EPCRS Questions - June, 2006 ASPPA Web Cast:

The following questions and answers are based on an oral presentation made by IRS officials at the ASPPA web cast on June 6, 2006, entitled, "It's Finally Here. EPCRS Updated." *The questions were submitted by the attendees and the responses were given at such meeting. These responses reflect the unofficial, individual views of the government participants as of the time of the discussion, and do not necessarily represent agency policy.*

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1) The updated Rev. Proc. 2006-27 included loans as a possible correction by retroactive plan amendment under SCP (Section 4.05(2) and Appendix B 2.07). In a situation where the plan already allowed loans however, the document was not written to allow loans that exceeded a 5 year period for the primary residence, could this type of failure if caught before the initial 5 year period from the loan origination, be corrected with a retroactive amendment under SCP? The client would be required to file for a determination letter by the end of their RAP (Rev. Proc. 2005-66). Thanks for you interpretation of this Rev. Proc. provision.

Answer: SCP is not available for this correction. Section 4.05(2) of Rev. Proc. 2006-27 provides that correction by plan amendment, under SCP, is only available for operational failures listed in Appendix B 2.07. The correction available under Appendix B relates to the operational failure of permitting plan loans to employees under a plan that does not provide for plan loans. The failure described is not among the listed failures provided for in Appendix B.

2) Appendix A .05 Exclusion of an eligible employee from all contributions or accruals under the plan for one or more plan years. Please confirm the Compensation used to determine the missed deferral opportunity will always be current year (year of the test) and not prior plan year when a plan elects the prior year testing method.

Answer: Compensation (and ADP) for the year of exclusion is used. In order to determine a participant's missed deferral opportunity, an estimate of what the participant's deferral might have been needs to be made during the period of exclusion. For that purpose, the participant's deferral percentage is estimated by referring to the average of the deferrals made by the participants' peer group (HCE or NHCE) during the period of exclusion. That percentage is then multiplied by the participant's compensation during the period of exclusion. The resulting number is the estimate of the deferral that might have been made by the participant during the period of exclusion (referred to in the Appendix as the employee's "missed deferral"). The amount required to make up for the missed deferral opportunity is 50% of the employee's missed deferral.

3) The definition of Under Examination has been changed. It says that if during the review process, the agent requests additional information that indicates the existence of a qualification failure not previously identified by the plan sponsor, the plan is considered to be under an employee plans examination. If the determination letter request is subsequently withdrawn, the plan is never the less considered to be under examination for purposes of eligibility under SCP and VCP. Question: How long is the plan considered to be "under exam"? What if they never hear back from the IRS? Are they still considered under examination 1 year, 10 years, down the road?

Answer: Yes. A plan's "Under Examination" status does not change when the Plan Sponsor, after notification of possible qualification failures, elects to withdraw its determination letter request. Please note that if an application for a determination letter is withdrawn, a plan is only considered to be "Under Examination" with respect to those issues raised by the agent reviewing the determination letter application. Other failures, assuming other provisions of the rev. proc. are satisfied, would be eligible for correction under SCP and VCP.

4) In Chapter 15 of the 2006 ERISA Outline Book Section VI Part C.2., it reviews correction methods for late correction of ADP and ACP tests with the QNEC correction method. It outlines an example of a 2005 correction for a 2003 plan year failure, and states EE's terminated prior to 2005 with no compensation for 2005 would not receive the QNEC since any contribution would violate the annual additions limit, and that the QNEC is simply re-solved for the other eligible participants from the 2003 test and the recomputation still passes testing. But what if an employee terminated DURING 2005 with compensation, but their QNEC would be greater than their compensation for 2005? Do they receive an amount to bring them to the maximum annual additions limit, with the remainder of their portion of the QNEC re-solved, or do they receive nothing since they terminate during the correction year?

Answer: The corrective QNEC made to a participant's account to correct an ADP failure will not be considered an annual addition with respect to the participant for the limitation year in which the correction is made, but will be considered an annual addition for the limitation year to which the corrective QNEC relates.

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5) Can the methodologies for correction of exclusion of an eligible employee described in Appendix A Section .05 be applied to situations where deferral elections are on file? Example: A company undergoes a payroll system conversion and during conversion certain compensation elements were inadvertently excluded (*e.g.,* bonus) as eligible compensation. To correct, can we provide QNC based on 50% of the deferral election on file on pre-tax, 100% on match and 40% on after-tax contribution?

Answer: Appendix A, section .05 applies to a situation where a participant has not been provided with the opportunity to make an election or make an elective deferral. However, the Service will permit the use of the lost opportunity analysis in similar situations where participants are precluded from making elective deferrals or after-tax employee contributions to the plan. In this situation, the plan may utilize the applicable percentages provided for in Appendix A/B. However, the plan may need to consider the impact of correction on applicable ADP/ACP tests.

6) Failure of a calendar 2004 ADP test is not distributed until this year (2006). What is the correction method?

Answer: If the failed ADP test was corrected by the end of the 2005 plan year, then distributions to the HCEs may have been sufficient. (For details, see IRC 401(k)(8)). Since the distribution was made in 2006, the plan has a qualification failure on account of the failed 2004 ADP test. The plan may elect to use the correction programs under Rev. Proc. 2006-27 for this purpose. Please refer to App. B 2.01(b) in the Rev. Proc. entitled “One to One Correction Method” for a possible solution. That method requires distribution of the excess contributions (plus earnings) to the HCEs (which appears to have been done already) and a qualified non-elective contribution equal to the amount distributed to be contributed by the employer to the plan and allocated among eligible NHCEs. In addition, it is expected that the plan sponsor will revise its procedures to ensure that if an ADP test is failed in the future, correction will be made timely.

7) Is there a correction method for a plan when 401(k) deferrals have occurred prior to the execution of the plan document?

Answer: If the goal is to preserve the elective deferrals in the plan and assuming that there is sufficient documentation to evidence intent to maintain a plan, and assuming other qualification requirements relating to 401(k) deferrals were satisfied, the plan sponsor may consider submitting a VCP application proposing a retroactive amendment providing for an earlier effective date for elective deferrals and requesting that the amendment be treated as if it was timely adopted as of that effective date. The standard used for determining whether a retroactive amendment would be accepted can be found in section 4.05 of Revenue Procedure 2006-27.

8) The correction methods and examples in the rev. proc. appear to be directed toward the realm of individual account plans (e.g., 415 limit violations). Can you confirm that an allowable self-correction method in a "pooled account" DC plan would be simply to re-run the valuation so that all the allocations are in compliance with the plan document?

Answer: Clarification of this question is needed.

9) Hypothetically....If a sponsor has allowed deferrals under their profit sharing plan, but have not amended the plan to provide for such, would the correction be through VCP?

Answer: Possibly. Please see answer to Q 12.

10) Client has a safe harbor 401(k) plan with a mandatory match. Client never gave a safe harbor notice since the inception of the plan. Can this be corrected under VCP?

Answer: Yes.

11) [While on slide 12] In the first example of correcting the $60,000 loan, is the $10,000 in excess of the limit taxable to the participant?

Answer: The excess amount is taxable to the participant pursuant to the provisions of Code section 72(p). However, if the plan sponsor makes a VCP application and proposes to correct the loan failure in a manner that satisfies section 6.07(2)(b) of Rev. Proc. 2006-27, then the Service may agree to not require the plan to report the loan as a deemed distribution on Form 1099-R. In that circumstance, the excess amount would not be taxable to the participant.

12) Assume you have a plan that failed to amend for GUST. Do you have to submit the plan for a GUST determination letter first, then under VCP, or should you just submit directly to VCP?

Answer: If you know that you have a failure to amend for GUST, then you should submit the plan for correction under VCP. A determination letter application will be required as part of the VCP application package and should be mailed to the same address as the VCP submission. See sections 4.06 and 11.03(3) of Rev. Proc. 2006-27. If instead of submitting under VCP, the plan is submitted for a GUST determination letter first without identification of the failure, then a much higher fee schedule applies. See section 14.04 of Rev. Proc. 2006-27.

13) I am a bit confused as to when submissions for corrections are required...can you summarize when submissions are and are not required?

Answer: It appears that this question is geared toward determining when the Self Correction Program (SCP) can be used and when the Voluntary Correction Program (VCP), which requires a submission, might be appropriate. Revenue Procedure 2006-27 describes the programs. However, for helpful information on the differences between the programs, you may want to consider reviewing the information provided on the IRS web site. You should be able to find an article describing the differences between the two programs as follows. Please go to the following web site: http://www.irs.gov/pub/irs-tege/epcrs_overview.pdf. Scroll down the screen until you see a link to the Voluntary Correction Program. Once there, there should be a link to the title "How the Voluntary Correction Program (VCP) and the Self-Correction Program (SCP) Differ." If the approach described does not work, you should be able to find the article with the following steps. Please go to www.irs.gov, click on the "Retirement Plans Community" link; click on "Correcting Plan Errors." On the right hand side of the screen, under "Overview of Programs," select the "Voluntary Correction Program" link. Page 38 of that document has a link to an article entitled "How the Voluntary Correction Program (VCP) and the Self-Correction Program (SCP) Differ."

14) (a) If an employer allowed an acquired company to enter into their plan without becoming an adopting employer (currently required by the document). The plan is being retroactively amended to permit these acquired employees to enter immediately, but these employees must wait one year for the profit sharing contribution. The plan is being submitted to VCP. Since this is a retroactive amendment, is a determination letter filing required?

Answer: Not if the plan is being submitted under VCP and is applying the provisions of Rev. Proc. 2006-27. For applications made under Rev. Proc. 2006-27, a determination letter would only be required to correct a non amender failure (if the plan sponsor is correcting the failure by adopting an individually designed plan). In other situations where qualification failures are being corrected by plan amendment, a determination letter filing is not required. In these situations, however, if the VCP submission occurs in the same year as the plan's on-cycle year (as provided in Rev. Proc. 2005-66) or the year of the plan's termination, then the plan sponsor may elect to submit a determination letter application as part of the VCP application.

(b) The VCP and determination letter submission together?

Answer: Please see answer above and response to Q 41. If a determination letter submission is made, it would be a part of the VCP application (i.e. submitted together). However, as noted above, a determination letter application may not be required in many instances.

15) Do you have any idea when we can expect additional guidance regarding excluded employees, specifically in regard to Roth and CUC?

Answer: Comments from the public have been requested regarding proposed correction methods for employees excluded from plans that offer employees the opportunity to designate elective contributions as Roth contributions and/or the opportunity to make catch-up contributions. In a subsequent revenue procedure, the Service may publish specific correction methods for plans with these features. The Service will, however, consider correction methods that satisfy the correction principles outlined in section 6 of Rev. Proc. 2006-27.

16) [At slide 28] How would you address this from a 403(b) perspective?

Answer: To the extent a failure listed in Appendices A and B could occur under a 403(b) plan, the correction method listed for such failure may be used to correct the failure.

17) Does the new correction for "failure to include" apply even when a participant has filled out and turned in an enrollment form? In that case, the participant's intent for a specific level of deferral is known.

Answer: Please see answer to Q 5.

18) Plan did not cease employee 401(k) withholdings after a participant took a hardship distribution. What is the appropriate correction method? Is this available for SCP?

Answer: Section 6.02(1) provides that the correction method should place the plan and the participants in the position they would have been in had the failure not occurred. Therefore, one option might be to return the erroneous withholdings, adjusted for earnings, to the participant. The distribution would be taxable to the participant. Since this is an operational failure, SCP may be an option in this instance provided the eligibility requirements for that program are satisfied. See Rev. Proc. 2006-27 for provisions relating to SCP. In addition, helpful information on SCP can be found in the IRS web site. Please try the following link: http://www.irs.gov/pub/irs-tege/epcrs_overview.pdf Scroll down the document and look for links to the various EPCRS programs, in particular SCP and VCP. In addition, the web site information provided in the answer to Q 43 might be helpful.

19) (a) For failure to submit deferrals timely as reported on the 5330, there is now a de minimus amount of 100 -- that is, if the Section 4975 is less than or equal to 100, no required 5330 filing -- please confirm.

Answer: Yes. However, the excise tax amount ($100 or less) must be contributed to the plan and allocated to the accounts of the plan's participants and beneficiaries in a manner consistent with the plan's provisions concerning the allocation of plan's earnings. Please see Amendment to Prohibited Transaction Exemption 2002-51 (71 FR 20135, April 19, 2006).

(b) If there's no 5330 required, do we still report the late deferral amount on the 5500 Schedule I?

Answer: Yes. Please see Instructions for the Form 5500 - Line 4a of Part II of the Schedule I.

20) What if the plan uses a non elective safe harbor of more than 3%? Does the QNEC for safe harbor have to include the full amount (percentage)?

Answer: Yes. An erroneously excluded employee should receive all of the nonelective contributions he or she would have been entitled to receive, had he or she commenced participation timely. In addition, if the employee was also erroneously excluded from making an elective deferral, then the employer needs to make up for the employee's missed deferral opportunity. In this instance, one can assume that the employee would have made a deferral equal to 3% of comp, thus requiring an additional QNEC of 1.5% of comp.

21) Under the new method of correction for deferrals, does using 50% of ADP for the group mean that we no longer have to calculate lost earnings? If not, do we calculate lost earnings the same way under current guidelines?

Answer: Earnings adjustments are still required. The guidelines for determining the earnings adjustment have not changed in Rev. Proc. 2006-27.

22) If the plan allows both normal salary deferrals and Roth deferrals how do you determine if you use the 50% QNEC rate instead of the after tax 40% QNEC rate?

Answer: The methods and examples described in App. A .05 and App. B 2.02 do not address situations where an employee was excluded from a plan that provided for the opportunity to make designated Roth contributions. Reasonable approaches to correct failures for plans that provide for Roth contributions would be considered. Rev. Proc. 2006-27 contains a request for comments regarding the appropriate correction for excluding employees from such plans.

23) Is this applicable to governmental plans? Sorry - the exclusion of ineligible employees in a post-tax plan but withdraw the question - ACP doesn't apply.

Withdrawn question.

24) Is the correction with QNECs for failure to include an eligible employee available under SCP?

Answer: Yes.

Also, please clarify - do we use compensation for the plan year the employee was excluded?

Answer: Yes. Please see answer to Q. 2.

Would the testing method determine/affect the compensation used?

Answer: No. Please see answer to Q. 2.

25) We understood that 457 plan failures were going to be covered by EPCRS. How do we now fix?

Answer: Submissions relating to 457(b) eligible governmental plans will be accepted by the Service on a provisional basis outside of EPCRS through standards that are similar to EPCRS.

26) Section 6.10(5)(a), related to SEP IRA and SIMPLE IRA plans, indicates that a "Plan Sponsor may effect distribution of the employer Excess Amount." However, IRA custodians must take direction from the IRA owner, not the Plan Sponsor. When will this section be changed to recognize the IRA custodian's limit to take direction only from the IRA owner?

Answer: Please see section 6.10(5)(b) re: Retention of Excess Amounts. It is an attempt to address the situation where excess amounts are retained. This provision recognizes the fact that excess amounts may be retained because of the limitation of the plan sponsor in effecting a corrective distribution.

27) If you are using current year ADP testing, and erroneously exclude some employees from the deferral, then are the erroneously excluded employees treated as 0% for ADP testing, and the ADP correction is made on that basis? If so, then can the ADP correction count towards the erroneously-excluded correction?

Answer: The correction methodology for an excluded employee is the same regardless of the method used by the employer to run its ADP test (current year or prior year). If the plan sponsor is applying the correction methodology for erroneously excluded employees in Appendix A or Appendix B, the ADP test would be run including only those employees who were given the option to defer timely. Therefore the erroneously excluded employees would not be treated as “zeros” for ADP testing.

28) What is the correction for a plan that did not amend for GUST? We have since amended to prototype document. Who must prepare the VCP submission (EA, attorney or can an unenrolled person file)?

Answer: In this case the plan sponsor corrected the failure by adopting a prototype document. Since the amendment was not made timely, the plan sponsor could file a VCP submission to address the failure by the plan sponsor to adopt the required amendments on a timely basis. If the prototype plan document is the subject of a favorable opinion letter, then generally, a determination letter submission will not be required. The Service does not place a limitation on who can prepare the submission. However, to sign the submission or to appear before the Service in connection with the submission, the Plan Sponsor’s representative must comply with the requirements of section 9.02(11) and (12) of Rev. Proc. 2006-4, 2006-1 IRB 132. An enrolled actuary or attorney could possibly meet those requirements. An unenrolled person would probably not meet these requirements. Such an individual could be authorized to inspect or receive confidential information on behalf of the plan sponsor. But the individual could not sign the submission or appear before the Service in connection with the submission.

How much is the fee (3 employee plan)?

Answer: $750.

Finally, since it's now on a prototype document, does it require a determination letter?

Answer: If the plan sponsor adopted a prototype document with a favorable opinion letter and did not modify the plan's provisions, a determination letter application would not be required.

29) I have a client who can't locate pre-GUST documentation, and has always used prototype plans. Is the lack of proof of document compliance in the past the same as being a non-amender? The fees are fairly steep if the plan goes all the way back to the early 80's.

Answer: Possibly. The plan sponsor needs to maintain records to show that the plan documents maintained by the employer complied with applicable laws.

30) If diversion or misuse of funds cannot be corrected by the VCP process, what process should be used?

Answer: The Employer could make a submission outside of EPCRS and request a closing agreement. The Service would coordinate correction of a failure involving diversion or misuse of assets with the Department of Labor.

31) Under Miscellaneous changes, please define Excess Amount.

Answer: Please refer to the definition in section 5.01(3) of Rev. Proc. 2006-27. The term "Excess Amounts" generally refers to excess allocations required to be distributed to the participant in order to keep the plan qualified (e.g., elective deferrals in excess of IRC 402(g) limits).

32) Does 50% QNEC apply to a negative election 401(k) plan? Does missed opportunity cost also apply?

Answer: Possibly. If deferrals should have been made pursuant to the plan's negative election provision, then the failure to implement such deferrals could result in a missed deferral opportunity. A QNEC is required to make up for the missed deferral opportunity. Please see answer to Q. 5 regarding issues that need to be considered when determining the appropriate correction for the plan's failure to implement the deferrals in accordance with the participant's election (which would include, if appropriate, the negative election provided for under the terms of the plan).