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Qualified Plan Mistakes Happen: What Plan Sponsors Do Next Is What Matters Most

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The Internal Revenue Service ("IRS") is very much aware that plan sponsors of tax-qualified retirement plans (such as 401(k) plans) make mistakes in plan administration. The types of mistakes are varied and numerous. For example, a plan sponsor may neglect to enroll an eligible employee in their 401(k) plan, apply the wrong deferral rate, use the wrong definition of compensation, or fail to timely deposit deferrals into the plan; and the list goes on and on. Plan mistakes (also called plan failures) are bound to occur due to the complexity of plan administration. Because to err in plan administration is human, the IRS created the Employee Plans Compliance Resolution System ("EPCRS")[1] to allow plan sponsors to fix certain plan failures and avoid the consequences of plan disqualification. Moreover, the IRS regularly updates its procedures, most recently on July 16, 2021,[2] and plan managers should be encouraged to become familiar with the updated procedures.

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This column provides an overview of the plan correction process utilizing the Self-Correction Program ("SCP") and Voluntary Correction Program ("VCP") under the IRS's EPCRS. This column also describes certain best practices to help plan sponsors avoid making mistakes in the first place.

EPCRS BACKGROUND

The purpose of the EPCRS is to provide a mechanism for plan sponsors to correct plan failures while continuing to provide their employees with retirement benefits on a tax-favored basis.[3] Through the EPCRS, the IRS encourages plan sponsors to voluntarily and timely correct any plan failures, which protects participating employees by providing them with their expected retirement benefits, while avoiding plan disqualification.[4] Under the EPCRS, a plan sponsor may correct mistakes under the following programs:

- Self-Correction Program ("SCP") – under this program, a plan sponsor may correct certain mistakes without contacting the IRS or paying a fee or penalty.

- Voluntary Correction Program ("VCP") – under this program, a plan sponsor pays a fee (up to $3,500) based on the size of the plan in order to submit an application to the IRS and, hopefully, receive a compliance statement from the IRS approving the correction of the plan failures.

- Audit Closing Agreement Program ("Audit CAP") – under this program, a plan sponsor pays a fine (or a sanction) and may correct a plan failure while the plan is under audit.

Ideally, if mistakes occurs, the mistakes are relatively minor and the plan sponsor catches them soon after they happen. Timing is of the essence as this is one of the main factors in determining whether the plan sponsor can correct the failure under SCP.

SELF-CORRECTION PROGRAM

Generally, SCP is available for insignificant and certain significant operational failures.[5] Insignificant operational failures may be corrected under SCP at any time; while significant operation failures must be corrected before the end of the third year following the year for which the failure occurred (the IRS expanded the SCP deadline under Revenue Procedure 2021-30 from two to three years following the year for which the failure occurred).[6] The significance of a plan failure is determined based on the facts and circumstances surrounding the failure.[7] While no

single factor is determinative of a failure's significance, the following are examples of some factors that are considered in making a determination:

(i) Other failures in the same period;

(ii) The percentage of plan assets and contributions involved in the failure;

(iii) The duration of the failure (i.e., the number of years over which the failure occurred);

(iv) The number of participants affected by the failure relative to the total number of participants in the plan;

(v) The number of participants affected as a result of the failure relative to the number of participants who could have been affected by the failure;

(vi) Whether a correction was made soon after discovery; and

(vii) The cause or reason for the failure.[8]

It is noteworthy that the IRS will not give an opinion as to whether or not the operational error is insignificant (unless the plan is under an examination). Therefore, while the only way to be certain that a plan correction is totally valid and complete is to submit an application to the IRS under VCP, in practice many plan sponsors prefer to view most plan failures as insignificant to avoid submitting a VCP application to the IRS.

In addition to reviewing a failure's significance to determine eligibility under the SCP, the plan sponsor must have established and routinely followed practices and procedures (formal or informal) reasonably designed to promote and facilitate overall compliance in form and operation with the terms of the plan and applicable law.[9] A plan document alone does not constitute evidence of established practices and procedures.[10] ERISA counsel can help a plan sponsor design such practices and procedures and determine whether SCP is available in a given situation.

If a plan sponsor is eligible to correct a plan failure under the SCP, then it must use a self-correction method that follows the general correction principles set forth in Section 6 of Revenue Procedure 2021-30, which include:

(i) Restoring all participants (and beneficiaries) to the benefits and rights they would have had if the failure had not occurred;

(ii) The correction should be reasonable and appropriate for the failure; and

(iii) The correction method should be applied consistently in correcting all failures of that type for that plan year.[11]

A common plan failure that plan sponsors correct under SCP is a failure to implement elective deferrals correctly in a 401(k) plan (also called an employee elective deferral failure). This failure includes a failure to apply an affirmative deferral election or an automatic contribution feature (e.g., automatic enrollment and automatic escalation features) and a failure to afford an employee the opportunity to make an affirmative election because the employee was improperly excluded from the plan.[12]

Generally, these types of failures can be corrected without making a qualified nonelective contribution ("QNEC") if the plan sponsor begins deducting the correct deferrals from participant paychecks within three months of the failure first occurring (or sooner if the plan sponsor is notified of the failure by the participant), provided that the plan sponsor (i) provides timely adequate notice of the failure to the affected participant, and (ii) makes a contribution to the participants account for any missed matching contributions (adjusted for lost earnings) due to the failure.[13] If the employee elective deferral failure is not identified within three months of the failure first occurring, the plan sponsor may still correct this failure if the plan sponsor begins deducting the correct deferrals on or before the first pay period on or after the last day of the third plan year following the plan year in which the failure occurred (or sooner if the plan sponsor notified of the failure by the participant).[14] In this scenario, the plan sponsor must (i) timely provide adequate notice to the affected participant, and (ii) make a QNEC equal to 25 percent of the missed deferral election plus any missed matching contributions (both the QNEC and the missed matching contributions must be adjusted for lost earnings).[15]

If the employee elective deferral failure relates missed elective deferrals for eligible employees who are subject to an automatic contribution feature in a 401(k) plan, then the plan sponsor may correct this failure without making a QNEC, provided that the plan sponsor:

(i) Begins deducting the correct deferrals no later than the earlier of the first pay period on or after the last day of the 9 1/2-month period after the end of the plan year in which the failure first occurred (or sooner if the plan sponsor notified of the failure by the participant);

(ii) Provides timely adequate notice of the failure to the affected participant; and

(iii) Makes a contribution to the participants account for any missed matching contributions (adjusted for lost earnings) due to the failure.[16]

If the plan sponsor misses the notice requirement or does not timely begin correct deferrals, then the employee elective deferral failure may still be corrected under SCP. However, the plan sponsor would not be able to correct the failure with a reduced QNEC. Instead, the plan sponsor needs to make a QNEC equal to 50 percent of the missed deferral election plus any missed matching contributions (both the QNEC and the missed matching contributions must be adjusted for lost earnings).[17]

VOLUNTARY CORRECTION PROGRAM

While SCP provides a mechanism for a plan sponsor to correct a plan failure without notifying the IRS, there are certain reasons why a plan sponsor may choose to correct a plan failure under VCP instead of SCP, including:

(i) The plan sponsor wishes to propose an alternative correction than the corrections explicitly addressed in EPCRS guidance;

(ii) The plan sponsor may be uncertain whether its failure is considered significant and eligible for correction under SCP;

(iii) The plan sponsor may prefer a written compliance statement from the IRS even for failures that are eligible for correction under SCP; and

(iv) Certain federal income and excise tax relief is only available under VCP.

Whatever the reason for submitting a VCP application, if a VCP application is submitted, plan sponsors should be prepared to discuss and negotiate an appropriate correction with the IRS.

As part of the VCP application, plan sponsors must disclose their identity. Prior to January 1, 2022, plan sponsors were permitted to submit VCP applications on an anonymous basis. This provided an opportunity for plan sponsors to discuss a proposal for a plan correction without disclosing the name of the plan sponsor or the plan and risking further scrutiny, including an audit. Anonymous VCP applications were ideal for plan sponsors that wanted to propose a correction that did not perfectly match the examples and the procedures set forth in the IRS's VCP materials. When the IRS and an anonymous plan sponsor could not come to an agreement regarding a correction, the plan sponsor retained the option to withdraw its application (and forfeit the application fee) while maintaining anonymity. Unfortunately, the IRS will no longer accept these anonymous VCP applications.[18]

While plan sponsors can no longer submit anonymous VCP applications, the IRS will provide plan sponsors with an option to request a free VCP pre-submission conference option before submitting a VCP application.[19] A pre-submission conference application is similar to the former anonymous VCP application in that the plan sponsor must describe the plan failure, proposed correction, related facts, and relevant plan provisions. There are significant differences between a pre-submission conference application and a former anonymous VCP application, including (arguably, most importantly) that the results of a pre-submission conference are non-binding on the IRS.

Additionally, a pre-submission conference may only be requested:

(i) For errors for which a compliance statement may be issued under EPCRS;

(ii) With respect to correction methods not described as safe harbor correction methods in Revenue Procedure 2021-30 Appendix A or B[20]; and

(iii) If the plan sponsor is eligible and intends to submit a VCP application following the conference.[21]

Lastly, VCP pre-submission conferences are held only at the discretion of the IRS, and as time permits,[22] so the correction process will be more unpredictable and take longer to reach a final resolution than the former anonymous VCP application.

AVOIDING MISTAKES

While it is helpful that the IRS established the EPCRS as a mechanism for plan sponsors to correct certain plan failures, a plan sponsor must have practices and procedures in place to avoid failures from occurring. Plan sponsors should work with their ERISA counsel to develop and implement appropriate practices and procedures.

Many failures result from the plan sponsor not being entirely familiar with the terms of its plan (e.g., which employees are eligible or should be excluded; what is included in the definition of compensation; and more). Plan sponsors should include annual periodic review of the terms of the plan on the agenda for plan committee meetings and may want to provide "cheat-sheet" summaries of these terms to anyone who is handling the day-to-day administration. Plan sponsors should work with their payroll teams to ensure that employees and compensation categories are coded as expected.

Additionally, plan sponsors should consider conducting an annual internal audit of its plan to ensure that the plan is being administered in accordance with its terms. For example, an internal audit should

review that eligible employees are properly enrolled and that contributions (both employee and employer) are correctly calculated and timely deposited in the plan. An internal audit should be able to assist a plan sponsor to identify if employee elections are being captured or if the wrong definition of compensation has been used for contributions. If an error were to occur in one of these areas, the plan sponsor hopefully will be in a position to catch it and able to correct it under SCP.

CONCLUSION

There have been some significant changes to the EPCRS over the past few years, including more flexible corrections and the removal of the anonymous VCP application. The IRS should be commended for encouraging plan sponsors to self-correct. The EPCRS provides a powerful tool for plan sponsors to keep their plans in compliance. Mistakes are bound to happen, so plan sponsors should consult with their ERISA counsel to understand the correction procedures under EPCRS and to develop and implement practices and procedures to help the plan sponsor catch these plan failures and make changes as they occur.

NOTES

1. Rev. Proc. 2021-30.
2. *Id.*
3. Section 1.01 of Rev Proc. 2021-30.
4. Section 1.02 of Rev Proc. 2021-30.
5. Section 4.02 of Rev Proc. 2021-30.
6. Section 9.02 of Rev Proc. 2021-30.
7. Section 8.01 of Rev Proc. 2021-30.
8. Section 8.02 of Rev Proc. 2021-30.
9. Section 4.04 of Rev Proc. 2021-30.
10. *Id.*
11. Section 6.02 of Rev Proc. 2021-30.
12. Section .05(10) of Appendix A of Rev Proc. 2021-30.
13. Section .05(9)(a) of Appendix A of Rev Proc. 2021-30.
14. Section .05(9)(b) of Appendix A of Rev Proc. 2021-30.
15. Section .05(9)(b)(ii) and (iii) of Appendix A of Rev Proc. 2021-30.
16. Section .05(8)(a) of Appendix A of Rev Proc. 2021-30.

17. Section .05(2) and (5) of Appendix A of Rev Proc. 2021-30.

18. Section 10.10 of Rev Proc. 2021-30.

19. Section 10.01 of Rev Proc. 2021-30.

20. For example, requesting a permission for an additional extension to refund deferrals to highly compensated employees to pass nondiscrimination testing.

21. Section 10.01 of Rev Proc. 2021-30.

22. *Id.*

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