

# CLIENT ALERT

## OPERATIONAL FAILURES & FORGIVENESS: THE EMPLOYEE PLANS COMPLIANCE RESOLUTION SYSTEM

Written by: Brian D. Wurpts, Vice President of Plan Administration Services

**A**ny complex process that produces a rational result might appear to be “correct” to the casual observer. The observers who matter most in the retirement plan administration business are the DOL and IRS examiners who scrutinize our work. Their standard is the premise that there is only one correct result: a result that conforms perfectly to the law, the rules of the plan document, and the intent of the plan sponsor, and which contains perfectly accurate facts. Retirement plans (particularly ESOPs) are complex systems. They often involve thousands of data points and hundreds of variables. They are subject to interpretation and interdependencies with other systems (payroll data, administration of other retirement plans, employment policies and accounting systems). Given this complexity, even the most diligent plan fiduciaries will eventually be confronted with an error. While the regulators seldom afford us the luxury of de minimus or harmless errors, they do provide some relief and guid-

ance through their voluntary compliance programs. This article describes the IRS programs collectively referred to as the Employee Plans Compliance Resolution System (“EPCRS”).

### **EPCRS Programs**

#### **Self-Correction Program (SCP)**

SCP requires that the plan have in place established compliance practices and procedures. SCP permits the plan to correct an “operational” failure (i.e., a failure to follow plan provisions) without the payment of a fee or sanction.

#### **Voluntary Correction Program with**

#### **Service Approval (VCP)**

VCP requires that the plan not be under a current audit. It permits a plan sponsor to pay a fee for the IRS’ review and approval of a correction. VCP applies to plan document failures as well as operational failures that are not self-corrected. A plan document failure is the presence (or absence) of a provision which causes the plan document to violate qualification require-

ments. VCP includes procedures for submitting anonymous and group applications.

### **EPCRS PRINCIPLES**

**Revenue Procedure 2008-50 outlines these principles (paraphrased):**

- **Sponsors and plan administrators should be encouraged to establish proper plan documents and administrative practices and procedures that ensure that these plans are operated properly;**
- **Sponsors and other administrators should make voluntary and timely correction of any plan failures;**
- **Timely and efficient correction protects participating employees;**
- **Voluntary compliance is promoted by providing limited fees for voluntary corrections, thereby reducing employers’ uncertainty regarding the potential tax liabilities for noncompliance;**
- **Fees and sanctions should be graduated in a series of steps so that there is always an incentive to correct promptly;**
- **Sanctions for plan failures identified on audit should be reasonable in light of the nature, extent and severity of the violation; and**
- **Sponsors should be able to rely on the availability of EPCRS in taking corrective actions to maintain the tax-favored status of their plans.**

*(Continued on page 2)*

# Operational Failures & Forgiveness

## Correction on Audit (Audit CAP)

If a failure is not corrected through SCP or VCP and is discovered under audit, the failure may be corrected by paying a sanction. The IRS and the plan sponsor negotiate the amount of the sanction, which is a portion of the taxes that would have been imposed if the plan were disqualified during the period of the failure. SCP and VCP generally offer plan sponsors the opportunity to correct failures at a substantially lower cost than the Audit CAP program.

## **Summary**

The EPCRS program provides plan sponsors with guidance and comfort regarding correction of errors, operational failures and plan document defects. These programs are designed to encourage timely and appropriate corrections. In exchange, they substantially limit exposure to fees, sanctions and additional taxes. The programs are only effective if the plan's fiduciaries are diligent in the administration of the plan. After all, an error or failure can only be corrected if

it is discovered prior to audit. Exposure to the adverse consequences of correcting a failure discovered on audit is far more costly than the effort required to establish and maintain a sound compliance review system.

## **Contact Brian:**

[bwurpts@sesadvisors.com](mailto:bwurpts@sesadvisors.com)

**SCP and VCP generally offer plan sponsors the opportunity to correct failures at a substantially lower cost than the Audit CAP program.**

SCP allows a plan sponsor to correct an operational failure by several methods, including correcting benefit calculations and making corrective employer contributions to restore benefits. The primary principle of SCP is restoration of benefits - i.e., the plan should restore the benefit that would have resulted had the error not occurred.

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Correcting an operational failure may require a determination of whether the failure is significant. Rev. Proc. 2008-50 provides these guidelines: (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; (6) whether correction was made within a reasonable time after discovery; and (7) the reason for the failure (e.g., data errors such as errors in the transcription of data, the transposition of numbers or minor arithmetic errors). No single factor is determinative.

Insignificant operational failures may be self-corrected at any time. If the failure is determined to be significant, the plan must have a favorable determination letter to qualify for SCP. Significant operational failures must generally be self-corrected within two years after the plan year in which the failure occurred. For other significant failures, the plan sponsor may use the VCP program.

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Under the VCP program, a plan sponsor (usually with the assistance of legal counsel) prepares a submission describing the nature of the failure and the proposed correction. If the IRS agrees with the correction method, it will issue a compliance statement specifying the corrective action required. If the IRS and the plan sponsor cannot reach agreement on the correction, or if the sponsor fails either to sign the compliance statement or pay the VCP fee, the IRS may refer the matter for audit.

Plan sponsors may submit VCP filings anonymously. The identity of the plan sponsor in an anonymous filing will be revealed to the IRS only if the IRS and the sponsor's representative come to agreement on the correction method.

VCP compliance fees are determined by the number of plan participants and range from a low of \$375 for a small employer's failure to timely adopt certain amendments to as much as \$25,000 for plans with more than 10,000 participants.

## **WEBCAST**

**"Second Stage Transactions and Mature ESOPs,"**  
presented by James Steiker on June 24, 2009.  
Register online at [www.sesadvisors.com/events](http://www.sesadvisors.com/events).

## **NEW SHAREHOLDERS**

**Congratulations to Mychelle L. Holloway and James V. Capone on becoming Shareholders of SES Advisors!**

# WHAT'S NEW IN ESOP ADMINISTRATION?

Written by: Mychelle L. Holloway, Senior ESOP Administrator

Seems that there is always something going on with new laws, regulations, or agency issued guidance that affects your ESOP either right away or down the road. Let's review some of the fresher aspects of ESOP administration.

## **Worker, Retiree and Employer Recovery Act of 2008**

In December 2008 both the House and the Senate unanimously (and in record time) passed the Worker, Retiree and Employer Recovery Act of 2008, which went on to be signed into law by the President. WRERA does not lend itself to a clever acronym like its predecessors EGTRRA, GUST, or PPA, but while we struggle on what to nickname this new law, a few components will definitely affect your ESOP.

- **Minimum Distributions** IRC Section 401(a)(9) requires that an ESOP account holder must withdraw minimum amounts annually starting with the year that they reach 70 and ½ years of age or, if later, the year they retire. (Note: if the participant is a 5% owner of the plan sponsor the minimum distributions begin regardless of termination). This requirement has been suspended for 2009 so that retirees not taking minimum distributions will not suffer penalties (generally a 50% excise tax). The logic here is that retirees can keep money in these retirement ac-

counts to hopefully recover some of the losses from the current economic downturn. In the ESOP world, these minimum distributions are based on the prior year allocation and valuation. So for example, a plan using the calendar year as its plan year would have the 2009 minimum distributions based upon the December 31, 2008 valuation, which could be a fairly low share price. Suspending the requirement until the 2010 year means that by the time the new round of minimum distributions are required, they can be based on the 2009 plan year valuation which will hopefully reflect some economic recovery. The suspension of this requirement also applies to beneficiaries of plan accounts and IRA owners. However, it does not apply to 2008 minimum distributions, even those delayed until April 1, 2009 (if 2008 was the first year a participant was required to take a minimum distribution).

- **Five Year Payout of Death Benefits** Generally death benefits from an ESOP must be paid out to the beneficiary(ies) within five years from the date of death of the account holder. However, with WRERA the beneficiary can waive the 2009 payment, effectively taking the distributions over a six-year period rather than a five-year period.

- **Non-Spouse Beneficiary Rollovers** The Pension Protection Act of 2007 per-

mitted rollovers of benefits of non-spouse beneficiaries from ESOPs, but it was unclear as to whether this was an option for plan sponsors to offer or if it was mandatory. For all plan years beginning after December 31, 2009, it will be mandatory for plan sponsors to allow direct rollovers for non-spouse beneficiaries.

- **S Corp Filer Penalties** A penalty is imposed for failing to file an S Corporation tax return on time or failing to provide information required to be shown on the return. The penalty amount has been increased from \$85 to \$89 per shareholder per month, up to a maximum of 12 months. This provision applies to returns filed after December 31, 2008.

## **Kennedy v. Plan Administrator for DuPont Savings & Investment Plan**

Beneficiary forms are important! If you are not already advising your participants to keep their beneficiary forms updated for life changes such as marriage, divorce or additional children, then the recent *Kennedy* court case should convince you to start right away. In summary, William Kennedy had named his wife (at the time) on the plan's beneficiary form as beneficiary in his 401(k) plan. When they later divorced, she waived her rights to the plan in the divorce settlement (however, not with a qualified domestic relations order - "QDRO"). You would think she would

# What's New in ESOP Admin?

## Client Q & A

no longer be entitled to any 401(k) benefits from the account of William Kennedy, right? But William never changed his beneficiary form after the divorce. William later passed away and his daughter sued to force the plan to pay the benefits out to William's estate, from which the daughter would inherit. In the final *Kennedy* ruling, by unanimous agreement, the U.S. Supreme Court overturned the lower court's original decision to pay the benefits out to the estate and ruled to give the 401(k) benefits to the ex-wife despite her waiver of such benefits in the divorce settlement. The reasoning was that the waiver she signed did not conform to or with the plan's procedures for a beneficiary to waive benefits. This could come as a shock to plan participants who may think that their ESOP accounts will just revert to their estate upon death. They need to update their beneficiary form and file it with the plan sponsor, otherwise the courts may get to decide who will receive their ESOP benefits upon their death.

### Different Look for the 2008

#### Form 5500

After quite a few years of hearing about electronic filing, you will finally notice steps in that direction with the Form 5500 and Schedules for 2008. You will notice a different look: a lot of fill-in

**Q:** We are cleaning out some of our old files...How long do we need to keep records or information pertaining to our ESOP or other retirement plans?

**A:** You are probably already aware of the reporting and disclosure requirements under the Employee Retirement Income Security Act of 1974 (ERISA), such as the annual Form 5500 and distribution of benefit statements to participants. What you may not realize is that ERISA also has requirements regarding the retention of plan records. Some documents must be retained for the life of the plan while others may be disposed of after six years.

boxes and a definite "scannable" look to the same questions. The goal for the EBSA is to have Form 5500s and related Schedules for the 2009 plan year and going forward to be filed electronically. SES Advisors is already working on updating our Administration software for Form 5500 preparation in order to comply with the new requirements.

### IRC Section 415: Trailing Income Issues

As reported in ASPPA ASAP, a publication of the ASPPA Government Affairs Committee, the final 415 regulations have caused something called "trailing income" issues. This income is the income that comes in with the paycheck or two following the date of termination from employment. Most plans are electing to count this trailing compensation in their plan's definition of compensation. The problem arises when employees terminate close to the end of a plan year. Their last checks are coming in the next plan year, but within two and half months and therefore counted as compensation. But in what year? The year the compensation is paid out or the year the

related services were performed? For example, an employee terminates in a calendar year plan on December 28, 2008 and receives their last check(s) in January 2009. That compensation received in 2009 is clearly 415 compensation and for most plans that is the same definition used to allocate compensation. For plans that do not have last day or hour requirements for their allocations, is this person eligible in 2009 even though they did not work any hours? Probably. Having a residual allocation due to carryover compensation could harm the lump sum distribution process, or in certain types of plans, even have a negative effect on compliance testing (in particular, ADP testing on the 401(k) side). You must carefully read your plan's definition of compensation to be sure you are including these trailing compensation amounts in the correct plan year. Hint: most documents tie the compensation to what year the amounts were reported on the Form W2, so those amounts paid in 2009 will be 415 compensation allocable for the 2009 year.

### Contact Mychelle:

[mholloway@sesadvisors.com](mailto:mholloway@sesadvisors.com)

10 Shurs Lane  
Suite 102  
Philadelphia, PA 19127  
SES (215) 508-1600  
SFE&G (215) 508-1500

6 South Street  
Suite 201  
Morristown, NJ 07960  
SES (973) 540-9200  
SFE&G (973) 540-9292

401 Warren Street  
Suite 201  
Redwood City, CA 94063  
SES (650) 216-7077

P.O. Box 205  
Lake Anna, VA 23024  
SES (540) 872-4601

235 Promenade Street  
Suite 497  
Providence, RI 02908  
SFE&G (401) 632-0480

156 College Street  
3rd Floor  
Burlington, VT 05401  
SFE&G (802) 860-4077