

retirement

plan news

Highlights of the EPCRS Changes

Retirement plan administration is complex. As a result, unintentional errors may occur. To address this situation, the Internal Revenue Service established a program in the early 1990s to allow plan sponsors to correct mistakes while preserving the available tax benefits for both employers and employees.

The program is the Employee Plans Compliance Resolution System (EPCRS), and it is occasionally updated to address developing issues. The latest EPCRS enhancement was issued in May as IRS Revenue Procedure 2006-27. The changes generally become effective September 1, 2006.

The EPCRS consists of three programs: the Self-Correction Program (SCP), the Voluntary Compliance Program (VCP), and the Closing Agreement Program (Audit CAP).

SCP. Under SCP, a plan sponsor may correct insignificant “operational failures” without paying a sanction, provided there are established plan procedures and the retirement plan document has been approved by the IRS.

VCP. The VCP allows a plan sponsor to submit more complex corrections for formal IRS approval. Under the program, the employer corrects the failure and pays a fee based on the number of plan participants. A VCP application may be filed up until a plan becomes the subject of an IRS audit. (VCP has an anonymous submission option that permits an employer to see what the IRS will require to bring its plan back into compliance before agreeing to the solution.)

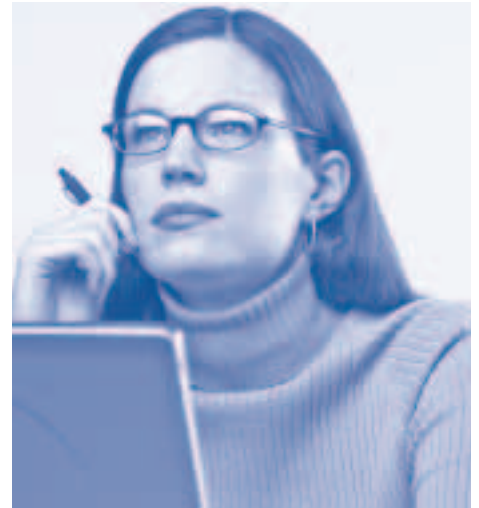
Audit CAP. If a failure (other than one corrected through SCP or VCP) is identified during an IRS audit, the plan

sponsor is required to correct the failure and pay a sanction. The sanctions are greater than the fees imposed under VCP for two reasons: to encourage voluntary submissions, and to impose fees that bear a “reasonable relationship” to the nature, extent, and severity of the failure. When setting the sanction amount, the IRS does take into consideration the extent to which an employer attempted to make a correction *before* the audit began.

New Corrections for Plan Loan Errors. EPCRS provides standardized correction methods for errors that frequently arise in day-to-day administration. Let’s take a look at an area recently enhanced by new EPCRS correction methods: participant loans.

Exceeding the Maximum Available Loan Limit. If a loan exceeds the maximum allowable amount (one half of the participant’s vested account balance, but not more than \$50,000), the appropriate correction is to allow the participant to repay the amount in excess of the limit

SEPTEMBER/OCTOBER 2006



at the time the error is discovered. The remaining loan balance is re-amortized, which reduces future payments by taking into consideration any overpayments made based on the excess loan balance. Note that the correction must be submitted under VCP.

Example: A participant with a vested account balance of \$60,000 was issued a
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nonconforming loan in the amount of \$40,000. The original repayment schedule of principal and interest is higher than would be necessary to repay the proper maximum allowable loan amount

(\$30,000). Under the new EPCRS correction method, the participant would repay \$10,000 to the plan. Any extra amounts already paid will reduce the unpaid principal amount after correction occurs. The recalculated amortization schedule will reflect this reduction.

Exceeding the Five-year Term. If a loan was initiated with a repayment period of longer than five years (and the loan was not used to purchase a primary residence), the employer may correct the nonconforming loan by making a submission through VCP. The applicable correction is to shorten the remaining term of the loan as of the date the error is discovered so the loan will mature *within five years* of its origination date.

In addition, the loan repayment schedule must be re-amortized. Note that the correction is not available if the discovery is made beyond five years from the loan origination date.

Paying Overdue Amounts During the Grace Period. When a participant is behind in loan repayments, but the loan is not deemed in default, he or she may either repay the overdue amount as a lump sum or re-amortize the amount over the remaining loan period. Grace periods are optional. If a plan includes a grace period for loans, the period may not extend beyond the end of the calendar quarter following the date of the first nonpayment. ❖

Eligibility Rules Part I: Hours of Service

If employees must perform 1,000 hours of service in a 12-month period before being eligible to join a plan, are they eligible to join as soon as they complete 1,000 hours of service? The short answer is “No.”

The law requires employees to first complete 12 months of service *before* a determination is made as to whether they have completed 1,000 hours of service. Pension geeks call this the “statutory eligibility rule” because it is based on Internal Revenue Code §410(a)(3)(A) and ERISA Code §202(a)(3)(A).

Here’s an example. A plan with a 1,000-hours-of-service eligibility requirement hires an employee on November 11, 2005. The plan has semiannual entry dates of January 1 and July 1. The employee completes 1,000 hours of service on June 8, 2006, but is not eligible to join the plan at that time. He or she must first meet the 12-months-of-service requirement (November 10, 2006, in this instance). The employee will then be eligible to enter the plan on the next plan entry date (January 1, 2007).

Although some employers may consider it an act of generosity to permit earlier entry, the law requires

employees to reach the 12-month anniversary of the day they first performed service *as well as* perform 1,000 hours of service before entering the plan.

The service computation period

is a 12-consecutive-month period. But it is possible for an employee to leave employment and, shortly thereafter, be rehired. If this happens, the employment periods are linked — provided there is no break in service (defined as a 12-month period during which the employee was credited with fewer than 501 hours of service). ❖



Eligibility Rules Part II: Elapsed Time

The elapsed-time method of determining plan eligibility is an alternative to the hours-of-service eligibility method. Instead of counting the actual or equivalent hours an employee works, the elapsed-time method measures an employee's period of employment, beginning with the date of hire and continuing through the date he or she meets the plan's eligibility requirements.

This method works well for employers who wish to ease the administrative burden of including part-timers, construction workers, truckers, seasonal workers, and employees in other jobs where counting hours is not always easy or possible.

However, if the employer's goal is to *exclude* these categories of jobs from plan participation, the hours-of-service method is a better choice.

The elapsed-time method doesn't require continuous employment. It only requires the employee to be employed on the original date of hire and on the last date of the eligibility period (provided any break in employment is less than 12 consecutive months).

One-year Requirement. Assume a plan has a one-year eligibility requirement. An employee who was hired on April 15, 2006, and is still employed on April 15, 2007, is considered to have completed one year of service under the elapsed-time eligibility method, regardless of the actual number of hours worked during that period.

Three-month Requirement. Assume a plan has an eligibility requirement of three months. The three-month period runs from the employee's date of hire to the anniversary of the date of hire three months later. For example, an employee who was hired on July 31, 2006, will complete the three-month elapsed-time requirement on October 31, 2006, assuming he or she is employed on that date.

Service-spanning Rules. IRS regulations provide rules for employees who leave employment and are then rehired. Under these rules, absences of less than 12 consecutive months are not counted against the employee. A break in service (called a "period of severance" under the elapsed-time

1	Sunday
2	Monday
3	Tuesday
4	Wednesday
5	Thursday
6	Friday
7	Saturday
8	Sunday
9	Monday

eligibility method) occurs only if there is an absence of 12 or more consecutive months.

Example One: A plan has a one-year elapsed-time eligibility requirement. An employee was hired on April 15, 2005, left employment on October 26, 2005, and was rehired on January 10, 2006. Under the elapsed-time eligibility rules, the employee satisfies the service requirement because he was absent for less than 12 months and was employed on his one-year anniversary date of April 15, 2006. The number of hours worked during the measuring period is irrelevant.

Example Two: In a plan with a three-month elapsed-time eligibility requirement, an individual was hired on July 31, 2005, left the job on August 23, 2005, was rehired on September 26, 2005, and was still employed on her three-month anniversary date of October 31, 2005. The employee completed the three-month elapsed-time eligibility requirement because no period of severance occurred in this case.

Example Three: In a plan with a one-year elapsed-time requirement, an employee was hired November 8, 2004, and worked until September 17, 2005. The employee then left, and was rehired December 8, 2005. Because he was not absent for 12 consecutive months, and the one-year-of-service requirement was met as of November 7, 2005, the employee was eligible to join the plan when he was rehired. (If the normal plan entry date passes during an employee's absence, he or she enters the plan immediately upon being rehired.) ❖

recent developments

■ **IRS Error.** The IRS has asked us to tell you about an error in Publication 590 regarding the conversion of a traditional IRA to a Roth IRA. Roth conversions are permitted only if a taxpayer's adjusted gross income (AGI) is \$100,000 or less. IRA distributions, which are normally included as income in calculating AGI, are excluded for Roth conversion eligibility purposes. Qualified retirement plan distributions, on the other hand, *are not excluded* in calculating AGI. Unfortunately, Publication 590 indicates that qualified plan distributions are excluded. Ignore Publication 590 on this point!

■ **Form 8905.** The IRS has issued Form 8905 for individually designed plans that wish to switch to a preapproved plan (i.e., prototype or volume

submitter plan). The form is a certification of intent to adopt a preapproved plan and must be completed before the end of the individually designed plan's restatement cycle. Form 8905 must be completed by the employer and signed by the firm sponsoring the preapproved document. (The form is to be kept by the employer and is only to be submitted to the IRS if the preapproved plan is being submitted for a determination letter.)

■ **DOL News.** The DOL recently issued two major releases. The first announced updates and enhancements to the voluntary fiduciary compliance program (VFCP). Similar to the EPCRS, the VFCP allows plan sponsors to voluntarily correct certain fiduciary errors. The second release announced final regulations on the

handling of abandoned plans. This long-awaited guidance establishes procedures for terminating "orphan plans" (those of sponsoring employers that are no longer in existence).

■ **PBGC E-filing Requirements.** Effective July 1, 2006, sponsors of PBGC-insured defined benefit pension plans with 500 or more participants must submit their PBGC premium filings electronically. The requirement will be extended to all other DB plan sponsors in plan years beginning on or after January 1, 2007. Pension practitioners can prepare and submit premium filings and electronic payments through the PBGC's My Plan Administration Account (My PAA) website. They may also use compatible commercial software to prepare filings for electronic submission. ❖

The general information in this publication is not intended to be nor should it be treated as tax, legal, or accounting advice. Additional issues could exist that would affect the tax treatment of a specific transaction and, therefore, taxpayers should seek advice from an independent tax advisor based on their particular circumstances before acting on any information presented. This information is not intended to be nor can it be used by any taxpayer for the purpose of avoiding tax penalties.

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