

Fixing Problems Under The Employee Plans Compliance Resolution System

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Common Failures

IRS identifies the following as "Top Ten" Failures in VCP

- ❑ Late amenders/non-amenders
- ❑ Failure to follow plan definition of "compensation" for contribution or allocation purposes
- ❑ Improper inclusion or exclusion of employees
- ❑ Loan failures
- ❑ Impermissible in-service withdrawals
- ❑ Failure to make required minimum distributions
- ❑ Employer adopted plan that it is not eligible to adopt
- ❑ ADP/ACP failures
- ❑ Failure to provide minimum top-heavy contributions/benefits
- ❑ Contributions/benefits in excess of 415 limits

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Common Failures

Other common failures:

- ❑ Failure to obtain spousal consent/compliance with notice and election requirements
- ❑ Improper vesting calculations
- ❑ Late remittance of elective deferrals.

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General EPCRS Correction Principles

- ❑ Full correction for all (including closed) years. Following exceptions, each with its own set of conditions, may apply:
 - Reasonable estimates
 - Corrective distributions of \$50 or less
 - Overpayments of \$100 or less
 - Lost participants
 - Excess amounts of \$100 or less (VCP or Audit CAP only)
 - Orphan plans
- ❑ Restoration of plan to position it would have if no failure occurred

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General EPCRS Correction Principles

- Correction method must be reasonable and appropriate for the failure
 - Correction methods specified in Appendices A and B will meet this standard
 - May be more than one “reasonable and appropriate method”
 - To the extent possible, correction method should resemble one provided under IRC, regulations, or other generally-applicable guidance

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General EPCRS Correction Principles

- Reasonable and appropriate for the failure (cont.)
 - Nondiscrimination failures should be corrected through added benefits for NHCEs
 - Keep assets in plan, unless existing correction methods under IRC, regulations or guidance provide otherwise
 - Can't violate another qualification requirement (or 403(b), SEP or SIMPLE IRA requirement)
- Consistent correction and earnings adjustment method for same type of operational failure for same year
- Corrective allocations/distributions should be based on plan terms as of the year of failure

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Special Loan Correction Principles

- Participant must make corrective payment, but employer should pay interest resulting from failure
- Generally, deemed distribution to participant must be reported on 1099-R for year of failure and employer must pay applicable income tax withholding
 - Option to report deemed distribution in year of correction if correction is through VCP

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Special Loan Correction Principles

- Special correction methods available only through VCP and only if maximum permissible loan period has not expired (IRS has discretion to limit use)
 - Exceeding maximum loan limit may be corrected by repayment of excess
 - Maximum loan period/amortization schedule may be corrected through reamortization from original loan date
 - Defaulted loans may be corrected either through “catch-up” payments or reamortization
 - No deemed distribution to participant under any of these special corrections

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Correction through Plan Amendment

- ❑ Available under VCP or Audit CAP to correct document, operational or demographic failures or to have document authorize the correction method for operational failure
- ❑ Available under SCP only (1) for operational failures listed in Appendix B; (2) to conform plan terms to plan's prior operations; and (3) if determination letter is submitted before end of applicable remedial amendment period
- ❑ Amendment must comply with all qualification requirements.

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Appendix A Correction Methods

Appendix A to Revenue Procedure 2006-27 identifies the following common operational failures and the non-exclusive methods of correction under SCP or VCP

- ❑ Failure to provide top-heavy minimum
 - Contribute and allocate top-heavy minimum (d.c. plan) or accrue minimum required benefit (d.b.) plan for affected participants
- ❑ ADP/ACP failure
 - QNECS for all eligible NHCEs (in same percentage of compensation) to the extent necessary to pass applicable test
- ❑ Elective deferrals in excess of 402(g) limits
 - Distribute excess, and report excess as taxable in both year of deferral and year of distribution

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Appendix A Correction Methods

- Exclusion of eligible employees from all contributions or accruals
 - For non 401(k), non-match, make contributions (d.c.), plans or provide accruals
 - For non-safe harbor, non-Roth 401(k) plans, QNEC equal to 50% of ADP of employee's group, times participant compensation; add QNEC equal to corresponding match that was missed, plus earnings
 - For non-Roth after-tax contributions and corresponding match, correction is similar but substitute 40% for 50%
 - For safe-harbor, non-Roth 401(k) plan, correction depends on whether safe harbor is a match or a QNEC, plus earnings

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Appendix A Correction Methods

- Minimum required distribution failures
 - Distribute required minimum. For d.b. failures, add interest for loss of use
- Participant/spousal consent failures
 - Give participant option to consent to distribution actually made or QJSA. Must be QJSA if consent cannot be obtained
- Excess annual additions in d.c. plan
 - Distribute excesses that are elective deferrals; place other excesses in suspense account; no employer contributions until suspended amounts are reallocated

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Appendix B Correction Methods

Appendix B to Revenue Procedure 2006-27 identifies additional non-exclusive methods of correction for common failures under SCP or VCP and earnings adjustment methods; also provides examples

- ADP/ACP failure
 - “One-to-one correction method” – combination of kick-out to HCEs and contribution of equal amount for all eligible NHCEs (in same percentage of compensation)

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Appendix B Correction Methods

- “Partial year” exclusion of employees from elective deferral/after-tax contribution participation
 - May use compensation for excluded period
 - No corrective contribution (other than missed match) necessary if participant was eligible for last nine months and could have deferred/contributed maximum amount
- Exclusion from profit-sharing allocation
 - Option to reallocate aggregate contribution
 - Special earnings adjustment rules
 - Distributions made before correction may be retained, but only if most employees who may retain are NHCEs

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Appendix B Correction Methods

- Vesting failure resulting in excess forfeiture
 - Employer may make corrective contribution; improper forfeiture allocation is not corrected
 - Option to “undo” the improper forfeiture and its allocation, subject to conditions
- Payments in excess of 415(b) (d.b.) limit
 - Employer may reasonably attempt to recover excess, and pay unrecovered amount; Option to adjust future payments
- Excess annual additions in d.c. plan
 - Unvested excess for terminated NHCE may be forfeited
 - Distributed excesses of employer contribution may be recovered

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Appendix B Correction Methods

- Overpayment corrections must include notification to employee of ineligibility for rollover/other favorable tax treatment.
- Other overpayments may generally be corrected in same way
- 401(a)(17) failures
 - Reduce allocation attributable to excess; reallocate if excess would have been allocated to other participants, or place in suspense account if not
 - Option to amend plan to allow for excess allocation but increase contribution/allocation for other employees accordingly
- Hardship distributions or loans not permitted by plan may be corrected by retroactive plan amendment

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Appendix B Earnings Methods

- ❑ Apply to corrective contributions/allocations only
- ❑ Earnings generally to be made from date of failure, but exclusion from elective deferral/match may use “midpoint” or beginning of failure period in the plan year
- ❑ For self-directed plans, earnings are based on affected participants’ actual investment choices
 - May use highest fund earning rate if most affected employees are NHCEs
 - Use plan-wide earnings rate if no participant investment choices
- ❑ May allocate either according to plan allocation method; to specific affected employee; or one of two hybrid methods.

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Loan Failure Fact Pattern

- ❑ In January 2001, 5-year loan is made to Participant and 15-year loan is made to Participant B.
- ❑ Loan terms are compliant; repayment is to be made by payroll deduction.
- ❑ Payroll systems change in March 2001; no payroll deduction or other repayment is made
- ❑ Failure is discovered in 2007

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Improper Distribution Fact Pattern

- ❑ ABC Co. is acquired by and becomes a wholly-owned subsidiary of XYZ Co.; ABC employees become XYZ employees.
- ❑ ABC's 401(k) plan is frozen; ABC employees become participants in the XYZ 401(k) plan
- ❑ ABC plan participants are not eligible to receive a termination distribution from ABC plan because "employer" includes parent XYZ
- ❑ The TPA for the ABC 401(k) plan incorrectly codes ABC employees as terminated and distributions are made to some who have become XYZ employees
- ❑ Some plan investment choices had losses afterward
- ❑ Some improperly-distributed assets experience substantial post-distribution gains and were then sold.

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ADP Failure Fact Pattern

- ❑ 401(k) plan failed ADP for plan year ending 12/31/05, but corrective kick-outs to HCEs were timely made
- ❑ In early 2007, the plan changes its TPA; the new TPA discovered that data used for the 2005 ADP testing was not accurate due to miscoding
- ❑ As a result, the plan fails ADP, even taking into account the earlier corrective kick-outs
- ❑ Plan document allowed for "targeted" QNECs in 2005.

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“Drafting” Error Fact Pattern

- ❑ Standardized prototype document adopted by employer defined eligible employees to include all employees of controlled group
- ❑ In 2000, the employer acquires two subsidiaries, whose employees are never permitted to participate

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Misallocation Fact Pattern

- ❑ Standardized prototype profit sharing plan provides for same percentage-of-compensation allocation formula
- ❑ Plan in practice used different allocation formula for different classification groups.
- ❑ Some HCEs, but no NHCEs, were permitted to invest in private placements

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Roth 401(k) Fact Pattern

- ❑ Employer adds Roth 401(k) feature to its existing 401(k) plan, effective 1/1/07.
- ❑ 10 employees are not informed of Roth 401(k) feature in 2007 and make maximum 402(g) contributions on pre-tax basis for that year
- ❑ Error is discovered in November 2008

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