Maximum Payment Amount")
- Procedure requires that the sanction:
  – Not be excessive
  – Bear reasonable relationship to the nature, extent, severity of the failure
- Problem: "excessive" and "reasonable" are in the eye of the beholder



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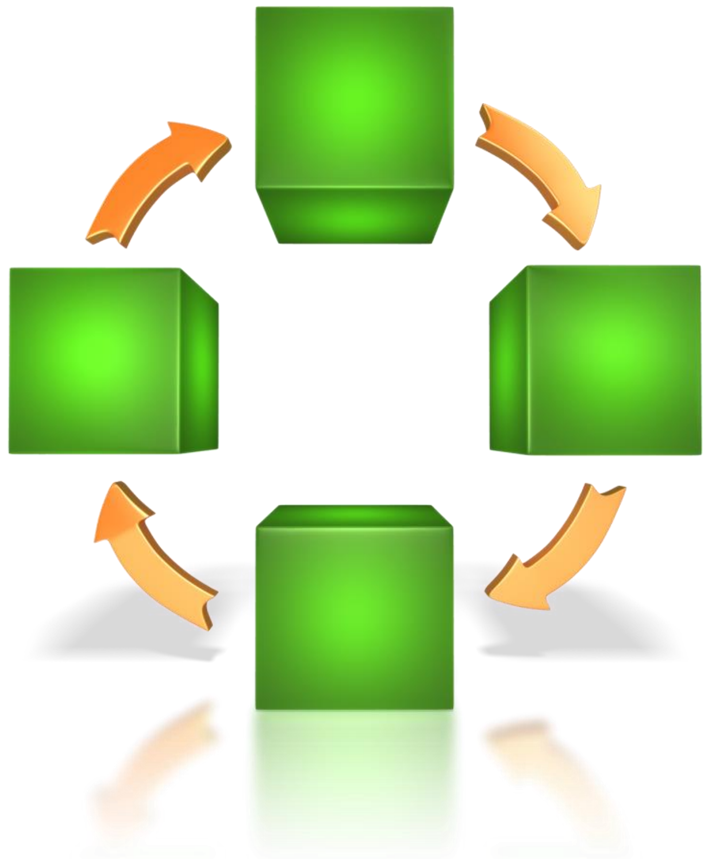

SO, HOW DO WE PROCEED?

Your Approach (The Playbook)

- Find out the facts … all of the facts
- Identify/categorize the various violations
- Self-correct, VCP, Other CAP, Audit CAP
- Determine corrections
  - Slam dunks (IRS-identified errors with pre-approved corrections)
  - Free throws (Not IRS-identified, but easy to determine acceptable corrections)
  - Jump shots (Reasonable issues, but you are pretty sure it is acceptable)
  - Three-pointers (You really need to show some finesse to get this done)
- Determine need/desire to file with IRS
- Do the work

Step #1:

Finding the Facts …
All of the Facts

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Suppose Your Client Comes to You . . .

- On July 1, 2012, Target was purchased by Buyer. Both companies sponsored 401(k) plans.
- Buyer began to cover Target's employees in its plan on August 1, 2012, despite the fact that the Buyer's Plan had a six-month wait. Deferrals were stopped to the Target's Plan, although no documentation was adopted. Deferrals were taken from Target's employees' paychecks and deposited to the Buyer's Plan based on the elections they had executed to the Target's Plan.
- Some Target participants had outstanding participant loans in the Target Plan when the acquisition happened. Buyer's payroll never took out loan payments for those participants, so no further payments were made on any of the loans.
- Target's participants were not given any past service credit for vesting purposes according to the Buyer's Plan document.

Initial Facts

- Buyer took action to terminate the Target Plan on November 1, 2013, and made distributions to participants in April of 2014. Participants were permitted to elect rollovers to the Target Plan, including any outstanding loans.

Where You Stand

- The client has told you what it thinks you want to know
  - But do you know everything <u>you</u> think you need to know?
  - Do the facts themselves raise any additional questions naturally?
  - Does your experience cause you to know that there "must be more" that you need to know?

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What We Heard … And What We Need

What We Were Told	Importance	Additional Questions
7/1/12 – Target purchased	Controls who is the employer, plan sponsor	What kind of transaction was it: stock, asset, merger?
Both companies sponsored 401(k) plans	The kinds of plans that could have errors	(a) Copies of plan documents (b) What did the plans say?
Buyer's plan covered Target employees 8/1/12 but had six-month wait, no past service credit	Error: employees covered too early	(a) What does the plan say?
Deferrals not stopped in Target Plan	Error: no legal reason to stop deferrals if employees continue to be employed by Target	(a) What kind of transaction was it? (b) Who is the employer of the employees?
Buyer Plan used deferral elections to Target Plan	Error: no actual deferral elections	

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What We Heard … And What We Need

What We Were Told	Importance	Additional Questions
No payments on outstanding loans in Target Plan	Default of loans?	Any Forms 1099R filed on the default?
Action taken to terminate plan and distributions made	Error? Successor plan prevented distribution	What kind of transaction was it?

Don't be afraid to keep asking questions until you are sure you understand what is going on!

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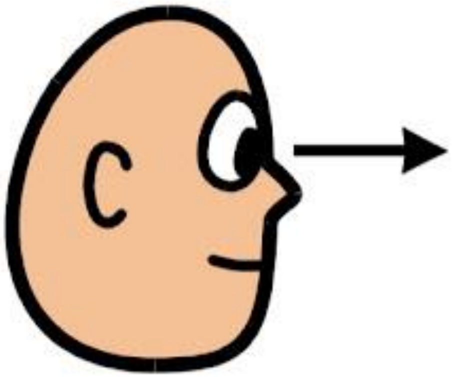
Step #2:
Identifying the Errors That the Facts Reflect



Approach

- Identify the problems first; worry about how to fix second
- Think about where the problems arise
  - IRS: qualification, taxation and funding, excise taxation
  - DOL: fiduciary breach, reporting and disclosure
  - PBGC: funding, premiums, and termination
  - Participant litigation: benefit rights, reporting and disclosure

Assume First That You Want to Fully Correct

- The client may decide down the road not to correct certain situations fully, but you need to know the gold standard
- It may be that there are things that *cannot* be corrected and your client needs to know the risks related to those issues

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Step #3: Which EPCRS (or other) Program Applies?

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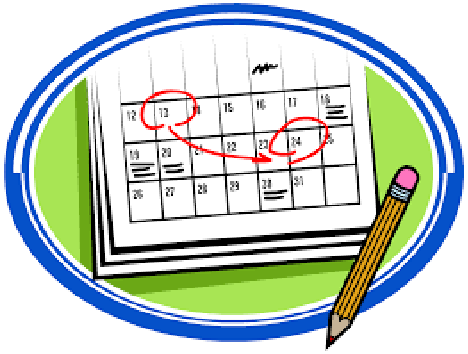
Self-Correctable Errors

- Do we have any?
- Do we have the requisite requirements?
  - FDL or equivalent?
  - Policies and procedures?
  - No exam by IRS noticed
- Options under self-correction
  - Correct
    - IRS-approved correction?
    - Unapproved correction?
  - Don't correct

Do We Have Any Errors That Can Be Self-Corrected?

- Remember timing rule:
  - If insignificant failure, can correct anytime
  - If significant failure, have until last day of the second year following the year of error (and ADP/ACP testing error is deemed to happen at end of testing year)
- Can we be sure an error is "insignificant?" How?



General Rules for Self-Correction Decision

- Generally, no reason to file if:
  - Within the self-correction period; and
  - Correction method is in Rev. Proc. or is commonly known to be acceptable (i.e., “Slam Dunk”)

- Consider filing if:
  - Outside self-correction period (are you *sure* it is an insignificant error?)
  - Correction method is suspect

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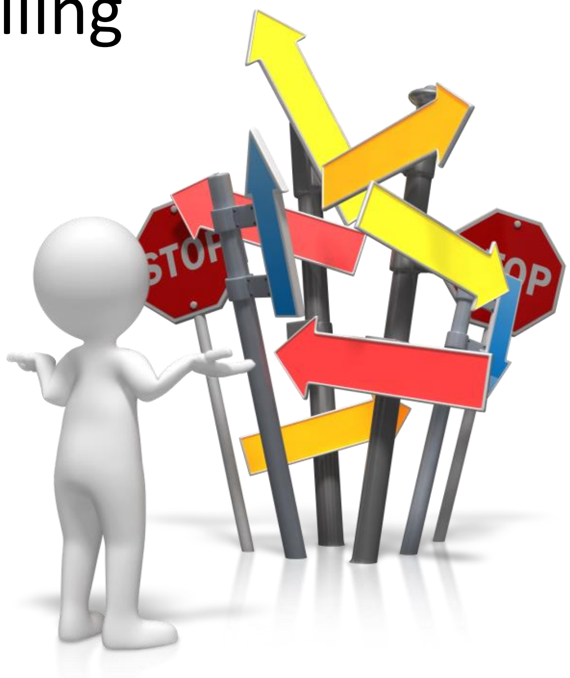
Self-Correction by Amendment

- Only three types permitted without VCP:
  - You let someone into the plan who did not meet the eligibility requirements and want to ease the requirements retroactively
  - You let someone take a loan or hardship distribution and your plan did not permit, and you are willing to modify plan to permit
  - You allocated to the HCE based on compensation in excess of 401(a)(17) and are willing to increase everyone else's contribution accordingly

What if Errors Are Not Self-Correctable Under EPCRS?

- In order of safety:
  - Option 1: VCP
  - Option 2: Correct with no filing
  - Option 3: Don't correct



What if I Am Not Eligible to Self-Correct, But I Do Anyway?

- If the IRS audits and the plan is not corrected in a permissible way:
  - The correction does not solve the problem
  - Likely will be required to enter audit CAP, with a sanction
  - The IRS may require that you pursue a different correction method
  - The correction method used could be considered an additional failure
  - But: the IRS is supposed to look favorably on a plan sponsor's attempt to be in compliance (so you should be better off than someone who did not correct at all)

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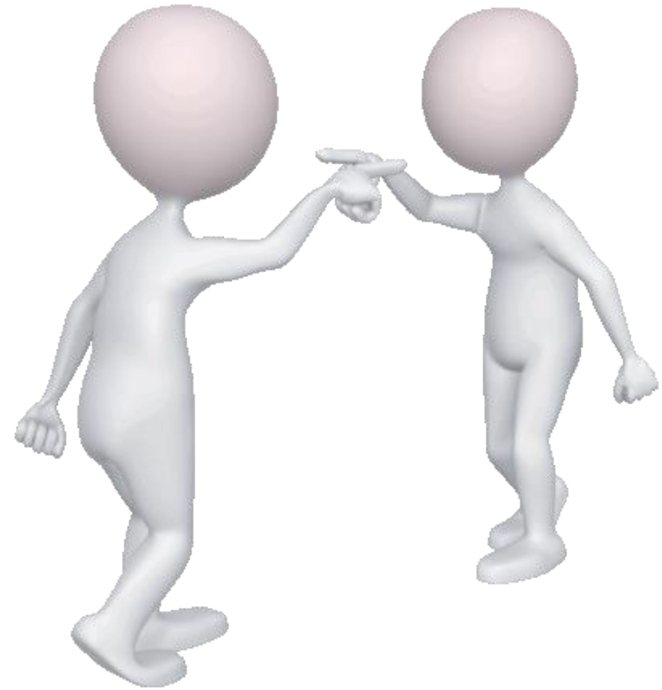
Key Practice Pointer

- Who is making the decision of *How to Move Forward*?
- What if it doesn't work?



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VCP Versus Voluntary CAP

- Not part of EPCRS
- To use VCP, must have **qualification** defect
- There are some nonqualification problems you can solve while in VCP
  - E.g., can get waiver of excise taxes on failure to pay RMDs
- If VCP is unavailable, because problem is not qualification error, consider Voluntary CAP

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Voluntary CAP

- Check out: https://www.irs.gov/Retirement-Plans/Employee-Plans-Voluntary-Closing-Agreements
- Eligibility:
  - Cannot be under exam or investigation
  - Cannot be eligible for resolution under VCP (but can resolve qualification problems, too)
  - Cannot be an abusive tax avoidance transaction or willful or intentional tax avoidance

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Voluntary CAP

- How it works
  - Submit detailed letter and Form 2848 to IRS in El Monte, CA (can talk on phone first)
    - Explain problem, including how/why it occurred, how many people involved, amount of contributions, distributions, etc.
    - Proposed correction
    - How tax, interest, or penalties were calculated
    - Proposed sanction and justification
  - They will respond and set sanction
  - Client and IRS will sign closing agreement

How We've Used It

- Client has 412(i)/412(e) plan that has not been handled correctly but is not an abusive tax-avoidance transaction
  - Failure to comply with IRC §412(e) creates funding problem, not qualification problem
    - Failure to fund (excise tax)
    - Failure to file Forms 5500, Schedules SB (penalty on failure)
  - There may also be qualification problems

Step #4: Formulating Corrections

Self-Correction Errors

- Which of the errors have preapproved corrections within EPCRS procedure?
- Do we want to try out any other possible corrections for any reason?
  - If we do, do we still want to self-correct?
- If we are making a VCP or Voluntary CAP filing for some things, is there any reason not to throw in the kitchen sink and get approval of everything?

General Guide for Corrections

- If there is an IRS-approved correction available, that is where to start
  - Rev. Proc. 2013-12, Section 6, Appendix A, Appendix B
  - Use that, unless there is a reason not to do so
    - Too impractical
    - Too expensive
    - Very unpopular to rank-and-file

  - Check out informal IRS guidance that is available
    - IRS answers to Q&As
    - What other practitioners have experienced

General Guide for EPCRS Correction

- If you have to formulate your own correction, remember the correction principles discussed on slides 8-11
- This is where experience helps: how hard will it be to get the IRS to approve what you want to do?

Correction of Scrivener's Errors

- Situation: plan is administered one way, document says something else
  - Very common with compensation definitions, entry rules, etc.
  - Plan sponsor wants to fix the plan to match what was actually done
- IRS view:
  - The IRS does not consider this to be the correction of a "Scrivener's error"
  - The IRS considers this to be an operational failure that the employer would like to correct with a plan amendment to match actual operations

Considerations

- IRS cares about:
  – Is there any extrinsic proof that the plan document provision was unintentional?
    - Letters to document drafter, advisors, participants regarding what was intended
    - Emails indicating what the employer was considering and what was decided
  – What was communicated to employees (i.e., what are their expectations?
    - SPD
    - Other communications

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Considerations

- For the employer:
  - EPCRS expressly applies to the IRS only
    - Not DOL
    - Not participants
  - Notwithstanding the intent of the employer, the scrivener amendment may or may not be considered by the courts to be valid retroactively if the participants sue
    - Is it better to just bite the bullet for past years and correct the plan administration to match the document, correcting the plan language for future years?

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Scrivener's Error Considerations

- Who's fault is this?
- For document drafter:
  - Be careful: if there is malpractice insurance, admitting the error may void the coverage

VCP and Voluntary CAP Filing Decisions and Procedures

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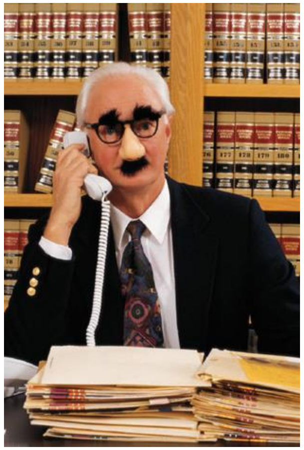
Decision #1: Should We Submit At All?

- Cost-benefit analysis for client
  - Differences between submitted correction and unsubmitted correction
  - Costs of filing, including:
    - IRS fee
    - Service provider fees
    - Internal client costs to gather information, etc.
  - Considering discoverability and Circular 230 requirements

Decision #2: Disclosed or No-Name?

- Advantage to “no-name”:
  - If you don’t like IRS’s correction requirements, you can walk away and get back half your money
- Disadvantage to “no-name”:
  - If the plan is called up for audit while VCP is pending, voluntary correction process is over and you’re in audit CAP
  - If the name is disclosed, audit process is suspended until VCP is complete



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Timing of Submission

- Hurry, as you don't want to get audited while things are pending!
- But, want a complete, well thought-out submission

What You Need to Submit for VCP

- Form 8950
- Form 8951 with user fee
- New Forms 14568, with attachments:
  - Describing failures (Section II)
  - Describing proposed correction, including ample calculations and corrections (Section III)
  - Describing procedure to locate missing people (Section IV)
  - Describing proposed revisions to administrative procedures (Section V)
- New Schedules 14568-A through -I, as appropriate
- Form 2848 Power of Attorney

What You Need to Submit for Voluntary CAP

- Written request letter
  - Explanation of problem, how/why it occurred, number of people affected, amount of contributions and distributions and such affected
  - Proposed correction
  - Calculation of tax, interest, or penalties and an explanation of how they were calculated
  - Proposed sanction amount and explanation and justification of proposal
  - If anonymous submission, unique identifying number plus penalty of perjury statement by submitter

Statement Under Penalty of Perjury

- Form 8950 is signed under penalty of perjury that the facts are true, correct, and complete
  - Have client carefully review the statement of how the failures arose and anything else that is factual in nature
  - Be careful about how you draft the various statements, both due to perjury potential and also to present the best “face” to the IRS

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Policies and Procedures

- We have historically emphasized that the employer has hired qualified advisors
- The IRS advises us that it is now looking for what the sponsor is doing *in its own offices* to prevent future failures:
  - Policies and procedures that have been established (who does what, whom to call with questions)
  - Checks and balances (who reviews what to make sure that it is correct)
  - Other

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Power of Attorney

- Must be able to practice before IRS: attorney, CPA, enrolled agent, enrolled actuary, enrolled retirement plan agent
- On “Description of Matter”: VCP Submission or “Application for Voluntary Closing Agreement”
- On “Tax Form Number”: 8950 and 8951 for VCP, “n/a” for VCAP
- On “Years or Periods”: leave blank

Audit CAP Suggestions

Quick CAP-Related Suggestions

- Do not dawdle in responding to IRS when the client is messed up; it doesn't help
  - You want the IRS folks to sympathize with your client if there are problems in the audit
- Always, always, always be the first to propose a correction method
- Sanction negotiations:
  - Try not to negotiate with yourself
  - Emphasize equities

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Closing Agreement

- Remember that this is a legal contract
- Consider having lawyer review
- Make sure that all issues are fully addressed

Final Thought

Do Not Do This if You Don't Know How

- A key element to successfully handling corrections is understanding the law, the correction options, and the effect of those options on your client, as well as the procedures
- If you cannot understand those elements, get someone who can
- Sad story ….

Questions?

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