Flashpoint: Corrections Made Easier: The IRS Expands the Self-Correction Program

Last year, the IRS modified its correction programs for qualification failures (the "Employee Plans Compliance Resolution System" or "EPCRS") to significantly increase the fees for taking part in the Voluntary Compliance Program ("VCP"). (See our previous FlashPoint on this subject.) Since that occurred, the retirement plan community has responded with demands that the IRS expand its procedures permitting plan sponsors to correct certain plan failures without IRS involvement. The IRS responded to those demands this week by issuing Revenue Procedure 2019-19, which is a significant rewrite and improvement of the EPCRS procedure.

This new revision was a complete surprise to the retirement community, as the IRS had not uttered a peep that it was imminent. Furthermore, it follows quickly on the heels of changes made last October to require VCP applications to be filed electronically. (See our previous FlashPoint on that topic.) This new Procedure provides many new ways in which a plan sponsor may act independently to fix errors to retain the plan's tax qualification, without IRS filings, user fees, or other involvement.

What Has Changed?

The new procedure permits plans to self-correct failures in two categories that previously required VCP filings: problems with participant loans and plan amendments.

Loan Failures

Generally, when a participant fails to repay his or her participant loan on time, the total principal and accrued interest of the loan become taxable income to the participant in the year of default. The law permits a limited "grace period" after the default. However, prior to the new procedure, once that grace period had ended without repayment, nothing could be done to prevent the full taxation outside of VCP. This was true even if the problem arose because the plan sponsor failed to start the intended automatic deduction for the loan repayment on its payroll system.

For many years, the retirement community has called on the IRS to make loan failures self-correctable, particularly when the failure was the plan sponsor's fault.

The new procedure permits self-correction of loan failures if the failure relates to:

- A default on loan payments (if the five-year maximum repayment period has not expired);
- Allowing participants to have multiple loans even though not permitted under the plan or loan procedure;
- Providing a loan when the plan does not permit (which was allowed under the old procedure, and continues under the new); or
- The failure to obtain spousal consent (assuming that the spouse is now willing to provide that consent—if not, VCP is required to repair this failure).

If a loan default is self-corrected properly, the participant avoids having the loan treated as taxable income. This is the most common participant loan failure, and having the ability to self-correct and avoid tax consequences is a wonderful option. If the loan default happened so long ago that the maximum five-year repayment period has already expired, the self-correction program may still be used to allow the income to be taxable in the year of correction, rather than the year of default.

The second two loan failures listed above—providing loans when the plan does not permit or failing to limit the number of loans a participant takes—would not produce taxable income to the participant, but could threaten the tax qualification of the entire plan. This problem can now be avoided through self-correction via a retroactive amendment.

If a plan sponsor allows participants to take loans in amounts that exceed the legal limits (generally, $50,000 or 50% of the participant's vested interest), that have repayment periods in excess of the five-year limit (or the extended period allowed for home loans), or that do not provide for level, fully amortized payments, such failures must still be corrected through VCP. Self-correction is not an option.

While it considers loan problems corrected under VCP to be fully corrected for ERISA purposes, the Department of Labor ("DOL") does not give that same deference to self-correction under EPCRS. Therefore, if the plan sponsor or participant wants to be sure that the loan does not represent a prohibited transaction or that excise taxes are not accruing, a separate filing under the DOL's Voluntary Fiduciary Correction Program will be required.

Amendment Failures

Historically, most amendment failures had to go through VCP for correction. There were three exceptions, all relating to operating the plan in a manner different than the plan provided. They were: allowing participants to enter the plan too soon (correct by amending the plan so that the eligibility requirements match what was already done); allowing participants to take loans or hardship distributions although the plan did not so permit (correct by amending the plan to permit loans or hardship distributions); and failure to limit the compensation used for contribution allocations to the legal limit ($280,000 for 2019) (correct by amending the plan to increase the contribution for everyone to the amount needed to justify the allocation given to the highly paid person, when applying the compensation limit).

The new procedure allows self-correction by amendment in many more situations.

Amendments to Match the Plan to Actual Operations or Late Adoption of Discretionary Amendments

Amendments may be made to repair operational errors where the plan has been administered differently than the document terms provide or to correct the failure to timely adopt a discretionary amendment, if:

- The amendment conforms the plan document to actual operations;
- A benefit, right, or feature of the plan would increase as a result of the amendment;
- The increase applies to all eligible employees; and
- Providing the increase is consistent with the procedure's correction principles.

Amendments to Cure Plan Document Failures

Amendments may also be used to self-correct plan documentation failures (i.e., failures relating to the inclusion of a provision that is prohibited or the omission of a provision required for plan qualification):

- If the failure is a so-called "nonamender failure," i.e., a failure to timely amend the plan. This includes a failure to timely adopt an interim amendment required by the IRS.
- Possibly, if the failure relates to not timely adopting a restatement of a preapproved plan. This option may be limited, because such a plan may no longer meet the requirement (needed for any self-correction) that it have a "favorable determination letter," which is defined for preapproved plans to be a favorable opinion or advisory letter on a preapproved document with respect to the most recently expired six-year remedial amendment period.

    > *For example:* It is expected that the next two-year restatement window for defined contribution plans will run from mid-2020 to mid-2022. The related six-year cycle will end on January 31, 2023. Therefore, if a plan is not restated by January 31, 2023 (which will likely be only a few months following the end of the two-year restatement window), the plan document may no longer be subject to an opinion letter for the most recently expired cycle (i.e., the cycle ended January 31, 2023). In that case, the failure may not be self-correctable, requiring a filing under VCP.

    Needless to say, this is an odd result, and we hope that it is simply an unintentional glitch caused by the procedure's wording. We hope the question will be clarified (favorably) by the IRS.

- If the failure is that the sponsor of an individually designed plan ("IDP") did not timely adopt an amendment needed to comply with an item that appeared on the Required Amendments List. Generally, the sponsor of an IDP must adopt such an amendment by the end of the second calendar year after the item first appears on the Required Amendments List.

It is important to note, however, that all corrections by amendment are considered to be <u>significant failures</u>. This means that, in order to self-correct these issues, the correction must be done before the end of the second year following the year in which the error occurred.

More to Come …

If you administer retirement plans, keep your eyes peeled for our upcoming editions of ***Solutions in a Flash***, providing you with the A-B-Cs for corrections under the new procedure.

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