Correcting plan errors

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Mistakes happen, even in plan administration.

Defined benefit plan administration is complicated. Errors can occur in following the provisions of the plan document, applying regulatory guidelines, or processing plan data. For example, you may find that a participant was not paid in timely fashion, the plan document was not amended, or a benefit was miscalculated.

If you identify an error, what do you do? Fortunately, the Internal Revenue Service (IRS) has established programs for correcting errors in a relatively easy manner.

Consequences for plan administration failures

Plan administration errors, or failures, can have serious consequences, including disqualification. What does that mean?

Failure to administer a plan in accordance with the plan document and applicable regulations can result in severe tax consequences. If a plan is disqualified, the plan's trust loses its tax-exempt status. This affects the plan sponsor's ability to deduct plan contributions. In addition, contributions are subject to Social Security, Medicare, and federal unemployment taxes, and trust earnings are subject to income tax. Furthermore, plan distributions are no longer eligible for rollover to another eligible retirement plan or IRA.

Preparation is key for correction

In order to correct plan failures completely, you must start with a plan. Begin by completing a root cause analysis to determine the source of the issue and identify the full scope of the impact. Determine the necessary correction procedures, and develop a plan for executing the correction. Review the plan with your legal counsel to ensure that it sufficiently corrects the failure and will meet the requirements of the applicable correction program.

Employee Plans Compliance Resolution System (EPCRS)

Failures in plan administration may be corrected through programs offered by the IRS. The IRS established the Employee Plans Compliance Resolution System (EPCRS) to provide plan administrators guidelines for correcting common failures. If the guidelines in EPCRS are followed, the plan will not be disqualified for the particular failure being corrected.
EPCRS defines four categories of failures:

1. **Operational failure:** The plan was not operated according to the plan document.
2. **Plan document failure:** The plan document does not comply with regulatory requirements.
3. **Demographic failure:** The plan fails minimum coverage, minimum participation, or nondiscrimination testing.
4. **Employer eligibility failure:** The employer is not eligible to sponsor the type of retirement plan.

The **EPCRS guidelines offer three correction programs:** the Self-Correction Program without an IRS filing, the Voluntary Correction Program requiring an IRS filing, and the Audit Closing Agreement Program for failures identified by the IRS during an audit. In general, operational failures may be corrected under any of the correction programs. Failures that fall under the other categories may only be corrected through the Voluntary Correction Program or Audit Closing Agreement Program.

**Correction considerations**

There are a few key principles to keep in mind when correcting a failure. Generally, the IRS requires full correction. This means that the correction must be made for all participants and beneficiaries, for all taxable years.

For most operational failures, the impacted participants and the plan must be made whole. In other words, the correction must restore the participants and the plan to the positions they would have been in had the failure not occurred. In addition, some corrections, such as corrective distributions, must include earnings or interest.

The correction should be reasonable and appropriate for the failure. EPCRS describes in detail many preapproved corrections for common plan failures. For example, these include overpayments, failure to pay required minimum distributions (RMDs), and failures related to the IRS compensation and benefit limits. For other failures, the plan sponsor should determine a reasonable and appropriate correction method that follows the principles outlined in EPCRS. In addition, corrections for similar failures must be consistent.

**Self-Correction Program (SCP)**

The Self-Correction Program (SCP) allows the plan sponsor to correct operational failures without involving the IRS. Under SCP, the plan sponsor does not receive specific approval from the IRS for the correction. Because there is no filing with the IRS, there is no user fee associated with SCP. In order to qualify for SCP, the plan must have documented procedures in place to avoid failures.

SCP may be used to correct insignificant failures, as well as significant failures in limited circumstances. Insignificant failures may be corrected through SCP at any time, even if the plan is being audited by the IRS. In general, significant failures must be corrected by the end of the second plan year following the year in which the failure occurred. Whether or not a failure is significant depends on many factors, including the number of participants impacted, the amount of the benefits impacted, and whether the failure was corrected within a reasonable timeframe.

**Voluntary Correction Program (VCP)**

The Voluntary Correction Program (VCP) is used when SCP is not available or when the plan sponsor wishes to obtain IRS approval for the correction. VCP may be used to correct plan document failures, demographic failures, employer eligibility failures, and operational failures. Under VCP, the plan sponsor files an application with the IRS and pays a user fee. The application must describe the details of the failure, the proposed correction, and the procedures established to prevent future failures. If the IRS approves the correction methodology, it issues a compliance statement and the plan sponsor then completes the correction.

**Updated 2018 VCP filing fees**

As noted in Milliman's Benefits Alert 2018-01, the IRS announced that it significantly reduced the fees for most plans to correct failures under VCP. The new, lower fees are based on plan assets and are capped at $3,500, whereas fees were previously based on the number of plan participants and capped at $15,000. These new fees allow plan sponsors to correct multiple eligible failures in a single filing, at a low cost for most plans.
Audit Closing Agreement Program (Audit CAP)

The Audit Closing Agreement Program (Audit CAP) is used when the IRS discovers a failure during an audit. The IRS and plan sponsor enter into a contract to correct the failure. The IRS charges a sanction for the failure. The IRS negotiates with the plan sponsor regarding the amount of the sanction, which depends on the type and severity of the failure.

Documenting the correction

If a failure is corrected under SCP or VCP, the correction should be carefully documented. If the plan is audited by the IRS, the documentation should be sufficient to demonstrate that the failure was fully corrected according to the EPCRS guidelines. For corrections under SCP and VCP, the plan sponsor should document the failure, the corrective action taken, and the procedures in place to prevent future failures. In addition, for corrections under VCP, the plan sponsor should retain a copy of the application, any correspondence with the IRS, and the compliance statement.

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