

Correcting Elective Deferral Failures

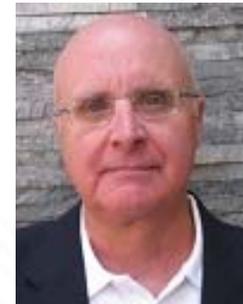
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Correcting Elective Deferral Failures

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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 missed deferral opportunity 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 (not 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 \$500 plus earnings. The calculation is as follows:

$$\begin{array}{l} \$ 875 (3.5\% \times \$25,000) = \text{missed deferral} \\ \quad \underline{\times 50\%} \\ \$437.50 = \text{missed deferral opportunity} \end{array}$$

- 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:

$$\begin{array}{l} \$1000 (4\% \times \$25,000) = \text{missed deferral} \\ \underline{\quad \times 50\% \quad} \\ \$500 = \text{missed deferral opportunity} \end{array}$$

- 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 knows 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:

$$\begin{array}{l} \$1,000 (5\% \times \$20,000) - \text{missed deferral} \\ \underline{\quad \times 50\% \quad} \\ \$500 - \text{missed deferral opportunity} \end{array}$$

- 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

Brief Exclusion Rule



Non-Safe Harbor Correction Method

- Under the non-safe harbor rule, an employer may correct an improper exclusion 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 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\% \times \400 [4% missed deferrals \times \$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\% \times \400 [4% missed deferrals \times \$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 **25%** (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 second plan year 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 default investment alternative 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



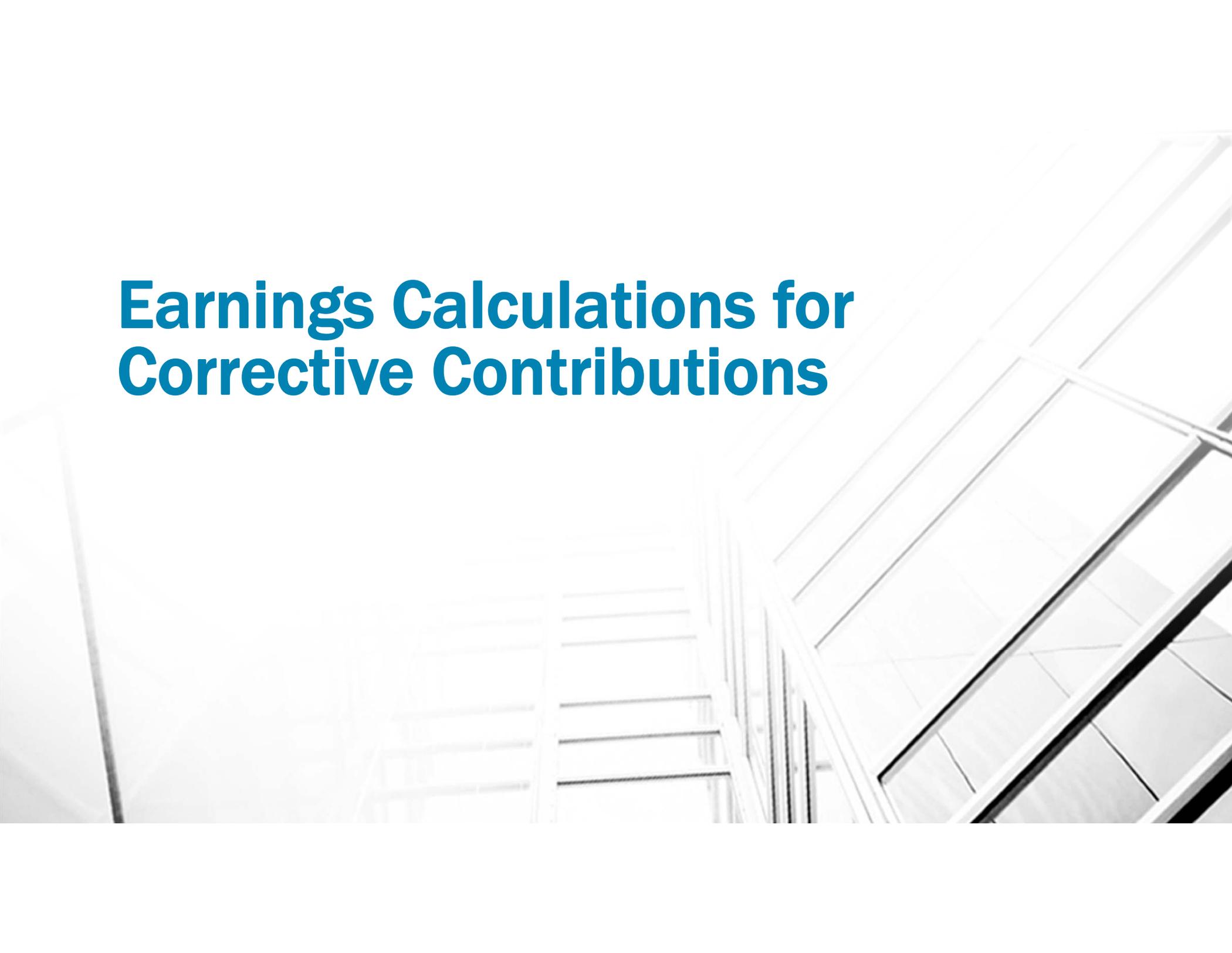
Example

- 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 "7" 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

THANK YOU

A stylized graphic consisting of two parallel, wavy blue lines that curve from left to right, positioned below the text 'THANK YOU'.

Contact Information

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