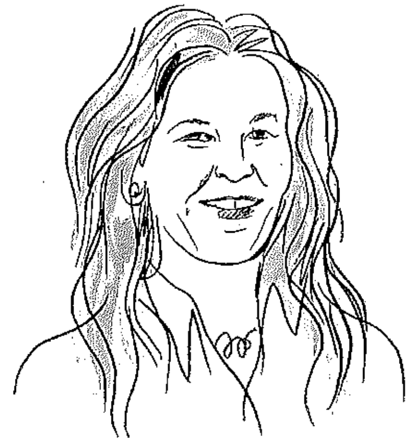

Fixing 403(b) Plans

IRS guidance for correcting document failures

THE Internal Revenue Service (IRS) updated the terms of its Employee Plans Compliance Resolution System (EPCRS) by issuing Revenue Procedure 2013-12 on December 31, 2012, and followed this in January with the Voluntary Corrections Program (VCP) application forms. For 403(b) plan sponsors that missed the deadline to adopt a written plan by December 31, 2009, the IRS included a VCP submission kit to give 403(b) plans the ability—for the first time—to fix document failures. The new EPCRS procedure is effective April 1, but plan sponsors may rely on new guidance given since December 31, 2012.

Document Failures Under Prior Rules. Under the prior iteration of EPCRS, Revenue Procedure 2008-50, correctable qualified plan failures included document, operational, demographic and employer eligibility failures. For 403(b) plans, only the last three categories apply. Thus, while self-correction—a correction without payment of fees or sanctions to the IRS—as well as VCP were open to 403(b) plans, the plans lacked the ability to make corrections by amendment.

The definition of a 403(b) failure under the new version of EPCRS now encompasses all four failure categories, including document failures. A document failure happens when a plan is not adopted in writing or amended to reflect a new requirement.

Role of Determination Letters. The new EPCRS procedure allows self-correction of operational defects but only if the plan has a favorable determination letter from the IRS. There is, as yet, no determination letter program for 403(b) plans, but, pending additional guidance, a 403(b) plan will be treated as having a favorable determination letter if one of two conditions is met. The first condition is met if the sponsor was an eligible employer on or before December 31, 2009 (or, if the plan was established later, on what particular date) and if the employer adopted a written 403(b) plan effective as of January 1, 2009 (or, if later, the first day of the plan year in which the plan was established). The second condition requires an employer that has failed to adopt a written plan in a timely fashion to correct the failure under VCP or the IRS Audit Closing Agreement Program (CAP).

Correction Methodologies. Generally speaking, correcting failures in 403(b) plans is the same procedure as for other types of qualified plans. However, specific rules apply when a 403(b) plan has excluded an eligible employee from making elective deferrals. In this case, the plan sponsor must make a contribution to the excluded employee's account sufficient to make up for the lost opportunity. This is 50% of the average deferral percentage for the employee's group (either highly compensated or non-highly compensated) multiplied by the employee's compensation for the year of exclusion. If the employer offered a matching contribution, that would need to be included, as would earnings adjustments. Revenue Procedure 2013-12 makes the point that this correction methodology does not apply to other failures, such as ADP/ACP [actual deferral percentage/actual contribution percentage] failures.

Correction by Amendment. In some instances—for example, failure to observe the limit on the amount of compensation that may be taken into account in determining contributions—a plan sponsor is allowed to self-correct by plan amendment. Generally, however, VCP or the Audit CAP is to be used when correcting document, demographic or operational failures by plan amendment. A sponsor may do this by conforming plan terms to the plan's prior operations or by authorizing additional plan sponsor contributions to satisfy ADP testing. Where a 403(b) plan (other than a church plan, which is not subject to the rule) was not reduced to writing by December 31, 2009, the revised EPCRS procedure requires adoption of a written plan and filing a VCP submission in order to restore the plan's tax-favored status. The IRS's VCP submission kit can assist plan sponsors through this process.

A VCP submission must now include two new IRS forms. Form 8950 provides the IRS with information that identifies the plan, plan sponsor and the nature of the failure, as well as a lengthy checklist of procedural requirements. Form 8951 indicates the applicable compliance fee, which ranges from a low of $750, for a plan with up to 20 participants, to a high of $25,000, for a plan with more than 10,000 participants. The otherwise applicable compliance fee will be reduced by 50% if a VCP submission is limited to correcting the failure to adopt a written 403(b) plan in a timely manner and the submission is sent to the IRS by December 31.

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