Flashpoint: The Newest EPCRS: All Good News (Except When It's Not)

The IRS issued the long-awaited update of its Employee Plans Compliance Resolution System (EPCRS) on Thursday, July 15, 2021. **Revenue Procedure 2021-30** ("Rev. Proc. 2021-30"), which supersedes the previous EPCRS procedure, Rev. Proc. 2019-19:

- maintains the now familiar structure of the IRS's correction procedures;
- lengthens the time for self-correcting significant operational failures and document failures;
- tinkers with the overpayment rules, particularly for defined benefit plans;
- increases the "*de minimis*" amount for additional distributions that need not be made;
- reinstitutes the safe harbor correction methods for failure to automatically enroll participants in 401(k) features, permitting timely corrections to avoid any employer cost for the missed deferral opportunities if the problem is discovered and remediated within 9½ months after the end of the affected plan year; and
- makes it easier to correct an operational error by amending the plan to match actual administration.

However, Rev. Proc. 2021-30 eliminates the anonymous Voluntary Correction Program ("VCP") procedure whereby a submission could be made without revealing the identity of the plan and its sponsor pending agreement on the correction terms. The IRS opined at times that it was unhappy with a procedure that caused perhaps more work than a regular VCP but sometimes ended up with no proper correction. In lieu of the fully anonymous procedure, the IRS will institute a free pre-submission anonymous conference process that is intended to give some assurances to employers and practitioners as to what is likely acceptable under VCP.

The new procedure is generally effective as of July 16, 2021. There are two provisions with special effective dates, both of which are discussed below.

And now for the details …

Extension of Self-Correction Period

The timing for self-correction of an operational failure is different for significant and insignificant problems. An insignificant failure may be corrected anytime, even if the plan is under IRS examination. A significant error, on the other hand, must be substantially corrected within a limited period. Once that period expires, full correction cannot be accomplished outside VCP or Audit CAP. Under Rev. Proc. 2019-19 and its many predecessors, an employer was required to substantially correct a failure by not later than the last day of the second plan year following the plan year of the failure. The deadline to self-correct a document failure was also subject to the two-year limit.

Because failures to pass ADP or ACP testing are not considered to occur until the last day of the plan year following the plan year being tested (i.e., the permissible correction period under the Internal Revenue Code (the "Code") and Treasury Regulations), the Rev. Proc. 2019-19 self-correction period for ADP/ACP failures extended through the last day of the third plan year following the year of failed testing.

Change Under Rev. Proc. 2021-30

Under Rev. Proc. 2021-30, an additional year is added: a plan may self-correct an operational failure or a document failure up until the last day of the ***third*** plan year following the plan year of the failure. Similarly, the deadline for self-correcting an ADP/ACP failure is now the last day of the ***fourth*** plan year following the plan year of the failure.

Example: The Happy Time Popcorn Company (HTPC) discovered in 2023 that it had allocated profit sharing contributions incorrectly during its 2021 plan year, allocating too much to some participants, but not enough to others. HTPC has until the end of the 2024 year to self-correct the problem.

Example: HTPC also discovered in 2023 that the ADP testing had been performed in error in 2021, and that the correction made in 2022 to fix the failed test was insufficient to pass. HTPC has until the end of the 2025 year (one year more than a regular operational failure) to fix the failed ADP test.

Why might the IRS have given sponsors this gift of the extra year? There has been noise from lawmakers that there should be more opportunity for sponsors to self-correct failures instead of incurring the expense of a VCP filing. Sponsors have also had to contend with an ever-increasing level of administrative complexity, with more to come as the long-term part-time employee rules become effective and Congress considers whether to impose mandatory automatic enrollment in future legislation. As the IRS shifts its financial resources from Compliance to Examinations, this change also reduces the workload for the VCP team. Win-win.

Fixing a Failure to Enroll a Participant in a 401(k) Plan

401(k) and 403(b) plans frequently suffer from elective deferral failures, either improperly excluding employees or failing to correctly implement deferral elections. This is particularly true for plans with automatic contribution features, i.e., automatic enrollment or automatic escalation.

EPCRS has detailed rules to calculate the "Missed Deferral" resulting from these failures. To correct the failure to enroll, the employer is generally required to contribute a QNEC equal to 50%

of the Missed Deferral (called the "Missed Deferral Opportunity" or "MDO"), plus a matching contribution (not necessarily a QNEC) on the full Missed Deferral, plus earnings on both amounts.

There are a number of situations permitting a smaller QNEC (or sometimes no QNEC at all) to be contributed by the employer (although the associated matching contribution and earnings thereon always must be contributed). For more information on these correction methods, see our ***Solution in a Flash*** dated October 1, 2018.

Changes Under Rev. Proc. 2021-30

Rev. Proc. 2021-30's change relates primarily to the elimination of the QNEC requirement for automatic enrollment plans under a special "safe harbor" rule. From 2015 through December 31, 2020, an employer was able to avoid making any QNEC at all if an automatic enrollment or automatic escalation failure was discovered and corrected by no later than the first paycheck following 9½ months after the end of the plan year in which the failure to enroll first occurred. The employer was required to provide notice to the employee within 45 days after the correct deferrals began. (The employer was also required to provide a contribution equal to the match that would have been earned by the employee had the automatic enrollment or escalation taken place.) It is important to remember that this treatment is not available for terminated employees, who must receive a QNEC equal to 50% of the Missed Deferrals.

Under the provisions of Rev. Proc. 2019-19, this option expired in relation to failures that began after December 31, 2020. Rev. Proc. 2021-30 reinstates this permissible correction scheme for 401(k) and 403(b) plans retroactively to January 1, 2021, and extends the "sunset" date until December 31, 2023.

Example: The Automated Processing Company (APC) sponsors a calendar year 401(k) plan with automatic enrollment at 3% of compensation, and automatic escalation by 1% per year thereafter (up to a maximum of 10%).

In July of 2023, APC discovered that it had failed to automatically enroll its entire 2022 newly eligible group, and also forgot to increase the rate of deferral for all existing employees. Prior to the first paycheck to occur after October 15, 2023 (the date 9½ months after the end of 2022), APC begins taking the right amount out of the currently employed affected participants' paychecks. Within 45 days of beginning to properly defer compensation, APC provides those participants with required notice.

APC does not need to contribute any QNEC on behalf of the affected currently employed participants – either those not enrolled or those not provided with automatic escalation. However, APC must contribute the matching contribution on the missed deferrals and the earnings thereon. And, APC must provide a 50% QNEC for terminated affected participants, along with any missed matching contribution.

It is possible that a diligent plan sponsor who discovered a failure to automatically enroll a participant in 2021 has already taken action to correct that failure before Rev. Proc. 2021-30 was issued, depositing the QNEC that was otherwise required for the missed deferral. There is nothing in Rev. Proc. 2021-30 that will now permit the QNEC to be forfeited because of the retroactive effective date of the reinstatement of the safe harbor correction. Therefore, an employer that was particularly assertive in making sure that a failure was corrected quickly may actually have contributed more than what ended up being legally required.

Change to 25% QNEC Timing

Another of the safe harbor correction methods for a failure to enroll a participant in a 401(k) plan in relation to deferrals applies if the error is discovered and corrected within the "significant error" self-correction period, which ended two years after the year in which the failure occurred. This method also requires notice to the actively employed participants within 45 days of beginning correct deferrals. Again, terminated participants would need to receive the 50% QNEC.

As the two-year self-correction period has become three years under Rev. Proc. 2021-30, the 25% QNEC rule also extends to three years after the year of the failure.

Correction of Operational Failures by Plan Amendment

One of the most well-received features of Rev. Proc. 2019-19 was the provision that permits a plan sponsor to self-correct certain operational failures through a retroactively effective plan amendment. While prior procedures permitted certain retroactive amendments (such as to correct an impermissible hardship distribution or the entry of a participant before the completion of the eligibility requirements) and Rev. Proc. 2019-19 continued these rules, the procedure broadened the potential amendment self-correction to include situations where the desired amendment would: (1) conform the plan document to actual operations; (2) result in an increase of a benefit, right, or feature; (3) apply to all employees eligible to participate in the plan; and (4) be permitted by the Code and satisfy EPCRS correction principles and other rules.

This provision, while helpful, caused consternation among practitioners in situations where only a limited group of employees were affected by the plan operations.

Example: Half a Loaf Bakery (HALB) sponsors a 401(k) plan that provides for an employer matching contribution equal to 50% of deferrals for its Atlanta employees, but only 25% for its Macon employees. However, in practice, HALB has always provided the full 50% match to all employees. When confronted with the qualification failure of not following the plan's terms, HALB expressed a desire to correct the error by amending the plan to conform to what they actually did, i.e., to broaden the 50% match to all participants. The company's TPA sadly advised HALB that the amendment would be ineligible as a self-correction, as it would benefit only the employees of the division with the 25% match, thereby failing the third requirement above.

It was also unclear to practitioners what the definition of a "benefit, right, or feature" is for purposes of plan corrections – i.e., is it as defined in the regulations to Code Section 401(a)(4), or is it broader than that? Unfortunately, the new procedure doesn't clear up this question.

Rev. Proc. 2021-30 Change

Under the new procedure, the requirement that all employees be benefited by the corrective retroactive amendment is eliminated. Under these rules, Half a Loaf Bakery would be able to self-correct the failure through use of a plan amendment, assuming all other relevant requirements were met.

This change also presents an interesting possibility for correcting a situation where the employees of a related company are included in the plan but that company failed to sign a participation agreement. We knew prior to Rev. Proc. 2021-30 that this could not be self-corrected, because the amendment would have benefitted only the employees of the related company, thereby failing the "benefits all employees" requirement (commonly referred to as the "universality" requirement). Does the Rev. Proc. 2021-30 change mean that we can now self-correct this failure?

Whether this can be self-corrected depends on how the failure is characterized. One school of thought believes that the failure is that the related employer did not adopt the plan. Rev. Proc. 2021-30 and Rev. Proc. 2019-19 are both clear that this failure cannot be self-corrected. However, a second school of thought believes the failure is properly characterized as a coverage or eligibility issue, which could be covered by this revised self-correction option. Until the IRS weighs in on its opinion, the conservative option would be to continue to correct such failures under VCP.

Elimination of Anonymous Submissions

Under Rev. Proc. 2019-19, employers unsure of whether a given correction method is acceptable to the IRS may have a practitioner submit a VCP filing on their behalf through the Anonymous Submission process. Under that process, the VCP is reviewed by an IRS representative, and the practitioner and the IRS endeavor to reach a mutually agreeable resolution of the issue. If agreement is reached, the practitioner identifies the plan and its sponsor, and the VCP is concluded as normal. If no resolution can be agreed upon, the VCP can be withdrawn without further action, surrendering the VCP fee, and leaving the affected plan unidentified.

The Anonymous Submission program is being eliminated under Rev. Proc. 2021-30 effective as of January 1, 2022. Needless to say, this gives a plan that is contemplating an Anonymous Submission time to do it; but do not dawdle!

In place of the Anonymous Submission process, the IRS will offer up what can only be considered to be sloppy seconds – better than nothing, but hardly satisfying. Under this procedure, beginning in 2022, the practitioner will submit a filing using a soon-to-be-revised Form 8950, outlining substantially all of the information about the situation that would be required in a VCP filing – a description of the failures and how they occurred, the proposed method of correction, the facts (including the type of participants affected); relevant plan provisions and amendments; and any other relevant information. The IRS will then have a pre-submission conference with the practitioner, providing oral feedback on the request that is advisory only and <u>not binding on the IRS</u>. The practitioner will receive written confirmation that the conference took place, but nothing to confirm his or her understanding of what the IRS said during the conference. There is no charge for this process.

How likely is it that the IRS will ultimately rule differently in the VCP filing than indicated by its representative in a conference? That certainly remains to be seen. We have experienced on a much more informal basis situations in which an IRS representative has shared with us his or her impressions of how a situation would be handled in VCP, and have been disappointed to find that the case once filed is treated differently than expected. However, due to the informal basis of those discussions, we had no expectation that the results were binding. Under this more formal pre-submission conference procedure, we are hopeful of several things: (1) the conference is with someone knowledgeable about the VCP program; (2) the IRS representative will provide insight that is not normally available to someone outside the Service that will give the pre-submission conference procedure real value; (3) that the IRS representative will be clear as to what is likely to be permissible and what has more risk of being rejected; and (4) the IRS representative will offer viable alternatives if the proposed correction is unacceptable.

Fixing Overpayments Generally

An overpayment is a qualification failure due to a payment being made to a participant or beneficiary in excess of what was due or payable under the terms of the plan or the Code or regulations. For example, in a defined contribution plan, an overpayment can be caused by overstating a participant's vesting under the plan, by allocating amounts to a participant to which s/he is not entitled (and then paying that excess allocation to the participant), or by not properly limiting the annual additions to a participant to the Section 415 limits. Examples of overpayments in a defined benefit plan include overstating the benefit by not limiting it to the Section 415 limits or by applying the plan's benefit formula or vesting schedule improperly.

Under Rev. Proc. 2021-30, there are basically four "safe harbor" ways to resolve an overpayment:

- If the overpayment is *de minimis*, often, no action needs to be taken. The participant can keep the money and neither the plan sponsor nor any other person needs to contribute the overpayment to the plan to make it whole. If the overpayment was due to a violation of a statutory limit, however, the plan must notify the affected participant that the overpayment is not subject to favorable tax treatment, including rollover. Under Rev. Proc. 2021-30, the *de minimis* amount has been increased from $100 to $250.
- The plan may be amended with a retroactive effective date to align the plan terms with the amount that the participant actually received. This amendment must conform to the rules on plan amendments in general under EPCRS, particularly those permitted under self-correction and the requirement that the amendment may not be discriminatory.
- If the plan owes the participant additional amounts, it may recoup the overpayment by reducing future payments. (If the participant is receiving periodic distributions, such as an annuity or an installment payment, the amount of the periodic payments must be reduced to the correct amount as soon as possible. The plan may then further reduce the payment in a permitted fashion to effect repayment of the excess.)
- The participant may enter into an installment agreement with the plan to repay the overpayment over time.

In addition to these methods, a practitioner may use another "appropriate" method that satisfies the correction principles of the revenue procedure.

More About Trying to Obtain Repayment of the Overpayment

The plan can try to recoup the overpayment from the participant. Under Rev. Proc. 2021-30, the participant's repayment can be made in a lump sum or through the use of an installment agreement. Alternatively, if more amounts are due from the plan to the participant, such remaining payments can be reduced to make up for the overpayment. This offsetting of future payments is mandatory if the reason for the overpayment is a violation of a statutory or regulatory limitation. The participant's repayment must include earnings at the rate earned by the plan during the interim period for defined contribution plans or at the plan rate for defined benefit plans.

Making the Plan Whole: Defined Contribution Plans

If the participant's overpayment did not adversely affect any other participant (e.g., when the overpayment was simply an amount to which the participant was otherwise entitled prior to a distributable event), no further action is required if the participant failed to repay the amount. However, if the result of the overpayment affected other participants (such as when the amount erroneously deposited to the participant's account would have otherwise been allocated to others), the employer or "another person" is required to contribute the amount necessary to make the plan whole. Presumably, the "other person" is a service provider or other individual who was responsible for the failure.

Special Defined Benefit Rules for Overpayments

A defined benefit plan may take advantage of both the increase in the *de minimis* amount and the plan amendment correction method discussed above. Additionally, if a participant is receiving periodic payments (such as an annuity or installments), the plan is permitted to adjust future payments downward to recoup the overpayment over time. No such adjustment is permitted in relation to the survivor portion of a joint and survivor annuity. Of course, in any event, the future payments to the participant must be reduced to the correct level so that the overpayment does not continue.

To the extent that the overpayment was not recouped, the plan sponsor or "another person" must contribute the amount necessary to make the plan whole.

(It is important to note that the EPCRS procedures do not preclude a plan fiduciary from attempting to obtain repayment from recipients through other means, including litigation. This is particularly true if the plan sponsor or fiduciary would otherwise be required to contribute a significant unrecouped amount from a recalcitrant recipient.)

More DB Correction Methods Under Rev. Proc. 2021-30

In addition to the correction methods outlined above for defined benefit plans, Rev. Proc. 2021-30 provides two new procedures. These new methods are intended to reduce the need for the plan to recoup the overpayment from the affected participants and to make the resulting process easier on the participants, while not negatively impacting the other participants in the plan.

Funding exception correction method: Under this method, no corrective payments to the plan are required if the plan is subject to the Code Section 436 funding rules and the plan's certified or presumed adjusted funding target attainment percentage ("AFTAP") is 100% or more. Future benefit payments to the affected participant must be adjusted down to the correct level (and no further), and no further payments are required by the participant or the plan sponsor.

Contribution credit correction method: Under this method, the amount that must be repaid to the plan is basically reduced (or even eliminated) by the amount of increased funding (whether by contributions or the use of credits) caused by the inclusion of the overpayment as a liability in the following years' funding calculations. Future benefit payments to the affected participant must be adjusted down to the correct level (and no further) and no further payments are required by the participant or the plan sponsor. If the increased funding is less than the overpayment, the difference must be contributed by the plan sponsor or another party. This method is unavailable if the plan has a funding deficiency or an unpaid minimum required contribution as of the end of the last plan year before the year in which the plan takes into account the corrected benefit payment for funding purposes.

Rev. Proc. 2021-30 requires a notice to go to a participant from whom repayment is requested under the contribution credit correction method. The contents of the notice are in Rev. Proc. 2021-30, App. B, section 2.05(4)(b)(iv).

These two new methods are <u>not</u> permitted if the overpayment is due to exceeding a statutory limit or if they are made to disqualified persons (as defined in the prohibited transaction rules of Code

Section 4975 – including participants who are fiduciaries, 50% owners of the plan sponsor, family members of the owners, or officers, directors, or HCEs of the plan sponsor).

The significant impact of these changes is to eliminate a requirement for a rank-and-file participant to repay amounts to a plan when the plan is either essentially fully funded or when the employer has already repaid the overpayment through taking the added liability into account for funding.

Installment Repayments or Reduction of Future Benefits

As noted above, Rev. Proc. 2021-30 also permits an overpaid participant in a defined benefit plan who is not a disqualified person to repay the overpayment under an installment agreement, rather than in a single sum or on a reduction of future benefits method. The plan must permit the participant to decide whether to repay the overpayment through a single payment, an installment agreement, or the reduction of future benefits method if the contribution credit correction method is used. Such a choice may be provided to participants (but is not required) under the other correction methods.

If the reduction of future payments method is used to recoup the overpayment, Rev. Proc. 2021-30 provides that the amount of the benefit cannot be reduced by more than 10% and that interest must be applied on the unrecouped balance during the period when the reduced benefits are being paid. If an installment method is being used, the minimum installment period must be 5 years, and interest must be charged on the unrecouped balance during the installment payment period.

Conclusion

We always welcome the expansion of self-correction, as well as improvement of procedures for correction of failures. Therefore, we are grateful for the improvements of Rev. Proc. 2021-30. However, we hope that the Anonymous Pre-submission Conference procedure is effective to help plan sponsors and their service providers better target correction methods.

If you have any questions about the new Revenue Procedure or about plan corrections in general, please call one of our lawyers. Remember, for all of your plan issues, *we are your ERISA solution*.

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