

## 401(k) Plan Corrections – Correcting the Top Ten 401(k) Plan Errors – 6/25/18 & 6/27/18 – Stephen Forbes

1. What happens if you effect corrective distributions, and later, by using an alternative definition (because you discovered an error in the testing), you find out the plan passed?

**Great question. On numerous occasions the IRS has stated that an employer is not obligated to exhaust every testing option in determining whether a plan passes or fails the ADP/ACP tests. Therefore, if you apply the tests using a particular method and fail and then make corrective distributions, the plan has not violated the 401(k) distribution restrictions if it is later determined that it could have passed using an alternative testing method.**

2. A plan withheld deferrals from a HCE, and then made mistakes when submitting these contribution. The mistake was not discovered for two years. The plan had a significant ADP/ACP test failures. This HCE's refund was based on the actual amount contributed to the plan. How would you recommend correcting this? The prior year W-2 reported the actual.

**If I am understanding the question correctly, the employer failed to contribute to the plan the full amount of the employee's deferrals that were actually deferred. Furthermore, the corrective distribution for the test failures was based on the amount contributed and not the amount deferred. The appropriate correction is for the employer to make an additional contribution (plus earnings) to the plan to make up for the deferrals not contributed. Of course, this will require additional corrective distributions for the test failures. To correct that failure, the employer should use the one-to-one approach and make the appropriate corrective distributions. If the W-2 is wrong, the employer will need to correct the W-2.**

3. I don't think the math works on the prior screen w/r/t \$7100. I did not think the 1 to 1 correction included earnings in the QNEC. Slide 20?

**My slide numbering is different than yours but I think I figured out which slide to which you were referring. You are correct that some of the numbers were off. Below, I have provided the examples with the corrected numbers.**

**Example. Company X maintains a 401(k) plan. For the 2016 plan year, the HCEs ADP% was 7.33%. The three HCEs deferred the following amounts:**

	Compensation	Deferral amounts	Deferral %
Ann	\$250,000	\$17,500	7%
Ben	\$220,000	\$17,600	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. The excess contributions are as follows:**

	Excess Contributions	Corrective distribution	Earnings	Total distribution
Ann	\$2,500	\$4,300	\$388	\$4,688
Ben	\$4,400	\$4,400	\$406	\$4,806
Dan	\$1,800	\$0	\$0	\$0
<b>Total</b>	<b>\$8,700</b>	<b>\$8,700</b>	<b>\$794</b>	<b>\$9,494</b>

To correct the failure under the 1:1 method, the plan will need to make the following corrective distributions: Ann (\$4,688) and Ben (\$4,806). The plan also will need to make a QNEC contribution for the NHCEs of \$9,494. If X had corrected under the QNEC allocation method, the corrective QNEC contribution would have been \$30,000.

- Hasn't legislation changed the 50% to 25% if found within a 2 year period? And 0% if discovered within 3 months?

**You are correct that EPCRS (not legislation) now provides a safe harbor correction of 25% if you meet certain conditions. However, the older rule (50%) continues to be in EPCRS and applies if the plan does not meet the safe harbor conditions.**

- If document allows employer to use forfeitures at direction of employer (offset, allocation and/or fees). Can forfeitures received in 2018 be used to offset an ER allocation related to 2017? Traditionally applied use of forfeitures to year relate. Not a forfeiture allocation.

**For purposes of making corrective contributions, the employer should be able to use forfeitures (assuming the plan document provides that they can be used to offset employer contributions) regardless of the year for which they occurred.**

- IRS's 401k fixit guide states that if the period of missed deferral is less than 3 months, no correction is required. I do not recall seeing this in EPCRS. Can you comment or clarify this?

**Under the brief exclusion rule (both the general and the safe harbor), the employer does not have to correct missed deferrals if the error is caught and corrected within three months. However, the employer still must correct for the matching contributions associated with the missed deferrals.**

- You mentioned the Missed Match to be made as a QMAC, can't it be contributed to their regular Match source (subject to vesting) and not a QMAC source?

**If the missed matching contribution is not an ADP safe harbor match, the corrective contribution can be contributed to the regular match source. If, however, the match is an ADP safe harbor match, EPCRS indicates that the corrective contribution be in the form of a QNEC. QNECs and QMACs are generally indistinguishable (100% vesting, subject to distribution restrictions).**

- Assume the participant is making the maximum deferral contribution for the year and there is a missed deferral opportunity because the participant's election did not get made for the first 3 months. The QNEC will apply to the 415 limit but not the 402g limit correct?

**Assuming the brief exclusion rule does not apply, the corrective QNEC contribution would be subject to the 415 limit. The 402(g) limit would apply indirectly because the employer should not make corrective QNECs for missed deferrals beyond the 402(g) limit.**

9. What correction method applies if the payroll company stopped deferrals for a participant for their last 2 payrolls? She terminated employment and has no more compensation coming.

**The employer must make a corrective QNEC contribution. A corrective contribution to a participant's account because of the failure in a prior limitation year is not considered an annual addition for the year in which the corrective contribution is made, but is considered an annual addition for the limitation year to which the corrective contribution relates. EPCRS §6.02(4)(b).**

10. In a Missed Deferral Opportunity where the plan uses the Basic Safe Harbor Match, What is the QNEC based on? 5% of compensation because that is the deferral rate to get the full match?

**In a safe harbor 401(k) plan, the missed deferral for an improper exclusion is the greater of 3% or the highest rate of deferrals at which the plan matches at 100%. The missed deferral opportunity is 25% of the missed deferral (50% if the plan doesn't satisfy the safe harbor correction method). The corrective contribution for the match is calculated by applying the matching formula to the missed deferral. Therefore, the matching formula would be calculated on 3% (the highest level of deferrals at which the plan matches at 100%).**

11. Can you confirm the 25% correction applies to a Safe Harbor plan? Slide 55?

**Unfortunately, my slide numbers are different from yours. However, if the plan satisfies the safe harbor correction requirements, the 25% correction applies for correcting the elective deferral failure.**

12. In a missed deferral opportunity for a plan with Basic Safe Harbor Match - do we use 4% (max contribution assuming 5% deferrals) as the match rate or is it capped at 3% like the deferral portion is?

**For purposes of correcting the match the plan applies the matching formula to the missed deferrals. In a basic safe harbor match, the missed deferral is 3% (the highest level of deferrals at which the plan matches at 100%).**

13. If bonuses were excluded for the deferral feature, wouldn't 414(s) testing be required?

**Yes. If the plan wants to use that definition for nondiscrimination testing, the plan would need to establish that the definition was nondiscriminatory under the compensation ratio test.**

14. If you exclude bonuses then you have to do the 414(s) test, which could possibly fail.

**For purposes of making deferrals, the compensation definition need only be reasonable. However, if the plan wanted to use that definition for ADP/ACP testing, the plan would need to establish that it is nondiscriminatory under the compensation ratio test. If it were nondiscriminatory, the plan would not need to modify its compensation definition for deferral purposes but it would need to use one of the safe harbor definitions for testing purposes.**

15. What if April 15th falls on a weekend? Do you have until the following business day to refund?

When the last day prescribed under authority of the internal revenue laws for performing any act falls on Saturday, Sunday, or a [legal holiday](#), the performance of such act shall be considered timely if it is performed on the next succeeding day which is not a Saturday, Sunday, or a [legal holiday](#). Code §7503.

16. In regards to failing to withhold on bonuses, what is your opinion on "surprise" bonuses? Compensation does not exclude bonuses, and the plan does allow for a separate election to be made on bonuses, but employer does not withhold 401k. How would you fix?

**I think the safest course of action is to make a corrective QNEC contribution (25% if the employer meets the safe harbor). If you have sufficient time left in the plan year for the employee to increase deferrals to make up for the error, you could take the more aggressive approach and apply the safe harbor brief exclusion rule.**

17. I have plan that allowed early entry on 1/1/2017 to one employee who was not an HCE for 2017, but will be an HCE in 2018. May we use the retroactive amendment?

**Yes.**

18. If a plan matches on a pay period basis and bonuses are excluded for deferral purposes, wouldn't compensation for the match actually be excluding the bonus, subjecting the plan to 414(s) testing?

**A plan matches on deferrals and not compensation. The definition of compensation affects the matching formula indirectly. A plan doesn't have to use a nondiscriminatory definition of compensation for allocation purposes; only for nondiscrimination testing. Therefore, if the plan definition does not pass the compensation ratio, the testing definition must change to one of the safe harbor definitions but not the plan definition for allocation purposes.**

19. If in 2017, the employer let in early 9 out of 20 employees and the 9 employees were all NHCEs in 2017 but 4 out of the 9 will be HCEs in 2018, can they still retroactively correct by amending the plan to allow all 9 in early?

**Yes. However, that is a fairly significant error. I would make certain the employer doesn't repeat the error.**

20. If the employer misses the Employee election and several months pass, does the employee have some sort of responsibility - as opposed to waiting several months before bringing it to the employer's attention?

**The employee's responsibility for the error is not discussed in EPCRS. In effect, the IRS lays all the responsibility on the employer. The employer is not forced to follow EPCRS. However, where the IRS has provided a specific correction method, the employer is well advised to follow it.**

21. Is the safe harbor correction method which requires a notice available if an employee has terminated in the meantime?

**Yes.**

22. If a participant is let in early due to retroactive amendment, do they need to be includible in the Code section 401(a)(4) testing?

**Yes.**

23. I'm sorry I did not catch the difference between the otherwise excludible employee rule and the early participation rule. Can you please clarify? Slide 10-12

**The otherwise excludible employee rule effective divides the employees into two groups for testing: (1) employees who would have met a one year of service/age 21 requirement, and (2) those who would not have met the requirements. The plan then tests the groups separately. Under the early participation rule, the plan applies a single test but is allowed to exclude the NHCEs who would not have satisfied the one year of service/age 21 requirement if it had been in effect.**

24. For the match associated with the missed deferral, is that match subject to the regular match vesting or should it be 100% vested – Slide 33

**The corrective contribution for the match would be subject to the plan's vesting schedule.**

25. So the match is calculated on the missed deferral based on the employer matching formula in the plan. If the plan is not a safe harbor plan, the corrective match is subject to the plan's vesting schedule? So is it not deposited as a QNEC then?

**A corrective contribution for a match subject to a vesting schedule could be contributed to the regular match source. However, if the match is an ADP test safe harbor match, the corrective contribution must be a QNEC.**

26. If they were excluded only for part of the year, you would include them, correct?

**If an employee was improperly excluded for a portion of the year, you apply the EPCRS corrections to the portion of the year the employee was improperly excluded.**

**The next questions are around slide 74 - 75....**

27. On the topic that a decrease in a participants 401(k) deferral did not occur. IF the participant is ok with the decrease not occurring do we still need to process a distribution of the excess

**Close question. The IRS does not permit retroactive deferral elections. However, I think if the employee provided a written instruction that they were fine with the failure to decrease, the IRS probably would not challenge the failure.**

28. How could you correct for using the wrong definition of compensation for deferrals - in other words there was no deferrals withheld on bonuses and bonuses are not excluded from compensation

**I think the safest course of action is to treat the failure as a failure to implement an election and correct accordingly.**

29. Is improper inclusion (deferral by ineligible) considered a top 10? Any comment for proper correct?

**The IRS doesn't address this failure in EPCRS but I would recommend correcting by returning the improper deferrals plus earnings to the employee. If the employee was an NHCE, the plan could use the retroactive conforming amendment to correct the failure.**

30. What about using the DOL calculator for lost earnings?

**EPCRS 6.02(5)(a) provides that in calculating earnings for a corrective contribution: "if in is not feasible to make a reasonable estimate of what the actual investment results would have been, a reasonable interest may be used. For this purpose, the interest rate used the Department of Labor's Voluntary Fiduciary Correction Program Online Calculator is deemed to be a reasonable interest rate."**

31. Although the 25% option for the missed deferral is available for a case, can the employer choose to utilize the general rule and fix it by doing the 50% missed deferral?

**Yes, as long as it used it consistently for both the HCEs and NHCEs.**

32. Participant eligible 5/1/17 but client miscalculated it to be 9/1/17. Client discovers this 1/1/18; is the safe harbor not possible since the 45 day notice cannot be distributed on time?

**Although this seems inconsistent with the intent of the safe harbor correction methods, your analysis seems to be correct. The 45 notice period commences on the date correct elective deferrals begin (i.e., 9/1/17).**

33. I have a Fiscal year plan and compensation is based on that fiscal year. Can we choose to use calendar year compensation for testing?

**An employer generally will measure 414(s) compensation on the basis of the plan year because nondiscrimination testing is a plan year determination. However, the employer may measure compensation for nondiscrimination testing purposes on the basis of any 12-month period, including the calendar year ending in the plan year. Treas. Reg. 1.401(a)(4)-12, *Plan year compensation*.**

34. If the definition of plan compensation is total W2 compensation including bonuses, does a participant have the right to elect not to have deferrals apply to bonuses?

**Yes. Of course, the employee would have to comply with the employer's requirements regarding changing his/her election.**

35. When is acceptable to use the DOL earnings calculator?

**See the response to question 30.**

36. If a 401(k) plan subject to ADP test and missed deferrals, corrected mid-year and so employee had correct deferrals part year, is this employee left off the ADP Test?

**Yes.**

37. So if the client is now 2 years past the 12 month (3 years late) and they do not correct should a qualified opinion be considered?

**I am assuming you are referring to the opinion associated with the plan audit. I believe you should refer that question to the AICPA or the DOL. It is important to note that a qualified opinion may cause a DOL investigation. My recommendation is to quickly correct the error under the general correction method (50%).**

38. How would you know that there were any HCEs if it's their first year of employment? Except ownership.

**As a general rule, an employee can only be an HCE during his/her first year if the employee is an owner. In general, an employer corrects according to the employee's status in the year of the failure.**