Employee Benefits Alert

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IRS Updates Voluntary Correction Program

For many years sponsors of qualified retirement plans lived in fear of plan audits because the Internal Revenue Code provides a single penalty for plans that are not in perfect compliance — disqualification. Disqualification of a qualified plan often represented a draconian punishment because it could result in years of tax deductions being reversed with accompanying interest and penalties for the employer — plus income taxes and penalties assessed on plan participants for years' worth of accruals in their retirement plans.

Fortunately, because the penalty was so severe, disqualification was rarely invoked except in truly egregious circumstances. This left many plan sponsors both complacent (because so few plans were actually disqualified) and insecure about their plans' qualification status. Some employers worked hard to avoid confronting compliance issues for fear of finding something wrong. Moreover, when they found errors they were reluctant to make adjustments for fear that the change would trigger audit activity and possible retroactive plan disqualification. In addition, because the penalties were so devastating to the employees (who had no role in plan governance), Internal Revenue Service agents were seldom willing to use the "nuclear option" of disqualification when they did find qualification problems. That resulted in an uneasy truce between the IRS and employers regarding plan qualification problems. However, it also meant that many employers (and some of their advisors) took a "don't ask, don't tell" approach to plan compliance. There was a reluctance to look too closely for fear of finding a problem that could not be fixed. Therefore, many plans that were not in compliance had long-standing problems that could have exploded under a particular set of circumstances. In reality, negotiations with IRS auditors often resulted in reduced penalties if it could be shown that the plan sponsor was diligent and took efforts to eliminate (or reduce) errors or even tried to fix mistakes when possible.

Several years ago, in an effort to encourage compliance, the IRS implemented correction procedures to provide employers with a method to fix their plans without fearing retroactive disqualification. The system was very popular, and recently the IRS has updated those rules.

IRS Institutes Voluntary Correction Procedures

The "uneasy truce" between plan sponsors and the IRS began to change several years ago. The IRS first issued rules about ten years ago providing a process whereby employers could come forward voluntarily, pay a penalty tax, and fix their plans without fear of disqualification. Over the years, that process, the Employee Plans Compliance Resolution System (EPCRS) has been updated and modified to permit plans that have failed to meet one or more qualification requirements to be corrected using one of three programs:

- Self-Correction Program (SCP),
- Voluntary Correction Program (VCP), and
- Correction on Audit Program (Audit CAP).

Generally, the programs require that the sponsor completely fix the problem, thereby incurring potentially large costs for doing so. However, by using one of the programs, additional taxes and penalties associated with plan disqualification will be avoided, thereby making the fix much more palatable, even if the "medicine" is itself unpleasant.

Many employee benefit professionals and employers welcomed the changes. The fact that there is an opportunity to fix a plan means that employers can take a more active role in compliance, with regular plan reviews, knowing that there are ways to bring the plan into compliance without incurring huge costs to do so. In fact, the IRS has stated many times that it intends to be much more aggressive with plan sponsors who do not avail themselves of the various methods of bringing their plans into compliance.

IRS Updates Process

The IRS has recently introduced changes in Revenue Procedure 2006-27 that could make EPCRS even easier to use to correct plan errors. The changes that may have the most impact on employer sponsored retirement plans are listed below.

- If the Plan Sponsor corrects the plan failures in accordance with EPCRS, the plan will be treated as satisfying the applicable provisions for FICA and FUTA taxes (as well as the income tax). Therefore, this change will further reduce the potential tax penalties associated with plan disqualification, *IF* the plan sponsor avails itself of the correction process.

- EPCRS is expanded to terminating “orphan plans.” (Loosely defined, orphan plans refer to benefit programs that have not been properly terminated before an employer goes out of business, thus leaving the plan with no sponsor or other entity to administer it.) With respect to those plans, the new rules provide for a possible exception to the general requirement for full correction and a waiver of the VCP fee in appropriate cases.

- A correction method has been created for certain plan loan failures. The correction method addresses the situation where the plan permits plan loans operationally but does not have the appropriate plan loan language.

- The Revenue Procedure also introduced an alternative correction method for a failure to obtain spousal consent — a problem that used to represent a particularly sticky issue for many employer plans.

- Several other taxes and fees are reduced including:
    - Reducing the number of excise taxes that the Service may pursue,
    - Lowering the compliance fee for a plan where the sole failure is the failure to satisfy the minimum distribution rules for 50 or fewer employees, and
    - Reducing the compliance fee for a plan where the sole failure is the failure to timely adopt certain plan amendments.

In addition, perhaps as a warning to those employers who would rather not be bothered with self-examination of their plans, the new process provides that if a plan violation relates to a failure to properly amend the plan and that problem is discovered during an Employee Plans Examination, then it is expected that the applicable sanction will be greater than the applicable fee under EPCRS.

Conclusion

Now more than ever, employers who find problems with their qualified plans should review the findings with their advisors and seek methods under EPCRS to fix those issues.

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