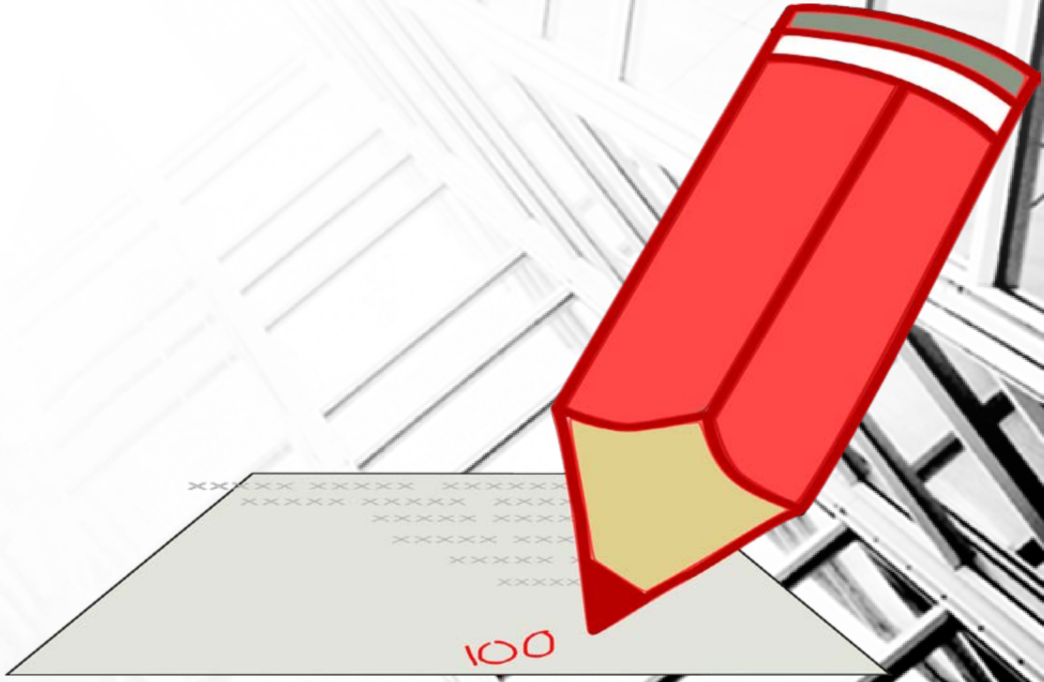
Self-correcting 401(k), Safe Harbor 401(k) and Profit Sharing Plan Failures



Presenter Information

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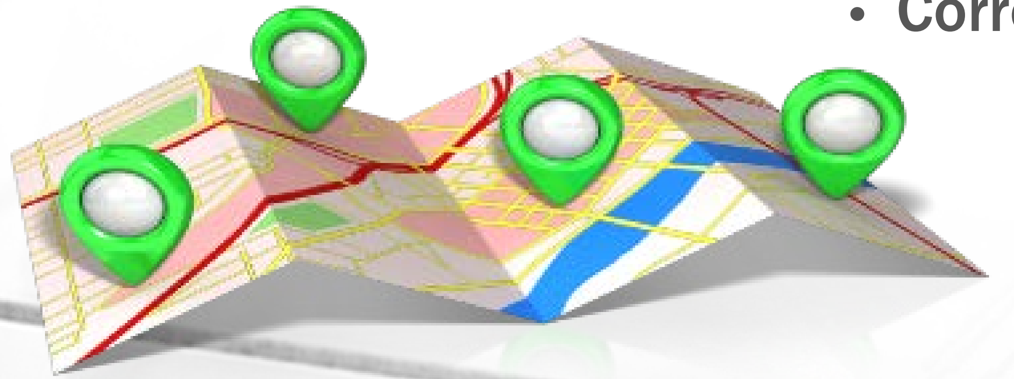
Agenda

- Notice 2023-43
- Participant loan failure
- RMD Failures
- Overpayments
- Compensation Failures/ Scrivener's Errors
- Elective Deferral Failures
- Ineligible Employees
- Failure to correct ADP/ ACP tests timely
- Self-correction by amendment – 11(g) retroactive amendment
- 415, 402(g), ADP and ACP failures
- Correction Methods



Notice 2023-43

Good News from the IRS!

Section 305 (and Sections 301 and 350)

- Previous to SECURE 2.0, the IRS generally only permitted self-correction of operational failures and normally those failures had to be corrected within three years
- Under Section 305, most failures (i.e., operational, demographic and plan document) may now be self-corrected
  - Section 301. Overpayments correction
  - Section 350. Automatic enrollment correction

What plan failures may be self-corrected?

- **Eligible Inadvertent Failure (EIF)**
  - Section 305 provides that any EIF that fails to comply with the qualified plan, 403(b), SEP or SIMPLE IRA rules may be self-corrected, except to the extent the failure was identified by the IRS prior to any actions that demonstrate a specific commitment to implement a self-correction with respect to such failure, or the self-correction is not completed within a reasonable period after identification of the failure
- **Indefinite.** Section 305 also provides that, for purposes of self-correction of an EIF, the correction period is indefinite, other than with respect to failures identified by the IRS prior to any actions that demonstrate a specific commitment to implement a self-correction
- **All plan failures.** In other words, effectively all plan failures may now be self-corrected unless the IRS identifies the failure before you have started the correction, or, the IRS has identified the failure as not eligible for self-correction

What plan failures may not be self-corrected?

- The list of failures that, until EPCRS is updated, may not be self-corrected:

1. the failure to initially adopt a written plan document;
2. failures in orphan plans;
3. a significant failure in a terminated plan;
4. a demographic failure that is corrected not using a method set forth in Treas. Reg. §1.401(a)(4)-11(g);
5. an operational failure that is corrected by a plan amendment that conforms the terms of the plan to the plan's prior operations in a manner that is less favorable for a participant than the original terms of the plan (scrivener's error);
6. excess contributions to a SEP or SIMPLE IRA that remain in the participant's IRA;
7. failures in SEPs or SIMPLE IRAs that do not use model or prototype forms; and
8. a failure in an ESOP involving Code §409.

Eligible Inadvertent Failure (EIF)

- Section 305 defines an EIF as a failure that occurs despite the existence of practices and procedures (EPCRS §4.04), or, similar standards in the case of an IRA
- Under Section 305, an EIF does not include any failure that is egregious, relates to the diversion or misuse of plan assets, or is directly or indirectly related to an abusive tax avoidance transaction

What self-correction rules are no longer applicable?

The Notice provides a list of provisions in the current version of EPCRS relating to self-correction that no longer apply:

1. the requirement that a qualified plan or 403(b) plan have a favorable determination letter;
2. the prohibition of self-correction of demographic failures and employer eligibility failures;
3. the prohibition of self-correction for significant failures of SEPs or SIMPLE IRAs;
4. the prohibition of self-correction of certain loan failures; and
5. the requirement that a significant failure must be completed or substantially completed by the end of the third plan year following the year in which it occurred.

Insignificant Failures

- If the IRS identifies a plan failure in IRS examination and the failure is “insignificant,” may the plan still self-correct the failure?
  - Yes. Under EPCRS, if a failure is insignificant, there is no time limit on correcting the failure and the employer may correct the failure even if it is identified in an IRS examination
  - The Notice makes it clear that this position continues under the expanded self-correction

Effective Date

- The Notice confirms that a practitioner may use Section 305 immediately and provides interim guidance, which is in effect until EPCRS is updated
- Section 305 applies to failures that occurred prior to its enactment

VCP

- A plan that wishes an IRS compliance letter may still file under VCP
- A practitioner may correct failures under VCP:
  - that are not eligible for self-correction, or
  - for which the plan wants to obtain a waiver of excise taxes associated with failures

Correction Documentation

- If requested upon an IRS examination, an employer must be able to provide documentation substantiating the self-correction, such as:

1. **identifies the failure**, including the years of occurrence, the number of employees affected, and the date the failure was identified;
2. explains **how the failure occurred** and demonstrates there were established practices and procedures (formal or informal) reasonably designed to promote and facilitate overall compliance that were in effect when the failure occurred;
3. identifies and substantiates the **correction method** and the date of the completion of the correction; and
4. **identifies any changes** made to those established practices and procedures to ensure that the same failure would not recur.

Participant Loan Failures

Typical IRS Loan Failures

- Plan sponsor fails to withhold loan repayments
- Loan in excess of limits (50%/$50,000)
- Loan exceeds duration requirements (5 years)
- Plan document doesn't provide for participant loans
    - Exceeds number of loans permitted
- Plan fails to obtain spousal consent

Self-Correction for Defaulted Loan

- Fact Pattern
  - Loan complies with Code §72(p)
  - Loan defaulted because of failure to timely pay (withhold)
  - Corrected within maximum repayment period (normally five years)
- Correction
  1. Employee must make lump sum payment for missed payments,
  2. The plan reamortizes loan and accrued interest over remaining loan term (or five-year limit), or
  3. Combination of 1 & 2
- *The employer pays the the interest that accumulates as a result of such failure (generally determined at a rate equal to the greater of the plan loan interest rate or the rate of return under the plan)*

Example

- Ed obtains a 5-year loan for $15,000 from the plan on January 15, 2022
  - Monthly payments of $280 withheld from wages
- Employer failed to implement payroll withholding
  - Administrator discovered after 8 missed payments
- Plan can correct the failure under SCP by:
  - Reamortizing the loan must interest accrued over remaining 4 years and 4 months, or
  - Ed can make a lump sum payment of $2,240 and the plan continues the loan
  - Combination of 1 and 2
- Employer would need to make a payment to plan of interest that accumulated on the late payments

Alternative Self-Correction

- Plan can issue a Form 1099-R in the year of correction (as opposed to the year of failure)
  - Interest continues to accrue until plan treats the loan as a deemed distribution
  - “Any applicable income tax withholding amount that was required to be paid in connection with the failure must be paid by the employer”

– *Note: If the participant is not cooperative, the plan would use this option.*

Voluntary Fiduciary Correction Procedure (VFCP)

- The DOL will now treat any loan failure which is self-corrected as meeting the requirements of the VFCP if the failure is corrected under EPCRS
- The DOL may impose reporting or other procedural requirements

Loan Correction Chart (72(p) failures)

Failure	Correction that avoids 1099-R (SCP vs. VCP)	Correction Method	Alternative SCP Correction (1099-R in the year of correction)
Loan default (failure to withhold)	SCP	(1) Reamortization, (2) Lump sum payment of missed payments, or (3) Combination of (1) and (2)	Yes
Loan in excess of limits (50%/$50,000)	SCP	Corrective payment of the excess loan amount	Yes
Loan payment term in excess of maximum repayment period (5 years)	SCP	Reamortization	Yes
Level amortization failure	SCP	Reamortization	Yes

RMD Failures

Failure to make an RMD

- Making RMDs is a qualification requirement
  - Failure to make an RMD is a disqualifying defect
- Participant (or beneficiary) also is subject to a 25% (reduced from 50%) excise tax on the shortfall
  - Code 4974
  - Form 5329
- If the RMD is corrected (make-up missed RMD) by the end of the second year after the year it was due, the penalty is further reduced to 10%
- Not so good news: Previously, the penalty was so draconian that IRS frequently waived it. Under the new reduced penalty provision, the IRS may be less likely to waive.
- <u>4 Correction Options</u>

RMD Correction

- In a **defined contribution plan**, the correction is simply to distribute a make-up distribution of the RMD (with earnings from the date of the failure)
  - The make-up distribution is calculated by dividing the adjusted account balance on the applicable valuation date by the applicable distribution period
  - For this purpose, the adjusted account balance means the actual account balance reduced by the amount of the total missed RMDs for prior years
- In a **defined benefit plan**, the permitted correction method is to distribute the RMD plus interest based on the plan's actuarial equivalence factors

Example

- Dan attained age 72 in 2023 and did not begin receiving his RMDs on his RBD (April 1, 2024)
- Company X did not discover and correct the RMD failures until 2026
- Dan's account balances reduced by the prior year corrective distributions (plus earnings calculated to the date of the correction) for the relevant years and the applicable ULT factor are as follows:

DCY	RMD due date	Adjusted account balance	Earnings	ULT Factor	Corrective distribution
2022	04/01/24	500,000	$3800	27.4	$22,048 (18248 + 3800)
2023	12/31/24	527,952 (550,000 – 22,048)	$2400	26.5	$22,323 (19923 + 2400)
2024	12/31/25	555,629 (600,000 – [22,048 + 22,323])	$1900	25.5	$23,689 (21789 + 1900)

- Dan is subject to an excise tax of $29,980 ($59,960 [18,248 + 19,923 + 21,789] x 50%) payable on three separate Forms 5329
- The earnings are not subject to the excise tax

Correction option #1: Correct by second tax year

- Make-up missed RMDs (plus earnings) by the end of the second tax year after the year it was due
- Pay the 10% excise tax

Correction Option #2: Form 5329 Waiver

- Self-correct the qualification failure by making-up missed RMDs
- Request waiver of excise tax on Form 5329
- The instructions to the form permit the participant to calculate the penalty and enter “RC” and the amount you want waived in parentheses on the dotted line of line 54
- The participant also would attach a statement to the form requesting the waiver and explaining the reasonable error
- *Note: Although the Form 5329 provides a reasonable method for requesting a waiver of the excise tax, many participants are reticent to report their error to the Revenue Service.*

Correction Option #3: VCP

- Make-up the missed RMDs
- File under VCP
- If the plan sponsor files under VCP, the plan sponsor may request a waiver of the excise taxes for all of the affected participants
  - Previously, the IRS has been generous in granting waivers

Correction option #4: Self-Correction

- Make-up missed RMDs (plus earnings)
  - The failure is operational so SCP should be available
- Rely on regulatory waiver of excise tax for “reasonable cause”
  - Recommendation: write-up reasonable cause statement and place in the file
- If the IRS doesn’t audit the plan, then no disqualification or excise tax issues
- If the IRS audits the plan, inform them that failure was self-corrected and that excise tax should be waived because of reasonable cause (document it)

Correcting Overpayments

Correcting Overpayments

If a plan overpays a participant or beneficiary, the overpayment is a qualification failure because it exceeded what was payable under the terms of the plan, or the Code or regulations. For example, in a defined contribution plan, an overpayment can be caused by:

1. misapplying the vesting rules under the plan;
2. allocating amounts to a participant to which he or she is not entitled. and then paying the excess allocation to the participant; or
3. not properly limiting the annual additions to the 415 limits.

- Defined benefit plan examples of overpayments:

1. overstating the participant's benefit by not limiting it to the 415 limits, or
2. misapplying vesting schedule, and thus overstating the participant's benefit.

Correction of Inadvertent Benefit Overpayments

- Gives plan fiduciary the option of not trying to recoup prior overpayments
  - Not ERISA fiduciary breach
- Plan sponsor can amend plan to increase past or decrease future payments to adjust for prior overpayments
- Doesn’t relieve employer of funding obligations
- Plan must comply with §415 and compensation limits

Act Section
301
Code Section
414(a)(aa)
Qualified
Yes
403(b)
Yes
457(b)
No
Eff. Date
Enactment

Inadvertent Overpayments

- If overpayment has been rolled over:
  - The rollover is ok if plan does not seek to recoup
  - If plan does seek to recoup, can roll the money back without tax
- Can continue prior installment payments or benefit reduction
- Many details in new ERISA §206(h) to protect innocent recipient
  - If fiduciary decides to recoup, no interest or collection fees
  - Can't recoup overpayments to participant from spouse or beneficiaries
  - 3-year statute of limitations on recoupment

Safe Harbor Methods (cont.)

- *Reduction of future benefits.* If the participant is entitled to future payments from the plan, the plan may recoup the overpayment by reducing future payments
  - If the participant is receiving periodic distributions, such as an annuity or an installment payment, the employer may reduce the amount of the periodic payments to the correct payment amount as soon as possible
  - The plan may then further reduce the payment in a permitted fashion to effect repayment of the excess
- *Installment agreement.* The participant may enter into an installment agreement with the plan to repay the overpayment over time

Example

- Example: Plan misallocated matching contributions
  - Peter got too much
  - Penny got too little
  - They both terminated employment and were paid out

General Rule: Excess Allocations

- Normal correction:
  - Reduce the account for the excess amount, plus earnings.
  - If the excess amount should have been allocated to others, reallocate. If not, hold in separate account and reduce contribution in following year
  - If excess was deferral or voluntary contribution, distribute to the participant (with earnings)
    - If Code §415 excess, do unmatched after-tax EE contribution first, then deferral and associated match (forfeit match)

Fixing the Underpayment

What to do?

- Pay the participant the remaining amount due, plus earnings
- Do not need to worry about underpayment if:
  - Corrective distribution is $75 or less; and
  - Reasonable direct costs of processing and delivering the distribution exceeds the amount to be distributed
  - Note: *this does not apply if the participant still has an account in the plan*

Compensation Errors
Scrivener's Error

Compensation errors: Correction

- Correction differs depending on whether it is a **fixed** or **discretionary** contribution formula
- **Fixed contribution** formula (match or nonelective)
  - If participant receives less than what he/she is entitled, ER makes make-up contribution
  - If ER contributes more than what participant is entitled
    - Treat as excess amount: Reallocate to suspense account and use to reduce future contributions
    - If contributed after the close of the plan year, plan could treat as next year's contribution
      - No need for reallocation
      - But if to an HCE, watch for discrimination

Compensation errors: Correction

- **Discretionary contribution** formula – <u>two</u> methods of correction
  - **Make-up contribution.** ER determines contribution % based on correct definition of compensation and makes make-up contribution (plus earnings)
  - **Reallocation.** Reallocates contribution based on correct definition of compensation
    - That will mean reducing allocations to some EEs and increasing allocations to other EEs
      - Adjust for earnings (EPCRS has detailed rules here)
    - If EEs who were going to be reduced have received distribution, the plan won't be able to retrieve distributions
      - ER must contribute the difference
- ***Note: you also may use these correction methods for a participant who was improperly excluded from PS portion of the plan***

Example – make-up contribution

- Plan has a nonintegrated profit sharing formula based on definition of compensation which excludes bonuses
  - ER makes discretionary contribution of 5% of participants' W-2 compensation
  - ER determines participant w/ highest allocation percentage based on correct definition of compensation (5.4%)
  - Makes an additional contribution to bring all participants to 5.4%
- Assume the same facts except the plan document included bonuses and the plan didn't include bonuses in operation
  - Plan may follow the same method of correction (i.e., make contribution for those who had bonuses)

Example - reallocation

- Plan has a nonintegrated PS formula based on definition of compensation which includes bonuses
  - ER makes discretionary contribution of 5% of participants' compensation excluding bonuses
  - ER reallocates contribution based on correct definition of compensation (everyone receives 4.8%)
    - If someone received a distribution and that EE received more than he/she was entitled to, plan contributes difference to the plan
- Assume the same facts except the plan excluded bonuses and the plan included bonuses in its allocation
  - Plan may follow the same method of correction (i.e., reallocation)

Scrivener's Error Doctrine

- The plan may disregard benefit provisions of a plan document if:
  1. Other governing document (e.g., SPD, collective bargaining agreements) or objective evidence (e.g., participant communications) shows the provisions are ambiguous
  2. Mutual mistake
- Although in a few instances the IRS has permitted a plan sponsor to reform a document as part of a VCP correction, the IRS generally feels that they do **not** have the authority to equitably reform plan documents
  - Participants should be able to rely on the written plan document
  - Anticutback rule
- In a number of cases, the courts have recognized that application of the doctrine to an ERISA plan
- **Warning:** Notice 2023-43 doesn't allow the employer to self-correct scrivener's error

Examples of Scriveners' errors

- Contrary to the ER's intention, plan document:
  - Included bonuses for allocation purposes
  - Used full year's compensationrather than compensation while a participant
  - Reflected a higher matching contribution %
  - Made increased contribution % retroactively effective
  - Failed to exclude certain categories of EEs
  - Provided a nonintegrated rather than an integrated formula
  - Provided immediate eligibility rather than one year/age 21
  - Misidentified classifications in a cross-tested plan
  - Reflected the wrong vesting schedule
  - Included a related ER

Correction options

- **VCP.** File under VCP and ask the IRS to approve reformation of the plan document
  - To have a chance of success, will need extrinsic evidence of intention
    - SPD, correspondence, participant communications, etc.
- **Live with it.** Recognize that plan is effectively a contract and mistakes are generally construed against the drafter
  - Amend prospectively
  - To make the ER "whole," the ER can reduce future contributions until ER has recovered "overcontribution"

    Ex: Company X intended to exclude bonuses in making fixed matching contributions

    - Plan document provided for W-2 compensation
    - Discovered error after three years
    - X corrects by making corrective contribution
    - X corrects plan document and lowers future match % until it "recovers" unintended contribution

401(k) Plan Elective Deferral Failures

Two Common Elective Deferral Failures

- Although the failures are similar, it is important to identify the type of failure because the corrections differ

1. *Failure to implement deferral election*. The employee makes a deferral election but the employer fails to implement the participant's deferral election. and
2. *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

- 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
  - a corrective contribution for the matching contributions (if any)

Two Methods of Correction

- The new safe harbor correction methods for elective deferrals did not replace the existing EPCRS correction methods. Therefore, EPCRS provides two correction methods for elective deferrals failures
  1. General method
  2. Safe harbor method
- Which rule an employer applies largely depends on the *notice and timing of correction*

Correction for Improper Exclusion (General Rule)

- The deferral election is unknown because employee was not provided an opportunity to defer
- **Correction**: 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 401(k) plan match, the employer makes the contribution in the form of a QNEC
  - For a regular match, the corrective contribution may be subject to the plan's vesting schedule
- The QNEC will need to be adjusted for earnings
  - Calculate earnings from the date the employer made the matching contribution

Additional Rules for Elective Deferral Corrections (cont.)

- In calculating the missed deferral, plan may not use the OEE rule
- Correction methods do not apply until <u>after</u> 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*

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, 2022
  - Dan should have entered the plan on January 1, 2022
  - 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% (calculated on a payroll basis)
  - 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

Example (cont.)

- The employer also would provide a corrective contribution equal to $750 for the matching contribution on the missed deferral
- The plan calculates the matching correction by making a contribution to Dan's account of $750 plus earnings. The calculation is as follows:

$ 750 (3% x $25,000) = missed deferrals eligible for match
x 100%
$750.00 = match correction

- The corrective contribution is subject to plan's vesting schedule

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, 2022
  - Ann should have entered the plan on January 1, 2022
  - 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

<u> X 50%</u>

$500 = missed deferral opportunity

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

Example (cont.)

- The plan corrects the match failure by making a QNEC to Ann's account of $1,000 plus earnings. The calculation is as follows:

$1,000 (4% x $25,000) = missed deferral eligible for match
<u> x 100%</u>
$1,000 = match correction

Failure to Implement Deferral Election (General Rule)

- 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

Example

- Company X maintains a calendar year 401(k) plan
- Ben made a 5% deferral election, effective January 1, 2022
  - Dan's monthly compensation for 2022 was $5,000
- The plan administrator failed to implement the election and the error was not caught until May 1, 2022
- 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

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 per pay period
- To correct, the plan applies the matching formula to the missed deferrals (100% of $800), but subject to the matching limits
  - The contribution will need to be adjusted for earnings
- The plan would correct the failure by making a corrective contribution to Ben's account in the amount of $800 plus earnings. The calculation is as follows:

  $ 800 (4% x $20,000) – missed deferral eligible for match
  x 100%
  $800 – match corrective contribution

- Same result if it were a safe harbor 401(k) plan
- *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 QNEC*

ADP and ACP Tests

- **Will the employer need to re-run the ADP test for the plan year of corrections?**
- No. The plan disregards the employees subject to the correction in applying the ADP test.
- **Will the employer need to re-run the ACP test for the plan year?**
- No. The plan disregards the employees subject to the correction in applying the ACP test.

Correction Questions

- **How does the plan determine the ADP percentage for an improper exclusion?**
- The ADP percentage is determined for the year of the exclusion (irrespective of whether the plan uses current or prior year testing). In applying the elective deferral correction, the employer first completes the ADP and ACP tests. In applying the tests, the employer excludes the employees who were improperly excluded.
- **If an employer permits an employee who was improperly excluded to make a deferral election but the employee intended not to make deferrals (in fact, deferred 0% when permitted to make deferrals), may the employer avoid making a corrective QNEC contribution?**
- No. The IRS requires the employer to correct by making a corrective QNEC contribution irrespective of the employees intention.

Partial Year

- **What compensation does the employer using in calculating the corrective contribution for a partial year failure?**
- In making a corrective contribution, the employer may use actual compensation for the portion of the year during which the failure occurred. Alternatively, the employer may use a pro-rata portion of the compensation.

Qualification Failures

- **With respect to which correction methods must an employer wait until it has corrected other qualification failures, before it may implement the EPCRS correction methods?**

- The requirement to resolve other qualification failures before implementing the EPCRS correction method applies to: improperly excluding an employee from making elective deferrals or after-tax contributions; failure to implement a deferral or after-tax contribution election; failure to receive a match because of an improper exclusion or failure to implement an election; and failing to permit an employee to make an affirmative election under an automatic contribution arrangement.

- **If an employer has improperly excluded an employee or failed to implement an election for a portion of the plan year, must it resolve other qualification failures before it applies the EPCRS correction methods?**

- As with a full plan year error, if an employer improperly excludes an employee or fails to implement an employee's election for a portion of the plan year, the plan does not apply the correction until after it corrects the other qualification failures (e.g., ADP or ACP test). Furthermore, in applying the ADP or ACP test, the plan does not include the improperly excluded employee or the employee for whom the plan failed to implement an election in the ADP or ACP test.

Correction Questions

- **Must an employer wait until it corrects the ADP or ACP test before it allows the improperly excluded employee to commence making elective deferrals or implements an election under the plan?**
- No. 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.
- **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 (General Method)

- Under the general rule, an employer may correct an 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.

Example

- Company X maintains a 401(k) plan
  - Don is eligible on January 1, 2022 but he is informed he is not eligible
  - X catches the error on March 1, 2022 and allows Don to commence making elective deferrals
- The brief exclusion 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

Safe Harbor Brief Exclusion Rule

- Under this safe harbor correction method, an employer may correct an elective deferral failure 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.*

Safe Harbor Brief Exclusion Rule (cont.)

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 advantage of the safe harbor brief exclusion rule is that it is not limited to failure occurring during the first three months of the plan year. The advantage of the general brief exclusion 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, 2022 but X failed to implement the election until September 1, 2022
  - X need not make a corrective QNEC contribution for the missed deferrals because of the brief exclusion safe harbor rule
    - X must provide a notice to Emma within 45 days of September 1, 2022
  - 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 QNEC*

45 Day Notice

- **Does the employer need to provide the notice to the IRS? Retain a copy of the notice?**
- *No. Although there is no specific requirement to retain the notice, the employer is well advised to retain a copy for its records. The employer may need to prove to the IRS that it complied with the requirements.*
- **What if the employer fails to provide the notice within the 45 days?**
- *The safe harbor brief exclusion rule is not available. Furthermore, the other safe harbor correction methods are not available. The employer would need to utilize the general correction methods.*

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.

Safe Harbor Correction Method

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, 2022 but X failed to implement the election until January 1, 2023
  - 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 QNEC 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 (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, 2021 rather than his correct eligibility date of July 1, 2022
  - 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

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.

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

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, 2022
  - 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, 2023
  - X will not need to make a corrective contribution for the 2020 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

Comparison: Elective Deferral Failure Corrections

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

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

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 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

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

Inclusion of an ineligible employee

ABC Let a Stranger In

- Jordan wasn't eligible to participate in the 401(k) plan, but we let him in anyway!

ABC Put Someone In By Accident Before He Was Eligible

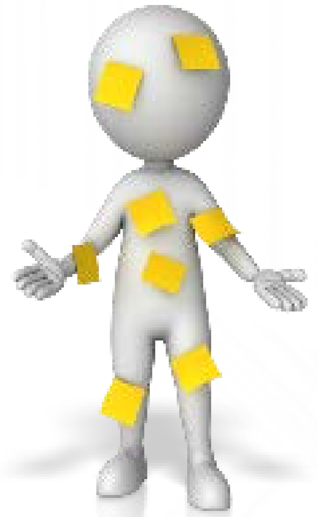
What to do?

- Two Choices:
  1. Kick him out:
     - Return deferrals (and earnings)
     - Forfeit employer contributions
  2. Retroactively amend plan eligibility to let him in
     - Permitted to self-correct this way
     - Can do for all or only accidental early entrants
     - Cannot do if affected employees are predominantly HCEs

Uncorrected failed ADP/ACP testing

Uncorrected Failed ADP/ACP Tests

- Example: ABC's TPA ran the tests and told them to authorize the corrections. They just forgot ….



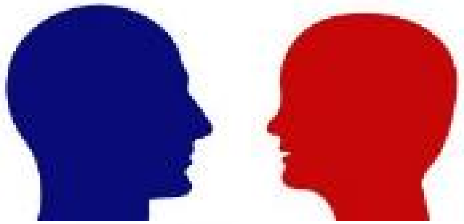
Uncorrected Failed ADP/ACP Tests

- If error is found within 12 months following plan year to which the test applies, ABC still has time to correct
  - Corrections must be completed within 12 months of the end of the plan year being tested
  - If correction is after 2½ months (6 months for EACA) and ABC corrects through refunds/distributions, 10% excise tax applies

Uncorrected Failed ADP/ACP Tests

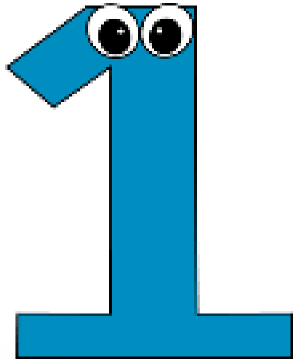
- ABC can self-correct
  - Option #1: make QNEC or QMAC
  - Option #2: "one-to-one correction"
  - *Note: Cannot use permissive disaggregation of excludable employees*

Uncorrected Failed ADP/ACP Tests



- One-to-One:
  - Determine excess contributions (i.e., deferrals in excess of ADP) to be refunded to HCEs
  - Determine excess aggregate contributions (i.e., matches in excess of ACP) to be distributed to HCEs or forfeited
  - Adjust for earnings
  - Do refund/distribution/forfeiture …

Uncorrected Failed ADP/ACP Tests



- One-to-One (cont'd):
  - Make a QNEC on behalf of participants equal to amount being refunded/distributed/forfeited plus earnings and allocate proportionate to compensation to:
    - Eligible NHCEs in year of failure; or
    - Eligible NHCEs in year of failure who are NHCEs in current year; or
    - Eligible NHCEs in year of failure (and, if desired, current year) only if employed on date in current year that is not later than date of correction

Self-correction by amendment
11(g) retroactive amendment

Self-Correction Program Retroactive Corrective Amendments

- The most frequent qualification error: failure to comply with the terms of the plan
- Fortunately, practitioners can self-correct most operational errors without the need to involve the IRS or pay a sanction to the IRS
- Correction of an operational error: ER puts the plan and the participants in the position they would have been if the error had not occurred
- What if the correction requires the ER to amend the plan (e.g., coverage or demographic failure):
  - Previously, EPCRS generally required the plan to file under VCP
  - Under Section 305, we can now self-correct

11(g) Amendment to Correct Demographic Failures

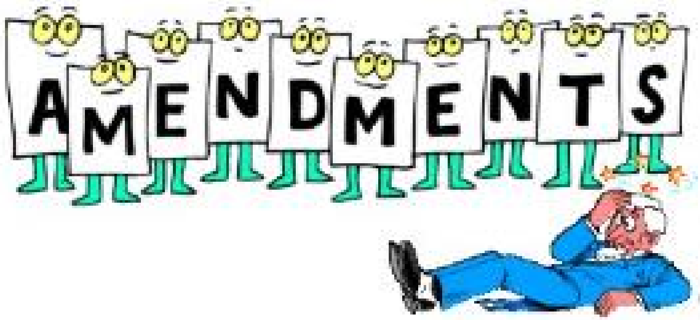
- An employer may now self-correct
  - Coverage failures
  - Nondiscrimination failures
  - Plan document failures
- What if the coverage or nondiscrimination failure (demographic failure) requires a plan amendment to correct the failure
  - The plan amendment must use a method set forth in Treas. Reg. §1.401(a)(4)-11(g) (11(g) amendment)

The More Serious Disqualification

- In *Yarish v. Commissioner*, 139 T.C. 11 (2012), Dr. Yarish (plastic surgeon) owned five separate medical practices. He formed a management company and received consulting fees from each of the medical practices
  - The management company established an ESOP that owned 90% of the stock of the management company. The only participant in the ESOP was Dr. Yarish.
- The IRS determined that the consulting practice was related to the medical practices. Consequently, the plan failed coverage and the IRS included in gross income his entire $2,439,503 account balance.
  - The IRS also assessed $619,540 of other taxes and accuracy-related penalties
- The case illustrates the dangers of failing to comply with the coverage requirements and the importance of properly applying the controlled group and ASG rules
- A failure to comply with the coverage requirements results in far more serious tax consequences that a typical plan disqualification – entire account balance includible in gross income

11(g) Amendment

- Through the 11(g) amendment, the ER
  - may add participants, or
  - increase allocations sufficient to pass the failed test
- In addition, a plan sponsor may use the 11(g) amendment to correct a failure regarding the current availability of a benefit, right or feature



11(g) Amendment Conditions

- In order for regulations to recognize an 11(g) amendment, the amendment must satisfy the following conditions:

1. The amendment cannot reduce a participant's benefit
2. The amendment must be generally effective as if the amendment were in effect on the first day of the plan year being corrected
3. The ER must adopt the amendment within 9½ months after the close of the plan year
4. The additional allocations must satisfy the coverage and nondiscrimination requirements on their own
5. If the amendment corrects the current availability of a benefit, right or feature, the amendment cannot be part of a pattern of amendments to correct repeated failures and the amendment must remain in effect through the end of the first plan year beginning after the date of the amendment
6. 401(k) plan: amendment may be considered for coverage purposes only if it provides a QNEC to NHCEs who were not eligible to defer. The QNEC must equal the average ADP of the group of NHCEs who were eligible to defer. 401(m) plan: amendment may be considered only if it provides a QNEC to NHCEs who were not eligible for the match. The QNEC must equal the average ACP of the group of NHCEs who were eligible for the match.

Example

- Corporation X maintains a profit sharing plan for the 2 HCEs and 10 NHCEs who satisfy the plan's eligibility requirements
  - 1,000 hours of service/last day of employment condition to receive an allocation
  - For the 2021, 4 of the NHCEs terminated before the end of the plan year and did not receive allocations
  - X will fail the ratio% test (60% coverage ratio) and, assuming it also will not satisfy the average benefit test, the plan will fail coverage for the 2021 plan year
  - X doesn't correct the coverage failure by October 15, 2022
  - Even if the ER doesn't correct by 10/15/22, the ER may <u>self-correct</u> the failure by amending the plan to cover one of the terminated NHCEs, it would be able to pass the ratio percentage test
- *Note: Alternatively, the ER could amend the plan to improve benefits for some or all of the NHCEs and pass the average benefit test*

Amendment Must Have Substance

- A corrective amendment may not be taken into account in determining whether a plan satisfies coverage or nondiscrimination if the amendment does not have substance
  - If the ER adopts a retroactive amendment to add a nonvested NHCE who has terminated employment, and therefore will not receive any economic benefit from the amendment, will not receive any economic benefit from the amendment
- *Example.* ER maintains a PS plan that fails coverage for 2017. Prior to the retroactive amendment deadline, ER amends the plan to add retroactively Joe (NHCE). Joe terminated employment on 11/15/17 and was 0% vested. The amendment will not resolve the coverage violation because it does not have any substance since Joe will not receive any economic benefit.

415, 402(g), ADP and ACP Failures

Order of Testing

- Plan may have to satisfy 4 sets of rules
  - 402(g) limit
  - ADP/ACP tests
  - 415 (annual additions) limit
  - 401(a)(4) discriminatory match rate rules (associated match rule)
- Tests are interactive
  - Order of testing may affect other tests and tax consequences

Ordering Rule for Testing

1. Fix 415 failures first
   - Because that pulls them out of 402(g) and ADP
2. Correct ADP test before 402(g) failure
   - Assuming HCE exceeded 402(g) limit (included in ADP test)
   - If NHCE exceeded 402(g) limit, fix 402(g) failure for NHCE first (not included in ADP test)
   - Match associated with excess deferrals forfeited
3. Correct ACP before fixing associated match
   - Because HCEs get vested portion of ACP failure
4. Fix the associated issue (if necessary)

Example: Multiple failures

EE	Comp	Defer	Match	PS	Total	ADR
Ed	150,000	10,500	10,500	11,145	31,500	7%
Fay	262,500	21,000	21,000	19,500	61,500	8%

- Calendar plan year 2022; testing in 2023
- Assume 401(k) plan's NHCE ADP = 4.5%
- Match = 100% of deferrals
- HCEs receive 7.43% PS allocation
- Ed and Fay are HCEs, 100% vested
    - Aren't catch-up eligible
- Fay has excess deferrals, annual additions; plan fails ADP

First: Correct 415 failures

EE	Comp	Defer	Match	PS	Total	ADR
Ed	150,000	10,500	10,500	10,500	31,500	7%
Fay	262,500	21,000	21,000	19,500	61,500	8%

- Correct excess annual additions (415) first
  - Distributed excess annual additions are NOT in ADP test and don't count against 402(g)
  - To correct 415 failure (if already allocated per plan):
    - Distribute $250 as excess AAs: partially corrects excess deferrals
    - Ed's deferrals reduced to $20,750
    - Forfeit $250 of matching contributions
  - Taxation of distributed amounts: taxable in 2023 – year of distribution

Next: Correct ADP

EE	Comp	Defer	Match	PS	Total	ADR
Ed	150,000	10,500	10,500	10,500	31,500	7%
Fay	262,500	20,750	20,750	19,500	61,000	7.90%

- NHCE ADP = 4.5%
- HCE ADP now = 7.45% (down from 7.5%)
- Correction
  - Reduce Ed and Fay to 6.5% each
  - Total excess contribution = $4,250; all to Fay
    - Excess contribution ($4,250) – all taxable in 2023
  - Fixes 402(g) failure

Consider the source

EE	Comp	Defer	Match	PS	Total	ACP
Ed	150,000	10,500	10,500	10,500	31,500	7%
Fay	262,500	16,500	16,750	19,500	52,750	7.90%

- If correcting excess annual additions (415) does NOT correct excess deferrals (402(g))
  - If HCE excess deferrals, correct ADP BEFORE 402(g), since ADP includes HCE excess deferrals
  - If NHCE excess deferrals, correct 402(g) BEFORE ADP, since ADP does NOT include NHCE excess deferrals
- In this case, fixing the ADP fixed 402(g)
  - Taxable in 2023, not 2022

ACP and Match Rate

EE	Comp	Defer	Match	PS	Total	ACP
Ed	150,000	10,500	10,500	10,500	31,500	7%
Fay	262,500	16,500	19,750	19,500	52,750	7.5%

- Next, correct ACP failure, if any
  - Because it is distributed to vested HCE, not forfeited like associated match
- Finally, check for discriminatory match rate, and correct if necessary (forfeiture or QNECs to NHCEs)
- In this case, NHCE ACP=4.5%
  - Distribute $4,250 to Fay plus earnings
  - Fixes associated match problem

What if Fay were catch-up eligible

EE	Comp	Defer	Match	PS	Total	ACR
Ed	150,000	10,500	10,500	10,500	31,500	7%
Fay	262,500	21,000	21,000	19,500	61,500	8%

- $500 of deferral is 415 catch-up
  - Fixes 402(g) issue
  - $3,750 is ADP catch-up
- We have a larger ACP problem
  - $4,500 plus earnings returned to Fay as excess aggregate contributions
  - Net contribution for Fay = $57,000
    - Better than $52,750 in plan if not catch-up eligible

WHAT IF????

What If?

- We don't like this correction?
  - Note: the Rev. Proc. says that there may be different corrections for different failures
  - The Rev. Proc.'s corrections are "safe harbors"
  - Careful: talk to an expert before formulating a correction (you don't want to create a new failure!)
- Section 305. The IRS will issue guidance on correction methods that <u>will be required </u>to be used to correct eligible inadvertent failures, including general principles of correction if a specific correction method is not specified by the Secretary

Thank You