

IRS Updates and Expands Qualification Correction Program

September 2, 2008

On August 14, the Internal Revenue Service (IRS) issued Revenue Procedure 2008-50, its latest guidance on methods available to sponsors of tax-qualified retirement plans to correct operational and plan document errors in order to preserve a plan's tax-qualified status. This guidance provides significant expansions and enhancements to the Employee Plans Correction Resolution System (EPCRS), which was last revised in Rev. Proc. 2006-27. The EPCRS provides three programs of correction known as (i) Self-Correction Program (SCP), (ii) Voluntary Correction Program (VCP), and (iii) Correction on Audit Program (Audit CAP). Plan sponsors of qualified plans, 403(b) plans, and other types of retirement plans are eligible to utilize these correction programs.

The following is a description of some of the highlights of the clarifications and changes that are found in the new Revenue Procedure.

- **Effective Date.** Plan sponsors may apply the revised EPCRS provisions of this revenue procedure beginning on or after September 2, 2008 (the date that the IRS anticipates publication of the revenue procedure in the Internal Revenue Bulletin). However, starting on January 1, 2009, the provisions of this revenue procedure must be used. In almost all cases, plan sponsors will want to use the revised procedure immediately.
- **Streamlined VCP Application Procedures.** The most significant change in the revenue procedure entails streamlined application procedures for a number of common failures. The IRS wanted to build on the success of the prior revenue procedure's Appendix F—the original streamlined application format for correcting failures to amend a plan timely for good faith and interim amendment requirements. Some of the new streamlined schedules include the following failures:
 - Interim and certain discretionary amendments not timely adopted (expanding the original Appendix F)
 - Nonamender failures
 - Plan loan failures
 - Employer eligibility failures (401(k) and 403(b) plans)
 - Failure to distribute elective deferrals in excess of the 402(g) limit
 - Failure to pay required minimum distributions timely under 401(a)(9)

- Plan amendment corrections pertaining to 401(a)(17), permitting hardship distributions, early inclusion of employee into the plan, and permitting plan loans

A standardized application form (Revised Appendix F) is included in the revenue procedure and should be used with all the above streamlined schedules. This streamlined format, which integrates an application and compliance statement, will provide significant time and cost savings for the plan sponsor in the preparation stage and during IRS processing of the VCP submission.

- **Section 403(b) Plans.** Although the revised EPCRS rules do not provide any substantive changes incorporating the 403(b) final regulations released in July 2007, the next reiteration will likely address the common failures that are likely to arise from the new requirements triggered by these final regulations including, but not limited to, the failure to adopt a written plan document by January 1, 2009.
- **Section 457 Plans.** Consistent with the prior guidance, the IRS still provides relief for governmental plans only on a facts-and-circumstances basis, and provides no relief for tax-exempt 457 plans. Since tax-exempt 457 plans are typically top-hat plans and more akin to nonqualified plans, the IRS has decided not to provide relief for these plans consistent with governmental 457 plans.

Substantive Changes

- **Impermissibly Excluded Employees.** An extremely popular correction tool involving a makeup contribution plus applicable earnings for employees erroneously excluded from making elective deferrals has been further expanded by the IRS to explicitly address three additional scenarios:
 - First, for plans that permit designated Roth contributions in addition to pre-tax elective deferrals, the correction (a makeup contribution equal to 50% of the Average Deferral Percentage (ADP) of either the non-highly compensated or highly compensated group that the affected employee belonged to) is the same as a plan that only permits pre-tax elective deferrals (but not designated Roth contributions).
 - Second, for missed catch-up contributions, the missed deferral is deemed to equal 50% of the applicable catch-up limit. The required makeup contribution would be 50% of the missed deferral. For example, if an employee was not given the opportunity to make a catch-up contribution in 2008, where the limit is \$5,000 the missed deferral would be \$2,500 (50% x 5,000) and the required makeup contribution would be \$1,250.
 - Third, the failure to implement an employee election is corrected by the plan sponsor providing a makeup contribution equal to 50% of the amount elected by the excluded employee that was not contributed.
- **Correction of Plan Loan Failures.** There are now increased opportunities to correct plan loan failures under VCP because loans that violate section 72(p) of the Internal Revenue Code (the Code) may still be corrected even if the plan does not provide for loans.

- **Compliance Fee Modifications.** Due to the frequency of plan loan failures, the IRS has created a significant fee discount of 50% for this type of failure provided the following conditions are met:
 1. The submission pertains to a failure to follow the plan loan requirements found in section 72(p)(2) of the Code.
 2. The failure only affects 25% or less of the plan sponsor's participants in any applicable year.
 3. This failure is the only failure of the VCP submission.
- **Waiver of Excise Tax and Penalties.** The IRS has expanded relief for excise tax and has added relief for income tax under 72(t) of the Code. If the participant or beneficiary (the recipient) receives an excess contribution to an IRA in connection with an overpayment from the plan that is not eligible for rollover, the 6% excise tax imposed by section 4973 of the Code is generally triggered. However, the revenue procedure provides rules under which the plan sponsor may obtain relief on behalf of the recipient, provided the recipient removes the overpayment plus earnings from the IRA.

In order to avoid the application of the additional income tax under section 72(t), the recipient must remove the amount that was improperly distributed (e.g., distribution prior to obtaining age 59½) and rolled over from the plan to the IRA (including earnings) and return this amount to the plan.

In order to obtain relief from either of these mechanisms, the plan sponsor must, as part of the VCP submission, request the relief with an accompanying explanation.

- **Excess Allocation.** The revenue procedure creates a new category of excess amounts for which neither the Code nor the regulations provide a corrective mechanism. A specific correction methodology is provided for these excess amounts. Examples of excess allocations include elective deferrals or after-tax contributions described below, that:
 - Exceed plan-imposed contribution limits
 - Exceed Code section 415 limits
 - Are made with respect to compensation that exceeds the limit in Code section 401(a)(17)
- **Section 415 Failures for a Defined Contribution Plan.** Starting with limitation years beginning on or after January 1, 2009, the correction for a failure to satisfy the annual addition limit has been changed and now includes a specific sequence of steps that must be followed.

Request for Comments from IRS

- **Automatic Enrollment Failures.** The IRS has asked for comments regarding automatic enrollment failures where no amounts were withheld from the compensation of an employee who made no election. Although the IRS has not yet provided safe harbor corrections for automatic enrollment failures, a reasonable correction may entail providing a makeup contribution based on 50% of the contribution percentage the affected employee would have received (default percentage) if not excluded from the plan.
- **Designated Roth Contributions.** The IRS also has asked for comments on special Roth contribution issues, such as when erroneous pre-tax elective deferrals are made instead of designated Roth contributions, with suggested corrections. Since these suggestions are included in the revenue procedure, the IRS is likely to accept these as well as other reasonable and appropriate corrections.

Procedural and Administrative Changes

- **Determination Letter Procedures Clarified.** Plan sponsors of individually designed plans must submit applications for determination letters once every five years, under a staggered system of five-year cycles that is generally based on the last digit of a plan sponsor's Employer Identification Number (EIN). An "on-cycle year" means the last 12 months of the plan's remedial amendment cycle set forth in Rev. Proc. 2007-44. In Rev. Proc. 2008-50, the IRS divides the procedures for submitting determination letter applications as part of a VCP submission into three categories:
 - **Determination letter required.** Applies to submissions that include a corrective amendment made during an on-cycle year or in connection with a plan termination. Also, any nonamendment failure will require an accompanying determination letter request.
 - **Determination letter not required.** Applies to any VCP submission in an off-cycle year where the failure involves an interim amendment or amendment required to implement an optional (discretionary) law change (e.g., catch-up contributions) that was not adopted on a timely basis. Also, an operational or demographic failure submitted under VCP in an off-cycle year should not include a determination letter request even if the proposed correction involves a retroactive amendment request. If a determination letter request is made with this submission category, the IRS has the discretion to reject and/or return the determination letter request back to the plan sponsor. Nonetheless, the plan sponsor still retains the right to obtain a determination letter by following the requirements in Rev. Proc. 2007-44.
 - **Determination letter optional.** In certain cases, an off-cycle submission may include a determination letter application for new individually designed plans that would otherwise have to wait at least two years past the end of the current off-cycle submission period for its designated on-cycle submission period. Also, a plan sponsor that has an "urgent business need" may include a determination letter application with an off-cycle VCP submission. However, the IRS will evaluate these "urgent business need" requests on a facts-and-circumstances basis.

- **Expansion of “Reasonable and Appropriate” Correction Principle.** The IRS provides that it will give consideration to a correction method authorized by another government agency such as the Department of Labor (DOL). Also, for a fiduciary breach that is corrected through the DOL’s Voluntary Fiduciary Correction Program, the IRS may now accept that correction as reasonable and appropriate for purposes of correcting a similar failure under EPCRS.
- **Calculation of Earnings.** For the first time, the revenue procedure clarifies when it is appropriate to utilize the earnings rate derived from the DOL Voluntary Fiduciary Correction Program’s online calculator in determining the earnings adjustment applied to corrective contributions, distributions, allocations, and reallocations. The online calculator may be used provided it is not feasible (e.g., such as when records are missing or unattainable) to make a reasonable estimate of what the actual investment results would have been. It is still not a safe harbor, however, and the IRS may ask a plan sponsor to justify the use of the online calculator.
- **Self-Correction for Plan Under Examination.** Significant operational failures may be self-corrected in certain cases even when a plan sponsor is “under examination,” provided that there has been “substantial completion” of correction for these significant operational failures prior to commencement of the audit. The revenue procedure expands the scope of the SCP by loosening the requirements in two ways for determining whether there was “substantial completion” of correction as of the first date the plan or plan sponsor is considered to be “under examination.”
 - For a significant operational failure that has been substantially corrected prior to being under exam, the time to complete correction is increased from 90 days to 120 days after notice of exam.
 - For a significant operational failure that has been completely corrected for fewer than all affected participants prior to being under examination, the portion of participants that require complete correction prior to receiving notice of exam has been decreased from 85% to 65%.

Insignificant operational failures continue to be permitted to be corrected at any time, regardless of whether or not the plan sponsor is under examination. The rationale behind these changes is that the IRS is pushing diligent and timely self-correction as a viable and certainly less expensive option than the harsher alternative of mandatory correction and a sanction under Audit CAP.

- **Modification of Compliance Statement.** The IRS has made it easier to request a minor modification to a compliance statement after it has been issued.
 - Time for requesting modification has been extended from 30 days to 150 days (general correction period)
 - Additional compliance fee now equals lesser of (a) one-half of the original compliance fee or (b) \$1,500 (this was formerly the lesser of (x) the entire compliance fee or (y) \$3,000)

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