

Benefit Insights

Pinnacle
Financial Services, Inc.

A 401(k) Third Party Administrator of
Exceptional Caliber & Experience

A non-technical review of qualified retirement plan legislative and administrative issues

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Voluntary Corrections for Qualified Plans

Given the complex nature of administering qualified retirement plans in accordance with ever-changing pension law, mistakes are inevitable. When the IRS discovers plan mistakes through audit, the plan risks being disqualified which results in severe consequences to the plan sponsor and participants.

Fortunately, the IRS recognizes that mistakes are a fact of life and has responded by developing voluntary error resolution programs. It has also posted on its web site the top ten failures reported through these resolution programs. Since the IRS recently announced its intent to conduct more audits this year, plan sponsors should become aware of the more common types of compliance problems and, if found in their plans, voluntarily correct errors by using the IRS correction programs rather than take a chance that an audit will reveal the mistakes.

Plan Disqualification

In order to reap tax advantages, qualified plans are responsible for complying with complex IRS

requirements. Failure to meet these requirements can lead to plan disqualification which results in severe consequences including:

- Prior corporate deductions are reversed;
- The plan trust becomes taxable;
- Participants are subject to immediate income taxation of vested contributions made on their behalf and cannot roll over these amounts into an IRA or another qualified plan; and
- Plan fiduciaries may face the risk of lawsuits by participants who were forced to prematurely recognize income.

To create awareness of common errors that may result in plan disqualification, the IRS has released the following list of the top ten failures found in the Voluntary Correction Program.

Top 10 Plan Qualification Failures

1. Failure to timely adopt amendments required by tax law changes.
2. Failure to follow the plan definition of compensation for determining contributions. This error results when certain types of compensation are incorrectly excluded or included (such as bonuses, commission or

overtime) which can result in participants receiving either higher or lower contributions than the amount they should have received.

3. Failure to include eligible employees in the plan or failure to exclude ineligible employees from the plan. By making this mistake, eligible employees may not receive contributions they are entitled to receive. Conversely, the employer may be making contributions for employees who are not entitled to receive contributions.
4. Failure to satisfy loan provisions. Errors regarding loan provisions include failure to withhold loan payments which results in a defaulted loan, issuing loans that exceed the maximum dollar amount (generally the lesser of 50% of the vested account balance or \$50,000) and loans with non-compliant payment schedules.
5. Impermissible in-service withdrawals. This failure can occur when a distribution is made to a participant and the law or plan terms do not permit a distribution. For example, making a hardship distribution even though the plan does not permit hardship withdrawals.
6. Failure to satisfy the minimum distribution rules. In general, participants who fall into the following two categories must begin receiving minimum distributions: (1) more than 5% owners who have reached age 70½, even if they are still actively employed; and (2) non-owner employees who have terminated employment and have reached age 70½.
7. Employer eligibility failure. In this failure an employer adopts a plan that it legally is not permitted to adopt. For example, the adoption of a Code Section 403(b) plan by an employer that is not a tax-exempt organization.
8. Failure to pass ADP/ACP nondiscrimination tests. This failure can occur for a variety of reasons including incorrectly classifying employees as either Highly Compensated or non-Highly Compensated employees, using incorrect compensation for testing purposes or excluding from the test eligible employees who elected not to participate in the 401(k) plan.
9. Failure to properly provide top heavy contributions to non-Key employees. In general, a plan is considered to be top heavy if more than 60% of the plan assets are for Key employees. If the plan is top heavy, non-Key employees are entitled to receive minimum contributions. One error that can occur is not using total compensation to calculate the minimum contribution—total compensation must be used even if the plan has a different definition of compensation for allocation purposes. Also, a 1,000 hour requirement cannot be imposed even if it is required by the plan for allocation purposes.
10. Exceeding the annual contribution limits. The law limits the annual amount of contributions a participant can receive in a defined contribution plan. The annual limit is the lesser of 100% of compensation or an indexed dollar amount (\$49,000 for 2009). If not monitored correctly, this limit can be exceeded when taking into account the total of all employer contributions, employee deferrals and forfeitures allocated to the participant's account (all plans sponsored by the employer and related employers must be aggregated for purposes of this limitation).

Plan sponsors who uncover plan qualification failures, such as those listed above, should promptly take advantage of the IRS's Employee Plans Compliance Resolution System.

Employee Plans Compliance Resolution System (EPCRS)

EPCRS is a series of correction programs that can be used by plan sponsors to correct common plan failures and bring the plan back in compliance.

“I’m from the government and I’m here to help” is actually true in this case! These programs may be used to correct qualification failures which generally fall into three categories:

- **Plan Document Failures:** Failure of the document to conform to the Internal Revenue Code and IRS regulations. Plan sponsors who fail to timely adopt required plan amendments fall within this group.
- **Operational Failures:** Includes failure to follow the terms of the plan document, such as failure to cover eligible employees, failing to satisfy the top heavy requirements and failing the ADP and ACP tests for 401(k) plans.
- **Demographic Failures:** Failure to meet minimum participation, minimum coverage or nondiscrimination requirements.

The IRS has provided pre-approved methods for correcting many types of common failures. The typical correction method is to put the plan and participants in the position they would have been had the plan been administered correctly. This may require additional contributions (plus earnings) for certain participants. In some cases, the failure can be corrected by a retroactive amendment to the plan. Below is an overview of the three EPCRS programs.

Self Correction Program (SCP)

SCP allows qualified plan sponsors to correct operational failures without filing with the IRS or paying a penalty tax. The program allows the correction of both insignificant defects as well as, in limited circumstances, significant defects. SCP cannot be utilized for demographic and

plan document failures or if the failure is egregious. The plan must have established practices and procedures (formal or informal) designed to promote overall plan compliance.

Plan sponsors should document the steps that were taken for fixing the failure in case they are later asked to justify their actions and should also put administrative procedures in place so the mistake does not happen again.

Insignificant Corrections

Generally, in order for a correction to be considered insignificant, it must be an isolated incident, and the plan must otherwise have a history of compliance in all other areas. Several factors need to be analyzed to determine if the correction is deemed insignificant including the number of errors that occurred, the percentage of plan assets and contributions involved in the error and the number of plan participants affected.

Insignificant defects can be corrected at any time following discovery. Also, SCP can be utilized for insignificant defects even if the plan is already under examination by the IRS.

Significant Corrections

To be eligible to utilize SCP for a significant operational failure, the plan must have a current determination letter or, in the case of a pre-approved plan, an opinion letter. For significant corrections, SCP is not available if the plan is already under examination by the IRS.

Significant failure correction must be completed, or substantially completed, by the end of the second plan year following the plan year in which the error occurred.

Voluntary Correction Program (VCP)

Defects that are not eligible for SCP, such as significant operational defects beyond the two-year correction period, plan document failures

or demographic failures, may be corrected using VCP. This program is not available if the plan is already under examination by the IRS.

The plan sponsor submits an application to the IRS outlining the failures and proposed correction methods and also pays a fee based on the number of participants. The IRS reviews the application and issues a Compliance Statement setting forth the agreed terms of correction.

If a plan sponsor is hesitant about disclosing plan failures to the IRS, a John Doe submission can be filed which allows the plan sponsor to propose a correction to the IRS anonymously. After a correction method is agreed upon in writing, the plan and plan sponsor are then identified.

Audit Closing Agreement Program (Audit CAP)

Audit CAP is available for problems that were not corrected voluntarily but instead were discovered during an IRS audit. By utilizing Audit CAP, the

plan avoids the consequences of disqualification. In addition to correcting plan defects, the plan sponsor must pay a penalty equal to a percentage of the amount of tax that would have been due if the plan were disqualified. The fee is generally negotiated based on the severity of the failure.

Conclusion

Because of the severe penalties associated with plan disqualification, plan sponsors should be aware of and on the lookout for common plan failures. Frequent internal audits of all aspects of plan administration can quite possibly prevent insignificant defects from becoming significant.

If the plan sponsor discovers any instance of non-compliance, the plan's advisors should be consulted to help determine the appropriate correction method. Fortunately, there are several EPCRS programs available for voluntarily correcting plan failures. The least expensive way to correct defects is to discover them early and before the IRS.

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