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SURVEY OF SELF-CORRECTION OF QUALIFIED PLAN DEFECTS UNDER APRSC



Comments by

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Service Providers Continue to Actively Use APRSC

Service providers to qualified retirement plans continue to actively use the IRS' Administrative Policy Regarding Self-Correction (APRSC) to correct qualification failures, 1999 survey data shows. In this, our second APRSC survey, responses from over 100 service providers, mostly third party administrators, detail the correction of "operational" qualification failures in over 700 plans during 1999. (The IRS defines "operational failures" as those qualification failures that arise solely from a failure to follow the plan's terms.) The survey results indicate that the APRSC program is having a positive effect on compliance by encouraging the discovery and resolution of these types of retirement plan problems.

History of APRSC

In 1990, the IRS created the first of its programs to permit qualified retirement plans to avoid disqualification by correcting errors in the plan documentation or operation. In the intervening years, those programs were expanded and formalized until 1998, when they were consolidated into the Employee Plans Compliance Resolution System (EPCRS) with the issuance of Revenue Procedure 98-22. The programs are referred to as the "remedial programs" for the correction of "qualification failures" (often referred to as "qualification defects").

EPCRS consists of five programs:

1. the Audit Closing Agreement Program (CAP), under which plan document failures (that is, the failure of the plan document to meet the current Code requirements as to form) and operational failures discovered by the IRS on audit can be corrected;
2. Walk-in CAP, which permits plan sponsors to voluntarily correct plan document failures with IRS supervision;
3. the Voluntary Compliance Resolution (VCR) program, under which plan sponsors may voluntarily correct operational failures with IRS supervision;
4. the Standardized VCR Procedure (SVP), which is a simplified program within VCR for voluntary correction of specified operational defects using specified corrections; and
5. APRSC, which permits plan sponsors to voluntarily self-correct any operational failure without IRS supervision by the last day of the second plan year following the plan year in which the failure occurred, and to correct "insignificant" defects at any time, even if the plan is under an IRS audit.

On August 5, 1999, the IRS issued Rev. Proc. 99-31, which contains guidance and examples upon which plan sponsors can rely in correcting operational failures in their qualified plans. Previously, this guidance consisted of only the SVP-mandated forms of correction set forth in Appendix A of Rev. Proc. 98-22. On January 22, 2000, the IRS issued Rev. Proc. 2000-16, which expands SVP to include the operational failures and correction guidance contained in Rev. Proc. 99-31. Rev. Proc. 2000-16 also updated and consolidated the balance of the guidance for EPCRS. The original SVP-mandated forms of correction and the guidance previously contained in Rev. Proc. 99-31 now appear as Appendix A and Appendix B of Rev. Proc. 2000-16, respectively; together, they create "safe-harbor" correction methods that can be used and relied on by plan sponsors and their advisors in resolving qualification defects under APRSC. [NOTE: On January 19, 2001, the IRS released Rev. Proc. 2001-17, which updates the guidance on EPCRS and makes a number of substantive and procedural changes to the remedial programs. Among other things, the new guidance renames APRSC the "Self-Correction Program" or "SCP."]

Instituted in early 1997, APRSC permits self-correction of qualification failures without IRS supervision. Because of this, evidence of how well or poorly the program works was, prior to our surveys, purely anecdotal. We have conducted these surveys in order to develop statistical data on the effectiveness of the program. We believe these statistics can assist plan sponsors and their service providers in making corrections in the

future. We also believe the data will continue to assist the IRS in developing its remedial programs, especially in areas where there is a high degree of non-compliance.

Survey Overview

As was the case with our 1998 survey, the respondents were predominately third-party administrators (TPAs) and actuaries (about 71%). The remainder were consultants and attorneys (roughly 7.5% each), with one respondent each from the categories of plan sponsor, accountant and trustee.

Since the survey information does not include the number of plans represented by each service provider, we were unable to develop statistics on what proportion of each service provider’s clients had a qualification problem. However, we did secure data indicating that over 56% of the responding providers represent between 100 and 599 plans, and nearly 10% represent more than 1,000 plans. This data, combined with the statistic that over 75% of the respondents used APRSC to correct 6 or fewer plans, gives a strong indication that operational non-compliance occurs in a small percentage of plans. This gives some degree of confirmation to what we surmised in our 1998 report.

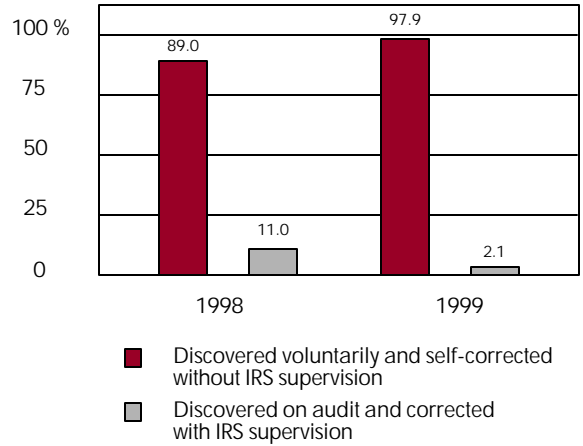
In nearly 76% of the cases, the service providers reported that the defects were insignificant. Just over 24% were reported as significant defects which were corrected within two plan years after discovery

of the defect. These statistics remain virtually unchanged from those developed from our 1998 survey.

The 1999 data, however, indicates that just over 2% of the insignificant defects (13 cases, or a little over 1.5% of all defects) were discovered by the IRS on audit and corrected under APRSC. In comparison to the 1998 data, in which 11% of the insignificant defects (8.5% of all defects) were discovered and corrected during an IRS audit, the decrease in the number of uncorrected operational defects discovered by the IRS suggests that service providers are taking greater advantage of APRSC to correct defects soon after they occur – although it may also reflect the low IRS audit level in 1999.

Voluntary Correction vs. Correction on Audit

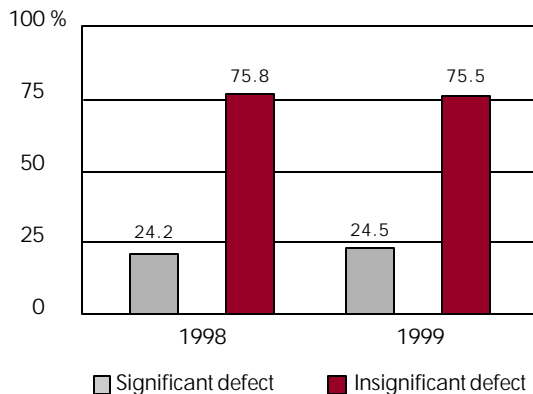
Service providers are taking greater advantage of APRSC to correct insignificant defects soon after they occur



As always, the accuracy of APRSC data is difficult to judge due to the absence of a clear definition of “insignificant;” however, the statistics do show that a substantial majority of APRSC cases involve minor operational problems which are self-discovered and self-corrected. In general, this suggests a very high level of voluntary compliance in resolving operational failures.

Significant vs. Insignificant Defects

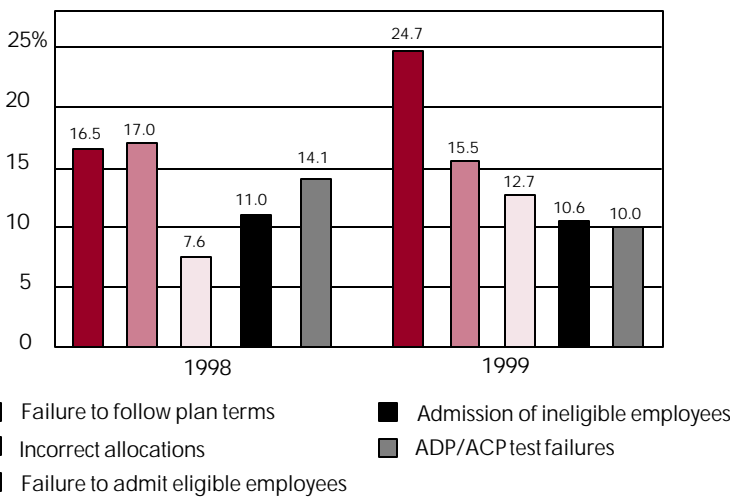
Defects were described as “insignificant” in over 75% of corrections



The types of operational failures were quite broad, but there are statistically meaningful categories. The largest percentage of defects occurred due to a failure to follow the plan’s written terms. This occurred in 24.7% of the plans, an increase of over 8% from last year’s survey, in which this was the second most common defect (after incorrect allocations). In our 1999 survey, incorrect allocations was the second most common defect (15.5%), followed by failure to admit eligible employees (12.7%), admission of ineligible employees

Most Common Defects

Comparison of most common defects from 1998 and 1999 corrections



(10.6%) and ADP/ACP test failures (10%). Other statistically significant groups of defects were top-heavy violations (9.2%) and incorrect distributions (6%). Note that the IRS has addressed all of these defects, except for the admission of an ineligible employee, in its “safe-harbor” correction examples under Rev. Proc. 2000-16. We have previously urged the IRS, based on anecdotal evidence, that the admission of an ineligible employee is a significant problem. This statistical validation should encourage the IRS to issue correction guidance on that defect. [In fact, with the recent issuance of Rev. Proc. 2001-17, EPCRS now provides a safe harbor correction for this defect.]

By a large margin, corrections were based on readministering the plan according to its terms (almost 40% of the cases). [NOTE: In both our 1998 and 1999 surveys, Question No. 8 (“How Defect Was Corrected”) shows a lower percentage of defects being corrected by

readministering the plan than Question No. 5 (which inquired as to the *basis* of the “Correction Method”). This discrepancy is most likely due to respondents breaking down the general category of “readministering the plan” in Question No. 8 into sub-categories, such as putting money into a suspense account or

reallocating money from the accounts of HCEs to the accounts of NHCEs.] Presumably, this is based on the overriding correction principle in EPCRS that operational violations should be resolved by putting participants in the position they would have been in absent the defect. In nearly 25% of the cases, correction involved putting more money into the plan, or otherwise increasing benefits, for rank-and-file employees.

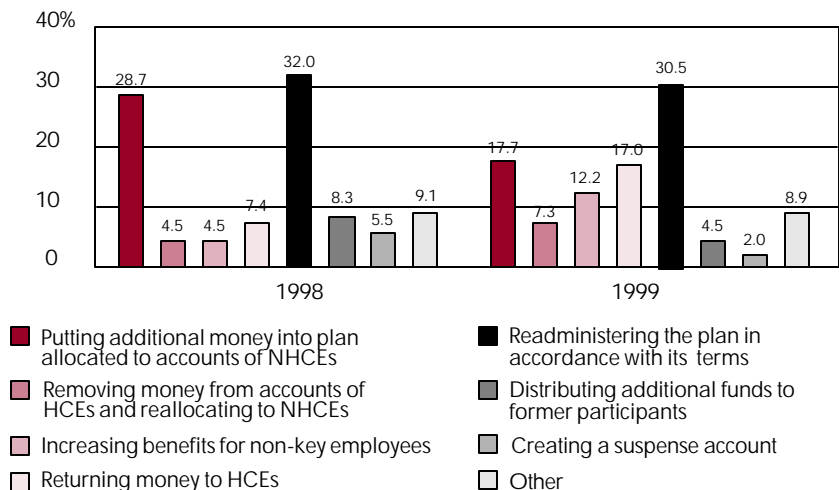
Finally, the percentage of plans in which the correction is documented remained very high from our 1998 survey (about 95% for both years). Based on our experience, documentation of the defect and the manner of correction is very helpful if the plan is subsequently audited by the IRS.

Survey Results in Detail

The survey results and additional comments follow.

How Defect Was Corrected

The largest category of corrections fell under the broad heading of readministering the plan according to its terms



1. Indicate the number of cases in which you have corrected or advised on the correction of plan qualification failures.

Number of Cases	Number of Respondents	Percentage of Respondents
0	11	10.6%
1	14	13.5%
2	20	19.2%
3	13	12.5%
4	9	8.7%
5	6	5.8%
6	7	6.7%
7	1	1.0%
8	4	3.9%
9	1	1.0%
10	4	3.9%
More than 10	15	14.4%

Table 1: Number of Plans

Since the survey information does not include the number of plans represented by each service provider, we cannot develop statistics on what proportion of each service provider’s clients had a qualification problem. However, it is significant that approximately 90% of the respondents identified and corrected at least one defect during the year. This indicates a high level of awareness of the IRS programs and suggests qualified plans are receiving advice to correct defects when discovered. Also, see our comment under the following survey question.

2. If you are an advisor to plans, indicate the appropriate number of qualified plans your firm administered or advised in 1999:

Number of Plans	Number of Respondents	Percentage of Respondents
Under 100	24	23.1%
100-199	19	18.3%
200-299	15	14.4%
300-399	11	10.6%
400-499	8	7.7%
500-599	6	5.8%
600-699	2	1.9%
700-799	1	1.0%
800-899	1	1.0%
900-999	1	1.0%
Over 1,000	10	9.6%
Plan Sponsor (N/A)	1	1.0%
No Response	5	4.8%

Table 2: Number of Qualified Plans Administered

Although we do not have the data necessary to prepare statistics on what proportion of each service provider’s clients had qualification defects, we do know from the data in survey question No. 2 that over 56% of the providers indicated that they represent between 100 and 599 plans, and nearly 10% indicated that they represent more than 1,000 plans. This information, combined with the data from survey question No. 1 indicating that over 75% of the respondents reported corrections in 6 or fewer plans, suggests that operational non-compliance is discovered (and perhaps only occurs) in a relatively small percentage of plans. This gives some degree of confirmation to what we surmised in our 1998 report.

3. Was the defect:

	Number of Respondents	Number of Plans	Percentage of Plans
a significant defect corrected within the first two plan years after it occurred?	48	181	24.5%
an insignificant defect corrected <i>within</i> the first two plan years?	65	423	57.2%
an insignificant defect corrected <i>after</i> the first two plan years?	41	135	18.3%
N/A	12		
No Response	1		

Table 3: Significant vs. Insignificant Defects

As was the case with our 1998 survey results, in over 75% of the corrections the defect was described by the service provider as “insignificant.” The difficulty in relying on this data is that the term “insignificant” has not been defined by the IRS. Therefore, whether a qualification failure

is insignificant is initially left to the determination of the plan sponsor and/or its advisors, subject to review by the IRS if the plan is audited. The problem for the plan sponsor in this regard is that there is always the risk that an IRS Revenue Agent might, on audit, disagree with the plan

sponsor’s or advisor’s determination that a defect is insignificant. This could result in plan disqualification; however, it is more likely to be resolved on the basis of an Audit CAP. To help avoid this serious problem, we continue to urge the IRS to provide further guidance to clarify the distinction between significant and insignificant defects.

In our 1998 survey, almost 20% of the defects were corrected more than two years after they occurred. In this survey, that percentage has *not* decreased significantly. This is somewhat surprising in view of the amount of press given to APRSC in 1999. At the same time, this may simply reflect the fact that the IRS did not issue formal correction guidance relative to APRSC until August 5, 1999, when it released Rev. Proc. 99-31.

4. For an insignificant defect, was the defect:

	Number of Respondents	Number of Plans	Percentage of Plans
discovered voluntarily and self-corrected without IRS supervision	86	600	97.9%
discovered on audit and corrected with IRS supervision	10	13	2.1%
N/A	18		

Table 4: Voluntary Correction vs. Correction on Audit

With over 97% of the insignificant defects being self-discovered and corrected, this indicates a very high level of voluntary compliance. This statistic is up nearly 9

percentage points from our 1998 survey. This suggests that as plan sponsors and service providers become more familiar with APRSC and the IRS’ safe-harbor cor-

rection methods, they are more likely to engage in self-auditing and self-correction.

In last year’s survey, the percentage of APRSC corrections made under IRS supervision on audit was approximately 11%. In view of the increase in self-discovery and self-correction, it is not surprising that in 1999 this percentage dropped to just over 2%.

5. Correction method:

	Number of Respondents	Number of Plans	Percentage of Plans
Readministering the plan in accordance with its terms	73	298	39.0%
By following a statutory or regulatory provision specifically related to the defect	40	204	26.7%
In accordance with an IRS example in a publication or speech	29	177	23.2%
Based on the plan sponsor's or advisor's judgement on equitable correction	35	85	11.1%
Other	2	3	
N/A	11		

Table 5: Correction Method

In our 1998 survey, nearly one-half of the defects were corrected by readministering the plan in accordance with its terms. We commented that this was not surprising,

since the primary correction principle listed in Rev. Proc. 98-22 is to put the participants in the position they would have been in had the qualification failure not

occurred. In the 1999 survey, the use of this correction method is down 8.5%. At the same time, the percentage of defects corrected in accordance with IRS examples is up nearly 14 percentage points. This suggests that the issuance of the correction examples in Rev. Proc. 99-31 has had a dramatic impact on correction methodology.

Not surprisingly, the survey also suggests that the IRS correction examples have reduced the number of instances in which correction was made based on the plan sponsor's or advisor's judgment of an equitable correction. The percentage of such cases has gone down nearly 5.5% from our 1998 survey.

6. If the failure was corrected without IRS supervision, how was the self-correction documented?

	Number of Respondents	Number of Plans	Percentage of Plans
Resolution of the Board of Directors	22	112	15.6%
Plan Committee minutes	14	111	15.5%
Service provider memorandum, letter or other documentation	71	457	63.7%
Memorandum in files of an attorney	16	38	5.3%
Other:	4	48	6.7%
5330	1	1	
Unknown	1	2	
Created APRSC Election Form	1	43	
Copies of all work papers showing correction	1	2	
Not Documented	6	41	5.7%
N/A	13		
No Response	3		

Table 6: Documenting Self-Correction

The percentage of plans in which the correction is documented remains very high from our 1998 survey (both surveys indicate nearly a 95% documentation rate). Based on our experience, documenting the failure and its correction is very helpful if the plan is subsequently audited. This is consistent with what IRS officials have indicated in both informal statements and speeches around the country.

7. Type of defect:

	Number of Respondents	Number of Plans	Percentage of Plans
ADP/ACP test failure	31	85	10.0%
Violation of 415 limits in a defined benefit plan	1	1	0.1%
Violation of 415 limits in a defined contribution plan	19	29	3.4%
Incorrect allocations	52	132	15.5%
Incorrect distributions	27	51	6.0%
Violation of the top-heavy requirements	18	78	9.2%
Early admission of ineligible employees	26	90	10.6%
Failure to timely admit eligible employees to participation	40	108	12.7%
Hardship distributions violating requirements	4	5	0.6%
Loan provision violating requirements	16	25	2.9%
Failure to obtain participant or spousal consents to a distribution	12	16	1.9%
Failure to follow plan terms	29	210	24.7%
Other:	13	20	2.4%
Minimum required distribution	2	5	
Failure to remit ADP contribution timely	1	1	
Investment broker errors	1	2	
Taking distributions without proper paperwork	1	1	
Failure to pass 401(a)(4) & 410(b)	1	2	
Vesting schedule improperly administered	1	1	
401(a)(4) grouping accrual rates	1	1	
Late 5500's , missed 70-1/2 min. dist., PBGC Form 500	1	1	
Failure to match at required level	1	1	
402(g) limit	1	1	
Deferrals exceeding document limits	1	3	
401(a)(17) failure	1	1	
N/A	11		
NoResponse	1		

Table 7: Type of Defect

Statistically, the most common type of defect was the failure to follow the plan's written terms. This occurred in 24.7% of the plans, an increase of over 8% from last year's survey in which this was the second most common category of defect (after incorrect allocations). Failure to follow the plan's terms is a catchall which includes a number of other possible types of failure. It is a common defect and it

highlights the importance of coordinating the administration of the plan with the documentation. In our experience, examples of common problems of this type are: participant loans where the plan documents do not permit participant loans; more outstanding loans to a participant than the plan document permits (*e.g.*, the plan document only permits one outstanding loan to a

participant at a time); hardship withdrawals where the plan document does not have a provision permitting such withdrawals or where the hardship withdrawal is not administered in accordance with the plan provision; distributions in forms or at times not permitted by the plan document; admission of employees to participation prior to completing the eligibility requirements in the plan; use of compensation data different from the definition in the plan document; deferrals in excess of the Code section 402(g) or plan document limits; failures to comply with the minimum required distribution rules; and failures to comply with the plan's requirements regarding matching contributions.

The second largest group of defects was incorrect allocations at 15.5%; the third was failing to timely admit eligible employees with 12.7%. Other statistically large groups of defects were ADP/ACP test failures (10%), top-heavy violations (9.2%) and incorrect distributions (6%). The IRS has addressed all of these defects in its safe-harbor correction examples in appendices A and B of Rev. Proc. 2000-16.

In this year's survey, early admission of ineligible employees remains the fourth largest identified group of defects, down less than 0.5% from last year's survey. Unfortunately, the IRS has not yet provided published guidance on correction for this type of qualification failure. We continue to urge the IRS to issue correction guidance on this significant problem. (NOTE: As indicated in the history of APRSC section on page 1, the recently released Rev. Proc. 2001-17 provides a safe harbor correction for this defect.)

8. Was the defect corrected by:

	Number of Respondents	Number of Plans	Percentage of Plans
Putting additional money into the plan allocated to the accounts of non-highly compensated employees (NHCEs)	42	122	17.7%
Increasing benefits for non-key employees (i.e., correcting a top-heavy violation)	18	84	12.2%
Returning money to highly compensated employees (HCEs) (e.g., to correct an ADP or ACP violation)	25	117	17.0%
Removing money from the accounts of HCEs and reallocating to NHCEs	13	50	7.3%
Readministering the plan according to its terms	58	210	30.5%
Creating a suspense account within the plan	9	14	2.0%
Distributing additional funds to former participants	23	31	4.5%
Other:	29	61	8.9%
Correction method not indicated	1	1	
Making minimum required distributions	1	3	
Additional money for employees not properly included in plan	1	3	
Additional contributions for incorrect allocations	1	2	
Money returned from IRA	1	1	
Calculated missed interest & earnings (compounded) on such income	1	1	
Reallocating contributions	1	1	
Obtained spousal consent following dist. & filed VCR	1	1	
Demanding excess distributions; reclassifying a rollover as a transfer	1	5	
Returning proceeds to sponsor	1	1	
Reallocating prior year contribution	1	1	
Obtaining participant/spousal consent post facto	1	2	
Adding another plan	1	1	
Completing appropriate paperwork after occurrence	1	1	
Money returned from IRA	1	1	
Calculated missed interest & earnings (compounded) on such income	1	1	
Taxing loan proceeds -- amended 1040	1	1	
Memos & forms (even though after the fact)	1	5	
Refunded contributions to ineligible employee (only in plan one month) when error discovered	1	1	
Distributing 415 excess	1	1	
Attempting to collect over distribution -- ER deposit of balance	1	2	
Depositing funds or removing funds to/from the plan	1	3	
Taxing ppts on defaulted loans in correct year & having ppts re-do their taxes	1	1	
Obtaining current forms to memorialize prior distribution	1	1	
Returning funds to plan for unauthorized and invalid loan	1	1	
Obtain spousal consent	1	1	

Table continued on next page

Table 8: How Defect Was Corrected

As was the case with the 1998 survey, the largest category of corrections fell under the broad heading of readministering the plan according to its terms (over 30%). As indicated above, resolving operational defects in this manner is consistent with the IRS correction principle under EPCRS that participants should be put in the position they would have been in absent the defect. It is also consistent with certain of the IRS’s correction examples, which formally approve readministration of the plan (referred to in the correction examples as the “reallocation correction method”) as a safe-harbor correction method. (NOTE: Survey Question No. 5 indicates that 39% of the defects were corrected by readministering the plan. In this Question No. 8, the percentage of defects corrected in this manner is 30.5%. The difference is primarily attributable to the fact that in Question No. 5 we were asking about the basis for the correction methodology, and in Question No.8 we were asking for the specific method of correction. Thus, in Question No. 8, it is logical to assume that some of the corrections which fall under the general category of “readministering the plan” were broken down by the respondents into other categories, such as (1) putting money in a suspense account or (2) reallocating money from the accounts of HCEs to the accounts of NHCEs.)

Nearly 25% of the corrections involved putting more money into the plan for, or otherwise increasing the benefits of, rank-and-file employees. This is similar to what the 1998 data showed. The fact that a

Table continued from previous page

	Number of Respondents	Number of Plans	Percentage of Plans
Other (continued):			
401(a)(4) -- no change	1	1	
Return of deferrals & cessation of deferrals for year of hardship distribution	1	1	
Return amts for ineligible & those exceeding 415 or document limits	1	16	
N/A	11		
No Response	1		

significant number of defects are being corrected in this manner may be due, in part, to plan sponsor concerns about the ill will that might be created if certain plan participants are asked to return a portion of their benefits in order to support correction for other participants through readministration of the plan.

9. When you worked on correcting the defect(s) under APRSC, was that in your capacity as

	Number of Respondents	Percentage of Plans
The plan sponsor	1	1.0%
Attorney	8	7.7%
Third party administrator	69	66.3%
Consultant	8	7.7%
Actuary	5	4.8%
Accountant	1	1.0%
Other:		
Trustee	1	1.0%
No Response	11	10.6%

Table 9: Capacity of Person Correcting

This information is not surprising and it is not significantly different from what the 1998 data showed. Clearly, the first person who is likely to discover an error is the third-party administrator who is in the business of reviewing the plan administration data. Also, given the fact that APRSC has simplified the correction process, especially when coupled with the new IRS correction examples, it makes sense that the TPA is the party who most typically assists the plan and plan sponsor in making correction.

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