Labor and Employment Corner

by Jason A. Rothman and Eric D. Penkert

Employee Benefit Plan Failures and Correction Opportunities

Employee benefit plans are primarily subject to two distinct sources of law: the Internal Revenue Code of 1986 (code), as amended and the Employee Retirement Income Security Act of 1974, as amended (ERISA). Given this combination of regulatory requirements, it should come as no surprise that sponsors of employee benefit plans find it difficult to comply with all of the rules at all times.

And while it is true that penalties for noncompliance can be severe, the Department of Labor (DOL) and the Internal Revenue Service (IRS) provide several programs for plan sponsors which allow them to voluntarily correct employee benefit plan compliance failures. These programs include the Employee Plans Compliance Resolution System (EPCRS), the Voluntary Fiduciary Correction (VFC) Program, and the Delinquent Filer Voluntary Compliance (DFVC) Program. Taking advantage of these correction methods will generally provide plan sponsors with quicker resolution of failures and reduced penalty assessments.

The Employee Plans Compliance Resolution System

On Dec. 31, 2012, the IRS published Revenue Procedure 2013-12, which provided the first updates to EPCRS in almost five years. Generally, EPCRS provides guidance on methods that sponsors of tax-qualified retirement plans may use to correct errors so that a plan maintains its tax-qualified status. In addition, under EPCRS there are opportunities for income tax and excise tax relief under the code in situations where such taxes may be assessable. It is generally available for retirement plans established pursuant to Code Section 401(a) (i.e. defined benefit plans, as well as defined contributions plans, such as profit-sharing plans and 401(k) plans). Additionally, EPCRS is available to sponsors of 403(b) plans, Simplified Employee Pensions (SEPs), SIMPLE IRAs, and 457(b) plans. Notably, the most recent revisions to EPCRS include expanded correction opportunities for 403(b) plans and 457(b) plans. These opportunities are discussed below.

A failure is not considered corrected under EPCRS unless a full correction is made with respect to all participants and beneficiaries, and for all taxable years. Significantly, this includes even taxable years which are already closed. Further, corrections under EPCRS should attempt to restore the plan to the position it would have been in had the failure not occurred and the correction should be reasonable and appropriate for the failure.

The guidance generally divides failures into four types: (1) plan document failures, where the terms of the written plan document violate code requirements (such as when a plan fails to adopt required amendments in a timely fashion); (2) operational failures that occur when a plan is not operated in accordance with the written plan document; (3) demographic failures that occur when the plan has a failure related to nondiscrimination or coverage requirements under the Code; and (4) employer eligibility failures, which occur when an employer is not eligible to sponsor a particular type of plan.

Depending on the circumstances surrounding the failure, plan sponsors may take advantage of three programs under EPCRS: (1) The Self-Correction Program (SCP); (2) The Voluntary Correction Program (VCP); and (3) The Audit Closing Agreement Program (Audit CAP).

SCP is available for operational plan failures in tax-qualified plans and 403(b) plans that are discovered and corrected within two years of the end of the plan year in which the failure occurred. SCP may also be used for "insignificant" operational failures at any time for qualified plans, 403(b) plans, SEPs and SIMPLE IRA plans. In limited situations, SCP permits correction by plan amendment. In order to use SCP, a sponsor must have established practices and procedures that are reasonably designed to promote and facilitate overall compliance, and the failure must occur because of an oversight or mistakes in following the procedures, or because the procedures, while reasonable, were not sufficient to prevent the failure. Finally, the plan must have a favorable determination letter (or, in the case of a 403(b) plan, comply with rules that are described below). If SCP is used, plan sponsors must document the correction.

A number of factors are considered in determining whether an operational failure is insignificant, including: whether other failures

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have occurred during the period being examined, the percentage of plan assets and contributions involved in the failure, the number of years the failure occurred, the number of participants affected relative to the number of participants in the plan, the number of participants affected compared to the number of participants who could have been affected, whether the failure was corrected within a reasonable time after being discovered, and the reason for the failure.

In the event that a failure is determined to be significant and it occurred later than two years after the end of the plan year in which the failure occurred, the plan sponsor should consider VCP. Unlike SCP, VCP requires a sponsor to submit an application to the IRS to correct a plan failure. This application may be submitted at any time prior to an IRS audit of the plan. VCP is generally available for correction of all failures and for essentially all plan types described in EPCRS. Unlike SCP, VCP requires the payment of a fee which varies based on the number of participants in the plan. The fees for certain types of failures, such as nonamender failures corrected within one year, are reduced and are not tied to the number of plan participants. A VCP application must contain a number of specific items, all of which are described in the Model VCP Application found in Appendix C of EPCRS. For some of the most common failures, sponsors may use the streamlined applications found in Appendix C. Further, VCP also has procedures for filing anonymous applications, which can be advantageous to a plan if the sponsor believes there is a good chance that the correction proposed in the VCP application will not be approved by the IRS.

The last correction method, Audit CAP, is available for plan failures that are discovered on IRS audit, and is used as an alternative to plan disqualification. Unlike the fixed fee schedule under VCP, Audit CAP fees generally are determined as a percentage of the "maximum payment amount," which approximates the maximum amount that the IRS could collect upon disqualification of the plan. The negotiated percentage of the "maximum payment amount" takes into account the nature of the failure(s) and considers a number of factors, such as the steps taken by the plan sponsor and the effects of the failure(s), among others.

As previously mentioned, the IRS made numerous changes, both administrative and substantive, in the most recent version of EPCRS. The most significant administrative change is the creation of two forms which must be filed with a VCP application: Form 8950 and Form 8951. Form 8950 serves as an application cover sheet, effectively replacing the former Part I of Appendix C and Part I of Appendix F. Form 8951 serves as a check-the-box compliance fee form, which is substantially similar to Form 8717 used for determination letter applications.

The recent revisions also provide significantly expanded guidance regarding the correction of 403(b) plan errors. These new correction procedures are substantially similar to those provided for other qualified plans. These methods include corrections for failures to timely or properly amend 403(b) plan provisions on or after Jan. 1, 2009. Further, EPCRS now allows correction of 403(b) plan operational failures where the terms of the written plan document are not followed. And finally, while a plan must generally have a favorable determination letter to make use of SCP for the correction of "significant" operational failures, EPCRS will now allow 403(b) plans to use SCP for such failures in limited circumstances. A 403(b) plan will be deemed to be subject to a favorable determination letter if the employer adopted the 403(b) plan document in accordance with Code Section 403(b), or if the plan failed to comply with the written plan document requirements of the final regulations but was corrected through VCP. While EPCRS continues to offer relief for governmental 457(b) plans, it also provides limited opportunities for relief for tax-exempt 457(b) plans. Specifically, the guidance allows for corrections when non-highly compensated employees are erroneously permitted to participate in the plan.

The Voluntary Fiduciary Correction Program

Title I of ERISA requires officials of employee benefit plans who are designated as fiduciaries to take on certain responsibilities and comply with particular standards of conduct. A breach of these rules by a fiduciary can result in a prohibited transaction, and in such cases, the individual involved is personally obligated to make the plan whole with regard to any losses to the plan that result from the breach. The Employee Benefits Security Administration (EBSA), an agency of the DOL, makes available the VFC Program as a method of correction for breaches of fiduciary duties under ERISA. Correction through the VFC Program relieves the individuals of possible civil investigation of breaches as well as civil action or imposition of civil penalties as a result of the breach. Once the correction is successfully completed, EBSA issues a "no action letter" with respect to the breaches addressed in the correction.

Correction under the VFC Program is limited to the specific types of breaches described in the guidance. One type of breach that many plan sponsors encounter, which is correctable under the VFC Program, is the delinquent deposit of a participant's elective deferral contributions into his account. This is deemed to be a loan from the participant to the employer, which is considered a prohibited transaction. To correct this type of breach, the employer must deposit the full amount of the participant's contribution, along with the greater of lost earnings on the contributions, or a restoration of profits due to the employer's use of a principal amount. These amounts are calculated from the date of the failure until the date of the full correction. In order to assist in the calculation of these earnings, EBSA has made an online calculator available on its website.

Fiduciary breaches in employee benefit plans that result in a prohibited transaction will also frequently incur excise-tax liability. As a corollary to the VFC Program, a correction of a prohibited transaction will generally require an employer to file Form 5330, Return of Excise Taxes Related to Employee Benefit Plans, for the years of the failure. In the case of a prohibited transaction resulting from delinquent deposit of a participant's elective deferral contributions into his account, the first tier excise tax will generally be 15 percent of the "amount involved," which is the amount of earnings or lost profits described above.

The Delinquent Filer Voluntary Compliance Program

Generally, when an employee benefit plan is subject to Title I of ERISA, the administrator of the plan is required to file an annual report for the plan (i.e., Form 5500 or Form 5500-SF). Failure to timely file the Form 5500 can result in the assessment of penalties by the IRS and/or DOL on a per day and per return basis, which can result in significant penalties where multiple filings over multiple years are delinquent. The DFVC Program is generally available to administrators of employee benefit plans who do not file the Form 5500 on time, but have not yet received notice from the DOL of a failure to timely file the annual report. Although administrators are required to pay a penalty when filing Form 5500 through the DFVC Program, this penalty amount is often significantly lower than those assessed outside the program.

As with EPCRS, the DFVC Program has been revised recently. On Jan. 28, 2013, EBSA announced several updates to the program. The most significant revisions to the program are the requirement that all filings be made electronically through the ERISA Filing Acceptance System (EFAST2).

Because EFAST2 only provides the appropriate Form 5500 for a limited number of years, the revisions also specify which plan year forms and schedules must be used for a delinquent filing. If the delinquent filing is related to plan years 2008 or earlier, or in cases where the filing is for a plan year more than three years prior to the most recent plan year forms available in EFAST2, plan administrators should file using the most current plan year form available on EFAST2, but with correct plan year dates in appropriate places on Form 5500 (and with PDF attachment of correct year schedules—for certain schedules specified in the guidance). When a delinquent filing relates to 2009 or a later plan year, plan administrators must use the correct plan year form and schedules (unless, as described above, the plan year is more than three years prior to the most recent plan year forms available in EFAST2).

Given the complexity of the rules for determining the appropriate form to use, the revisions also explain that an online tool will be available to plan administrators to assist in determining which version of Form 5500 (or Form 5500-SF) to use when filing a delinquent annual report.

Along with online filing, online payment is now the preferred method of paying the appropriate penalty. The website provides a calculator for determining the amount of the penalty, and once calculated, allows the user to click through to a payment site for immediate processing. Generally, the penalty for a plan that has less than 100 participants at the beginning of the plan year and is required to file Form 5500 will be $10 per day for each day the Form 5500 is late. This penalty is capped, however, at $750 per Form 5500, or $1,500 per plan if the plan is filing late Forms 5500 for multiple plan years. For plans with 100 or more participants at the beginning of the plan year, the penalty is still $10 per day for each day the Form 5500 is late, but the cap on the penalty is raised. For these plans, the penalty will not exceed $2,000 per Form 5500 or $4,000 per plan if the plan is filing late Forms 5500 for multiple plan years.

Conclusion

These programs are, in part, an acknowledgment by the IRS and the DOL of the difficulties involved in complying with two sources of complex law. Accordingly, they provide a means of correcting failures. While compliance failures will often result in some form of financial penalty, even penalties can sometimes be avoided if a failure is not significant. Further, the penalties associated with participating in these programs will inevitably be preferable to the alternative of plan disqualification. ⊙

GIDEON continued from page 12

Impact on Indigent Federal Criminal Defense, www.fd.org/ods-other/budget-cuts-the-devastating-impact-on-indigent-federal-criminal-defense.

[6]For example, CBS News Polls (May 1, 2013) www.cbsnews.com/8301-250_162-57582228/poll-most-say-sequester-has-not-impacted-them/.

[7]Defense Secretary Hagel lowered their original estimate of 22 days furlough to 11. Julian Barnes, *Hagel: 11 Furlough Days for DOD Civilians*, Wall Street J., May 14, 2013.

[8]The BLT: The Blog of LegalTimes, U.S. Courts Announce Sequestration Plan for Defenders, legaltimes.typepad.com/blt/2013/04/us-courts-announce-sequestration-plan-for-defenders.html (April 18, 2013).

[9]As a practical matter, many dedicated defenders and their staff have continued to work during their furlough days despite not receiving pay for the work. *See* money.cnn.com/2013/05/03/news/economy/public-defender-furlough/index.html.

[10]U.S. Courts, Federal Judiciary Braces for Broad Impact of Budget Sequestration, news.uscourts.gov/federal-judiciary-braces-broad-impact-budget-sequestration (March 12, 2013).

[11]Letter from Federal Public Defender Steven Kalar to Hon. Claudia Wilken (June 7, 2013).

[12]In the Southern District of Ohio, the public defender, Steve Nolder, eliminated his own job after cutting travel, getting rid of cell phones, stopping expert payments, and a furlough of his entire staff for 17 days. *See* now.msn.com/steve-nolder-federal-lawyer-fires-him-self-to-save-other-jobs-in-his-office.

[13]*See* endnote 11, *supra*.

[14]*See* endnote 2, *supra*.

[15]*Uzbek Charged with Terrorism Gets New Lawyer*, Idaho Press-Tribune, June 19, 2013.

[16]*See* endnote 11, *supra*.

[17]The BLT: The Blog of LegalTimes, Federal Courts Ask for Emergency Funding, legaltimes.typepad.com/blt/2013/05/federal-courts-ask-for-emergency-funding.html#more (May 15, 2013).

[18]*See* endnote 4, *supra*.

[19]For instance, April 2013 filings showed a 6 percent increase over the previous month, and a 12 percent increase over the preceding April. TRAC Reports, Prosecutions for April 2013, trac.syr.edu/tracreports/bulletins/overall/monthlyapr13/fil (June 10, 2013).

[20]*See* endnote 2, *supra*.

[21]*See* endnote 10, *supra*.

[22]*See* endnote 4, *supra*.

[23]Ian Millhiser, *Public Defenders Hit up to Six Times Harder than Prosecutors by Sequester*, Think Progress, March 18, 2013.

[24]*See* endnote 3, *supra*.