April 16, 2010

Internal Revenue Service
Attention: SE:T:EP:RA:VC
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Enhancements to EPCRS

Dear Sir or Madam:

The American Benefits Council ("Council") is a public policy organization representing principally Fortune 500 companies and other organizations that assist employers of all sizes in providing benefits to employees. Collectively, the Council's members either sponsor directly or provide services to retirement and health plans that cover more than 100 million Americans.

The Council strongly supports the Employee Plans Compliance Resolution System ("EPCRS"). EPCRS has been a tremendous success. It recognizes that the benefit plan rules are complicated and that occasional compliance failures are inevitable. EPCRS encourages employers to timely identify errors and provides methods of correction at a reasonable cost. For the most part, the principles and methods of correction outlined in EPCRS are protective of participant interests without being overly punitive for employers and plan service providers. The Council greatly appreciates the efforts of the Treasury Department ("Treasury") and the Internal Revenue Service ("Service") in developing and refining the program through the years. It is important that EPCRS evolves just as retirement plans evolve. To this end, we are writing to suggest further improvements to the program.

Automatic Enrollment

The Council is grateful for the steps that Treasury and the Service have taken over the years to facilitate and encourage automatic contribution arrangements. As you know, automatic enrollment can play a significant role in enhancing retirement security by harnessing employee inertia to improve plan participation. Treasury and the Service have clearly taken automatic enrollment to heart as a public policy matter, publishing numerous guidance items, including a revenue ruling last Fall, which have drawn attention to, and eliminated perceived barriers to, automatic contribution arrangements.[1]

[1] *See, e.g.*, Rev. Rul. 2009-30, 2009-39 I.R.B. 391; Rev. Rul. 2000-8, 2000-1 C.B. 617 (amplifying and superseding Rev. Rul. 98-30, 1998-1 C.B. 1273). *See also* General Information Letter from IRS to J. Mark Iwry (Mar. 17, 2004).

EPCRS presents a further opportunity to nurture the widespread adoption of automatic contribution arrangements. As EPCRS has become part of the fabric of the employment-based retirement system, well-advised employers consider the method of correction for a plan operational failure when they consider whether to adopt a plan feature. It is important that the correction method for an automatic enrollment failure strike a careful balance. A correction method that is overly punitive could have the effect of discouraging employers from implementing automatic enrollment programs. At the same time, we are keenly aware of the need to protect employee interests and treat participants fairly.

Revenue Procedure 2008-50,[2] the most recent iteration of EPCRS, requests comments regarding methods of correction for a failure to implement a plan's automatic enrollment provisions. Notwithstanding the request for comments, an IRS newsletter published in August, 2009 discusses the appropriate method of correction for an automatic enrollment failure and applies the safe harbor method of correction to a failure to implement an employee's affirmative election.[3] The newsletter does not recognize any difference between correction for a failure to implement an affirmative election and a correction for a failure to implement a negative election.

The Council appreciates that the correction method for a failure to implement an affirmative election is a natural place to start in developing a safe harbor correction method for automatic enrollment failures. The conceptual underpinning to an automatic enrollment arrangement is that a negative election is the equivalent of an affirmative election, provided that an employee had reasonable advance notice of the default arrangement and an effective opportunity to make an affirmative election.

Correction for a failure to implement an affirmative deferral election is, however, very costly for employers. It generally involves a corrective contribution for the missed deferral opportunity equal to 50% of the deferral that was elected.[4] A corrective contribution equal to the matching contribution the employee would have received had the missed deferral been made is also required. Both corrective contributions must be adjusted for earnings.

The Council believes it would be appropriate to adjust the method of correction for an automatic enrollment failure to encourage employers to adopt automatic contribution arrangements. Specifically, the Council recommends an expansion of the brief exclusion rule for a failure to implement an affirmative deferral election. The brief exclusion rule is a rule in the existing EPCRS safe harbor methods of correction which provides that a corrective contribution attributable to a lost deferral opportunity is not required for an exclusion from eligibility to make elective deferrals if the employee is provided an opportunity to make elective deferrals for a period of at

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[2] Rev. Proc. 2008-50, 2008-35 I.R.B. 464.

[3] *Fixing Common Plan Mistakes: Correcting a Failure to Implement the Plan's Automatic Enrollment Provisions*, 6 Retirement News for Employers 5 (Summer 2009).

[4] Rev. Proc. 2008-50 app. A § .05(5). *See also* Rev. Proc. 2008-50 app. B ex. 12. Revenue Procedure 2006-27, 2006-1 C.B. 945, a prior iteration of EPCRS, reduced the amount of the required corrective contribution from 100% to 50% of the missed deferral. The reduction reflects that the employee received the amount that should have been contributed to the plan as cash compensation. The 50% amount appears to be intended as a rough approximation of the tax benefit associated with a qualified plan. Nonetheless, the corrective contribution is still widely perceived as resulting in a windfall to affected participants. The 50% seems high for a number meant to approximate the value of the tax benefit of deferral.

least the last 9 months of the plan year in which the error arose.[5] A corrective contribution attributable to the matching contribution, however, is required, even if the exclusion was for a brief period. Automatic enrollment is frequently implemented on a basis other than a plan year. For example, plans commonly provide for automatic enrollment upon initial eligibility, which is often a date other than the first day of the plan year. The brief exclusion rule, however, is limited to a 3-month period beginning on the first day of the plan year. The result is that the brief exclusion rule is frequently unavailable even where the error is identified and corrected very quickly.

In the context of automatic enrollment, the 3-month period should run from the date the employee would otherwise have been automatically enrolled. Under the correction method we suggest, the employee would still receive a corrective contribution attributable to any foregone matching contribution but would not receive a corrective contribution attributable to any deferrals that would otherwise have been made had the automatic enrollment feature been properly administered.

One of the concepts underlying the brief exclusion rule is that employees should have at least 9 months remaining in the plan year in which to make up for their lost deferrals. The rationale is apparently that employees can adjust their deferral elections to recoup lost deferrals without significantly affecting their take-home pay if there are at least 9 months remaining in the plan year. We believe that this concern is not as acutely presented in the context of automatic enrollment. Put simply, the plan year has much less significance in the context of automatic enrollment than other contexts involving an affirmative election to defer. Employees are much less likely to run into annual contribution limits, such as the section 415 limit or a plan ADP limit. Further, the section 402(g) limit, which is typically a calendar year limit, is rarely at issue. Finally, as mentioned above, we propose a 100% corrective contribution for any foregone matching contributions so that plan year limits with respect to matching contributions are not relevant.

To the extent that Treasury and the Service are concerned about restoring missed elective deferrals during the 3-month period, the issue could be addressed through a special increase in the default contribution rate. Thus, correction could involve a higher default rate of contribution than would have applied but for the failure. To illustrate, consider, for example, an employee whose plan entry date is April 1. The employee should have been automatically enrolled for the first pay date commencing on or after April 1. The employer fails to implement the plan's automatic contribution rate of 3%, but discovers the error before July 1. The employer increases the employee's automatic enrollment rate to 4% and automatically enrolls the employee for the first payroll period beginning on or after August 1. Within 9 months of the correction, the employee will have had elective deferrals made on his or her behalf that are equal to the elective deferrals that would have been made had the employee been automatically enrolled in a timely manner (assuming compensation is unchanged). Thereafter, the employee will have had greater cumulative deferrals.[6] Moreover, in plans with matching contribution rates in excess of the default contribution rate, affected employees would be ahead very quickly because they would receive both a corrective contribution for the lost matching contributions as well as additional matching contributions on the enhanced deferrals.

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[5] *Id.* at app. B § 2.02(1)(a)(ii)(F).

[6] The employee may, of course, choose a different deferral rate or no deferral rate at all.

We recognize that some employees may terminate employment before the enhanced deferrals restore them to the position they would have been in but for the failure. In the example above, the enhanced deferrals would not put the employee in the position he would have been in but for the failure for 9 months. There are a number of approaches to this issue. A make-whole corrective contribution could be required if the employee terminates employment prior to the full restoration date. However, we believe that no make-whole contribution should be required for any employee who remains employed for at least 3 months after notice of the failure. An employee who has had notice of the failure may affirmatively increase his or her deferral rate to restore his or her account more quickly. Further, a rule that is calibrated to the time period necessary to fully restore the account could encourage steep automatic enrollment increases as part of the correction. This could in turn result in higher opt-out rates. For this reason, we submit that a more flexible rule -- no corrective contribution if an employee remains employed for at least 3 months following automatic enrollment -- is appropriate.

The approach we suggest would have a number of virtues. First, the 3-month window in which the brief exclusion rule would be available would encourage employers to quickly identify and correct any failures. Second, a higher automatic enrollment rate would send a message to employees that they should be deferring at a higher rate in order to put themselves "on track." Third, a more gentle correction for failures to implement a default election would conform to employee expectations. In our experience, employees who would otherwise have been automatically enrolled are typically surprised that any corrective contribution for the lost deferral opportunity is required. The notion that they should both receive the cash and receive a corrective contribution for an election that they did not affirmatively make simply does not comport with many participants' sense of fairness. Fourth, the correction method we suggest would strike a more appropriate balance between encouraging employers to adopt an automatic enrollment feature and ensuring retirement security for affected participants.

Automatic Escalation

As reflected above, there are a number of reasons for concluding that an automatic deferral correction should be less onerous for the plan sponsor than the safe harbor method for a failure to implement an affirmative deferral election. The case for a less burdensome method of correction for a failure to implement an automatic escalation feature (as opposed to a basic automatic deferral arrangement) is even more compelling.

As with automatic enrollment, Congress has shown strong support for automatic escalation features. In the Pension Protection Act of 2006, a new nondiscrimination safe harbor was created for plans that include, among other requirements, an automatic escalation feature meeting certain conditions. Moreover, last Fall, Treasury and the Service published Revenue Ruling 2009-30, which highlights the use of automatic escalation as a plan design option. Put simply, automatic escalation is clearly a favored feature as a matter of public policy, and it is appropriate that the method of correction reflect its important place in retirement policy. Absent automatic escalation, many employees will remain at the plan's default automatic enrollment rate, which is almost always too low to ensure that contributions over a working lifetime are sufficient to provide for a secure retirement.

Apart from the public policy rationale for a special correction method for automatic escalation failures, there are also a number of reasons for distinguishing automatic escalation from automatic enrollment in general. First, unlike an affirmative deferral election or a default election, the deferral associated with automatic escalation will not be effective for many months, often up to a year, from a participant's initial enrollment. Even with sophisticated recordkeeping systems, this time lag and the complexity of coordinating recordkeeping and payroll systems mean that errors will be more probable. While employers and plan service providers are developing procedures and systems to identify and prevent errors, there is a steep learning curve. The inevitable "growing pains" associated with automatic escalation should be taken into account by the Treasury and Service in evaluating the acceptability of a correction method.

Second, an automatic escalation failure will not be readily apparent to the vast majority of employees and, therefore, will not quickly come to the attention of the employer or plan service provider. Employees are much more likely to notice, for example, that salary reduction contributions that they affirmatively elected are not being made than they are to notice that an automatic escalation feature is not being implemented. In fact, automatic escalation features are often designed to be "invisible" (in some instances they correlate with the date of a pay raise) in order to reduce the likelihood that employees will affirmatively opt out. Taken together, these traits mean that automatic escalation errors are more likely to occur and far more likely to go unnoticed.

Third, automatic escalation typically involves a 1% increase in an employee's deferral rate. A failure to implement an automatic escalation feature does not mean the employee's deferrals are entirely discontinued; it means only that the 1% increase has not been implemented. Thus, an automatic escalation failure almost invariably involves modest amounts, and it should, therefore, be easier to use automatic escalation itself to correct a failure.

Given these qualitative and quantitative differences, we believe that EPCRS should include a safe harbor method of correction that is available in lieu of the current safe harbor method for a failure to implement an affirmative deferral election. At a very high level, the new method of correction would involve (i) a special automatic escalation adjustment, and (ii) a corrective contribution equal to 100% of any lost matching contributions (plus earnings).

Like the adjustment we suggest for an automatic enrollment failure, the special automatic increase in a participant's deferral rate would be designed to put the employee in at least the position he or she would have been in but for the failure to implement the election. Affected employees would be given reasonable advance notice of the special increase and an explanation of the reason for the special increase, as well as an explanation as to how to opt out of the special increase. The explanation would disclose the duration of the automatic escalation failure and the deferral percentage at issue, and indicate that the special increase is intended to correct for the late escalation.

To illustrate, consider an employee who was scheduled for 1% increases as of January 1 of each year and should have been at 4% as of January 1, 2010. The 4% increase was not implemented. The employer identifies the issue outside of the brief exclusion period, discussed above. The employer increases the employee to 5% as of May 1, 2010. The employee's deferral rate will then go to 6% as of January 1, 2011, and 1% increases will be scheduled thereafter.

In this case, the Council believes that the plan should be treated as having fully corrected the failure. The employee's deferral rate would be greater than it would have been, and the employee would be put in a better situation than he or she would have been in had the failure not occurred.

This method of correction has the obvious attraction of symmetry – fixing an automatic escalation failure with an automatic escalation adjustment. Moreover, given the modest amounts that are typically involved in an automatic escalation program, it is reasonable to conclude that the additional increase will not cause participants to opt completely out of the plan at higher rates, particularly since participants can always affirmatively elect whatever contribution percentage rate that they would prefer.

Like the method we suggest for automatic enrollment, this correction should be available only for failures that are identified within a specified period. In particular, we believe that the method of correction we suggest should be available for failures that are corrected within 2 years of the automatic escalation failure.

We realize that there may be participants who terminate employment after the scheduled increase should have been implemented and before the special increase is implemented, or who terminate shortly after the special increase is implemented. In those cases, it may be appropriate to require a corrective contribution for the lost deferral along the lines contemplated by the safe harbor correction method for a failure to implement an affirmative deferral election. However, in circumstances where the employee is continuing to work, it is perfectly reasonable to correct through a special adjustment in the automatic escalation rate. Further, even in circumstances where an employee does not continue to work until the special adjustment would fully restore his or her account balance, we believe that no make-whole contribution should be required if the employee had a reasonable opportunity to self-adjust his or her deferral rate. Like the automatic enrollment correction that we suggest, we believe that a 3-month period following notice of the failure would be reasonable and appropriate.

A closely related issue is the extent to which the ADP or ACP test must be re-run in connection with an automatic escalation failure. In general, EPCRS allows plans to rely on the ADP and ACP test determined without regard to any corrective contributions. The Council greatly appreciates this rule because employers would otherwise be put to the burdensome and expensive task of re-running the relevant test to account for any corrective contributions. EPCRS, however, is not written with an automatic escalation correction in mind. It states that a plan may rely on the results of a prior ADP or ACP test which "*may disregard employees whose elections were not properly implemented*."[7] However, in an automatic escalation failure, the previous ADP or ACP test will almost invariably take employees affected by the failure into account but only to the extent the employees' deferrals were implemented. For example,

[7] *See* Rev. Proc. 2008-50 app. A § 05(2)(d) (permitting disregard of employees from the ADP or ACP test whose deferral elections were not properly implemented). *See also* Rev. Proc. 2008-50 app. A § .05(2)(g) (permitting the disregard of employees from the ADP or ACP test who were improperly excluded with respect to contributions or accruals under the plan); Rev. Proc. 2008-50 app. A § .05(4)(b) (permitting the disregard of employees from the ADP or ACP test who were improperly excluded from making catch-up contributions and receiving corresponding matching contributions).

consider an automatic escalation failure in a plan that provides for automatic enrollment at 3% and automatic escalation at 1%. The prior ADP test will take an employee into account who was automatically enrolled at 3%, but will not reflect the 1% automatic escalation that was not implemented. The literal language of the Revenue Procedure does not contemplate disregarding the 1% failure. However, it seems apparent that EPCRS was not drafted with an automatic escalation failure in mind, and we believe that the language is not meant to suggest a different rule for automatic escalation failures. Thus, the Council respectfully requests confirmation that neither the ADP test nor the ACP test needs to be re-run in the event that such employees are in fact included for purposes of the testing to the extent deferrals were in fact made.

De Minimis Rule for Corrective Contributions

Under the current iteration of EPCRS, there are circumstances in which very small corrective contributions must be made on behalf of participants. EPCRS generally draws a distinction between corrective contributions and corrective distributions. Full correction is not required if the total corrective distribution due to a participant is $75 or less and the reasonable direct costs of processing and delivering the benefits would exceed the amount of the distribution.[8] However, there is no parallel rule for very small corrective contributions where the amount of the contribution made on behalf of a participant is far exceeded by the cost to the plan of processing and making the contribution. This is particularly problematic because this rule may result in numerous accounts with very small balances, which are expensive to administer.

The Council believes that a small contribution rule would be a significant improvement in circumstances where the cost to the plan would exceed the benefit to the participant. We see no reason to distinguish between corrective distributions and corrective contributions. Both obviously affect the benefits that participants receive. Moreover, the costs associated with a corrective distribution are not conceptually or economically distinguishable from the costs associated with a corrective contribution. Finally, there are circumstances in which it is difficult to distinguish between a corrective distribution and a corrective contribution. Consider, for example, a corrective contribution where a participant's account will be immediately paid out under the small sum cash-out rule of section 411(a)(11). This is in fact a corrective distribution yet it appears that it is not covered by the de minimis rule for corrective distributions since it is technically a corrective contribution followed by an involuntary distribution.

Loans

Revenue Procedure 2008-50 includes correction methods for plan loans that do not comply with section 72(p). The Council greatly appreciates the availability of loan correction methods, particularly since section 72(p) failures may not be tax-qualification issues and the correction methods may have an effect on a participant's individual income tax return.

The loan correction methods involving relief from Form 1099-R reporting were added to EPCRS as part of Revenue Procedure 2006-27, and are relatively new. As relatively new correction methods, it is not surprising that Treasury and the Service would be careful about providing relief too broadly. For this reason, EPCRS currently provides the Service with discretion to limit

[8] Rev. Proc. 2008-50 § 6.02.5(b).

the use of the correction methods in certain circumstances. In particular, the notion appears to be that correction should be available where the employer caused the failure but not where the participant is responsible for the failure. Significantly and apparently as a corollary to the notion that the relief is discretionary on the part of the Service, EPCRS limits loan correction to VCP, which means that self-correction is not available.

The Council respectfully suggests that the Service reconsider its current prohibition against self-correction of loan defects. Self-correction is much less costly and time-consuming for employers. Many plans feel compelled to engage outside consultants in order to make a submission under EPCRS. This cost is a drag on the retirement system, and we strongly believe that self-correction of loan defects would result in efficiencies without any cost to compliance. We are not aware of any abuses related to plan loan correction, and the Service has now had substantial experience with the administration of loan corrections.

If Treasury and the Service remain concerned about self-correction of all loan defects, for example, because correction may not be appropriate in certain circumstances, it should be possible to create a class of loan defects for which correction is available. For example, EPCRS could limit the availability of self-correction to circumstances in which the failure was caused by the employer or a plan service provider. An alternative would be to limit the availability of self-correction if the deemed distribution is not going to be reported on the Form 1099-R. Our point is simply that there is room for greater efficiencies with respect to plan loan defects, and we urge you to consider additional flexibility.

Another problem that frequently arises involves a loan defect that is identified after the maximum amortization period for a loan has expired (typically 5 years) or when there is only a short period remaining in the maximum period for repayment. Revenue Procedure 2008-50 explicitly provides that its methods of correction for loan failures are not available if the maximum period for repayment under section 72(p) has expired.[9]

The Council recommends that EPCRS permit loan corrections that extend beyond the statutory repayment period. There are instances in which the repayment period limitation is fundamentally unfair to participants. Consider, for example, a loan that is defaulted because the employer fails to deduct from payroll scheduled repayments. If the failure occurs early in the amortization schedule, then correction under EPCRS is available. If, however, the failure occurs at the end of the repayment schedule, the participant is simply out of luck. We see little reason to hewing to the statutory repayment schedule in such a circumstance. EPCRS is fundamentally administrative relief from the statutory requirements, and we believe that extending the repayment period, for example, by the period of the failure, would be reasonable and appropriate.

Safe Harbor Notice

A safe harbor plan described in sections 401(k)(12) or (13) must, among other requirements, provide notices to eligible employees informing them of their rights and obligations under the plan. The notice must be provided within a reasonable period before the beginning of the plan year and, in the case of a newly eligible participant, within a reasonable period before the

[9] Rev. Proc. 2008-50 § 6.07(2).

employee becomes eligible to participant. A similar notice requirement applies to an eligible combined plan described in section 414(x).

There is no safe harbor method of correction in EPCRS for a failure to timely provide the required notice. The Service has, however, published an article that discusses the method of correction in some detail.[10] The article posits that the method of correction depends on the impact of the failure to provide the notice. If the failure means that an affected employee did not have notice of his or her right to participate, then the failure should be viewed as an improper exclusion of the employee from participation, in which case the correction would involve corrective contributions for any lost deferrals and lost matching contributions. In contrast, however, if the employee has otherwise had notice of his or her right to participate, then the failure may be viewed as not affecting the employee's right to participate. In such a case, correction would involve new plan procedures to avoid future notice failures but would not involve a corrective contribution.

The Council agrees with the analysis in the article. The method of correction should depend on whether the notice failure is the effective equivalent of an improper exclusion from participation. This would ordinarily only occur if the notice was not timely provided in connection with initial participation. Thus, a corrective contribution would only be required in exceptional circumstances if the notice failure involved a failure to provide the annual notice thereafter. To this end, we believe that this correction method should be formally incorporated into EPCRS.

Erroneous Distributions from a Defined Contribution Plan

Another common issue for which the method of correction could be improved involves erroneous distributions to a participant from his or her individual account. These are typically payments made at a time in which a participant is not eligible for a distribution under plan terms, for example, a hardship distribution made to an employee that did not in fact meet the plan's hardship distribution requirements.

These payments appear to be considered "overpayments" under Revenue Procedure 2008-50. The correction method for an overpayment failure in a defined contribution plan involves (i) the employer notifying the participant that the erroneous distribution is not eligible for favorable tax treatment or tax-free rollover, (ii) the employer taking reasonable steps to have the overpayment plus interest repaid to the plan, and (iii) if nothing is repaid to the plan, the employer or a plan service provider must contribute an amount equal to the erroneous distribution to the plan. An amount contributed by the employer must be held in a suspense account and may be used to either reduce future employer contributions or may be allocated among other employees as appropriate.

The Council believes that the repayment requirement where, notwithstanding the employer's reasonable steps, the employee does not repay the overpayment is too punitive in some circumstances. In many situations, for example, where the employer is making ongoing employer contributions, the repayment requirement is essentially meaningless. The employer would have made the same contribution regardless of the overpayment failure and the

[10] *Fixing Common Plan Mistakes: Failure to Provide a Safe Harbor 401(k) Plan Notice*, 5 Retirement News for Employers 6 (Fall 2008).

repayment is merely a formality. In contrast, however, correction where a plan does not have ongoing employer contributions may be punitive. The employer or plan service provider would be obligated to make a corrective contribution equal to the amount of the overpayment plus interest. This contribution could not, however, be used to offset future contributions, and it is far from clear how the corrective contribution may be used other than through a windfall allocation to participants. This may arise, for example, in a plan that solely provides for elective deferrals or in a plan that is frozen. For these reasons, the Council suggests that the repayment requirement be eliminated. It has virtually no significance in contexts where there are employer contributions against which the corrective contribution may be offset, and it is punitive in contexts where there are no ongoing contributions.

We appreciate that a correction that merely involves notice that the distribution is not eligible for rollover and reasonable efforts to secure repayment may strike some at Treasury and the Service as too gentle. However, the current system is untenable and we see few palatable alternatives.[11] It is better to err on the side of fairness than to create an arbitrary and punitive correction method simply to deter potentially abusive behavior, *i.e.*, systematically disregarding the in-service distribution restrictions. This is particularly true given the existing protections in EPCRS which make the program unavailable for egregious failures.

If you have any questions about these comments, please contact Jan Jacobson, the Council's senior counsel, retirement policy, at 202-289-6700.

Sincerely,

Jan Jacobson
Senior Counsel, Retirement Policy

[11] One possible alternative might be to require a corrective contribution from the employer or plan service provider only in circumstances where the erroneous distribution is part of a pattern of noncompliance, although in such circumstances it is fair to question whether EPCRS is available to the plan.