

The Dirty Dozen

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THE MOST COMMON PLAN MISTAKES AND HOW TO FIX THEM



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Your Presenters Today

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Polling question 1

- Have you ever been involved in a VCP filing for your client (whether prepared by your office or another practitioner)?
 - Yes
 - No



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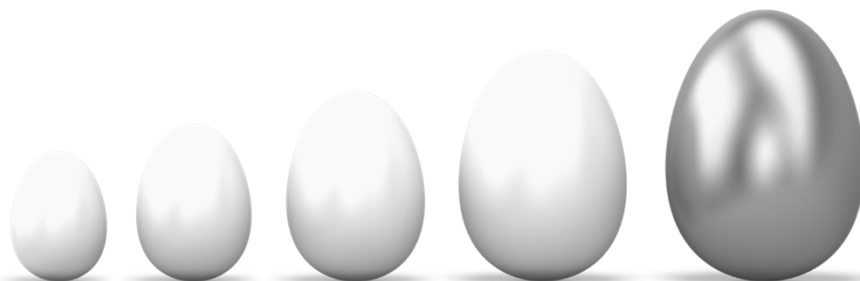
Polling question 2

- Do you generally do VCP filings in your office, or do you get legal counsel's assistance?
 - We do them in our office
 - We handle them if they are straightforward; otherwise, we refer to a lawyer
 - We leave the decision up to the client, but we will do it if they approve
 - We always refer to a lawyer



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401(K)-RELATED ISSUES



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Late ADP/ACP Test Correction

[Plan Corrections eSource §9.1]

- Situation: ADP/ACP test was failed, but no correction was made before the end of the plan year following the year of the failed test.
- Self-correctable?
 - Yes, if insignificant.
 - Yes, if do so by the last day of the 3rd year after the year for which the test was failed.



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Late ADP/ACP Test Correction

[Plan Corrections eSource §9.1]

- Correction Options:
 - QNEC/QMAC
 - Contribute enough to NHCEs for test to pass
 - One-to One
 - Determine refunds due HCEs (including earnings)
 - Refund those amounts
 - Make a contribution to the accounts of NHCEs equal to the total refunded



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Late ADP/ACP Test Correction

[Plan Corrections eSource §9.01]

- Important Correction Elements:
 - If self-correcting, cannot use any disaggregation methods, even if used on initial test
 - i.e., cannot do one test for “otherwise excludables”
 - If want to use QNEC/QMAC method and plan does not permit, may do retroactively effective amendment
 - Cannot use targeted QNECs and QMACs (allocation must go to all eligible)



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Late ADP/ACP Test Correction

[Plan Corrections eSource §9.01]

- Important Correction Elements:
 - QNEC for one-to-one correction can be allocated pro-rata to compensation to:
 - All NHCEs eligible in testing year;
 - All NHCEs eligible in the year of correction;
 - All NHCEs eligible in testing year if still employed in year of correction; or
 - All NHCEs eligible in testing year if still eligible in year of correction



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Late ADP/ACP Test Correction

[Plan Corrections eSource §9.1]

- Important Correction Elements:
 - If the plan is subject to prior year testing, the “testing year” is the year before the plan year for which the test is failed



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Excess Refund in Failed ADP Test

[Plan Corrections eSource §10.2]

- Situation: TPA runs ADP/ACP test on a timely basis. Test is failed, and refunds of excess contributions are made to HCEs. Later, it is discovered that compensation information was incorrect. Test is rerun and it is determined that too much was refunded to an HCE.
- Self-correctable?
 - Yes, if insignificant or corrected by the end of the 2nd plan year after year in which excess payment occurred



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Excess Refund in Failed ADP Test

[Plan Corrections eSource §10]

- Correction:
 - EPCRS considers this an operational failure: making an improper distribution not permitted under §401(k)(2)
 - Improper distribution: Overpayment
 - Request repayment from participant of overpayment plus earnings
 - No further action is needed, if amount is not repaid, but it is better from appearance standpoint if HCE repays



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Failure to Implement Auto Increase

[Plan Corrections eSource Chapter 9]

- Situation: Y'All Come 401(k) Plan provides for automatic enrollment at 3% of compensation, with annual increases on each January 1 of 1% of compensation. In 2020, Y'All Come forgot to implement the automatic increase for Sue, whose 2019 deferral rate was 5% (and whose 2020 rate should have been 6%)
- Self-correctable? Yes, if within done by end of the 2nd plan year following year of failure



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Failure to Implement Auto Increase

[Plan Corrections eSource Chapter 9]

- Correction:
 - Missed deferral for Sue is 1% of compensation (i.e., the amount of the auto increase that was not implemented)
 - Method of correction depends on employer preference and the timing of the correction and usually (but not always) requires a QNEC
 - Employee must *always* receive missed match and earnings based on intended deferral



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Polling question 3

- Do you feel comfortable that you understand and can apply all the options in correcting missed deferrals?
 - Very comfortable
 - Reasonably comfortable
 - I struggle, but I think I get it right in the end
 - My head spins every time I do this and I need a short cut!



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Failure to Implement Auto Increase [Plan Corrections eSource Chapter 9]

- Correction:
 1. Special auto enrollment rule: NO QNEC
 - Applies if failure found within 9½ months of end of year in which failure occurred
 - Initiate correct deferrals by first paycheck following that time
 - BUT, if employee notifies employer of failure, must correct by first paycheck for the month following notice
 - Employer must provide notice within 45 days of starting correct deferrals



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Failure to Implement Auto Increase [Plan Corrections eSource Chapter 9]

- Correction:
 2. Rolling 3-month Safe Harbor: NO QNEC
 - Applies if failure found if proper deferrals initiated by first paycheck following third month after error first occurs
 - BUT, if employee notifies employer of failure, must correct by first paycheck for the month following notice
 - Employer must provide notice within 45 days of starting correct deferrals



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Failure to Implement Auto Increase

[Plan Corrections eSource Chapter 9]

- Correction:
 3. Brief Exclusion Rule: NO QNEC
 - Failure must be discovered within first three months of plan year, and employee must have the opportunity to defer properly for nine months
 - No notice required



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Failure to Implement Auto Increase

[Plan Corrections eSource Chapter 9]

- Correction:
 4. 2-Year Safe Harbor: 25% QNEC
 - Failure must be discovered and correction initiated by the first pay period on or after the last day of the 2nd plan year following the plan year in which failure first occurred
 - Must provide notice within 45 days of starting correct deferrals



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Failure to Implement Auto Increase [Plan Corrections eSource Chapter 9]

- Correction:
 - 5. General Rule: 50% QNEC
 - Applies if none of the other options is available



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Failure to Implement Auto Increase [Plan Corrections eSource Chapter 9]

- Special Rules for this Issue
 - None of the reduced deferral rules applies if the participant has terminated employment before correction
 - All of the “special deals” depend on the ability of the participant to “make up” missed deferrals at some point in the future, if he or she wants to do so
 - Do not rerun ADP/ACP after corrections



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Failure to Implement Auto Increase

[Plan Corrections eSource Chapter 9]

- Special Rules for this Issue
 - QNECs and matching contributions are annual additions for years being corrected, not year of correction
 - QNECs and matching contributions are deductible in connection with limits in year of correction
 - No correction needed for missed deferrals that would have exceeded the §402(g) limit



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No 401(k) Safe Harbor Notice Given

[Plan Corrections eSource §9.12.4]

- Situation: Plan is a safe harbor matching plan, required to give notice a reasonable time before the plan year begins. Employer forgets to give notice.
- Self-correctable?
 - It appears so ...



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No 401(k) Safe Harbor Notice Given

[Plan Corrections eSource §9.12.4]

- EPCRS contains no formally recognized correction for failed notice
 - Likely correction: give the notice ASAP; tighten procedures for the future
 - Differentiator:
 - Did employees know of right to defer and match (and notice was a mere formality), as opposed to:
 - Participants who knew nothing anything about the plan are better analyzed as a failure to enroll



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Late Deferral Deposits

[Plan Corrections eSource §18.7]

- Situation: salary deferrals removed from participants' paychecks on a timely basis but not deposited to the plan
- Analysis: the DOL considers this to be a use of plan assets by the employer, which is a prohibited transaction



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Late Deferral Deposits

[Plan Corrections eSource §18.7]

- Correction Options:
 1. Treat as prohibited transaction and self-correct:
 - Deposit late deferrals plus interest
 - Use greater of amount that would have been earned by participant's account or amount gained by employer from use
 - File Form 5330 by 7 months after end of employer's tax year in which deferrals were not deposited
 - Pay 15% excise tax on loan interest



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Late Deferral Deposits

[Plan Corrections eSource §18.7]

- Correction Options:
 1. Treat as prohibited transaction and self-correct:
 - Period of correction: from date deferrals should have been deposited until correction
 - Remember that excise tax "pyramids" if loan (and, therefore, the correction) crosses plan years
 - IRS can subject late deferral to an additional 100% excise tax if it is uncorrected within 90 days after IRS issues a deficiency letter



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Late Deferral Deposits

[Plan Corrections eSource §18.7]

- Correction Options:
 2. Use VFCP
 - Must use VFCP if want to permissibly use the calculator to determine lost earnings
 - May get relief from excise tax if give notice to employees about late filing (not required if excise tax is \$100 or less; can put money into plan for affected participants rather than paying on Form 5330)
 - There are good reasons to choose excise tax over notice



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Polling question 4

- Which correction method do you use for late deferrals:
 - VFCP only
 - VFCP and Form 5330
 - Form 5330 only
 - I don't use any of these; we just have them put in the late deposit with earnings
 - Other



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DOCUMENT FAILURES



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6 Failure to Adopt Interim Amendment [Plan Corrections eSource §§7.1, 7.2]

- Document Failure: a failure of the plan to include required language or to eliminate impermissible language
- Nonamender Failure: A document failure that occurs when the plan sponsor fails to adopt an amendment required to keep the plan qualified (including a plan restatement)



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6 Failure to Adopt Interim Amendment **[Plan Corrections eSource §§7.1, 7.2]**

- Situation: It's 2023, and the Old Folks PS Plan has a participant, John Ancient, who turned 72 in 2022. The Plan Administrator is preparing to authorize an RMD to John by April 1, and discovers an unopened envelope from the plan's TPA, which arrived the prior September. He opens the envelope, which includes a remedial amendment to change the RMD rules from 70½ to 72, effective for plan years beginning in 2020, and clear instructions to sign by the 12/31/22 due date.



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6 Failure to Adopt Interim Amendment **[Plan Corrections eSource §§7.1, 7.2]**

- Is Old Folks' failure to adopt the RMD amendment a nonamender failure? Yes!
- Self-Correctable?
 - All document failures are significant, so must be corrected within the 2-year self-correction period
 - As we are within that period (remember, it's 2023), Old Folks can self-correct if they have a FDL (or are on a preapproved document) and have policies and procedures



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6 Failure to Adopt Interim Amendment

[Plan Corrections eSource §§7.1, 7.2]

- Correction:
 - Old Folks signs the Interim Amendment (currently!) with the proper retroactive effective date
 - Recommended: Old Folks documents the nonamender failure and its correction; tightens procedures to make sure future amendments are promptly signed



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7 Failure of Participating Employer to Adopt Plan

[Plan Corrections eSource §7.1.1]

- Situation: Humongous, Inc. is the parent of a controlled group of companies. Its 401(k) plan does not automatically cover all controlled group members; the members must adopt the plan for its employees to participate. Nonetheless, the latest acquisition, IttyBitty, Inc., did not adopt the plan, but its employees have participated since the beginning of the year.



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Failure of Participating Employer to Adopt Plan

[Plan Corrections eSource §7.1.1]

- Generally, the failure to adopt a plan is not self-correctable, but must be resolved under VCP
- Is the failure of a participating employer to adopt a failure to adopt?
 - The speakers disagree on this topic (which is not specifically addressed by EPCRS)



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Failure of Participating Employer to Adopt Plan

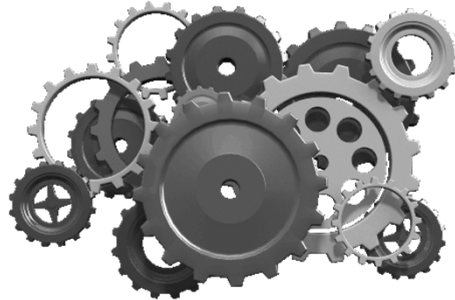
[Plan Corrections eSource §7.1.1]

- Is the failure of a participating employer to adopt a failure to adopt?
 - If the PE was an unrelated employer, this would clearly be a failure to adopt (VCP needed)
 - Because it is a related employer, it could be considered to be a coverage failure, self-correctable under Treas. Reg. §1.401(a)(4)-11(g)(3) (or under VCP after 9½ month period)



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OTHER OPERATIONAL FAILURES



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What is an Operational Failure?

- Definition: failure to follow the terms of the plan
- For extra credit: what are the other types of qualification failures?
 - Document Failures
 - Demographic Failures
 - Employer Eligibility Failures



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Failure to Make RMD

[Plan Corrections eSource §10.5]

- Situation:
 - Remember the Old Folks Nursing Home (Failure #6)?
 - When they opened the envelope from their TPA, they also found a note reminding them that Mathilda Oldbody was due her second RMD by 12/31/2022. Because the Plan Administrator did not read this reminder, the RMD was not timely made.



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Failure to Make RMD

[Plan Corrections eSource §10.5]

- Correction:
 - Self-correctable? Yes (with usual caveats re: timing and procedures)
 - Pay RMD with earnings from date it should have been paid to actual payment date
- But, what about 50% excise tax?
 - Mathilda can request waiver by filing Form 5329
 - Old Folks can get the tax waived if it files under VCP



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Pension Payment Without Spousal Consent

[Plan Corrections eSource §10.6]

- Situation: Happy Together Dating sponsors a pension plan for its employees. Maggie terminated employment with a lump sum distribution payable to her of \$25,000. She requested payment and received it. Only problem: Maggie is married and HTD did not require her to get spousal consent to her distribution.



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Pension Payment Without Spousal Consent

[Plan Corrections eSource §10.6]

- Operational failure: presumably, the plan document requires spousal consent (if it doesn't, there is also a document failure).



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Pension Payment Without Spousal Consent

[Plan Corrections eSource §10.6]

- Correction:
 - If Maggie can get her spouse's consent (after notice from the plan), do that. Problem solved.
 - If Maggie cannot get spouse's consent:
 - Her payment method is converted to the QJSA she would have received had she not obtained spousal consent, minus actuarial value of her payment
 - Her benefit is likely reduced to \$0, but her spouse must get full survivor annuity when she dies



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Participant Loan Default

[Plan Corrections eSource §12.2]

- Situation:
 - Marty, a participant in the Boffo Choco Candy Company, worked in the Caramel division in Carmel, CA. He took a loan from the company's 401(k) plan in January of 2019 for \$20,000 (his vested interest is well above \$40,000), and bimonthly payments were taken from his paycheck for 14 months.



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Participant Loan Default [Plan Corrections eSource §12.2]

- Situation:
 - In month 15 (April 2020), he was transferred to the Cordials division in Cherry Hill, NJ, but the payroll there forgot to register his loan payment. Therefore, all payments stopped at that time. The failure was discovered at the end of the year, when he was looking over his final pay stub and advised the employer of the mistake.



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Polling question 5

- Have you ever been involved in a VCP submission for a client due to a Loan Failure?
 - Yes
 - No, we didn't do a Form 1099-R either; we just hope no one will get caught
 - No, but we issued a Form 1099-R to the employee for the year of the failure



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Participant Loan Default [Plan Corrections eSource §12.2]

- Analysis:
 - The loan went into default, at the latest, on September 30, 2020 (the end of the quarter following the quarter of the last payment)
- As of Rev. Proc. 2019-19, loan defaults are self-correctable



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Participant Loan Default [Plan Corrections eSource §12.2]

- Correction Options:
 1. Loan is taxable income to Marty (it sucks to be him)
 - If the loan were outside the 5-year maturity repayment period, this is the result
 - Can either provide Form 1099R for year of default or for year of correction (but interest accrues through the issuance of the Form)



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Participant Loan Default [Plan Corrections eSource §12.2]

- Correction Options:
 2. Marty may make a lump sum payment of amount in arrears to bring the loan up to date
 - Since it was the company's mistake, the company may choose to pay the differential interest, but Marty must pay the principal
 3. The loan may be reamortized over the remaining portion of the 5-year repayment period (again, company can make lump sum correction for interest)



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THE FINAL TWO ...



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Failure to Pass Coverage

[Plan Corrections eSource Chapter 8]

- Situation: Do Your Own Thing Craft Store sponsors a profit-sharing plan. Participants must complete 1,000 hours and be employed on the last day of the year to participate in the employer contribution.
- When the administration is done for the 12/31/19 plan year, it is discovered that sufficient employees terminated before year end to cause the plan to fail coverage.
- Plan does not have coverage failsafe clause



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Polling question 6

- Do you usually use a failsafe clause to prevent a coverage failure?
 - Yes
 - No
 - I don't know what a failsafe clause is



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Failure to Pass Coverage

[Plan Corrections eSource Chapter 8]

- Analysis:
 - Plans must meet coverage rules for profit-sharing plans considering all employees who have more than 500 hours of service, regardless of whether they terminate before year end
 - If a plan has a last day requirement, if enough people quite during the year, the ratio percentage test could be failed



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Failure to Pass Coverage

[Plan Corrections eSource Chapter 8]

- Failures of Nondiscrimination Testing, Coverage Testing, or IRC §401(a)(26) are Demographic Failures, not Operational Failures
- Under EPCRS, Demographic Failures cannot be self-corrected, but must be fixed under VCP
- However, Treas. Reg. §1.401(a)(4)-11(g)(3) permits a Demographic Failure to be repaired without IRS involvement within 9½ months of the plan year end



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Failure to Pass Coverage

[Plan Corrections eSource Chapter 8]

- If the failure is located within the 9½ month period, the employer can adopt an amendment to bring in sufficient NHCEs to participate in the contribution (and to make a contribution to cover those employees) to meet coverage
 - Cannot be short service or nonvested employees (must have substance)
 - Cannot reduce the amount that the other participants get (i.e., cannot reallocate original contribution)



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Failure to Pass Coverage

[Plan Corrections eSource Chapter 8]

- Once the 9½ month period is over, only option is VCP
 - The correction is the same as under -11(g)(3): amend to include enough participants and give them an equivalent contribution
 - Submit the amendment in proposed form
- Note: there are ways to meet coverage besides the ratio percentage test. Perhaps the plan could have passed the average benefit percentage test?
- Note: the IRS will not permit the employer to retroactively elect to be a QSLOB



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Failure of a 403(b) Plan to Meet Universal Eligibility

[Plan Corrections eSource §16.1.3]

- Situation: Send Me Your Huddled Masses, a nonprofit organization that helps homeless people, sponsors a 403(b) program for its employees. They let employees make salary deferral contributions after 6 months of service.
- This is a violation of the 403(b) Universal Availability rule, whereby almost all employees must be permitted to defer upon hire.



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Failure of a 403(b) Plan to Meet Universal Eligibility

[Plan Corrections eSource §16.1.3]

- Correction:
 - The IRS treats a universal eligibility failure in the same way it treats any failure to enroll participants in a 401(k) or 403(b) plan. The employer must enroll the participants and provide a QNEC to the extent required under the various options. See Failure #3.
 - Missed deferrals based on greater of 3% of compensation or deferrals that would generate at least a 100% match



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**OKAY, LET'S MAKE IT A BAKER'S
DOZEN ...**



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Failure to File Form 5500 on Time **[Plan Correction eSource Chapter 19]**

- Situation: PrimeTime Retro Fashions goes to see a new TPA about its 401(k) plan. The new TPA discovers that PTRF has not filed its Form 5500 for the plan since the late 1980s.
- Analysis: Late Forms 5500, 5500-SF, and 5500-EZ can be repaired through the DOL or IRS late filing program (the latter applies for Forms 5500-EZ)



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Polling question 7

- What is the most common reason why a client's Form 5500 is late?
 - They didn't send data timely
 - The auditor's report wasn't ready
 - The form was prepared on time, but the client never did what it needed to do to file
 - Someone in our office accidentally missed the deadline



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Failure to File Form 5500 on Time [Plan Correction eSource Chapter 19]

- Correction Entails:
 - File all forms in arrears
 - Pay a fixed penalty that is significantly less than the otherwise applicable penalty
 - Note: keep in mind that IRS penalties were increased 10-fold under SECURE
 - Correction under the DOL Program resolves IRS penalties



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Failure to File Form 5500 on Time

[Plan Correction eSource Chapter 19]

- DFVC Details:
 - Use for Form 5500 or Form 5500-SF
 - File all forms for a given plan at one time to take advantage of maximum penalties:
 - For Form 5500: \$10 per day up to a maximum of \$2,000 per form. If filing for multiple years, the maximum penalty for a given plan is \$4,000.
 - Form 5500-SF: \$10 per day up to a maximum of \$750 per form; multiple year filing maximum is \$1,500



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Failure to File Form 5500 on Time

[Plan Correction eSource Chapter 19]

- Cannot use DFVC if the DOL has already issued a notice regarding late filing (but IRS notice is still fair game)
- Can file online or by mail, but online filing gives immediate confirmation (particularly handy if the IRS is at your door)
- Can include a late filed Form 8955-SSA with the DFVC filing (if only the Form 8955-SSA is late, no program available; file with IRS as soon as possible and hope to have the opportunity to send a reasonable cause waiver request)



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Failure to File Form 5500 on Time [Plan Correction eSource Chapter 19]

- IRS program for Forms 5500-EZ (Rev. Proc. 2015-32)
 - Waives IRS penalties for plans not eligible for DFVC
 - Penalty is \$500 for late filing, up to maximum of \$1,500 per plan for multiple filings
 - If employer has already been assessed a penalty for a delinquent return (i.e., CP 283 Notice), this procedure is unavailable
 - File using Form 14704 with a check for the penalty. Online filing is not available
 - Follow instructions of Rev. Proc. very carefully!



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Questions?



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For Further Study

Joanne Pecina will demonstrate how to find more information on today's topic from the ERISApedia.com resources.



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