Relaxed IRS Self-Correction Rules a Boon for Plan Sponsors—and an Opportunity to Correct Failures Now

A Practical Guidance® Article by Michelle M. McCarthy, Jacob M. Oksman, and Claire P. Rowland, Morgan, Lewis & Bockius LLP

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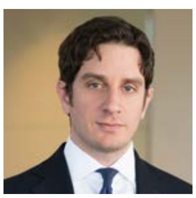

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On July 16, 2021, the Internal Revenue Service (IRS) released Revenue Procedure 2021-30, which made several important changes to the Employee Plans Compliance Resolution System (EPCRS) and expanded the ability of plan sponsors to correct certain compliance failures under their retirement plans. This LawFlash discusses how plan sponsors can leverage the relaxed rules for retroactive plan amendments to more easily effect compliance corrections during a period of heightened audit scrutiny. In addition, plan sponsors using preapproved defined contribution plan documents should pay particularly close attention to the provisions selected in the restated plan documents currently being prepared for their plans to help avoid future operational compliance failures.

Key Changes Expand Ability to Self-Correct Via Retroactive Amendment

Two key changes in the IRS's latest update to EPCRS include the relaxation of the requirements for self-correcting operational failures via retroactive plan amendments, and the extension of the time limit to self-correct significant operational failures from two years to three years.

An "operational failure" occurs when a plan is not operated (i.e., administered) in accordance with its terms. The IRS first added the option to self-correct certain operational failures via retroactive amendment in 2019 when it released Revenue Procedure 2019-19 to modify EPCRS. However, the practical utility of the newly added self-correction option was limited to circumstances in which the corrective retroactive plan amendment resulted in an increased benefit, right, or feature that applied to **all** employees eligible to participate in the plan.

Responding to industry feedback and requests for clarification on whether a retroactive plan amendment could satisfy this requirement under EPCRS where the increased benefit, right, or feature, although available to all eligible employees, does not inure to each eligible employee's benefit, the IRS eliminated the controversial requirement entirely under Revenue Procedure 2021-30. As a result, effective July 16, 2021, a plan sponsor may utilize the option to self-correct a failure to properly administer the provisions of its plan by adopting a plan amendment that retroactively conforms the terms of the plan to its operation, so long as the following two requirements are satisfied:

1. The plan amendment must result in an increase of a benefit, right, or feature –and–
2. The increase must be permitted under the Internal Revenue Code (Code) and satisfy any applicable coverage and nondiscrimination testing requirements.

The increased flexibility of this retroactive plan amendment self-correction option, coupled with the extension of the two-year self-correction period for significant operational failures to a three-year period, is a boon for plan sponsors looking to correct operational failures under their plans and that, without the increased flexibility afforded by the retroactive plan amendment self-correction option, otherwise would have been required to submit a formal application to the IRS under the Voluntary Correction Program (VCP)—including the payment of a VCP user fee of up to $3,500—to obtain the IRS's approval of a proposed correction.

This is especially true for significant operational failures that arose during the 2018 plan year, as a plan sponsor now has until the end of its plan's 2021 plan year (i.e., the end of the third year following the year of the failure) to adopt a retroactive plan amendment to correct that failure, rather than having to pay to submit a VCP application to the IRS. Likewise, plan sponsors now have until the end of their plan's 2022 plan year to adopt a retroactive plan amendment to correct a significant operational failure that arose during the 2019 plan year.

With that said, where there is any question as to whether a retroactive amendment would result in an increase of a benefit, right, or feature; the increase is permitted under the Code; and/or the proposed method of correction is permissible under EPCRS, plan sponsors are well advised to err on the side of caution and submit through VCP rather than attempt to self-correct. This is especially true in situations where the failure is deemed significant, even when the failure is corrected within the three-year correction period.

EPCRS identifies certain factors that may be relevant in determining whether an operational failure is significant, including but not limited to:

1. Whether other failures occurred during the period being examined
2. The percentage of plan assets and contributions involved in the failure
3. The number of years the failure occurred
4. The number of participants affected relative to the total number of participants in the plan
5. 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
6. Whether correction was made within a reasonable time after discovery of the failure –and–
7. The reason for the failure (for example, data errors such as errors in the transcription of data, the transposition of numbers, or minor arithmetic errors), with no single factor being determinative.

A compliance statement issued by the IRS at the conclusion of the VCP process offers plan sponsors assurance that the proposed method of correction is reasonable and appropriate given the facts and circumstances of the failure at issue in any given case.

Plan Sponsors Need to Correct Operational Failures Now

Despite the extended time limit for self-correcting significant operational failures, plan sponsors should act as soon as possible to identify and correct operational failures under their plans.

Interestingly, the IRS's relaxation of the requirements for self-correction via retroactive plan amendments coincides with a recent pattern of increased enforcement activity by both the IRS and the US Department of Labor (DOL). This increased activity—and the stricter enforcement measures the IRS and DOL are wielding when these entities identify failures during plan audit—dramatically increases the risk of investigations and hefty penalties being imposed. The IRS and DOL periodically release "top 10" lists of the most commonly identified plan compliance issues. Many of the plan compliance issues discovered and sanctioned by government auditors are operational failures. See Morgan Lewis LawFlash, Top 10 Areas of Focus in IRS Investigations of Retirement Plans (July 15, 2019); Morgan Lewis LawFlash, Top 10 Areas of Focus in DOL Investigations of Retirement Plans (May 20, 2019).

Meanwhile, more stringent reporting standards now apply to the private auditors who conduct the independent plan audits for plan sponsors with large plans and prepare the annual audit reports for Form 5500 filing purposes. As a result, it is more likely that various compliance issues—including operational failures—will be discovered during the independent plan audit and flagged for public disclosure in the audit report attached to the Form 5500 filing. This, in turn, potentially increases the risk of a plan audit by either the IRS or the DOL.

In addition, both the IRS and the DOL have been known to refer plans to each other when significant issues are uncovered during an audit, which means that some plan sponsors are spending months—even years—defending audits of their plans by the IRS and subsequently the DOL, or vice versa.

In light of these risks, plan sponsors should consult with ERISA counsel regarding the specific facts and circumstances of any operational failures identified under their plans to evaluate the availability and feasibility of self-correction of those operational failures via a retroactive plan amendment. Moreover, plan sponsors should also consult with ERISA counsel to determine whether modifications to their policies and procedures are needed to ensure that future operational failures are avoided and/or identified and corrected in a more-timely manner moving forward.

Watch Out for Operational Failures Caused by Plan Amendments and Restatements

Plan amendments and restatements are a perennial bugaboo when it comes to operational failures. In some cases, provisions that a sponsor intends to preserve in the plan are in fact deleted or plan provisions that the sponsor does not wish to include in the plan are inadvertently added. Too often a plan sponsor may add or delete a certain plan provision, thinking that doing so means one thing, when in fact the result of the added or deleted provision means something else entirely.

Regardless of the root cause of the disconnect between how a plan sponsor intends to operate its plan, how a plan sponsor actually operates its plan, and what the plan document says about the operation of the plan, the resulting operational failures are compliance failures that the plan sponsor must correct to avoid costly sanctions and the disqualification of the plan by the IRS.

Unfortunately, the answer is not as simple as avoiding the amendment or restatement of plan documents. In fact, not only are plan documents routinely restated in the retirement plan industry when a plan sponsor changes recordkeepers or third-party administrators, but the IRS itself mandates that sponsors using "preapproved" plan documents must regularly restate their plan documents on a recurring six-year cycle to keep the document up to date with existing law. A "preapproved" plan is a plan document that is sold by a document provider that has requested preapproval by the IRS that the form of the plan document meets the applicable requirements of the Code. The IRS then issues an opinion letter when it preapproves the plan document, and the document provider then makes the preapproved plan available for plan sponsors to adopt.

Currently, plan sponsors of preapproved defined contribution plans (e.g., 401(k), profit sharing, and money purchase pension plans) are in the midst of a mandatory document restatement period. These plan sponsors must restate their plan documents in their entirety and execute the restated plan documents no later than July 31, 2022. Because use of a preapproved plan document affords a plan sponsor with no protections when the plan sponsor's operation of its plan does not conform to the provisions selected in that preapproved plan document or adoption agreement, the plan sponsor is well advised to take steps now to verify that the provisions and plan terms selected in its restated plan document and adoption agreement accurately reflect the sponsor's intended and actual operation of its plan.

Related Content

Lexis

- Revenue Procedure 2021-30
- Revenue Procedure 2019-19

Practical Guidance

- EPCRS Correction Rules and Procedures
- Pre-approved Plan Design and Compliance

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Michelle M. McCarthy is partner and practice group leader of the Southern California-based employee benefits and executive compensation practice. Michelle focuses her practice on the representation of numerous multiemployer and other collectively bargained pension, health, and welfare plans, as management-appointed ERISA plan counsel. Michelle advises boards of trustees on matters regarding ERISA compliance, tax-qualification, plan design, documentation, modification and termination.

Michelle also counsels both single-employer and multiemployer plans on issues pertaining to plan administration and operation (including claims and appeals), participant communications, plan investments, fiduciary obligations, prohibited transactions, funding issues, service provider contracts, negotiating side letters that contain provisions that afford greater protection to the Employee Retirement Income Security Act (ERISA) plans that she represents, ERISA litigation (including deadlock arbitrations), and withdrawal liability matters.

As management-appointed counsel, Michelle has guided some of the largest multiemployer funds in the United States through plan mergers and has assisted in agency investigations and audits, including those involving the US Internal Revenue Service (IRS), the US Department of Labor (DOL), and the Pension Benefit Guaranty Corporation (PBGC), as well as internal audits.

Michelle also advises corporate counsel, company executives, and HR professionals in all aspects of the employee benefit plans sponsored by their organizations. She advises retirement plan fiduciaries regarding their responsibilities under ERISA and regularly meets with investment and compensation committees to ensure they are fulfilling these responsibilities. Michelle has worked extensively on structuring employee benefit plans and amending those plans to comply with various, and ever changing, federal laws.

In addition, Michelle has spent a large percentage of her career representing both single and multiemployer plan sponsors in controversies before the IRS, DOL, and PBGC. She has negotiated the resolution of compliance issues for retirement plans through IRS remedial programs such as VCP, Audit CAP, and SCP. Michelle also has considerable experience in the DOL's remedial programs such as the DFVC and VFC programs.

Michelle also represents employers with respect to multiemployer pension withdrawal liability issue, in a variety of contexts, including litigation, collective bargaining, workforce restructuring, subcontracting, corporate transactions and plan relocations and closures. Michelle's representations span a wide variety of industries, including maritime, international delivery systems, entertainment, transportation, construction, manufacturing, hospitality and textiles.

Michelle frequently speaks on employee benefit plan compliance issues and has presented to the International Foundation of Employee Benefit Plans, the American Bar Association, Pensions & Investments, the California State Bar, the Los Angeles County Bar Association and the Beverly Hills Bar Association.

Before joining Morgan Lewis, Michelle was with the employee benefits and compensation practice of a Los Angeles-based law firm.

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