Insights: Alerts

SECURE 2.0 Upends IRS Correction Procedure

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The SECURE 2.0 Act of 2022 ("SECURE 2.0") is one of the most significant pieces of retirement plan legislation in many years. (See our high level summary of SECURE 2.0 at link.) Among other things, SECURE 2.0 brings sweeping changes to the correction of inadvertent errors for employer retirement plans. These include:

- Expanded options for employers and IRA providers to self-correct inadvertent errors.
- New protections for employees who receive inadvertent overpayments from retirement plans and modifications to the correction rules for plan qualification failures relating to overpayments.

These new rules will be beneficial to virtually all 401(k) plans, pension plans, or 403(b) plans that incur any noncompliance failure. In this article, we explore the impact of these changes in more detail.

Expanded Self-Correction

The IRS maintains the Employee Plans Compliance Resolution System ("EPCRS") for correction of tax compliance issues for 401(k) plans, pension plans, 403(b) plans and other retirement plans. In its current form, EPCRS allows for certain compliance issues to be self-corrected by plan sponsors, while others may only be corrected with IRS approval through the Voluntary Correction Program ("VCP"), depending on the type of issues.

Under EPCRS's current rules, self-correction is generally available with respect to compliance issues that relate to a failure to properly follow plan terms (known as an "Operational Failure") or a failure to properly write the plan terms or to timely amend the plan to comply with the Internal Revenue Code ("Code") and other regulations or guidance (known as a "Plan Document Failure"), as long as the correction is substantially completed by the end of the third year following the year in which the failure occurred (known as the "Correction Period"). Operational Failures may also be eligible for self-correction at any time, including when the plan is under examination by the IRS, if they are not determined "significant" based on a number of factors, including the number of participants affected and the dollar amount involved. Certain other failures, including coverage and nondiscrimination failures, are not eligible for self-correction.

SECURE 2.0 expands the availability of self-correction under EPCRS by providing that any inadvertent failure is eligible for self-correction without regard to the Correction Period. Accordingly, this potentially represents a significant expansion of the self-correction program under EPCRS because it is not limited to specific types of failures.

There are a number of limitations on the availability of SECURE 2.0's self-correction rules:

- Established Practices and Procedures. To qualify as an eligible inadvertent failure, the plan must have established practices and procedures in place that are reasonably designed to facilitate compliance and routinely followed. An eligible inadvertent failure is a compliance issue that arises despite reasonable

practices and procedures due to a mistake or oversight.

- Egregious Failures. Self-correction is not available for egregious failures (such as plans that consistently and improperly cover only highly compensated employees), failures involving a diversion or misuse of plan assets, or tax avoidance transactions.
- Timely Implementation of Correction. Failures must be corrected within a reasonable time after they are identified. (As noted above, under EPCRS currently, significant failures must be corrected within the three-year Correction Period.) Further, a failure identified by the IRS prior to actual correction is not eligible for self-correction unless the plan sponsor has already taken actions that demonstrate a specific commitment to self-correction. Notably, self-correction may still be available even if the correction is not actually completed or substantially completed before discovery of the failure by the IRS as long as some actions have been taken to implement the self-correction process.
- Other Limitations. SECURE 2.0 provides an exception to the expanded self-correction opportunities when otherwise provided by the Code, regulations or guidance of general applicability. Thus, it appears that the IRS may have authority to issue guidance that narrows the availability of self-correction in certain situations.

SECURE 2.0 still requires that any self-correction comply with the general principles of EPCRS. SECURE 2.0 also directs the IRS to issue further guidance on correction methods for eligible inadvertent failures, including general provisions where a specific correction method is not specified. EPCRS currently includes general correction principles, so it is uncertain to what extent the IRS will need to revise the correction methods in EPCRS.

SECURE 2.0 also requires the IRS to expand EPCRS to cover IRA custodians, clarifies that loan failures generally may be self-corrected, and clarifies that self-correction of a loan failure under EPCRS will result in deemed satisfaction of the Department of Labor ("DOL")'s Voluntary Fiduciary Correction Program as well (although the DOL may require documentation of such self-correction).

Unlike the overpayment rules discussed below, the expanded self-correction provisions of SECURE 2.0 do not include an express effective date, and so they appear to be effective upon the date of enactment. The IRS is directed to revise EPCRS within two years after the date of enactment to take into account these provisions, but SECURE 2.0 does not specify that the effective date of the expanded self-correction program is dependent on the IRS's issuing updated guidance.

While self-correction appears to be broadly available for inadvertent failures, there may still be circumstances where IRS approval of corrections under VCP may be necessary or desirable. For example, if EPCRS does not specify a particular correction method for a failure, or if it is unclear that a failure would be eligible for self-correction (for example, because of a delay in implementing correction or because there are questions regarding reasonableness of practices and procedures), IRS approval through VCP would provide certainty that the compliance issue has been resolved. IRS approval may be especially desirable for corrections that involve large dollar amounts or large numbers of participants. In addition, certain types of relief (such as for excise taxes) may only be available through VCP. As noted above, the IRS may also issue future guidance that limits the availability of self-correction in certain situations.

Modifications of Overpayment Correction Rules

SECURE 2.0 overrides several existing IRS rules relating to the recovery of inadvertent benefit overpayments. Overpayments are payments from a defined contribution or defined benefit plan that either are not permitted by the plan or the Code or that exceed the amount of the benefit payable to the participant. These rules are intended to

protect “innocent” participants who unknowingly receive overpayments. SECURE 2.0 also limits the circumstances in which a plan sponsor would be required to make a corrective contribution for an overpayment, as addressed below.

Currently, EPCRS allows for an overpayment to be corrected by retroactively amending the plan to provide for the overpayment as long as the amendment satisfies nondiscrimination and other Code requirements. However, a plan sponsor may instead correct the overpayment by recovering it from the participant either by reducing future annuity payments (if applicable) or by taking reasonable steps to have the participant repay the overpayment to the plan.

These rules are applicable to an “inadvertent benefit overpayment.” The restrictions on recovering overpayments are not intended to protect participants who have culpability for the overpayment, including if the overpayment resulted from misrepresentations from the participant or if the participant knew that the payment was materially in excess of the correct amount. However, a participant would not be culpable if they informed an appropriate plan official of the overpayment.

SECURE 2.0's changes to the overpayment correction rules include:

- Return of Overpayment. Currently, a plan sponsor may take reasonable steps to have an overpayment, with appropriate interest, returned to the plan by a participant in a lump sum or a series of installment payments. SECURE 2.0 includes the following limitations on the ability to recover overpayments:
    - No recovery may be sought if the first overpayment occurs more than three years before the participant is notified of the overpayment, absent fraud or misrepresentation by the participant.
    - No interest or other amounts (such as collection costs) may be sought for an overpayment.
    - Recovery of overpayments to a participant may not be sought from a surviving spouse, former spouse or other beneficiary of the participant.
    - Threats of litigation against the participant are not permitted unless the responsible plan fiduciary determines that there is a reasonable likelihood of recovery of an amount greater than the cost of recovery.
    - Any referral to a collection agency is prohibited unless the participant ignores or rejects recovery efforts following a final judgment against the participant in Federal or state court or a settlement between the participant and the plan, in either case that authorizes recoupment.
        - A participant or beneficiary is entitled to contest the overpayment recovery under the plan's claims procedures. If the overpayment has been rolled over to another eligible plan, the plan would be required to notify the receiving plan of the dispute and the receiving plan could retain the overpayment pending resolution of the dispute and return the overpaid amount to the plan if it is finally determined to be an overpayment.
        - Efforts to recoup the overpayment are subject to any other requirements developed by the DOL.
- Offsetting Future Benefits. When an overpayment is recovered by reducing future annuity payments, SECURE 2.0 imposes the following limitations:
    - Any reduction of annuity payments must stop after the full dollar amount of the overpayment (without an interest adjustment) is recovered.
    - The amount recouped in any calendar year cannot exceed 10% of the full dollar amount of the overpayment, and the adjusted payments cannot be less than 90% of the payment otherwise due under the terms of the plan. If an overpayment is recovered through installment payments, the total amount of

installment payments in a year cannot exceed these limitations.

- Make-Whole Contribution. Generally, EPCRS requires the plan sponsor (or another party) to make a contribution to the plan to the extent that the amount recovered from a participant is less than the amount of the overpayment as adjusted for interest, subject to exceptions for fully funded pension plans or overpayments that are distributions of a participant's own account before a distribution event occurs under the plan. SECURE 2.0 modifies the overpayment rules so that a make-whole contribution is not required, unless:
  - For a defined benefit plan, the plan's ability to pay all benefits due may be materially affected if a make-whole contribution is not made faster than required under the funding rules. (SECURE 2.0 does not relieve plan sponsors of obligations to make minimum contributions under the funding standards.)
  - The overpayment is due to a fiduciary breach. An inadvertent benefit overpayment is not a fiduciary breach to the extent that the plan has appropriate procedures to prevent and minimize overpayments and the fiduciary has followed the procedures.
  - In a 401(k) or other defined contribution plan, if an overpayment would otherwise result in an impermissible forfeiture (for example, a distribution is made from one participant's account balance to the wrong participant), the plan sponsor must take steps to make the affected participant whole. However, consistent with the current EPCRS rules, there is no requirement for a “make-whole” contribution for an overpayment that relates to distributions to participants of their own accounts before allowed under the plan.
- Eligible Rollover Distribution. Currently, EPCRS requires a plan sponsor to notify a recipient of an overpayment that was treated as an eligible rollover distribution that the overpayment is not eligible for the favorable tax treatment afforded to rollover distributions. SECURE 2.0 amends these rules to provide that an inadvertent benefit overpayment that has been rolled over and for which recoupment is not sought will be treated as an eligible rollover distribution. Overpayments that are actually returned will be treated as eligible rollover distributions, and both the transferor and recipient plans will be treated as having permitted the transfer.
  - SECURE 2.0 does not address the treatment of an overpayment that has been rolled over if a plan seeks to recover the overpayment but the participant does not cooperate in returning the overpayment to the plan. This suggests that if a participant does not cooperate with efforts to return an overpayment, the participant may incur adverse tax consequences due to rolling over amounts not eligible for rollover, which would be consistent with current EPCRS rules.
- Fiduciary decision. ECPRS refers to the “plan sponsor” taking corrective actions to recover an overpayment. However, SECURE 2.0 refers to the “responsible plan fiduciary” and makes it clear that any decision to seek recoupment of an overpayment would need to be made in a fiduciary capacity. Therefore, in determining whether to seek recovery of an overpayment, the fiduciary will need to determine whether it is in the interest of the plan. Further, the fiduciary is authorized to consider any hardship that would be imposed on the participant by seeking to recover all or some part of the overpayment.
- Other Tax Compliance Considerations. If a distribution exceeds the statutory limits under Code section 401(a)(17) or 415, then SECURE 2.0 clarifies that a plan may enforce the limitations under EPCRS rules (although it is not clear to what extent this would be limited by the participant protections limiting a plan sponsor's ability to recover overpayments described above). SECURE 2.0 also provides that the IRS may issue regulations or guidance of general applicability to address the effect of overpayments on plans.
- Effective Date. SECURE 2.0 expressly provides that the overpayment rules are effective as of the date of enactment. Plans may generally continue to rely in good faith on existing regulatory guidance for recoupments and recoveries that commenced before the date of enactment, but there is some ambiguity regarding the

extent to which this reliance overrides the participant protections limiting overpayment recovery described above.

SECURE 2.0 specifically permits installment repayment plans or reductions in periodic payments that commenced before the date of enactment to continue after enactment. But SECURE 2.0 does not clarify what actions specifically must have occurred before enactment in order for plans to be permitted to continue to rely on existing regulatory guidance. For example, this grandfathering could be interpreted to be limited to overpayment recoveries where at least one installment on a repayment plan has been processed, or it may be read more broadly to include all overpayment recovery efforts where the plan sponsor has determined a course of action and taken some tangible step (such as the mailing of an overpayment recovery letter) before SECURE 2.0 was enacted, even if the plan sponsor has not successfully recovered a portion of the overpayment by the date of enactment.

The overpayment rules are generally applicable to all Code section 401(a) and 403(a) qualified retirement plans (including 401(k) plans and qualified pension plans) and ERISA-covered 403(b) plans. Certain of these overpayment rules (those codified in the Code) also apply to non-ERISA 403(b) plans, governmental retirement plans, simplified employee pension plans, and simple retirement accounts.

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