401(k) Plan Corrections
Correcting the Top Ten Plan Errors

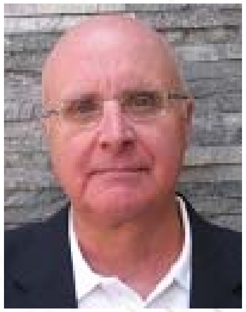
Stephen W. Forbes, J.D., LL.M. (taxation)
Timothy McCutcheon, Esq., CPA, MBA

ERISApedia.com
Get Answers. Win Clients.

Your Presenters Today

- Stephen W. Forbes, JD, LLM

- Tim McCutcheon, JD, CPA, MBA



Correcting Elective Deferral Failures

- Facilitator:

  Chuck Gouge

- Question Board Moderator

  Joanne Pecina

During the Webinar

- All attendees' lines are muted
- Question board available and monitored
- Mr. Forbes will post answers to questions on ERISApedia.com/webcasts
- Slides and a recording of the webinar will be available from ERISApedia.com/webcasts

CE Credit

- ERPA/ASPPA/NIPA
  - Will receive certificate by email in several days
  - ERPA will take longer (please be patient)
  - Please check spam folder
- Any questions, email: support@erisapedia.com

ADP and ACP Test Failures

EPCRS corrections for failed ADP or ACP test

- ADP/ACP corrections more than 12 months after the plan year must correct under EPCRS
- Operational Failure: can be corrected under SCP, VCP or Audit CAP depending on facts
- Correcting the failure solely by distributing excess amounts to HCEs is not an option

Other Testing Options

- If an employer fails to correct its ADP or ACP tests timely, before conceding it must correct the failure under EPCRS, it may want to apply alternative testing methods to determine if the plan actually failed the ADP or ACP tests
  - Alternative definition of compensation for testing
  - Otherwise excludible employee rule (OEE)
  - Early participation rule
- *Example*. For the 2016 plan year Company X failed the ADP and ACP tests, X did not correct the failure by the close of the 2017 plan year. Before correcting the failures under EPCRS, X applied the otherwise excludible employee rule and transformed the failures into passing the ADP and ACP tests. X does not need to use EPCRS to correct the plan.

ECPRS: Two alternative correction methods

- EPCRS provides two alternative correction method for a plan that fails to correct timely the ADP test or the ACP test:
  - The QNEC allocation method
  - The “one-to-one” method
- The “one-to-one” method is less costly, and therefore the most popular correction method

QNEC Correction

- QNEC correction: Give QNEC to all eligible NHCEs (not exceeding 415 limit for the year of the failure), with earnings
  - Allocate pro rata (by compensation) – not “bottom-up”
    - Even if plan provides for bottom-up QNEC
  - If plan has match, need not match QNEC, but plan must pass ACP test
  - ER may not test using OEE, early participation rules or restructuring

Example

- Company X maintains a 401(k) plan. For the 2016 plan year. The average ADP and ACP percentages were:

	ADP	ACP
HCEs	5.0%	4.2%
NHCEs	2.7%	2.0%

- X failed to correct the ADP test by the end of the 2017 plan year
- X may correct the failure by making a corrective QNEC contributions to the NHCEs eligible for the 2016 plan year:
  - 0.3% (ADP test correction)
  - 0.2% (ACP test correction)

One-to-one correction method

- As an alternative to the QNEC allocation method, the employer may use the 1:1 correction method
- Under the 1:1 correction method the employer corrects *both* by distributing excess amounts to HCEs *and* by making a QNEC to eligible NHCEs
- Under the 1:1 approach, a plan may not be treated as two separate plans under the OEE rule
  - Likewise, restructuring the plan into component plans is not permitted
  - The allocation is treated as an annual addition under Code 415 for the year of the failure

1:1 Correction Requirements

- The employer determines the total amount of excess contribution or excess aggregate contribution and the amount distributable to each HCE under the normal distribution method applicable to correction within the twelve-month statutory period
- The employer distributes this amount (less amounts previously corrected under the statutory method) including earnings
  - *Note: The employer is responsible for paying the 10% excise tax for not making the corrective distribution within 2½ months following the close of the plan year in which the failure occurred*
- However, if the employer has made a match on distributed deferrals, the plan forfeits the associated match (regardless of vesting) plus earnings
- To correct an ACP failure, the plan also forfeits any nonvested match plus earnings
- The plan treats any forfeited match in accordance with the plan terms in effect in the year of failure, either reallocating the match to the participants or applying the forfeited amount to reduce the employer's matching contribution

1:1 Correction Requirements (cont.)

- The employer contributes as a QNEC, including earnings, the same amount as the plan distributes or forfeits, *except* the employer need not contribute the amount of any forfeited match associated with distributed deferrals
- The employer may allocate the QNEC to the
  - the eligible employees for the year of the failure who were NHCEs for that year,
  - the eligible employees for the year of the failure who were NHCEs for that year and who are also NHCEs for the year of the correction,
  - Alternatively, the contribution is allocated to account balances of eligible employees (1) or (2), except that the allocation is made only to the account balances of those employees who are employees on a date during the year of the correction that is no later than the date of correction
- Regardless of which group of NHCEs to which the employer allocates the QNEC contribution, the eligible employees must receive a uniform allocation (as a percentage of compensation)
- The QNEC contribution made to the NHCEs is not further adjusted for earnings
- If the employer uses prior year testing, the eligible NHCEs are those eligible in the year *prior* to the year of failure

Example

- Company X maintains a 401(k) plan. For the 2016 plan year, the HCEs ADP% was 7%. The three HCEs deferred the following amounts:

	Compensation	Deferral amounts	Deferral %
Ann	$250,000	$17,500	7%
Ben	$220,000	$17,800	8%
Dan	$180,000	$12,600	7%

- **The** ADP% for the NHCEs was 4%. The 2016 payroll for the eligible NHCEs was $1,500,000. X failed to correct the ADP test failure by the end of 2017. X decides to correct the failure using the 1:1 method.

Example (cont.)

- The excess contributions are as follows:

	Excess Contributions	Corrective distribution	Earnings	Total distribution
Ann	$2,500	$4,300	$388	$4,688
Ben	$4,000	$4,600	$406	$5,006
Dan	$2,000	$0	$0	$0
Total	$8,900	$8,900	$794	$9,694

- To correct the failure under the 1:1 method, the plan will need to make the following corrective distributions: Ann ($4,688) and Ben ($5,006)

- The plan also will need to make a QNEC contribution for the NHCEs of $9,694

- If X had corrected under the QNEC allocation method, the corrective QNEC contribution would have been $30,000

Example

- Assume the same facts as in the previous example except the plan also include a matching formula of 100% of elective deferrals not in excess of 6%. The matching formula is subject to a vesting schedule. For the 2016 plan year, the HCE ACP% was 6% and the NHCE ACP% was 3%

	Compensation	Matching contribution	Match %
Ann	$250,000	$15,000	6%
Ben	$220,000	$13,200	6%
Dan	$180,000	$10,800	6%

Example (cont.)

- X failed to correct the ACP test failure by the end of 2017. X decides to correct the failure using the 1:1 method. The excess aggregate contributions are as follows:

	Excess aggregate contributions	Corrective distribution	Earnings	Vesting	Forfeiture	Total distribution
Ann	$2,500	$4,150	$390	100%	$0	$4,540
Ben	$2,200	$2,350	$210	80%	$512	$2,048
Dan	$1,800	$0	$0	60%	$0	$0
Total	$6,500	$6,500	$794		$512	$6,588

- To correct the failure under the 1:1 method, the plan will need to make the following corrective distributions: Ann ($4,540) and Ben $2,048
- Because Ben is only 80% vested, the plan will forfeit $512
- The plan also will need to make a QNEC contribution for the NHCEs of $7,100
- If X had corrected under the QNEC allocation method, the corrective QNEC contribution would have been $15,000

Source of QNEC Contributions

- The contributions may only come from employer nonelective contributions, including forfeitures, assuming the plan document uses forfeitures to reduce employer contributions
- Previously, the IRS took the position that an employer could not use a forfeitures to fund a QNEC contribution
  - However, the IRS has changed its position and permits an employer to use forfeitures as long as the plan document provides that forfeitures will be used to reduce employer contributions

401(k) Plan Elective Deferral Failures

Common Elective Deferral Failures

- ***Failure to implement deferral election***. The employee makes a deferral election but the employer fails to implement the participant's deferral election. and
- ***Improper exclusion***. The employee satisfies the plan's eligibility conditions but the employer fails to allow the participant to make elective deferrals.

EPCRS Correction Methods

- Unlike many errors where the IRS only provides guiding correction principles, for these errors, the IRS provides specific correction methods
- To correct an elective deferral failure, EPCRS generally requires the employer to make a corrective QNEC contribution for the <u>missed deferral opportunity</u> and contribution for the matching contributions (if any)
- To encourage employers to correct plans with elective deferral failures, the IRS amended EPCRS to add some additional ***safe harbor*** correction methods
  - The additional safe harbors reduce (or, in some circumstances, eliminate) the correction cost
  - Which rule an employer uses largely depends on *timing of correction*

Correction for improper exclusion (General Rule)

- The employer makes a QNEC contribution equal to the missed deferral opportunity
- The missed deferral opportunity is 50% of the missed deferral
- **Traditional 401(k) plan**: the missed deferral is the average ADP% of the group (HCE or NHCE) to which the employee belongs
- **Safe harbor 401(k) plan:** the missed deferral is the greater of:
  1. 3% of plan year compensation, or
  2. the maximum deferral percentage for which the employer provides a matching contribution rate that is 100% or more
- The plan calculates the missed deferral for the portion of the plan year in which the employee was improperly excluded

Match correction

- The plan must first calculate the missed deferral
- The employer then applies the plan's matching formula to the missed deferral (<u>not</u> the missed deferral opportunity) to determine the corrective contribution for the match
- The corrective contribution is subject to statutory and plan limits
- For a safe harbor match, the employer makes the contribution in the form of a QMAC
  - For a regular match, the corrective contribution may be subject to the plan's vesting schedule
- Depending on when the correction is made, the QMAC may need to be adjusted for earnings
  - Calculate earnings from the deadline for making the matching contribution

Additional Rules for Elective Deferral Corrections

- The plan also will need to include **earnings** with the corrective contribution
- Improper exclusion: plan uses average ADP% for the year of exclusion regardless of whether plan uses current or prior year testing
- Corrective contributions are subject to plan and statutory limits (e.g., 402(g) and 415)
- In calculating the missed deferral, plan may not use the OEE rule
- Correction methods do not apply until after the correction of other qualification failures
  - In other words, the plan disregards improperly excluded EEs or EEs for whom the plan failed to implement deferral elections, in applying the ADP and ACP tests

- *These additional rules also apply to corrections for failure to implement deferral election.*

401(k) Plan Example (improper exclusion)

- Company X maintains a 401(k) plan
  - The plan administrator misapplied the eligibility requirements and delayed Dan's entry into the plan until July 1, 2017
  - Dan should have entered the plan on January 1, 2017
  - Dan's compensation for the plan year was $50,000
  - The average ADP% for the NHCEs was 3.5%
  - Plan's matching formula is 100% of elective deferrals not exceeding 3%
  - The plan corrects the elective deferral failure by making a QNEC to Dan's account of $437.50 plus earnings. The calculation is as follows:

$ 875 (3.5% x $25,000) = missed deferral
X 50%
$437.50 = missed deferral opportunity

- The employer also would provide a corrective contribution equal to $750 for the matching contribution on the missed deferral

Safe Harbor 401(k) Plan Example (improper exclusion)

- Company X maintains a safe harbor 401(k) plan with a matching formula of 100% of compensation not exceeding 4% of compensation
  - The plan administrator misapplied the eligibility requirements and delayed Ann's entry into the plan until July 1, 2017
  - Ann should have entered the plan on January 1, 2017
  - Ann's compensation for the plan year was $50,000
  - The plan corrects the elective deferral failure by making a QNEC to Ann's account of $500 plus earnings. The calculation is as follows:

$1000 (4% x $25,000) = missed deferral
X 50%
$500 = missed deferral opportunity

- The employer also would provide a corrective QMAC contribution equal to $1,000 for the matching contribution on the missed deferral

Failure to Implement Deferral Election (General Rule)

- One of the administrative challenges in maintaining a 401(k) plan is timely and properly implementing participants' deferral election or a change in the deferral election
- If an employer fails to implement a participant's deferral election, the participant will receive all of his/her normal compensation instead of having the compensation deferred
- The employer will need to make a corrective contribution to the participant's account to correct for this failure
- The method of correction is similar but not identical to the correction for an improper exclusion of an eligible employee
- Unlike the improper exclusion correction, in the case of a failure to implement the deferral election, the plan <u>knows</u> the participant's deferral election
- The participant's deferral election forms the basis of the correction

Correction Method (General rule)

- With respect to a failure to implement a deferral election, the correction method is the same as it is for a traditional 401(k) plan - the plan corrects by making a QNEC contribution equal to the "missed deferral opportunity"
- **Missed deferral opportunity** = 50% of the "missed deferral"
- **Missed** deferral = the participant's deferral election applied to the compensation for the period of time for which the plan failed to implement the election
  - Same calculation for traditional and safe harbor 401(k) plans
- The employer also would need to include earnings with the corrective contribution

Example

- Company X maintains a calendar year 401(k) plan
- Ben made a 5% deferral election, effective January 1, 2017
  - Dan's monthly compensation for 2017 was $5,000
- The plan administrator failed to implement the election and the error was not caught until May 1, 2017
- The plan would correct the failure by making a QNEC to Ben's account in the amount of $500 plus earnings. The calculation is as follows:

  $1,000 (5% x $20,000) – missed deferral
  x 50%
  $500 – missed deferral opportunity

- Safe result if it were a safe harbor 401(k) plan

Roth Deferral Failure

- The employer still corrects by making a QNEC contribution to the participant's account

Failure To Implement: Match Correction

- As with the correction for an improper exclusion, the plan will apply the plan's matching formula to the missed deferral (not the missed deferral opportunity)
- The plan first calculates the missed deferral
- Then, applies the plan's matching formula to the missed deferral to determine the corrective contribution for the matching formula
  - The corrective contribution is subject to statutory and plan limits
  - If match is a safe harbor match, the contribution will be in the form of a QMAC. Otherwise, the contribution is subject to plan's vesting schedule
- The employer also will include earnings with respect to the corrective contribution

Example

- Assume the same facts as in the previous example except the plan also includes a matching formula of 100% of elective deferrals not exceeding 4% of compensation for the plan year
- To correct, the plan applies the matching formula to the missed deferrals (100% of $800)
  - The employer will make a matching contribution of $800
  - Depending on when the correction occurs, the contribution may need to be adjusted for earnings
- *If the plan were a safe harbor 401(k) plan and the match were a safe harbor match, the matching contribution would need to be a QMAC*

Example

- Assume the same facts as in the previous two examples except the plan also includes a matching formula of 100% of elective deferrals not exceeding 6% of compensation for the plan year
  - Failed to implement 5% deferral election for 4 months
  - Dan's compensation = $5,000/month
  - The match is subject to a vesting schedule
  - Missed deferral = $1,000
- Dan also will receive an additional corrective contribution of $1,000 (100% x $1,000 [5% x $20,000])
  - The corrective contribution will be subject to the plan's vesting schedule
  - Possible adjustment for earnings

Other Qualification Failures

ADP and ACP Test

- The EPCRS correction methods do not apply until after the correction of other qualification failures
  - For example, if, in addition to improperly excluding an employee (or failing to implement a deferral election), the plan also failed the ADP or ACP test, the EPCRS correction method cannot be applied until after the after the correction of the ADP or ACP test failures
  - In applying the ADP or ACP test, the plan excludes the employees who were improperly excluded from the plan

Example

- Company X maintains a 401(k) plan
  - For 2017, X improperly applied the eligibility conditions to two employees and improperly excluded them from the plan
  - The administrator identified the error in February, 2017 and recommended using the EPCRS correction method
  - X immediately makes the two employees eligible for the plan but delays making the corrective QNEC contributions for the deferral failure and the corrective nonelective contributions for the match until after it has applied the ADP and ACP tests
  - In performing the tests for 2017, X does not include the improperly excluded employees in the tests

Deferral Election

- The employer needs to permit the improperly excluded employee to commence making elective deferrals or implement an election immediately upon discovering the error
- The employer need only wait to for the ADP or ACP correction before making the corrective contributions
- The employer needs the ADP percentage for the plan year to determine the corrective contribution for an improper exclusion

Alternative Correction Methods

- **For an improper exclusion or a failure to implement an election for a portion of the plan year, could the employer elect to correct immediately rather than wait for the ADP or ACP test to be performed?**
- The EPCRS correction methods, although strongly recommended, are not exclusive means of correcting failures
- An employer may elect to correct immediately to reduce the additional corrective contributions for earnings
- However, the employer faces the difficulty of determining the appropriate corrective contributions for an improper exclusion because it relies on the ADP percentage
  - The employer could use a reasonable estimate of the ADP percentage

Brief Exclusion Rule

Non-Safe Harbor Correction Method

- Under the non-safe harbor rule, an employer may correct an **<u>improper exclusion</u>** elective deferral failure without making a corrective QNEC contribution for the missed deferrals if the employer satisfies the following conditions:

1. The employee has the opportunity to make elective deferral under the plan for a period of at least the last 9 months of the plan year (i.e., elective deferral failure is 3 months or less).

2. The employee has the opportunity to make elective deferrals in an amount not less than the maximum amount that would have been permitted absent the failure. and

3. If the participant would have been entitled to a matching contribution on the missed deferrals, the employer makes a corrective contribution for the match equal to the matching contributions that would have been allocated if the missed deferrals would have been contributed.

Note: The non-safe harbor correction method for the brief exclusion rule only applies to an improper exclusion

Example

- Company X maintains a 401(k) plan
  - Don is eligible on January 1, 2017 but he is informed he is not eligible
  - X catches the error on March 1, 2017 and allows Don to commence making elective deferrals
- The non-safe harbor rule is available (*i.e.*, no need to make a corrective contribution for the missed deferrals) because Don has at least 9 months left in the plan year to make up elective deferrals
- If the plan has a matching formula, X, however, will need to make a corrective contribution for the match

Example

- Company X maintains a 401(k) plan
  - Don is eligible on January 1, 2017 and makes a deferral election of 4% of compensation
  - X fails to implement the election until March 1, 2017
- The non-safe harbor brief exclusion rule is not available to correct because it only applies to an improper exclusion
- *However, X may correct under the safe harbor brief exclusion rule*

Example

- Company X maintains a safe harbor 401(k) plan with a periodic safe harbor match of 100% of elective deferrals not exceeding 4% of compensation
  - Don (compensation: $5,000/month) was improperly excluded from the plan for the first two months of the plan year
  - The missed deferral is $400 (4% x $10,000)
  - X corrected the failure on March 1, 2017
- X does not need to make a corrective QNEC contribution for the missed deferrals because of the brief exclusion rule
  - Don can increase his deferrals during the last 10 months to make up for the improper exclusion for the first two months of the plan year
- However, X must make a corrective QMAC contribution of $400 (100% x $400 [4% missed deferrals x $10,000])
- *Note: Same result in a traditional 401(k) plan but the match is subject to the plan's vesting schedule*

Safe Harbor Correction Methods

Not just for Safe Harbor 401(k) Plans

Safe harbor correction methods

- Many practitioners felt that the corrective contribution for elective deferral failures was too costly and created a "windfall" for the participants because those affected employees received not only their full salary but also the corrective contribution
  - To encourage employers to correct plans with elective deferral failures, the Revenue Service amended EPCRS to add some additional, lest-costly correction method
  - EPCRS refers to these additional correction methods as *safe harbor correction methods*
  - The safe harbor correction methods are in addition to the general EPCRS correction methods for elective deferral failures
  - The additional safe harbors reduce (or, in some circumstances, eliminate) the correction cost but make the correction options more complicated
  - If the plan does not satisfy the safe harbor correction method requirements, the employer will need to apply the general correction methods
  - Which rule (general or safe harbor) an employer uses largely depends on when the employer corrects the failure

Safe Harbor Brief Exclusion Rule

- Under this safe harbor correction method, an employer may correct an elective deferral failure (failure to implement or an improper exclusion) without making a QNEC for the missed deferrals if the employer satisfies the following conditions:

1. Correct deferrals begin no later than (1) the first payroll date on or after the last day of the three-month period that begins when the failure first occurred; or (2) if the employer was notified by the affected participant, the first payroll date on or after the end of the month after the notification.
   - *Note: For a failure to implement a deferral election, the employer simply implements the deferral election. For an improperly excluded employee, the employer would need to communicate the deferral option and implement the participant's election, if any.*
2. The employer provides a **notice** of the failure to the affected participants not later than 45 days after the date on which the employer implements the participant's deferral election. and
3. If the participant would have been entitled to a matching contribution on the missed deferrals, the employer makes a corrective contribution equal to the matching contributions that would have been allocated if the missed deferrals would have been contributed.

- *Note: The benefit of the safe harbor rule is that rule can be used regardless of the type of elective deferral failure and when during the plan year it occurs while the non-safe harbor rule only is available for improper exclusion and if the failure occurs during the first three months of the plan year. The advantage of the non-safe harbor rule is that it does not have a notice requirement.*

Example – Failure to implement

- Company X maintains a 401(k) plan with a periodic match of 100% of elective deferrals not exceeding 4% of compensation
  - Emma makes a 4% deferral election (compensation: $5,000/month) on her entry date of July 1, 2017 but X failed to implement the election until September 1, 2017
  - X need not make a corrective QNEC contribution for the missed deferrals because of the brief exclusion safe harbor rule
  - However, X must make a corrective contribution of $400 plus earnings (100% x $400 [4% missed deferrals x $10,000]) for the match
  - *Note: Same result in a safe harbor 401(k) plan but the corrective contribution for the match would need to be a QMAC*

Example – Improper exclusion

- Assume the same facts in the previous question except X improperly informed Emma that she was not eligible on July 1, 2017
  - X discovered the error and allowed her to make elective deferrals on September 1, 2017
  - X does not need to make a corrective QNEC contribution because of the brief exclusion safe harbor rule
  - However, X must make a corrective contribution of $400 plus earnings (100% x $400 [4% missed deferrals x $10,000]) for the match

Elective Deferral Failure
(between 3 months and 2 years)

Safe Harbor Correction Method

- For elective deferral failures (both types) that have not been corrected within the three month period following the date the error first occurred
- Under this safe harbor, an employer may correct an elective deferral failure by making a corrective QNEC contribution of <u>25%</u> (rather than the normal 50% corrective contribution) provided the employer satisfies the following conditions:

1. The employer provides the employee the opportunity to make elective deferrals under the plan not later than the earlier of (1) the last day of the <u>second plan year</u> following the plan year in which the failure occurred, or (2) if the employer was notified of the failure by the affected employee, the first payroll date on or after the end of the month after the notification.

2. The employer provides a notice of the failure to the affected participants not later than 45 days after the date on which the employer implements the participant's deferral election. and

3. If the participant would have been entitled to a matching contribution on the missed deferrals, the employer makes a corrective contribution (plus earnings) equal to the matching contributions that would have been allocated if the missed deferrals would have been contributed.

Example

- Company X maintains a safe harbor 401(k) plan with a periodic safe harbor match of 100% of elective deferrals not exceeding 4% of compensation
  - Ben makes a 5% deferral election (compensation: $5,000/month) on his entry date of July 1, 2017 but X failed to implement the election until January 1, 2018.
  - To correct, X needs to make a corrective QNEC contribution for the missed deferrals equal to $375 plus earnings (25% x $1,500 missed deferrals [5% x $30,000]) because of the safe harbor rule
  - X also must make a corrective QMAC contribution of $1,200 (100% x $1,200 [4% missed deferrals x $30,000])
  - *Note: The result would have been the same in a traditional 401(k) plan but the corrective matching contribution would have been subject to the plan's vesting schedule.*

Example

- Assume the same facts in the previous question but X improperly informed Ben that he was eligible on January 1, 2018 rather than his correct eligibility date of July 1, 2017
- X discovered the error and corrected it as follows:
  - X calculates the missed deferrals to be $1,200 (4% [highest level of deferrals at which the plan matches at the 100% rate] x $30,000)
  - X makes a corrective QNEC contribution of $300 plus earnings (25% x $1,200 [4% missed deferrals)
  - X also must make a corrective QMAC contribution of $1,200 (100% x $1,200 [4% missed deferrals x $30,000]) to correct the match failure

Example (Traditional 401(k) Plan)

- Assume the same facts in the previous question except the plan is a traditional 401(k) plan (improper exclusion)
  - X improperly informed Ben (earning $5,000/month) that he was eligible on January 1, 2018 rather than his correct eligibility date of July 1, 2017
  - The average ADP% for the NHCEs was 3.5%
- X discovered the error and corrected it as follows:
  - X calculates the missed deferrals to be $1,050 (3.5% [average ADP%] x $30,000)
  - X makes a corrective QNEC contribution of $262.50 plus earnings (25% x $1,050 [3.5% missed deferrals)
  - X also must make a corrective contribution of $1,050 (100% x $1,050 [3.5% missed deferrals x $30,000]) to correct the match failure

Notice Requirement for Safe Harbor Corrections

- To satisfy the notice requirement under the two safe harbors for correcting elective deferral failures, the notice must include the following information:

1. General information regarding the failure, such as the percentage of eligible compensation that should have been deferred and the approximate date that the compensation should have begun to be deferred.

2. A statement that the appropriate amounts have begun to be deducted from compensation and contributed to the plan.

3. A statement that corrective allocations have been made (or will be made). Information relating to the date and the amount of corrective allocations need not be provided.

4. An explanation that the affected participant may increase his/her deferrals in order to make up for the missed deferral opportunity, subject to the 402(g) limits.

5. The name of the plan and plan contact information.

Safe Harbor Correction for a 401(k) plan with an Automatic Contribution Feature

- EPCRS provides a safe harbor correction method for a 401(k) plan that includes an automatic contribution arrangement
- Under the safe harbor, the employer does **not** have to make a corrective contribution for an elective deferral failure (failure to implement and improper exclusion) in a 401(k) plan with an automatic contribution arrangement provided the following conditions are satisfied:

1. Correct elective deferrals begin by the first payroll date on or after the earlier of:
   a) 9½ months after the end of the plan year in which the failure first occurred; or
   b) The last day of the month after the month the affected employee first notified the employer of the failure.
2. The employer provides a notice of the failure to the affected participants not later than 45 days after the date on which the correct deferrals begin. and
3. If the eligible employee would have been entitled to additional matching contributions on the missed deferrals, the employer makes a corrective allocation equal to the matching contributions that would have been allocated on the missed deferrals. These contributions must be made within the two year timeframe for correcting significant operational failures.

Example

- Company X maintains a QACA with the matching contribution formula (100% on the 1% of deferrals and 50% match on deferrals between 1% and 6%)
  - Ann becomes eligible for the plan on January 1, 2017
  - Ann makes neither an affirmative election nor a contrary election
  - Ann's compensation is $5,000/month
  - X fails to implement the 3% automatic elective deferral for Ann until January 1, 2018
  - X will not need to make a corrective contribution for the 2017 missed deferrals
  - However, X will need to make a corrective allocation of $1,200 for the matching contributions on the missed deferrals (2% [100% x 1% + 50% on the next 2% of deferrals] x $60,000)
  - X also will need to provide Ann with a notice

Calculation of Earnings for 401(k) plans with Automatic Contribution Features

- For 401(k) plans with automatic contribution features that correct elective deferral failures using the safe harbor method of correction
- The employer may calculate the earnings on the corrective contributions by using the plan's <u>default investment alternative</u> if the participant has not made an investment election under the plan
- However, if the default investment alternative has a loss, the employer may not reduce the required corrective contribution

Notice Requirement for Corrections of 401(k) Plans With Automatic Contribution Arrangements

- To satisfy the notice requirement under the safe harbor for 401(k) plans with automatic contribution arrangements, the notice must include the following information:

1. General information regarding the failure, such as the percentage of eligible compensation that should have been deferred and the approximate date that the compensation should have begun to be deferred.

2. A statement that the appropriate amounts have begun to be deducted from compensation and contributed to the plan.

3. A statement that corrective allocations relating to missed matching contributions have been made (or will be made). Information relating to the date and the amount of corrective allocations need not be provided.

4. An explanation that the affected participant may increase his/her deferrals in order to make up for the missed deferral opportunity, subject to the 402(g) limits.

5. The name of the plan and plan contact information.

Sunset of Safe Harbor for Correction Method for Plans with Automatic Contribution Arrangements

- *The safe harbor correction methods for plans with automatic contribution arrangements are available with respect to failures begin on or before December 31, 2020*
- *The Revenue Service will then review the safe harbors to determine whether they should be continued or modified*

Comparison: Elective Deferral Failure Corrections

	Correction Time Period	Corrective Contributions	Notice Required
Non-safe harbor Brief Exclusion Rule	First 3 months of the plan year	0%	No
Safe Harbor Brief Exclusion Rule	Rolling 3 month period	0%	Yes
General Rule	No limitation	50%	No
Safe Harbor	Between 3 months and 2 years	25%	Yes
Safe Harbor (automatic contribution arrangements)	Earlier of: 9½ months after the PY of failure or the last day of the month following EE notification	0%	Yes

Corrective Contributions

	Traditional 401(k) Plan	Safe Harbor 401(k) Plan
Missed deferral (improper exclusion)	Average ADP% for the group to which the EE belongs (NHCE or HCE)	The greater of (1) 3%, or (2) the highest rate of deferrals at which the plan matches 100%
Missed deferral (failure to implement)	Participant's deferral election	Participant's deferral election
Match	Corrective contribution subject to plan's vesting schedule	Corrective contribution for SH match must be a QMAC; other matching contributions subject to plan's vesting schedule

Failure To Implement a Change in Deferral Election

- Not specifically discussed in EPCRS
  - The principals as well as the safe harbors should apply when the employer fails to implement an increase in the participant's deferral election
  - The employer makes a corrective QNEC contribution for the missed deferral opportunity and calculates any match on the missed deferral

Example

- Company X maintains a safe harbor 401(k) plan that provides a safe harbor match of 100% of elective deferrals not exceeding 4% of compensation
  - Effective July 1, 2017, Mary increases her deferral election from 3% to 4%
  - Mary's compensation is $5,000/month
  - The plan fails to implement the change until January 1, 2018
- The missed deferral is $300 (1% x $30,000)
- Since the failure was discovered and corrected within the safe harbor period (between 3 months and two years), the corrective QNEC contribution for the missed deferral opportunity will be $75 ($300 x 25%)
- The corrective QMAC contribution to correct the matching failure is $300
- Earnings adjustment
- *Note: If the employer had caught the error within three months, it could have taken advantage of the brief exclusion safe harbor and avoided making the QNEC contribution for the elective deferral failure. The employer would still have needed to make a corrective contribution for the matching contributions.*

Failure To Implement Decrease in Participant's Deferral Election

- Not addressed in EPCRS
- The appropriate correction would be for the plan to return the inappropriately withheld contributions to the participant
- If there is enough time left in the plan year, the employer could decrease the deferrals for the balance of the plan year so that the participant's annual deferrals equal the amount of deferrals the participant intended
  - Of course, the employer would need to make certain the participant received the match he/she should have received if the change had been properly implemented
- The plan should report the returned contributions on a Form 1099-R with a code "E" for other distributions so the participant is not subject to the 10% penalty
- With respect to any employer contribution allocated in error, the plan either should allocate to other participants if they have not received their full allocation or forfeit the allocation and use it in the next plan year

Earnings Calculations for Corrective Contributions

Earnings adjustment

- General rule: whenever a correction requires a corrective contribution, the contribution should be adjusted for earnings
  - Reasonable estimates permitted
  - Generally, employer does not adjust for losses
- Period of failure: is the period from the date the failure began through the date of correction
  - In the case of an exclusion of an eligible employee, the beginning date is the date on which contributions of the same type were made to the plan
- Safe harbor match and nonelective contributions are due 12 months after the close of the plan year
  - If the employer corrects within the time period, no earnings adjustment would be necessary

Elective Deferrals and Matching Contribution

- 401(k) or (m): For administrative convenience, the employer may treat the date on which contributions would have been made as the midpoint of the plan year (or the midpoint of the portion of the plan year) for which failure occurred
- Alternatively, the employer may treat the date on which contributions would have been made as the first day of the plan year (or portion of the plan year) during which the employee was excluded, provided the earnings rate is one-half of the earnings rate

Earnings Rate

- Multiple investment funds:
  - The rate is based on the participant's investment choices
  - If most of the employees are NHCEs, the rate can be the fund with the highest rate of return for the period failure
  - If the employee has not made an investment choice, the rate can be the average of the rates earned by all of the funds weighted by the portion of the plan assets invested in the various funds

Earnings Calculations for Safe Harbor Corrections for Elective Deferral Failures

- Alternative method for calculating earnings for elective deferral failures, including for corrective contributions for the matching contributions
  - If an affected employee has not affirmatively made investment choices under the plan, the employer may calculate the missed earnings on the basis of the plan's default investment alternative
  - Any accumulated losses will not result in a reduction in the required corrective contributions
  - Plan also may use the Earnings adjustment method in Section 3, Appendix B or EPCRS

Corrective QNEC Contribution (missed deferral opportunity)

- Prior to the issuance of the safe harbors for elective deferral failures under EPCRS, the corrective QNEC contribution was 50%
- With the issuance of the safe harbors, the corrective QNEC contribution percentage depends on when the correction takes place

Correction takes place	Corrective QNEC %
First 3 months after the beginning of the plan year	0%; but would need to make a corrective match contribution if the plan had a match
Between 3 months and 2 years after the beginning of the plan year	25%; Also would need to contribute a corrective match contribution if plan has a match
After 2 years	50%; Also would need to contribute a corrective match contribution if plan has a match

Plan includes a match feature

- If the plan includes a matching contribution feature, the employer would need to make a corrective contribution for the match by applying the plan's matching formula against the missed deferrals (not the missed deferral opportunity)
- If the plan provided a safe harbor nonelective contribution, the correction would include that contribution
- With the corrective contributions, the employer also may need to make a contribution to make-up for the lost earnings

Failure to Apply Deferral Election to a Bonus

One of the More Common Errors

- One of the more common errors in a 401(k) plan is the failure to apply a participant's deferral election to a bonus despite the fact that the plan definition of compensation includes bonuses
  - Plan could exclude bonuses from its compensation definition for elective deferrals
- Although this error is common and raises a lot of important questions, EPCRS does not provide any guidance on the correction of such errors
  - Because of the lack of guidance, practitioners are left to determine which of the various correction methods are available
- Factors that will affect the correction options are:
  - Does the plan treat it as separate from the normal payroll (i.e., require a separate election)
  - When the bonus is payable

Application of the Brief Exclusion Rules

- An underlying principle of the brief exclusion rules is that the employee has the opportunity to make-up the missed deferrals
  - For a bonus paid at the end of the year, such an opportunity is effectively not available. Therefore, it is unlikely the IRS would consider the application of the brief exclusion rules to be an appropriate correction method
  - Furthermore, if the plan and employer treat the bonus as a one-time payment (not just another payroll period) for which a separate election is required, neither brief exclusion rule would be available because correct deferrals couldn't begin within three months of the error
- If the bonus is paid early in the plan year (first three months for the general brief exclusion rule) and is treated as part of the normal payroll (no separate election), the IRS might accept the application of the brief exclusion rule
  - However, if the employer is relying on the safe harbor brief exclusion, the correct deferrals begin with the next payroll, and therefore the notice would need to be provided within 45 days of the next payroll period
  - Otherwise, the plan is subject to the general EPCRS correction (50% QNEC)

Corrective Contributions for Deferral Failure Involving Bonus Payments

- Probably the safest correction approach to apply to bonus payments is to treat the bonus as separate from the normal payroll and either:
  - apply the safe harbor corrective contribution (25% QNEC) if the correction occurs before the end of the second plan year following the failure, or
  - The general corrective contribution (50%) if the correction occurs after the second plan year following the failure
- If the employer treats the bonus as a separate from the normal payroll, the correct deferrals would start with the next bonus payment
  - The correct deferral with the next bonus payment also would trigger the 45 notice period

Example

- Ann participates in her company's 401(k) plan
  - Ann makes a 5% deferral election
  - Plan defines compensation as W-2 compensation
  - Bi-monthly payroll with bonuses paid at the end of the year
  - Ann's bonus: $10,000
  - The employer failed to apply her deferral election to her 2017 bonus
- The brief exclusion rules are not available because Ann doesn't have an effective opportunity to make-up the missed deferrals
- Ann's missed deferral is $500 and under the safe harbor correction method her missed deferral opportunity is $125 (25% of $500).
- The plan also would make a corrective contribution for any missed matching contribution and earnings

402(g) Failure

402(g) Correction

- If an employee defers in excess of the Code 402(g) limits (2018: $18,500), the plan must distribute the excess deferral no later than April 15th of the following taxable year
  - The individual must include in his/her gross income for the year of the deferral the excess deferral, except to the extent the excess deferral was a Roth deferral
    - The income on the excess deferral is taxable in the year of distribution
    - Distribution of the excess deferral is the only means to correct an excess deferral

Corrective Distributions After April 15th

- If the plan distributes the excess deferral after the April 15 deadline, the plan has a disqualifying defect
- EPCRS provides a correction for such a failure but the correction does not affect the tax consequences
- Double taxation: For a corrective distribution of excess deferrals after April 15, the *entire* distribution is includible in gross income for the taxable year in which distributed, even though the portion representing the excess deferral was includible in the employee's gross income for the taxable year to which that deferral related

SCP Correction

- The employer may avoid plan disqualification by correcting the failure under EPCRS
- EPCRS includes a self-correction (“SCP”) method to correct “late distribution” of excess deferrals
  - To correct the failure, the employer distributes the excess deferral
  - In other words, the plan is permitted to make the corrective distribution beyond the April 15th deadline
  - Self-correction of the failure avoids disqualification of the plan but does *not* eliminate the double taxation to the employee

Example

- Company X maintains a 401(k) plan. For 2017, Kathy defers $20,000 (2017 402(g) limit: $18,000)
- The plan does not distribute the $2,000 excess deferral (plus allocable income) by April 15, 2018
  - The plan discovers the error later in 2018
  - The plan is subject to disqualification, however, X may correct the error by distributing the excess deferral after the April 15th deadline
  - The corrective distribution does not affect the double taxation of the excess deferral. Kathy is taxable on the excess deferral in the year of the deferral (2017) and in the year of distribution (2018). The income is taxable in the year of distribution.
- A distribution of excess deferrals, including a corrective distribution under EPCRS, to an HCE is included in the ADP test. However, a distribution of excess deferrals, including a corrective distribution under EPCRS, to an NHCE is not included in the ADP test.

Early Inclusion of Otherwise Eligible Employee

Operational Error

- Employers commit a plan operational error when they include an otherwise eligible employee to enter the plan who either
  - (1) has not yet completed the plan's minimum age and service conditions, or
  - (2) has completed the plan's minimum age and service conditions but has become a participant earlier than the plan's entry date
- In either case, the failure is disqualifying and the employer needs to correct it. EPCRS provides a generous correction option that an employer may utilize under SCP.

Retroactive Amendment

- The employer may amend the plan's eligibility provision retroactively to allow the employees who were allowed to enter the plan in error if the amendment satisfies the following conditions:
  - The amendment satisfies Code 401(a) at the time it is adopted,
  - The amendment would have satisfied Code 401(a) had the amendment been adopted at the earlier time when it is effective, and
  - The employees affected were predominantly NHCEs
- Normally, if an employer must amend the plan to correct a plan error, it needs to file under VCP. However, EPCRS contains several exceptions to this general rule. The retroactive amendment to correct an early inclusion failure is one such exception.

Example

- Employer X maintains a calendar year 401(k) plan with eligibility conditions of one year of service and age 21
  - The plan's entry dates are January 1 and July 1
  - In 2017, hired four new programmers and, despite the plan terms, permitted immediate entry into the 401(k) plan for them
  - The makeup of the new hires was: 3 NHCEs and 1 HCE. In 2018, the administrator identified the plan error
- X corrected the failure by adopting a plan amendment permitting the programmers (and no one else) to enter the plan immediately upon hire
- *Note: Another advantage of the retroactive amendment is that the plan will not have to rerun the ADP and ACP tests*

Example

- Assume the same facts as in the previous example but the makeup of the new hires was 2 NHCEs and 2 HCEs
- The option of adopting the retroactive amendment is not available because the employees who entered the plan earlier than what the plan permitted were not predominantly NHCEs

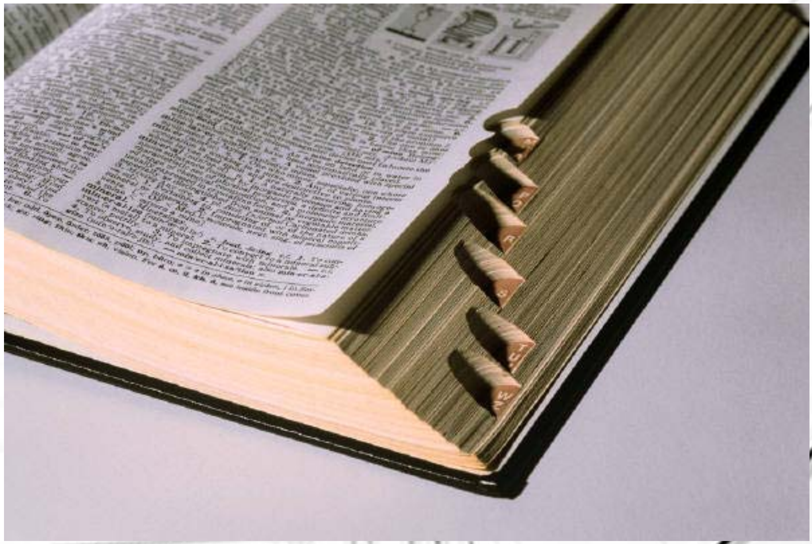
Alternative Correction Method

- An employer that has an early inclusion failure either may not qualify for the retroactive amendment (employees are predominantly HCEs) or may not want to correct using such an approach. In such a circumstance, the employer may correct the failure by:
  - Returning the elective deferrals plus earnings to the employees,
  - Forfeiting the employer contributions (including matching) and using them to reduce future employer contributions, and
  - Rerunning the ADP and ACP tests if the test had already been performed.
- When returning the elective deferrals and earnings, the plan would need to use a code “E” on the Form 1099-R to avoid subjecting the distribution to the premature distribution tax.

Example

- Employer X maintains a calendar year 401(k) plan with eligibility conditions of one year of service and age 21
  - The plan's entry dates are January 1 and July 1
  - In 2017, hired four new programmers and, despite the plan terms, permitted immediate entry into the 401(k) plan for them
  - The makeup of the new hires was: 2 NHCEs and 2 HCEs. In 2018, the administrator identified the plan error
- X corrected the failure by
  - Returning the elective deferrals to the employees plus earnings
  - Forfeiting the matching and nonelective contributions
  - Rerunning the ADP and ACP tests
- *Could the employer adopt a retroactive amendment just for the NHCEs and return the deferrals to the HCEs?*

Compensation



90

What compensation definition for testing?

- In applying the ADP and ACP tests, the plan must use a nondiscriminatory definition of compensation
- "Testing" compensation is an operational decision unless the plan dictates a specific testing definition (it should not)

Nondiscriminatory compensation definition: start with 415

1. Safe harbor nondiscriminatory definition
   - **415 compensation** is nondiscriminatory
     - Sometimes called "total comp"
   - Alternatively, can use "net" compensation
     - **W-2** or **federal withholding wage** definition (also may use safe harbor exclusions, *e.g.*, fringe benefits)
   - Can limit to compensation while a participant
2. Alternative definition that is reasonable and that satisfies the **compensation ratio test**
   - "reasonable" definition can't include items not in 415 definition; can't exclude % of comp; can't exclude by period within limitation year (a month)

Compensation for deferral

- 401(k) plan may limit *type* of compensation from which participants may defer to a reasonable definition of compensation (*e.g.*, base comp, etc.)
- Definition does not need to be nondiscriminatory (*i.e.,* does not need to pass compensation ratio test)

Compensation Errors

- If an employer doesn't allocate contributions, including deferrals, in accordance with the plan definition of compensation, the plan has a disqualifying defect because the employer has failed to comply with the plan document
- Correction:
  - Discretionary contributions: either reallocate based on correct definition, or, contribute an additional amount to bring everyone to a uniform percentage based on the participant with highest contribution
  - Fixed contributions: make additional contribution
  - Deferrals: Correct using corrections for missed deferrals

Compensation Errors - Testing

- If the plan doesn't use a nondiscriminatory definition of compensation for testing, the employer will need to re-test using an appropriate definition of compensation
  - If the corrective distributions are more than they should have been, the employer will need to make a reasonable effort to retrieve the excess distributions
  - If the plan fails the ADP or ACP test when it uses the correct compensation definition, the plan will need to apply the ECPRS correction for ADP/ACP test failures

Roth Deferral Failure

- If an employee elects to make a Roth deferral but the employer effects a pre-tax deferral, the correction is to reclassify the deferral as a Roth
  - The employer will need to amend its W-2
  - The employee will need to amend his/her tax return

Matching Contribution Failure

- With respect to a matching contribution, if the plan:
- Fails to make a required matching contribution
  - Correction: Make-up contribution
- Uses the wrong definition of compensation
  - Correction: Make-up contribution or reallocation; forfeiture
- Makes too large of a matching contribution
  - Correction: forfeiture
- Make-up contributions need to include earnings calculated from the date such contributions were normally contributed

THANK YOU

Contact Information

- Author of the Plan Corrections: answers to your questions
  - Stephen W. Forbes
  - (720) 799-7039
  - stephen.forbes32@gmail.com
- Publisher of ERISApedia.com:
  - Timothy M. McCutcheon
  - (612) 605-2266
  - tmm@erisapedia.com / sales@erisapedia.com

CE Credit

- ERPA/ASPPA/NIPA
  - Will receive certificate by email in several days
  - ERPA will take longer (please be patient)
  - Please check spam folder
- Any questions, email: support@erisapedia.com